THE PER JACOBSSON FOUNDATION

The Monetary Crisis of 1971 - The Lessons to be Learned

Henry C. Wallich
C. J. Morse
I. G. Patel

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FOREWORD

This booklet contains the proceedings of the lecture meeting of The Per Jacobsson Foundation which was held in the Great Hall of the International Monetary Fund building in Washington on Sunday, September 24th, 1972. The subject of the discussion was "The Monetary Crisis in 1971—The Lessons to be Learned". The principal paper, which was distributed in advance, was prepared by Professor Henry C. Wallich who summarized and presented it orally at the lecture meeting. Commentaries on the paper were offered by Mr. C. J. Morse and Dr. I. G. Patel. The speakers, whose biographies appear elsewhere in this booklet, subsequently took part in answering written questions from the audience. The meeting was presided over by Mr. W. Randolph Burgess.

The 1972 meeting was the ninth in a series which started in 1964 following the establishment of the Foundation in February of that year in commemoration of the name and ideas of the former Managing Director of the Fund whose name it bears. The Proceedings have been published in English, French and Spanish and are available without charge from the Secretary of the Foundation. Many of the lecture texts have also been translated and distributed through the kindness of banks and bankers' associations in China, Iran, Israel, Italy, and Japan.

The Officers and Directors of the Foundation wish to express their appreciation to the Managing Director of the International Monetary Fund and his colleagues both for their hospitality on the occasion of the 1972 lecture meeting and for their continuing encouragement and support.

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Introductory Remarks

Frank A. Southard, Jr.

LADIES AND GENTLEMEN, all of you, I am sure, are friends of The Per Jacobsson Foundation and are people interested in the commemoration of Per Jacobsson's service in this building. In the absence of Mr. Schweitzer, I wish to welcome you to the Fund, to this room where many of you have been before and where we again today have an opportunity to hear three very able men speak. The subject of course is one which would today be very dear to the heart of Per Jacobsson.

I hope you are going to enjoy being here in the Fund for a little while. It seems to us very appropriate that this meeting should be in this building, on those occasions when an Annual Meeting is held in Washington.

W. Randolph Burgess

THANK YOU VERY MUCH, Frank, both to you for your introduction and to the Fund for making this lovely room available to us. We all regret that Pierre-Paul Schweitzer can't be with us now. We all wish him enormous success. We hope we can see him later in the afternoon—that he can break away for the reception which he is giving at the conclusion of the meeting, but that remains to be seen.

This does give me an opportunity, Frank, to say before this group that Frank Southard has been of enormous help to this Foundation from its very beginning nine years ago. We have leaned on Frank. He is younger than I, but he is our Father Confessor and has helped us in all of our steps. We are delighted that he had the platform for a few moments; he could appropriately occupy it very much longer.

Now before going on with the meeting, there are some other very distinguished people in the audience that I would like to recognize.

In the first place the only representative of the Jacobsson family who is here is Erin Fleetwood. We are delighted to see her. I would like to tell you that Erin is now launched on a venture in which we are very interested. She is writing a definitive biography of Per Jacobsson at the University of Sussex, under their auspices and with assistance from the Monetary Fund and from our Foundation. We are all eager to see the results of that work; I am sure it will be a number of months yet, but she has our best wishes for a successful venture.

I would like to welcome also two additions to our Board of Directors—Wilfried Guth of Frankfurt and Bill Martin of Washington. We are delighted with the new Directors and we value having the benefit of their wisdom.

Well, now, you all have copies of the program and have noted our subject "The Monetary Crisis of 1971—The Lessons to be Learned".

Henry Wallich, with very great courage, some weeks ago submitted the paper that you have before you today. A great many things have happened since that time, so he will use this opportunity to present that paper to you, not to read it, but to add to it in any way that he sees fit. I don't think he has to retract anything as far as I can see. We are delighted to have him now give us any thoughts that he had had since that time, and to show us the highlights of his thinking.

I am very happy to introduce Dr. Henry Wallich of Yale.

The Monetary Crisis of 1971—
The Lessons To Be Learned

by Henry C. Wallich

On this page begins the text of the paper on this subject prepared and distributed in advance by Professor Wallich. His oral presentation begins on page 41.

It is a great honor, and a responsibility, to be asked to give the 1972 Per Jacobsson lecture. This is a time when the principles for which Per Jacobsson stood, and the wisdom which he acquired and bequeathed, will stand us in good stead. Per Jacobsson had an important part in an earlier period of monetary reconstruction. Such a period is before us again.

The Events of 1971

In examining the lessons of 1971, I have consulted with numerous experts whose views command respect. These views, as you might expect, differ. But they have one common denominator: almost everyone finds his particular views confirmed by what happened in 1971. I am bound to concede, therefore, that my own interpretation is necessarily subjective.

It is not at all easy, to begin with, to reach agreement on what actually happened in 1971, a year apparently best forgotten. Perhaps you will allow me to refer to the complex of causes, effects and implications as "the Events of 1971". Having lived through the period, I am sure you will recall details with sufficient vividness to make a particularizing account unnecessary. Suffice to say that a system that long had served the world well but had of late run into increasing difficulties and criticism had suffered a final breakdown when the United States formally declared the dollar inconvertible and a large number of major currencies floated.

The lessons of experience usually are expensive. Fortunately, in this regard, the lessons of 1971 so far have been atypical. The world has gone through a major financial upheaval, yet in terms of output and employment no major damage was suffered. The main threat now seems to stem from the possibility that we may misinterpret the lessons and proceed to "reform" the system in ill advised directions.

Causes of the Breakdown

Experience is the name we give to past mistakes, reform that which we give to future ones. We are likely to proceed more safely if we ask ourselves systematically what role structural changes, existing institutions, and national policies have played in the breakdown of the international monetary system. The first two questions we must ask are these: Did the System break down because of major world developments that were incompatible with it? Did it break down because of flaws inherent in the System itself? In either case the answer is the same—the System must be reformed. We are not going to change the world in order to make it conform with the Bretton Woods System. Nor is there anything sacrosanct about the System that puts it beyond the reach of reform.

The Need for Reform

It is not difficult to demonstrate that reform of the System is called for on each of these scores. The world has changed, in a way that makes the dollar standard with virtually fixed rates unfeasible. The System contains basic flaws, in its adjustment mechanism, in its method of altering exchange rates, in its form of reserve creation, in its asymmetry, all of which need improvement. National policies also have been inconsistent with the System, such as frequent failure to control inflation, failure to use fiscal policy effectively in combination with monetary policy, failure to coordinate national balance of payments objectives. One may hope for improvement on all these scores, but failures are bound to recur. The System has to be adapted so that it will survive, although not encourage, such lapses.

These conclusions would hold even if the breakdown that occurred had been avoided and the year 1971 could indeed be safely forgotten. The evidence of adverse world developments, built-in flaws, and inconsistent national policies would suffice to justify reform. The conclusions would hold also if we were to abstract from the special problems introduced into the System by the role of the United States. This role has featured prominently in criticism of the System. Part of the needed reform has to do with reducing it. But the lesson of 1971 would still point toward reform if this set of problems did not exist.

To call for reform is not necessarily to criticize the Bretton Woods System. The "System" that broke down in 1971 had in any event moved a long distance away from Bretton Woods, as regards the special role of the dollar, the degree of fixity of exchange rates, and the freedom of capital movements. The System, more as it was in 1971 than as it was originally conceived, reflected a certain view of the future of the world economy. It was to be a world economy increasingly unified by trade and investment, where national policies would be internationally coordinated, and where political unity and world peace were supported by growing economic integration. This was a view of the world that justified fixed exchange rates and free capital movements. History has dealt with this vision, not unkindly, but certainly not very constructively. Without sacrificing the ultimate vision, it is time to recognize that the world is approaching its destiny by a rather circuitous route, and to make the appropriate institutional changes.

The changes are those required by structural developments, national policies, and the defects of the System that have become apparent. They should reflect the lessons of 1971 and earlier. I shall examine these lessons in terms of the major aspects of that System: capital movements, the adjustment process, exchange rates, liquidity creation, and convertibility.

CAPITAL MOVEMENTS, FIXED EXCHANGE RATES, AND INDEPENDENT MONETARY POLICIES

The Flows of 1969-71

In reviewing the breakdown of the world monetary system in 1971, short term capital movements supply an excellent jumping-off point.

They were admirably analyzed by Sir Eric Roll in his last year's Per Jacobsson lecture. The heavy flows of that year, out of the dollar and into strong European currencies, leading to the floating of the DMark and the guilder, were the proximate cause of the crisis. More fundamentally, of course, the long standing payments deficit of the United States, and since 1965 the deteriorating current account, must be held responsible for the dollar crisis that led to the formal ending of dollar convertibility in August 1971. A house may be ultimately destroyed by fire long after it has been inwardly consumed by dry rot.

Initially, the short term capital flows of early 1971 signalled the ebbing away of the great floods of money that had moved to the United States in 1969 and 1970. That was the period when the U.S. business cycle peaked out, and when the Federal Reserve made its maximum effort to restrain the growth of the money supply. The combination of inflation and exceptionally tight money pushed interest rates to levels unheard of in generations.

When the cycle had turned down decisively in the United States, the Federal Reserve relaxed monetary policy. It took a while until interest rates, particularly long term rates, fully reflected the new easy policy, but in November 1970 rates dropped precipitously. Then money flooded back to Europe. The flow at first reflected interest differentials. But, as has happened before, interest-oriented flows induced speculative flows. The volume of funds entering particularly the Federal Republic of Germany threatened to undermine the Bundesbank's efforts to reduce the rate of inflation. Confronted with the choice of giving up this policy, and giving up a fixed exchange rate for the DMark, the German authorities decided in favor of a floating exchange rate. A similar sequence of events ensued in the Netherlands.

The flight from the dollar continued, however, and eventually accelerated. U.S. reserves were altogether inadequate to maintain even the semblance of convertibility. After the gold window had been formally closed, the major currencies either floated or were shielded against further dollar inflows by controls over capital inflows.

The Inconsistent Trinity

This sequence of events dramatically illustrates a fact well known to economists but never recognized in our institutional arrangements or avowed principles of national policy: fixed exchange rates, free capital movements, and independent national monetary policies are inconsistent. In certain situations, such as those of 1969-1971, one of the three has to give. A country can have any two of the trinity. It can have fixed exchange rates and free capital movements, but in that case it must pursue a monetary policy oriented toward keeping capital movements in bounds. Monetary policy then is no longer independent. Alternatively, it can have free capital movements and an independent monetary policy. But in that case, it will have to allow its currency to float, to avoid losing control over its money supply and seeing its monetary policy neutralized by international flows. Finally, a country can maintain fixed exchange rates and an independent monetary policy, but then it must control capital movements.

The principle of this inconsistent trinity of exchange rates, capital movements, and monetary policy becomes abundantly obvious when we consider what fixed exchange rates and free capital movements really mean. They mean that the world has been converted, in effect, into a single currency area. It is obvious that within any country, the various branches of the central bank cannot pursue independent monetary policies. The Federal Reserve, whose 12 regional banks were established on the contrary assumption, learned this early in its career, and most other central banks never tried. By the same token, there cannot be different monetary policies, leading to different interest rates, in the United States, Germany, England, and so on.

It seems evident that we have here come across a serious flaw in the international monetary system itself. The elements that it seeks to reconcile are at times unreconcilable. One could argue, of course, that national policies were available that could have avoided the consequences of the impasse. For instance, monetary policies could have been adapted or coordinated internationally. But that would have been at variance with the principles of the System, which promises independence to national policy makers.

Recent Intensification of the Problem

What caused this flaw of the System to produce such drastic results as it did in 1971? Both structural change and failure of national policy played a role. For one thing, interest rate differentials have rarely been as wide as they were at that time. Most of the time they have been kept small because the business cycle was fairly well synchronized in the major countries. The conflict of cyclical phases is something that in the past occurred only rarely and then probably with less virulence.

One must expect that such phase conflicts may occur more frequently hereafter, because the United States no longer has its old weight in determining the state of the world economy. This is a clear structural change in the world, the fault neither of the System nor of national policy. Since the probability of a recurrence is uncertain, the implications for the System are not easy to define, but surely that probability has increased.

The width of interest rate differentials, however, reflects also a failure of national policies. High rates of inflation mean high rates of interest. Differentials, therefore, will also tend to be higher. It is unlikely that rates will rise equally beyond their normal range everywhere even if rates of inflation were the same, which of course they usually are not.

The disruptive effect of inflation on interest rates and capital movements was intensified, as far as the United States is concerned, by the monetarist tinge that U.S. monetary policy had acquired at that time. When monetary policy takes the form of trying to control the money supply rather than interest rates, one must expect the fluctuations of uncontrolled interest rates to broaden. This was widely expected when the growth of monetary aggregates became the principal criterion of policy, and did indeed happen. Thus policy failures, in the form of high rates of inflation and unusually wide fluctuations in interest rates, contributed to the events of 1971. This is only one of several ways, still to be discussed, by which inflation in the United States as well as elsewhere contributed to the breakdown of the System.

These observations do not exhaust the reasons why the inconsistency of the System had never come into full evidence. Another reason is that exchange rates have never been truly fixed. Even under the old band of 0.75 percent on either side of the dollar parity, capital movements involved risks. The cost of forward cover reduces flows, unless the interest differential comes to exceed the maximum gap between spot and forward rates that can occur within the band. However, by no means all interest-sensitive flows are covered. In particular, the implicit capital movements that take place through leads and lags of trade payments need not be. The popular image of the interest arbitrager as a man behind an exchange trader's desk moving currencies around ignores the large range of interest-sensitive trade and investment transactions, just as the popular image of the currency speculator out for a killing fails to recognize that a large number of speculators are simply trying to avoid a loss. A wide band, therefore, though it helps the central bank in maintaining large interest rate differentials, is no complete solution to the problem of interest-oriented flows.

A third reason why the inconsistency of free flows, fixed rates, and independent monetary policy has never become altogether obvious is that capital movements have never been completely free except in few countries, recently notably Germany and Switzerland. While controls are no defense against many types of movements, they do help with some.

Finally, the problem often has been patched up because central banks, confronted with the fact that short flows and fixed rates did not permit independent policies, have yielded and have adjusted their policies to world interest rate levels. It is only when short term movements have become speculative that this accommodating policy has ceased to avail. In fact, a monetary policy oriented toward balance of payment equilibrium is of course the classical policy "assignment," fiscal policy being pointed toward domestic stability. With all the qualifications that research and analysis have introduced into this division of financial labor, it remains broadly true that such an assignment of policies has a better chance to attain payments balance than another one.

The trouble with attaining the optimal "mix" of monetary and fiscal policy has been the widespread failure of fiscal policy to do its job. Instead of helping to solve problems, fiscal policy has become the main part of the problem. Inflation has surely been caused far more often by lack of fiscal than of monetary discipline. To blame monetary policy for all inflation because ultimately it is compelled to finance fiscal deficits is to misconceive the appropriate nature of the constraints: monetary policy must constrain private borrowing, but public borrowing must be constrained directly by public action.

This state of affairs has left monetary policy, in most countries and on many occasions, as the lone goalkeeper facing the inflationary onslaught. The goalkeeper cannot then be out all over the field keeping international payments rolling according to the rules of the game.

What we observe here is a failure of national policy—the wrong fiscal monetary mix—interacting with a defect of the System—the inconsistent trinity. A hard choice thus must at times be made. One of the three elements of the trinity must be sacrificed. Of course, this inconsistency need and probably will not prevail much of the time. When the domestic business cycle is in step with the rest of the world, interest differentials will be small and the problem is solved. But what is to be done when differentials are large?

Alternative Solutions

Most economists probably would advise the policy maker to sacrifice fixed exchange rates, and good riddance. This advice is not helpful, however, to countries that, like those of the Common Market, want to maintain fixed rates with each other. The lessons of the 1971 floats, moreover, which will be discussed in more detail hereafter, suggest that when an upward float undertaken to free monetary policy for domestic use has reached a high level, the freedom of monetary policy disappears again because the currency threatens to float out of reach. Short term capital movements should not be allowed to dictate the level of exchange rates.

