The Per Jacobsson Foundation

Federation of Bankers Associations of Japan

全国銀行協会連合会

Steps to International Monetary Order

Conrad J. Oort
Puey Ungphakorn

Saburo Okita
William McChesney Martin

Friday, October 11, 1974
Tokyo

STEPS TO
INTERNATIONAL MONETARY ORDER

Conrad J. Oort
Puey Ungphakorn
Saburo Okita
William McChesney Martin

THE PER JACOBSSON FOUNDATION

11 October 1974

Tokyo

FOREWORD

The 1974 lecture meeting of The Per Jacobsson Foundation was held in Tokyo on October 11 at the invitation and in the headquarters building of the Federation of Bankers Associations of Japan. This was the first time that the Foundation had met in Asia and it is appropriate to record here the great appreciation of its Directors and Officers to the officials of the Federation, of the Bank of Japan, and of the Ministry of Finance who were all so gracious and helpful to all participants on this occasion.

This booklet contains the complete Proceedings of this lecture meeting. Two written papers were prepared as a basis for the discussion on the subject "Steps To International Monetary Order," one by Dr. Conrad J. Oort and the other by Dr. Puey Ungphakorn. They introduced and summarized these papers orally at the meeting. Commentaries were offered by Dr. Saburo Okita and Mr. William McChesney Martin. The meeting was presided over by Mr. Marcus Wallenberg.

This meeting was the eleventh in a series which started in 1964, following the establishment of the Foundation in February of that year in honor of the former Managing Director of the International Monetary Fund whose name it bears.

The Proceedings of each of these meetings have been published in English, French, and Spanish by the Foundation and are available without charge from the Secretary. Many of the texts have also been translated and distributed through the kindness of bankers' associations in Arabic, Chinese, Hebrew, Italian, Japanese, Persian, and other languages.

TABLE OF CONTENTS

specter of economic recession, and international monetary problems and credit uncertainty. And we see various programs on a world-wide scale to cope with these influences. Thus, the central theme of this eleventh annual lecture meeting of the Per Jacobsson Foundation, "Steps to International Monetary Order," is a subject of exceptional interest.

The four distinguished guest speakers for this meeting, Dr. Oort, Dr. Puey, Dr. Okita, and Mr. Martin, have been playing very active roles in international monetary affairs. I believe you all share my interest in looking forward to hearing them.

I wish to express a deep appreciation to those of the Foundation who have been instrumental in organizing this meeting here in Tokyo. I know I reflect the feelings of all of you in saying how much we regret that Ambassador Randolph Burgess was not able to be with us here today. We wish him a speedy recovery.

I am glad to welcome Mr. Marcus Wallenberg, Honorary Chairman of the Per Jacobsson Foundation, who will act as Chairman of this meeting in place of Mr. Burgess.

Mr. Wallenberg is an old friend of Japan and in fact was host to the Crown Prince of Japan during his visit to Sweden in 1950. As a founding Chairman of the Business and Industry Advisory Committee to the Organization for Economic Cooperation and Development, he welcomed the accession of Japan to that body. He has been Chairman o the Federation of Swedish Industry and of the Swedish Bankers Associations and President of the International Chamber of Commerce. H is now Chairman of the Skandinaviska Enskilda Bank of Stockholm. am glad to welcome him as well as the other Directors and Officers o the Per Jacobsson Foundation who are here today.

Following this meeting our Federation is hosting a reception at th Bankers Club next door. I hope that all of you will give us the hono of your attendance. In closing, again, to all of you I extend a ver warm and cordial welcome to this meeting and hope that this lectur meeting will be most pleasant and rewarding. Thank you.

Marcus Wallenberg

MR. CHAIRMAN, YOUR EXCELLENCIES, LADIES AND GENTLEMEN: I a very sorry to have to tell you, perhaps as a bit of repetition, that o old friend Randolph Burgess, the President of the Per Jacobsson Fou dation, will not be with us today. His doctor advised him last week that he should not make the trip to Tokyo, and I was asked to act as Chairman of this meeting in his place. He was in good spirits and it seemed to me that, generally speaking, he was also in good shape when he presided over last week's Directors' meeting of the Foundation. He sends his apologies and also his warmest greetings to all of you.

In his place, it falls to me to express to you, Mr. Sasaki, and to Mr. Matsumoto and all the members and staff of the Federation of Bankers Associations of Japan, as well as our other Japanese friends, our great appreciation for their invitation and for our reception here. The support that was given to the Foundation in organizing the meeting was thorough and helpful. The welcome you have just given us is further evidence of the wholehearted and warm hospitality the Federation has extended throughout this exercise.

Now I think we must get on with our activities this afternoon, for we have a full schedule. You all have received copies of the Program. In it you will find biographies of our four speakers. In addition, you will find cards on which you may write questions addressed to any of them. You have also received copies of the excellent written papers prepared for this discussion by Dr. Oort and Dr. Puey. I will ask each of them to introduce their papers in a short statement, bringing the papers up to date as necessary and drawing attention to those points which they wish particularly to emphasize.

Following their presentations, we will have a very short intermission. During the intermission, we will ask the ushers to pick up the question cards—which I hope will be numerous. After the intermission our two other speakers, Dr. Okita and Mr. Martin, will offer their commentaries. Then we will ask the speakers to reply to the questions we have received.

I hope we will be able to finish our proceedings by five o'clock and then take advantage of the hospitality being so kindly offered us by our hosts.

But before getting the program under way, I wish to express our regret that no member—I believe for the first time—of the Jacobsson family is with us today. Mrs. Jacobsson, as many of you know, is now quite elderly and does very little traveling. She has, through her daughter, Mrs. Erin Jucker-Fleetwood, sent us the following cable: "Best wishes for a very successful meeting in connection with the Japanese

Bankers Association. Greetings to friends old and new on behalf of the Per Jacobsson family."

I also wish to express pleasure in the presence here on the platform of our newest Director, Mr. H. Johannes Witteveen, Managing Director of the International Monetary Fund. It is a tribute to the importance of these discussions that he has found time in his busy schedule to be with us today. Mr. Witteveen, I wonder if you would like to share with us at this time any of your thoughts on the topic under discussion?

H. Johannes Witteveen

MR. CHAIRMAN, LADIES AND GENTLEMEN: Let me take this opportunity just to make a few introductory remarks on the subject.

It seems to me that the subject is very characteristic of the situation —the international monetary situation in the world today—after the end of the work of the Committee of Twenty this summer. It has become clear that the work of this Committee has not given us the completely reformed system that was dreamed of when this Committee started its work two years ago. We have to be content with a much more modest conclusion of its work—that in the present situation, there are some immediate steps that can be taken and that we must look for a gradual process, an evolutionary process, that will in the course of the next few years bring us to a new system. I think it may be a more modest conclusion than we had hoped for, but it is quite realistic. The world is changing very rapidly; the positions of different countries change; and purposes and ideals change. It is not the time now to decide, once for all, what system we should have for the next 20 years or so. That was done in a very remarkable way, I think, at Bretton Woods at the end of the Second World War. We can still be grateful for the foresight shown by those who participated in that conference. They gave us a system that worked very well for the world for about 25 years. They created institutions such as the International Monetary Fund of which I have the honor now to be the Managing Director, institutions which, in the quite different world of today, still have a vital role to play. It was perhaps too ambitious to expect, in this uncertain and changing world, that we could repeat the performance of Bretton Woods. We have to find our way much more cautiously, by trial and error, by learning from experience, but nevertheless trying amidst the present difficulties, to continue to cooperate and to improve cooperation.

One thing is quite clear. The world has never needed international economic and monetary cooperation so much as it does now. Its present imbalances alone, with enormously increased interdependence of the economies of all parts of the world, certainly of the free world, are such that we are absolutely dependent on international cooperation. We have to take steps to international monetary order, as the subject of today indicates, and by taking steps in a certain situation, by reacting to the challenges and difficulties inherent in that situation, and moving forward in this way we can aim at creating the new system. That is what we have to do. But of course for every step you take you need a sense of direction. It is not sufficient just to say, let us react in the best possible way to events. You need a sense of direction, you need some perspective, you need a purpose. There I think the work of the Committee of Twenty has been useful.

The *Outline of Reform,* which has been published as a result of much thinking about what the final system should be, can be very useful in directing our steps. In the same way, continued thinking about the final system, about where we want to go, is useful, and it seems to me that here the speakers of today have an important contribution to make. This discussion can be extremely useful for all those who have to prepare these steps and to take care that these steps carry us in the direction that is really desirable—that is in the right direction. Of course, this thinking may change the picture as we see it in the *Outline of Reform.* For example, one of our speakers, Dr. Oort, as you may have seen from his paper, has second thoughts about the central idea, this rather elusive concept of stable but adjustable rates. He argues that it is much better to have a system of managed floating. That is quite interesting, for in a sense we have that system already. We might say he is not very original, he just recommends what we have. But that is a very good thing if it is right. Well, let us not look too far into the future, but let us try to make that system work. Of course, we still have quite a lot to do about it.

He mentions later in his paper the guidelines for floating that have been accepted now by the Committee of Twenty and that we have to start applying in the International Monetary Fund. I realize that this is a difficult, but also very important, task and that probably a number of important steps to international monetary order can be taken, and will have to be taken, in applying these guidelines. That will not only be difficult in itself, but it will require effective cooperation, it will require certain strengths in the Fund, a strengthening of the Fund. And that again will require certain steps which we are in the process, I hope, of taking. But in this world of today, this uncertain world, you are never quite sure exactly which step will follow the step you are just in the process of taking. So, thinking and discussing are very important to know where we will go. For discussion you need different views. I think the speakers have different views, so probably all the elements are there, Mr. Chairman, for a very interesting afternoon. I will not take any more of the time as I think we all look forward to hearing what the speakers have to say to us. Thank you very much.

* * * *

MR. WALLENBERG: Thank you, Mr. Witteveen, for your remarks. The problems are complex. Your active participation in the resolution of these problems, combined with your knowledge and wisdom, have set a tone for this meeting that will be very useful for the subject we are going to discuss today, namely, "Steps to International Monetary Order."

And now we turn to our first speaker, Dr. Conrad Oort, Treasurer-General of the Department of Finance of the Netherlands Government. I will not repeat the biographical information which you have in front of you and which you will find in the printed Program. All I will say is that in my opinion the Foundation chose well in inviting you, Dr. Oort, having in mind your sound judgment, useful experience, and scholarly learning in these fields. It will be a great privilege to hear your talk.

Steps to International Monetary Order
The Exchange Rate Regime of the Future

By Conrad J. Oort

This is the written version of the paper presented by the first speaker, Dr. Oort. His oral presentation begins on page 53. The written paper presented by Dr. Puey Ungphakorn begins on page 63; his oral presentation begins on page 90. The written papers of both speakers were prepared and distributed in advance.

Outline

I. Introduction

THE COMMITTEE OF TWENTY has officially buried the fixed exchange rate system. A very decent burial, with resurrection provided for, but a burial nonetheless. Should we weep for kingdom lost or rejoice at the demise of a fairly benevolent but often misguided aging monarch? The history of the Bretton Woods dynasty and the events of August 1971 which finally toppled it make fascinating reading. Historians will judge in retrospect, when the new order has been firmly established and judgment is no longer clouded by the nearness of events. Economists must take what undigested facts there are and shape their counsel accordingly.

Should we revive the dynasty or create a new order? The question may not seem so urgent; the present interregnum will last some time. But the old monarch's minor son will soon begin to claim his rights. He has already been half-heartedly recognized by the regents under the ambiguous device of "stable but adjustable." Academia, so often the hotbed of revolution, appears to reject even the enlightened monarchy and would rather accept a more flexible regime. Should the regents reconsider or should they just continue to review the constitution under which the new monarch will reign? This paper is neither a manifesto nor a Magna Carta. It is a personal view that does not commit anyone in any capacity—not even the author himself.

According to the final report of the Committee of Twenty, the future exchange rate regime should be based on "stable but adjustable" par values, with floating allowed "in particular situations." During an undefined interim period, however, widespread floating is accepted as inevitable. This paper will focus on the final system, not because the so-called interim period is a relatively unimportant transitional state—it may well last into the eighties—but because the interim regime should be shaped against the perspective of the future international monetary order.

The Committee of Twenty has papered over the differences between countries' views on the final system by accepting an interim period, in which the reform will gradually emerge as the result of an evolutionary process based on experience to be gained. This was wise under the circumstances, as the changed international payments situation calls for a flexible procedure toward reform. But if we do not want to simply drift along in the coming years, we will have to have some idea as to where we want to go.

There appears to be consensus or near-consensus that in the new system exchange rates will have to be adjusted more promptly than they used to be. The Bretton Woods system—or rather the actual policies of countries under that system—is said to have impeded or at least not stimulated early rate adjustment. Inspired by the experience of the thirties, the Bretton Woods exchange rate system was essentially a mechanism to prevent the abuse of parity change. Competitive devaluation had to be avoided and demand management was to ensure balance of payments equilibrium, with parity changes allowed only to correct irreversible shifts in international demand and supply conditions.

For nearly a quarter of a century, this philosophy fitted the postwar world because it was endorsed by governments willing to implement it, vide, e.g., the French Government's stabilization-without-devaluation program of 1964 and Britain's stabilization-cum-devaluation program of 1967–68. However, throughout the industrial world demand management became more and more geared to maximizing economic growth by maintaining full employment and different degrees of cost-push began to create their own irreversible and largely uncontrolled shifts in competitive conditions. In the face of these developments, governments appeared too reluctant to change the par values of their currencies, or change them sufficiently, up as well as down. And even when governments did decide to move the peg in one direction or the other, they frequently appeared unwilling or unable to support these moves by the appropriate domestic policies, or to do so for a sufficiently long period, to make the parity change effective in turning the balance of payments right. The Bretton Woods formula thus became irrelevant to the real needs of the system, which moreover—in part because the exchange rate policy of the governments of major countries lacked credibility—was increasingly battered by rising flows of international capital. In the late sixties and early seventies these capital movements appeared time and again to be of such force that they could play havoc with the professed desires of governments to cling to fixed exchange rates.

Some entered the reform exercise with the conviction that the prevailing system had failed by preventing the United States from devaluing the dollar—the key currency of the system—and by not providing incentives or pressures for other countries to revalue. Others considered excessive reserve creation the villain of the piece in that it destroyed the discipline of the system by allowing all countries to coast along on the inflationary tide without taking appropriate adjustment action. Although differing in emphasis on the various types of action (exchange rate or domestic), all seemed to agree on the need for more prompt adjustment, a greater flexibility of exchange rates, and international control of liquidity creation as major ingredients of a reformed system.

The lack of flexibility before 1972 was always more a matter of governments' attitudes than of international constraints. In this respect, the system largely reformed itself. Developments since 1972 have shown that any bias which countries may have had toward excessive rate rigidity appears to have gone: changes of par values—or central rates—have become respectable. What is more,, the supposed bias toward devaluation and against revaluation has been counteracted by the increased awareness of cost-push. Future analysis will show whether excessive reserve ease and the convenient access routes of borrowing in the international money markets while by-passing the stern policy conditions of drawing on the resources of the International Monetary Fund have merely contributed to this change in countries' attitudes, or have been the major cause of it. In any case, it cannot be denied that cost-push considerations have clearly limited if not eliminated the danger of competitive devaluation.

The oil crisis has fundamentally changed the picture once more. It has created very large shifts in current payments, and correspondingly large financing problems, coupled with the possibility of short-term shifts in capital flows, which in their order of magnitude and their volatility would dwindle even the disturbing flows of the early seventies. Under these changed conditions, what rules should the international monetary system impose upon its participants?

One of the major issues that will presumably continue to be debated during the interim stage is whether the future system should be based on floating rates, managed under internationally accepted rules, or on stable but adjustable par values. I have come to the conclusion that managed floating is preferable, for reasons to be presented in this paper. I would, however, like to stress at the outset that managed floating in my interpretation is closer to a par value system than to free floating, in the sense that management of the rate should be guided as much as possible by considerations of a long-term nature. The difference between managed floating and the—reformed—par value system would therefore be one of degree rather than of kind. Parities that are adjusted promptly, and hence rather frequently by small steps, may approach a system of managed floating if the latter is in fact directed mainly at dampening short-term movements and allowing the incidence of what are recognized as longer-term factors. I believe, however, that there are some rather important differences, both on the level of national policy and on that of international surveillance of the adjustment process.

The issue of fixed versus flexible exchange rates or, in its more relevant operational form, of adjustable peg versus managed floating is almost as old as the theory of economic policy itself. The only excuse for taking it out of the closet again is that we have gained some new experience in the past years and, more urgently, because the Committee of Twenty has left us with an open question that must be resolved in the coming years.

II. The Par Value System

The great debate on the reform of the international monetary system, started by academic economists soon after Bretton Woods and carried on by policymakers in the Committee of Twenty, has not produced a common diagnosis of the ills besetting the parity system which led to its breakdown in 1971, nor has it led to any precise remedies. There does, however, seem to be consensus or near-consensus on two major defects of the par value system as it operated in practice:

< Par values were too rigid in the sense that they tended to be adjusted only after a major disequilibrium had already developed. Delayed adjustment led to prolonged misallocations of resources, to pressures that ultimately led to the system's breakdown, and to discontinuous and relatively large parity changes that confronted international trade and investment with sudden major shifts in competitive positions. In addition, the system had become a vehicle for world inflation instead of an instrument of monetary discipline. I need not go into this point which has been so forcefully argued by Dr. Emminger in his paper for the 1973 meeting of the Per Jacobsson Foundation. As he put it: "There can be no doubt that the universal propagation of price inflation has been facilitated by the transmission mechanism of fixed parities."

< The system was too rigid also in the sense that the fairly small margins of fluctuation around parity left an insufficient degree of freedom for independent national monetary policy, and failed to provide an adequate defense against destabilizing capital flows.

Can these defects be remedied? In the following sections I shall take up the two issues in turn and comment briefly on the various policies and proposals aimed at correcting the shortcomings of what I shall refer to as "the par value system." The use of this convenient shorthand term does not imply an a priori judgment that it is in fact the institutional framework and its rules rather than countries' policies that are responsible. The term "par value system" will be used as a reference to the actual operation of the system until August 1971.

1. *Prompt adjustment of par values*

The excessive rigidity of the par value system has for many years already been the major topic in the discussion of the adjustment process. Many ingenious suggestions have been offered to ensure more prompt adjustment of parities. In this short section I cannot possibly do justice to all these contributions. In order to emphasize that the following does not pretend to be an analysis, but simply a statement of my personal opinions, I shall present my ideas in a number of annotated propositions.

(a) *The failure to adjust par values promptly is due to the national decision-making process*

Those who have been close to the decision-making process on par values agree that the failure to adjust parities promptly is not due to constraints imposed on national policymakers by international obligations. In particular, the commitment as members of the IMF not to change par values except in case of "fundamental disequilibrium," and the procedure of obtaining concurrence of the Fund in a change of the par value, may have served to prevent unwarranted parity changes, but it has not impeded prompt action. In line with this general feeling, the Committee of Twenty has not wasted time on attempts to redefine "fundamental disequilibrium" or to change Fund procedures, but has concentrated on ways to put pressure on countries to take positive action.

Why are countries reluctant to change their parities promptly? It is my conviction that this is basically due to the political asymmetry between positive action and nonaction on parities. Governments are rarely criticized for not changing the par value, and when they are, it is easy to silence such criticism by appealing to the national interest that forbids open debate on such sensitive issues. A change of the par value, on the other hand, is a conscious, overt policy action that is unavoidably accompanied by all the trappings of a major public decision: comments in the press, complaints from groups that are injured, windfall profits and losses by "speculators" and traders, book gains or losses for the Central Bank or the Treasury, parliamentary debates, international repercussions, etc., etc. Behind all this commotion are the very real facts that a parity change does hurt certain sectoral interests, particularly in the case of revaluation, and that a devaluation adds to cost-push inflation at home.

