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TWO HISTORIES OF INTERNATIONAL MONETARY DEVELOPMENTS

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1. Introduction

This essay deals with issues raised in recent books by Charles A. Coombs, *The Arena of International Finance*, and Robert Solomon, *The International Monetary System, 1945–1976*. The topics addressed are: the lack of impersonal objectivity in a fixed system; the relation between exchange rates and inflation and unemployment; U.S. inflation and exchange rate pressures; the role of the price of oil; and the theory underlying 'international money.'

2. The role of personalities in Bretton Woods

Coombs and Solomon, two former officials of the Federal Reserve System, have written personalized histories of international monetary developments, focusing primarily on the 1960s and early 1970s. If one is going to read one of the books, it is informative to read both. They duplicate each other in only the most minor ways. Both authors emphasize the importance of the issues they were involved in, and the roles of many well known and important people are mentioned in both books. However, Coombs never mentions nor assigns any role at all to Solomon, and Solomon's brief references to Coombs are in cases where they were in complete disagreement on issues. Each author talks about how closely he worked with William McChesney Martin, Arthur Burns and various U.S. Treasury officials, but even if Coombs did not reveal his bitterness quite so openly, a reader of both books would get the impression that all was not harmonious within the Fed on international issues. Coombs also avoids mentioning Paul Volcker by name, although he cannot avoid a reference to 'an Undersecretary for Monetary Affairs'[1] – meaning Volcker. Coombs is very generous in his praise of those he respected, and is pretty rough on some he did not, including former President Nixon (in post-Watergate fashionableness), but he simply omits the role of his boss (Volcker), the President of the Federal Reserve Bank of New York at the time of Coombs' retirement.

[1]Coombs (1976, p. 229).

This essay is introduced in this way for a specific reason. Both authors (but especially Coombs) emphasize the great importance of communication and cooperation in international arrangements during the period they served as top Fed officials. If the reader is convinced that the issues were large he should be left with the feeling that some of the individuals dealing with them were not.

Coombs is very frank in expressing his dislike for floating exchange rates and his strong preference for the old Bretton Woods fixed rate system, yet he has written a highly effective critique of the old system. For anyone who wants to read 'what's so bad about fixed exchange rates,' Coombs' book should be high on the reading list. He opens the book with references to decisions by John Connally and Charles de Gaulle who were 'stubbornly' or 'rigidly' doing something for the advantage of their country, but concludes that 'earlier adversary relationships with foreign financial officials yielded to mutual understanding and often personal friendship. The arena was still there, but governments and central banks had now become allies in an interlocking defense against speculation in the foreign exchange markets.'[2] Having thus assured the reader of the cooperative environment in which he operated, much of the remainder of the book documents breakdowns in 'cooperation.'

At one point Coombs' reports that Guido Carli complained about the 'unsympathetic response'[3] of Italy's trading partners (what role does sympathy play in international finance?). It appears that speculators are always bad guys, and 'the market was challenging . . . the whole structure of international financial cooperation built up since Bretton Woods'[4] (aside from the sloppy reference to a market as a person, Coombs definitely would have been a 'hanging judge' in dealing with anyone who tried to gain, or to avoid losses, as a result of potential exchange rate changes). After relating all his frustrations with uncooperative foreign officials and U.S. Treasury officials, Coombs does not reach the conclusion that most readers probably will – a system that was so dependent on the personalities of such a large number of individuals representing such a diverse array of interests, was fundamentally flawed. Coombs retained the belief that a sufficient amount of intervention would have held the system together, but he is not at all convincing and he indicates no awareness that the interests of consumers are influenced by central bank foreign operations, as well as their domestic operations.

Solomon realizes that the old system was flawed in many ways, including the influence of personalities. He suggests that 'international monetary arrangements ought to be fashioned in such a way as to be relatively immune to the public statements of officials.'[5] This call for a more objective, impersonal system should be extended to include immunity from the personalities of central bank and

[2]Coombs (1976, pp. 1–3).
[3]Coombs (1976, p. 84).
[4]Coombs (1976, p. 115).
[5]Solomon (1977, p. 337).

finance ministry officials in order to eliminate the potential for the types of 'breakdowns in cooperation' which left Coombs so frustrated.

