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INTERNATIONAL MONETARY REFORM

Remarks by Governor J. Dewey Daane
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It is a real pleasure and privilege for me to deliver this year the Assembly Lecture to the Stonier Graduate School of Banking.

Next week I begin my 30th year of service with the Federal Reserve System which I confess tempts me to look back a bit, although not in any formal way, as well as forward at the evolution of the international monetary system, and the Reserve System's role in that evolution.

When I first accepted a job with the Federal Reserve Bank of Richmond my father, Gilbert L. Daane, a former bank President in Grand Rapids, Michigan, and a good friend of Harold Stonier, reluctantly conceded that it might be all right for me to work "a year or two" at the Fed "for the experience." Almost 30 years later, I wonder whether a commercial banker's advice to his son would still be the same! Anyway, as an "old" central banker, I would like to reminisce with you just a bit this evening. One of the first tasks I had at the Federal Reserve Bank of Richmond, almost 30 years ago, was to draft that Bank's answer to an inquiry from a Senate Committee on a question concerned with the taxation of reserve deficiencies of Reserve Banks, at a time when gold cover requirements were 35 per cent against deposits at Reserve Banks and 40 per cent against Federal Reserve notes. The epilogue of this drama came this March when the gold cover requirement, which had already been reduced to 25 per cent of notes outstanding, was removed completely at a time when, on the day the Act repealing the 25 per cent requirement was signed into law, the gold holdings of the Reserve Banks against notes had dropped to 25.007 per cent and the amount of gold held was less than four million dollars

above the minimum required! And this removal of the cover was essential, too, in making possible and meaningful the historic mid-March Washington meeting of Central Bank Governors.

This reminiscing reminds me there are supposed to be three signs of old age. The first is loss of memory and I can't remember the other two! So as an old central banker, I will not try to remember all of the changes that have occurred over the past three decades, and are still occurring, in the international monetary system, but select only a few of the highlights that stand out in my own mind. Of necessity both because these significant events are fresh in my mind, and because they may prove to be of even greater significance over time, I will focus more on what has emerged from the turmoil of recent weeks and months. During those months, there have been at least two events of historic importance for the functioning of the international monetary system. These two events were the decisions taken by the Central Bank Governors at their meeting in Washington in mid-March, and those taken at the end of that same month in Stockholm by the Finance Ministers and Central Bank Governors of the Group of Ten (the ten leading industrial countries) with the related working out by the Executive Directors of the IMF of a Proposed Amendment to the Articles of Agreement of the International Monetary Fund. These events may--and I would underscore the "may"--represent a turning point in monetary history. I will return to this question of whether or not they "can" represent such a turning point in my concluding comments this evening.

At the outset, however, I would like to look back just a moment at the Federal Reserve's growing role and interest in all of these matters. For as one who has attended meetings of the System's policy-making Federal Open Market Committee, in one capacity or another, for almost 20 years, I well recall that international considerations and the balance of payments did not begin to play a major role in our deliberations until near the end of the 1950's. As the United States' balance of payments deficit persisted and became larger, involving undesired losses of monetary reserves for the United States, the Reserve System's policy mix increasingly had to give greater weight to the external standing and status of the dollar. I would immediately emphasize that external standing and status rests in large part on our domestic economic growth with price stability. Thus, monetary as well as fiscal responsibility are basic to the maintenance of the dollar's strength.

Of course, ever since the days of Governor Strong in the early 1920's the Federal Reserve has had close relations with other central banks. And, most importantly, the Board of Governors played an active part in the development of the Bretton Woods Agreements in 1944 and in supporting the legislation passed by the U. S. Congress implementing those agreements. The International Monetary Fund established under the Bretton Woods Agreements has proved to be a highly successful institution and has become the centerpiece of the international monetary system, a system embracing the principle of fixed exchange rates with par values to be altered only in cases of fundamental disequilibrium.