The post-Smithsonian reality and the new approach to parity changes may somewhat reduce the political weight of such decisions, but the very fact that it is a discontinuous change, resulting from an overt act of policy, cannot fail to elicit public reaction. These institutional aspects will unavoidably affect exchange rate policy.

According to the new consensus, parity changes should be made more promptly, which presumably means by small and relatively frequent steps. I am afraid that this is unrealistic, unless special measures are taken. No government will on its own initiative go through the politically difficult process of parity adjustment for a change of less than, say, 5 per cent. Moreover, it will not change the parity until it is convinced that at least the direction of change is right. No government wants voluntarily to put itself in a position of having to reverse a decision of that kind within a period of, say, two years. Left to themselves, governments will continue to take *delayed, discontinuous* action on parities.

Some recent examples of relatively small upward adjustments of the par value or central rate might be cited as evidence to the contrary. I do not believe it is. To the extent that these small adjustments have not been a reaction to exchange rate action of other countries (and thus have often served only to restore the *effective* parity), the small revaluations were a matter of too little too late rather than prompt adjustment by small and frequent steps.

My conclusion is that prompt adjustment of par values requires more than international consensus on the principle and active indoctrination of governments by the academic community. It requires a change in the political setting of the decision-making process. A radical way to achieve this would be to scrap the parity system altogether and accept a system of managed floating. This option will be examined in the next part of this paper. The following sections will briefly review the changes that have been suggested in the framework of the par value system.

They can be roughly classified as internationalist solutions, automatic rules, discretionary crawling-peg systems, and compromise solutions such as that proposed by the Committee of Twenty.

(b) International management of par values is not (yet?) a realistic option

If national authorities do not manage their parities in a way that is consistent with the optimum parity pattern for the world as a whole, the most obvious solution theoretically would be to transfer the authority over parity adjustment to the international community. As has so often been remarked, exchange rates are by their very nature multilateral, so that the logic of multilateral decision making is unassailable.

In a context much broader than only the failure to adjust promptly, the possibility of mutually harmful national exchange rate management has always been recognized. The use of exchange controls is an obvious area of collective suboptimum; the fear of competitive devaluation was one of the main thoughts behind the Bretton Woods formula for parity adjustment; and the export of demand and cost inflation is a more recent chapter of the same potential conflict of national interests. In addition, countries may have balance of payments objectives that are basically inconsistent, for example, when they desire current surpluses that do not add up to zero for the world as a whole, or to the expected net capital outflow or inflow for a certain group (such as, for example, the OECD area). In all these cases, international cooperation is needed to prevent a collective suboptimum in the form of restrictions on trade or payments, or of domestic policies being pushed toward deflation or inflation.

A radical way to prevent such negative sum games is to suspend the game altogether and leave the management of exchange rates to an international authority such as the IMF. Obviously, the world as a whole is simply not (yet?) ready for this solution. The Smithsonian Agreement was a unique historical incident, and a fascinating one, but one that does not lend itself to being generalized into a system. The pressures that had built up in the international monetary system were enormous and it was obvious to everyone that something had to be done about the parity of the dollar. Since every country was strongly affected by the dollar rate of its currency, and the dollar happened to be the "nth currency" whose relative value was maintained by the intervention policies of others, the conditions for a multilateral process of rate negotiation were ideal. None who attended the conference will ever forget its high drama and no one believes that it can ever be repeated. In fact, the next dollar devaluation had already become a big-five affair and all later decisions on exchange rates—including some of quite fundamental importance, such as the decisions to float—were taken unilaterally with no more than the required prior notification and with a formal commitment to remain in consultation with the Fund. Par values had become central rates, and central rates in practice are a concern of the individual country only.

I believe that, at least on the world level, the determination of exchange rates by international decision will remain a castle in the air in our generation—beautiful, desirable, but unattainable. This skepticism need not hold for arrangements among a limited group of countries. The most notable case is that of the European Economic Community which will be discussed separately in part IV. In the earlier parts of this paper I shall discuss only regimes that are appropriate for the world as a whole, or rather for that part of the world that is willing to accept the international monetary obligations embodied in their membership of the IMF.

(c) Parity zones by international decision?

Even if we grant that, on the scale of the present IMF membership, the supranational solution is unrealistic, we may still be tempted to search for solutions that imply a strong international influence on national exchange rate action. The approach is a natural one since the area of potential conflict is reduced by a transfer of decision making to the international level. It is certainly necessary to keep up the intellectual and political pressure toward really one-world solutions, for the world is far behind in this respect. But as long as nations are what they are, we have to operate within narrow political constraints which one may deplore and attack, but which one must recognize as relevant in building an international monetary system, just as we recognize individual and group autonomy in building our national order. Closing our eyes to the severe constraints that this imposes on the system means that we ignore facts that are at least as relevant as other elements of behavior that are customarily analyzed at great length: elasticities, time lags, capital movements, effects of uncertainty, etc., etc.

These comments imply that I reject—not as undesirable, but as unrealistic—all those proposals that transfer the primary responsibility of exchange rate action from the national to the international level. I believe that nations are not ready to loose so important a policy variable and that the international community is not ready to accept the consequences of such a responsibility in terms of mutual support.

An interesting example of an exchange rate system with strong international influence is Mr. Hirsch's proposal for "rough tuning" of exchange rates by international consent. According to his proposal the Fund, in consultation with the member state, would establish a "parity zone" of about 10 percentage points for each currency, to be periodically reviewed in the light of recent developments. Within that zone, any specific parity would be automatically authorized, but when a parity fell outside the zone and the country refused to adjust its par value so as to bring it back in the zone, the country would become subject to sanctions (ineligibility to use the Fund's resources, zero-interest deposits with the Fund, etc.). Such proposals I believe to be unrealistic.

(d) Automatic adjustment rules are not acceptable

If we cannot have international management of par values, can we not accept fixed rules for the adjustment of par values so as to take parity action out of the hands of national authorities? Parity adjustment by fixed rules is very appealing if we could only define the "right" rules and make countries accept them. All the ingenious schemes that have been suggested so far fail on both counts. The automatic versions of the crawling peg, the reserve indicator systems, composite indicators—they all have the same three fundamental drawbacks: (a) that reality is simply too complicated for automatic rules to be sensible under all conditions, (b) that many relevant variables cannot in practice be described in a sufficiently objective manner to serve as the basis for automatic rules (e.g., "basic balance" concepts), and (c) that many variables can be influenced by the policies of national authorities and hence again cannot serve as the basis for automatic rules (e.g., official reserves).

Discussions in the Committee of Twenty have shown a consensus or near-consensus among policymakers that automatic rules are not acceptable. Since the academic community also seems to have lost interest in such schemes, I shall limit myself to these brief reasons for rejecting the option.

(e) Band-and-crawl systems are not adequate

All the many versions of the band-and-crawl system (often referred to as crawling peg) aim at inducing parity adjustment by small and frequent steps. The various authors appear to agree on maximum adjustment of about 3 per cent per annum (or proportionately less for a shorter period, without the option to carry over unutilized portions to the next period), combined with a band of about 4 to 5 per cent. So far, these proposals, which have come mainly from academic economists, have had little or no support from policymakers.

One family of band-and-crawl proposals requires the automatic adjustment of parity on the basis of objective indicators. Best known is the proposal to prohibit intervention within the band and to adjust the parity on the basis of the average market rate in the preceding period. I have already stated my reasons for rejecting such automatic adjustment systems. In particular, automatic crawling-peg systems do not prevent national authorities from influencing market rates by means other than intervention (monetary policy, official capital transactions, direct controls on trade or on capital transactions of the private sector).

Most of the discretionary band-and-crawl proposals have two aspects: they absolve countries from the obligation to justify parity adjustments of less than the indicated maximum, and they make larger parity adjustments more difficult. I very much doubt the practical merits of such proposals. The freedom to make small parity adjustments without IMF consent would induce prompt parity changes only if the approval procedures as practiced in the past had in fact been a real constraint on national action. That is simply not a realistic view of what happens in practice. As I have already stated, by far the most important constraints on prompt parity adjustments lie in the area of national decision making; it is simply naïve to believe that either the treaty obligations ("fundamental disequilibrium") or the approval procedures (concurrence in fact or "noting" by the Executive Board of the Fund, usually overnight or over the weekend) have been significant drags on prompt national action. This cynical but, I believe, unfortunately realistic view is amply supported by the events of the past years.

It is theoretically conceivable that countries might be induced to adjust their parities more promptly if large changes were made more difficult for them. I fail to see how such a system could work in practice. Countries will know that the Fund has no alternative but to authorize a substantial parity adjustment, once they have delayed adjusting promptly and by small steps. Other sanctions are very unlikely to prove acceptable now or in the foreseeable future. Consequently, there is no or at best an insufficiently powerful feedback from the international community to national decision making on par values.

My conclusion is that there is no future in band-and-crawl systems, either of the automatic or of the discretionary type.

(b) International assessment and pressures: a workable compromise?

On all the options mentioned so far, the Committee of Twenty appears to have come to the same negative conclusion, as shown by their implicit rejection in the Committee's final document. The mixed process of reasoning and negotiation in the Deputies' Committee and in the technical groups set up to study particular aspects of monetary reform may not always have been conducive to analytical clarity, but the general conclusions on the adjustment process were fairly clear.

The Committee of Twenty's positive recommendation for a system of "stable but adjustable" parities is a compromise. It retains the parity system (although it provides for floating "in particular situations") but provides for a more active role of the international community with regard to the adjustment process. This active role would be based on an assessment of the situation, triggered either by objective indicators reaching certain predetermined critical values, or by a judgment of the Fund's Managing Director. Assessment might lead to a recommendation to adjust, and a failure to adjust might lead to sanctions being imposed on the country or countries concerned. It has not been possible so far to obtain agreement on the precise details of this scheme: what objective indicators besides international reserves, what numerical values for their critical levels, what pressures to be imposed under what conditions, what decision-making procedures, etc. Nor was there sufficient time to work out a practical solution: before the Committee of Twenty could finish its task, the oil crisis destroyed any hope of putting the reform into operation much before the end of the decade. The famous interim period—initially interpreted as the time needed for restoration of equilibrium in international payments, particularly for the United States—became a period for "evolutionary reform" during which the future system would be gradually established in the light of developments.

Given the vague outlines of the reform proposal, it is difficult to pass a judgment on its analytical merits or its political realism. On the narrow issue that concerns us here, the prompt adjustment of parities, I strongly doubt whether the Committee's approach is adequate. I have two reasons for this skepticism. First, the procedures envisaged by the Committee would at best induce a country to adjust earlier than it otherwise would, but they are unlikely to have much influence on the national choice between alternative methods of adjustment: action on the parity, on monetary policy, on demand management, on incomes policy, or on exchange control. If it is true that governments are reluctant to change their parities they may well try other methods of adjustment first, thus frustrating any effect of the new procedures in the direction of more prompt adjustment of par values. Second, if governments are reluctant to act until a major disequilibrium has in fact developed, the same holds, perhaps *a fortiori,* for international recommendations and sanctions. In this wicked world it is simply inconceivable to ask countries to adjust on the basis of projections, of "impending disequilibria," or even of small apparent disequilibria. The inventiveness of national policymakers in explaining away any such indications is only too well known to all those who have ever participated in international discussions of this kind. The same is true for the extreme reluctance of others to put a country in the dock on anything but the strongest evidence: one could always get in a similar position later and then regret the precedent.

It is my conviction that the procedures envisaged by the Committee of Twenty, if worked out in a sensible manner and agreed upon by all member states, might conceivably serve to ensure that major disequilibria are tackled before they lead to an international crisis such as the 1971 dollar crisis. But they will not contribute to really prompt adjustment of exchange rates, unless the framework of national decision making is changed rather radically. Before presenting my ideas for such changes, I would like to make some brief comments on the other defects of the par value system.

2. *Margins for national monetary policy and the defense against destabilizing capital flows*

In his paper for the 1972 meeting of the Per Jacobsson Foundation, Governor Wallich referred to the "inconsistent trinity" of fixed exchange rates, free capital movements, and independent national monetary policies. He also noted that the problem had recently been intensified because of the vastly increased international mobility of capital. Since then, of course, the volume of potentially volatile capital has again been expanded manyfold. There is no need to go into the facts behind this: the continued growth of the Euro-currency markets, the continuing process of internationalization of business and banking, the increased awareness of exchange risks in particular vis-à-vis the dollar, rampant inflation with its effects on relative interest rates, and, last but not least, the huge and growing volume of oil capital.

An important step was taken at the Smithsonian conference, when the exchange rate margins were tripled from the then prevailing 0.75 per cent to the present 2.25 per cent below and above par. Those who attended the conference will attest to the fact that no economic analysis entered into that decision at all: it was the result of a split-second compromise between the advocates of a 2 per cent margin and those of a 2½ per cent margin—a textbook case of sensible political decision making in a situation where analysis might have delayed action forever. Few seem to contest that the order of magnitude is about right. The decision increased the band with respect to the dollar from 1½ per cent to 4½ per cent, and the band of nondollar cross rates from 3 per cent to 9 per cent (with the exception of the band for the cross rates between EEC currencies, which was originally maintained at 4½ per cent by means of the well-known "European snake" arrangement, to be discussed in part IV). The new, enlarged margins have since been accepted by the Committee of Twenty for dollar rates as well as cross rates and are now a well-established element of the future international monetary system.

Have the enlarged exchange rate margins solved the dilemma by allowing countries a sufficient degree of monetary autonomy and an adequate protection against destabilizing capital flows? Unfortunately, the answer is probably negative. Recent experience and the avowed policy of prompt adjustment have led the market to believe that parities are not immutable. This limits the effectiveness of the enlarged exchange rate margins.

When exchange rates are always expected to return to parity within a relatively brief period, destabilizing capital flows would obviously not occur and present margins would ensure sufficient freedom for national monetary policy. A restrictive monetary policy leading to a relatively high rate of interest would drive up the spot exchange rate by inducing capital inflows. Given the stable expectations of the market, the rise in the spot rate would in turn produce a forward discount which would choke off the capital inflow long before it began to frustrate national monetary policy. For example, if the exchange rate is expected to return to parity within 3 months, the interest rate differential could rise to 4 times 2.25 per cent, i.e., to 9 per cent, before national monetary policy would be constrained by international capital movements. The same would be true, *mutatis mutandis,* in case of an expansionary monetary policy.

However, when exchange rate expectations are neutral, in the sense that future rates are always expected to be equal to spot rates, an interest rate differential would never be offset by a forward premium or discount, so that an independent national monetary policy becomes impossible: any interest rate differential is eliminated by uncovered capital inflows or outflows. Admittedly, this is an extreme assumption, but even if market expectations were more conservative, in the sense that any rate maintained for some time tends to become the focus for market expectations, the freedom of national monetary policy would be severely limited. Once the exchange rate has been close to the upper margin for some time, the country concerned can no longer effectively tighten its monetary policy: the interest rate differential would cause a capital inflow that could not be checked by a rise in the spot rate and a corresponding forward discount. Conversely, once an exchange rate has been close to the lower limit for a certain period, an expansionary monetary policy becomes impossible.

These problems are exacerbated by "speculation," i.e., capital flows induced by an expected change of parity. Such expectations may push the forward rates outside the limits of 2¼ per cent on either side of parity. As a result, the country is forced either to adapt its monetary policy or to satisfy the speculative demand by intervention or, more likely, to practice a combination of the two. All these alternatives can be very uncomfortable. In the case of an expected devaluation, the country would either have to tighten its monetary policy so as to produce a positive interest rate differential to offset the forward discount, or it would have to satisfy all speculative demand for foreign currency by intervening in the market. The former may be impossible as well as undesirable: very large interest rate differentials and the associated sharp reduction of liquidity may be needed to offset a limited forward discount (4 per cent for a 3-month forward discount of only 1 per cent!). The latter policy may also be very painful: it leads to a drain on the country's international reserves and it involves a free gift to speculators when the currency has to be devalued after all. Any intermediate policy will contain a mix of these problems. The reverse would be true for an expected revaluation: the country would either have to accept an undesired expansion of liquidity or it would have to accumulate international reserves and thus put pressure on the international system —the case history of Germany in the early seventies is a clear example of the difficulties in which a surplus country may find itself. In the end, the country may be forced to adjust its parity after all—a familiar story that we know from recent experience both in the case of deficit and of surplus countries.

My conclusion would be that the enlarged margins of the Smithsonian Agreement are not sufficient under all circumstances to permit an independent national monetary policy or to prevent destabilizing capital flows. Nor would still wider margins necessarily solve the problem, unless they are made so wide as to make a mockery of the par value system. Of course, one could avoid the difficulties by adjusting the parity whenever the margin becomes a real constraint on policy, but this would be a par value system in name only; in fact, we would then have a system of (managed) floating.

As long as we remain in the framework of the par value system, the only way to maintain an independent monetary policy and to defend the system against speculative capital flows is by resorting to capital controls, either as a permanent feature or in case of need. Again, in the confines of this paper I cannot do justice to the various solutions practiced or suggested. A few brief comments on each of the major types of regimes will have to suffice. In discussing the various classes of policies, I shall assume that it is their purpose to regulate reversible, destabilizing capital flows and to avoid restricting trade flows, direct investment, and "normal" portfolio transactions. In practice, however, it is extremely difficult if not impossible to distinguish between flows that are "normal" and "abnormal" in this sense.

(a) Taxes on the proceeds of capital flows

One way to regulate capital flows is to tax the proceeds of foreign assets held by residents (regulating capital outflow) or of domestic assets held by nonresidents (regulating capital inflow). Countries have utilized various types of tax measures to create an artificial interest differential between the domestic and foreign markets. Examples are the U. S. Interest Equalization Tax, the German Bardepôt, and the tax on nonresident deposits as practiced in the Benelux countries, France, and Switzerland (sometimes in the form of banks not being allowed to pay an interest of more than x per cent on nonresident deposits, sometimes even going so far as to impose a negative interest rate or, as in France, the threat of blocking the account).

The case history of the last example is revealing with regard to the difficulties and drawbacks of such measures. In the first place, the tax affects all nonresident accounts, also those of a perfectly normal nature. This forced countries to apply the tax only on deposits above a past level, which tends to make the system rigid and inequitable when maintained beyond a fairly short period. In the second place, the tax was circumvented in various ways. Deposits were denominated, not in the domestic currency, but in dollars, with a forward cover in the domestic currency. This loophole could be stopped by regulating the forward market, but at the cost of subjecting regular commercial forward transactions to the burden of administrative regulation. The tax could also be avoided by the purchase of triple-A bonds, in particular those with only a short period until maturity. This was in fact the major form in which "speculative" capital entered the Netherlands before special measures were taken to stem this particular inflow (namely, a closed circuit with a separate exchange rate for trade in guilder-denominated bonds held by nonresidents).

This case history is by no means unique. On the one hand, it is hard to avoid affecting "normal" transactions along with destabilizing capital flows. On the other hand, the inventiveness of market operators, the internationalization of business and banking, and the possibilities of modern financial centers are such that measures of the type mentioned above are bound to spring leaks whenever the pressure becomes high.

(b) Dual exchange markets

Some countries have regulated capital flows by means of a dual exchange market. The normal exchange rate within the margins around parity would apply to all transactions except those that would be relegated to a separate exchange market with a freely floating rate. There have been many different variations on this theme. The Belgian-Luxembourg Economic Union has had this regime consistently since 1955 and has applied it to all capital (as well as some current) transactions; France and Italy have had it for limited periods only; the United Kingdom has consistently applied it but only to a limited class of capital transactions by residents (portfolio investment); the Netherlands has had it for just over two years and only for trade in guilder-denominated bonds by nonresidents.