For the most part the lessons of 1971 as drawn by central bankers seem to point in the direction of controlling capital movements, at least in the case of countries suffering inflows. There are some good economic arguments, along with regrets, concerning this. Short term capital flows, after all, do not influence greatly the allocation of real resources. Trade and physical investment does not, and usually should not, change when liquid funds move from one country to another in search of yield, profit, or safety. What does affect the allocation or degree of utilization of resources is a change in monetary policy designed to prevent short term capital movements. If policy was previously optimal from a domestic point of view, the change is for the worse. This is not to deny that the greater integration of national economies implicit in free capital movements has benefits, particularly when funds flow from a capitalrich country to a capital-poor country. But cyclically determined short term flows are hardly of that kind.

The difficulty with controls over short term capital movements is that they are not watertight and become more porous over time. Then the choice is between giving up a bad job, or making the controls more comprehensive. No one can predict where the second choice may lead. The volume of liquid funds—some call them hot money—has been increasing sharply, as recent experience demonstrates. The facilities of large firms for moving money about have been built up and demand use. Action that would control such pressures may have to be far reaching.

Given these unattractive alternatives, many countries may continue to opt for adjusting their monetary policies to the international climate. A constructive way of facing reality in this way is to seek coordination of national monetary policies. The difficulty with coordination is that its costs differ for different countries. Small countries can at best conduct an independent monetary policy only within rather narrow limits, because of their high national interdependence. Large countries, in particular the United States, would sacrifice much more if they were to subordinate their policies to the needs of the group. Historically, it has been the policies of the Federal Reserve that have dominated the international monetary climate. One of the lessons of 1971, and one of the structural changes in the world that contributed to the crisis, is that the United States no longer carries its former weight in determining international monetary conditions. But that does not reduce the cost to the United States of coordinating its monetary policy with the rest of the world.

In the area defined by relations between fixed exchange rates, free capital movements, and independent monetary policies, the lessons of 1971 are that a basic flaw exists in the world monetary system. This flaw has been brought to light by events which reflect a structural change in the world economy—the diminishing weight of the United States. It has been aggravated by seriously faulty policies—the acceptance, albeit temporarily, of very high rates of inflation, and a poor fiscal-monetary mix. What changes, if any, in the system are counselled by these circumstances cannot be determined, of course, without considering several related factors. We turn, therefore, to a discussion of the adjustment mechanism.

THE MECHANISM OF ADJUSTMENT

Discussion of the adjustment mechanism can start with a welcome note of universal agreement: everybody believes that it has worked poorly. Deficits and surpluses have been excessive, in magnitude and duration. Pressures on the countries sustaining them have proved too painful. Exchange rate changes brought on by imbalances have been attended by too much turmoil, speculative gains and losses for monetary authorities.

Payments adjustment is one of the two options available to a country in payments imbalance, the other being continued financing. Both options have costs. That of adjustment is the resulting disruption of domestic markets, income distributions, and asset valuations. The cost of financing takes the form, among others, of holding reserves or borrowing them. Adjustment and financing costs often are incurred simultaneously, e.g. by countries accumulating reserves from a payments surplus that also inflates their price level. The noteworthy implication of the universal dissatisfaction, including that of the United States, with the slow working of the adjustment mechanism then is that in effect all countries have come to regard the cost of financing as greater than the cost of adjustment. This may be recorded as one of the lessons of recent experience.

Adjustment with Stable Exchange Rates

Agreement also seems to exist that the adjustment process today means mainly changes in exchange rates. This was not always true, and even today rate changes are not the only mechanism. The original conception of the adjustment process was the gold standard mechanism. Countries expanded and contracted under the influence of surpluses and deficits. In practice this led to numerous asymmetries in the burden of adjustment. Surplus countries got inflation, deficit countries got unemployment. If the surplus countries were able to control their expansion, the full burden fell upon deficit countries. Inflation brought lasting adjustment, whereas unemployment and loss of income yielded only transitory relief while imports were being curtailed. If the deficit country was the United States, it could ignore the contractive impulses from the balance of payments and leave both adjustment and financing to the surplus countries.

These asymmetries were tolerable only provided imbalances were small and brief, and provided the costs were incurred in a worthwhile cause. That cause—the prospect of an integrated world economy, with fixed rates, in effect a single currency area—vanished during the 1960s. Imbalances became bigger and more protracted as national inflations became more virulent. Thus exchange rate movements, instead of rare remedies for otherwise insoluble cases, became the standard form of the adjustment process.

Adjustment with Rate Changes

One lesson imparted by this mutation of the adjustment process is that it by no means removes the asymmetries. The problem of how the burden of adjustment is to be shared remains, although in mitigated form. A further lesson, however, is that the participants in the process tend to view the adjustment process excessively in terms of their own country and their own situation. Thus they tend to overlook the infinite variety of conditions that makes the setting up of simple rules for burden sharing unexpectedly complicated.

A large country whose deficit accounts for a substantial part of world surpluses naturally sees the removal of the deficit in terms of a joint operation. If the country, such as the United States, has special difficulties in devaluing its currency, and if other countries seem determined to defend their surpluses, this view gains plausibility. If in addition only a small fraction of the country's total demand is directed toward imports, so that removal of a deficit requires a cutback in aggregate demand equal to many times the deficit, the country will ask itself whether adjustment is worthwhile.

Adjustment Burden

Much of this is alien to the experience of the financial authorities of countries differently structured. Many of them have known their country in deficit, and have pulled it out in short order. They raised interest rates, they tightened the budget, and did whatever else was needed. Had they not done so, the penalties for a country heavily dependent on international trade would have been severe. And they found that the cost of "putting their house in order", in an open economy, was small. Nor would they have encountered international resistance to adjustment, because removal of their deficit did not cut down the surpluses of others very much. They would not have thought of asking for burden sharing, because they would not have expected the whole world to inflate or deflate in order to help a single, possibly small, country. And if, as happens a good part of the time, the initial deficit had been due to domestic mismanagement, so that there was no suggestion of a "dilemma" situation with a conflict between internal and external stability, domestic tightening would have appeared desirable for both internal and external reasons. It would have seemed both economically logical and morally right.

With concepts of the adjustment process shaped by very different national experience, it is not surprising that, in discussing adjustment, countries have talked past each other. There is not much evidence so far that this particular lesson of recent years has been accepted.

Structural Changes

Structural changes that occurred during this period also have influenced the adjustment process. One has been the shift from dollar shortage to dollar glut. This reflects more than a mere overvaluation of the dollar. The American economy has become far more accessible to foreign producers, as indicated by the rise in the imports/GNP ratio from about 3 percent to almost 5 percent in some ten years. Another is the reduced weight of the United States in the world economy. American trade dropped from a peak share in world trade of about 20 percent to one of about 15 percent. United States GNP dropped from its postwar peak of 52 percent of world GNP to less than 40 percent prior to the 1971 devaluation. All this means that the tendency of the United States to dominate world economic conditions and, under certain conditions, contribute to its own and other's balance of payments adjustment has diminished. In some respects, the smaller relative weight of the United States eases the adjustment process, because the United States has become a little more "like other countries." But in absolute terms, the dependence of the United States on its foreign trade, and its willingness to make sacrifices on that account, has not increased significantly.

The emergence of the EEC as an economic unit is another structural change influencing the adjustment mechanism. Once consolidated, this group is likely to exhibit a similar priority concern with domestic as against international interests. When trade relations are between two continents, adjustment with fixed rates will be slower and more costly on both sides.

Policy Objectives

Policy behavior has also influenced the adjustment mechanism, and not to its advantage. The outstanding fact is the higher tolerance for inflation. This has been the decisive factor that has shifted the entire concept of adjustment from one proceeding through domestic expansion and contraction under fixed exchange rates to one powered by changes in the rates themselves. With price levels moving in the range from zero to close to ten percent, the classical mechanism cannot work. It is hopeless, moreover, to think of making it work by equalizing rates of inflation. Countries can agree on zero inflation as the norm, but not on five or seven percent.

New departures in domestic policies have had further effects on the mechanism. Economic policies—or their constituents—have become increasingly demanding. Government action extends into more fields, leaving less margin for international adjustment through free markets. Adjustment pains are borne less willingly, with the same result. Short run demands take precedence over long run objectives. All this bodes ill for the adjustment mechanism at fixed rates, and explains why it has been working increasingly poorly.

The Bretton Woods System and Inflation

Some rays of hope, however, are reflected by this picture even if the facts should not change. High rates of inflation would facilitate balance of payments adjustment if these inflation rates differ in the right direction. One of the difficulties of the classical adjustment mechanism has always been its implausible requirement that prices should fall in the deficit country. With inflation all around, this is no longer necessary.

If the deficit countries manage to reduce their inflation close to zero, as the United States did in the early sixties, payments adjustment comes within reach without rate changes. Even the United States balance of payments has shown that it can move toward large surpluses under such conditions, as in 1964.

There is also the possibility, which should not be underestimated, that countries may get their inflations under control. If lip service to the objective were any help, the outlook would be promising. There is indeed a real danger that from a decade of inflation the System's reformers may draw the wrong lessons. The world monetary system need not be one designed for permanent inflation. The appropriate system for that kind of world would be one of high, perhaps unlimited exchange rate flexibility. But such a system has high costs. To pay these costs would mean to overinsure against the consequences of inflation for international trade and finance.

Rate Changes in the System

In this regard, the defect of the Bretton Woods system as it operated of late, was that it underinsured against inflation. Rate changes were limited to fundamental disequilibrium. Countries were expected to make a strong effort to regain payments balance under fixed rates before throwing in the towel. This is appropriate to a world in which price stability is the rule, inflation the exception. In such a world, the normal expectation derived from a burst of inflation is that the country thereafter will make a special effort to return to the norm of price stability. In today's world, the normal expectation derived from a burst of inflation is that the country will allow inflation to continue, although at a lesser speed. The experience tends to be extrapolated, not reversed.

That the Bretton Woods System got into this impasse is not the fault of the founding fathers. They limited rate changes to fundamental disequilibrium, but nevertheless did not place them beyond the pale of ordinary policy action. Keynes personally, moreover, was much concerned with what he considered the proper sharing of the burden between deficit and surplus countries. What made the system more rigid even as mounting inflation increased the need for flexibility was the growing freedom of capital movements, especially short term. These made rate changes into worldshaking events, to be delayed as long as possible, and produced the inconsistent trinity alluded to earlier of fixed rates, free capital movements, and independent policies. Whether one regards this development as reflecting deficient policies in managing the system, or a defect of the system itself, it has led into a trap from which the world must now be extricated.

Capital Movements and Rate Changes

Greater ease to vary fixed rates, i.e. to adjust the peg, is not necessarily an effective device for correcting imbalances due to capital movements. Complete rate flexibility is, since it completely shields the domestic money supply against international flows. It does so, however, at the expense of possibly very wide rate movements, which in turn may tempt countries into "dirty floating."

Exchange rate movements do influence speculative flows. Once a rate has been established that the market regards as realistic, speculation diminishes. Interest-oriented short term flows, to the extent that they are covered, are controlled by the interaction of spot and forward rates. Uncovered short flows, and long term flows for which usually there is no cover, follow rates of return.

One of the views frequently heard during the 1960s was that American direct investment abroad was encouraged by an overvalued dollar. Bricks and mortar were cheaper in Europe; that is why American corporations bought them. It is too early to observe the lesson of 1971 on this score, but the underlying analysis is clearly wrong. What the foreign investor buys is a rate of return. If the currency unit in which he buys the foreign asset is cheap, so is the unit in which he earns his profit. A change in the exchange rate does not alter the relation between the number of units invested and the number of units earned. An exchange rate change may of course affect the earnings of the subsidiary and thus the rate of return. It may also—if it involves a depreciation of the dollar—make investment in the United States more attractive than investment abroad. But the basic fact is that the capital sector of the balance of payments responds in large part, not to exchange rate movements, but to interest rates. Once more it becomes evident that capital movements present a difficulty for the international monetary system for which neither the Bretton Woods version nor any other offers a wholly satisfactory solution.

Lags

One further lesson of experience deserves to be recorded. The exchange rate movements of the 1960s worked their influence on trade movements with a considerable lag. This is not surprising—the rechannelling of trade in response to prices is bound to take time. It does compare not very favorably with the experience of frequently very prompt responses to monetary and fiscal restraint with fixed rates. It also raises questions about how well, under a system of flexible rates, the market could foresee and speculatively establish equilibrium rates following some substantial disturbance in the world economy. Obviously a related difficulty attaches to discrete rate changes made under the Bretton Woods system.

The length of the lag may be affected by the way in which exchange rates move while the adjustment process is going on. The widening of the band may provide some surprises in this context. Given a rate change, it makes a great deal of difference for the country in question whether its currency, during the following year or two, is at the upper or lower edge of its band. The position of other countries within their bands can magnify—or reduce—that effect. Following the devaluation of the United States, the initial drop in the dollar to the lower edge may have helped the adjustment process. But if a renewed American boom were to raise interest rates in the United States, with an attendant reflow of short term funds, the dollar might move to the other edge. Clearly this could significantly affect the speed of the adjustment process. The wider band, however, is of major interest for other reasons as well and we now turn to this subject.

EXCHANGE RATES

Wider Bands

The first applied lessons of recent experience are those embodied in the wider band for currency fluctuations. The widening agreed on in December 1971 reflects the experience that the old band of 1.5 percent did not create enough of a risk for speculators and did not allow enough freedom for monetary policy.

The way in which the 4.5 percent band is to remedy these defects is familiar. Speculators face a higher risk when they sell a currency which, because it is at the lower edge of its band, can theoretically appreciate 4.5 percent instead of only 1.5 percent. This supposes, however, that there is a reasonable probability that the currency might indeed recover. If the realistic alternatives are devaluation or drawn out support near the lower edge of the band, the speculators' risk is not much enhanced.

Greater elbowroom for monetary policy is obtained from a wider band, provided spot and forward rates are reasonably free from speculative influences and free therefore to move to opposite edges of the band. The width of the band then marks the maximum interest rate differential between domestic and foreign financial markets, this differential diminishing as the maturity of the investment lengthens. The high cost of cover protects the central bank against capital flows, provided these movements are covered. If they are not, the wider band helps only in that it increases the risk inherent in this type of movement.

The widening of the band also fails to deal with the problem of trends in equilibrium rates. When a country persistently inflates more than others, or for some other reason suffers a progressive deterioration or improvement in its balance of payments, a change in parity will eventually be needed. All these familiar facts about bands deserve mention only because they help to clarify both the importance of the reform and its limitations.

Consensus on Limited Flexibility

Another step forward can be reported as a lesson both of experience and of fruitful discussion: the growing consensus on limited flexibility. Ten or fifteen years ago, a wide chasm separated the proponents of fixed and flexible rates. The fixed rate advocates hoped to eliminate even discrete rate changes, if necessary by closing an eye to fundamental disequilibrium and hoping it would go away. The flexible rate proponents saw no good in anything but total flexibility, from which all conceivable blessings would spring. This chasm has narrowed. Fixed rate advocates have come to realize that the notion of a one world system, integrated by fixed exchange rates, must be shelved for the time being at least. Flexibility advocates, whatever their theoretical convictions, seem to have accepted that full flexibility is not a realistic objective, at least as a first step. A broad consensus has developed on "limited flexibility" as a desirable form of behavior for exchange rates.

Limited flexibility may take various forms, and no doubt means different things to different people. The wider band and the crawling peg are both manifestations of limited flexibility. So is a system of parities varying by "small steps". Temporary floats, i.e. full flexibility for limited periods, might also rate as a form of limited flexibility. It goes without saying that, as between these different forms of limited flexibility, there still exist very sharp differences of opinion.

Inadequacy of Fundamental Disequilibrium

The reasons for the abandonment of the one world vision were examined in the previous section. They may be temporary—outgrowths of a wave of inflation that may subside—or they may prove permanent—if inflation continues, or differential productivity and growth trends cause payments imbalances even at stable prices. The immediate problem, however, that limited flexibility must deal with is a much narrower one. Given that rate changes are necessary from time to time, there is serious doubt that the Bretton Woods formula of "fundamental disequilibrium" is the proper guide for making them. Experience has shown that rate changes made after a fundamental disequilibrium has been reliably diagnosed are highly disruptive. The approach of a fundamental disequilibrium is plainly visible to the market. Speculation then takes over, and takes the decision out of the hands of the national authorities and of the IMF. This method of making rate changes has proved to be a serious defect of the Bretton Woods system.

