

BRETTON WOODS MACH II -- THE SHAPE OF THINGS TO COME

Remarks by

BRUCE K. MacLAURY
President
Federal Reserve Bank of Minneapolis

at

The Money Marketeers Dinner
New York

May 17, 1972

BRETTON WOODS MACH II -- THE SHAPE OF THINGS TO COME

There's a certain irony in the fact that President Nixon's announcement last August 15 that the dollar was no longer convertible into gold came as a shock to a world that had long since become accustomed to the idea that the dollar was no longer convertible into gold. Were it not for the obviously serious consequences of that announcement, one would be tempted to compare it to that of the boy who finally called attention to the fact that the Emperor had no clothes.

But the consequences were - and are - serious. Indeed, during the four month interval between August and the Smithsonian Agreement in December, there were times when it seemed questionable whether a new order would in fact emerge to take the place of the old.

This turbulence should not have been particularly surprising, since it had been pretty clear that when the chips were down, and the gold window finally had to be formally closed, the reaction was not likely to be the neat one postulated by the benign neglect "dollar standard" advocates -- of foreign countries holding more inconvertible dollars, or revaluing their currencies. The risk, rather, was of retaliation through restrictions on exchange transactions or trade, or both. Indeed it was to minimize this very risk that most of us felt that we should avoid taking the ultimate step -- implicit and well understood though it was on all sides -- until it was clear that the United States had no other choice. To have renounced our

obligation to remain convertible before exhausting all other possibilities would have been considered an act of bad faith by our trading partners, and would thus have invited the retaliation that nobody wanted.

Even when, in the face of massive outflows of dollars and a rapidly deteriorating trade account, it became clear to nearly everyone last summer that dollar convertibility at existing exchange rates could no longer be sustained, the spectre that most threatened international financial markets was that of spreading protectionism through restrictions and a breakdown in cooperation. Fortunately, that threat, though a real one, did not materialize in any extensive or irreversible way.

But if we have successfully avoided a collapse of the working arrangements among nations in support of their international commerce, there's no denying that those arrangements have undergone a profound change in the last few months. The world of Bretton Woods, to which we had become so accustomed, survived as long as it did largely because there was no practical alternative that could be set in its place, even when it became increasingly apparent that the postulates of 1945 were no longer workable. Now, however, the situation is different -- the system has already changed in fact, and the task is no longer how to preserve the semblance of past traditions, but how to forge new rules and postulates in keeping with the needs of the future.

Perhaps the most difficult aspect of the task is the need to construct a system that will work in a world where the balance of economic power is now more evenly distributed than at any time

in the post-war period. For it's difficult to avoid the feeling that what made Bretton Woods as durable and workable as it was, was the existence of a dominant, and by and large benevolent, center of power in the system -- namely, the United States. No amount of negotiation is going to restore that concentration of power, nor provide a ready substitute for it in the near future. Instead, we are going to have to recognize that internationally agreed rules must replace dominant sovereign powers as the guardians of peace and order. But as we know from our experience in other areas, the recognition of this fact doesn't make the task of fashioning the rules any easier.

As you know, the communique issued at the time of the Smithsonian Agreement last December spelled out the areas in which further discussions were needed -- in effect, an agenda of unfinished business. I'd like to comment on a number of those areas this evening in hopes that wider discussion of the issues will help to advance the cause. Two prefatory remarks are in order, however. First, although I continue to work for an official institution, my responsibilities no longer encompass the field of international finance, and I have not tried to stay in touch with official thinking in this fast-moving area. So when I say that my comments represent strictly personal views, I hope you will believe me. Second, when I started to think about these remarks a couple of weeks ago, I had no idea that the subject would already have received such extensive coverage as a result of the ABA's International Monetary Conference last week in Montreal. But despite that coverage -- or even perhaps because of it -- I think there is still room for some clarification of views in this admittedly difficult area.