3. Exchange rates, employment, and inflation – Chicken or eggs

Solomon bravely provides some economic analysis in his opening chapter and immediately raises issues that have divided economists for some time. Two of them are very fundamental and re-emerge throughout the book. One is the relationship between a country's exchange rate, or balance of payments, and employment, and the other is the relationship between a country's exchange rate and its rate of inflation.

The discussion of the relationship between the balance of payments and employment is not very satisfactory since it does not give any indication of what is different about international trade as compared to *intra*national trade. New York may have a perpetual 'trade deficit' with Michigan and Iowa, and a capital surplus with both, so why don't we hear the New York would-be automobile workers and farmers complaining about midwest competition? Solomon doesn't say that a trade deficit means 'foreigners are stealing our jobs,' but he doesn't say it isn't true either. He does say, 'A higher exchange rate for the dollar improves the welfare of the American consumer by making foreign products less expensive; at the same time it may weaken employment opportunities in some industries as other consumers choose foreign over domestic products.'[6] Since Solomon chooses to discuss the basic economics of several issues (which Coombs does only minimally) one would have hoped for better. To begin his analysis with 'a movement in the exchange rate' or 'a higher exchange rate'[7] implies starting from a disequilibrium point, and the welfare of consumers or workers cannot be ascertained until one knows the previous developments that led to the exchange rate changes.

The consumers mentioned in the quote above are not necessarily better off in a present value sense. When a country incurs trade deficits because the exchange rate is maintained at an artificially high level, the foreign surplus countries are accumulating claims on the deficit country. The issue is whether government control of the exchange rates (a form of price controls) results in different relative prices between present and future consumption in each of the countries than would have prevailed in a free market. This particular form of distortion of relative prices by government is not possible between areas within a country because of the common currency. This issue will be further discussed below.

Politicians, as well as business executives and union officials in import competing industries, seem to believe that the total number of people employed in a country can be affected permanently by exchange rates or the balance of

[6]Solomon (1977, pp. 2–3).
[7]Solomon (1977, p. 2).

payments. Since Coombs and Solomon are both economists, one would have hoped that they would be careful to not lend support to those beliefs. Just as serious is the relationship between the domestic rate of inflation and the exchange rate. To say that depreciation of the currency causes inflation, as both Coombs and Solomon do, is beginning analysis at disequilibrium and confuses price level changes with an ongoing inflationary process. This is a common error that does not give any weight to the previous inflationary policies that created the conditions leading to devaluation.

Solomon writes 'as these words are being written the Italian Government is struggling to prevent its currency (the lira) from depreciating further in order to avoid additional upward pressures on prices in that country.'[8] Later he argues that 'in countries whose exchange rates tended to depreciate, the rising cost of imports aggravated domestic inflation'[9] and 'it has been estimated that one-fifth of any depreciation in the effective exchange rate of the dollar will show up in the consumer price index.'[10] But that is reversing cause and effect and fails to distinguish between one-time changes in the price level and continuing inflation.

Inflationary monetary policies result in pressures on the exchange rate and loss of reserves if the currency is not allowed to depreciate. Fixing the exchange rate prevents part of the inflation from being reflected in the price indexes, like any other form of price control, and 'decontrolling' allows the price index to adjust to demand and supply conditions. The removal of wage and price controls in the U.S. in 1973 allowed the price indexes to rise rapidly, but few would argue that the ending of controls 'caused' the inflation that year.

Instead of a depreciation of a currency (associated with trade deficits) causing inflation, experience has been that maintaining an undervalued currency and a trade surplus, for a while, has resulted in greater inflation in some countries. With the U.S. dollar serving as the dominant form of international reserves, our major trading partners were faced with a choice between inflating at least as fast as we did in the late 1960s and early 1970s, or allowing their currencies to appreciate (barring use of controls). Since their exports were becoming progressively cheaper to U.S. consumers, their balance-of-payments surpluses meant their central banks found it necessary to acquire increasing amounts of dollar assets, in exchange for their own currencies, in order to prevent their exchange rates from rising relative to the dollar. This injection of domestic currency fueled inflation in those countries. The alternative was to allow their exchange rates to appreciate, but often there was political pressure from exporting industries to prevent that from happening.

