

Group of 30, Bermuda Meeting

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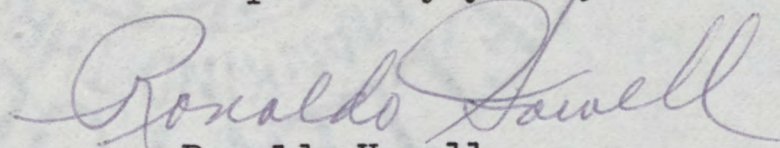
May 10, 1979

TO: All Members
FROM: Ronaldo Howell

Enclosed herewith please find the Report of the Group's meeting in Bermuda. Also included is a verbatim report of two sessions, which we hope will help you to recall the flavor of the discussions.

I shall be back to you shortly to make arrangements for our next meeting, which will be held in Yugoslavia.

Respectfully yours,


Ronaldo Howell

RECEIVED

MAY 14 1979

P. A. V.

ANSWERED

ATTENDED TO

GROUP OF THIRTY

(Consultative Group on International Economic and Monetary Affairs)

Bermuda Meeting, 17-18 February 1979

February 17--First Morning Session
Introductory Discussion

The Chairman welcomed the group to its first meeting and informed the members that a private corporation had been set up under the laws of the State of Delaware to handle the group's affairs. Its headquarters would be in New York and offices would soon be established in the World Trade Center. The Steering Committee members would serve as Trustees of this non-profit corporation. An Executive Director, Robert Pringle, and an Administrator, Ron Howell, had been appointed.

At the first meeting of the Trustees, it had been decided to seek funds from other sources in addition to the Rockefeller Foundation as this would allow the corporation a more favourable status under United States tax laws.

The group, which had been called the Group of Thirty, would be extending its membership from the present 28 members to its full complement of 30 in due course.

Minutes of the meeting were to be taken, though no names would be mentioned in the final report. The Chairman had to leave the meeting after the two morning sessions, his place being filled by another member of the group, Dr. Otmar Emminger, pro tem.

The first morning session was to be given to an exchange of views on the subjects the group wished to discuss and to a consideration of further work it wished to undertake in the future. The group concentrated on three aspects of the subject:

- (a) the framework for, and the general nature of, the discussions to be undertaken;
- (b) the procedures which should be followed in organising discussions and research;
- (c) the future programme.

1. The framework for, and the general nature of, the discussions

In the course of discussion the group was reminded that its aim was to find out what was wrong with the world's economic and monetary system, and if possible, to make a contribution towards improving it.

It was not anticipated that the group should aim to reach a consensus on the topics it discussed, though at some points it might produce a joint paper or agreed position.

It was generally agreed that the group should not be preoccupied with matters which were already much studied, such as the technicalities of the European Monetary System and of the Euro-markets, but should consider more broadly based topics concerned with the nature of the international system itself, and the factors which lay behind specific problems.

It was noted that the make-up of the group, including as it did several distinguished members from developing countries, reflected an increasing awareness of the interdependence of North and South in the modern world. There was concern that the predominance of members from advanced industrialized countries might give the group a Northern bias. It was suggested that it would be unrealistic for the group to try to avoid taking, to some extent, a Northern view of subjects, but that it should constantly have in mind the need to take account of the concerns and interests of the developing countries.

The group considered the sort of time scale it should have in mind. The Bellagio Group had made it one of its aims to tackle current problems and try to influence the attitudes of officials to these problems. There was some feeling, however, that the Group of Thirty was, by its nature and the requirements of the time, better suited to consider underlying factors and the longer-term aspects of problems.

A compromise was suggested in terms of which the group should not be prohibited from considering short-term problems but should tackle them as current manifestations of problems in the underlying structure of the system. If the perspective of the group were basically medium and longer-term, short-term questions would be considered from a broader angle.

2. Procedures

The group recognized the necessity for a distinction between the issues on which it wished to hold substantive discussions itself, and discussion of projects on which it would like to see further research carried out. It was not intended that research should be generated on every aspect of the group's discussions.

The function of the Academic Panel would be to survey and summarize research already undertaken, to formulate questions which needed to be asked and to commission work itself. It would be ready to advise the core group on the best operational approach to the research which the group wished to be seen undertaken. Its membership was shortly to be enlarged by two new members. It was stressed that the time scale of the programme for academic work was important. There would be a considerable time lag between deciding on subjects to be researched, setting the work in progress and actually receiving the results.

