

LONGER-RUN ASPECTS OF INTERNATIONAL MONETARY REFORM<sup>1/</sup>

By

Henry C. Wallich,  
Member, Board of Governors of the Federal Reserve System  
Washington, D.C.

In the immediate future, the principal consequences of the work done by the Committee of Twenty will be measures to which the Committee, in its final report, refers to as "Immediate Steps." These relate to guidelines for floating, strengthening of the IMF through establishment of a high-level Council, a pledge against trade restrictions, and a method to value the SDR, along with others.<sup>2/</sup>

The longer-run future of the international monetary system, however, may well be shaped, in important respects, by what the Committee refers to as "The Reformed System."<sup>3/</sup> This long-run plan was left as a torso, agreed in part but with important matters unresolved. It is generally understood that evolution, rather than negotiation and explicit decision and agreement, will have to be

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1/ The views expressed are the personal interpretation of the author and do not necessarily reflect views held in the U.S. Government, or in the Committee of Twenty, nor those of the two principal architects of the American plan, former Under Secretary Paul A. Volcker and former Secretary George P. Shultz.

2/ "Outline of Reform," IMF Survey, June 17, 1974, Supplement, Part II, p. 197. I have discussed these "Immediate Steps," in Finance Magazine, September 1974, and Challenge Magazine, September/October 1974.

3/ Ibid, Part I, p. 193.

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relied upon for longer-term reform. But the understanding gained in working out the general principles of the Reformed System, in clarifying the issues and in appreciating more precisely the interests and intentions of the participants, will play an important role in the evolutionary process. The future shape of the system remains uncertain. But the major alternatives will almost certainly be found to have been implicit if not precisely spelled out in the agreed and the unagreed portions of the "Reformed System."

It would be wrong to regard failure to reach an agreement on long-run reform as revealing major conflicts among national interests. The existing disagreements are deep but narrow. Nobody is debating basic issues of the kind posed during the 1930's, such as bilateralism versus multilateralism, autarchy versus trade liberalization, tight control over payments against full exchange market convertibility. The disagreements that separated the members of the CXX can be overcome by an effort of political will. The world has lived so well on the capital generated by past efforts of this kind made following World War II, that it seems to have become too complacent to repeat them. It is not a hopeful sign for the future if calamity rather than comfort must be looked to as the mainspring of action. But evolution may very well lead us where cooperation failed to take us. On that trip the "Reformed System" may be a useful guide.

### Antecedents

When the Bretton Woods system finally broke down in the summer of 1971, many observers looked to the U.S. to come forward with some plan of action for repair and reconstruction. The U.S. was hesitant. It was widely felt on the American side that the U.S. role in the world had diminished, and that the U.S. could no longer afford nor effectively assert the kind of leadership that helped to create the Bretton Woods institutions, the Marshall Plan, and the GATT. It took time before the U.S. was prepared, beginning with the IMF meeting of September 1972, to put forward some components of a plan.

The American approach to international monetary reform, as well as the response on the part of other countries, reflected the experience of the final years of the Bretton Woods system. Everybody understood that exchange rates, in conditions of mounting inflation and differential rates of real growth, could no longer be as stable as they had been during the 1950's and early 1960's. It was clear also that the world wanted a more symmetrical system than that into which the Bretton Woods blueprint had evolved. The original design of that blueprint had been almost entirely symmetrical. The same rules, rights, and obligations applied to Paraguay and to the U.S. But because reality was asymmetrical, the system evolved to a dollar-gold exchange standard and eventually, when the dollar had

become convertible only in a very limited sense, into something close to a pure dollar standard.

In its early stages, that system suited both the U.S. and most other countries. The U.S. received easy financing for its perennial payments deficits. Other countries thereby acquired dollar reserves. The U.S. was unable, in a system where all currencies were pegged to the dollar, to modify its own exchange rate, but for many years it felt no desire to do so. Other countries could change their rate and could thereby regulate the degree to which the system required them to finance American deficits.

As time went on, both sides increasingly found the benefits of the system less attractive while its costs seemed to become more onerous. The world became tired of financing American deficits and inflating national currencies and price levels in the process. The U.S. became increasingly troubled by its inability to devalue as the overvaluation of the dollar became more and more evident.

From this experience there developed a universal desire for a more symmetrical system. In such a system, the U.S. felt, it would have the same ability as others to modify its exchange rate. The U.S., so other countries seemed to feel, should be required to make the dollar convertible and settle its deficits in reserve assets like every other country. The role of the dollar would be greatly reduced.