But it seems clear that the whole range and magnitude of the Fed's relations with other central banks has changed and increased substantially in the last 10 or 15 years. Most notably, the development since 1961 of the entire swap network of mutual credit lines, now totaling 9.4 billion dollars, has required a substantial proportion of the attention of the Federal Open Market Committee at its regular meetings at approximately three or four-week intervals. Reports at those meetings on the balance of payments and international monetary matters were added to regular staff presentations beginning in 1959 and have since continued regularly. The Special Manager of open market operations in foreign currencies also, since 1962, has regularly reviewed at those meetings the relevant international developments and the extent to which System swap lines have been, or may be, utilized.

And the Federal Reserve has played an active role in the most recent historic events to which I referred in the beginning of my remarks, and to which I would like to devote the rest of my time this evening--specifically, the Washington and Stockholm meetings and their implications for the present and prospective functioning of the international monetary system.

The first of these meetings, the mid-March 1968 weekend meeting of the Central Bank Governors of the seven active gold pool contributing countries--Belgium, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the United States--was initiated and presided over by Chairman Martin and held in our Federal Reserve Board Room. We met in a crisis atmosphere, aware that continuance of the policy of keeping

the price of gold in the London market at \$35 an ounce had clearly become untenable. It had become untenable despite the brave words, and intentions, of the same Central Bank Governors evinced after a secret special meeting in Frankfurt in early December, 1967, and reiterated after their regular meeting in Basle, Switzerland, just the Sunday prior to the mid-March 1968 Washington session. Despite these intentions and matching efforts it became perfectly clear in that second week in March that the market price of gold in London could no longer be maintained for all comers against such a massive wave of speculation. The policy of maintaining the market price of gold in London had been undertaken originally for the purpose of keeping commercial and private transactions in gold close to the official price, thereby averting or minimizing possible runs on the gold stock. But it had become perfectly clear that the speculators had outrun us, and that the gold pool operations, rather than reenforcing the credibility of the official price of gold, had, in fact, made that system lose credibility, and had provoked a demand for gold that was feeding upon itself.

So at this Washington meeting the Governors of the Central Banks agreed on a number of very important steps, including the suspension of the gold pool operations, and in so doing they said a number of very important things. The four or five main points in this Communique, and I will read them very briefly, are:

First, "they noted that the U. S. Government will continue to buy and sell gold at the existing price of \$35 an ounce in transactions

with monetary authorities. The Governors support this policy and believe it contributes to the maintenance of exchange stability."

Second, the Governors stated that "henceforth officially held gold should be used only to effect transfers among monetary authorities, and therefore they decided no longer to supply gold to the London gold market or any other gold market."

Third, "they agreed that henceforth they will not sell gold to monetary authorities to replace gold sold in private markets."

Fourth, and a very important affirmation, the Governors "agreed to cooperate even more closely than in the past to minimize flows of funds contributing to instability in the exchange markets, and to offset as necessary any such flows that may arise," and they expressed their determination to maintain the existing parities. And I should mention that on the same day of this Communique they announced--to put themselves in a better position to do this--an expansion of the Federal Reserve swap facilities, mutual credit lines between countries, from some \$7 billion to \$9.4 billion.

Fifth, and finally, and in my opinion perhaps most significant of all, they said: "Moreover as the existing stock of monetary gold is sufficient in view of the prospective establishment of the facility for Special Drawing Rights, they no longer feel it necessary to buy gold from the market.

All of these points are worth consideration individually, but I would only stress for you tonight this last one. What does it say? It says that they, the central banks concerned, suspended the operations of the

gold pool in the London market, that they established a two-market system for gold with monetary gold to be kept inside a closed circuit for exchange only among the monetary authorities, while all other gold would presumably be left to flow into private markets wherever located.

In labeling this agreement "historic", I do not mean that it is historic because it involved separation of the official and private markets. The markets were separate through the post-World War II period up to the establishment of the gold pool at the end of 1960. Rather, it is historic, I think, because the Governors of the several Central Banks related this step to the clear prospect of the creation of new reserve assets to supplement gold and dollars.

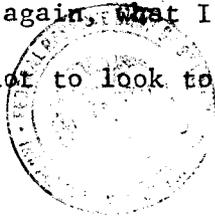
It thus becomes historic only in the light of the Stockholm decisions and the subsequent actions taken by the Executive Directors and Governors of the International Monetary Fund that effectively incorporate those decisions. The fact is that at Stockholm we reached the successful culmination of our quest, a quest on which we have been engaged for more than five years, to develop a new international money to be used by monetary authorities to supplement gold and dollars in their official reserves for use in settlement of balance of payments deficits and surpluses.