The Belgian policy is the most interesting because it is both comprehensive and long lasting, and because it is based on a consistent philosophy rather than just emergency planning. The main purpose of the Belgian regime is to insulate the current account from the capital account so as to enable the authorities to pursue their policy objectives with regard to the composition of the balance of payments. In theory, the parity would be set such as to produce the desired average surplus on current account (e.g., equal to development aid); the floating capital rate would ensure a corresponding balance on capital account (either by means of directing development aid via the official market or by official intervention in the free market).

The idea of a separate closed circuit for capital transactions has a great deal of intellectual support in official circles in the other EEC countries as well. To the extent that they have an explicit or implicit objective for their balance on current account, these countries will want to set their parities such as to achieve that objective. The capital account then becomes a residual item, to be regulated by special measures in order to keep reserve movements within nationally and internationally acceptable limits.

Given that philosophy, the dual exchange market is probably the least harmful way of regulating capital flows. The philosophy itself invites a great many comments, but only two points will be made here. One is that the dual market does distort economic relationships, in particular the substitution between foreign trade and foreign investment: a discount of the capital rate will tend to induce foreign investment and discourage investment abroad, both leading to import substitution and export creation. The same holds, vice versa, for a premium of the capital rate. The second comment relates to the practical aspects of the system. A fairly strict registration of all trade movements and payments is required in order to ensure that all current transactions and none but current transactions are settled via the official exchange market. This involves a considerable administrative burden. Moreover, experience shows that the insulation between the two markets tends to become rather porous; there are many ways to arbitrate between them. This is confirmed by the Belgian experience. Except for relatively brief periods, the free rate of the Belgian franc has always been within a few percentage points of the official rate.

To the extent that the dual exchange market can be maintained in practice, it does enable the country to carry out an independent monetary policy. Interest differentials are prevented from inducing net capital flows, since the free exchange rate will adjust itself so as to re-establish equilibrium on capital account. The system tends to be less effective, however, with regard to speculative capital flows. In practice, the most important loophole arises from leads and lags (reducing or stretching the payment terms in current transactions). Countries operating a comprehensive dual exchange rate system have in fact found it necessary to regulate payment terms as well, which is not a simple matter in practice. Leads and lags are especially difficult to regulate in the case of intraconcern transactions, where it is often possible to disguise capital transfers as current payments. In the Belgian case even the fairly straightforward instance of speculative capital inflows taking the form of nonresident deposits had to be restricted by supplementary measures (zero or even negative interest), because technical reasons required initial conversion of all foreign payments, allegedly for current transactions, at the official exchange rate.

The general picture that emerges is one of limited effectiveness, achieved at the cost of considerable administrative burdens, possibly of some economic misallocation, and almost certainly of unjustified profits from fraud. Insiders can cite a great many examples of fictitious or fraudulent transactions which have become the living folklore of the dual exchange rate system. In any case, the system can be no more than a partial solution to the problem, and a costly one at that.

(c) Exchange controls

Exchange control is the classical method to regulate international payments. There is no need to go into the various methods of exchange control as practiced in the recent past: prohibition or restriction of foreign borrowing or lending beyond "normal" trade credits, restrictions on portfolio investment, regulation of direct investment, etc., etc.

Exchange controls of this kind tend to be rather effective in a technical sense, but the main drawbacks and disadvantages of all exchange control measures are that they impose an administrative burden on the authorities as well as on the private sector and, of more importance, they tend to affect "normal" transactions along with those which the authorities want to restrict. The dividing line between "speculative" capital flows and other payments is often very vague in practice, witness the capital flows disguised as leads and lags, the short-term speculation disguised in the form of portfolio investment, and normal business financing shifted across borders for speculative reasons. This very vagueness causes controls to be extended over a much wider area than the transactions one wishes to be regulated. I submit that exchange control, intended simply to limit speculative capital flows, tends to be a real impediment to international investment, to optimum portfolio management, to efficient financing of international business, and even to trade. I strongly agree with Professor Machlup's pithy statement that "the future growth of foreign trade and investment will depend on the elimination of controls."

The Committee of Twenty has at least recognized some of these drawbacks in refusing to recommend capital controls and accepting the alternative option of floating "in particular situations." The significance of that escape clause will, of course, depend on the operational interpretation of particular situations. The majority of the Committee undoubtedly tended toward a very restrictive interpretation: floating only as a transition to a new parity or in case of major speculative pressures. This would imply that floating would not be considered as a more or less normal policy instrument, to be employed whenever internal policy objectives are temporarily inconsistent with the maintenance of fixed margins. I doubt, therefore, whether the Committee's limited escape clause is really an adequate answer to the problems posed in this section: the parity system's constraint on national monetary policy and its insufficient defense against speculative capital flows.

3. *Summary*

On the basis of the preceding considerations, my personal views on the major defects of the Bretton Woods par value system and their suggested remedies can be summarized in the following propositions.

< The excessive rigidity of the par value system in the past has not been due to the constraints of the international regime, but to the inherent characteristics of the national decision-making process on parities.
< Prompt adjustment of par values is desirable to avoid prolonged misallocations of resources, sudden disturbances, and crisis situations in the exchange markets with all their attendant drawbacks.
< Since international management of parities or parity zones is not (yet) a realistic option in the world framework, since automatic rules are not acceptable, since band-and-crawl systems are not adequate, and since international assessment-cum-pressures is unlikely to be an acceptable means of enduring prompt adjustment of parities, I conclude that the chances of improving the par value system in the direction of more prompt adjustment policies are slim.
< The widened bands around par do not under all circumstances enable countries to follow independent national monetary policies, nor do they always provide an adequate defense against disruptive capital movements.
< Restrictions on capital flows are never watertight, are usually inequitable, and will often be harmful in economic terms. One needs to seriously consider the trade-off between these defects and the possible disadvantages of letting the exchange rate float whenever there is a (major) conflict between the elements of the "inconsistent trinity."

III. Managed Floating

Why concentrate on *managed* floating as the major alternative to the parity system? Should not free floating be considered as well? Free floating is not at all the simple concept it appears to be. It cannot sensibly be defined as the absence of official intervention since the exchange rate can be managed by other policy instruments such as monetary policy, official borrowing or lending abroad, and trade and exchange controls. If the exchange rate is considered a relevant policy variable, it is of secondary importance whether it is managed by intervention or by other instruments. This leads to the conclusion that free floating should be defined by (a) the absence of official intervention in the (spot and forward) exchange markets, (b) the absence of official borrowing and lending abroad, and of any kind of trade or exchange control, aimed at regulating the exchange rate, and (c) a domestic policy mix that does not include the composition of the balance of payments as a (final or intermediate) variable. Without going into the well-worn arguments for and against free floating, let me simply state that I believe it to be an utterly unrealistic as well as an undesirable option. I even have some analytical difficulties in visualizing how domestic policy could possibly ignore the composition of the balance of payments. For the domestic policy mix will influence the composition of the balance of payments, which will in turn affect the national growth rate.[1] But, however that may be, it is my conviction that governments simply will not relinquish to the market forces all control over a variable as important as the exchange rate. They have never done so and they will not do so in the future.

So we are left only with the option of managed floating. In theory, managed floating might seem to be potentially similar to a par value system with reasonably wide margins (say the present $\pm\ 2\frac{1}{4}$ per cent) and prompt adjustment. In practice, I believe there is a world of difference. I have mentioned in the previous part that the institutional framework of decisions on parities is such that we simply cannot expect prompt adjustment. In order to change the parity, governments either need solid evidence, which by definition comes too late for prompt action, or they want a solid political package which by its nature is a discontinuous and infrequent matter. The procedures under managed floating are, of course, far more flexible. In a sense, the burden of proof is reversed since resisting a tendency for the rate to change requires decisions rather than the adjustment of the rate. There is no built-in bias toward rigidity, no built-in fear for a "wrong" decision that is politically difficult to reverse. By depoliticizing and de-emphasizing decisions about exchange rate policy, a regime of managed floating increases the policy options of the monetary authorities and adds to the flexibility of national policy.

Managed floating permits a *gradual adjustment* of the rate, whereas the par value system tends to result in discontinuous, delayed, and therefore relatively large adjustments. In addition, managed floating allows

---

[1] Take the example of additional national expenditure, the resulting deterioration of the current account being financed by capital imports induced by a restrictive monetary policy. Unless the additional expenditure takes the form of domestic investment only, future national income will be reduced by the interest charges on foreign debt.

the monetary authorities to meet reversible capital flows by a combination of policy measures, including *temporary movements* of the rate. Under the par value system the authorities must either make the highly dramatic and therefore disruptive move of a "temporary float" or rely completely on the measures mentioned in the previous part of this paper, which all have their rather serious specific drawbacks. In a world with increasingly large and volatile capital flows, the added flexibility of managed floating may well be of great importance.

Obviously, a regime of managed floating is as good or as bad as its management. It could be worse than a par value system if it erred on the other side, i.e., by allowing excessive fluctuations of the rate. This seems to me a rather unlikely development, central bankers being what they are. But this still begs the question as to what a reasonable management of a floating rate would look like if there were no international constraints. I believe that there is little point in attempting to describe the model in detail. The essence of managed floating is that it permits a continuous pragmatic trade-off between the various potentially conflicting interests involved: that of maintaining "orderly market conditions" (i.e., avoiding nonfunctional short-term fluctuations of the rate), the use of monetary policy for domestic economic management, and the desire to avoid exchange control as much as possible.

Managed floating does, however, raise a number of specific questions on which I shall briefly comment in the following sections: the alleged loss of the balance of payments discipline (section 1), the instability of floating rates (section 2), and the increased uncertainty and its effects on international trade and capital flows (section 3). In the latter context, the operation of the forward exchange markets deserves special attention.

Last but not least, there is the question of international surveillance. Parities afford a convenient peg for international action. Adjusting the parity is a discontinuous and rather infrequent occurrence, based on an overt government decision that lends itself rather easily to international surveillance procedures. A failure to adjust the parity could conceivably be made the object of international procedures and pressures as well. Floating rates are more difficult or at least are different in this respect. They do not present the same easy entry for international action. The problems involved and suggestions for their resolution are discussed in the final section.

1. *The alleged discipline of the par value system*

Let me state immediately that I do not believe in the discipline of the par value system in advanced economies. The advocates of this thesis contend that domestic policy is effectively constrained by a "political" reluctance to adjust the parity. The reluctance must be political in their thinking, because any economic reason against devaluation would hold just as much against depreciation of the currency under a system of managed floating. I have three major objections to the discipline thesis.

First, in true dilemma cases domestic policies aimed at restoring equilibrium on the balance of payments are, of course, downright silly. The masochism of deflation into unemployment in order to eliminate a deficit or, conversely, the active or passive acceptance of inflationary pressures in case of a surplus are both highly detrimental to economic welfare and disruptive to international economic stability. In the past years, when a combination of well-known factors caused an excessive expansion of international liquidity, the system of sticky parities had in fact become a major vehicle for world inflation. To quote Dr. Emminger once again: "It has helped to pervert fixed parities from an instrument disciplining deficit countries to one forcing monetary debauchery on surplus countries." Conceivably, the reverse could happen in the future, as a result of the balance of payments deficits created by the rapid increase of oil prices.

One can argue two ways and come up with the same answer. Either discipline in dilemma cases is politically dead anyway—and good riddance—or it is not dead yet, notwithstanding the new consensus on prompt adjustment, in which case it should be eliminated by other means. In the former case, no discipline is lost by going over from a parity system to one of managed floating; in the latter case the loss is a positive benefit.

My second objection concerns the more interesting nondilemma case of excess demand with a balance of payments deficit. I very much doubt whether, under present sociopolitical conditions, the par value system provides an effective discipline in the sense of convincing policymakers, parliaments, press, and pressure groups that unpopular measures are necessary in order to protect the balance of payments. And whatever power it had will be largely lost by the new doctrine of prompt adjustment of the parity. But it does not matter much anyway, since there is now a much stronger countervailing power against "the easy way out" of currency depreciation. In the context of cost-push inflation, which has become very much a matter of public knowledge and public concern, depreciation is no longer considered an easy way out at all, because it feeds the inflationary spiral via the increased prices of import goods. Cost-push has thus created a strong *economic* penalty on depreciation, making the political penalty of overt devaluation superfluous. In fact, countries with a relatively high ratio of foreign trade to GNP and strong elements of formal or informal wage indexation may well tend to be overly cautious in depreciating their currency. Recent experience seems to provide some support for this view.

My third and last objection against the proposition that managed floating implies a loss of national discipline as compared to the par value system relates to cost-push as well. Whereas the par value system might exert a certain discipline on fiscal and monetary policies, based on the political reluctance of policymakers to adjust parities, no such link exists with cost-push factors. Cost-push inflation results from competing attempts by social groups to improve their relative positions. Since public policy so far has had remarkably little success in influencing this process, and since the actors themselves are not interested in the balance of payments, the feedback mechanism of the par value system is inoperative in the case of cost-push inflation. While excess demand was the only or surely the major cause of inflation in the early postwar period, cost-push factors are now at least as important. By the same token, whatever role the par value system may have played in containing inflation during that period is now greatly reduced by the increased importance of cost-push factors.

This concludes my prima facie case for rejecting the discipline thesis as an argument in favor of the par value system. Stephen Marris appears to come to much the same conclusion, although couched in more diplomatic terms, in his closely reasoned and very balanced comments on the Bürgenstock communiqué: "A careful examination of how decision making might evolve over time suggests that there might, on average, be less rather than more inflation with a system of limited exchange-rate flexibility."

2. *Instability*

It is alleged that freely floating exchange rates are inherently unstable, in the sense that rates move not just from one long-run equilibrium level to another, but tend to gyrate under the influence of short-term market forces. These short-term fluctuations are said to induce misallocations of resources, because long-run decisions are taken on the basis of prevailing rates (or of expected rates, strongly influenced by prevailing rates) which do not reflect long-term equilibrium levels.

The main reasons for postulating such instability are (1) the relatively long time lag between a change of the rate and the full response of trade to that change, and (2) the fact that, under certain circumstances, expectations with respect to the future course of exchange rates tend to be elastic, leading to destabilizing rather than stabilizing capital flows.

It is usually granted that systematic factors (such as seasonal fluctuations of trade) as well as incidental factors tend to be smoothed out by stabilizing capital flows, especially when forward exchange markets are functioning adequately. To the extent that markets do not by themselves compensate for these short-run factors, it is clearly the function of exchange rate management to take action to ensure orderly market conditions.

(a) Time lags in trade

There is, of course, an immense amount of literature on the elasticity of exports and imports and the time lags involved. Although the econometric findings differ, depending on countries and periods considered, the general conclusion appears to be that it takes up to two years for a change in the rate to have its full effect on trade. Whether short-run elasticities are so low as to actually produce perverse effects in the early stage of the J-curve is still an undecided issue, but one I cannot get too excited about: if depreciation has perverse effects that are recognized as such, and if they cannot be financed out of reserves or by drawing on stand-by credits, compensating inward capital flows supported by policy measures should take care of their impact on the balance of payments. Conversely, appreciating countries could, if necessary, stimulate outward movements of capital. More serious from a policy viewpoint is the lagged response over the medium term, because it is less likely that autonomous capital flows will provide compensation over this longer period. This implies either an overreaction of rates, or a need for longer-lasting policy measures to tide over the interim period.

How bad is some overreaction of rates? The answer to that question is largely a matter of conviction and political philosophy. One extreme view is that the so-called overreaction of rates is precisely what is needed in order to correct the imbalance quickly. Since private enterprise in advanced economies can gauge the future as well as the authorities, and since it is strongly motivated to prevent errors, the danger of long-term misallocation of resources is limited. The losses, resulting from the errors of judgment that are committed, are the natural feedback from the system to the market. The other extreme view is based on hog-corn cycle type of models: the market expects present rates to be more or less representative of future rates and will overreact accordingly.

I doubt whether market evidence will ever produce a clear answer, since it would require hard data on such subjective matters as incorrect investment decisions based on incorrect expectations concerning the future course of the exchange rate. Recent experience seems to me a particularly poor guide for several reasons. Even though exchange rates have in some cases fluctuated rather wildly (see Figure 2), we do not yet know whether rates have in general overreacted, nor do we have any clear evidence on overreaction to these rates by the market. Moreover, the experience of recent years was very untypical because it represented the release of pressures that had been bottled up during the many years that unrealistic parities had been maintained.

I will not try to draw any conclusions on the desirable degree of exchange rate management. Depending on national convictions and on circumstances, the rate will be left largely to market forces, or will be strongly managed. Even in the latter case I doubt whether the interest of international trade and investment would be well served by the declaration of a par value, which tends to make the exchange rate more rigid and might in time create a false sense of security with all the attendent dangers of a market caught unaware: uncovered exchange positions, crisis situations on the exchange markets, etc.

(b) Destabilizing capital flows

Destabilizing capital flows have played a large role in the recent monetary crises and may well continue to do so in the future. Liquid funds have become internationally footloose as a result of the increased awareness that parities are not permanent and that the dollar can devalue as well. The immense oil revenues will presumably continue to feed these flows. The real issue here is the trade-off between on the one hand a flexible rate policy as a prerequisite for a more independent national monetary policy and as a defense against destabilizing autonomous capital flows, and on the other hand a policy of fixed (but adjustable) parities to prevent speculation on the exchange rate.

The very declaration of a par value, provided it is and remains basically credible as judged by actual policies and actual developments, could conceivably inspire such confidence as to eliminate speculation and even induce stabilizing capital flows when the rest of the balance of payments is out of equilibrium for reasons that are believed by the market to be temporary. I have argued before that these conditions are not very likely to be satisfied in the industrialized world of today and of the foreseeable future. And once a parity is suspected, the game really starts. Determined intervention and appropriate monetary policies may convince the market that the authorities believe the parity to be basically sound and that they are resolved to defend it "at all cost." If so, it could conceivably stop speculation in its tracks. The loss (or gain) of reserves may on the other hand feed the suspicions of the market and induce it to use what it considers a low-risk option offered by the authorities, as long as the option is still open. When the country's international reserves are nearing the danger point or domestic monetary policy is seriously frustrated by an inflow of liquidity, the authorities may have to throw in their towel as they frequently have in the past. Clearly, the general credibility of a "determined defense of the parity" has been rather seriously undermined by recent experience.

Managed floating gives the authorities additional degrees of freedom. They can defend the rate at a certain level; they can "lean into the wind" to test the market or they can simply let the rate slip for a while. Presumably, different policies are appropriate to different conditions, which makes a very strong case for managed floating. The only thing which managed floating lacks in comparison with a system of declared par values is the symbol of stability.

I am personally convinced that the practical value of the tarnished symbol is not worth its very real cost. The option to give a little on the rate can have a positive function in restoring a two-way risk for speculators: it releases monetary policy from its one-sided bondage to the foreign exchange market, and it avoids the crisis atmosphere surrounding the "defense of the parity at all cost."

3. *Uncertainty and the forward market*

Are more flexible exchange rates a serious impediment to the growth of world trade and the optimal use of the world's capital resources? To many, this is the real crux of the exchange rate issue. One would like to be able to answer the question on the basis of recent experience, gained during the first extended period of widespread floating in monetary history. Unfortunately, these recent developments do not provide conclusive evidence one way or the other. The period has been too short, considering the time lags involved, and the circumstances have been too exceptional to permit a valid analysis. All dire predictions to the contrary, international trade and investment have not shriveled up under the impact of the very large exchange rate movements of the past years: the volume of world trade has grown by 9 per cent in 1972 and by 11½ per cent in 1973, compared with an average growth of 8 per cent during the preceding decade. But all one can conclude from this is that floating has not so far affected world trade significantly.