ADJUSTMENTS IN THE EXCHANGE RATE MECHANISM

One of the first items on anyone's agenda of unfinished business is the regularization of the present ad hoc arrangements with respect to exchange rates. After a pretty bumpy take-off, the new central rates agreed upon last December now seem to be accepted increasingly widely as a reasonable reflection of viable exchange relationships for the foreseeable future. Inevitably, one hears comments about the durability of this or that rate, but by and large, the general structure is acknowledged to have been worked out pretty well, and fears that the whole Smithsonian Agreement would fall apart, so prevalent only a couple of months ago, have now disappeared.

Floating Rates

Similarly, with one or two well-reported exceptions, there has been a notable absence of calls for a return to floating rates. There are those, of course, who saw the re-establishment of central rates as snatching defeat from the jaws of victory, believing that with a little more time, businessmen would have learned to cope with the uncertainties implied by floating rates. But such comments, I'm afraid, don't accurately gauge the depth of anxiety on the part of many businessmen who saw export orders, especially for long-delivery capital goods, literally dry up during the interregnum from mid-August to mid-December.

Now I would be the first to acknowledge that the four months following August 15 was about the worst possible time to conduct a meaningful experiment with floating exchange rates. Hardly a week went by but what there was some new announcement

or rumor as to the eventual rate structure that was likely to emerge from the tugging and hauling among the major trading countries. Uncertainty, in other words, was not the product of floating rates as such, but rather of the official poker game (and associated fears of restrictions) that was going on just beneath the surface throughout that period.

But even granting that little light was shed on the inherent viability of a floating rate system by last fall's "experiment", the fact remains that few businessmen and fewer officials have any inclination to weigh anchor again on such seas for some time to come. Indeed, perhaps the best hope for those who remain philosophically wedded to a world of freely flexible rates is to push for as much flexibility as possible, not just in the immediate institutional arrangements with respect to exchange rates, but in the degree to which such arrangements can themselves be easily amended in the future. Frankly, the arguments pro and con floating rates have long since exhausted both the tellers and the listeners, and only practical evidence is likely to advance the cause - one way or the other. Thus if experience with wider bands or more frequent changes in rates turns out to have a salutary effect on trade and commerce, there at least will be a case for pushing the limits somewhat further.

Transitional Floats

For the time being, however, the main task with respect to exchange rates is to seek agreement on the changes that must be made in the Articles of Agreement of the International Monetary Fund (IMF) to bring existing (or perhaps slightly modified) arrange-

ments back within the bounds of law. Much of the groundwork in this area has already been laid. It's now two years since the IMF executive directors issued their report on possible means of achieving greater flexibility in exchange rate adjustments. And the areas of common ground have been further solidified by the sanction of experience. For example, the technique of using transitional floats to move from one rate to another has now been used often enough to nearly qualify for common law status. There are any number of details that remain to be settled before the principle can be codified in legal language, of course. How long may such a float last, for instance; must it be approved in advance, and if so under what circumstance? But at least the principle is no longer very controversial.

Wider Bands

Likewise, differences of view concerning wider bands have narrowed. From the beginning of discussions on this subject, it was recognized that there was no magic number that would provide the unique balance between a range wide enough to accommodate seasonal swings and minor transitional shocks on the one hand, and narrow enough to permit forward planning by those engaged in international trade on the other. Now, however, there is a number that has been accepted as a workable compromise among conflicting views and interests - namely, the 2 1/4 percent either side of parity that was agreed in December. At least there is now a pragmatic starting point, in other words, on which to base language to replace the inflexible 1 percent limit in the present Articles. But the key word is "inflexible." As Roosa and others have pointed out, what

is needed is some degree of discretion on the part of the IMF to adjust the width of the permitted band in the light of further experience, without having to crank up the extremely cumbersome machinery required to change the Articles themselves.

It goes without saying that a country, or a group of countries, could decide to operate on narrower limits than those set by the IMF. Indeed, that has been the practice throughout much of the post-war period, and we are now witnessing a new variation on the same theme within the European Economic Community (EEC). The implications of this particular experiment, of course, go far beyond the question of appropriate widths of the band around parities. To the extent that the expanded Common Market forges an increasingly closely linked currency system, the greater will be the pressures for harmonization of policies internally, and the greater will be its ability to act as a unit vis-a-vis outside currency blocs, and the dollar in particular. Indeed, even if the EEC adopts an outward-oriented policy stance - which at this point is by no means certain - it is hard to escape the conclusion that progress toward a unified currency within the Common Market will mean a reduced role, relatively at least, for the dollar as an international currency.