### Convertibility

In the fall of 1972 it seemed apparent -- which is no longer obvious today -- that the decision-makers of the world wanted to return to a fixed exchange rate system. Academics might prefer flexible rates, but finance ministers, central bankers, the private financial sector, and internationally oriented businessmen saw fixed rates as the rule and floating rates as a temporary makeshift. Yet a system of rates fixed by a peg to the dollar, in which every currency would be convertible into reserve assets except the dollar, was not negotiable. Thus the American reform plan, as it evolved and was gradually presented, had as its keystone the promise of dollar convertibility.

It was clear that convertibility raised severe problems for the United States. But it also held one advantage. A dollar convertible into exchange assets would give the U.S. an effective opportunity to control the dollar's exchange rate. There might have been ways other than by making the dollar convertible to accomplish this major American objective. Convertibility, moreover, was not a foolproof means of assuring control over the dollar rate. Under the Bretton Woods system, even during the years when the dollar remained convertible into gold de facto as well as de jure, other countries could and very probably largely would have frustrated an American change in the gold value of the dollar by changing their own gold

price accordingly while retaining their dollar peg. But convertibility into reserve assets probably was the cleanest way of regaining control over the dollar rate.

Under convertibility, the U.S. could shift from one fixed exchange rate to another while continuing to convert. Alternatively, by ceasing to convert and allowing the dollar to float, the U.S. could achieve a rate change in accordance with market forces to the extent that other countries did not intervene in exchange markets to prevent this.

Convertibility at a fixed rate, nevertheless, raises severe problems for the U.S. A large economy with a small foreign sector finds balance-of-payments adjustment at such a rate more difficult than one structured inversely. The number of dollars by which GNP must be reduced in order to eliminate one dollar's worth of trade deficit is greater in a nearly closed economy than in an open one. Payments adjustment via the income mechanism is costly. Adjustment via the price mechanism, to be sure, is easier for the nearly closed than for the open economy, because the range of possible substitutions of domestic production for imports and the elasticity of supply of exports both are greater in the nearly closed economy. But to activate the price mechanism, given the usual rigidity of prices, would require freedom to alter the exchange rate.

The greater difficulty experienced by a nearly closed economy, such as the American, in adjusting its balance of payments at a fixed exchange rate is not universally accepted. The American economy, moreover, is not all that closed. Since the 1950's, its average propensity to import has about doubled -- from about three to six per cent. But there can be very little doubt that a large country with a small foreign sector has less of an incentive to subject its domestic economy to discipline in order to achieve a balance-of-payments objective than has an economy where the foreign sector is of major importance. The U.S. is close to being an optimum currency area, i.e., one that finds it preferable to adjust its balance of payments by exchange rate movements rather than by deflating or inflating the domestic economy.

Convertibility is difficult for the U.S. also because its currency is used so widely in official and private international balances and transactions. Capital movements running into many billions of dollars, in response to interest rate differentials or speculative incentives, would require very large reserves. The fact that the Eurodollar market can create dollars adds to potential demands upon the U.S. for conversion of dollars, even though the dollars presented for conversion necessarily must be dollars in the U.S. rather than Eurodollars. Dollar flows among third countries also can give rise to conversion demands if the country losing dollars

is in the habit of holding dollar balances while the country gaining dollars is in the habit of demanding conversion.

Finally, planning for convertibility raised problems in the light of the low level of American reserves and the large holdings of dollars by foreign monetary authorities. Resistance to U.S. devaluation in 1971 had shown that it would not be easy for the U.S. to achieve current account surpluses sufficient to permit accumulation of substantial reserves. So long as dollars were used in international settlements, moreover, the current account surplus might merely cause the U.S. to earn back its dollars and reduce liabilities, instead of acquiring assets. Arrangements would clearly have to be made for dealing with these problems, but they were not spelled out in much detail in the early stages of the CXX discussions. The subsequent unsettlement of all balances of payments resulting from the rise in the price of oil has for the time being materially altered this aspect of the monetary reform problem, as it has so many others.

Given these difficulties, the American plan might have opted for some qualified form of convertibility. For instance, the U.S. might have offered to pay in reserve assets for the amount of its trade deficit, or current account deficit, or some part thereof. This would have avoided the need to convert dollar balances that foreign monetary authorities acquired as a result of capital movements,

as well as the need to convert the existing official balances. A serious difficulty, under such a scheme, would have been the allocation of these reserve assets to countries which might have acquired dollars through trade surpluses both with the U.S. and with other countries as well as through capital movements. Conceivably the IMF could have acted to allocate reserve assets made available by the U.S. in accordance with some key, such as members' total current account surpluses, or surpluses with the U.S., or in accordance with quotas. Problems of computation as well as of equity would have been serious but perhaps not impossible to overcome. This, however, was not the road chosen in the American plan.