Those who praise the par value system on the basis of its alleged stability are often thinking implicitly of the period before the monetary crisis of August 1971, when the average annual parity adjustment was only just over ½ per cent.[2] That is obviously inadmissable. One cannot judge a system that erupted into a major monetary crisis by looking only at the period before the eruption. The currency realignments in the years following the crisis were clearly to a large measure the result of disequilibria which had accumulated during the preceding period.

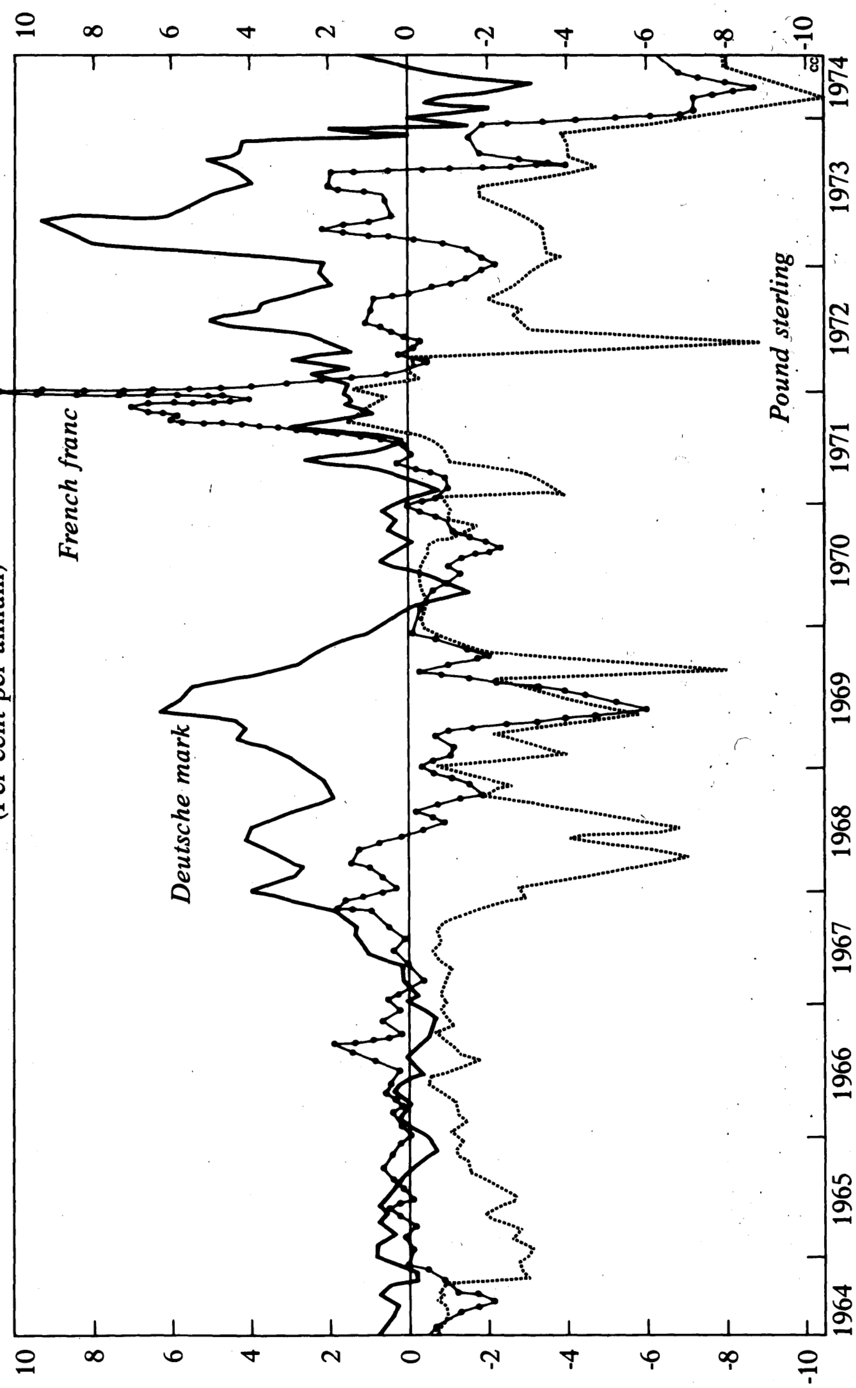
Moreover, the actual movements of spot rates do not really tell us the story of uncertainty under the parity system. Part of that story is told by the movement of forward rates which are, after all, of more importance for many international transactions than spot rates (Figure 1). Especially after 1967, forward rates show relatively large premiums and discounts, with an occasional complete breakdown of the forward market.

[2] Based on absolute values of nominal changes since end-1958 in parities or central rates of currencies now making up the SDR basket, different currencies being weighted as in the SDR basket.

Figure 1

MARGIN ON THREE-MONTH FORWARD RATES FROM SPOT RATES, MARCH 1964 - APRIL 1974[1]

(Per cent per annum)



Source: International Monetary Fund.

[1] Based on quotations in New York.

The points just made are intellectually accepted by most people and have been politically consecrated by the Committee of Twenty, in the form of its recommendation for prompt adjustment. But the obvious convenience of fixed exchange rates for the business world is not easily forgotten: witness the frequently heard remark that "the system did, after all, work very well for a long period, so why should we not try to restore it?" Nostalgia and conventional wisdom do not die easily. Let me just state once more that the real choice is between prompt adjustment and infrequent large adjustment. That issue has for all intents and purposes been settled. The only remaining question is whether adjustments should be made by discrete steps within the par value system or by managed floating.

After these introductory remarks, I would like to present my observations on the issue of uncertainty under two headings: general comments and the forward market.

(a) General comments

In the medium term or long term—say any period in excess of two years—the net variation of exchange rates will, on balance, tend to be the same under managed floating and under promptly adjusted parities. Consequently, for medium-term or long-term international commitments, the effective uncertainty is no greater under managed floating than it would be under the modern version of the par value system.

For shorter periods, the variability of rates will be somewhat greater under managed floating depending on the intervention policies of the authorities. The authorities will not only let the exchange rate slip in the direction in which a parity would eventually have been moved as well but they may also use the exchange rate instrument to check destabilizing capital flows or to increase the effectiveness of monetary policy for domestic economic management. Also, they may occasionally make mistakes, in the sense of letting the rate go on the basis of a mistaken judgment about the underlying trend of the basic balance of payments.

In complaining about the additional uncertainty that stems from floating exchange rates, the business world tends to ignore the disadvantage of the alternatives. Holding a parity against strong market forces involves a cost as well: the vicious circle of intervention, compensatory monetary action, and renewed (interest-induced) capital flows will all too often end in exchange control measures. In all business surveys I have seen on the subject, there is one clear conclusion: the possibility of exchange controls is far more detrimental to international trade and investment than any uncertainty about exchange rates. Rate movements resulting from a decision on the part of the monetary authorities to carry out a monetary policy primarily directed at domestic objectives should also be confronted with the costs of the alternative. Not being able to use the monetary instrument to the desired extent presumably means less effective economic management, i.e., more inflation or more unemployment. Finally, and this holds for all three causes of increased exchange rate variability, the business world should not have any difficulty in obtaining insurance against the risks involved, provided there is a well-developed forward market and business firms have the management knowledge to use it. When uncertainty is thus converted into insurable risk it becomes a normal element of comparative cost.

(b) The forward market

In the absence of exchange control and with a sufficiently developed forward market, the whole trauma of exchange rate uncertainty turns out to be a minor matter, at least for regular commercial transactions in the major currencies. Take the example of a Dutch firm exporting to the United Kingdom, payment in six months, with a forward discount on sterling. Assuming that the exporter does not want to carry the exchange risk, he has three options: (a) he can invoice in Dutch guilders, (b) he can invoice in sterling and cover the exchange risk on the forward market, or (c) he can borrow sterling and use the proceeds to buy guilders at the current spot rate.[3] The first option is uninteresting, because it transfers the exchange risk to the importer. The last two options are in principle equivalent: interest arbitrage will tend to make the forward discount on sterling equal to the difference in interest rates between the United Kingdom and the Netherlands. In practice, this is true unless the mechanism is frustrated by exchange controls or by strong intervention to maintain a spot rate which is not credible to the market (a situation not entirely unknown for sterling). In the absence of such policies, the last two options will in fact tend to be equivalent;

[3] If the third option takes the form of early payment by the importer in exchange for a rebate on the price, it appears in the balance of payments statistics as leads and lags rather than short-term capital. The two are obviously very close substitutes in practice.

the choice between them will then depend on factors such as the availability of credit in sterling to the Dutch exporter, his cash flow, spreads on forward cover, etc.

If we disregard the last item, which is normally of minor importance, the effect of the exchange risk on the Dutch exporter's position is simply to raise the actual or implicit cost of financing the trade credit to the level of interest rates prevailing in the United Kingdom (= Dutch interest rates plus forward cover on sterling). Since competing U. K. producers will have to pay the U. K. rate of interest as well, the Dutch exporter should in principle have no difficulty in charging the cost of forward cover to the importer. This would lead to the general conclusion—subject to the assumptions on exchange control and intervention—that the cost of insuring against exchange risk does not hamper international trade. Nor does the cost of forward cover distort international competitive conditions, since all exporters to the United Kingdom will pay the same covered interest on the trade credit they give. One might even go so far as to say that the cost of forward cover tends to correct the distortion of trade that would occur if rates of interest were different in different countries *without* a corresponding forward premium or discount. In any case, the "cost" of forward cover is not a real (factor) cost in economic terms at all: insurance against risk does not reduce aggregate real income.

All business surveys I have seen, as well as my own contacts with the banking and business world, confirm this general picture. Provided exchange controls (including strong intervention to maintain a noncredible exchange rate) do not stand in the way, it is almost always possible to obtain forward cover in the major trading currencies for periods up to a year, and even for somewhat longer periods cover can usually be arranged within a short time. Moreover, the business world generally does not consider the "cost" of forward cover to be a serious impediment to international trade. This leaves an area of exchange rate uncertainty for really long international commitments, e.g., on direct foreign investment, but it is generally agreed that over these long periods the uncertainty regarding the exchange rate becomes completely intermingled with (and perhaps to a large extent compensated by) the more general uncertainties of relative cost and price developments.

It is stressed time and time again by the international banking and business world that exchange controls are the real villain of the piece.

Forward markets cannot function properly when exchange controls frustrate the short-term capital flows that are essential to their operation. Paradoxically, the uncertainty would therefore be greater under a parity system than under managed floating, since the former is more likely to be accompanied occasionally by exchange controls and by strong intervention to maintain a rate which is not credible to the market. It is, in fact, precisely in times of such artificially contained pressures on the parity that the forward market tends to break down (see Figure 1). From a practical point of view this constitutes another, and I believe a weighty, argument against exchange controls and therefore in favor of a system that can utilize the alternative of letting the spot rate slip temporarily.

In recent years, the international business world has become much more aware of exchange risks and has turned increasingly toward the forward market. The total volume of forward cover handled in the Amsterdam market, for example, has just about doubled in 1973 alone. Recent events in the international banking world will probably strengthen this tendency. But it is not yet normal trade practice to cover all exchange risks. It is my impression that business policies are still at an early stage of development in this area. As a result, the overall picture is rather varied both as between countries and between individual firms. In some countries, the forward market is highly developed, in others it is practically nonexistent. Some large international concerns have a consolidated corporate policy on exchange risks, but in surprisingly many cases it is left to the individual subsidiaries to fend for themselves; some firms systematically cover their net exchange exposure on the forward market, while others primarily attempt to hedge against exchange exposure by adapting their trade credit directly or via leads and lags;[4] still others follow a discretionary policy which may involve accepting a net position in currencies that are considered "strong" or safe and covering any exposure in weak currencies. Smaller firms, and surprisingly some quite large concerns as well, often do not seem to follow a consistent policy at all, thus becoming passive "speculators" in the foreign exchange market.[5]

---

[4] See footnote 3.

[5] There is very little evidence of active speculation, in the sense of deliberate switching of corporate funds in order to profit from an expected change in rates.

On the basis of what fragmented data we have on the forward market—surely a deplorable deficiency in our knowledge of the international financial system—it appears that real problems arise only in two areas. First, the business world in general and the smaller firms in particular have not yet fully acquired the financial management skills needed to deal efficiently with exchange risks. In addition, the banking system, at least in some countries, may not be capable of handling a rapidly increasing volume of forward trading at short notice. Second, there simply is no organized forward market for most minor trading currencies, because the potential volume of business is too small and often also because forward exchange dealing is impeded by exchange controls. The first problem will disappear in time. The second problem is more serious. There might well be a case for international initiatives to provide effective foreign exchange coverage in these minor currencies, particularly of developing countries.

I conclude that, in principle, the forward exchange market provides an economically sensible and commercially viable solution to the problem of exchange rate uncertainty in the case of major trading currencies, provided its operation is not frustrated by exchange controls. In practice, the business world has not yet fully adjusted to the relatively new phenomenon of exchange rate flexibility, but I am convinced the adjustment will be made. Once that is the case, and I do not believe the process will take very long, the bogey of uncertainty under floating exchange rates will vanish of itself. In the short term and medium term it is simply an insurable risk; in the long run the uncertainty about rate developments has little or nothing to do with the exchange rate regime.

4. *The international framework*

Inconsistency of national balance of payments policies and policy aims may lead to mutually harmful actions. It is the function of international cooperation to see that potential conflicts are resolved before they arise. I have already rejected mechanical rules and direct international management as viable solutions. I believe, therefore, that international cooperation on balance of payments policies and aims should be based on agreed procedures of surveillance, consultation, and decision.

The main pegs for international action in the Bretton Woods system were the adjustment of par value, which required Fund consent, and the granting of credit by the Fund. The system has been criticized, among other things, for inducing or permitting an excessive rigidity of exchange rates and for implying an asymmetrical treatment of deficit and surplus countries. The proposals of the Committee of Twenty aim at correcting both defects by strengthening the positive role of the Fund on adjustment. Regular surveillance, assessment triggered by international judgment and by objective indicators, and a new political body to impose sanctions are proposed as improvements for the institutional framework of the future. I have no quarrel with these proposals. They need to be worked out, particularly the criteria for assessment of a country's balance of payments prospects and the actual content of the objective indicators, but they seem to me steps in the right direction.

Does not a system of managed floating weaken the possibilities of successful international cooperation in this area? The whole point of managed floating is, after all, to increase national policy options. By the same token, it would seem to reduce the coherence, the transparent pattern of the par value system, so dear to most European and developing countries' hearts. It is undoubtedly true that discrete parameters, which change only as a result of specific and rather infrequent policy decisions, can more readily be subjected to international procedures than parameters which can move continuously. But is that essential?

According to one view all that matters is the international consistency of policies and aims with respect to international reserves. If it were true that countries are (or should be) concerned only with the official settlements balance, there would not be much point in concentrating international cooperation on exchange rates. Reserve movements are influenced as much by monetary policies, by general demand management, by capital controls, etc. It would be the general stance of policy, as it affects the current and the capital account together, that should be the object of review and consultation. There would be little point in paying special attention to the exchange rate, and countries should generally be free to choose the method of adjustment they prefer, provided that the net effect on their reserves is consistent with an internationally acceptable pattern.

Reserves are undoubtedly relevant. International consistency is required first and foremost with regard to reserves. An excessive accumulation of reserves by one country creates problems for other countries that may find their reserves falling below a critical level. Excessive loss of reserves sets up strains as well, particularly in the case of reserve currency countries that can sustain very large losses of net reserves without being forced to take measures; the inflationary effects on the rest of the world are all too familiar. The Committee of Twenty has made an important contribution to international monetary order by introducing reserve movements as a trigger for international consultation, and by accepting (at least in principle) certain sanctions on excessive reserve accumulation. This has added a potentially powerful force for international consistency to the international community's arsenal.

The exclusive concentration on reserve movements implies that the international community should be indifferent with regard to the composition of countries' balances of payments, in particular as between the current and the capital account. But countries clearly are not. For various perfectly rational reasons, countries do have current account objectives. Since these objectives are not necessarily consistent—in fact, experience in the OECD's Working Party III shows that they usually are not—and since inconsistent policies in this area can set up major pressures in the system, international coordination should also be directed at current account positions and prospects. Next to general demand management and incomes policy, the exchange rate is, of course, regarded as the major policy variable to influence current account positions in the longer run.

This establishes the case for international coordination of exchange rate policies. But it does not imply that we need a par value system to carry it out. I submit that effective international coordination of exchange rate policies is quite as feasible under managed floating as it is in a par value system. In fact, it could avoid certain important defects of international coordination of exchange rate policies under a par value system. The latter (a) imparts a political bias toward rigidity by making a change of par value the focus of consultation, (b) involves procedural difficulties in that consultation on par value must necessarily be very brief and secretive in order to avoid disturbing the exchange markets, and (c) tends to concentrate on changes in par value rather than the more relevant changes in *effective* rates.

The "guidelines for floating" which the Fund has recently established seem to me an excellent basis for international coordination of exchange rate policies under managed floating. The main thrust of these guidelines is to disallow "aggressive" exchange rate policies, except to bring the exchange rate closer to a "target zone," to be established in consultation with the Fund. Aggressive policies are defined as policies —by intervention or otherwise—that push up the rate when it is rising and depress it when it is falling. Moreover, the Fund could initiate consultation with a country on its exchange rate policies when the rate moves outside "what the Fund considers to be the range of reasonable estimates of the medium-term norm for that exchange rate to an extent the Fund considers likely to be harmful to the interests of members." This careful formula, representing a major victory for the "internationalists" in the Committee of Twenty, establishes the important principle that the Fund can take positive action. It is a new and hopeful element that was lacking in the original Bretton Woods system.

The guidelines will have to be worked out in more detail, and their application in practice will have to make them into a living code of international monetary behavior. If the political will is there—and that is essential to any system—the guidelines will serve to subject managed floating to as much and possibly more effective international coordination than was possible under the par value system. If it is felt that the danger of competitive depreciation is still (or again) acute—which I do not, for reasons indicated before—the guidelines could easily be strengthened by adding objective triggers for international action, similar to those inherent in the par value system. It could, for example, be agreed that a certain cumulative movement of the effective exchange rate from a certain base level will trigger consultation with the Fund. In order to allow sufficient flexibility in the short run, the consultation point should be set, not at an absolute level of the rate, but at a net cumulative deviation over a longer period. Consultation would be triggered when the daily percentage deviations of the rate from the base level, summed over the period since the base date, reached a certain figure.[6] Once the consultation point is reached, the country concerned would have three possible courses of action:

(i) it could ask the Fund to change the reference rate to a new level—this would be similar to a change of parity under the par value system;

(ii) it could ask the Fund to ignore certain past deviations on the

[6] The trigger could, for example, be set at 600 percentage points, which would allow roughly a full year's systematic deviation of the effective rate by 2¼ per cent (to be more precise: 268 days x 2¼ per cent deviation each day = 600 percentage points), a three-month systematic deviation by 9 per cent, etc.

grounds that they were due to highly exceptional temporary causes (e.g., large short-term capital flows); or

(iii) it could indicate its intention to hold the rate to the original level and ask the Fund to move up the base date without moving the base level (which would eliminate rate deviations before the new base date from the calculations and could thus give the country more room to maneuver).

In all cases, the Fund could be approached before the trigger becomes active, and the Fund could impose certain conditions.

But these are embellishments. The main thing is that operational guidelines for floating have been agreed upon and that they offer a promising framework for international consultation on exchange rate policies, which could be at least as effective as the par value system. I conclude, therefore, that the interests of the international community are not at all injured by managed floating, unless countries are not willing to observe the agreed guidelines—but that course of action would destroy the basis of any coordinated international system, whether based on managed floating or on par values.