The different methods of undertaking research or further consideration of a subject should be considered so that the method most appropriate to each study could be decided upon. The group had been set up in such a way that it would be possible to commission individual case studies as well as to set up study groups to prepare reports for the core group, in addition to the work of the Academic Panel. Reports of study groups would enable the core group to be responsive to immediate as well as longer-term issues.

3. The future programme

Bearing in mind the constraints recognized under (a) and (b) above, it was decided that since research was already under way on monetary matters (for example, in the Weatherstone Group), and since the next meeting of the core group would follow immediately upon the IMF annual meeting, monetary subjects would be discussed in September. Economic subjects, the research for which would require a longer time span, would be reserved for 1980. Specific ideas suggested by members for further study would be discussed by a small group before the next meeting in the autumn.

February 17 - Second Morning Session Reserve Asset Diversification

It was suggested that the group should begin by trying to explain why there was a move to diversify reserve assets, to establish its causes, examine how it took place and its likely consequences in the medium and long term, in addition to the short term effects of the actual processes of moving to a new system. It would be helpful to look at the alternative vehicles for diversification, but also to assess both those which were most likely to be acceptable and whether this development would be a stabilizing or destabilizing influence in the international system.

A distinction was made between the movements in official and private reserves. On the official side the influence of the Group of Ten and the guidelines it set up were important. So far the diversification process had been kept within manageable rates. There was an opinion that central banks could become increasingly reluctant holders of the by-products of their intervention policies, if private holders continued to diversify. Another speaker pointed out that this would only result if central banks continued their policies of intervention.

The group considered the question of the movement of reserve assets held by private concerns, such as multi-national companies and pension funds. It noted the distinction to be made between speculative buying and the desire for a more stable reserve asset base.

As to whether an improvement in the US economy would have a significant influence on movements out of the dollar, there was some difference of opinion within the group. Some members felt that diversification was likely to continue whatever the circumstances of the US economy, others felt that with a marked improvement, there could be a strong flow back to the dollar.

This influenced opinions as to whether the world should be making provision for a non-disruptive phasing out of the dollar as the principal reserve asset. There was some feeling that the only option was to re-establish confidence in the US economy which would call for a collaborative relationship between the United States and the rest of the world, while on the other hand, many speakers said that the desire to diversify was more than a short term change in fashion and that the alternative ways of organizing reserve asset holdings should be examined.

The optimum situation, it was suggested, would be for the establishment of a single well-managed national reserve asset for the world. However, the historical evidence was that a single national reserve asset would not be well managed.

There was considerable feeling in the group that a system of multiple reserve assets would not be stable. There was then the alternative of a multi-national reserve asset, such as the SDR. In this case, experience had shown that it would have to be made a more attractive asset to hold.

When considering the mechanisms for ensuring stability during the process of reserve asset diversification, the possibility of establishing a substitution account, or multiple substitution accounts, needed to be examined.

The particular problems of the developing countries resulting from the increasing tendency towards reserve asset diversification needed to be considered, it was suggested. It was difficult for central banks in developing countries to explain to their political masters why, when an increasing proportion of their trade was carried on with Germany and Japan, their reserves had to be held in dollars. The developing countries were not unsympathetic to the problems of Germany and Japan, but there needed to be channels for discussion and exchange of views on these problems and the possible ways of dealing with them.

Further questions which developing countries would like to see answered concerned: (a) the SDR--there had not been much heart behind the officially sanctioned move to use of this asset, and further discussion of the SDR substitution account was called for; and, (b) the attitude of central banks to gold, which was supposed to have been demonetized, but which was being valued at market rates in the EMS.

The acting chairman summed up the discussion by stressing the need to look at the ways in which interdependent communities could co-ordinate their policies. He felt that the setting up of a study group to look at the reserve asset system and the related question of substitution accounts would be the best way to handle the subject.

February 17--Afternoon Session The Exchange Rate Regime

The afternoon discussion began with Professor Kenen's review of several of the key policy questions raised in his overview paper on the present exchange rate regime. On the initial topic of the fixed-rate system, the group decided not

to devote more time or effort to strictly fixed rates, as it was argued rather persuasively that the adoption of flexible rates since 1973 and the resulting modification of the IMF's articles of agreement in effect precluded the resurrection of the par-value system.