#### The Defense of Dollar Convertibility

Instead, the American plan sought to make convertibility livable for the American economy principally by two devices. One was a semi-automatic or presumptive system of balance-of-payments adjustment activated by a reserve trigger. The other was an option to float when exchange losses -- or possibly gains -- became unmanageable. Particular stress was placed on the need for symmetry -- surplus countries were presumptively expected to adjust in response to the same reserve indicators. The method of adjustment was not specified. It might take the form of domestic contraction or expansion at a fixed exchange rate, or, more likely perhaps, adjustment of the exchange rate itself.

Foreign countries who viewed themselves as potential surplus countries saw many objections. One objection related to the postulated symmetry in adjustment. Why, it was asked, should the countries that had succeeded in getting into surplus positions and therefore supposedly were doing things right be required to adjust along with those who had deficits and therefore must have been following bad policies? Why try to cure the quick as well as the sick? This had been an issue that Keynes confronted in designing his Clearing Union, and at that time the U.S. had taken a dim view of his proposition that surplus countries as well as deficit countries should adjust. Now the situation was reversed. The U.S. had to overcome considerable resistance before it became generally accepted in the CXX that adjustment should be symmetrical.

A leaning toward automaticity or, as the U.S. preferred to call it, presumption in a country's response to the indicator or trigger and the choice of a reserve indicator for triggering this response were harder to defend. The U.S. made clear that no absolute automaticity was intended. Triggering of the indicator was to create a presumption of need for adjustment only. But more than a mere signal that it was time for possibly inconclusive, consultation and assessment clearly was needed if reserve movements under convertibility were not to become excessive.

In continuing informal discussions of monetary arrangements during former years, it had become evident that few governments were willing to surrender power over their exchange rate to an automatic mechanism. The automatic version of the "crawling peg," for instance, had been widely rejected in the ongoing dialog between government officials and academics.<sup>4/</sup> For politicians, exchange rates are too important a part of the economy to be left to economists and their contrivances.

The reserve indicator had been evaluated during the public debate over the crawling peg. There seemed to be a good deal of support for the view that, in terms of the likelihood that the signals thrown off would be the correct ones, reserves would perform as effectively as would spot or forward exchange rates or the current or basic balance of payments. But in a plan that sought to make the dollar convertible, a reserve indicator rather than something else was needed for a reason other than the timeliness of its signals. This simple reason was that, when U.S. reserves ran low while those of other countries ran high, the U.S. was in imminent danger of having to suspend convertibility. There could be no better signal for urgently needed action.

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<sup>4/</sup> A proposal popular in academic circles during the late 1960's, involving frequent small exchange rate changes in response to some indicator which would provide flexibility while making speculation on future moves relatively expensive.

Fundamentally, the reserve indicator was a replica of the textbook version of the pre-World War I gold standard. The rules of that legendary game -- which even in 1914 was not what it used to be, and perhaps never was -- told central banks to contract when gold reserves were low and to expand when they were high. The mechanism of adjustment was the discount rate, rather than the exchange rate. The problem with the gold standard, as with the U.S. plan, had been that central banks were more ready to act when reserves were low than when they were high. Reserve indicators, however, involved several additional difficulties.

One problem relates to the nature of these reserves. There is agreement in the CXX that the SDR should become the principal reserve asset and that the role of gold and of reserve currencies should be reduced. In the U.S. view, however, immediate and total elimination of the dollar as a reserve asset would deprive the system of flexibility and would also be inconvenient for those numerous countries, especially among the developing countries, that prefer to hold their reserves in reserve currencies. Total elimination of the dollar from reserves, except perhaps working balances, would also, of course, increase the difficulties that the U.S. might at times experience under convertibility and increase the frequency with which adjustment action may have to be taken by the U.S.

Another not fully resolved question concerning reserves is whether they should be interpreted gross or net. For a reserve currency country, liabilities to official holders are an important determinant of its net reserve position. If holding of official dollar balances were permitted, a net reserve indicator might be activated by the ups and downs of liabilities even though the gross reserve assets of the reserve currency country remained unchanged.

Still another reserve problem relates to the relative advantages of using, respectively, reserve stock or reserve flow indicators. Situations could be visualized in which rapid loss of reserves, even when their absolute level is still high, would require adjustment action. The same could be true, vice versa, for reserves increasing rapidly from a low level. On the other hand, the absolute level of reserves obviously cannot be ignored and in many cases may be the more relevant concern, especially in a system of convertibility.