The Washington Communique, which represents a sort of "Declaration of Independence" from gold on the part of the monetary authorities--a decision not to look to new gold as a significant source of additions to the reserves of the monetary authorities--was possible only in the light of the prospective creation of new assets within the International Monetary

Fund, marking the culmination of our search for a new international money. And I will take a few minutes to discuss with you this quest for international money which I have been participating in for the Federal Reserve as one of the so-called Deputies of the Group of Ten (the Deputies of the Finance Ministers and the Central Bank Governors of the ten leading industrial countries) in meetings, almost monthly, in Europe for the past five years.

Before I turn to the story of that quest, however, I might say that for me the most memorable sidelight on the historic Washington weekend meeting was when I encountered my little 2 1/2 year old daughter at breakfast on the following Monday morning and tried to explain to her why she had not seen me over the entire weekend. Knowing that her favorite poem is the A. A. Milne one about changing the guard at Buckingham Palace, and so on, I said: "Well, Whitney, you know we had to close the London gold market, and in order to do it we had to wake up the Queen in Buckingham Palace at one o'clock in the morning!" She immediately looked up at me and said: "Well, why did you want to close the gold store, daddy?" I replied that the speculators had run away with us, and showed her a picture in the morning paper of the speculators on the Paris Bourse being restrained by the gendarmes. She seemed to accept my answer and then looked up at me and said: "And what was the Queen wearing when you woke her up?" I referred that question to wife Barbara!

But to be serious again, ~~what~~ I refer to as a "Declaration of Independence"--a decision ~~not to look to~~ new gold as a significant source



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of additions to new monetary reserves--was clearly dependent on the establishment of something to replace it. That motivated, and is the real significance of, our successful quest for a new international money.

Why did we initiate this quest some five or six years ago? We undertook it because as we looked down the road ahead it was perfectly clear that the traditional types of reserve assets, gold and reserve currencies, could not continue to meet the long run demands for reserve growth which most countries were experiencing. As we looked to the future it was clear that there simply would not be enough of such assets to go around.

I might digress to talk at length about the traditional assets in terms of the gold component. But I will simply note that the international monetary system (in terms of the reserves of central banks) was actually losing gold in recent years to the outside because of an array of private demands, including not only the "traditional" speculative demands, but also including growing industrial demands.

And on the reserve currency component side I think you are familiar with the growing unwillingness on the part of other countries

to add to official holdings of reserve currencies, and the growing unwillingness on the part of the United States to see the dollar weakened by continuance of its balance of payments deficits.

As a result of all these negotiations and discussions over the past five years we came to the Stockholm meeting at which the Ministers and Central Bank Governors of the Group of Ten decided to go forward with the deliberate creation for the first time of an international money: a money that at this stage takes shape in the form of a Proposed Amendment to the Articles of Agreement of the International Monetary Fund. The Proposed Amendment sets up a new kind of asset with the seemingly unexciting title: "Special Drawing Rights in the International Monetary Fund."

What kind of an asset is it? First of all it is a Special Drawing Right within the Fund in a separated and segregated account, which is significant in itself because it means that it will be located within the International Monetary Fund but it will be a separate asset, not commingled with existing assets nor dependent upon them.

Second, it will be open to the participation of, and allocation to, all member countries that wish to join. At Stockholm all of the leading countries, with the exception of France which deferred its decision, did indicate a desire to join in. So in that sense it will be a universal asset.

Third, it will initially be created for a basic period of five years under this Amendment. So that, roughly speaking, if we could think of an initial creation of somewhere in the neighborhood of \$2 billion a year for five years, this would mean \$10 billion of the new asset being created in this first basic period.