Solomon addresses the causes of inflation in the early 1970s by taking issue with arguments put forth by Otmar Emminger and Robert Triffin.[11] They

[8]Solomon (1977, p. 3).
[9]Solomon (1977, p. 228).
[10]Solomon (1977, p. 288).
[11]Solomon (1977, p. 287).

assigned a major role to monetary developments, but Solomon musters theory, evidence and appeal to authority (BIS and OECD) to say it isn't so. Solomon cannot be considered to be very objective in his analysis, since he obviously doesn't like the implications of the argument that rapid growth in international reserves played a major part in the world-wide inflation. He was then, and still is, involved in promoting increases in a new form of international reserves – Special Drawing Rights – and would find it awkward to admit that the problem was too many, rather than too few, reserves.

4. U.S. inflation and exchange rate pressures

While Solomon was willing to enter the debate as to the causes of inflation and the relationship between inflation and exchange rates, Coombs only cites a few instances of restrictive or anti-inflationary policies being adopted as a result of balance-of-payments problems and exchange rate pressures, but generally avoids tackling the causes of inflation. His view clearly is that behavior of speculators caused exchange rate pressures, but he never tells us what the speculators were looking at to cause them to take the risks they did. Late in the book, Coombs mentions that 'the 1970–1971 clash of easy money in this country and tight money in Germany was left unreconciled,'[12] but the reader is left to guess as to what constitutes 'tight' or 'easy' money in his view.

Earlier Coombs related a meeting he had in 1961 with Bank of England officials to outline President Kennedy's policies of maintaining the price of gold and pursuing anti-inflationary policies to achieve equilibrium in the balance of payments. Coombs tells us the British officials 'listened in silent, deepening gloom.'[13] To Coombs 'their reaction confirmed the urgent necessity of new cooperative arrangements to defend the world monetary system against speculation.'[14] Why? Why didn't he conclude that the system was flawed and that greater flexibility was required? It seems odd now, and must have then also, that the idea that the U.S. was *not* going to pursue highly inflationary policies would be so depressing to a major trading partner. What Coombs saw was that if the British were going to continue inflating, but we were not, something had to give. That should have been a sign that greater flexibility was called for – not increased central bank efforts to maintain disequilibrium exchange rates. Coombs continues, 'Sterling did in fact weaken in response to the Kennedy program, but the major damage was done instead by the surprise revaluation of the German mark.'[15] Damage to whom? Coombs apparently believes that the 'blame' for exchange rate pressures lies with the non-inflators, rather than the inflators. The reader is left to wonder why the realignment of the DMark

[12] Coombs (1976, p. 203).
[13] Coombs (1976, p. 108).
[14] Coombs (1976, pp. 108–109).
[15] Coombs (1976, p. 109).

was not applauded as appropriate to relieve pressures on the pound. Instead the German action is cited as the source of a potential crisis which hasty meetings and announcements by central bankers were able to prevent.

The basic issue usually is referred to as the 'problem of asymmetry.' In general, this means that deficit countries must take corrective action or continue to lose reserves, while surplus countries merely continue to acquire reserves. The problem took on different dimensions when the U.S. began to inflate more rapidly in the mid-1960s. Since our currency was an international reserve asset, and because of the relative size of the U.S. economy, the balance-of-payments deficits that were associated with domestic inflationary policies (and fixed exchange rates) did not force U.S. policymakers to accept the same discipline as other deficit countries. A third policy option (other than devalue or stop inflating) was available – close the gold window and do nothing.