Diminished International Role of the Dollar

It is convenient to divide the international role of the dollar, conceptually, into three aspects; as a reserve currency; as an intervention currency; and as a transactions currency. As and when the arrangements among the Common Market partners provide for some pooling of reserves, it seems reasonable to assume that

their need for reserves in the aggregate, and hence for dollars, will be diminished somewhat. And while the pooling of reserves is one of the more sensitive political issues among them, it is worth noting that the first steps along this path have already been taken, first in the establishment of credit facilities for use within the group, and more recently in the agreement to settle monthly balances through transfers of reserves from net debtor to net creditor in proportion to the composition of the debtor's reserve assets.

Second, the partners have agreed to use each others' currencies rather than the dollar for official intervention in the exchange market so long as the narrower band (2 1/4 percent vs. 4 1/2 percent against outside currencies) is not at the permitted outside limits against the dollar. In this case as well, therefore, reliance on the dollar has been diminished, though by no means eliminated.

Incidentally, by adopting the technique of intervention in each others' currencies, the Common Market partners seem to have finessed one of the stickier political problems that they would have faced had they used the dollar exclusively; namely, a conscious decision as to where within the wider band against the dollar (the "tunnel") the narrower Market band (the "snake") should fall. The potential for disagreement among partners (i.e. those with strong payments wishing the band to be at the upper end of the permitted range, while those with the weaker payments wishing to conserve reserves by permitting the Market band to settle toward the lower end of the range) has not been eliminated,

but apparently the inner Market band will now simply "float" within the tunnel in response to market forces, thus avoiding an explicit decision on its position against the dollar.

Finally, a narrower band among Common Market currencies is also likely to diminish the role of the dollar as a transactions currency, at least in trade and financial transactions within the Common Market itself, and perhaps more widely. The argument here is that as the risk of exchange fluctuation is reduced relative to the dollar through the narrowing of the permitted band, Common Market businessmen will find it increasingly convenient to denominate transactions in each others' currencies, and in practice hold those currencies rather than the dollar as working balances. This point was in fact made quite explicitly by André deLattre, Deputy Governor of the Bank of France, in a talk three years ago outlining the advantages of moving to a narrower internal band.

In my own view, the prospect of a diminished role for the dollar as an international currency is not cause for alarm, but rather a fact to be taken into account in assessing the likelihood and timing of exchange market equilibrium for the dollar, and thus is part of the calculus on the timing and terms of convertibility. If we could expect the same rate of growth in demand for the dollar in the future as was experienced in the past - whether as a reserve, intervention, or transactions currency - this would imply one set of circumstances with respect to an equilibrium exchange rate. If we cannot - and it is quite certain that we cannot - then this implies a lower rate of exchange - other things equal - against other currencies. As a practical

matter, of course, the dollar is not likely to be displaced in any of its international roles very quickly, at least in any absolute sense, so that there should be time to adjust gradually to any decline in relative demand.

Smaller, More Frequent Exchange Rate Adjustments

Perhaps the toughest question facing those who must translate the present pragmatic compromise on exchange rate mechanisms into precise formal language for amendment of the IMF Articles is how to define the terms that would justify, or even require, a change in parities. There is now fairly widespread agreement that waiting for a "fundamental dis-equilibrium" to be documented and certified, at least as practiced in the past under the IMF rules, involves waiting too long. We are now prepared to accept the idea of smaller, more frequent changes as representing an improvement in the system.

But this is a very slippery concept, as anyone knows who has tried to come to grips with it in detail, and translate the principle into workable rules. Much of the advice on this issue seems to advocate moving the rate before the case is clear, in order not to be caught holding out too long. Indeed, when one hears the Chancellor of the Exchequer assure British businessmen in the budget message that they can count on an expansionist policy in their investment plans, since the exchange rate will not be allowed to stand in the way, one wonders whether the desired flexing of the system may not produce more mischief than improvement.