Fourth, it will be allocated to countries on the basis of their quotas in the Fund. Since our quota is, roughly, 25 per cent, this means that of every \$2 billion of SDR's created, the U. S. would receive a half a billion dollars. Very careful procedures were put into place governing decisions to create this new asset once the enabling machinery is in place--very careful procedures involving an initial call by the Managing Director of the IMF when he has broad support, and requiring an 85 per cent weighted majority vote of the participants in the agreement. The controversy over the 85 per cent figure is no secret. It was a long-standing controversy between the U. S. and the Common Market countries because having 85 per cent rather than an 80 per cent majority vote requirement in effect gives them a veto. At the same time it became more and more clear that any meaningful creation required participation of most of these countries in any event, so that the 85 per cent requirement is a realistic solution.

I might add, parenthetically, that one of the questions frequently raised is as to the effectiveness of this asset assuming the French do not participate. The answer is that it obviously would be less effective but only in degree; a degree that reflects a French quota of only about 4 per cent of the total.

Finally, as to the nature and quality of this asset, what is it? Basically, it consists of a firm and unequivocal and solemn obligation on the part of the participants to accept and pay currency in exchange for the SDR's. So when people ask me what it is, essentially it, like any money, is based on acceptance. And that is what makes it a good asset: in other words when countries participate, when they take these assets on initial allocation, they also agree to accept the asset in turn when some other country presents it. And they agree to accept SDR's in an amount up to three times their initial allocation. To illustrate, for every half a billion dollars that the U. S. is allocated, the obligation to accept up to three times the initial allocation would give us an obligation to accept SDR's until our total holdings amounted to up to a billion and a half dollars of the new asset.

Since the Washington and Stockholm meetings there has been a great deal of confusing talk, and perhaps even some confusing thought, about the viability of the present system, with skeptics questioning both the indefinite maintenance of two markets for gold, and the reality of new asset creation, as we look ahead.

The basis of their concern, of course, is the willingness or determination, and the success, of the United States and the United Kingdom in rectifying their external balance of payments positions.

But taking a little closer look at these two questions: first, can the two-market system for gold be maintained indefinitely? Here I would answer resoundingly in the affirmative. There is no doubt

that it "can"; the question is only one of will and determination. Following the Washington meeting that weekend in March, Chairman Martin sent the Communique out to some 92 central banks. We have heard back from more than 80 of those central banks, all indicating an acceptance of the spirit--although some were somewhat ambiguous about the letter--of that Washington Communique. So what we have really done and said to the world at large is that everything outside the official gold stocks is now part of a commodity market, just like wheat, and as such we as monetary authorities should be impervious to price changes in this private commodity market.

For the present transitional period until the actual creation of the Special Drawing Right assets, obviously there is still sensitivity to what is going on in the private market, and many observers are, I am sure, still keeping an eye on what is happening in the private market. Nevertheless, as the system continues and then is supplemented by SDR creation it means that hopefully over time the price changes in the private market will have less and less relevance to the official price of gold, and to the maintenance of that official price.

I am reminded that on a recent weekend when I was in Bologna, Italy, attending a meeting of central bank and government officials together with some of the leading academicians in the world who deal with these matters--one of those academicians remarked, in effect, "You know, if the speculators continue to buy gold under current circumstances they are idiots, but the reason they are idiots is

because they expect the Central Bank Governors to be idiots" and not to carry forward on their determination to maintain the official price.

I do not expect the Central Bank Governors to be idiots--quite obviously! Why would it be "idiotic" to go down the route of a changing gold price? Chairman Martin spelled the answer out in detail in a New York speech a few months ago. In brief, these are some of the reasons. First, a gold price change would be a very arbitrary and inequitable way of meeting that growing demand for reserves over time which I referred to as basic to our search for a new international money. It would be extremely arbitrary. It would not be related to need. It would only be related to existing gold holdings, not to the kinds of agreed criteria that govern IMF quotas. It would be inequitable in terms of the countries that would be the greatest gainers, including the principal gold producing countries, South Africa and the USSR.

A second disadvantage is that an increase would have to be extremely large to be credible, otherwise everyone would simply expect any one change to be followed by another change in the price of gold. And yet if it were decisively large it would have a seriously inflationary potential impact and a great possibility of leading to unmanageable inflationary problems.

Finally, as Chairman Martin pointed out much better than I can take time to do this evening, it would have absolutely no relevance to the needed improvement in our balance of payments, the solution of which is basic to the viability of any international monetary system.