The discussion then shifted to the reasons for the lack of responsiveness of the adjustment mechanism to changes in exchange rates. This also raised the question of the role of exchange rate policy and how much reliance should be placed on it in correcting international imbalances. Related to this set of issues is the kind of discipline (or lack thereof) that a floating exchange rate imposes on individual countries.

While it is difficult to isolate these critical influences of the floating exchange rate system on any given country, many members expressed the view that floating rates can exaggerate the underlying economic fundamentals. In some cases, however, internal economic policies had exacerbated the volatility of its currency. Other members emphasized the consequence of the interaction of the individual and collective economic performances and the interplay of political events.

On the linkage between the exchange system, the adjustment process and currency movements, one member suggested that under fixed rates the appreciation of certain currencies (e.g. DM and yen) might have been more "orderly" in the sense that there was a more formal mechanism for the adjustment of exchange rates when they were out of alignment. Other members questioned whether even large movements in nominal rates under floating had been effective in bringing about long-lasting changes in real rates.

A question arose regarding the exchange rate management policies of developing countries. Most developing countries peg their exchange rate to one of the primary floating currencies (notably the dollar). The question of alternatives to pegging for developing countries was raised. The group was informed that the IMF staff had done a considerable amount of work on the appropriate exchange rate for developing countries and these studies would be made available for review.

The IMF and OECD had also conducted work on the extent to which and speed with which changes in real rates have been effective in achieving shifts in current-account balances. This discussion assumed however that one can measure the real currency appreciation or depreciation, though some members doubted this could be done precisely. It was suggested that the Academic Panel should examine these questions and commission papers for submission to the group at its next meeting.

February 18--First Morning Session

EMS and the working of the international monetary system

In the early part of the discussion some points on the internal functioning and technical problems of EMS were raised. However, the group was reminded that the paper under discussion dealt with the relationship between EMS and the rest of the world. It was suggested that it would be more useful to centre discussion in this area.

On the subject of EMS's relations with the global monetary system three questions had already been raised in the paper under discussion on pages 3 and 4, and a fourth was added from the group asking what would be the impact on the world system of combining in a mini-Bretton Woods system six of the ten largest economies in the IMF.

It had been established in the early part of the discussion that the EMF required mandatory intervention at the limits in members' currencies, as was the case with the snake, and that although intra-marginal intervention could be in dollars, dollars would not be used if that currency were under pressure. If intervention were to be mainly in Community currencies and central banks were to settle in ecus rather than dollars, the question was raised as to whether this would lead to greater use of the European currencies as denomination and invoicing currencies, and the future of the ecu. There was also the question of whether this would lead to less holding of the dollar for settlement and other purposes.

The group discussed the possibility that the sort of regional grouping which the EEC was aiming for might be set up in various other areas, with the regional groups floating against each other, either in a free, or managed float. The general view, however, was that fixed exchange rate zones in other areas would neither be advisable nor feasible, and this applied especially to groups including newly industrializing countries. One member felt that in order to integrate the new economic powers into the world system, it was important to retain the possibility for relatively smooth adjustment of real exchange rates. It might be helpful to have somewhat more managed rates within areas, but any such arrangement should reflect the need for real exchange rate flexibility between old and new powers.

There was also an opinion that this extension of the regional grouping idea would not fit the real world. Countries such as India and the oil producers had their own reasons for exchange rate movements, while others had high inflation rates and would not be suited to join in zonal arrangements.

Looking at the reality of the political situation in the Asian countries around Japan, they had none of the sort of institutional traditions of the EEC area to make such an arrangement feasible. They had no wish to give up the prestige of national sovereignty and most trade in the area was expressed in dollars rather than in yen as the settlement currency.

However, alternatives under consideration were not a straight choice between fixed and floating rates, it was pointed out. Within the spectrum of floating rates there was a point at which it was useful to introduce the concept of "stickiness" in exchange rate changes. There was a need to retain if possible what had been useful in the Bretton Woods system.

The whole question of the management of exchange rates raised many problems. Were they to be managed for structural reasons, so that some estimate could be made of forward rates, or for cyclical reasons in order to try to avoid cyclical changes being driven into the real economy, or for the sake of the restraining effect of "stickiness" on a country's policies?