Solomon repeats the accusation that former President Johnson's 'guns and butter without tax increases' policies caused the inflation in the first place (given accommodating monetary policy). The reason given is that Johnson did not want the costs of his Great Society programs and fighting the Vietnam war to be debated in Congress (or the public) as a prerequisite to a tax increase.[16] Solomon does not take the next step and point out that the fixed exchange rate system meant that the U.S. was able to transfer some of the real economic costs of 'guns and butter' to foreign countries. In other words, part of the effect of using monetary inflation rather than a tax increase to finance increased government spending in the U.S. was to impose a tax on the consumers in other countries. Our consumers increasingly bought more of foreigner's current output than they did of ours since fixed exchange rates and U.S. inflation meant their goods became progressively cheaper relative to our domestic goods, and U.S. goods became progressively more expensive to foreigners. We 'settled' by giving them low yielding claims to our future output – primarily, U.S. Government securities. To the extent that the yield was less than the rate of inflation, the U.S. was able to consume the current outputs of foreign countries, while not being forced to give up as much future real consumption as a free, mutually voluntary, exchange would have required. The system provided extra meaning to the dictum that 'debtors gain and creditors lose during unanticipated inflation.' It didn't matter whether our international creditors fully anticipated our inflation rate or not, as long as we could give them 'special issues' of our securities at less than market interest rates. Foreign consumers paid part of the real cost of U.S. intervention in Vietnam.

5. Oil, inflation, and exchange rates

The analysis underlying the preceding discussion implies that the effects of the five-fold increase in the price of OPEC oil since October 1973 could not have

[16]Solomon (1977, p. 102).

been 'offset' by more stimulative monetary and fiscal policies. Solomon argues that the oil price increase caused part of the inflation in the U.S. (and elsewhere) in the mid-1970s, but that the loss of output could have been prevented.[17] I have argued elsewhere[18] that there was a real wealth loss to the U.S. that could not be offset by printing money, but that the inflation could theoretically have been prevented. To the extent that there was a real gain to the oil exporting countries, there was a real loss to the oil importing countries. More stimulative policies in the latter countries could have reduced the decline in output only to the extent that former countries were subject to a form of 'money illusion' and allowed the real price of oil to decline as other prices were inflated.

The combination of ceilings on the prices of domestically produced oil and gas, fixed exchange rates, and inflationary policies contributed to our becoming 'cheap energy junkies' over the past twenty-five years. The real price of petroleum and natural gas, relative to other resources (including labor) had declined progressively for two decades prior to 1974. The declining relative prices of these sources of energy greatly influenced the development of production processes and consumption patterns. The large increases in the relative prices of natural gas and imported oil since 1973 resulted in a decrease in the real economic capacity of the U.S. economy – a wealth loss. The reduction in our standard-of-living could not have been prevented by more stimulative policies any more than the effects of the Irish potato famine could have been offset by 'easy money.'[19]

6. International money

A fundamental issue that remains unresolved and underlies the continuing discussions regarding 'international monetary reform' is the role of international 'money' or reserves. In Solomon's words, 'the system is concerned with the amount and form of international money'[20] and he makes it clear throughout the book that something must be done to insure that world trade does not suffer from inadequate growth of international 'money.' However, the context of his discussion leaves him subject to an accusation of the familiar confusion between credit and money. He provides no theoretical analysis of the services of money, and seems to be unaware of recent literature identifying the characteristics of those entities which serve the function of 'money.'[21]

Solomon confuses money with wealth when he says 'money moves from one currency to another.'[22] Other than that, Solomon takes care to insure that his

[17]Solomon (1977, p. 293).

[18]Jordan (1977a, b, c).

[19]See Karnosky (1976), Rasche and Tatom (1977a), and Rasch and Tatom (1977b) for an in-depth discussion of this issue.

[20]Solomon (1977, p. 6).

[21]See Alchian (1977), Alchian and Allen (1977a, especially pp. 32–35), Brunner and Meltzer (1971) and Klein (1974, 1976) for a further discussion of this issue.

[22]Solomon (1977, p. 7).

readers do not fail to recognize his economic conceptions as being derived from J.M. Keynes. A Keynesian 'transactions demand for money balances' clearly underlies his approach to determining the appropriate growth in international reserves. He shares the traditional Federal Reserve view that growth of the money supply is derived from the 'transactions needs for cash' which has resulted in persistent procyclical growth of money. Solomon argues forcefully in favor of a greater role for Special Drawing Rights (SDRs), but leaves this reader uncomfortable with his conclusion that, 'the time may be near when it will be appropriate to create additional SDRs ... countries will continue to feel a need for reserves and, as income and trade increase, this need will grow'[23] – a prescription for accelerating world-wide inflation.