The choice of a reserve norm, departures from which up and down to certain levels would constitute warning or action signals, presents another set of problems. Countries presumably would enter the plan with the reserves they happened to have at the time. Gradual movement up or down to the country's norm, which then would be on a rising trend over time, seems appropriate. Norms in the aggregate should add up to a desirable, i.e., noninflationary and nondeflationary, level of world liquidity. But countries' view of their appropriate

shares in world reserves and of the appropriate rates of growth of these reserves may lead to results inconsistent with existing or desirable aggregate international liquidity.

Even a detailed working out of the foregoing problems would not necessarily guarantee symmetrical functioning of the adjustment mechanism under all conditions. An American deficit or surplus, for instance, might have as its counterpart the surpluses or deficits of a large number of countries. This diffusion would mean that no single country, other than the U.S., would necessarily experience a reserve movement sufficient to carry it to a trigger point. Only the U.S. would be required to adjust in that case. Alternatively, some smaller country or group of countries might have a large surplus or deficit mainly with the U.S. while the U.S. was in balance except for these particular relationships. Such imbalance might be sufficient to trigger off the smaller participants but would probably not do so for the U.S., nor of course for any third country, with asymmetry in adjustment against the result.

These are highly technical problems that nevertheless contain very marked elements of national interest. The question is not only which solution may be technically superior, but also how these interests can best be balanced.

The second major device by which the U.S. sought to make dollar convertibility livable, in addition to the reserve indicator structure, was the option to float. Thus the question whether and in what circumstances the International Monetary Fund might be authorized to allow or disallow a float acquired major significance. This, too, remains on the agenda for the future. In addition, the right to float and its limitations involve the question whether a reserve currency country, when it wants to float, could request other countries not to peg their currencies to that of the reserve currency country. If they peg, they would, of course, be impeding the free float of the reserve currency. On the other hand, if the reserve currency country can deprive others of the right to intervene by the use of its currency, -- pegging is an extreme case of intervention -- difficulties may arise for these other countries in managing their exchange rates.

#### Evaluation

Some observers suspected the American plan to have been a thinly disguised prescription for a floating rate system. In support of this interpretation it was argued that the plan made no provision for dealing with the so-called "dollar overhang," did not concern itself with how the United States was to acquire additional reserves, and ignored the problem of making discrete changes in fixed rates, especially when these were signalled ahead to the market by an

approaching trigger point. It was argued that the plan thus failed to provide the conditions that would be prerequisite for a serious effort to achieve and maintain convertibility. Such criticism can be rejected. The plan was presented piecemeal, as it was evolved by a small group working within the U.S. Government. Its gestation period, and the attendant staff work, was far more limited than the White Plan and possibly the Keynes Plan had enjoyed in pre-Bretton Woods days. In contrast to those discussions of 30 years ago, the American plan and the work of the CXX as a whole had had a large input of ideas from the academic community and from continuing discussions of international monetary problems within various groups bringing together officials, academics, and often businessmen. The intellectual basis of the effort therefore was as broad and as solid as the world's idea-generating processes could have made it. But the final molding of these diverse and often conflicting inputs into a tightly organized plan of notable internal consistency necessarily had to be the work of a few people.

In the discussion of the CXX, the American plan has been modified and combined with many other elements. In the areas in which the plan was most specific, however, -- the reserve indicator structure and the exchange rate regime -- it has set a distinct stamp on the "Reformed System" to the extent it was agreed by the CXX. The way in which the resulting system would work, assuming its

unsettled portions to be sensibly compromised, would depend very much on the behavior of national economies. It could be a system of very stable rates, if inflation were avoided, real growth rates were not too dissimilar, and structural factors in national economies did not change too much. Such an outcome undoubtedly would be pleasing all around.

The system could also, however, turn out to be one approximating floating rates. To at least some of the participants, this would probably be a disappointment. The system is the result of an effort to satisfy a widespread demand for dollar convertibility without yielding to the desire, possibly implicit in this demand, of subjecting the American economy to the "discipline of the balance of payments." The need to protect the American economy against deflation, one that, with respect to the British economy, Keynes had stressed very strongly at Bretton Woods, has given rise to a blueprint with a much higher degree of potential exchange rate flexibility than many of the participants probably intended when the negotiations began. Meanwhile the world has moved to an improvised system of total flexibility. To date it has not fared too badly with that system. If this experience should continue into the future, a shift to something like the long-term blueprint of the CXX should not constitute as much of a change as might have been the case had it been completed and adopted in 1974.