Second Morning Session--18 February 1979

Report on the Weatherstone Study Group

Three principal areas of the Weatherstone Report were reviewed by the group. The first concerned how the increased number of market participants and the reduction in the number of principal market makers in the foreign exchange markets have influenced the movement of exchange rates. The second area of discussion revolved around whether or not the impact of accounting changes on US corporations have increased overall currency volatility. Thirdly, the group discussed one of the major differences between international foreign exchange markets in the degree of regulation on the trading activity of commercial banks.

The Weatherstone Report implied that basic economic imbalances among the major countries were the primary sources of currency volatility. The floating rate system sui generis does not appear to be one of the root causes of instability. However, there are other salient factors--namely, technology, the larger number of participants and smaller number of principal market makers--which have to some extent modified trading practices and patterns, but should not be confused with systemic developments. Continuous trading of foreign exchange around the globe, for example, has given rise at times to thin one-way markets. Nonetheless, it was generally agreed that the currency markets under floating rates have functioned rather well despite disruptive economic shocks and the structural changes of the market.

As stated in the report, it is difficult to determine the impact of additional foreign exchange activity brought about by changes in the US accounting standards. Of these, the most important is the Financial Accounting Statement No. 8, known simply as FAS 8.

It requires US corporations to recognize in all financial statements gains or losses on the translation of all of their liabilities and certain assets denominated in foreign currencies. Several studies have shown that despite the increase in corporate activity related to foreign currency exposure management, FAS 8 has not materially contributed to currency volatility. It has, however, contributed to some distortion in the financial statements. One member pointed to the sharp rise in interbank volume and bank profits from foreign exchange activity. The group was reminded that the volume of interbank transactions originate as commercial orders from private sources and not from bank trading. Further, it was suggested, even though foreign exchange profits had risen, the trading risks have increased as well.

The Weatherstone Group was asked to continue and expand its current study efforts to include, in particular, (1) how market participants' view official regulation and its relationship to the changing nature of the market. (2) How developing countries' central banks might take better advantage of the forward markets. (3) How changes in invoicing practices might influence currency movements and (4) how several broader questions raised in Professor Kenen's report relate to the nature and operation of the exchange markets.

Third Morning Session--18 February 1979

International Banking and the Euromarkets

After a brief discussion of this topic, the following comments were made from the Chair.

(a) Facts and interpretation

An analysis both of the relevant recent facts relating to international bank lending and deposits and also an interpretation of the facts would be useful to the Group. In this category should also be placed the role of bank lending in international reserve creation; the contribution of bank lending to the overall payments 'speculative' deficit of the United States; and the markets' role in facilitating movements of capital, leading and lagging and so forth.

(b) Costs and benefits

Some members had described the benefits of the markets; others described some of the worries--the markets' inflationary potential, prudential aspects, the disturbing effect on domestic monetary policies, the possible effect in delaying necessary adjustment policies. There were also the new worries in the United States about the effect on US monetary policy. A paper on this for the next meeting could put all sides of the case without coming to a definite conclusion.

(c) What are the factors that make the markets grow?

The size of the "Eurocurrency credit multiplier" and related issues. The Academic Panel might look into this question.

Afternoon Session--18 February 1979--The Pringle Report

Policy Co-ordination

This subject had been among those suggested for further discussion by Robert Pringle's report. It was considered to be an important topic since the interdependence of nations would continue whatever the exchange rate system happened to be. It was noted that the last good work done in this field was that by Richard Cooper ten years ago in his book, "The Economics of Interdependence."

There was some feeling in the group, however, that there were plenty of bodies and mechanisms already existing for ensuring co-ordination, but since the political will to bring this about was lacking, they were ineffective.

Other members felt that even acknowledging this difficulty and the difficulty of gaining information in a field where personal recollections and assessments were an important research source, it would be worthwhile making an attempt to

pursue the subject further. The aim would be to look for inconsistencies in policy of a structural or political nature and to ask why mistakes had been made in the past, rather than to recommend the establishment of any new bodies.