The problem has been aggravated by governments' unwillingness to recognize a fundamental disequilibrium, and by the inability of the IMF, legal and practical, to press for rate changes. Governments' resistance to rate changes has piled errors of policy on top of the defects of the System. For both reasons, it is clear that a different method is needed. The big question is how to diagnose the need for rate changes before they become overdue, and how to get from one fixed rate to another without disruptive and costly speculation. I believe that experience points certain lessons here, and I shall try to explicate them at the end of this paper.

Selective Use of Fixed Rates

It may be noted that while some consensus has been reached on limited flexibility, the case for fixed rates has gained theoretical and political strength in a number of particular situations. The most striking case of a choice favoring fixed rates is that of the European Economic Community. Promising or not, a deliberate decision has been made to create the conditions in which fixed exchange rates can exist, on the basis of free capital movements and surrender of independent national policies. The belief in the integrating force of a single currency is the same as in the "one world" vision with fixed rates, although the "world" has been shrunk to a region. Smaller countries pegging their currencies to those of larger countries are another instance of a preference for the fixed rate option.

There are good theoretical reasons for the preference shown both by the EEC countries and by these others. Somewhere along the spectrum that runs from a single currency for the world to a separate currency for every province, town or village, each economic unit will find an optimum point. This point is not necessarily given by the frontiers within which a unified national economic policy is conducted. It can be defined by the area over which factors of production can move freely, or within which there is heavy dependence on reciprocal trade. It can also be defined by the choice to be made between optimum allocation of resources, which calls for integration of national economies, and optimum utilization of these resources, which calls for maximum compartmentalization of national resources and even local economies in order to conduct independent full employment policies appropriate to local conditions. The EEC countries seem to be choosing optimum allocation of resources, being prepared to sacrifice some of the benefits derivable from national employment policies. The developing countries and others that attach their currencies to those of their main trade partners do so presumably because of their close trade relations.

If these trends continue, a balance will be struck between fixity and flexibility in the System. The great majority of exchange rates will be fixed, and only a few major rates will require some degree of flexibility. It is not clear whether this combination deserves to be called a "system". Much of the policy effort today expended on dealing with international monetary relations will retreat into the less spectacular but no doubt equally thorny problems of maintaining stability within regions.

Devaluation Bias

These lessons of exchange rate experience still belong to the future. A different lesson, which reaches back far to the early postwar years, has to do with the overall trend of exchange rates. In the United States, the view is widely held that the dollar has been subject to an upward bias, because other currencies on balance have exhibited a devaluation bias. If there is such a downward trend, it is inevitable that the reserve currency should become overvalued. If true, this would indicate that the role of a reserve currency involves serious costs.

The evidence depends in part on whether one includes the widespread devaluations of 1949. But if they are excluded, it probably still remains true that devaluations have tended to be relatively frequent and large while revaluations were infrequent and cautious. Of course the overall trend of currencies could have been downward without making the dollar overvalued, if prices in the devaluing countries rose more than in the United States. The overvaluation of the dollar which was corrected or reduced in 1971 was the result of many factors. The devaluation bias of other currencies can account at most for part of it.

Even the fear of a devaluation bias, however, raises important questions for any system of limited flexibility. The opportunity for downward movements will be greater under such a system. The danger that a devaluation bias will manifest itself will be accordingly greater. This is one of the reasons for the insistent call for clear rules to govern a system of limited flexibility.

Floating

One of the most interesting currency experiencies of recent times has been the period of widespread floating of currencies in 1971. It practically cries out for lessons to be drawn. Unfortunately, any such lessons are bound to be highly controversial. For many reasons, which I shall list, the experience of the float and its aftermath seems to me to imply a highly adverse verdict on flexible rates. But I have not found proponents of flexible rates to share this interpretation. For each argument, there is a counterargument. The following are my observations, with the rebuttal stated as fairly as I can.

1) To the extent that floats were clean, they did not lead to equilibrium rates, because exchange markets were dominated by speculative capital movements of an often very short run character.

But: there is no evidence that the rates reached in the rare cases of clean floating were not equilibrium rates. Given time, the markets would find the right level.

2) Clean floats threatened to carry exchange rates to levels where export industries would have suffered disruption.

But: this is a questionable judgment that puts undue emphasis on temporary problems of particular industries.

3) Upward floats were undertaken, in many cases, not to reach new equilibrium exchange rates, but to regain control of monetary policy. This control, however, was not fully regained, because tight policies had to be modified when they threatened to drive national currencies too high.

But: This is the subjective judgment of central bankers which underestimates the ability of markets to make adjustments.

4) Currencies generally were not allowed to float cleanly, in order to avoid the dangers listed above. This meant controls over capital flows that eventually might have engulfed trade transactions.

But: This simply reflects the old fixed rate mentality and in some cases protectionism which in fact denied flexible rates a fair test.

5) Market reports indicated that the quality of markets deteriorated during the period of floating. In particular, forward facilities other than very short term, whose improvement is predicted by the flexible rates school, tended to deteriorate. Spreads widened and forward markets became less efficient.

But: There are some contrary reports of forward markets improving.

6) Market participants generally objected to floating.

But: Some market participants said they could get on very well with floating rates and preferred them to periodic crises.

7) Monetary authorities so disliked floating rates and were so concerned about the controls to which they might lead that in the end they decided to repeg to a dollar that had become *de jure* inconvertible.

But: This was a mistake, as demonstrated by the subsequent instability of exchange markets and the downward float of the pound.

Evidently it is too early to draw firm conclusions from the experience of floating. In a future world monetary system floats might play various roles. At one extreme, floating might be the normal condition of some national currencies or currency blocs, which would be the case of a perfectly flexible rates system. At another, it might be a means, limited in duration, of moving from one exchange rate to another without prejudging the new rate by official action. An in between function would be a temporary float designed to recover control over the money supply, during periods of large international interest rate differentials.

Competitive Depreciation

A very dangerous use of floats would be their employment for anticyclical purposes. The Bretton Woods System was designed to prevent competitive depreciation, which had been discernible during the interwar period. "Fundamental disequilibrium" means more than just a cyclical disequilibrium. The same danger of anticyclical misuse is inherent, of course, in altering exchange rates by "small steps". In the latter case, the rules of the System, presumptive or binding, could be designed to guard against misuse. It would be more difficult to devise such rules once floating had been sanctioned within the System as a legitimate technique.

LIQUIDITY

Concentrated discussion of the defects of the international payments system began more than a decade ago with the "Triffin Dilemma." The supply of international liquidity was seen to depend heavily on the deficit in the American balance of payments. Attainment of equilibrium by the United States would shut off a large part of the increase in reserves. A continued deficit on the other hand, would weaken the reserve position of the dollar. To make the supply of liquidity dependent upon the American balance of payments was in any event a haphazard system.

The Dollar Standard

As things have worked out, the branch of the dilemma along which events moved was not a worldwide reserve shortage, but excessive reserve creation. The weakening of the dollar took the peculiar form of ultimate inconvertibility accompanied by the conversion of the gold-dollar standard into a pure dollar standard. The conclusion widely drawn from the experience remained unchanged: the creation of reserves had to be put on a more systematic basis, and the role of the dollar had to be reduced.

An effort to give practical content to this conclusion had been made once before, through the creation of Special Drawing Rights (SDR). This move reflected, however, fear of a liquidity shortage. Today the move for reform reflects the opposite, with the aggravating circumstance that the system is widely believed to have bestowed excessive advantages upon the United States.

A contrary view is that the system could be made to work adequately, both as a source of liquidity and in apportioning benefits. Since the United States, under the dollar standard, cannot freely determine its own exchange rate, other countries can regulate, by adjusting their own exchange rate, the volume of reserves to be created through American deficits. If the American deficit were kept in line with world liquidity needs, the special benefits enjoyed by the United States would also be kept under control. There would exist an asymmetry in the system acceptable to both sides: the United States would forego control of its exchange rate but receive financing of deficits at going American rates, while other countries would have control of their balance of payments and of the volume of liquidity created.

In addition to adjusting exchange rates, however, other countries would have to make one further adjustment: they would have to keep interest rates in line with American rates, if flows of dollars to and from the United States were to be kept to a level consistent with the needed supply of reserves. The United States could voluntarily share in this process of adjusting interest rates, in contrast to its inability to adjust exchange rates. But under the dollar standard the United States would be under no pressure to do so.

The dollar standard, if operated in this way, would be workable.

Would it be acceptable? Adjusting an exchange rate, especially upwards, is onerous. A country may do it when its surplus is the result of its own policies. When the surplus is the result of American inflation, willingness diminishes. American deflation would also pose problems.

The cost of adjusting interest rates may be less, because few countries can conduct an independent monetary policy under any monetary system. This at least is true so long as exchange rates are fixed and capital movements are not fully controlled. But the adjustment may have to be more frequent, and the role of the United States in the process even more irritating.

Evidently the workability of the System relies heavily on the domestic policies of the United States. These policies, while aimed at domestic objectives, must also achieve satisfactory international results. At the time of Bretton Woods, with the unemployment of the 1930s a recent memory, it was frequently said that domestic full employment was the principal contribution to be made by the United States to world stability. Evidently this was not enough. The United States must also maintain price stability to make the Bretton Woods System, as it evolved into the dollar standard, internationally attractive. These two objectives the United States can be expected to pursue in its own self interest. Except for the years of inflation during the Vietnam war, the United States has not acquitted itself badly. But hardly anyone would argue that the United States should also maintain stable interest rates. International coordination would be the most that could be expected.

The abstract discussion of the dollar standard, however, has been relegated to the background by concrete experience. What might have been acceptable at one time is not acceptable now. The lesson the world has drawn from the experience of the last few years is that the dollar standard is very costly. The defects of the system have been magnified by inappropriate policies. In addition, the non-economic issue of sovereignty has been raised. Is it feasible to allow one country so much influence in the world economy, circumscribed though that influence may be by the control that others have over the rate of the dollar?

Special Drawing Rights

The United States gave its answer to this question by promoting and helping to enact the SDR scheme. The action made clear that the United States did not consider the dollar as the appropriate sole source of additional reserves. A curious inversion of apparent interests and views ensued. The United States, although increasingly concerned about the willingness of foreign central banks to hold dollars, was promoting a plan that was bound to reduce the demand for dollars. Given a limited demand for reserves in the world, the SDR was a competitor of the dollar for room in the portfolios of central banks. A wing of opinion in the United States that favored a world dollar standard protested against the issuance of SDR in large amounts.

Monetary authorities in other countries viewed the matter differently. They were concerned mainly with the immediate increase in liquidity resulting from SDR allocation. They were less than enthusiastic, therefore, about an action the ultimate result of which should have been to cut back the role of the dollar.

The crisis of 1971 rekindled interest in the SDR. Suddenly it was widely recognized for what it had been all along: a substitute for the dollar. Thus an impulse was given to numerous plans proposing to put SDR in place of the dollar in its various roles as international unit of account, official intervention currency, and reserve medium.

Consolidating Reserve Assets

Concern with liquidity was stimulated by the events of 1971 in several other ways. Given large official holdings of dollars in many parts of the world, how could the United States earn reserve assets when its balance of payments went into surplus? The prospect was that many countries would use dollars rather than gold or SDR to meet deficits. This problem illustrates the asymmetry of the dollar standard from another angle: the United States may experience no gain in reserves, and no monetary expansion, when it is in surplus.

This American dilemma, combined with concern about excess liquidity and the desire to reduce the role of the dollar, gave rise to proposals for funding official dollar liabilities. Plans for consolidating reserve assets and reducing shifts among them attracted renewed interest. Typically, however, these plans were predicated on the full convertibility of the dollar on one side and willingness of monetary authorities to dispose of their gold holding at the equivalent of $38 per ounce. That both conditions involved difficulties was a lesson of the events of 1971 that hardly needed re-emphasizing.

Gold

Gold, though increasingly less useful in international settlements and in this sense approaching demonetization, remained a brooding presence in the background. Once more, as in previous crises, the events of 1971 seemed to confirm the role of gold as an ultimate fallback position. If efforts to negotiate a new international monetary system should fail, if in some crisis national or international credit instruments should cease to be universally acceptable, world-wide belief in the "intrinsic value" of gold, now buttressed by mounting industrial demand, might again restore gold as the basic world money.

CONVERTIBILITY AND THE DOLLAR

Asymmetry of the System

The events of 1971 have brought the world to the clear realization that a different international monetary system is needed. Dissatisfaction had long been building up on the side of both the surplus countries and the United States, the principal deficit country. One of the changes desired on many sides is a reduced role of the dollar, which was aimed at but not achieved with the creation of the SDR mechanism. In many quarters, this reduced role is seen in the form of convertibility of the dollar into reserve assets, payment by the United States in reserve assets for any deficit, and displacement of the dollar by other reserve assets, presumably SDR, in central bank reserves.

All this adds up to greater symmetry in the world monetary system. It is worth remembering that the asymmetry that developed within the system was not programmed into the Bretton Woods structure. The Bretton Woods System, except for its reliance on the dollar as a unit of account, treated the smallest developing country virtually as it did the United States. Differences in size and wealth were recognized mainly by giving countries in weaker positions certain options. That the United States tied the dollar to gold while other countries tied their currencies to the dollar was made possible but not required by the System.

The United States government, in fact, supported the creation of the Bretton Woods System over the protests of a group of economists and bankers who would have preferred the "key currencies approach". This approach, evidently reflecting a more realistic understanding of world finance, eventually found informal expression in the evolution of the Bretton Woods System towards a gold-dollar standard and ultimately a dollar standard.

Uses of the Dollar

The use of the dollar in its various roles proved to have considerable advantages for the world. If central banks are not to operate mainly in gold, an intervention currency is needed. World trade and finance can operate more cheaply, in many cases, if conducted in a single currency. The cost to multinational firms of holding liquid balances can be minimized by holding them in a single currency. Raising capital in international markets is cheaper in a single currency than in several national currencies. The development of the Eurodollar market reflects the economies of operating in dollars.

The use of the dollar as a reserve currency was a natural consequence and complement of its other functions. The move to reduce the role of the dollar following the events of 1971, is directed primarily against the reserve currency function. To eliminate that role, the dollar would have to be made fully convertible into other reserve assets. There is a real question, however, whether the United States could carry the burden of full convertibility so long as the rest of the world employs the dollar freely for its own transactions. For this use means that many transactions which are only remotely connected with the U.S. economy and the U.S. balance of payments can lead to the acquisition of dollars by foreign central banks and consequent demands upon the United States to convert.

The United States as a Reserve Currency Country

An examination of the structure of the American economy shows that the dollar in many ways is not particularly suited to play the international role it does. The United States, like the ideal automobile, is big inside, small outside. Its international economic interests are not large enough to justify subordinating to them its domestic level of output and employment. An effort, moreover, to equilibrate the balance of payments at the expense of the domestic economy runs into exceptionally high costs. It is one of the facts of international economics that the cost of equilibrating international payments stands in inverse relation to the gains from doing so. For small countries, the cost is low, the gain is large. For the United States, the inverse is true.

Its relatively small international trade and its large GNP and its consequent high volume of total savings predestine the United States to the role of an international investor rather than trader. Only very inept policies have been able to obscure this basic structural fact. In this character, the dollar can better perform the functions of a reserve currency. But for many reasons, an investment currency encounters more difficulties around the world than a trading currency. A country with large foreign trade, particularly if it habitually has a trade deficit covered by other earnings, can influence economic conditions elsewhere. It also finds it worthwhile to adjust its domestic economy to the needs of its balance of payments. This was the case of England and the sterling standard during the 19th Century. Britain was a big trader as well as a big lender, an essential structural difference. In today's world, moreover, the lot of the big lender or investor is a less happy one than during the 19th century. The dollar therefore is less well suited to the role of international money than was its predecessor, the pound.

Obstacles to Convertibility

These difficulties have been intensified by the decline in the American share in world trade since the war. American trade means less to the world, but this trade still does not mean significantly more than before to the United States. The structure of the American economy, therefore, raises questions as to the ability of the United States to make the dollar fully convertible, and also about its interest in doing so. Earlier in this paper, the difficulty of reconciling free capital movements and an independent monetary policy with fixed exchange rates was examined. For the United States, under a convertible dollar standard, this takes the form of an inconsistency between free capital movements, an independent monetary policy and a convertible dollar. To control the current account of the balance of payments, as it should be, is difficult enough for the United States. Capital movements, however, particularly short term, take place in dollars among so many countries, for so many purposes, and in such amounts, as to seriously threaten convertibility. The United States would have to possess enormous reserves, or unconditionally available credit facilities, to handle this kind of convertibility without disturbance to its domestic economy.