The other doubting Thomas query is: Can the SDR's come into being? Here again I would make a strongly affirmative answer while recognizing that much still depends on our own performance. Where do we stand on the SDR's at the moment? The Amendment that was worked out by the Executive Directors of the IMF, following the Stockholm agreement of the Ministers and Governors was, as of April 22nd, forwarded to the Governors of the International Monetary Fund for their approval. The necessary majority of IMF Governors, representing over 90 per cent of the total voting power in the Fund, now have approved that Amendment so that it can be submitted for legislative and parliamentary approval in the large majority of the 107 countries of the International Monetary Fund.

As for the United States, we have pressed forward in the legislative part of this process. Following Hearings with the Subcommittee of the Banking and Currency Committee, and with the full Banking and Currency Committee of the House of Representatives, the legislation enabling United States participation passed the House by a substantial majority on May 10. The Senate Foreign Relations Committee also held Hearings and favorably reported out the legislation and it subsequently passed the Senate on June 6. The legislation was then submitted for White House approval and I was privileged to be present this morning when President Johnson signed the bill.

We are, therefore, under way and on any realistic timetable, assuming that other countries will follow the lead of the United States

and press forward with their legislation, we could have the machinery in place for the creation of the new reserve asset by sometime early next year. The activation of the machinery creating the assets, to answer the question of whether they will really come into being, would require the invoking of the very careful procedures that I referred to earlier. Again this comes back to the question of what does the situation look like, notably with respect to the world's need for reserves but also the balance of payments patterns and positions prevailing at that time.

In conclusion, I see a real potential both for the durability of the two-market system for gold, and for the creation and use of a new international reserve asset. Any significant qualifications are related directly to the United States' and the United Kingdom's determination and success in restoring or moving much closer toward equilibrium in their balance of payments accounts.

On this score I for one welcomed the very restrictive United Kingdom budget, and the measures that they proposed and are taking with respect to incomes and wages policy. And I would more than welcome the long-awaited United States' move toward fiscal restraint in our own situation here at home.

For no international monetary system--not even the so-called "pure" gold standard which General de Gaulle has some vision about--no international monetary system could survive indefinitely with two

leading countries like the United States and the United Kingdom indefinitely, or persistently, in balance of payments deficit.

On this score it is disturbing that a worsening of our trade balance--reflecting inflationary pressures in the United States--seems to have offset much of the gain to our balance of payments on capital account resulting from the President's program. This again reenforces the case for fiscal restraint.

My conclusion, therefore, in all of these comments this evening is that if, and only if, the United States' and the United Kingdom's efforts bear fruit--and here I would for my part not exonerate monetary policy and can only assure you that I am certain we will continue to do our part--if, and only if, the United States' and United Kingdom's efforts bear fruit can we be optimistic re the outcome of these historic decisions at Stockholm and Washington, and the results of all the painstaking work in the International Monetary Fund that I have been describing for you this evening. I believe it was a Danish philosopher named deGroot who said that the road to wisdom is to continue to err and err and err but to do so less and less and less. There are times when I think that the road to international monetary reform can be similarly characterized. Clearly in recent months the road has been a rough one, marked by errors as well as steps forward, and sometimes fraught with peril. I recall the well-known story about Gladstone and Disraeli in which the latter distinguished between a calamity and a catastrophe by saying that if Gladstone fell or was pushed into the Thames this would be a calamity but if someone fished him out this would be a catastrophe.

Our international monetary system in recent months often appears to have veered daily between calamity and catastrophe. Despite this, I do not think it leads to a counsel of despair but rather a counsel of hope for international cooperation. Indeed we have during this same perilous period witnessed a truly remarkable degree of international cooperation. While staying overnight in a friend's home recently I had the opportunity to look at the Jewish Haggadah used during the Passover. In it there is a line to be read on the Sabbath, "May the All Merciful grant us a day that shall be altogether good." As a Protestant Christian may I say that I have faith that while that day in the international monetary affairs of men is not today, nor likely tomorrow, it will, with the continuance and strengthening of international cooperation, most assuredly come.