There was a view that a prior problem which should be considered was the possibility that different nations had differing perceptions of their priorities and different levels of tolerance in their acceptance of certain conditions. It was necessary to take account of the fact that, for instance, developing countries might be willing to accept a higher level of inflation in order to avoid unemployment problems, while advanced countries might have the reverse order of priorities. The threshold of tolerance differed in different countries, for example, over the degree of recession which was tolerable, which might safely be higher in countries with more stable political institutions.

In looking at co-ordination, it was thought important to recognize the way in which the political feed-back from international or regional meetings could influence national decisions. These meetings were part of an important conditioning process at all levels. In fact, the level of decision making, it was suggested, had been pushed up over the years from the official to the ministerial, to the level of heads of state, until now even heads of state could not take decisions, but had to go back to pressure groups and legislatures --such as Congress in the American case.

It was suggested that a useful case study in this area would be policy co-ordination between Japan and the USA.

It was recommended that the Academic Panel should be consulted about the best way to set up a study on this subject and should provide a report in time for the October meeting. It was thought that any study group on the subject should contain academics, practitioners and national officials.

The Group of 30--Final Session--18 February 1979

Final Summing-up From the Chair

The subjects discussed in the past two days may be divided into six categories:

- (1) Diversification of reserves and a multiple reserve currency system;
- (2) Exchange rate problems and overlapping with this;
- (3) The exchange markets;
- (4) The European Monetary System;
- (5) International bank lending and offshore markets;
- (6) International policy co-ordination.

1. Diversification of reserves and a multiple reserve currency system

Here some of the main questions were the following:

Under what circumstances would such a system be stable? What ideas could be conceived for making it less unstable? Also there were the factual questions relating to the extent of diversification and the role of the Euromarkets in facilitating the process. This subject could be studied by a Study Group or approached by commissioning a number of papers or by some combination of the two approaches.

2. Exchange rate problems

Some of the leading questions here were the following:

How well or how badly has the present system functioned? Are we confronted with systemic or policy faults? What has been the extent of real exchange rate appreciations or depreciations and what have been their effects? To what extent can Governments alter the real exchange rates of their currencies? What has been the role of speculative movements in exchange rates? Then there was the question of the overshooting of exchange rates (which could be investigated both from the side of the Weatherstone Study Group and the Academic Panel) and of "stickiness" of rates. Some countries of course peg their exchange rates and there are arguments to be investigated in favour of this, drawing for instance on IMF material. The possibility of fixed exchange-rate regimes on a regional basis was also discussed and some members raised the further questions of practices in the invoicing and settlement of trade and their implications, notably for developing countries. This investigation should lead therefore not only to study the past but also goes into the future.

3. The exchange markets

The Weatherstone study group should continue.

It should investigate among other aspects the whole subject of overshooting and deal with some of the questions in Professor Kenen's paper.

4. EMS

It was not considered necessary to continue with the Study Group on this subject nor to commission papers. A substantive discussion of current issues could however be held by the Group at its meeting in October if considered appropriate.

5. International bank lending and offshore markets

No study group may be necessary at present.

Dr. Lamfalussy is however to be asked to make proposals as to how the various aspects of these markets might be investigated further and to advise the Steering Group accordingly.

6. International policy co-ordination

A wide-ranging discussion was held on this topic, focussing particularly on the question of how well or badly co-ordinated decision-making had functioned.

Various suggestions were made as to how this subject might be studied further; these could be considered by the Steering Committee and by a small ad hoc committee which was to be formed to consider a possible agenda for the Group's work in 1980.

INTRODUCTORY DISCUSSION OF TOPICS

- Member: One of the most important problems is the further study of the possibilities of a substitution account.
- Member: I support the idea of studying the possibilities of a substitution account in the general context of policies over reserve composition and in the context of some analysis of how a multiple reserve system would operate. Another important subject is the functioning of the Eurocurrency markets or offshore markets. A lot has been said about this but there are many different views and the market is growing and has an impact and raises questions of the appropriate form of control and whether control is necessary. A Study Group might be an adequate way to approach this. Then there is the whole question of the co-ordination of intervention and exchange rate policies.
- Member: There is the problem of the effect of exchange rate changes on the balance of payments and the time lags involved.
- Member: This morning we are stretching our minds over both monetary and economic subjects. We shall find that we are drifting into a discussion of the ingredients of structural change in the world economy. We cannot take on every issue but are not limited to monetary issues.
- Member: Two important subjects have been mentioned--relations between advanced and developing countries and the Eurocurrency market. We need a summary of the main questions to ask of both subjects. I and others must admit we are not clear what the questions are. The Academic Panel should sort out the issues in a way that is operational so that research can be done and be discussed by us.
- Member: We should distinguish between the broad issues we want to discuss here and projects for research. The two should be connected, but we need not generate research on every subject. The Academic Panel will commission others to do the research for us. The next meeting may seem a long way off but it is close in terms of commissioning papers. We need to think of the range and sequence of our discussion. If we deal mainly with monetary issues this year and in 1980 turn to structural change and trade policy we need to look ahead a year. Two more members of the Academic Panel are to be appointed.
- Member: Since we are starting with the EMS we could have a paper for next October on the EMF and discuss what the group thinks of this fund.