To achieve some degree of influence over the domestic economy of the United States is of course precisely the purpose of a convertible dollar. Convertibility has a double meaning—market convertibility, and asset convertibility. The dollar has never lost market convertibility, thanks to the fact that other countries have kept their currencies convertible into dollars. The preservation of market convertibility has been the reason why the world has been able to go through a great financial crisis without major damage to trade. For this, of course, the dollar deserves no particular credit.

What the dollar has lost, and what in the view of many is to be restored, is asset convertibility. Foreign central banks holding dollars are to be able to exchange them for reserve assets. This obligation is to prevent a recurrence of the events leading up to the crisis of 1971. The United States is to keep outflows of dollars within the limit of its ability to convert them. The analysis presented above concerning the magnitude of these flows, and concerning the means available and the cost to the United States of employing them, raises questions about the feasibility of a fully convertible dollar.

The dollar, to be sure, has been convertible throughout its long career. But an examination of American monetary history since the inception of an independent monetary policy, i.e. since the creation of the Federal Reserve System in 1913, will show that thanks to a series of historical accidents the dollar has almost always been able to operate from strength. This was true during the 1920s, essentially a post World War I reconstruction period. It was true during most of the 1930s, following the devaluation of the dollar by about 70 per cent against gold. It was true again during the post World War II reconstruction period. The only major historic instance when monetary policy was used drastically to support a weakening dollar was in 1931, following the devaluation of the pound. The Federal Reserve's shift to tighter money in the face of heavy gold losses drove down the price of bonds and caused the collapse of many banks already weakened by the Depression. It has been severely criticized as a major mistake of the Federal Reserve System. Devaluation followed shortly. History, therefore, provides no positive evidence that a structurally weak dollar can be kept convertible.

U.S. Interest in Convertibility

The United States, nevertheless, is by no means without reasons for being interested in a convertible dollar. An economy of its size has little to gain from the ability, such as it is, to draw freely on the resources of the world. This is particularly true when the net inflow of resources disrupts markets and produces protectionist pressure with attendant political problems. The effort that the United States made to obtain the world's consent for dollar devaluation reflects American recognition of those facts. The United States is strongly interested in obtaining control over the exchange rate of the dollar. This it can only do if the dollar is convertible in some degree. It can then influence that rate at which the dollar is to be exchanged for foreign currencies and possibly SDRs.

A solution could be found by establishing a partial convertibility, related perhaps to the current or the basic account of the balance of payments. There is no particular reason to expect either of these accounts to show a deficit once the devaluation has worked itself out and the United States has further reduced its inflation. Bilateral deficits presumably could be cleared in the market, or via the IMF, against bilateral surpluses, so that only a net deficit would have to be converted. If a net deficit arises, convertibility obligations would go into effect. This would leave uncovered, however, those dollars received by other countries through capital movements, especially short term. Conceivably these could be covered by maintenance of value clauses, in terms of the creditor country's currency, or of SDRs, or of some index of purchasing power.

Partial convertibility would leave open the question mentioned earlier: how the United States could earn reserve assets from a current or basic surplus so long as dollars from other sources are at large in the world. It would also leave open the question of how payments by the United States in reserve assets would be allocated among other countries, many of which would have dollar receipts from various sources. These are difficult technical problems which, however, could be given technical solutions, possibly with the help of the IMF, if the principle can be agreed upon.

Funding

It is often assumed that funding of the present dollar overhang would make convertibility possible. Funding of all existing official dollar obligations, however, is not easy to visualize, since some countries may have a pronounced preference for dollars as a reserve asset. Furthermore, dollars now in the hands of non-official holders could always be shifted to official holders and thus give rise to demands for conversion. The Eurodollar market, which can create dollars independently of the U.S. balance of payments, could at least indirectly contribute to conversion demands by official holders. And beyond all these difficulties there is the fact that the United States is a reserve-poor country in a world disinclined to let it run the large surpluses needed to accumulate adequate reserves. The experience of Britain in 1947, pushed into premature and unsustainable convertibility by the United States, is a warning example.

RATE CHANGES BY SMALL STEPS

The coming reform of the international monetary system will cover a wide range of issues, all interrelated. I have elsewhere presented my views as to the principal features and requirements of a workable system.[1] At this point I would like to conclude my review of the lessons of 1971 by applying some of those lessons to a limited problem that nevertheless is close to the core of whatever reform is to be attempted. This is the exchange rate regime that is to replace the system of rate changes, in practice excessively delayed and excessively disruptive, that has been guided by the rules of "fundamental disequilibrium."

Requirements

We may take for granted that innovations in the international exchange rate regime will be made only with great caution. Much is at stake, errors could be very damaging. It seems clear, therefore, that the

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[1] "The Shrinking Economic Base of U.S. Leadership," in *National Strategy In A Decade Of Change,* a symposium cosponsored by Stanford Research Institute and Foreign Policy Research Institute, February 18, 1972.

system must progress in an evolutionary way, rather than by quantum jumps, and that some of the bolder inventions such as the crawling peg should be ruled out.

Our problem is how to get from one set of exchange rates to another whole avoiding the pitfalls encountered in the past such as excessive delay in making changes, excessively large movements, and heavy speculation in anticipation of large movements.

There are additional pitfalls that may beset a reformed regime, such as speculation in anticipation of small movements expected with a high degree of certainty, and inconsistent rate changes which could result if the United States were to take independent direct action to determine the dollar rate through attempts at parity changes or through market intervention.

In the past, governments have jealously guarded their right to control the parity of their currency. The Smithsonian negotiation however has brought home the obvious fact that the parity of any one country is a point in a vacuum, of little economic meaning when numerous other countries are changing their parities. What matters is the effective exchange rate, an average of all other rates weighted so as to reflect the role of each country in the international economy or with particular trade partners.

General Features of the Regime

The following proposal starts with the fact that, in a system of small changes, the effective rate will be a more important variable than the par value or the central rate of a currency. Under the existing Bretton Woods regime, a country cannot determine its effective rate, because that depends on the parity changes of other countries as well as its own. In addition, a country's ability to determine its own parity or central rate is circumscribed by making parity changes subject to the existence of a fundamental disequilibrium and to the approval of the IMF. To maintain its effective rate constant, for instance, a country would have to change its parity every time any other country moved its parity. Thus, a partial or qualified control of its effective rate will be as valuable to a country as is the degree of control over its parity under the Bretton Woods system.

The more fully one country insists on determining its own effective rate, the more difficult it makes this for others. If a large number of important countries were to insist on achieving particular effective rates, while some others were passive, the latter might find their own effective rates moving in an extreme direction. For instance, if the countries of Europe, acting individually, desired effective rates that put a high value on each individual currency, this could be accomplished only by putting a very low value on the Dollar and the Yen. If all countries were to specify some single effective rate, the chances are that the resulting rate structure would be inconsistent, unless laborious negotiations had brought them to agree on a set of consistent rates.

It follows that a system that emphasizes effective rates must provide some leeway in the rates that countries are prepared to accept. The wider the leeway that any one country will tolerate, the easier it will be for others to achieve the effective rates they seek. There will be less of a tendency, then, for a parity change on the part of one country to be partly neutralized by a parity change on the part of another.

Emphasis on effective rates does not imply abandonment of parities or central rates. Given the parities of other countries, any country can express its own desired effective rate in terms of a parity with respect to whatever standard of value is generally employed—gold, dollars, or SDR. Parity rates, therefore, would remain the financial yardstick of the system.

The need for a degree of leeway, or a range, and the use of such ranges as the basis for an exchange regime, has been analyzed by Fred Hirsch. In Hirsch's framework, the IMF sets the range within which parities can be altered, and countries are free to alter their parities within those ranges. For reasons that will become apparent, I prefer an approach different from Hirsch's. Either approach, however, makes clear that the concept of a range, applied to parities or to effective rates, is a fruitful one.

Under the regime established by the Smithsonian agreement, there are two levels of exchange rate determination. The monetary authorities of the participating countries, by mutual agreement, have established their respective central rates. The equilibrium mechanism of the exchange market then determines the actual rate within the band of 2¼ percent on either side of the parity (unless there is intervention within the band.) We may refer to the first decision as the major one, a kind of rough-tuning, the second as the minor one or fine-tuning. In shifting from emphasis on parities to emphasis on effective rates, a third level of exchange rate determination becomes necessary. This is the determination of the range within which the effective rate should be allowed to vary.[1] This is a major decision, a profoundly political one. It should be reserved to the national authorities. Few countries would want to delegate it to an international body. If it were so delegated, the international body, in practice the IMF, would find itself in a position of having to make decisions gravely affecting its members and therefore in constant danger of conflict with these members.

This major decision on rates once more takes care of the function of rough-tuning. At the second level, a decision is needed where within the specified range the effective exchange rate (derived from parities, not market rates) is to fall. This is a fine-tuning decision. It can well be made by the IMF. Conflicts with members are defused because the Fund would only choose among rates previously authorized by the respective members.

Leaving the fine-tuning of effective rates to the IMF offers a number of advantages. In the first place, it would make sure that rate changes do get accomplished. Experience indicates that the politics, if not the economics, of exchange rate variation tend to bias national authorities toward inaction. This inertia can be overcome by placing the initiative, within limits specified by national authorities, in the hands of the IMF.

In the second place, the IMF probably has a better chance of so scaling and timing rate change as to minimize speculation. It can do this

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[1] To clarify the discussion, the following concepts should be kept in mind:

1. the effective exchange rate, i.e. the weighted composite value of all other currencies in terms of each country's own currency, based on their parities or central rates;
2. the range, i.e. the outer limits within which a country is prepared to allow its effective exchange rate to be varied by the action of the IMF or of other countries;
3. the parity or central rate of each currency in terms of some numeraire, such as SDR, dollars, or gold;
4. the band around this parity or central rate, now of a total width of 4½ percent;
5. the market rate for each currency, which must fall within the band.

by making the movements small, and by making them at irregular intervals. The movements should be larger, however, than those typically envisaged by a crawling peg scheme, and considerably less frequent. A guide to the proper size of effective rate movements, implemented through the appropriate parity changes, would be that parity changes should be small enough so that the spot rate in the market continues to lie within the band of 2¼ percent around parity. In addition, parity changes should be made, if possible, while the spot rate in the market is at some distance from the upper or lower intervention point. These two provisions would tend to reduce the impact of a parity change on the market rate. The optimal result, a parity change with no impact on the market rate, is unlikely to be achieved. But the impact can perhaps be made sufficiently small to discourage speculation in anticipation of a parity change.

A third reason for leaving the fine-tuning function to the IMF is the need to avoid inconsistent parity movements. Depending on what pivot or peg for parities is employed, these could occur if individual countries simultaneously altered their parities, and particularly if the United States were to engage in an active policy of parity changes.

A fourth reason is the desirability of avoiding the use of parity changes for anticyclical purposes. This danger become acute if countries are in a position to make frequent small changes in their parities. Placing the function with the IMF forestalls this.

Finally, the IMF can be instructed, if the members so desire, to maintain a balance between devaluations and revaluations. This would go some way toward resolving the problem of sharing the burden of adjustment between surplus and deficit countries.

The IMF, in this system, is not an independent authority controlling the world's exchange rates. It is more nearly in the position of a stock exchange specialist who has a book of orders giving him a certain amount of discretion, and who determines a price on the basis of certain rules. National authorities should be all the more willing to leave this amount of discretion to the IMF because, by accepting the present wider band, they have already indicated that they are willing to tolerate exchange rate movements larger than in the past.

The IMF would act on the basis of indicators, commonly referred to as presumptive rules. Various kinds of rules have been extensively examined. The indicators include spot exchange rates, exchange reserves, the current account of balances of payments, price movements, interest rates and others. They may include indicators of domestic economic conditions, but reliance on the latter implies some risk that cyclical factors may influence unduly the determination of exchange rates and encourage competitive devaluation or possibly perverse appreciation.

In addition to the fine-tuning of parities by the IMF, the present fine-tuning of spot rates by the market would of course continue. Conceivably, if parity changes were to become frequent and cumulatively substantial, a compensating reduction in the width of the band around parity would again become desirable.

The major decisions that national authorities make about the range of their effective rates would have to be reviewed from time to time. Else the leeway allowed to the IMF would be whittled away as particular countries' effective rates approach the upper or lower limit of the range. The degree to which other countries' effective rates could be changed in the opposite direction would then become constrained. Ultimately all flexibility in one direction could be lost. The IMF could inform particular countries when such a condition was approaching. Alternatively, a high level conference analogous to the Smithsonian meeting, convened periodically or ad hoc, could negotiate new ranges. These meetings would be the proper place also for decisions on how to allocate adjustment burdens.

New ranges declared by the participating countries would almost certainly leak to the market if they were not made public. The prospect of changes in ranges will therefore become an occasion of speculation. A change in the range of a country's currency, however, does not imply immediate action by the IMF to change effective rates, and a change in effective rates (based on parities) does not necessarily imply immediate changes in market rates. Thus, speculation induced by the mechanics of the system, as contrasted with speculation induced by visible weakness or strength of a currency, may be held to a minimum by appropriate timing of the various steps.

The system could contain rules specifying a minimum range to be declared. They would prevent some countries from declaring a very narrow range, which would nullify the rate-setting role of the IMF and destroy the flexibility of the plan.

The number of countries participating presumably would be quite limited. A majority of developing countries may prefer to continue to peg their currency to a single major currency, in which case the effective rate of that currency would also determine their own. The EEC countries, if they operate as a group, would have to specify ranges consistent with their intra-EEC arrangements.

Briefly then, the principal operative provisions would be:

(a) Participating countries would communicate to the IMF a range within which they would be prepared to see their effective rate, as derived from parities or central rates, varied by the IMF.

(b) Countries would revise the range from time to time.

(c) The IMF would adjust effective rates within the ranges given to it, in accordance with specified presumptive rules.

(d) The changes made by the IMF should occur at irregular intervals; they should be small enough to keep the spot rate from falling outside the band around newly established parities, and should be made, if possible, while the spot rate is within rather than at one of the edges of the band.

(e) Spot rates would be maintained within a band around parity by intervention of national authorities.

The proposed exchange rate regime, in short, leaves major decisions concerning exchange rates to national authorities, delegates minor decisions to the IMF, and thereby seeks to achieve prompt rate changes, consistent rate movements, protection against anticyclical misuse of rate changes, and a reduction of speculation.

Such a system, I believe, could help to solve the dilemma implicit in most variable peg systems, in which inertia, conflict of rates, and speculation threaten to interfere with smooth adjustment until no way out is left except floating. Not the least advantage is that the system would lend itself to extended periods of rate stability. Even though governments might allow leeway for rate changes, the IMF, in conditions of national price stability, might find no basis for international rate changes. As time went on, the market's growing expectation of continuing rate stability would make it worthwhile to avoid changes and thereby strengthen renascent confidence in the rate, the most desirable solution would probably have been achieved.

The Monetary Crisis of 1971— The Lessons To Be Learned

by Henry C. Wallich

There follows the text of the oral presentation by Professor Wallich on this subject. The text of his written paper begins on page 3.

Ladies and gentlemen, you have the paper and, as Randy Burgess has said, I do not have anything to change in it.

It contains a great deal more than I can say here, and if perchance I should not refer to something that later Jeremy Morse might say I said, he is quite right, I will have said it in the paper.

I would also like to say that as far as the reference in the programme to my relationship to the Treasury is concerned, any resemblance of my views to those of the Treasury is purely coincidental. I am sure you recognize that I am just a professor at Yale and speaking as such.

It is a great honor to speak here on this occasion, and give a lecture that bears this distinguished name. Per Jacobsson played a leading role in the first phase of monetary reconstruction. The heritage that he left us will stand us in good stead as we go into another phase of reconstruction.

Everybody, I think, is agreed that a crisis occurred, in the international financial system—we read it every day—and so I found it quite hard to free my thinking from that hypnotic belief.