Clearly, the basic point must not be lost that changes in exchange rates by definition involve consequences for more than one country, and cannot be allowed to become a tool of, or completely subservient to, domestic policy goals. This implies international surveillance of rate changes, whether they are made "more flexible" or not. Again, I would subscribe to a suggestion put forward by Roosa that the IMF be allowed to establish a limit, say 2 percent, within which countries would be permitted to adjust their parities annually without explicit authorization from the IMF. This limit, in turn, could be adjusted in the light of experience. As you recognize, this is simply a modification of the principle incorporated in the original Articles that permitted countries to adjust their parities unilaterally up to a cumulative change of 10 percent.

Exchange Rate Changes for the Dollar: Symmetry?

Related to the question of new, and more flexible, rules for exchange rate changes generally is the equally difficult problem of assuring that the dollar, too, will be able to avail itself of the same possibilities for exchange rate changes that are open to other currencies; assuring, in other words, that the system works symmetrically for the dollar. The inherent problem, of course, is that even though the dollar is now "more equal" than in the past, it is still the dominant currency and is likely to remain so for some time, regardless of whether one wants it to be so or not. And so long as this is the case, it is hard to imagine that the rest of the world will permit us to adjust our rate on the same terms as, say, the Belgian franc or the pound

sterling. Yet so long as we do not have the same "rights" with respect to exchange rate changes, or there is no mechanism for requiring surplus countries to revalue, it's hard to see how we can be expected to adhere to exactly the same rules on convertibility.

DOLLAR CONVERTIBILITY

Which brings us right up against the much-debated issue of dollar convertibility. Again, it's useful to distinguish the different senses in which this term is used. Dollar convertibility, meaning interchangeability into other currencies, exists now and for the most part has existed throughout the difficult transition period through which we have been passing. (The main qualification to this statement is the reduced useability of the dollar resulting from restrictions, both U.S. and foreign, on certain types of exchange transactions or investment outlets imposed in an effort to limit foreign accumulations of dollars.) Earlier this year, as expectations of a dollar reflow were washed away in a flood of new outflows, the markets began to question whether this interchangeability - at least at then-existing rates - would survive. Day-to-day responsibility for defense of the newly established rates fell squarely and solely on the foreign central banks, and the question was posed as to how many more inconvertible dollars they were prepared to swallow.

In these circumstances, a number of people argued that the United States had a responsibility to take some initiative in defense of the new rates. Roosa, for example, suggested that we

offer some form of exchange guarantee on dollar accumulations above a given level. But my own impression is that such guarantees have raised as many problems as they have solved in the aftermath of actual rate changes. Moreover, since Roosa suggests a guarantee only against the effects of a dollar devaluation and not against foreign currency appreciations, it's questionable whether foreign countries would consider such an offer very meaningful. Perhaps the best that can be said on this issue is that it seems to have gone away for the time being. With the cessation of dollar outflows and the distinct possibility of increased inflows, the pressures to restrict further interchangeability of currencies has faded, and in some notable cases has even been reversed.

Convertibility into Gold and Reserve Assets

Dollar convertibility in the pre-August sense, however, usually implied ultimate convertibility into gold. So far as that is concerned, I'm afraid we can only speak of the golden past, for I see no chance of resumption of convertibility into gold as such. The more meaningful question is when, and under what conditions, the dollar should again become convertible into reserve assets generally. You'll note that I didn't say "whether", for in a world of more or less fixed parities, I can see no rationale for the dollar remaining inconvertible indefinitely. To permit the system to operate in such a fashion would be to accord to the Federal Reserve the role of central bank to the world, a role which it neither seeks nor deserves. (It should perhaps be noted that in a world of freely floating rates, the question of con-

vertibility into reserve assets would not arise, since in the extreme case even the need for reserves would disappear.)

Convertibility - the Implications

1. A Strong U.S. Balance of Payments. Agreeing to the principle of convertibility doesn't take us very far in the real world, however. The crux of the matter lies in the terms and conditions, a couple of which I've already alluded to. In the first place, we have to have more assurance than we can possibly have at present that the exchange rate relationships agreed to in Washington will in fact bring the U.S. balance of payments back into equilibrium. The science of economic forecasting is hazardous at best, and predicting the results of changes in parities is particularly uncertain. Only time and experience can give us sufficient assurance that U.S. payments equilibrium is in fact a reasonable prospect - without it, convertibility would be a fraud.