- Chairman: The Study Group will have this in mind; this should be one of the subjects for October.
- Member: We should study both economic and monetary problems. The monetary system is only a means.
- Member: We should distinguish between three categories of issues: an analysis of present problems, future policies (as for instance a substitution account) and present protective measures including the EMS, multi-currency reserve policies, etc. In reply to a question from the Chair the member said we should concentrate on the first question but not exclusively.
- Member: We should plan to discuss these technical subjects against some background or scenario of where we think the world will be moving in the next few years. Is the dollar overhang going to persist? Where will the major surpluses and deficits be located? What growth rate is foreseen for LDCs? What is the future of the Pacific Basin and the Middle East? Monetary questions will depend partly on how the real economy is going to develop. What are our views?
- Member: We should not run straight into subjects that everybody else is talking about, such as the EMS or Eurocurrency market. The real questions are how the system as a whole will develop over the next five or ten years and what we can do about it--these are the subjects we should tackle. Filling up little holes with coefficients is not important. The big questions are about the system. One approach would be to ask what has gone wrong and why--why for instance have some countries coped so much better than others. We should also consider discussing the views of people who have views. We should try to get these together and develop some vision of the future.
- Member: There is a need to differentiate our product. What can this group with its independent status contribute? The operation of the money and capital markets and the exchange rate system are important, but we need to go behind them if possible. Pringle's paper shows areas where not enough thinking has been done. For instance, the first question Pringle poses--are the problems essentially domestic or international? How is it that some countries have coped well? Insofar as we agree we are facing international problems, what is their nature? How far are they the subject of economic analysis and to what extent do they ----- From the political and institutional environment? ----- cannot tackle these without looking at the political decision-making process. How are decisions taken in an increasingly interdependent world? That is the question.

- Member: To follow up this idea, Pringle's paper on page 6 puts a question about the various arenas of international cooperation and about the respective roles of inter-governmental and inter-central bank cooperation. We have representatives of all such groups. This would give a basis on which to follow up the question. What is hampering international coordination and what are the factors in decision-making in these fields?
- Member: I support the suggestion that we consider economic questions next year, so that we may have time to discuss what questions we want to develop. I would like to suggest ideas on such questions. One of the most important is the new aspect of unemployment in advanced countries. What is the threat to unemployment from the growth of advanced LDC trade? Then there is the future role of big companies of the manpower resources of some Eastern countries and especially of China; the threat of protectionism (with special reference to compensation agreements); the price of energy.
- Member: Two subjects in particular deserve further discussion. One is the balancing effect of autonomous capital flows; another is the feasibility of 'external reflation'--by the export of purchasing power to LDCs. What is discussed at summit meetings is always internal reflation within the advanced countries. But external reflation would be less inflationary and we could discuss ways to achieve this. We should reinforce the Academic Panel with people specifically interested in such ideas.
- Member: We should not duplicate other people's work. As another speaker has noted, the efficiency of international policy coordination has not been explored elsewhere. We come from various institutions. In one sense it is not interesting to talk about current preoccupations, e.g., EMS, international liquidity, etc. But there is a longer-term perspective where we could evolve forecasts or scenarios. Most people do not have time to do this because they are so involved in day-to-day issues and management.
- Member: We are concerned with present day problems and we also have to look ahead. We need to make up our minds: there is the possibility of trying to have some influence on developments leading up to decisions that will be taken in the next six to twelve months, as for instance on the substitution account or Euromarket controls; there are also the longer range problems--for instance, where developments in the offshore markets could lead to. The Chairman could give us his thoughts on this perhaps as he will not be here this afternoon.
- Chairman: It is a fundamental choice but perhaps we should hear some more views first.