What we have seen in 1971 was certainly a very serious crisis, but the real breakdown of the system, I think, occurred before and was quite another one. Some of us, by no means all, thought of this system as a one-world, stable exchange rate world; we thought that exchange rate changes would be increasingly the exception and stability the rule. Well, this happy dream of one financial world has been destroyed by inflation. Perhaps it could not have survived even without inflation. That, I think, has been the real breakdown. We have now had to resign ourselves to frequent rate changes. That is the most dramatic lesson of 1971 and that lesson really originated earlier.

As for the crisis itself, I shall not try to describe it. You have all lived through it and I am sure remember it painfully. It has nevertheless done surprisingly little damage. This is either a compliment to the financial managers or evidence that finance and the real sector of the economy are not quite as closely related as we would like to think.

But certainly there is widespead agreement that reform is needed and that the events of 1971 point a lesson. The lesson can be couched in terms both of the defects of the old system, of poor policies pursued both in administering that system and also in the domestic sphere, and of the world trends that made survival of the system difficult.

I shall begin with a defect of the system as it appears to me which became particularly apparent in the late '60s. In the paper I have referred to it as the "inconsistent trinity"—the effort to have fixed exchange rates, free capital movements and independent monetary policy, all at the same time.

You can see that this may not work when you recall that such a system really is a one currency area. Free capital movements, stable currencies also exist inside the United States. When the Federal Reserve System was established, the founding fathers did think they could have one discount rate in Chicago and another in New York, i.e., monetary policies differing regionally. They learned this does not work. In the international sphere we have the same problem, although controls offset short term capital movements and the bands around parities work as a kind of offset. The three objectives are not consistent.

In 1969-1971, we ran into this inconsistency with great virulence. When very high interest rates occurred in the U.S., money flowed to the U.S. Then interest rates came down in the U.S. and money flowed out. At that point the system broke down. With this kind of free movement of capital, independent monetary policy is inconsistent at fixed exchange rates, as we have seen.

How do we deal with this dilemma? We can have any of the following combinations: We can have free capital movements and fixed exchange rates, but then we have to coordinate monetary policy and give up our independent domestic monetary policy. Or we can have fixed exchange rates and independent monetary policy; then we have got to control short-term capital movements and, in the long run, perhaps more than that. Or we can have independent monetary policy and free capital movements, but then we have got to give up fixed exchange rates.

In practice, I suspect we are going to yield a little on each. Right now it looks as though central bankers were picking up the option of limiting the freedom of short-term capital movements. We have also limited the fixity of exchange rates by widening the band, and as a matter of history, monetary policies often are adjusted in a way that implies voluntary, if not systematic, coordination.

On all three fronts, therefore, compromises are likely. In that way I would think this difficulty can be solved.

Recent experience would have been fruitless only if we did not recognize that there is this fundamental difficulty with which every monetary system has to come to grips.

We have had lessons also on the adjustment mechanism in the balance of payments. Fortunately, here one can announce one point of universal agreement. Everybody is agreed that the mechanism has worked poorly. The adjustment mechanism has let us down, even though quite surreptitiously we have made a change in assumptions. We used to talk about the adjustment mechanism with fixed rates. Then we really did not see how it could work. Now we are talking implicitly about an adjustment mechanism with variable rates. That indeed is more promising.

We have found ourselves embroiled in the debate over burden sharing. Who is to share the burden of balance of payments adjustment? Should the surplus countries participate, or should the deficit countries alone put their house in order? My impression is that both sides are quite right in their differing views. It all depends on circumstances. When a small country has a large payments deficit, the rest of the world cannot share the burden by inflating to help it out. The small country will have to put its house in order.

When a group of large countries is in deficit and another group of large countries is in surplus, then burden sharing becomes more meaningful. But again, if the deficit is concentrated and the surpluses are widely spread around so that no country is in very substantial surplus, there is a different burden sharing problem than when the deficit countries make up one group and the surplus countries make up a clearly definable small counter group.

There is another circumstance that needs to be observed, namely, whether the country with the imbalance faces a so-called dilemma or not. No dilemma exists when a country, say, has an over-heated inflationary economy and simultaneously a payments deficit. In that case what it needs to do to restore domestic stability is exactly what it needs to do to attain balance of payments stability. Thus there is no harm in letting the burden of adjustment fall on this deficit country. A dilemma exists when a country has unemployment and a payments deficit at the same time. Then whatever it does to cure its payments deficit worsens its unemployment. Whatever it does to remove the unemployment worsens the balance of payments. Under such conditions burden sharing seems to be appropriate.

The year 1971 has brought some further lessons which are among the least understand of the whole experience. In making a balance of payments adjustment, the relation of cost and benefit to the adjusting country depends very heavily on the size of the country and on the share of exports and imports in that country's GNP. A country where that share is large has a great interest in balance of payments equilibrium. The benefits of adjustment therefore are great. At the same time the adjustment process is relatively easy when a large part of GNP is spent on imports. For instance, when imports account for one-half of GNP, reducing the payments deficit by one dollar calls for a reduction of GNP, and therefore employment, by the equivalent of only two dollars.

For a country with only a small foreign sector, balance of payments equilibrium is not all that compelling. The benefit from achieving adjustment is relatively small. On the other hand, the cost of reaching adjustment at fixed rates is very high. When a country spends only, say 1/20 of its GNP on imports, it must reduce this GNP by a multiple of 20 in order to reduce imports by one dollar. Benefit and costs are inversely related, as you look at the spectrum of countries from those having a large trade sector to those with a small trade sector. This is a structural fact that in international debates does not always seem to be fully observed.

We have had a further lesson concerning the adjustment process. That lesson deals with the works of inflation. Inflation is the basic factor that destroyed all hopes of reaching a one-world, one-fixed exchange rate system. I would not say for that reason that we should build a new system geared wholly to inflation. We ought to regard inflation as an aberration of which we hopefully can rid ourselves. On the other hand, it is by no means sure that we will succeed. Therefore the new system, I am afraid, will have to be capable of accommodating inflation.

Next, the year 1971 has taught us something about exchange rates. Here economists have come to some kind of agreement, surprising as that may seem to some of you. Ten years ago we were bitterly divided. There were the flexible rates people and there were the fixed rates people and there was nothing in between. Now we have all agreed more or less on limited flexibility. We cannot have perfect stability, and we cannot have perfect flexibility. So we talk about what is feasible and that is some form of limited flexibility. The wider band is one version of limited flexibility. It suffers from one defect, that when a currency reaches the edge of the band, flexibility has run out. Then there needs to be a mechanism for moving the band. I will have some suggestions to make in a minute for that mechanism.

In the United States there has developed a belief that the system contains a devaluation bias which causes the dollar to become over-valued. If one adds up all the devaluations that have taken place since World War II, one finds that they are numerous and large. When one adds up the revaluations that have taken place, one finds that they were not so numerous and not so large. If that trend, which is understandable, continues, then any numeraire will find itself over-valued. If there is a key currency in the system, it will become over-valued; that probably was one of the things that happened to the dollar.

Now I come to the exchange rate experience that derives from the brief history of floating rates. In my opinion, which is controverted by many, the floating period of 1971 was an unmitigated disaster. There are many reasons I could give. You may say that one good reason is enough. None of these reasons is uncontested and it may turn out that I am wrong. Let me just list my reasons and leave it to the floaters to refute them.

First, we found that clean floats do not lead to equilibrium. Currencies can be carried beyond the equilibrium point.

We found that clean floats can hurt export industries precisely because they can go above the equilibrium level.

We found that when a clean float is undertaken with the intention of regaining freedom for monetary policy, i.e., by not monetizing the balance of payments surplus, a country can resume restraining monetary policies. This, however, may lead the currency to such high levels that the authorities are compelled to re-peg and so to resume monetizing dollars or whatever is flowing in, thereby losing their freedom of monetary policy.

As a result of these circumstances, most floats have been dirty, to use a term coined by Professor Schiller. I am told by some of my banker friends that the forward market, at least for maturities of more than three to six months, deteriorated. I am told, by some of them at least, that the markets disliked floating. I have no doubt at all that the authorities disliked floating, because they put an end to it.

I stand ready to defend my views on this issue, and I turn now to the next lesson of 1971, which has to do with liquidity creation. If there had been any doubt in anybody's mind, I should suppose it has been proved now that the dollar standard is capable of generating excessive liquidity. The question is whether the dollar standard can be handled in any other way. If the answer is yes, there is the further question whether one would want to make the necessary arrangements. If countries were prepared to revalue as soon as they had enough reserves through trade, or were prepared to lower their interest rates as soon as they had enough reserves through capital inflows, they then could limit the volume of reserve creation under the dollar standard. I doubt that countries would be very enthusiastic about this arrangement. If it is not acceptable, then the dollar standard is revealed to have defects that require correction.

Fortunately, we have the SDR. I think it is fair to say that until very recently, the SDR was a much misunderstood instrument. The United States, which had some sort of an interest in maintaining a world demand for dollars, pushed the creation of SDRs, although the SDR is a competitor of the dollar, for space in the portfolios of central banks. Meanwhile the world's central banks, which had some interest in not acquiring excessive amounts of dollars, nevertheless objected to large-scale SDR creation, although that would have cut back the volume of dollars that the U.S. could, so to speak, have placed.

Today, everybody has noticed the virtues of the SDR. It is a potential successor to the dollar. The means of liquidity creation, as a major feature of the new system, are already there in our hands. We have already taken this important step.

That leads me to the last of the lessons of 1971, before I come to make a positive suggestion. This lesson has to do with convertibility. There are two kinds of convertibility. Market convertibility, thanks to the good sense of central bankers around the world, has been well preserved in these difficult days. Asset convertibility, which is what is meant when one talks about the dollar, has been stripped from the dollar. Market convertibility for the dollar and other convertible currencies exists today thanks to the action of non-American monetary authorities. Asset convertibility is not needed for market convertibility, but it is needed in order to control the volume of dollar creation in the international system.

When one considers the problem of convertibility for the United States, one observes that the U.S. is not a country well suited to the role of a reserve currency country. The U.S. is not a big trader. Its exports and imports are four percent to five percent of GNP. This is very unlike the U.K. in the nineteenth century. The U.K. was a big trader and could make the sterling standard stick that way. The U.S., on the other hand, while not a big trader, is a country with a large GNP, and therefore with large savings. By virtue of this structure, it is naturally a big international investor. In that way the U.S. might support a key currency. But where the big trader is popular, particularly when he runs a trade deficit as the British did in the nineteeenth century, an international investor is not unconditionally popular. Hence his power to supply capital may not be a good means of supporting a reserve currency role.

For the time being, however, the dollar is stuck with the role of a vehicle currency. So long as that is the case, it is difficult to see how the U.S. could have enough reserves to make good on all of the demands for conversion that could come from operations quite unrelated to the American balance of payments. When money flows from Frankfurt to Paris or vice versa, that can give rise to conversion demands on the U.S. Interest rates somewhere in the world go up, money flows, and again conversion demands could descend upon the U.S. Even the Eurodollar market, which also creates dollars, could indirectly contribute to conversion demands. Under those conditions, the U.S. would have to have enormous reserves in order to make the dollar unconditionally convertible.

Now the U.S. does, I think, have a genuine interest in some degree of convertibility. The U.S. would like, or should want, to obtain some control over its exchange rate, such as other countries have. This would be easier to do backed by a degree of convertibility of the dollar. So long as the dollar is wholly inconvertible, as now, the U.S. has not even a handle for getting control of its exchange rate; it depends wholly on the decision of others. Some partial convertibility, conversion of some fraction of our deficit, if there is one, is something that the U.S. ought to consider. This could perhaps be done through the IMF, so that any reserve assets the U.S. would make available would be fairly distributed.

Very quickly let me suggest where I think we stand. I have laid down my views on the ideal international monetary system elsewhere and I will not take up your time with it here. I think a surprising number of the components of a new system are already in place. We have after all only three major areas to deal with: One is reserve management, another the payments regime, third is the exchange rate regime. That's what an international payments system conists of.

For reserve management we have SDRs, and we need control of dollar reserve creation. For the payments regime, the Bretton Woods prescriptions are perfectly sound; be as convertible as you can, control capital movement if you must.

The foreign exchange rate regime is the difficult point. We know what we want, we do not quite know how to get it. What we want is exchange rate changes that are timely, rather than too late as they usually have been until now. We want exchange rate changes that, when they have to come, do not cause disruption as they have until now. We want exchange rate changes that can not be taken advantage of by speculators and therefore cause magnified flows. We also want to see exchange rate changes conducted in such a way that we do not suffer conflicting market intervention, one country wanting to push its currency up, another trying to push the same currency down. And finally we want to be sure that exchange rate changes are not misused for anticyclical purposes. All this is easy to prescribe and very difficult to do.

As a possible handle on the problem, I suggest that we might try the following:

First, let us stop thinking in terms of parities and begin to think in terms of effective rates. The effective exchange rate for each country is based on the parities of all other currencies, weighted by their trade. Such effective exchange rates have been computed since August 15 for many countries.

Next, let each country communicate to the IMF a range for its effective rate, say five percent. Within its particular range, each country would be willing to see its effective rate modified by changes in the parities of other countries as well as its own. This I would call rough tuning, by setting a range. The fine tuning, where exactly within this range the effective exchange rates would come to be established would be decided by the IMF. The IMF could modify all parities within these limits. Its power would be sharply circumscribed, and it could not act contrary to the intentions of countries. But it could, by its fine tuning of parities, avoid a good many of the dangers of exchange rate movements. It could act in a timely way, without the familiar delays. It could engage in small parity movements, sufficiently small so that a change always would fall within the band. Such small parity changes would not necessarily lead to an equivalent change in market rates. It could inject a sufficient element of uncertainty and surprise into these parity changes to obviate speculation. The IMF could also avoid conflicts of intervention and it could avoid misuse of parity changes for anti-cyclical purposes.

This division of labor, the rough tuning done by the countries and the fine tuning by the IMF, strikes me as politically acceptable and economically promising. It could be sufficiently promising so that, if we have no inflation and if everything else in the world goes well, parity changes might become increasingly less frequent. And, if the market doesn't expect changes, then we would have equilibrating capital movements and changes will become increasingly less necessary. If we all manage our domestic affairs properly, it may even turn out that we can get to that one world of fixed exchange rates which I certainly would like to see.

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MR. BURGESS: Thank you very much, Henry, for leaving us with that optimistic note. As you went ahead and simplified these matters, it almost sounded as though a solution was possibly in sight.

The two other speakers will now have a chance to unsimplify what Henry laid out before you, and I will call first on Mr. Jeremy Morse of the Bank of England,

Commentaries

by C. J. Morse and I. G. Patel

Following Professor Wallich's presentation, commentaries were offered by Mr. C. J. Morse and Dr. I. G. Patel. The text of their statements follows on this page and on page 59.

MR. C. J. MORSE: I too am very honored to take part in this meeting under the name of Per Jacobsson, a great man whom I never met, but of whom I have heard so much.

We are asked to comment on Mr. Wallich. If you put together all he has in his written paper and what he added to it this afternoon, I think it is very difficult to comment on him. He said so much, very little of which I would seriously dissent from. But, rather than follow up small disagreements, I would like to pick out three things which he said, two of them in his speech today and one in his paper, which seemed to me, from observing and taking part in some of the events of the 1971 crisis, to be particularly important, and to expand them a little.

As Henry Wallich has shown, the seeds of the 1971 crisis were planted over a long span of earlier years. But the crisis itself, which lasted from August 15th to December 18th of last year, was the sort from which lessons should be drawable. In that time the underlying trends of the international monetary system were made plain to a wider public than the small group of ministers, officials, bankers and journalists which habitually follows them; and the crisis did not either dwindle away into insignificance or lead to a general mind-defeating disintegration, but was instead brought—at least in its most immediate sense—to a solution. A period of disorder, reflecting real conflicts and tensions in our semi-international world, was closed by the Smithsonian bargain; and the Smithsonian communiqué looked both to the completion of that bargain and to a more fundamental reform.