IV. European Monetary Integration

The European Community has set full economic and monetary union as its goal, to be achieved in 1980. Long before the plan was officially adopted in March of 1971, academic economists had already made a great many contributions to the discussion, especially on the monetary aspects. The theory of the optimum currency area, although still too abstract to have any direct relevance for policy, has clarified some of the issues involved and has at least helped to give monetary integration academic standing. Monetary integration has continued to fan the imagination of politicians, because they saw it as the focus for European political integration. The business world has always strongly supported the idea on the—I believe quite valid—premise that the existence of independent monetary areas in Europe is a serious drag on economic integration: especially the imposition of exchange controls or even just the risk of their being imposed constitutes a strong impediment to the real integration of business operations across borders, more so even than the variability of exchange rates. The official world, finally, has paid lip service to the plan, but has always been skeptical about it, as long as it saw no real evidence of the political will to transfer national authority to "Brussels" on such important but essential areas as fiscal and monetary policy.

1. *Monetary integration and economic policy coordination*

The world monetary events of the past years have increased the pressure for European monetary integration and have in fact brought about the first operational experiment in the form of the common float against the dollar, the famous snake arrangement. At the same time, recent experience has proved once more that monetary integration is not possible without effective economic integration and the related transfer of political authority. As the European snake gradually reduced itself to the present minisnake, because one country after another was forced to float its currency independently, one could no longer avoid the conclusion that isolated monetary experiments are just not viable. Political rhetoric aside, it is difficult to predict today what practical consequences the countries of the European Community will draw from this experience. One thing is already clear, however, that there is definitely a new sense of realism that may succeed where slogans failed.

I do not want to take up the tired old issue of monetary versus economic integration as the pacesetter. The idea that a quantum jump in the monetary field might pull national economic management with it appears to be politically dead. Good riddance, for it never was a credible approach. People and countries are sometimes willing to close their eyes and jump, but not when something as vital as their purse strings —their employment, their taxes, their social benefits—are involved. The promised land would have to be much richer or the enemy at the gates more threatening to justify an experiment which, if it were to fail, would do great harm to the countries involved and to the whole future of European integration.

So we are left with the parallel approach: coordination of national demand management and incomes policies, harmonization of fiscal and parafiscal regimes, common regional and structural policies, and coordinated management of external monetary policies (exchange rates, capital controls, and international reserves)—accompanied by the necessary institutional changes to ensure effective decision making on the European level. I do not want to go into the very broad subject of the minimum requirements for an effective approach to full monetary union in areas other than the external monetary policies that are the subject of this paper. Let me just make two brief comments of a very general nature on these other subjects.

One is that the required degree of centralization of decision making should not be exaggerated, unless one wants to frustrate progress toward monetary union for a very long time to come. The harmonization of fiscal and parafiscal regimes need not go all the way, as the American, Canadian, and other examples clearly show. Given the constraints on fiscal and other policies, imposed by the need to avoid distortions of competition, national budgetary policies can be entirely autonomous, except for the relevant total deficit of the public sector and its financing. Theoretical sophistications such as the Haavelmo effect are swamped by the degree of freedom in the system. Regional and structural policies need to be coordinated only in so far as they could be used as instruments of national protection. In addition, economic integration must be based on some degree of purse-string solidarity, not only in favor of regions and industries that are directly harmed by integration itself, but also in a more general sociopolitical sense.

My second comment relates to the speed of the integration process. As I have just indicated, coordination may not have to go as far into the details of economic policy as some pessimists would have us believe, but the task is still quite substantial. The European Community has so far made little progress in the areas that really matter, such as budgetary policy. In practice, national action has not been constrained in any real sense by international coordination. Any insider, and most outsiders as well, know that the periodic rituals of coordination have usually served to put the stamp of Community approval on national budget plans, rather than to change them. This is hardly surprising, given that even recommendations have to be approved by the unanimous vote of the national ministers concerned. I am convinced that this deadlock can be broken only by a quantum jump on the institutional level. Real authority must be transferred to the Community in order to give it any power vis-à-vis the national policymakers. Such power should not be of the piddling kind that the Community has been given so far—in agriculture, in "own resources," etc. They have the double disadvantage of not really being relevant to the major decisions that affect monetary union and of leading to additional expenditures that feed inflation and act as an irritant to policymakers and public alike. What I believe the Community needs is a big financial stick in addition to the few carrots it already has. If national treasuries were not allowed, without prior Community approval, to finance budget deficits either by recourse to the central bank or by floating loans on the market, the process of economic and monetary integration could really be set on the track.

After these preliminary and far too general comments to do any justice to the grave problems involved, I would now like to concentrate on the exchange rate regime.

2. *The European snake*

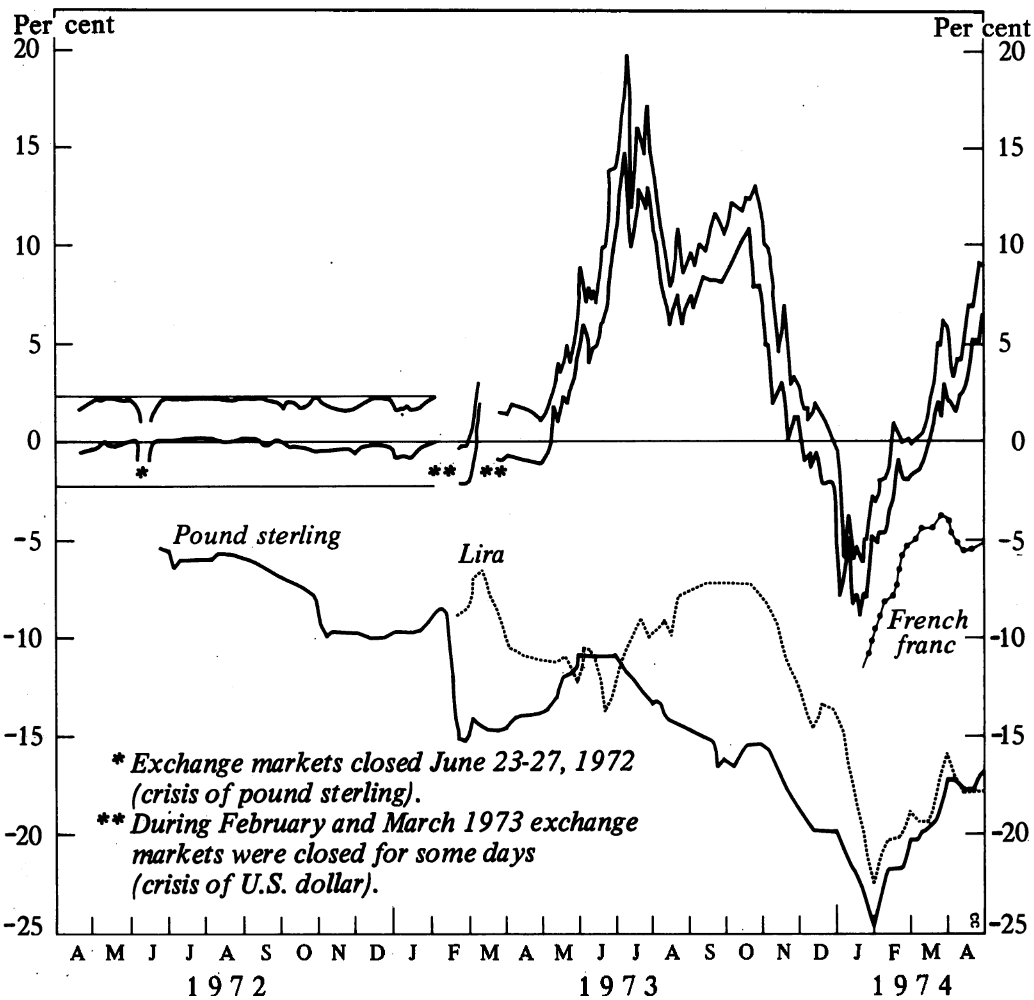
The snake has become the favorite animal of the Eurocrats. It resides on an empty floor in Luxembourg, called the European Monetary Fund. So far, its most distinctive virtue is that it has created a whole new serpentine folklore and a Eurolingo exclusively devoted to the life and habits of the snake.

The snake was originally planned as a device for narrowing the margins of fluctuation of the cross rates between the European currencies from $\pm\ 1\frac{1}{2}$ per cent to gradually lower figures, so as to end up at zero by 1980. Conceived as a fairly innocent exercise, the snake became a very serious serpent right at birth. For it was hatched in the Smithsonian cauldron, when the intervention margins against the dollar were increased from $\pm\ \frac{3}{4}$ per cent to $\pm\ 2\frac{1}{4}$ per cent. The implied cross rates of $\pm\ 4\frac{1}{2}$ per cent between the European currencies were considered detrimental to intra-Community trade, which led to the decision to hold cross-rate margins at the same level as margins against the dollar, i.e., at $\pm\ 2\frac{1}{4}$ per cent of cross parities. Thus the snake was born on April 24, 1972. Until March 1973 it lived in the relative protection of the dollar "tunnel," but the decision made by the EEC countries to let the dollar float brought it out into the open. The snake had become a free agent. The fact that it carried a live worm in its innards (the Benelux agreement to keep the guilder-Belgian franc cross rates within the old band of $\pm\ 1\frac{1}{2}$ per cent) did not seem to bother it at all.

The vicissitudes of the international monetary jungle were, however, too much for the poor animal. After it had already lost the United Kingdom and Ireland, it started shedding its Italian and later also its French skins prematurely, until it is now a shadow of its former self, with only Germany, the Benelux countries, and Denmark to sustain it.

A few associates (Norway and Sweden) help its image, but do not really take part in its digestive or locomotive processes. A graphical picture of the snake's life history to date is shown in Figure 2. At the time this paper was written, there was no indication that the present minisnake will again assume its majestic shape of earlier days in the near future. There is much talk of "snake reform"—making the animal wider, more flexible, less demanding, and feeding it with more credit food and gold nuggets—but none of it is very clear and those now outside do not seem to be in a hurry to rejoin.

Figure 2
FLUCTUATIONS IN SOME EUROPEAN CURRENCIES IN RELATION TO U.S. DOLLAR, APRIL 1972-APRIL 1974



Source: De Nederlandsche Bank N.V.

So much for serpentology. What has the experience taught us? Before presenting some comments on such snake-type arrangements, let me briefly describe the main features of the European snake as it operates today.

Cross parities. Since the snake is an agreement to maintain cross rates among members within a certain margin around cross parities (or cross central rates), the latter are absolutely essential. It is curious, therefore, that so far the snake countries have not devised any "hard" Community procedures for adjusting cross parities. Consultation and assessment, yes, but no effective provisions for common decision making or the application of pressures.

Intervention in the snake. The general rule is very simple: all central banks intervene in all other snake currencies, each in their own exchange markets, so as to maintain cross rates within the prescribed margins. There is no intervention within the margins except by mutual consent.

The level of the snake and dollar intervention. When the snake was still in the tunnel (i.e., when there were still parities or central rates of the European currencies with respect to the dollar), the level of the snake was obviously determined by the parities. My comments on cross parities apply here as well. As a general rule, dollar intervention was carried out only by the central bank whose currency was at the margin of intervention with respect to the dollar. When the tunnel disappeared as a result of the decision to let the dollar float, the level of the snake was effectively determined by agreement about dollar intervention or nonintervention (or by agreement with the United States about its intervention in European currencies). Since this does not require formal decisions by governments, the common procedures have generally worked quite smoothly. In the situation of a common float, the distinction between snake intervention and dollar intervention becomes somewhat blurred, since the one can replace the other.

Settlement. The settlement rules of the initial snake arrangement were simple. Settlement is made in the various types of international assets in proportion to the composition of the debtor's reserves, unless countries make another bilateral arrangement. The official valuation of reserves at prices other than their market values has set up definite strains in the settlement arrangement. A more realistic valuation of the SDR and of Fund positions in relation to the dollar have helped to solve part of the problem, with a possible arrangement for gold still uncertain at the time of writing.

Credit. Arrangements for credit have been a major point of disagreement in the European Community. There are two schools of thought. One holds that practically unlimited credit is necessary in order to make the snake arrangement workable. Cross rates must be defended against possibly quite large capital flows either from outside or from within the snake. According to this view, it is unreasonable—and, considering the previous willingness of countries to absorb large amounts of dollars, it is also quite illogical—to demand full settlement within the Community. The other school of thought will usually grant the need for substantial short-term credit lines, although they are somewhat hesitant in making them entirely automatic beyond a certain level. But they have major objections against automatic credit beyond the short term (say a maximum of one year). Unless it is demonstrated that temporary factors are at work (which requires prior assessment, i.e., conditionality), such automatic credit could become a license for national debauchery at the expense of other countries: it is precisely this process which fed world inflation and led to the collapse of the parity system on the world scene. Credit should therefore be conditional also in the sense of policy conditions being imposed on debtor countries that follow an inflationary economic policy.

In my opinion, the second school of thought on credit is basically right—in the Community framework as well as on the world level. The possibilities for imposing effective policy conditions should be better in the Community than in the Fund. Whether the Community will realize these possibilities is still an open question. An interesting test case on the willingness of creditors to help and on the ability of the Community to set up effective procedures for policy coordination will soon come up, when the Community considers the first request for medium-term economic aid.

This brings me back to the more general point of policy coordination in the Community. If the snake experiment has taught us anything, it has proved again that close monetary arrangements among a limited group of countries cannot survive, particularly not in a setting of major monetary upheavals in the world at large, unless the economic policies and the economic prospects are sufficiently similar in the participating countries. In the short run, monetary policies in particular must be closely coordinated. But a failure to follow appropriate general economic policies will just as surely set up uncontainable pressures, as the Italian case has shown very clearly.

Even then it may be difficult enough to keep the arrangement together under the influence of diverging economic developments—strikes; differences in wage setttlements, in business prospects, or in general confidence; changes in terms of trade; differences in the growth of productivity; etc.—all this possibly foreshadowed and aggravated by speculative capital flows. Is it worth trying to keep a snake-type arrangement together against such pressures relieved only by periodic adjustments of cross parities?

I tend to be rather skeptical for the reasons I have set out in the previous parts of this paper. Until the Community is much further along the way of real economic integration, I do not believe it is possible or desirable to immutably fix the exchange rate relationships between individual currencies. Rather then fiddling with such monetary experiments which, instead of pulling economic integration with them, tend to break under pressure, the Community should concentrate on the real issues. As long as countries are not willing to submit decisions on their budget deficits, on their budget financing, on their monetary policies, or on their parities to effective Community procedures, is it likely they will allow themselves to be forced by a monetary gimmick?

Let Europe get to work in these really important areas of policy coordination. A return of the positive Community spirit, serving the regional as well as the international interest, is urgently needed if we are to avoid a process of gradual decay that would be disastrous for Europe, bad for the world, and a grave setback for all other attempts at regional monetary and economic integration.

Steps to International Monetary Order

The Exchange Rate Regime of the Future

By Conrad J. Oort

The oral presentation by Dr. Oort follows. The text of his written paper begins on page 7, above.

MR. CHAIRMAN, LADIES AND GENTLEMEN: Some time in the spring of this year, one of the Directors of this Foundation, M. Larre, called me from Basle and told me that he wanted to ask me a strange question. He then proceeded to invite me to submit a paper to the 1974 meeting of the Per Jacobsson Foundation. I told him that I would very gladly do so and that I well understood why he considered it a strange request, since I myself had never dreamed of being offered this unique opportunity to present my views on some international monetary issues to so distinguished an audience. What he had meant, however, was that the meeting would be held here in Tokyo just after the Annual Meeting of the Fund and the World Bank in Washington. To me, the location of this meeting was definitely an added inducement. Ever since my first and all too brief visit to Japan I had hoped to be able to return to this fascinating and hospitable country. My wife and I are very grateful to the Board of Governors of the Per Jacobsson Foundation and to the Federation of Bankers Associations of Japan for having made this visit possible. I consider it a very great honor to join the ranks of the distinguished speakers at previous meetings of the Foundation. May I say again how pleased and honored I am with your invitation.

A government official is always in a somewhat delicate position when he is asked to present his personal views on a subject which directly concerns him in his official capacity. I would like to express my sincere gratitude to Wim Duisenberg, the Dutch Minister of Finance, for having given me complete freedom to write and to say whatever I wanted. As a result, many things I have said in my paper, and Mr. Witteveen has just alluded to that, are definitely not the official policy of my country and, where there is any resemblance between my paper and that official policy, it is purely coincidental! I hope that the freedom I have received and used will be respected by those outside this gathering, who might wrongly assume that a civil servant will always toe the official line.

I must apologize for having written an inordinately long paper. My only excuse is that I got too carried away with my subject. I shall try to compensate for this by being brief today, and leaving as much time as possible for discussion. I shall not try to summarize my paper, because I have the arrogance to assume that you have read at least some parts of it. A summary would only bore an audience which, I am sure, is ready to pounce on the intrepid critic of the very system which this Foundation was set up to honor.

My theme is the exchange rate system of the future, and my main thesis, as the Managing Director has just mentioned, is that we should abandon the par value obligations of the present IMF Articles of Agreement in order to replace them by a system based on national management of exchange rates under international surveillance and control. I was glad to note that Dr. Puey in his paper takes the opposite position, because such differences of opinion can only contribute to a lively discussion. Upon closer inspection, however, our views turn out not to be as radically opposed as they may seem to be at first sight. On the surface, managed floating appears to be very different from the par value system and it does in fact present a number of important institutional and economic differences. But I shall try to demonstrate later in my comments today that my conception of managed floating under international surveillance is basically rather similar to the ideas underlying the Bretton Woods system.

In my paper I have argued that managed floating would liberate the international monetary system from the artificial constraint of pegged exchange rates. The par value system, while no longer serving its original purpose of preventing competitive devaluation and of enforcing national economic discipline, has become, in my view, an impediment to the rational management of the national and of the international economy. It has, in my view, three major drawbacks, which I will mention in random order. At the same time, these drawbacks constitute what I consider to be the main potential advantages of a well-designed system of managed floating.

My first proposition is that the prompt adjustment of par values, although almost universally accepted as desirable, will in practice be a dead letter. Because of the institutional and political context in which decisions to devalue or to revalue are taken in practice, adjustment of par values will always be a highly discontinuous, delayed process. The consequences of this stickiness are surely obvious after our experience of recent years. Second, the obligation to maintain exchange rates within the prescribed margins imposes a severe and often undesirable constraint on national monetary policy and, even more seriously, may lead countries to resort periodically, or even permanently, to direct exchange controls. I strongly believe that such direct exchange controls, however well-intended and however sincerely meant to affect only so-called disruptive capital flows, are in fact very harmful to the international financial system. Third and last, but certainly not least, it seems to me that really meaningful international cooperation on exchange rate policies is not possible in the framework of a par value system. Par values have always been taboo. In any forum, national policymakers and officials will always deny that there could possibly be a case for a parity change and even our semi-independent Executive Directors in the Fund cannot openly discuss the par values of their constituents in the confidential circle of the Executive Board. In practice, consultation on changes in par values takes place *after* a national decision has been taken and *after* it has for all intents and purposes become irreversible. It is my conviction that managed floating offers far greater opportunities for a true dialogue between the Fund and member countries on exchange rate policies. Even though such dialogues would have to be confidential and should therefore be based on a series of bilateral contacts, this would still be a significant advance compared with the situation in the past.

It is mainly these three considerations, argued at greater length and I hope more convincingly in my paper, which have led me to express a clear preference for managed floating. I regret that I have not been able to substantiate my case with reference to hard, quantitative evidence on the economic effects of different exchange rate regimes. There is no dearth of econometric studies on price elasticities in international trade, on time lags, on the relationship between volatility of exchange rates and the developments of international trade and investment, and on many other important aspects of the exchange rate issue. But the results of these studies are often contradictory, sometimes demonstrably irrelevant, and in my opinion never entirely convincing one way or the other. In an earlier draft of my paper I did include some quantitative material, but I decided to delete it, precisely because it was so inconclusive. My case, perforce, must rest on general considerations and on a personal interpretation of the facts as I see them.