- Member: Why are industrialized economies more rigid than they used to be? What are the implications of the rapid shift in comparative advantage now a small group of LDCs have such an advantage? After this brainstorming session today, someone must propose a framework for 1979 and another for 1980 and we should be ruthless in restricting the questions under discussion to fit in with that.
- Member: Should we not follow the example of the Bellagio group? But perhaps now there is a greater need for emphasis on underlying longer-term problems.
- Member: We can focus on the long term by distillation from current issues and those with longer-term significance. We don't want to feel we must not go into current issues; but our aim should be longer-term. We should be able to find ourselves in agreement on the implications of some subjects that would give rise to a joint paper or agreed position but I doubt if there is a capability to reach a unanimous view of the nature of the world economy. At the same time we will instruct the Academic Panel to discuss long-term changes.
- Member: I have been involved in OECD's Interfutures project. This got too far away from the present. The future will depend on how we resolve present difficulties. One approach would be to take issues of current concern and look at them from a longer-term point of view. For instance a substitution account would have great long-term implications; the same with North-South issues and protectionism.
- Member: The short versus long-run is not the issue. We have an underlying set of problems which are on-going: exchange rates, the Euromarkets, North-South. We have current manifestations and need for policy actions in all these fields. We need to look at many issues but with a good understanding of the underlying structure of the problems and their analytics. The analysis is not agreed on what makes exchange rates move nor on how the Euromarkets function.
- Member: On the front burner for October we should have the reserve position question; private capital and money markets; and a range of exchange-rate problems. On the back burner we should have North-South questions; and some case studies.
- Chairman: To summarize, there are a number of conclusions:
- Several members feel that we should do work on more basic issues-- the real economy, changes in the world economy, the implications of the growth of exports of developing countries, unemployment. We agreed at our introductory meeting that we would have to move into this field at some time. As Kenen has said, it would be useful to try to agree on the sequence. Work on the long-term

development of the world economy will take time. We must avoid generalizations. We may perhaps begin to outline subjects to be taken up in 1980, and we can ask the Academic Panel to prepare some studies. In October this year we had better concentrate on monetary subjects, but a wide range of subjects placed in the context of the fundamental aspects and long-term development. We can get the best view of the longer-term by concentrating on the problems we see now. We also need to avoid duplicating the work of others.

We need a fundamental and long-term analysis of reserve diversification and a substitution account; the capital markets; and a third subject--exchange rate management--that is more difficult and more related to the real economy. Finally, could we do something by concentrating on case studies or country studies to see how they coped? We might for instance look at different developing countries and ask why some are succeeding and some lag behind.

RESERVE ASSETS, DIVERSIFICATION AND A SUBSTITUTION ACCOUNT

- Member: Perhaps we can draw on the different experience of different participants. The deep questions that arise are: Do we need a multiplicity of reserve assets or can we get along with two? What are the hazards and anxieties of having four assets as opposed to the use of SDRs? Can we contemplate the world working well with a number of reserve assets? Is there less reason rather than more for encouraging other countries to take on a reserve-currency role?
- Member: Of course these are basic questions but there is another one: not what we would like to see happen but what will happen. There is no doubt that reserve diversification is taking place. It is possible to argue that the process will stop, if the dollar recovers and there is a fundamental change. But I do not think diversification will die down; prudent portfolio management is behind it.
- Member: We could discuss various schemes and techniques for managing diversification, remembering that private diversification could even be encouraged and could swamp official diversification. We should remember that central banks of the Group of Ten have renewed the agreement not to redeposit funds in the Euromarkets. What in fact is the agreement?
- Member: First, the agreement among the central banks of the Group of Ten has been reaffirmed. The Eurodollar holdings of the G10 central banks are only about \$10 billion, compared with total central banks Eurodollar holdings estimated at \$80 billion or more (there are various estimates). So, G10 holdings are a minor part; but the total reserves of G10 countries are so large that if they really moved into holding reserves in the Euromarkets this would make quite a difference. Secondly, reserve diversification so far has been at a pace which appears to be manageable. G10 central banks have by far the largest part of their currency reserve in dollars and the total has been increasing. But some banks outside the G10 group have been diversifying on a considerable scale. Thirdly, there is diversification on the part of multinational corporations and pension funds. However, even this in conjunction with some official diversification has been manageable. I draw this conclusion from an analysis of the US balance of payments; but it is true that it could get out of hand.