The first and most comprehensive lesson of the 1971 crisis is that the prolonged post-war phase of super-dominance of the United States and of the U.S. dollar has come to an end. This lesson was stated forcefully during the crisis by Mr. Connally at international meetings and to the American public, and was brought home to the world when the President of the United States announced from the Azores that he was ready to devalue the dollar. Americans who called for some of the burden to be shifted from the dollar and those in other countries who called for a move away from the dollar standard could both accept a formulation that pointed to less asymmetry between currencies in future. Symmetry between currencies, as Mr. Wallich has rightly said, was part of the design of the Bretton Woods system. It was always a weakness of that design that the scarce currency clause did nothing to reinforce the relatively modest economic pressures for adjustment by surplus countries. But, on the other side, the way in which the system has been overshadowed by American super-dominance is strikingly illustrated by the fact that there were experts who claimed, almost up to the moment when it was done, not merely that it would be destabilising for the dollar to be devalued but that it was not possible within the system.

The crisis of 1971, then, was a watershed for the U.S. dollar. To this some object that 1972 is not so different after all. At the beginning of the crisis the finance ministers of the E.E.C. rejected the idea of establishing a gold bloc, and the subsequent European attempt to construct a scheme of narrower margins with intervention in European currencies and some settlement in non-dollar assets has been interrupted. At the end of the crisis the major countries were willing to refix on the dollar and have since accepted inconvertible dollars at the upper limit. But these facts are evidences not that the dollar standards is immutable but that it will, in the natural course of things, be changed only slowly. When one crosses a watershed, the terrain does not immediately change; but the important difference is that the rivers are flowing in a new direction, in this case away from the super-dominance of the dollar. Though the European scheme may not at first succeed, the attempt to construct it is significant. So is the fact that a number of sterling area countries, which were glad in 1968 to have from the United Kingdom a guarantee in dollar terms, would now rather have one in terms of some other asset. So is the fact that a number of oil-producing countries no longer want their contracts with the international oil companies to be expressed in dollar terms. Where before there was largely the dollar, now we hear talk of the S.D.R., the yen, the D-mark, the Europa, the bag of currencies, the bag of commodities, gold.

Still, a great reserve currency is a sort of empire, and as such cannot be run down quickly, at least not without chaos. A slow retreat from the dollar standard would be both natural, as I have said, and desirable. I also think it likely. It could happen that, at some point before the dollar standard had disappeared, the retreat might be arrested, or even reversed, by a striking improvement in U.S. competitivity; and it is also possible, as certain gloomy predictions would have it, that the retreat may be rapid. But I believe that, if short-term fluctuations are ignored, the relative performance of countries does not change quickly. So, over the longer run, putting in one balance the United States' slightly below-average growth rate and the modest bias in the system against the key currency, and in the other balance the United States' slightly better-than-average cost performance, I judge that the dollar should continue to weaken, but only slowly, in its key currency role: which implies, given the United States' economic size, not only a slow but a long retreat.

In the meantime, it is in the post-war tradition of planning, which is well rooted in international monetary affairs, that we should be developing some other reserve base to retreat to. This might be another national currency, or even a regional currency such as the Europa—and unfashionable though the idea of a European reserve currency is in official quarters, there is obviously a significant trace of it in the movement for European monetary integration. Since, however, the fragility of reserve currencies has been doubly demonstrated in the dollar and sterling, many people feel that the new reserve base should be a neutral asset, such as might be developed out of the S.D.R. It is also generally recognised that a new reserve base cannot be built in a day, and that it is therefore urgent to get on with it now, not only to demonstrate our strategy but because its full development, like the retreat from the dollar standard, will take time.

In this perspective, and given the relative brevity of many human enterprises including governments, the tactics of the retreat are likely to be as important for the good functioning of the international system and the maintenance of world trade as is the strategic choice of the alternative reserve asset system to which we move. Under the head of tactics I would put such topical questions as consolidation of existing dollar balances, limitation of new dollar balances arising in future, reduction of the asymmetry involved in the special position of the dollar, and restoration of convertibility. How and over what time these are achieved will be of the first importance. Equally important will be the roles of the countries and international institutions concerned: will the United States take initiatives or wait to be pushed by the holders of dollars; will the impetus die away when the dollar is temporarily strong; will there be cooperation or antagonism?

On these last points the crisis offered some preliminary indications. For instance, the United States acted boldly to open up the issues, but then left it to the I.M.F. and to other countries to suggest both immediate and longer-term solutions. This pattern may repeat itself over the years ahead. Given that the United States faces a great variety of dollar-holding countries, many of them sophisticated, it is not going to be easy to determine where the initiative will or should lie. Again, the particular form of confrontation produced by the Group of Ten was manifestly irksome to the United States during the crisis. So there were antagonisms within the Group of Ten, and also elsewhere—between the United States and the I.M.F., between the third world and the Group of Ten. But most of these were based, as I have said, on real conflicts and tensions. On the other side, there were encouraging signs that the strength of international cooperation is by no means spent. The machinery of international meetings kept moving, and last year's annual meeting in Washington in particular provided the opportunity for a massive exchange of views and pressures on the main issues of the crisis. The new slogan of "a one-world system" was promulgated and generally adopted. Finally the immediate crisis was resolved in little more than four months—to the surprise, as M. Giscard d'Estaing had predicted, of most commentators.

I have drawn, and elaborated, my first lesson in the reserve asset field, not because—as some think—it is a British obsession but because it was here that the 1971 crisis marked a turning-point or watershed and has pointed us towards a correspondingly clear objective. Very different is it in the other main area of difficulty, that of the adjustment process and more particularly the exchange rate regime. There we continue, as we did unsuccessfully before, to search for a place on the slippery scale between too much fixity and too much flexibility of exchange rates, a place on which we can stand with recovered confidence. It is evident that the progressive integration of commerce and finance, spearheaded by international companies and banks, has created, especially since the general resumption of convertibility in 1958, a weight of short-term capital movements which pushes the system towards floating. But it is also evident—and this is the second main lesson I draw from the crisis—that there remains a strong antipathy to floating among governments and officials and also, though less universally, in the business world.

It was generally accepted from the Group of Ten meeting in London onwards that the right first step to solve the crisis was to achieve a realignment of currencies in which the United States would obtain an effective devaluation sufficient for them to remove their import surcharge; and it was assumed, almost without argument, that the realignment should be marked and as it were ratified by a general refixing. Of course there were in most countries advisers and commentators who advocated continuing floating, and of course governments weighed the arguments for and against. But no Governor of the I.M.F. at last year's annual meeting spoke out against a realignment with refixing, and many argued vigorously for it. In the later negotiations, although some governments were dissatisfied with the rates which others proposed for their currencies, and although Canada asked to remain floating for a while longer, no country objected to the principle of refixing. When the realignment was agreed in December, it was greeted with general relief both inside and outside the official world, a relief not less genuine because it later proved to be short-lived. Nor did the simultaneous adoption of slightly wider margins, sensible though it may have been in itself, imply a different attitude; for this was thrown into the bargain—and knocked down at 2¼%—as a political compromise rather than an economic judgment.

What were the reasons for this antipathy to floating and attachment to the principle of fixed rates? They seem to lie in the experience of the past forty years. The development of international cooperation since Bretton Woods has gone along with a great expansion of world trade and the avoidance of another world war. This cooperation, valued for itself as well as for its accompaniments, has been set in the framework of a fixed rate system, with the result that it is not easy to dissociate the two. The cumbrous phrase "the adjustment process" expresses the philosophy that nations can and should, by changing or defending their exchange rates, live together in economic peace. Behind this satisfaction with the post-war experience lie darker memories of the thirties, and a belief that it was in revulsion against the trade restriction and competitive depreciation which accompanied the floating rates of the thirties that the founders of the Bretton Woods system chose fixed rates. The U.S. import surcharge, which may have been intended to be no more than a bargaining counter, struck a highly resonant chord in this memory of the thirties. The result was that other arguments for refixing, including the justified preference of developing countries for a reasonable degree of stability in major currencies, were carried forward on a wave of almost instinctive feeling that to refix would help to sustain an international cooperation which was threatened by the antagonisms shown in the crisis and that since trade restrictions go with floating rates the removal of trade restrictions should go with a return to fixed rates.

This latter proposition is probably less valid than the former. For if the crisis evoked responses conditioned by the thirties, it also exhibited some important differences from that era. I have already mentioned the emphasis on international cooperation: what was the utopian vision of earlier times has become the accepted thing in the age of jet and telex. There is also the fundamental switch from deflation to inflation in the western world. In keeping with both these changes, one of the ugly features of the thirties, the immediate resort to trade restriction in the face of balance of payments difficulties, seems to have been largely exorcised. Whatever fears the U.S. import surcharge may have aroused, it did not in fact lead to any significant retaliation. Indeed we have come out of the crisis with the major countries committed to another review of the more fundamental barriers to world trade. On the other hand, the third and last main lesson I draw from the crisis is that we have not yet succeeded in exorcising competitive depreciation, or—to put it in its modern guise—the desire to maintain undervalued exchange rates.

No doubt everyone who followed the crisis closely could quote examples from his own country of the tendency to advocate competitive depreciation which was unleashed when rates generally began to float. As the pattern of the likely realignment emerged, the revaluing countries, principally Japan and Germany, were reluctant to go as far as was necessary; of the three countries which were cast to make no effective change, France, Italy and the United Kingdom, each could find arguments why it alone should have a small net devaluation; and the United States, as chief devaluer, was continually on the watch against dirty floating by others. The *locus classicus* in which the depreciatory tendencies of these and other countries were brought together and convincingly demonstrated was the meeting of O.E.C.D.'s Working Party No. 3 in Paris in October.

This meeting was convened at the request of the Group of Ten to assess more precisely how big the U.S. imbalance was and how its counterpart should be distributed among the other major nations. As part of the arithmetic, the member countries of the working party were asked to say what current account position (excluding official transfers), surplus or deficit, they would expect to have in 1972, and also what position they would like to have. When the answers were added together it turned out that the aggregate surplus these countries expected in 1972 was of the order of $5 billion whereas the aggregate surplus they would like to have was of the order of $16 billion. Now the aggregate current surplus of these countries has been a fairly constant magnitude in recent years, no doubt partly because it reflects a corresponding aggregate deficit on current account for the rest of the world and that deficit cannot vary sharply without creating severe problems of debt and even bankruptcy. This aggregate was about $10 billion in 1971 and is likely to be much the same in 1972. Compare this with the two figures emerging from the working party's discussion, and it is plain that those countries as a group were excessively gloomy in their balance of payments expectations and excessively ambitious in their balance of payments aims. The size of the excess was no doubt exaggerated by the fact that the countries concerned were engaged in a negotiation and were represented at this meeting only by officials, but the trend to depreciation was unmistakable.

Once the crisis had exposed this trend, one could see that it had been running like an underground river through the twenty-five years of the Bretton Woods system, generally suppressed by the acceptance of fixed rates but manifesting itself occasionally to the observant eye and helping in the end to undermine the U.S. dollar. For it is this which has underlain the bias in the system whereby, as Mr. Wallich says, devaluations have tended to be relatively frequent and large, while revaluations were infrequent and cautious and, if the important but plainly untypical British devaluation of 1967 is excepted, devaluations have tended to be prompter, too.

Devaluation bias is an old problem, which has been much discussed by economists. The pressures to adjust are not equal or symmetrical for surplus and deficit countries. Reserves can be run up without limit, but to run them down to nil is to be bankrupt. Bankruptcy can be avoided by borrowing, but it is one of the growing pains of what I have called our semi-international world that, while more such credit—and in more forms—is available than ever before, governments do not like the increased inspection and surveillance that goes with it. Also, exporters have become a strong lobby in many countries since the war. In resisting revaluation or welcoming devaluation they can legitimately plead the employment they provide, and they do so to governments who are generally more concerned to maintain employment than they were in the thirties.

Another telltale sign, which I have already mentioned, is the large aggregate surplus on current account consistently maintained over recent years by the developed countries. Recently this has been mitigated by the U.S. deficit. But as the devaluation of the dollar takes effect and the current account of the United States begins to improve, will the other developed nations be willing to accept the corresponding deterioration for themselves? Or will they resist it, and so either partly frustrate the United States or impose an increased deficit on the third world? There is a danger here that it is prudent to recognise. And more generally, in the reform of the system, it would be prudent to recognise the underlying trend that gives rise to the danger, and to make better provision for it than was made at Bretton Woods. This is why two of the most crucial, and appropriate, issues for the Committee of Twenty should be the reconciliation of balance of payments aims and a fair sharing of the burden between surplus and deficit countries.

So, to draw my three lessons together, it is likely that in the next two decades we will move away from the dollar standard to some new reserve base; this will be better done by international cooperation, and the general reaction in the crisis was to feel that to this end we should keep some sort of fixed rate system; if so, the justification may lie in the need to control a recurrent tendency to maintain undervalued exchange rates, for which effective provision should be made in the forthcoming reform.

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MR. BURGESS: Thank you very much, Mr. Morse. You have disposed of what one might call the political aspects of this program and I assure you that those of us who are Americans are glad to hear somebody from over the water bringing out this point so vigorously.

Now we move to Dr. Patel whom we have associated in times past with the monetary policies of India, but who is going to be nearer to us in the coming year when he takes office as Deputy Administrator of the UN Development Program. We are very glad to hear from Dr. Patel.

DR. I. G. PATEL: First of all, Mr. Chairman, like Professor Wallich and Mr. Morse before me, I would also like to pay my tribute to Per Jacobsson. Some of you perhaps know that for three years, 1958 to 1961, I had the privilege of being a member of the International Monetary Fund Board when it was presided over by Per Jacobsson; and my wife and I were privileged at that time to receive a great deal of warmth and affection from this extraordinary man. It is, therefore, a matter of particular pleasure and pride to be called upon to assosciate myself with this token of tribute to his memory.

There are essentially two ways in which we can draw lessons from the monetary events of 1971. In a larger sense, we can treat the year 1971 as a sort of watershed where the international monetary system that had evolved over a quarter of a century after Bretton Woods took a decisive new turn. The lessons of 1971, then, would cover the entire field of the functioning and reform of the international monetary system. This is clearly how Professor Wallich, and to some extent, Mr. Morse, have chosen to interpret their mandate. For my part, however, I would like to focus first rather narrowly on what actually happened in 1971. For one thing, it is by no means certain yet that 1971 would be really that much of a watershed year. Even if it is, the central question of fundamental reform is already on the agenda of the Fund; and I at any rate do not feel any urge to deliver myself of all I may have to say on the subject so early in the game. On the other hand, pointing the searchlight at what actually took place in 1971 has, I think, important lessons to offer, particularly in regard to the process of decision-making which may not be altogether irrelevant irrespective of whether or not there is a brand new Bretton Woods in the making at present. But being the third speaker with the last word, as it were, I would also like, Mr. Chairman, to have my say, I hope briefly, on some of the more glamorous topics such as adjustment of exchange rates and convertibility.

The Events of 1971

The main events of 1971 were obviously two—suspension of convertibility and the realignment of parities. One can even say that realignment was the only significant event and that the suspension of convertibility was really a non-event in the sense that even prior to August, 1971, the right to convert was hardly really exercised as a matter of course.

In fact, it is possible to argue, that contrary to what is often said, the Bretton Woods system was not asymmetrical or inequitable in regard to the privilege enjoyed by different members in obtaining finance for their payments deficits. It was the non-exercise by and large of the right of conversion of dollars into gold by other countries which really created the dollar exchange standard and the consequent asymmetry.

Apparently, whatever may be the aesthetic virtue of symmetrical rights and obligations, the world had long realized that when it comes to the disciplining of major powers, it cannot be done by a routine or automatic application of rules of the kind which would bring them instantly to a halt so to speak in the pursuit of their national objectives. The suspension of convertibility was thus a mere formalization of what was already in existence informally and would in any case have been tacitly agreed to if proposed by the United States.

Be that as it may, it is, I think, clear that the United States decision to suspend convertibility was essentially a sort of invitation to other major currencies to seek a new relationship with the United States dollar.

The more substantive development of 1971 was certainly the realignment of parities which came to be enshrined in the Smithsonian agreement. But it is equally significant to note that this realignment of parities did not take place in the most natural or normal or economical way in terms of the need to take decisions. Normally, when a country comes to realize that its exchange rate is out of line, it proposes a change in its own parity. If the United States had proposed such a change to $38 or even $40 an ounce, the rest of the world including the I.M.F. would have accepted it readily. 1971 would then have been just another year like 1958 when the French franc was devalued or like 1967 when the pound sterling was devalued.