2. Symmetry: Dollar vs. other currencies; Surplus vs. Deficit countries. Related to this point is the need for some mechanism that will either permit the United States more easily to change its rate in relation to other currencies, or provide sufficient pressure on surplus countries to induce needed revaluations, or preferably both. Substituting SDR's for gold as the numeraire or yardstick by which the values of all currencies are defined should ease the cosmetics, and hence the politics, of any future changes in dollar parity. But this will do nothing to reduce the "first among equals" position of the dollar that will continue to hamper, if my earlier reasoning was correct, any willingness by the rest of the world to treat the dollar symmet-

rically when it comes to exchange rate changes.

This particular bias against the dollar, based on the realities of the world as it exists and is likely to exist, would not be particularly troublesome if a way could be found to provide for symmetry as between surplus and deficit countries. But again I am not very optimistic that major countries will be any more prepared to have the IMF play a strong role in signaling the need for upward rate changes in the future than they have been in the past. The sanctions of the scarce currency clause have always been available, but never used. Even if one is fairly optimistic about achieving somewhat greater symmetry in exchange rate adjustments between surplus and deficit countries than in the past, it is hard to imagine that the system won't continue in some small measure to favor devaluations rather than revaluations, thus biasing the chances of maintaining an equilibrium position for the dollar, even when achieved.

As in other areas, some modus operandi may be worked out to overcome these natural biases inherent in the system, but until it is - and no solution is immediately apparent - moving to make the dollar convertible would involve risks.

3. The "Overhang". Then, there is the sticky question of what to do about the nearly \$50 billion already in foreign official hands. As a practical matter, I cannot picture U.S. officials agreeing to any plan that contemplated an amortization schedule for the repayment of these balances. But nor can I imagine any repudiation of responsibility for these balances either. As a sort of middle ground, some have suggested a special "consolidation"

issue of SDR's - a funding into a fiduciary issue without a repayment schedule. But this strikes me as equally difficult to negotiate, both because it would appear to be a special concession to the U.S., and because the haphazard distribution of such an issue among dollar-holding countries would conflict sharply with the concept of orderly distributions that are supposedly a hallmark of the SDR.

Faced with these many unacceptable alternatives, I see little choice but to wait until a better balance is achieved between U.S. assets and liabilities, either through a rebuilding of U.S. reserves (through surpluses or regular SDR allocations) or through reductions in liabilities (through basic surpluses or reflows of dollars).

4. The Link between Financial and Trade Arrangements.

Finally, there is the very practical question of whether the U.S. should agree to convertibility of the dollar without assurance of progress toward what Administration officials refer to as "fair trading practices." Should the U.S. be satisfied, in other words, with arrangements that promised overall equilibrium, but were silent on the composition of the U.S. balance of payments. In the real world, I suspect that most countries, including the U.S., do care about structure - export surpluses, non-discrimination on certain categories of trade, etc. - and that this concern goes far beyond a crude mercantilist approach to economic life. For the United States, for example, the ability to finance aid to Less Developed Countries depends in large measure on our having a

current account, and hence a trade, surplus. Similarly, military burden sharing is something about which we feel strongly, quite apart from balance of payments equilibrium. Thus, I find it quite understandable that the Administration seeks to associate discussions of trade and financial matters, even though this probably implies slower progress toward convertibility. The more troublesome question with respect to trade discussions is whether dismantling of restrictions, however desirable, isn't going to be as painful for some vested U.S. interests as it is for foreign countries, once all the areas for discussion are out on the table.