If SDRs are intended to be an asset and a form of international money rather than a credit instrument, as Solomon argued earlier in his book, then his approach to identifying the appropriate growth of new SDRs is wrong. If the entity that serves the function of money (medium of exchange) is that which minimizes the use of other real resources in gathering information about relative prices and conducting transactions, increasing the nominal quantity does not imply a proportional increase in the real quantity any more than increasing the quantity of Reichsmarks in Germany in the early 1920s implied an increase in the money services that were rendered. The 'quality' of the money is not independent of the growth in its quantity.

During early discussions that led to the creation of SDRs, Solomon reports that the Deputies of the Group of Ten (G10) agreed that the supply of reserves, such as gold and reserve currencies, 'is unlikely to keep pace with legitimate demands ....' 'Supplementary means are therefore likely to be needed in order to provide for adequate secular growth in world reserves.'[24] It is unimaginable that the deputies did not realize that the reason gold had become an international reserve was exactly because of its relative scarcity. There is no indication that they realized that the deteriorating role of sterling was related to its excessive growth rate. Yet Solomon remains concerned that SDRs will not become a major international reserve currency if they are not created rapidly enough.

Later the Committee of Twenty agreed, 'that the international monetary system ought to treat countries with greater uniformity; in particular, the system should be more symmetrical with respect to both balance-of-payments adjustment and the settlement of deficits and surpluses. As an aspect of the greater symmetry, the United States should have both rights and obligations more like those of other countries. It was also broadly agreed that the exchange rate regime should be more flexible than in the past. Finally, the SDR should become the principal reserve asset.'[25] The fundamental issue they were deciding was that the U.S. dollar would no longer be a primary reserve asset in order that

[25]Solomon (1977, p. 335).
[24]Solomon (1977, pp. 132–133).
[25]Solomon (1977, pp. 238–239).

the U.S. could devalue or revalue relative to its major trading partners. It is not clear whether they intended to design a system in which other countries would not *want* to hold dollars as their primary reserve asset because something else was superior in an economic sense, or whether they were going to prohibit the holding of dollars as the principal reserve asset even if that was the preference of the nations. If they were to create a 'superior international money' what would be the criteria for doing so? Here they could have benefited from Ben Klein's restatement of Gresham's Law – 'high confidence monies will drive out low confidence monies.'[26]

Solomon had proposed in 1971 that, 'all international reserve assets would be consolidated into a single new asset, a super SDR. In essence the United States would be offering to give up the reserve currency role of the dollar ....'[27] Apparently, he continues to believe that would have been possible if his proposal had not been 'overtaken by the decisions of August 15, (1971).'[28] But he never tells the reader how the creators of a form of money would go about deciding that others would not employ that form of money. His discussions of the problems of asymmetry and convertability would have been more valuable if he had provided analysis of the characteristics of the assets that are relatively most efficient in providing money services. The succinct distinction between the store-of-value and medium-of-exchange roles of money provided by Ben Klein brings the issue into focus, and is highly recommended to anyone desiring to understand this issue.[29]

As a possible explanation for advocacy of SDRs, Klein suggests 'the U.S. monetary authorities want to decrease foreign dollar holdings because they do not recognize that to a large extent the postwar increase in foreign holdings of dollar assets has resulted from the relative rise of the dollar brand name. If monetary services were considered to be a good, voluntary increases of dollar holdings by foreign individuals and governments should be recognized as exports and not as a balance of payments 'deficit.'[30] Solomon's discussion of foreign dollar holdings and SDRs confirms that Klein's conjecture was correct.

[26]Klein (1976, pp. 513–519).
[27]Solomon (1977, pp. 183–184).
[28]Solomon (1977, p. 184).
[29]Klein (1976, pp. 513–519).
[30]Klein (1974, p. 446).

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