Traditionally, the oral presentation is used for the purpose of bringing the written paper up to date. In previous years, speakers in this forum have certainly had reason to do so. We have recently experienced many a long hot summer in international monetary affairs. I myself had expected that I might have to comment on major upheavals in the monetary arena, as a consequence of the very large balance of payments surpluses of the oil producing countries and the corresponding deficits of others. Fortunately for all of us, such major upheavals have not, so far, occurred. I shall resist the temptation to claim that floating exchange rates have contributed to this lack of drama, although I personally believe that an attempt to defend par values, or central rates, would have generated additional pressures which the system could not have resisted. But that is speculation.

Even though the past months have been relatively calm on the exchange markets, our ignoring the oil problem could be considered a glaring omission. One might well wonder why neither Dr. Puey nor I have gone into this matter, which is probably the most challenging monetary problem of the immediate future. I believe it was a very wise decision of the Foundation's Board of Directors *not* to focus today's discussion on that topic but to set our sights on the further goal of international monetary order in the future. The petro-problem is so recent and so sensitive that it would have been very difficult to have a sensible and constructive discussion at the present time of the many issues involved. I would not be surprised, however, if the subject were to feature very prominently in next year's Per Jacobsson lecture program.

Although I therefore do not want to go into the monetary consequences of the oil crisis, I would like to supplement my paper on another point which is indirectly related to it, namely, the question of European monetary cooperation. Under the pressure of the so-called "oil deficits," European monetary cooperation has made certain steps forward in recent months, on which I would like to report to you very briefly. I have the more reason to do so, because my written paper is perhaps overly skeptical with regard to the immediate prospects for European monetary cooperation. In an earlier draft of my paper I did have a more constructive final section, but at the time it seemed too unrealistic to be useful. The fact that I can now report to you some real progress just goes to show that, fortunately, cynics are sometimes wrong and governments can move fast once they are convinced by events that something must be done.

Several initiatives have recently been taken that may eventually lead to a new phase in the monetary relations between the countries of the European Community. One new initiative is the decision, in principle, to activate the mechanism that has existed on paper since 1971 for extending medium-term credit to member states in balance of payments difficulties. The total amount involved is not large in comparison with present deficits, namely, only SDR 2.7 billion, but it is not primarily the amounts involved that make this an interesting new development. Rather, it is the fact that the credit arrangement will be accompanied by Community-determined conditions with regard to the economic policies to be followed by the borrowing country. This may have important implications for the future. The need to work out procedures for periodic review, surveillance, and reconsideration could give a new impetus to coordination of economic policies, which is now generally agreed to be the main prerequisite for any real progress in European monetary cooperation. The procedures to be devised could initially be similar to those practiced by the Fund, but they could conceivably go somewhat further. Moreover, activities of this kind sometimes have an important fall-out in other areas. Institutional arrangements and procedures, once accepted in a limited context, may carry over into a wider field and may gradually strengthen the economic and monetary cohesion of the European Community.

The other new development that has been reported in the press is the intended common effort to recycle oil capital to member countries in need of such financing. Ideas on this subject have not yet crystallized completely, nor have any decisions been taken, but countries seem willing in principle to engage in common efforts in this area. If the plans materialize, they will add another important dimension to the monetary cooperation in the European Community, not least because here again the loans would be accompanied by appropriate conditions with regard to the economic policies to be carried out by the borrowing country.

Will these new activities lead to the creation of a common European currency in the foreseeable future? This is one of the intriguing questions that academic economists as well as politicians, bankers, and businessmen have toyed with ever since the European Community announced its plan to achieve full monetary union by 1980. The "Europa" has continued to fan the imagination of Europeans, either because they saw it as a welcome rival to the dollar, or as the focus for European political integration.

Until now, there has been no real progress in this area because, in the minds of many policymakers, the idea of a common European reserve unit has been associated from the beginning with liquidity creation and with the freezing of exchange rate relationships between the currencies of the European Community. Since various countries of the Community were, and are, strongly opposed to one or both of these alleged implications of creating a common reserve unit, all initiatives in this direction have so far been effectively squashed.

The academic community long ago pointed out that the creation of a common reserve unit need not necessarily imply the creation of additional international liquidity nor necessarily require the freezing of exchange rates. Moreover, the business world has already given the lead by expressing capital market issues in a basket of European currencies. But this has not convinced the policymakers, and understandably so. The policy discussion on monetary matters in the European Community has been dominated from the start by the unfortunate idea of gradually narrowing exchange rate margins and gradually freezing exchange rate relationships, with a common European currency at the end of the road. The whole so-called snake experiment was a product of that approach, although it was in fact put into practice under entirely different circumstances and for entirely different reasons than originally envisaged. Whereas the snake was designed to reduce the margins of fluctuation between the European currencies, by 1972 its main function was to allow a common float against the rest of the world, keeping European cross rates within slightly wider margins than before. Throughout this whole period, however, official thinking continued to be based on the mistaken idea that no real progress on a European reserve unit would be possible unless margins were further reduced and relative exchange rates were pegged and gradually frozen. Events have proven that these are at best very distant goals. As long as trade unions have national memberships and national ministers depend on national electorates, decisions will continue to be taken along national lines of power and influence, and economic developments, particularly of costs and prices, will continue to diverge from country to country. Policy-makers came to the conclusion that the whole idea of a common European reserve unit had to be shelved for the time being.

Now that the European Community is beginning to approach these matters from a more practical angle, we may well witness some new developments in the not too distant future. I cannot go into the great many fascinating and difficult problems and potentials of a future European reserve unit. Much has already been written on the subject, both wisely and foolishly. I would just like to say that it is my sincere hope that we can approach this whole matter not as a defensive effort, but as a constructive element in international monetary cooperation. In particular, I would hope that we will define the "Europa" so as to provide a direct link with the SDR.

This leads me to one final comment on European monetary integration. It is sometimes said that these regional developments, including the snake arrangement and the formal or informal pegging of minor currencies to a major currency, will lead to a breaking up of the one-world system of Bretton Woods into so-called monetary "blocs." We would have a dollar bloc, a Europa bloc, and perhaps a yen bloc. The term "bloc" is again one of those emotive words that we should distrust. A tendency for national currencies to group themselves in this manner may well emerge, but I fail to see why this should threaten the basic tenets of the one-world system. Provided we can avoid imposing restrictions on trade or payments between these so-called blocs, separate arrangements for relations between currencies that are linked by relatively close economic ties are natural, useful, and, at worst, harmless to the world as a whole.

With that, I return to the main theme of my paper. It is my firm conviction that the sound development of international trade and investment is impeded far more seriously by the imposition of controls to defend par values against market forces, than it is by floating exchange rates, provided they are managed intelligently under international surveillance. A greater freedom for exchange rate management means less pressure for restrictions and less danger for the kind of discrimination against outsiders which leads to truly closed blocs. From the one-world point of view, which I sincerely hold, I am far more disturbed by attempts to set up a common European system of capital controls toward the outside than I am by special relationships between the individual European currencies and a common float against the rest of the world. The common float reduces tensions, it focuses on positive common action in managing exchange rates rather than defensive action in the area of restrictions, and last but not least, it can be made subject to international procedures of surveillance and control.

Is a world of floating exchange rates, nationally managed under international surveillance, a nonsystem, is it chaos, is it the crumbling of world monetary order? I do not believe so at all. The underlying economic factors are much the same, whether we peg or float. Terms of trade, the relative returns on investment, and all the other factors that influence the balance of payments, do change over time; exchange rates will eventually have to reflect these changes under any system or nonsystem. Uncertainty will exist in any case, although it may take different forms. But uncertainty is a normal aspect of economic life, and exchange rate uncertainty is one of the least disturbing risks that the international trader or investor has to face. Exchange rate risks can be and often are covered on the forward exchange markets, which are potentially quite capable of handling any volume of forward business. It is true that the business world is not yet accustomed to systematic forward coverage; it is also true that the banking system is not in all financial centers adequately equipped to deal with a much larger volume of forward business. But these are temporary problems of adaptation. I am quite certain that the international banking world will rise to the challenge, as to a very large extent it already has. A much more real problem faces developing countries whose financial markets are too small to support a viable forward exchange market, and where currency controls often impede its operation. I do not believe, however, that the problem is insoluble. With ingenuity and a critical review of existing regulations it must be possible to provide forward coverage in minor currencies as well. I shall not go into that problem here, but I do recommend it for closer study.

I would just like to make one final comment on forward cover. In contrast to a very widely held opinion, it does not involve a net cost to society, except for the relatively small payment for the services of the intermediary. In forward markets, one man's loss is the other man's gain. I also fail to see how forward cover can be inflationary. Unless we believe that our economic system has become completely asymmetrical, in the sense that a cost to one party leads to a price increase whereas the corresponding benefit to its counterpart does not result in a lower price, we cannot seriously maintain that forward cover is inflationary. I therefore reject the argument that a system of floating exchange rates necessarily adds to world inflation.

In my paper I have taken the position that a regime of floating exchange rates, nationally managed under international surveillance, is to be preferred to a system of stable but adjustable par values. I am not going to repeat the reasoning which led to that conclusion. But upon closing these remarks I do want to reiterate once more that in my opinion a regime of managed floating can be operated as a one-world system, provided countries have the political willingness to subject their national policies to some measure of international coordination. That political willingness is, of course, essential for any one-world system, most particularly also in the Bretton Woods formula. In fact, I have argued that the par value system is least conducive to adequate international coordination of exchange rate policies since its central concept, the par value, has been completely taboo. Managed floating has dedramatized the exchange rate to the extent that it can now be openly discussed in international forums. I believe that the role of the international community with regard to exchange rates can be much greater under managed floating than it has been in the par value system. If the dialogue between the Fund and individual countries on the management of their exchange rates can be made to work, it is my belief that the Fund can gain a far more important role in exchange rate matters than it ever had before. On this hopeful note, which surely is in the spirit of Per Jacobsson, I conclude my oral presentation.

* * * *

MR. WALLENBERG: Thank you, Dr. Oort. You have given us a very clear, penetrating, and powerful defense for managed floating, which is going to enrich our debate.

And I now ask the second speaker, Dr. Puey Ungphakorn, former Governor of the Bank of Thailand and in recent years Head of the Economics Faculty at Thammasat University in Bangkok. Dr. Puey brings to the discussion a wealth of experience and academic study.

Steps to International Monetary Order

By Puey Ungphakorn*

This is the written version of Dr. Puey's paper. His oral presentation begins on page 90.

Outline

* The author is grateful to Mr. Vijit Supinit and Miss Viyada Avilasakul of the Bank of Thailand for making this paper possible.

I. Introduction

IT IS A GREAT HONOR AND PRIVILEGE to be given the opportunity to present a paper on a subject of great importance for the world today. In the past few years, we have constantly witnessed a rapid and seemingly unending succession of turbulences and crises of immense proportion in the international monetary system. The Bretton Woods system gradually crumbled down, true to forecasts made in the late 1950s, so that we now have a nonsystem for the conduct of international monetary affairs. Although the present international monetary situation is not as anarchical as in the period before the last World War, there is a clear and urgent need to reconstruct the system to provide a basis for orderly international monetary conduct in the future.

International efforts for the reconstruction of the present international monetary system began just over two years ago when the International Monetary Fund set up the so-called Committee of Twenty to study and advise on all aspects of international monetary reform. As most of us are aware, in the middle of such a process, uncertainties affecting the world economic outlook—related to inflation, the energy crisis, and other unsettled conditions—have made it difficult to arrive at reformed measures of a long-term nature. Priority has, therefore, been given to certain aspects of reform that have become urgent in the interim period. It is expected that it might be quite some time before the situation is adequately stabilized and before long-term measures can be agreed and implemented (if that is at all possible).

Thus I would like to deal with the immediate and long-term aspects separately. I attach great importance to measures needed in the immediate future, as we are now faced with many serious problems which may get out of control and lead us into even deeper quagmires.

II. Immediate Steps

1. World-wide inflation and the international monetary system

Ours is a confused economic and financial world. The difficulties are so many and so severe that it is hard to recall a comparable period in recent history. Among the world economic problems, those that are uppermost in the minds of the people—the ordinary people as well as policymakers—are inflation and energy. And in the recent past, the threat of recession has also emerged, adding significant confusion to the already muddled world economic scene.

Global inflation affects all aspects of our economic, social, and political life. It creates tension, distorts income distribution, and undermines the relationship among the various groups of the population. For the poorer areas of the world, it radically undermines the developmental efforts of the nations. Inflation can therefore be rightly seen as a corrosive element with deep repercussions on the stability of society. Its impact on society is both extensive and intensive and its cure warrants the most urgent action. It is worth noting that this is the first time in recent history that a significant number of countries, particularly developed countries, are experiencing inflation in double figures. Its magnitude is unprecedented, as it has been rampant to such a degree in almost all major countries.

Inflation has been the main cause contributing to instability and uncertainty in the international monetary system. The breakdown of the Bretton Woods system was due to the implication of such a severe inflationary development which, with its disequilibrating effects on the foreign exchange market, makes it difficult for many countries, developed countries in particular, to defend their exchange rates. By necessity, floating exchange rates have become a noticeable feature of the current exchange system, which is understandable. This necessity, however, should not be allowed to give rise to claims that the present floating nonsystem be adopted permanently. If the present rampant inflation were to become an intractable problem among the major countries, the prospects of the recovery of exchange stability would not be very encouraging, to say the least. As exchange stability is the ultimate aim, the international community has an important responsibility urgently to solve the existing problems. The first priority, both in time and importance, is to bring the rate of inflation down to a manageable level. A reformed international monetary system could then see the light of day, and one would hope that its improved features would help prevent the recurrence of this type of problem in the future.

The subject of inflation has been fashionable indeed in the past few years. It is a well-worn topic and a great deal has been said on the subject. In fact, in last year's Per Jacobsson Foundation lecture, as you may recall, Mr. Emminger dealt extensively and elegantly with the subject in relation to the international monetary system and I am sure his statements are still fresh in the minds of many of us. I do not wish therefore to look at this problem in great detail; only some basic aspects will be attended to.

I believe there is a consensus that the responsibility for the emergence of the present bout of inflation rests mainly on the major countries, owing to their policies that have placed undue emphasis on domestic requirements with inadequate concern for their external repercussions. The Bretton Woods system has contributed to this situation not only by making it possible for major countries to disregard good economic discipline, thereby letting loose the inflation monster, but also by facilitating the transmission of this inflation to other countries throughout the system. Many countries find it necessary to float the exchange rates for their currencies or to resort to more frequent par value changes in order to insulate themselves from the effects of spreading inflation. It may be recalled that Mr. Emminger also pointed out that the Bretton Woods system in itself contributed directly to the emergence of inflationary pressure. The unexpected appearance of the energy crisis toward the end of last year helped aggravate the problem and put additional pressure on the international monetary situation. Unless the energy problem too is stabilized in order to provide a greater degree of certainty in economic prospects, it would be difficult to see inflation settling down, and a quick recovery of international monetary stability.

This is not the place to moralize on the behavior of the leading governments of the world in social and political fields; but social and political actions are closely connected with economic and financial phenomena. The general neglect of agricultural development, and in particular food production, has led to the skyrocketing of the prices of foodgrains and meat. True, the vicissitudes of nature have played some part in this state of affairs; but mankind's preoccupation with long wars, medium-term wars, and even short wars, everywhere on our globe, has seriously undermined food production and distribution; and it is still doing so. Where production of food has been successful, the faulty system of subsidy and "harmonized" distribution also succeeds in keeping huge food inventories away from needy consumers. Hence the phenomena of general scarcity concurrent with the piling up of wrong-priced foodstuffs in well-to-do countries: these phenomena are strange but not new. We simply have not begun to learn from past mistakes.

Industrial countries have been struggling with possible solutions to their wage-price problems, which, for political expediencies, are often divided into various phases of action. This is nothing other than the old unresolved conflict between capital and labor. On the labor side, appeal has been made to the principles of social justice, more equitable income distribution, and full employment. On the capital side, it has been claimed that price stabilization and real benefit to the nation cannot be achieved by allowing salaries and wages to rise ahead of productivity. Caught between these two worthy sets of arguments, governments would naturally try to mix oil with water in order to please both sides and their own consciences. Instead of tackling the root of the trouble —the basic national economic structure, which at least would need a drastic fiscal shake-up and social reform—they employ the wrong instruments to restrain galloping inflation: i.e., monetary measures, which have borne a burden incommensurate with their proper functions. As a consequence, we have seen exceedingly tight monetary conditions everywhere and a sharp upsurge of interest rates to an unprecedented level all over the world, causing a severe distortion in monetary conditions, especially the structure of interest rates.

Although some reduction in the inflation rate is forecast in the second half of this year and next year, as the effect of higher prices for oil and other commodities begins to subside, the rate of inflation is expected to remain high because of a wage-price spiral caused by the struggle of different groups of people to offset large relative price changes and to maintain their real income. And perhaps the price level may not be stabilized after all in view of recent reports of lower-than-expected crop production in the United States and a new spurt in prices of farm commodities. In this environment, there is justification for very cautious and selective policies. There is little ground for optimism, however, that such a cautious policy approach would be taken. It is also quite clear that the limit of resource availability could not allow the unprecedented rate of economic growth in the past few years to continue much longer without extremely severe price pressures. It is the responsibility of the major countries of the world community to attempt to put their houses in order at the earliest opportunity. Increasing international economic interdependence makes it imperative that the large developed countries, the United States in particular, take the lead in trying to correct their inflation problems first so that the rest of the world would have the environment conducive to solving their own individual problems. In the present environment, it is almost impossible for any country to isolate itself from the repercussions of external disturbances.

It is therefore inescapable that the major countries must make rigorous efforts in connection with their problems of inflation. The more these efforts are closely harmonized among countries, the more assured the results are likely to be. In a situation such as the present, national actions that support and reinforce each other are needed rather than those individual measures, e.g., exchange rate changes, which cancel out at the international level. Among the least demanding actions could be the organized timing of national stabilization programs. The initiative of the EEC countries last year in collective economic decision making to cope with inflation is most welcome. There is a good case for the strengthening and widening of such initiatives which, besides traditional measures, could also cover wage-price control on an extensive scale. This approach of joint and simultaneous national measures could have a powerful international psychological impact on the public's expectation impulses.

The future international monetary system must provide for safeguards that will minimize the possibility of the international monetary system contributing to the spreading and the severity of inflation. To my mind, the future system must be more symmetrical and tight, and less permissive to reserve currency countries. These reserve currency countries should be prevented from continuously financing their balance of payments by accumulating currency liabilities. Even if we succeed in devising such a system, that will not be the end of our trouble regarding inflationary tendencies. This will depend entirely on the economic situation in major countries, most of all in the United States, and their determination to keep on a stable course.

2. Prevailing widespread floating and scope for international cooperation

The Smithsonian Agreement on the realignment of major currencies, including the increase in the official price of gold from US$35 to US$38 a troy ounce, was followed by a brief period of calm in foreign exchange markets. The currency realignment, however, did not lead to expected adjustments of balance of payments disequilibria; in fact, payments deficits of the United States and the United Kingdom continued to deteriorate while the surplus positions of Germany and Japan persisted. Due to balance of payments problems and speculative capital inflow, the pound sterling was allowed to float from mid-1972. Exchange rate uncertainties heightened in January 1973 following (1) Italy's adoption of separate foreign exchange markets, with floating rates for financial transactions, and (2) the floating of the Swiss franc, which quickly appreciated. In February 1973, renewed capital movements out of the U. S. dollar led to the second devaluation of the dollar by 10 per cent, the floating of the Italian lira for all transactions, and to the floating of the yen. The system of fixed exchange rates finally broke down in March 1973 when the EEC countries, except Italy, together with Norway and Sweden, entered into the snake arrangement for joint floating vis-à-vis the U. S. dollar, following a revaluation of the deutsche mark. From March to July 1973, the U. S. dollar continued to depreciate against the currencies of the other Group of Ten countries and the deutsche mark and the Netherlands guilder were again revalued in order to maintain their rates vis-à-vis the other snake currencies within a 2¼ per cent band. Realizing that exchange rate movements determined purely by market forces could prove to be erratic and out of line with underlying trends in the balance of payments as well as basic economic objectives, the United States, Germany, and the United Kingdom, as well as other EEC countries and Japan, began to engage in market intervention. Subsequently, exchange rate fluctuations eased and U. S. dollar rates appreciated due to improvements in the U. S. trade balance. However, exchange rate uncertainties were renewed in early 1974 due to expectations of oil-induced deficits. In January, the French franc left the snake arrangement and floated independently against all other currencies.