- Member: The marginal rate of diversification is high. During the third quarter of 1978 central banks put about \$8 billion into international bank deposits, of which \$4 billion was in non-dollar assets.
- Member: Is not diversification merely a symptom?
- Chairman: We should consider the problem in all its aspects--why, how, and what are the consequences of diversification and only then whether we like it or not.
- Member: We have the reaction of the market and should not say this is bad--the consequences of not having the reaction might be worse. Big private companies as well as central banks outside the Group of Ten are taking decisions in terms of market-related exchange rates and expectations.
- Member: I would put the problem differently. With the move to flexible exchange rates, people would have diversified even if they thought that the dollar would be stable because of the possibility of it moving down. I would make a case for looking at the official side, because we can't do much about private diversification. On the other hand to the extent that private diversification goes on it will place additional pressures on currencies. Central banks will become increasingly dissatisfied with the reserve by-product of their intervention policies and co-ordination will become more difficult. The SDR is an instrument of diversification because it is a composite of currencies.
- Member: For October we should have a report on private capital markets; a critical aspect of this is the process of private sector diversification and the interplay with central bank diversification.
- Member: It would be useful to get an idea of the changes in different countries' attitudes with respect to reserve composition. We might also distinguish between the advantages and disadvantages of a world where reserves are diversified and the process of getting there.
- Member: I would put the same question, but more fundamentally. How do we evaluate the possible evolution into a multi-reserve system as a permanent arrangement? Could this be stable or would it be inherently unstable? Here we have an immediate issue placed in a long-term perspective.
- Member: The alternative to the present system is not necessarily several reserve currencies--it is conceivably a single reserve asset.
- Member: We cannot explain holding dollars as the only reserve asset to our political masters. We have no quarrel with Germany or Japan but we can't explain why, at a time when a significant proportion

of our trade is with them, we still have to convert the proceeds into dollars. This is a major political question, not just a technical one. Why cannot we discuss this with Germany or Japan? With regard to the capital markets, the advanced countries have created them, but is there anything we can do to live with them with greater safety? Also the fact is that SDRs have not taken on; the choice seems to be in favour of own reserves, not borrowed reserves. Another question: is there resistance to the ECU becoming a reserve asset? Also, why is gold valued at market prices in the EMS? It seems that European central banks have not subscribed to the demonetization of gold.

- Member: The desire to diversify may continue even if US policy is turned round. There is a need to prepare what can be done for orderly substitution.
- Member: The rules of portfolio management on the stock market do not apply to reserve-currency choice. Central banks have been pushed into holding dollars through their intervention policies.
- Member: The indexed-fund analogy in the foreign exchange field is not the SDR, but one's own currency cocktail.
- Member: Are we faced with a stock problem based on outstanding stocks of dollars or a flow problem? What would be the problem if exchange rate expectations were neutral? The real dominance of the US is less. There would still be a process of diversification. There is also a natural tendency for a reserve currency centre to overreach itself. I believe that if the US economy were to improve markedly, we might see a flow back to the dollar. There is, however, a desire to hold assets denominated in the currencies of the emerging strong countries. We have not really explored fully the pros and cons of this. Are there mechanisms for enabling currency denominations to be shifted without having a disturbing effect on exchange rates?
- Member: I do not see how. I have a feeling that a multi-currency reserve system is inherently unstable. If so, what are the preconditions for moving to a system based on the SDR? It is not just a matter of making SDRs available.
- Member: We could say that a unitary system is better if it is well-managed, but is it likely to be?
- Member: Only the US government's economic policies can reduce the pressure, not SDRs etc.
- Member: The US could run its own substitution account by issuing obligations in foreign currencies, as it has in fact done.

Member: If the first step is to give confidence that shifts will be kept within reasonable bounds, the first requirement is a degree of mutual understanding about what is going on and about what each major country is prepared to do in the way of policy co-ordination.

Chairman: So, substitution is a question for the longer-term. Probably the technique of a study group would be a most effective method to approach this question.