What was set in motion instead was a prolonged bargaining process involving a number of countries which were all invited to contribute towards an improvement of a certain order in the United States balance of payments or towards a certain overall depreciation of the United States dollar which was in fact notified at the outset through the 10 percent surcharge on imports.

Now I am aware, Mr. Chairman, that there are people who suggest that the realignment of parities that occurred in 1971 was the result of scientific calculations made in the Fund about how much the value of each major currency needed to be changed in relation to the other. Not having access to the calculations, one cannot be sure how far this is true—and, if true, how scientific the calculations really were. But the fact that the average devaluation of the dollar in terms of the major currencies turned out to be the same 10 percent as was heralded in the import surcharge plus the fact that some parts of the Smithsonian package, like the rate for sterling, came apart rather soon would lend weight to the feeling that the realignment was more an exercise in collective bargaining than in objective economic forecasting.

If this version of Rashomon or the elephant and the three blind men bears at least a reasonable resemblance to reality, what are the lessons we can draw from it?

The Process of Decision-Making

First and foremost, Mr. Chairman, the events of 1971 are I think a timely reminder that international monetary cooperation is essentially a matter of reconciling conflicting national objectives and this conflict, when it relates to major powers, can seldom be resolved by laying down certain precise rules of the game. Nothing can be more naive than to imagine that since the Bretton Woods system is supposed to have failed, all we need to do is to devise a new system with new rules. While a reform of the system may be and indeed is necessary and has, in fact, to be a continuing process, it is not the system alone but also the manner in which it is worked from day-to-day with an implicit or explicit process of negotiation or give and take among the major partners which can really deliver the goods.

This should have been fairly obvious for a long time as what finally collapsed in 1971 was not the Bretton Woods system but the patchwork that came to be evolved over the fifties and the sixties in deference to the wishes or the interests of a few major countries. The original Bretton Woods system was a finely calibrated one with a remarkable balance it sought to maintain between different objectives or between the rights and obligations of different members or between different remedial measures. Thus it recognized that each country must have adequate freedom to pursue its national objectives without being constantly overwhelmed by balance of payment difficulties; at the same time, the right to get finance for covering deficits was not unlimited for any member. As already mentioned, this symmetrical position got altered long before 1971 as no one would really dare involve the United States in an immediate financial crisis. On the other hand, paradoxically, the rights of automatic finance for members were further circumscribed by new rules and procedures which had little or no sanction in the Articles of Agreement, e.g., by policy decisions on the precise discipline to be followed when a member draws on the Fund the equivalent of successive tranches of its quota.

The way in which the system was overburdened by insisting on freedom of capital movements and the manner in which the technique of the scarce currency clause was disregarded as a means of sharing the burden of adjustment equitably between surplus and deficit countries illustrate further how no system can long remain immune from the twists and turns which its strong members would like to give to it. Here again, it is noteworthy that the same richer members which were generally in favor of freedom of capital movements were not prepared to carry this to logical conclusion. Thus, for example, the advocacy of freedom for capital movements did not extend to untying of official aid or even to unrestricted freedom for other monetary authorities to hold their reserves in any major currency they like.

While we cannot dismiss the reality of unequal power and influence from the international monetary scene, the fact remains that we cannot allow the decision-making process to degenerate into periodic bargaining among whoever happen to be the largest members of a community. Apart from anything else, decisions reached in an atmosphere of crisis—and with emotional and political overtones which cannot be avoided when more or less equal parties negotiate in a sort of open arena—cannot always be rational and are apt to include some irrelevant, if not ill-advised, elements. We all, I am sure, have our own pet ideas about the rightness or wrongness of the many things that happened in 1971. For my part, I would classify the original import-surcharge of 10 percent as ill-advised, the decision to include the United Kingdom and perhaps some other countries in addition to Germany and Japan as candidates for appreciation vis-a-vis the dollar as not so well considered, and the insistence on a change in the gold parity of the dollar as somewhat redundant at least economically once the straight-forward path of just devaluing the currency in need of adjustment most was discarded. The point, however, is not whether any of these assertions are necessarily valid, but that these issues became sufficiently controversial to leave a rather long trail of dust behind.

What then is a practicable middle course which recognizes the need for great power accommodation, negotiation and even bargaining and yet keeps their combined or conflicting vested interest from vitiating the objectives of the system as a whole? I do not pretend that I have any definite or precise answers. But I think the question does deserve to be discussed and answered.

I like to think that one of the main reasons why all major decisions regarding international monetary problems should be taken in the International Monetary Fund and not in any limited forum is that it is only by the active participation of comparatively disinterested smaller members and of the Fund management and staff that prompt and rational decisions are at all likely to be taken on important issues. The newly set-up Committee of Twenty should concern itself not only with specific issues of monetary reform but should convert itself soon into a sort of Standing Committee for informal consultation on important issues as they arise from time to time.

One of the major defects of the present system of decision-making in the Fund has been that mere contacts at the level of Executive Directors are not enough for establishing the kind of rapport that is necessary among policy makers from all parts of the world. The format and functioning of the Annual Meetings of Governors have not been such as to overcome this difficulty. Perhaps the meetings of the Committee of Twenty and of their Deputies could be so structured as to provide this much-needed forum for informal contacts and discussion on a continuing basis.

The process of arriving at a consensus on important issues would also be greatly facilitated if the policy-makers could be brought into greater personal contacts with the large number of academic and other persons who have devoted so much of their time to a consideration of basic monetary issues. There is perhaps no area of practical international cooperation which has benefited as much from the attention of the academics as this area of international monetary cooperation. Attempts have been made in the past to bring the academics, the members of the Fund staff and decision-makers from selected countries together; and having participated in some of these highly cross-fertilizing gatherings, I can say with confidence that if the Per Jacobsson Foundation is looking for some alternative format for its annual tribute, it can do no better than arrange every year—preferably away from the Annual meeting—an informal get-together of the kind I have suggested with a somewhat loose agenda covering more than one topic of current or prospective interest.

There is scope also for more informal and closer contacts between the Fund management and staff on the one hand and the highest policy-making authorities in important countries on the other. Whether this can be done best by changes in the present method of consultations with Article VIII countries or in any other way is more than I can say. Perhaps in matters like this, while it is easy to note the need, there can be no standard prescriptions which would work in all possible concatenation of circumstances, including above all the juxtaposition of different kinds of personalities. But it is well to remember that international monetary cooperation is a rather fragile substance which requires the support of many intangible factors if it is not to explode into an unnecessary crisis from time to time. In this connection, the story that Per Jacobsson was so fond of telling about how he finally persuaded General DeGaulle to devalue the French franc in 1958 is perhaps worth recalling. "Napoleon introduced a franc which served the needs of France for a hundred years. You, my General, have now a chance to give France a new franc which can stand the test of time for the next hundred years." This kind of touch has also to be there somewhere in the picture.

So much for the lessons of 1971 as far as the process of decision-making is concerned. May I now turn to some of those glossier titles like Adjustment of Exchange Rates where I hope I will have some comments to make on what Professor Wallich and Mr. Morse have already placed before you.

Adjustment of Exchange Rates

Perhaps the most difficult problem in international monetary cooperation is the determination of the extent to which exchange rate changes are necessary from time to time. One might be inclined to think that we have become a little wiser in this regard after 1971. But I am afraid it is difficult to share this optimism. I have already said, Mr. Chairman, that it is not easy to accept the claim, for reasons already hinted at, that the Fund acquired experience in 1971 of evolving scientific and objective criteria for determining appropriate exchange relationships between major currencies and that this experience was already reflected in the Smithsonian agreement. One has also the apprehension that excessive preoccupation with objective and precise criteria in this field will lead to pseudo-quantitative theorising of the kind with which we are already too familiar. Much of the worldly wisdom on inflation today centers on the quantity theory of money; and one shudders to think that the purchasing power parity theory might acquire the same preeminence in the determination of exchange rates. By all means let us have a good deal of discussion on how to go about deciding on appropriate exchange rate relationships between major currencies. But let us not jump to the conclusion—unless more evidence is produced than we have today—that some definite progress in this direction was made in 1971.

Much the same I think is true of the experience with floating rates in 1971 and with wider margins after December, 1971. A brief period of floating rates is supposed to help in establishing realistic rates. Wider margins are expected to help in reducing speculative capital flows and thus to facilitate orderly changes in exchange rates in small steps. Both these propositions have obviously a grain of truth; and it would be certainly a great step forward if some automatic or semi-automatic procedure for making small but not necessarily frequent changes in major exchange rates could be devised. But I am inclined to agree with Professor Wallich that recent experience with floating rates or wider margins is not so conclusive and requires at any rate a more detailed analysis of our experience so far before we can generalize on the practical usefulness of these two devices in arriving at more appropriate changes in exchange rates. Professor Wallich's own suggestion at the end of his remarks did not convince me instantly, so to speak. But maybe I have not sized up all the nuances of his suggestion. Perhaps all one can say with confidence is that exchange rate policy like all economic policy is a matter of trial and error and successive approximations to truth so that while one can and must be sure of the direction in which change is necessary, it is always desirable to retain a degree of skepticism regarding the magnitude of the change.

To me, the most important lesson to be drawn from 1971 in regard to exchange rate policy is that almost imperceptibly we have now entered a new era in which competitive devaluation is once again a real danger to watch out for. I think Mr. Morse shares this view—although perhaps for different reasons. Whatever may have been the truth in oft-repeated statements about the bias in favour of over-valued exchange rates—incidentally, the charge really has been that there is generally a bias in favour of not making a change in exchange rates irrespective of whether they were overvalued or undervalued and irrespective of whether there was any intrinsic difficulty for the United States in changing its exchange rates on its own—the fact remains that the United States was able to shake off its inhibitions with considerable ease. The forbidden fruit has now been tasted by all and the world is not likely to be the same again.

One of the most significant parts of Professor Wallich's analysis is the attempt to show that a country like the United States with a relatively small proportion of GNP entering foreign trade would find it very difficult to adjust its balance of payments through adjustment of income or demand levels and would, therefore, presumably be inclined to opt for a change in exchange rate unless it had continued access to financing facilities. Apart from the fact that there are many countries, including my own, which have a low proportion of foreign trade to GNP, this claim for a special dispensation is not likely to be overlooked by others who would also try to avoid income adjustments by resorting instead more frequently to exchange rate changes. Already, the psychology—and I think it is a misguided psychology—that freedom to vary exchange rates more frequently somehow enables a country to pursue its national objectives in a more unfettered way is gaining ground. But the central problem in the adjustment process for a country in deficit is to moderate its national ambitions (unless it can persuade others to finance the deficit). That being the case, before one accepts the need for a country to devalue its currency, it is all the more important to inquire whether it should not instead—or at least in addition—seek adjustment through measures which operate on incomes and demand. At any rate, it is difficult to avoid the feeling that the era of resistance to exchange rate changes has yielded place to one in which governments are likely to accept too readily that adjustment of exchange rates will save them from many unpopular decisions at home. Even speculative capital movements can be summoned into existence by a mere whisper to justify what is desired. In such a climate, a response from the Fund or the international community that any offer to devalue is so rare that it should be accepted without question like a gift-horse would provide only one more illustration of how often institutions respond to problems of the day in the light of their memory of days gone by.

Convertibility

On the question of convertibility, Mr. Chairman, Professor Wallich's suggestion that there are special reasons why the full rigours of asset convertibility should not be insisted upon may not be convincing—and is not at any rate convincing to me. It can be argued that the United States is not all that unique as Professor Wallich would seem to suggest. Nevertheless, it is I think necessary to be clear about what is really sought to be achieved by insisting on restoring convertibility—some day and to some extent—of dollars into other reserve assets such as gold and SDR's. This is obviously going to be one of the most difficult questions to settle during the forthcoming discussions on international monetary reform; and it is not my intention to suggest any rigid or final position on such a complex and controversial subject. But I think there are some questions that at least need to be answered or at any rate borne in mind in the consideration of this problem of convertibility.

First of all, does not the experience of 1971 remind us that no great power really places its vital national interests and objectives at the mercy entirely of any fixed rules? What guarantee is there then that any new rules of convertibility will not be set aside in future with or without the tacit approval of others? If the only force that can discipline the great is moral force or the power of public opinion, why make such a fetish of symmetry in rules when in real life there is no such ultimate parity among unequal partners? Would it not be better instead for the smaller members to suggest that since no precise limits can be put in practice on the extent to which the big powers can obtain finance from each other more or less automatically for covering their deficits, the financing facilities available to the weaker members should also be liberalised? It is I think a moot point that when so many things about the monetary system are questioned today, no one has yet questioned the wisdom or the validity of the policies that started in the fifties and grew in the sixties regarding the discipline to be imposed on smaller members when they come to borrow successive tranches of their quota. It is very much to be hoped that any discussion on symmetrical treatment of all members would include an examination of these practices so that in the name of formal symmetry a more far-reaching asymmetry is not perpetuated.

One has also got to ask if insistence on convertibility does not land us into other kinds of problems. Thus the United States becomes inveterately opposed to any suggestion which might reduce in absolute terms its share in any SDR creation as it feels that someday, to meet its hitherto undefined convertibility obligations, it may need every SDR it can legitimately lay claim upon. At any rate, it is at least worth considering seriously whether a check on the United States running unduly large deficits cannot be exercised by means other than a formal restoration of convertibility and whether a less moralistic and more pragmatic approach to symmetry may not serve better the interests—if not the amour propre—of the majority of the Fund's members.

Developing Countries

Finally, Mr. Chairman, one might ask: are there any special lessons that the developing countries can draw from the events of 1971? The most important lesson, viz, the need for their being fully involved in the decision-making process has I think been learned all round at least to some extent; and one can earnestly hope that the actual functioning of the Committee of Twenty will genuinely strengthen the effective role of developing countries in international monetary cooperation on an enduring basis. It would also be well for the developing countries to remember that what matters ultimately is not just an opportunity to sit around the same table or even to get equal time for expounding their views. What the developing countries really require is that the world community should devote the same time, energy, and statesmanlike effort in solving the problems of concern to the poorer nations as it does in overcoming the difficulties of the richer nations. When we find, for example, that the whole world is thrown into turmoil all of a sudden when problems of the richer countries are to be solved but that problems of concern to the poorer countries, like IDA replenishment, take long to settle, one cannot but wonder whether sitting around the same table and having one's say is really a substitute for problems of concern to all getting equal attention all round.

In monetary matters, the developing countries have generally a preference for a greater degree of fixity in exchange rates and for a somewhat liberal approach to financing of deficits as distinguished from premature remedial measures. There is nothing in the experience of 1971 which would suggest that the developing countries should be less vigilant in questioning the need for frequent changes in the exchange rates for major currencies or that they should be less opposed to suggestions that their modest investment programmes should be curtailed or abandoned at the first sign of payments difficulties. Indeed, as already suggested, there is more reason for them now to ensure that any proposed change in the exchange rate for a major currency is not just an easy exit out of internal discipline. At the same time, on questions relating to how much of financing of deficits—as distinct from reducing them—might be appropriate, the developing countries have everything to gain by the encouragement of a more liberal climate.

It may also be noted in passing that the tendency to link the settlement of monetary issues with changes in trade and other policies which came into evidence in 1971, while desirable in itself, needs to be handled with care as far as the developing countries are concerned. There is every danger that trade negotiations may once again proceed on the basis of an exchange of mutual concessions or reciprocity rather than in pursuit of truly multilateral objectives or principles which take existing inequalities into account and try to remedy them. Having not so many concessions to offer, the developing countries may well find that they are left in the lurch except on the basis of alliance with one or the other of the big trading powers; and the greater the number of issues that get mixed up in any particular negotiation, the less the chances of the interests of the rest of the world being kept in mind. The spectre of the world being divided in four or five major power blocs—both political and economic—has been clearly raised; and the main task before the developing countries is to ensure that economic colonialism does not get revived in a new garb in the name of creating a more manageable structure of international economic cooperation.