In view of rising inflationary expectations and increased balance of payments uncertainties, floating exchange rates are likely to prevail for an indefinite period. A system of general floating appears to be the appropriate course of action under existing circumstances, since it enables oil-induced deficit countries to avoid introducing or intensifying trade and payments restrictions for the purpose of defending par values which have ceased to be realistic. By eliminating the obligation to intervene in exchange markets, floating also prevents undue reserve losses or gains and their adverse impact on the domestic economy.

On the surface, recent experience with widespread floating does not appear to have had harmful effects on trade because traders seem to have been capable of adapting to increased exchange rate uncertainties, and both the volume and value of world trade continued to grow in 1972 and 1973. The total value of world trade increased by 17 and 34 per cent while the volume of world trade expanded by 9 and 11 per cent, respectively, during these two years. It should be noted, however, that the average unit value of internationally traded goods rose sharply in 1973 by 21 per cent, compared with the average rate of 4 per cent during 1968–72. This was due partly to the dollar devaluation and partly to the commodity boom arising from hedging as well as speculative demand. The increase in the volume of trade was concentrated in a group of developed countries. In the case of the less developed countries, the volume of export and import trade rose by 1½ per cent in 1973 compared with 14 and 5 per cent, respectively, in 1972. Thus, recent experience with floating cannot be said to have had no adverse effects on trade expansion, at least as far as less developed countries are concerned.

On the other hand, increased exchange rate uncertainties have contributed to inflationary pressures by increasing the need of private traders and investors to cover against exchange risks and unstable price expectations. Consequently, medium- and long-term investment outlays and production plans are affected. The above-mentioned effects of floating apply universally but are generally more keenly felt by the less developed countries with limited international reserves and heavy reliance on imported capital goods and investment funds. Exchange rate uncertainties, therefore, tend to have a severe impact on their development plans and external debt burdens.

Floating by the major industrial countries has also affected balance of payments and exchange rate policies of the less developed countries whose exchange rates are pegged to a floating intervention currency. While some less developed countries switched to other intervention currencies, their choice in this matter is rather limited due to traditional links and the pattern of trade. In Thailand's case, the U. S. dollar has remained the official intervention currency and the baht has continued to float vis-à-vis the other major currencies.

In sum, the effects of floating should not be assessed on the basis of short-term trends alone. Its impact on economic growth and long-term prospects for world trade should also be considered. While floating is justifiable under present circumstances, early return to a system of more stable but adjustable rates reinforced by an effective adjustment mechanism would be more beneficial to world trade and economic growth.

In the meantime, international cooperation is essential to promote orderly exchange rate developments and to minimize the adverse effects of exchange rate uncertainties on the world economy. It has generally been agreed that current widespread balance of payments problems cannot be solved by competitive depreciations or intensified use of trade and payments restrictions. Toward this end, a voluntary trade pledge is currently being proposed for adoption by Fund members. The Fund has also established a facility for recycling oil funds to countries facing oil-induced deficits, although funds to be recycled through the new oil facility in 1974 will amount to only about SDR 3 billion compared with an aggregate deficit of oil importing countries estimated at over SDR 60 billion in 1974. While the major industrial countries and creditworthy less developed countries should have no difficulty in raising loans in the money markets, terms are likely to be hard and competition stiff. In order to prevent market disruptions, deficit countries should find some means of coordinating both the timing and the terms of borrowings in the money markets. In this connection, it has been suggested that the Bank for International Settlements could play a useful role. Adequate financing for countries that do not have access to the money markets should also be provided.

In order to prevent competitive downward floating and to promote orderly exchange rate developments, the Fund has adopted a set of guidelines for the management of floating exchange rates in accordance with the provision that members "collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements and to avoid competitive exchange alterations." Under guidelines 1 and 2, members are allowed to intervene in the exchange markets to smooth out day-to-day fluctuations as well as fluctuations from medium-term trends. While "aggressive intervention," i.e., to depress the value of a currency when it is falling or to enhance that value when it is rising, is normally prohibited, members are allowed or may be encouraged to intervene aggressively (guideline 3) in order to bring exchange rates closer to "target zones" which have been set in consultation with, or at the initiative of, the Fund. Under guideline 4, the Fund may also initiate consultation regarding medium-term reserve aims of individual member countries consistent with global trends and needs, and may encourage members to intervene more strongly so as to induce reserve movements closer to agreed aims. Under guidelines 5 and 6, countries with floating currencies are expected to refrain from imposing trade and exchange restrictions for balance of payments purposes and to consider the interests of other members, particularly the issuer of the currency used in intervention.

These guidelines should help to prevent wide fluctuations in exchange rates and promote broadly consistent exchange rate policies and balance of payments aims. However, the effectiveness and adequacy of these guidelines remain uncertain as they are not legally binding, the reason being that floating has not been legalized by the Fund. When the Fund's Articles of Agreement have been amended to allow the Fund to authorize floating in particular circumstances, international surveillance of floating could be made more effective by requiring members with floating exchange rates to apply for prior approval by the Fund and to observe conditions and rules laid down by the Fund. For instance, regular consultation with the Fund might be required to ascertain the need to maintain floating rates and time limits for floating could be set. The present diluted version of rules for intervention could also be strengthened by requiring Fund members to intervene to smooth out exchange rate fluctuations and to apply for prior Fund approval before resorting to aggressive intervention. With regard to target zones for equilibrium exchange rates and reserve aims of individual countries, the technique for their determination, as well as the procedure for their application, has yet to be laid down. The Fund should avoid using target zones and reserve aims as automatic indicators to trigger exchange rate changes and should maintain a flexible approach in this matter. Finally, the choice of intervention policies other than smoothing operations should, as far as possible, rest with individual countries.

In sum, the floating of exchange rates should be legalized and more effectively controlled by the Fund to prevent disorderly exchange rate developments and unfair intervention policies aimed at strengthening the trade balance at the expense of other countries. More effective international management of floating would be a step toward an eventual return to a system of stable but adjustable exchange rates.

3. *Recent developments and interim arrangements for global liquidity*

The volume of international reserves, which had grown at a fairly constant rate of about 2 per cent per annum from 1954 to 1969, rose sharply in 1970, 1971, and 1972 at rates of 22, 32, and 19 per cent, respectively. Total international reserves at the end of 1972 were SDR 144 billion compared with SDR 76 billion in 1969. This increase was due almost entirely to the increase in official foreign exchange holdings, which tripled during these three years. In 1973, global reserves rose by 15 per cent to SDR 152 billion, owing to the increase in the official price of gold and to the revaluation of some major currencies.

The composition of reserves for 1973 was foreign exchange holdings 66 per cent, gold 24 per cent, SDRs 6 per cent, and reserve positions in the Fund 4 per cent.

The pattern of reserve distribution has favored the industrial countries, whose total holdings amounted to 67 per cent of world reserves in 1973. Reserve holdings of the less developed countries totaled SDR 37 billion, of which about one third represented reserves of oil producing countries. If the latter's reserves are excluded, reserves of the less developed countries would account for only 13 per cent of total reserves. The oil crisis that occurred at the end of 1973 is expected to alter the pattern of reserve distribution substantially during the next few years, with most of the traditionally surplus industrial countries facing substantial reserve losses along with the less developed countries that are net importers of oil.

Assessments of reserve needs have normally been based on import requirements and money supply as well as evidences of balance of payments and reserve policies, e.g., use of trade and exchange restrictions, domestic demand management, use of balance of payments credits, and aid flows. On this basis, and on expectations of a normal rate of trade growth, global liquidity was estimated to exceed global reserve needs by about SDR 20–30 billion in 1972, and the Fund decided against a further SDR allocation in 1973 and 1974.

The existence of excess liquidity on a global basis did not allow for liquidity shortages on an individual country basis because of the concentrated and skewed pattern of distribution. Moreover, too much weight has been given to past trends of trade growth and reserve needs, too little consideration to growth targets and long-term reserve aims.

The occurrence of the oil crisis in 1973 not only altered the reserve distribution pattern but it also reduced the urgency of the problem of huge currency "overhang." The industrial countries which had accumulated huge dollar reserves which were officially inconvertible no longer pressed for substitution or funding arrangements for the overhang, as the oil exporting countries were content with market convertibility of foreign exchange holdings. While the problem of immediate concern is the recycling of oil funds to oil deficit countries, urgent attention should be given to the destabilizing effects of the liquid and extremely volatile foreign exchange holdings of oil exporting countries on the international monetary system. Toward this end, arrangements should be made to stabilize the Euro-currency market and bilateral funding arrangements concluded between the issuer countries and the oil exporting countries. At the same time, the Fund should initiate a "substitution facility" whereby reserve currency holdings could be converted into SDRs. This facility should operate on a voluntary basis.

In view of the present shortage of liquidity experienced by oil importing countries, urgent attention should be given to the problem of making gold generally usable. In this connection, the Group of Ten agreed to use gold at the market price as collateral for central bank borrowings from June of this year. As this arrangement is inconsistent with existing Fund provisions for official gold transactions at par, the following alternatives have been suggested for dealing with the gold problem:

(1) maintain the official gold price and allow monetary authorities to sell gold in the market;

(2) abolish the official gold price, allow monetary authorities to sell gold among themselves and to sell to the Fund at market-related prices, and to sell, but not to buy, gold in the market;

(3) as in (2) above but allow monetary authorities to buy gold in the market also; and

(4) establish a gold substitution account in the Fund for conversion of gold reserves into SDRs at market-related prices and authorize the Fund to sell gold in the market from time to time.

A direct increase in the official gold price is generally not regarded as an acceptable solution, since it would directly conflict with the long-term objective of demonetizing gold by increasing expectations for further price rises. An increase in the official price of gold would also result in increased liquidity which would be unevenly distributed and is also likely to jeopardize future allocations of special drawing rights.

Any arrangement for gold should not only ensure more efficient management of global liquidity by increasing the role of internationally managed reserve assets such as the SDR, but should also promote fair distribution of gains between those countries that have accumulated gold and those that have observed the Fund's ruling against accumulating gold at the market price. One means of ensuring fair distribution of gains would be through international management of gold sales and the transfer of profits to development finance institutions.

In order to enlarge the role of the SDR as the main primary reserve asset and to promote substitution of reserve currencies and gold into SDRs, the attractiveness of the SDR should be increased by guaranteeing its capital value and by increasing the yield on SDR holdings. An adequate rate of "effective yield" should make the SDR as attractive to hold as other reserve assets but not so attractive as to make SDR holders unwilling to part with these reserve assets.

Toward this end, the method for SDR valuation for purposes of official transactions was changed from the use of the par value of the SDR (in terms of the U. S. dollar) and market rates between the U. S. dollar and other currencies to the "standard basket" approach. Under the new method, the value of the SDR is equivalent to the sum of 16 currency components broadly weighted according to the countries' relative shares in world trade; the U. S. dollar, however, is assigned a weight of 33 per cent to allow for its role as the principal reserve currency. The value of the SDR in terms of the U. S. dollar is then determined by converting the various currency components in the basket into U. S. dollars at market rates. The rate of the U. S. dollar per one SDR thus derived is used for computing the value of the SDR in terms of other currencies by applying the prevailing market rates between the U. S. dollar and the currency desired.

Under this method of valuation, the value of the SDR in terms of currencies will vary constantly, i.e., increasing in terms of the depreciating currency and decreasing in terms of other currencies. When currencies are generally appreciating, the value of the SDR in terms of currencies in general will decline. In times of general depreciation, however, the value of the SDR will appreciate. Thus, assuming that currency appreciations and depreciations are balanced over a period of time, the value of the SDR in terms of currencies should remain fairly constant.

This method of valuation ensures that the value of the SDR will reflect the effective relationship between currencies instead of linking the SDR value to the par value of the U. S. dollar when market rates of the major currencies are in fact floating freely against the U. S. dollar. Thus, members using SDRs should get more value for each SDR than the previous method whereby currency values were tied to an overvalued dollar.

The basket approach should make the SDR more widely usable, since its gold-like character will henceforth be merely a formality and transactions prices in terms of currencies will be computed from market rates. The reluctance to use the SDR in times of uncertainty regarding the gold price should therefore be eliminated.

The SDR will, however, be more attractive than reserve currency holdings under the new method of valuation, since exchange risks will be spread out over 16 currencies. Moreover, changes in currency value will correspond to the relative weight of that currency. On balance SDR holdings will be more secure than holdings of any one currency.

In addition to the change in the valuation method, the rate of interest on SDR holdings has also been increased from $1\frac{1}{2}$ to 5 per cent per annum. In the future, this rate will be reviewed at frequent intervals and changes will reflect average short-term interest rates in five major industrial countries (France, Germany, Japan, the United Kingdom and the United States).

The combined effect of a stable capital value and a higher interest rate should make the SDR more widely acceptable and usable in official transactions, which should help to ensure more efficient management of international reserves and prevent destabilizing shifts between various forms of reserve assets.

4. The Euro-dollar market

Since its emergence in the 1950s, the Euro-dollar market has enjoyed a record of remarkable growth. Development of the Euro-dollar market has been encouraged by the relative freedom from restrictions which apply to other types of transactions as well as to the competitiveness of its interest rates relative to rates in national money markets. The con venience and anonymity offered by the market have also contributed to its popularity among banks and other institutions in the United States as well as in other countries. The structure of the market has undergone a rapid transformation involving a decline in the U. S. dollar component which has always made up the bulk of Euro-dollar transactions, and a change in the geographical pattern of lending and borrowing through the market. In 1969, U. S. residents were the main net users while the main net supplier was the reporting European area. By the end of 1973, the main user on the market was Japan, followed by the United States, while the main net supplier was the Middle East. Loans to developing countries, mostly on a roll-over basis, more than doubled in value last year, while borrowing by developed countries, made in anticipation of balance of payments difficulties, increased substantially in the wake of the recent shifts in terms of trade due to increases in the price of oil.

The recent spectacular development of the Euro-currency market has been contrary to general expectation. In view of the United States being able to reduce its balance of payments deficits, it was widely expected that the reflow of liquid funds to the United States would dry up much of the resources of the Euro-dollar market, and its development would be moderated. Other factors that have been, and are expected to continue, operating in the direction of reducing the rate of growth of the Euro-dollar market and encouraging deposits in local currency markets rather than with banks in the Euro-currency market are the removal of U. S. capital controls, the decreasing differential between interest rates in the Euro-currency market and local money markets, and the possibility of controls being imposed on the market by governments of countries in which the banks are situated, possibly making it difficult for depositors to withdraw funds from the market at will.

In its role as an intermediary for international financial transactions, the Euro-dollar market has promoted the efficient allocation of financial resources and has encouraged, through the influence of its interest rates on that of different countries, a certain degree of homogeneity of monetary policy. By facilitating international loan transactions, it has played an important role in encouraging the expansion of international trade. More recently, funds have been channeled through the Euro-dollar market to the developing countries and used for developmental purposes.

In spite of the valuable services the Euro-dollar market is recognized to have performed, its scope and intricate mechanism are far from being generally understood in depth. A number of problems may be mentioned in relation to the Euro-dollar market. It is often contended that the Euro-dollar market is a major force contributing to the present state of inflation due to the fact that banks in the Euro-dollar market create credit by expanding loans in the same manner that banks in a domestic banking system create deposits up to the limits of required reserves. In this way the global supply of money is said to be increased. However, it should be noted that Euro-dollar deposits are not a direct means of payment but must be converted to a bank deposit in the United States. Furthermore, the major portion of funds in the market is held in the form of term deposits rather than at call and therefore cannot be considered as part of the money supply in the same manner as demand deposits of nationally operating commercial banks. While there is no consensus as to whether deposits in the Euro-dollar market can indeed initiate a process of money creation, it has been recognized that total liquidity is in fact increased by central bank deposits in the market, because when a central bank deposits money in the market, total liquidity in the domestic market is not correspondingly decreased, which is what occurs with deposits by private institutions, while liquidity in the recipient country is increased. The central banks from which the funds originated still hold in their reserves the balances they have deposited in the market, while the central banks of the recipient countries also show in their reserves the new balances which have come into their hands. Hence, global liquidity is increased.

In an attempt to prevent this increased global liquidity from causing inflation, the Group of Ten in 1971 agreed not to increase their official placements in the Euro-currency market and a limitation on the placement of official reserves by all Fund members is being examined. There is no real reason why central banks should object to this proposal because traditionally, before the emergence of the Euro-currency market banks have always deposited their reserves in the countries in whose currencies their reserves are held. The interest rate advantage of the Euro-currency market has now been diminished due to high interest rates in the national money markets, and depositors are already turning to national money markets to place their funds. The advantage left is that of convenience, for if major countries re-establish or maintain controls on the inflow of capital similar to those which existed during th greater part of 1973, it would be very difficult or very unprofitable for central banks to deposit in such countries. As this would in effect encourage deposits in the Euro-currency market once again, it is important that such controls be discouraged.

Critics of the Euro-dollar system often point out that due to the fact that banks in the Euro-dollar market operate under relatively few controls over their activities, they can sometimes give rise to flows of funds of substantial size which can undermine national economic policies. Furthermore, they contribute to destabilizing capital movements by being a source of speculative funds connected with flights of funds out of weak currencies and rushes into strong currencies. This is said to have been most pronounced during the first few months of 1974 when Euro-bank liabilities to U. S. residents increased by about $2 billion. The opposing view is that most deposits in the Euro-dollar market are term deposits and cannot be immediately withdrawn in response to interest rate or exchange rate advantages so that their exact role in promoting instability is debatable. In any case, these movements of capital have not been the cause of instabilities of the monetary system but rather the consequence of lack of confidence arising from more basic disequilibrium, coupled with an inadequate adjustment mechanism. To prevent the potential damage caused by flows of capital via the Euro-currency market, a prompt adjustment process is therefore desirable. In an attempt to minimize destablizing capital flows, capital controls may be necessary in some cases, though it is generally recognized that, ordinarily, capital flows should be as free as possible. Controls on capital flows should be used only as a temporary measure and should not inhibit flows for investment or developmental purposes. Though controls on capital flows are not by themselves desirable, they are preferable to controls on trade.

More recently, the instability of the Euro-dollar market caused by the changing pattern of supply and demand of funds in the wake of the recent oil crisis has become a matter of increasing concern. Increased demand for funds by countries suffering balance of payments problems, and by developing countries suffering a declining supply of economic assistance regularly forthcoming from industrial countries, together with high interest rates prevailing in domestic money markets due to the universal pursuit of contractionary monetary policies, has caused interest rates in the Euro-currency markets to soar to unprecedented heights.

For example, a record 14 per cent for the three-month Euro-dollar was achieved in early July. A greater part of the current demand for funds in the Euro-currency market is for medium- or long-term finance, while a greater part of the supply is very short term. Most notably, petrodol-lars are placed in very short-term deposits for maximum maneuvera-bility due to the prevailing climate of uncertainty and distrust in the foreign exchange markets. In fact, many banks have experienced seri ous losses due to their foreign exchange commitments. Consequently banks are finding it necessary to finance long-term loans with short term deposits and this has resulted in the fear that, if maturing fund fail to be redeposited, banks may be unable to meet their obligation and a moratorium will have to be declared. This fear has accentuated the problem by increasing the desire of customers for shorter rathe than longer-term deposits. Further complicating the matter is the possi bility that banks may find their lending growth inhibited by the inabilit to take on additional deposits due to their rapidly declining capital deposit ratios.