FUTURE RESERVE ASSETS

If agreements on exchange rate mechanisms and convertibility are high on the agenda of unfinished business, so too is the question of the nature of future reserve assets. Here, though, I believe a consensus is much closer, and I largely subscribe to the conventional wisdom. There is little doubt in my mind that SDR's, perhaps somewhat modified, should be the source of future additions to reserves, and hence will fairly soon become the dominant reserve asset. In one sense, it seems a bit odd to describe this view as "conventional wisdom", since agreement on the creation and issuance of SDR's is so recent. Yet the implications for other types of reserves, at least among those negotiating the SDR's, were clear enough some years back. If SDR's worked, there would no longer be any need for additional gold - or dollars - to provide reserve growth. The only question was whether SDR's would work, and be accepted. That question has now been answered in the affirmative, at least to my satisfaction.

I've already indicated my belief that the role of gold as a monetary metal will continue to diminish, and I accept the diminishing role of the dollar as an international currency as well. The awkward question is whether one takes the logic of this position to its ultimate conclusion and tries to prevent countries from accumulating dollars by requiring periodic encashments into reserve assets. I frankly think that any effort on the part of a few countries or the IMF to push this extreme view would seriously delay agreement on other matters. Indeed, I question whether such a system wouldn't be so fragile, particularly in the absence of strict controls on short-term capital movements, as to represent a step backward in attempts to create a more flexible international financial system.

The rationale, yet impracticality, for rigidly restricting accumulations of dollars or other reserve currencies in a world whose reserves are to be supplied through SDR's is vividly demonstrated by the present circumstances. No case can be made on grounds of needed additions to international liquidity for a new round of SDR distributions next year, given the massive infusion of dollars into the system in the last two years. Yet there is probably no single step that would do more to demonstrate continued support for the system than agreement to carry forward this experiment in coordinated reserve creation, if only in a modest way. In the future as well, when a choice must be made between strict logic and practical reality for dollars as reserves, I would opt for the latter.

One side point that arises in connection with reserve

creation through SDR's is whether there should be a link to development assistance through direct allocations primarily to less developed countries. The issues involved are perhaps more easily understood by putting the question in terms of domestic institutions: should the central bank create reserves for the banking system, and hence determine the money supply, by buying the obligations of, say, a regional development bank? The danger, of course, is that political pressures to increase the financing of development efforts may influence inappropriately the decisions of the central bank on the need for monetary growth. Perhaps I am unduly influenced by the gingerly way in which the Federal Reserve has approached the question of purchases of agency issues - which raised some of the same questions - but my own view is that, given the many other hurdles that must be cleared in the next couple of years in restructuring the international financial system, the issue of the aid link had best be kept off the agenda at this time.

CONCLUSION

This survey of some of the issues that must be resolved before we can claim to have codified a Bretton Woods Mach II is daunting, even while being incomplete. In the pursuit of the common goal of international monetary reform, I'm not sure that it advances the cause to search for differences of approach within the U.S. administration, amusing and time-honored though this game may be.

For what it is worth, my own impression is that there was really very little difference between the basic positions set forth last week by Dr. Burns and Undersecretary Volcker in Montreal.

It's true that their approaches differed: the Chairman emphasized the broad principles that he would expect to find in a new monetary system; Volcker on the other hand, stressed the difficult practical problems that would have to be overcome in reconciling conflicting national interests, agreeing on a set of mutually consistent principles, and finding workable mechanisms to implement those principles once agreed. Similarly, while the Chairman emphasized the necessity to start the rebuilding process promptly, Volcker made it clear that one should not expect that process to be easy or short.

Despite the clear desire on the part of many Europeans to get on with the job of reform, I personally think that we are fortunate now in being able to afford to take time to do the job well. My optimism rests in the belief that the dollar is on the road toward greater strength, despite the lack of much concrete evidence thus far to support this view. And if the dollar is strong, then experience indicates that the international financial system can operate pretty well, almost regardless of the detailed characteristics of that system during the interim period of negotiations.

Because important national interests are at stake, not just for the U.S., but for the rest of the world; because men's conception of reality changes more slowly than reality itself; because we are engaged in building a system that should serve us in changing circumstances for at least another quarter century; and because a false start could be as disillusioning as the British rush to convertibility in 1947, but with far wider

repercussions - for all these reasons, we should not expect progress on international monetary reform to be easy or rapid.

But because the most important asset along the way will be the good will and continued cooperation of the world's trading nations, we should get started.