To Sum Up

To sum up, Mr. Chairman, the lessons to be learned from a particular set of events, like beauty, are generally in the eyes of the beholder and perhaps most of us seek in each passing year a vindication of our own prejudices and preconceptions. For my part, the most important lessons of 1971 relate to the process of decision-making. When it comes to issues of major significance both internally and as between nations, no system or set of rules can be a substitute for negotiations. And yet, if every important question that needs to be settled is not to erupt into a major bargaining contest with its inevitable quota of irrelevance and irrationality, many subtle and intangible bridges between decision-makers have to be built so that the contacts, discussions and exchange of views more or less informally and on a reasonably continuing basis enable the problems to be solved or settled long before they reach explosive proportions. As in marriage, so also in monetary cooperation, it is not so much the system or the guidelines but the mutual forebearance that comes out of being constantly exposed to each other which ultimately stands in good stead in resolving the inevitable conflicts of will, interest and even understanding.

The experience of 1971 is not conclusive about the merit of wider margins in discouraging speculation or of floating rates in serving as a guide to realistic or appropriate exchange rates. Nor can it be said that we have advanced far in establishing objective criteria for determining appropriate exchange rate relationships between major currencies. It would be a good thing if some reasonably automatic procedure for making small but not necessarily frequent changes in exchange rates could be evolved. But it is doubtful if we have yet hit upon any such procedure which would be easily acceptable to all. At the same time, one has an uneasy feeling that the danger of competitive devaluation is now greater than ever, so that some objective procedure for adjudicating on exchange rate changes is all the more necessary.

Without presuming to come to any final conclusion, there is reason to question whether a return to asset convertibility may be the best way of achieving as much symmetry as between the big and small as may be really practicable in any case.

For the developing countries, the year 1971 led to a welcome recognition of the importance of their being fully involved in the discussion on international monetary reform. But there are enough pointers to further dangers to their interests which would require vigilance on their part. In the meanwhile, there is nothing in the events of 1971 to suggest that the developing countries should give up their general suspicion of frequent changes in the exchange rates for major currencies or of any Calvinistic attitude towards the financing of external deficits.

And finally, Mr. Chairman, and this is a new point, if the most significant aspect of recent international history is the attempt to carry the torch of discussion, dialogue and even cooperation to hitherto ostracized but important parts of the world, is it really prudent to imagine that a new era in international monetary cooperation can be ushered in without making any serious effort to see if it cannot also embrace those large parts of the international community which have not yet been included in the membership of the International Monetary Fund? Is there not a danger here that if international monetary cooperation fails to reflect the same trends as in international cooperation in general, much of our labours in trying to reform the monetary system may prove to be in vain and we may have to start all over again in a few years to accommodate the needs of those who cannot merely be wished away? At any rate, should we not at least incorporate in our scheme of reform all those aspects, including the voting structure and the system of election or appointment of Directors, which may have a bearing on how easily we can enlarge and indeed universalise the area of monetary cooperation as represented in the only international institution established for that purpose?

Thank you, Mr. Chairman.

Questions and Answers

Following the formal presentations, the speakers answered written questions from the audience. The text of some of these questions and answers are given below.

PROFESSOR WALLICH: There are, as always, more questions than answers. There are even more questions than there is time. Here is one: *When you suggest that, to maintain its effective rate constant, a country would have to change its parity every time another country moved its parity, do you not agree that declines in parity should be confined to cases of over-valuation?*

I think the answer is: Possibly, but not necessarily. The important implication of this question is that we are not really accustomed to thinking in terms of effective rates. We think that a sovereign country has control of its exchange rate if it can determine its parity.

The question brings out the fact that this is not the case. Any time any country changes its exchange rate, the effective exchange rate of every other country is changed. Exchange rates are two-ended things.

Now, if we move into a world in which we have more frequent exchange rate changes—I share Mr. Patel's hope that will not be very frequent—but more frequent than in the past and smaller, then I think we had better give up thinking in terms of parities and stop thinking that anything has been accomplished by holding one's own parity, when actually others have undermined the economic meaning of that parity by changing theirs, and thereby changing the effective exchange rate of the country with the stable parity.

To answer the question: should a country necessarily change its parity whenever others have appreciated its effective exchange rate? I would say, no. If country A were to change its parity every time country B does, it would nullify B's actions. The question is certainly correct in suggesting that a minimum of countermoves is desirable. But one cannot say that no countermoves should ever be countenanced, nor that they should only reflect overvaluation. It depends on whether a country feels that it can afford to let its effective exchange rate move outside a certain range. The country tells the IMF, let's say, that the effective exchange rate should be between 100 and 105 or 110. When devaluations of third countries force its effective rate beyond the upper or lower edge of this range, the Fund will have to change that country's parity until the effective exchange rate is back within the range.

Another question reads: *You suggest that the U.S. thought SDRs were to lessen the world's dependence on dollars. But were they not created because for five years there had been no addition to stocks of monetary gold?*

Well, I think SDRs were created by the United States in a slight misreading of the situation, namely, in the belief that dollar reserve creation would come to an end as a result of an evening-out of the American balance of payments. In 1964-65 this was a justifiable expectation—reflecting the dilemma that Robert Triffin has described for us so eloquently—of either too many dollars or a reserve deficiency. If too many dollars, the dollar tends to be undermined; if reserve deficiency, we need some other source of reserve creation. The United States, seeing this dilemma, proposed creation of SDR.

It turned out that we were impaled on the other horn of the dilemma—too many dollars rather than reserve deficiency. That could not be foreseen at the time. It would seem to me that SDRs were quite *bona fide* created in the first instance as a substitute for dollars.

Now here is one that says: *Would you comment on the stability of exchange rates, including the dollar and the stability of the securities markets, including the United States stock market?*

I think the point of this question goes to the convertibility issue. Suppose that finally Wall Street's dream comes true and the Dow-Jones Average breaks through the one thousand barrier. Vast amounts of capital flow in from Europe. Then some day—I am making no predictions—the cycle turns down again, the Stock Market goes down and vast amounts of dollars flow out again.

Now, if the dollar is convertible, these flows have to be met with reserve assets. In a world in which the New York Stock Exchange has become, perhaps, a central market for investors, this could be many billions.

It wouldn't be possible to counteract such a flow by means of monetary policy, because if, at a time of collapse of the stock market interest rates were raised, this would accelerate the collapse and make things worse. Traditional tools of monetary policy thus would not be capable of dealing with a Stock Market-induced international flow. This is just one more illustration of the difficulty of making a vehicle currency fully convertible.

Would you agree that the floating period of 1971 was not an adequate test for a system of flexible rates because everybody knew that the rates would be fixed again and that the final rates would result from negotiations not necessarily reflecting market conditions?

Well, here is one attack against my seven or eight reasons why floating rates didn't work. The implied rebuttal is that we didn't do the floating right. The passage in my paper that contains these seven or eight points reflects conversations with various friends, some of whom are present here, and this question makes one of their points.

The question says in effect: If you know in advance that you are not going to continue floating, then you don't float to the right level.

I must say this makes it rather difficult for the floater to get conditions that suit him. If floating has to go on forever to be pure, who can give us that assurance?

Another question: *A country can maintain fixed exchange rates, an independent monetary policy, but then it must control capital movements. Wouldn't it be necessary also to change exchange rates as demonstrated by the experience, for instance, of the European Clearing Union?*

I think the answer clearly is yes. Control of capital movements does not make it possible to maintain an overvalued rate forever. So, if a country has an overvalued rate and manages to control capital movements—a very iffy matter, because in the long run these controls become rather porous—I would say the country is simply postponing the evil day. Eventually it will indeed have to change the rate.

This gentleman says: *Could another lesson of the monetary crisis be that monetary agreements can be obstructed by national non-monetary measures, for example, tax measures. And if this is true, how can it be prevented?*

I presume that this refers to the 10 percent surcharge imposed by the United States which could be conceived of as a tax non-monetary measure. Now, if there should be any readers of *Newsweek* among you, they will know that for as long as three years I have been talking about a tax device that would get the United States from one exchange rate to another. Given the nature of a reserve currency, it is not possible to change the dollar rate arbitrarily, since others are pegged to the dollar. The technique that seemed to commend itself was to impose a surcharge on imports, saying that one would expect to remove it when the balance of payments had returned to equilibrium. But if perchance that should never happen, one would then complete the operation and say, "We've already devalued on the import side, now would you also allow us to devalue on the export side, and please don't move with us as we move".

This procedure would have split the devaluation into two parts and thereby perhaps enabled the United States to achieve what otherwise seemed very difficult, a devaluation, should it become necessary.

I think that for a currency in the particular predicament of the dollar, of not being able to change its exchange rate like any other currency, a measure like the surcharge may be the only way of doing what may be needed.

As you know, the U.S. devaluation was not done in that form. The surcharge was imposed as a means of inducing others to relinquish their pegs to the dollar. But basically, I think under that kind of an arrangement in which a reserve currency's hands, as it were, are tired, some non-monetary device may have to be resorted to, however, much one deplores it.

Another question: *The Atlantic Council of the United States recently* *distributed a white paper* suggesting specific steps to reform the international monetary system. Would you share with us your views of this report?*

This is a monumental report and very well done by a group of top experts. I think this is the kind of thing that in many ways our officials are relying on. Consider that 30 years ago Lord Keynes and some of the top economists in the United States were worrying about international monetary reform. We had a tremendous input into the reconstruction of the monetary system.

Today again this activity goes on. We have journal articles, we have meetings of economists, and we have voluntary efforts such as that of the Atlantic Council. It is certainly a compliment ot the private process of research and opinion-making.

Here is a question from a gentleman who is concerned about the problem of controlling capital movements at a time when inflation is destroying the purchasing power of capital. The text of this question is: *How can it be thought that, through control of short-term flows, whilst inflation continues, short-term money market stability can be ensured?*

If on the one hand we destroy financial systems by inflation and on the other hand we try to lock the victims of that process into a country by exchange control, we are doing two things—one, we are doing something that is very unfair, and second, since these people are not going to be altogether helpless but will find their own ways of dealing with these controls, we are undermining the system with which we need to operate. In other words, inflation at home and then an effort to contain the consequences of inflation by tight exchange controls is doomed to failure. And aside from the unfairness of it, it surely leads to an inefficient form of inflation.

I think I am as strong an anti-inflationist as any. But there are some situations where one might conclude that the better part of valor is not to keep fighting inflation. But if you can't stop it, at least do it right. And that means don't maintain disequilibrium rates of exchange, do not maintain negative interest rates, do not make wage adjustments of 30

* Interim Report of the Monetary Committee of the Atlantic Council of the United States; September 18, 1972.

percent once a year—I am not referring to any particular country—and if you have to inflate, at least do it properly within an equilibrium system.

MR. MORSE: I have two questions here. The first is: *Do you agree that if a currency operates as the major international trading currency, it will probably remain to some extent a reserve currency when the SDR becomes the main reserve currency,* a question obviously looking to the future of the dollar. And the simple answer to that is, yes, I certainly do agree. If we look at the franc and sterling, there is still a French franc zone with a small reserve currency attached to it, and sterling, despite the weakness of recent years, remains quite a large reserve currency. By these analogies, the dollar is likely to remain some sort of substantial reserve currency for a while ahead. Nothing lasts forever, but I would think the dollar might be a reserve currency nearly forever for some parts of the world.

I think the phrase "phasing out" which is quite often used—I have used it myself loosely about sterling—is wrong. What we are about is reducing the role of these reserve currencies. Phasing them out, I think, is extremely unlikely.

The second question is: *Are we any closer to the concept of a world central bank as outlined by Mr. Martin in 1970? And what is your view of that concept as an ultimate solution?*

I hesitate to answer this question in Mr. Martin's presence.

If I remember rightly, one of the things he said in that address which I profoundly agreed with was that we had the scattered limbs of a world central bank at present in various organizations—IMF, OECD, and BIS. I very much agree with that, and I think in all of those three we have made some small further progress toward the sort of operations that a world central bank would do. In the BIS we have been looking at the intervention of central banks in the Eurodollar markets which is a form of open market operation in world money such as might be contemplated by a world central bank. In OECD, we have been not only continuing the usual surveillance, but developing this idea of compatibility of balance of payments aims which would be something that would be centralized in a world central bank. And in the IMF, of course, we have made considerable progress in the issuance of a world money, because that is what the SDR is in embryo.

So I think we are continuing to move by small steps toward what some say is the ultimate solution. Well, it is perhaps the ultimate; certainly it is very far away. But, just as in the political sphere, I suppose one world government is the ultimate toward which all efforts tend, so obviously a world central bank is the ultimate to which all efforts toward international economic cooperation tend. And provided we are not blinded by such ideals to the particular stage of internationalism, or semi-internationalism, that we have reached, I think it is very helpful to have this concept in mind as an ultimate solution.

MR. BURGESS: Would Mr. Martin care to comment on that?

MR. MARTIN: I would only make one point: the subject of the 1970 discussion was "Towards a A World Central Bank," and I think we have been moving in that direction clearly. And if we are not willing to pool individually some of our sovereignties, we will never have a reasonable opportunity for developing the standard of living that is possible in this world of ours. Therefore, I think the concept has been strengthened by what has happened, no matter how far distant the achievement of it may be.

MR. BURGESS: Well, ladies and gentlemen, I think our speakers have given us full measure, pressed down and running over. We are very grateful to them for a very fine meeting. The meeting is now adjourned.

Biographies

C. Jeremy Morse has been an Executive Director of the Bank of England for seven years, at first on the home side and, from July 1966, in charge of overseas affairs. He is the Alternate Governor for the United Kingdom on the International Monetary Fund.

Mr. Morse was born in London in 1928 and educated at Winchester and New College, Oxford. On leaving Oxford in 1953 he joined Glyn, Mills & Co., where he was trained in banking and became a director in 1964. In October 1964 he moved to the Bank of England. He held a fellowship at All Souls College, Oxford, from 1953 to 1968.

I. G. Patel for the past four years has been Secretary to the Government of India in the Ministry of Finance (Department of Economic Affairs). He has just recently been appointed Deputy Administrator of the United Nations Development Programme, to take office around the end of 1972.

After his education in India, Cambridge, and Harvard, Dr. Patel in 1949 became Professor of Economics in the University of Baroda. In 1950 he joined the International Monetary Fund for four years, returning to his country to join the Government as the Deputy Economic Advisor in the Ministry of Finance. After four years in India he returned to the International Monetary Fund, this time as the Alternate Executive Director for India. In 1961, Dr. Patel was appointed Chief Economic Adviser in the Ministry of Finance, Government of India, a position he held from 1961-68, except for a brief return to the world of education as Visiting Professor of Economics in the University of Delhi in 1964.

Among the several articles published by Dr. Patel are "Inflation and Economic Development" (written in 1951 jointly with Prof. E. M. Bernstein in "Selected Readings on Economic Development" edited by

Prof. Okun); "Trade and Payments Policy for a Developing Economy" (in "International Trade Theory in Developing World," 1963, edited by Profs. Harrod and Hague); "Capital and Growth" (in "International Capital Movements," 1965, edited by Mr. Adler); and "Aid Relationships for the Seventies" (in a volume edited by Barbara Ward for the Columbia University).

Dr. Patel was born in 1924, is married and has one daughter.

Henry C. Wallich, Professor of Economics at Yale University since 1951, was an economist for the Federal Reserve Bank of New York and from 1946 to 1951 was head of that Bank's Foreign Research Division.

From 1958 to early 1961, Professsor Wallich, on leave from Yale, served in Washington, D. C., first as an Assistant to the U.S. Secretary of the Treasury and from 1959 to January 1961 as a member of the Council of Economic Advisers.

Earlier, he had served with the Economic Cooperation Administration in 1948, as consultant to the U.S. Treasury from 1951 to 1953, and as a foreign economic policy adviser to the White House in 1954-55. Since January 1969, he has been serving as senior consultant to the Secretary of the Treasury. He has also from time to time been adviser to other governments and central banks.

From 1961 to 1963 he was an editorial writer, part-time, for the Washington Post. Since 1965, he has been a columnist for *Newsweek* magazine. He is also the author of, *inter alia,* "The Cost of Freedom," (Harpers, 1960); "Mainsprings of the German Revival," (Yale University Press, 1955); and "Monetary Problems of an Export Economy," (Harvard University Press, 1950).

Professor Wallich was born on June 10, 1914, in Berlin. He studied ancient languages at the Bismarck Gymnasium in Berlin and economics at Oriel College at Oxford University and New York University. He took his M.A. and Ph.D. degrees at Harvard in 1941 and 1944. He is married and has three children.

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