Due to the lack of confidence in the Euro-currency market, holder of funds are turning toward national money markets in Europe and th United States instead of the Euro-currency market. This tendency ha been more pronounced recently due to the decline in the interest rat advantage which once existed in the Euro-currency market. The possi bility of controls being devised to limit the operations of banks in th market has raised fears of increasing difficulty in withdrawing fund from the market and has reinforced the preference for short-tern deposits.

These problems have resulted in increased concern over the stabilit of the institutions within the Euro-dollar market and measures ar being considered with a view to improving the security of the market.

For instance, major Western countries have reportedly reached a informal agreement to protect the Euro-currency market against collaps by providing support to a major bank with substantial Euro-currenc exposure, and which is facing liquidity problems that could lead to major failure, to a certain extent of their regular swap lines. They are therefore, acting as lenders of last resort in a limited way. Though th role of central banks is important in building up confidence in th banks, the problem remains as to which country should have the fin responsibility over any particular bank, and the extent of authority the should have over the operation of the bank, in order to enforce rules for orderly and prudent conduct of banking business. Controls worth considering are direct limits on total Euro-currency liabilities or lending, or reserve requirements on liabilities or lending. These controls will limit the expansion of banks' Euro-currency business but will also cause a reduction in the exposure of the banks, promoting a healthier investment climate. Through reducing Euro-currency transactions it may also be argued that controls on Euro-currency activity will cause global liquidity to be reduced, relieving inflationary pressures created by the Euro-currency market, if in fact they do exist. On the other hand, with a reduction in the supply of credit, it would become increasingly difficult to take out loans for balance of payments or for developmental needs, and could increase the cost of any loans obtainable.

In recognition of the importance of the Euro-dollar market's contributions to the growth of the international economy, care must therefore be taken not to make credit so expensive or constraints so overpowering that it would impair the market's function as an efficient medium for the allocation of credit on a world-wide scale. As an important source of capital and outlet for investment, the continued existence of the market is desirable, particularly for developing countries. Studies of the nature and implications of the market should therefore be made with a view to introducing long-term measures to improve the security of the market without considerably affecting its efficiency and cost elements. Increased confidence in the market is particularly urgent in order to recycle money from the oil producing nations to oil importing nations which are suffering substantial balance of payments deficits. In the event that the Euro-dollar market is greatly restricted in the future by international agreements and as a result of consolidation of currency overhangs, alternative sources of funds must be found for the developing countries.

III. Long-Term Objectives of Monetary Reform

1. Introduction

International monetary problems discussed in part I of this paper demand immediate and concerted action to ensure that international trade and investment are not disrupted by the general abandonment of par value obligations and the breakdown of the gold exchange standard.

Toward this end, some steps have already been taken. The Fund has adopted a new standard of value, the SDR, whose value is linked to a basket of currencies at the current market rates for transactions with member countries involving SDRs as well as currencies that are floating. Guidelines for Fund management of floating exchange rates have also been established. In order to provide a more effective forum for international consultation on monetary issues of mutual concern, the structure of the Fund will be streamlined by increasing the functions of the Executive Board and establishing an Interim Committee of the Board of Governors. This Interim Committee, consisting of high-level representatives of the constituencies which are entitled to appoint or elect an Executive Director, will be of about the same size as the now defunct Committee of Twenty (160 persons in attendance). It will advise the Board of Governors on the need for adjustment of imbalances and the appropriateness of exchange rates and payments policies, as well as act as a forum for international cooperation in dealing with monetary crises and the future of the international monetary system. It is expected that the Interim Committee will be replaced in due course by a permanent Council of Governors with decision-making powers.

These interim arrangements should adequately meet present needs of the world community. However, uncertainties with regard to exchange rate flexibility, the usability and value of gold and foreign currency holdings, and the criteria for balance of payments adjustment will persist, with adverse consequences on the long-term prospects for international trade and economic growth in the following ways: Fluctuations of exchange rates, which serve the function of translating international prices into domestic prices, will generate price instability and accelerate inflation rates, thereby eroding confidence in money. Failure to agree on the value and usability of reserve assets will affect the need for balance of payments financing and encourage destabilizing shifts between various forms of reserve assets. Finally, and perhaps the most important shortcoming of this present nonsystem, is the lack of an adequate adjustment mechanism, the root cause of past monetary crises which led to the breakdown of the Bretton Woods system. While the Fund will begin to play a more active role in promoting prompt and adequate adjustment of imbalances, there has been no agreement on the criteria to be used in determining the need for adjustment and the forms and degrees of sanctions to give more "bite" to the adjustment mechanism. The effectiveness of Fund surveillance will thus be hampered.

Another aspect of international economic relations which remains to be rectified is the transfer of real resources to the less developed countries. While it is generally recognized that the welfare of the less developed countries is of vital concern to world peace and stability, very little has been done to translate this principle into concrete action.

In sum, long-term monetary issues which should be dealt with are as follows: the exchange rate system, the adjustment mechanism, improved management of global liquidity, convertibility and intervention practices, and the special interests of the less developed countries.

I cannot venture to predict how long the present upheavals in the payments positions and prospects will last. This may take two to three years. But for all we know, monetary conditions may take as long as a decade to stabilize. To prepare for any eventuality, negotiations on the features of the system which will replace Bretton Woods should be resumed by the Council of Governors. The findings of the Committee of Twenty should be used as the starting point, adding to the "skeleton" of the reformed system the necessary technical points and operational details. These long-term issues need not be tackled in one package, since the degree of urgency varies from case to case. Priority should be given to improvement of the adjustment mechanism, management of global liquidity, and the special interests of the less developed countries. Agreement on the exchange rate system and convertibility and intervention practices could be postponed until conditions become more stable. The evolutionary and piecemeal approach to international monetary reform may not result in an ideal system. However, this approach will ensure that solutions to long-term monetary problems will be acceptable and practicable.

I shall now proceed to discuss each of the basic objectives of reform separately.

2. *The adjustment mechanism*

In order to ensure smooth functioning of the international monetary system, both surplus and deficit countries should be obliged to undertake prompt and adequate adjustment measures. The basis for determining the need for adjustment in both cases would be either (1) a dis-

Error

An error occurred while processing this page. See the system log for more details.

The need to improve management of reserve currency holdings has already been discussed in connection with the Euro-currency market arrangements for reserves accumulated by oil exporting countries. Possible arrangements for gold have also been examined. Suggestions for substitution of reserve currencies and gold for SDRs and for periodic sales of gold in the market are in line with the long-term objective of enlarging the role of an internationally managed reserve asset, i.e., the SDR. In the long run, the SDR should become the center of the international monetary system, replacing the gold exchange standard.

Toward this end, the value of the SDR should be more stable than currency holdings. This could be achieved by increasing the value of the SDR at a given rate per annum, i.e., increasing the number of currency units in the basket under the modified "standard basket" approach. Alternatively, the "asymmetrical basket" approach could be adopted, whereby the number of units of the currency which has devalued or floated downward will be increased in proportion to exchange rate changes. This approach will prevent the value of the SDR from declining in terms of nondepreciating currencies, while a revaluation or upward float will continue to raise the value of the SDR in terms of other currencies. Both approaches will ensure that the capital value of the SDR will increase over time and will make it an internationally preferred reserve asset. A stronger SDR would, however, imply lower interest rates on SDR holdings to prevent hoarding. Finally, existing rules for the use and holding of SDRs should be amended to improve the reserve asset nature of the SDR and to reduce its role as a short-term balance of payments credit. In this respect, reconstitution provisions and acceptance limits for the SDR should be abolished. The possibility of promoting general understanding and use of the SDR by the private sector should also be explored.

Regarding official holdings of foreign currencies, the conflict between the desire of individual countries to retain the freedom of determining the composition of their reserves, on the one hand, and the general recognition of the need for more effective control of global liquidity increases and destabilizing shifts between the various forms of reserve assets, on the other hand, should be resolved. The existing currency overhang not only creates the problem of uneven reserve distribution but also defeats the aim of improving the adjustment mechanism. We are sympathetic to the needs of monetary authorities to choose the composition of their reserves according to their income-earning objectives and the need to maintain adequate working balances to ensure access to the money markets. However, the principle of improved management of liquidity should prevail. Under the reformed system, countries should avoid sudden changes in the composition of their reserves and should aim to reduce foreign currency holdings over time. The Fund should be authorized to issue SDRs for substitution of reserve currencies presented by official holders and should be able to designate members to substitute reserve currencies for SDRs when necessary.

Under the reformed system, the volume of global reserves should be managed by means of SDR allocations so as to prevent inflation as well as deflation. To allow for shifts from private holdings of currencies to official holdings, a sufficient degree of elasticity will have to be provided either by means of limits on primary reserve holdings (beyond which countries would not be entitled to convert foreign currency holdings into gold or SDRs) or by allowing for exemptions of obligations on asset settlement as discussed below.

3. *Special interests of less developed countries*

The reformed system should provide for the less developed countries to be exempted from adjustment obligations and the application of pressures due to the special characteristics and needs of these countries. The special needs of the less developed countries should also be recognized with regard to reserve norms. The reformed system should also ensure that the transfer of real resources to the less developed countries will increase steadily in proportion to their growth objectives.

The principle of resource transfer is justified by the fact that less developed countries have always been at the losing end throughout the recent international monetary upheavals arising from factors beyond their control. This is seen clearly in the case of exchange rate uncertainties. Price instability resulting from exchange rate uncertainties and inflation has not only disrupted development plans of the less developed countries but also domestic production, income, and employment. Exchange rate flexibility is likely to remain a permanent feature of the international monetary system. In addition, the less developed countries will be subject to more control with regard to reserve management, convertibility, and adjustment, in spite of the fact that their conduct in these matters will not have substantial impact on the rest of the world. To offset these adverse effects, concrete measures should be adopted to ensure increased transfer of real resources to the less developed countries.

In this connection, the proposal to link SDR allocations to development finance either by direct SDR allocation to the less developed countries or indirectly through development finance institutions should be implemented as soon as possible. The establishment of a link will ensure that the benefits hitherto enjoyed exclusively by major countries whose currencies are held by other countries as reserves will now be enjoyed by the less developed countries. The link should not, however, accelerate world inflation, and SDR creation should continue to be based on careful assessment of global reserve needs alone. Technical problems seem not to exist; what is lacking is political support and commitment.

The Fund should also endeavor to improve existing credit facilities, particularly the compensatory financing facility and the buffer stock financing facility, aimed at stabilizing prices of primary products. Longer-term balance of payments support should also be considered by the Fund in addition to the link under the proposed extended Fund facility.

Other aspects of the transfer of real resources to less developed countries—i.e., improved quality of aid, higher targets for official aid, access to capital markets, and external debt relief measures—have been recognized as desirable objectives of monetary reform. However, the machinery for overseeing work in this area has been lacking. The Committee of Twenty's proposal to set up a joint Ministerial Committee of the International Monetary Fund and the World Bank to study this matter is therefore very welcome.

In view of the pressing needs of the less developed countries, the proposed link, as well as other aspects of resource transfers, should be implemented as soon as practicable.

4. *Exchange rate system*

I have already indicated my preference for a system of stable exchange rates. To be more specific, this would imply a return to fixed but adjustable parities, with floating in special cases when approved by the Fund. Thus, under the reformed system, countries should be obliged to maintain exchange rates within agreed margins. At present, the Fund allows rates to fluctuate within margins of $2\frac{1}{4}$ per cent above or below the par value in terms of SDRs. This means $4\frac{1}{2}$ per cent margins above or below the parity relationship between any two currencies derived from the ratio between their par values in terms of SDRs. Exchange rates of any currencies could therefore be as much as 9 per cent apart. Under the reformed system, wider margins than prevailing at present should not be accepted. Proposals for simplified procedures for Fund approval of small and frequent changes in par values as well as managed floating rates would likewise not be in the interest of the world community. It is conceivable that there could be very little difference in the degree of exchange rate flexibility under (1) a stable but adjustable rate system with floating in particular cases; (2) a fixed rate system with simplified procedures for Fund approval of small and frequent par value changes; and (3) a system of managed floating. However, in terms of psychological effects and the effectiveness of international surveillance, the first alternative appears to be more beneficial to the long-term prospects of trade and economic growth.

5. *Convertibility*

Another basic feature of the reformed system should be the resumption of convertibility obligations. This means that all countries would be obliged to settle in primary assets all official currency holdings presented for conversion. For countries whose currencies are not used for trading and reserve purposes, convertibility obligation would be observed by official intervention to maintain exchange rates within agreed margins.

The reformed system should, therefore, ensure that all countries whose currencies are held as official reserves would reduce their currency liabilities to the full extent of their balance of payments deficits. This could be done by bilateral conversion or through the Fund, based on changes in total currency liabilities to official holders. Countries in surplus should, however, have the option to convert reserve currency holdings, provided that accumulations beyond appropriate limits would be subject to Fund designation for substitution into SDRs. This mechanism would ensure that deficit countries would not be able to finance their imbalances by increasing currency liabilities, while surplus countries would enjoy a degree of freedom in reserve management policies. To ensure an adequate degree of elasticity, limits of primary asset holdngs or exemptions of reserve currency countries from settlement obligaions would also have to be provided.

›. *Intervention practices*

Under the reformed system, all countries should be obliged to interrene to maintain their exchange rates within agreed margins. The same legree of exchange rate flexibility within these margins should be availıble to all countries. Toward this end, it has been suggested that counries whose currencies are widely traded should undertake to maintain xchange rates vis-à-vis each other's currency within a band of $4\frac{1}{2}$ per ent based on parity relationships under the multicurrency intervention ystem. Other countries will maintain rates within the same margins is-à-vis their intervention currency or currencies, which would norıally be the currencies of countries participating in the multicurrency ntervention scheme. This would ensure that any pair of currencies vould not be more than 9 per cent apart. Alternatively, the SDR has ieen suggested as the intervention medium. However, this would conlict with the use of the basket approach for SDR valuation, as SDRs ısed for intervention will be transacted at agreed margins above or ielow the par value. This approach would also involve private use of he SDR which may take time to develop. The multicurrency intervenion system appears to be more feasible in the foreseeable future.

Regarding intervention practices, it is hoped that currencies that are ied to a major currency will continue to have the same degree of flexiility vis-à-vis their intervention currency regardless of where their ıtervention currency stands.

Steps to International Monetary Order

By Puey Ungphakorn

The oral presentation by Dr. Puey follows. The text of his written presentation begins on page 63, above.

MR. CHAIRMAN, LADIES AND GENTLEMEN: It is indeed a great honor and privilege to be given the opportunity of speaking before this distinguished assembly on a subject of great importance for the world today.

I left central banking and all responsibility regarding international monetary problems exactly on the 15th of August 1971, just on the dot to escape the first blast of the U. S. dollar explosion. Since then, I have been preoccupied with the more peaceful subjects of rural development and rural education. Meanwhile, the international financial world has become more and more confused and confusing. So, I thanked my stars for having been able to leave my previous burden to my friend and successor, the present Governor of the Bank of Thailand, whom I see sitting here today.

I somewhat regret my foolhardiness in having accepted Ambassador Burgess' invitation to present a paper here on Steps to International Monetary Order. The person who influenced my rash decision in the spring, apart from Mr. Burgess, Mr. Tun Thin, and the Governor of the Bank of Thailand, was my old friend and colleague, the late Mrs. Suparb Yossundara, who managed to persuade me to it on her deathbed. Suparb has in this assembly many friends who loved her, so, maybe I could be forgiven for invoking our cherished remembrances of her.

For me, the transition back to international finance from rural development has been rather painful and laborious. So, I asked Vijit Supinit and Viyada Avilasakul of the Bank of Thailand to help me. Even so, I ealize that, in spite of the excellent help given to me by the Bank of hailand, my ignorance and confusion on the subject have not really iminished. It is perhaps a mercy that because I have no responsibilities ι the international financial world today, I am free to make a fool of ιyself.

Mr. Chairman, I have divided my paper into two sections, Immediate teps and Long-Term Objectives of Monetary Reform.

On the immediate steps for international monetary order, I submit ιat (1) we must all cooperate to control inflation as the first priority; 2) major currency floating is necessary at the moment, but it must be ιbject to management both by the governments concerned and under ιe surveillance of the Fund; (3) the problems of volatile oil funds and ollar overhang necessitate the establishment of a Fund substitution fa-lity; (4) there should be international management of gold sales, with rofits transferred to development finance institutions; (5) special rawing rights should be promoted to play a more and more important ɔle as international numeraire and in reserves; (6) the Euro-currency ιarket, useful as it is at present, should, however, be under regulation; ιd (7) arrangements for recycling petrodollars for development pur-ɔses should be made as speedily as possible.

I am glad to say that Mr. Witteveen has already pronounced on ιany points which coincide with my way of thinking and I am glad to e that some of the steps have already been taken at the recent IMF nnual Meeting.

For the long-term objectives, I am afraid, despite Dr. Oort's power-ιl and eloquent arguments, I still feel that, from the point of view of eveloping countries, we need a system of stable exchange rates with a rompt adjustment mechanism. The proposed Council of Governors of ιe Fund, the enlarged role of the Executive Board, more teeth in the und surveillance responsibilities could, to a large extent, correct the gidity of the past system. I still disagree with Dr. Oort on one point at ast. For one thing, I think that the costs to the less developed coun-ies of a forward market mechanism would not be acceptable. Dr. Oort imself has stated in his paper that the success or failure of managed ɔating would depend on the quality of the management. Who is going ι manage that floating in each country? Governors, civil servants, per-aps, but they will fall under the guidance of politicians, and I must admit to some skepticism regarding the quality of politicians for dealing with day-to-day floating in national currencies.

Even if the IMF could conduct very effective surveillance services, other proposals required for achieving long-term objectives are as follows: (1) SDRs must be made ultimate, primary reserves, while gold and reserve currencies should fade out; (2) at the same time a link between SDRs and development finance should be established, subject to suitable regulations; (3) convertibility obligations should be resumed; and (4) a multicurrency intervention system should be encouraged in which countries whose currencies are widely traded should undertake to intervene in each other's currency to maintain their exchange rates within the prescribed margins.

I believe that in my written presentation I have given adequate reasons for the various proposals. So in order to save time I am not going to repeat them. However, before I sit down may I make a few further remarks?

First, if mankind were not too much preoccupied with wars and the production of arms, perhaps we could devote more resources to the production and distribution of food, and the prices of food need not have inflated so much, which is one of the main reasons for our inflationary status at the moment.

Second, the problems of wages versus prices or, as we sometimes put it, cost-push inflation need to be attacked at the root by drastic social and fiscal reforms, instead of monetary measures. This is true of less developed countries as well as industrial developed countries.

Third, it is unrealistic as well as unnecessary to expect petroleum prices to climb down before international monetary reform is achieved. What we, the oil importing countries, need is the assurance of a stable price or at least a stable price trend which will enable us to have a clearer idea of the payments and inflationary problems ahead of us.

Fourth, I notice that in the past, discussions on international monetary problems have taken an unduly long time and in many instances they have been overtaken by new events. Whenever there was a lull between crises, there was also a lull in the discussions in favor of the status quo, until the next crisis compelled decisions to be taken quickly under pressure. The reports are usually very polite, which is perhaps a good thing. But they have rarely been concrete or specific enough, which is not so good. Perhaps specific reference or warning to culprits is taboo in international financial diplomacy. Is it too much to expect, from now on, freer and franker discussions leading to more timely and more effective international monetary reform?

Finally, in this unequal world, less developed countries and developed countries are subject to asymmetrical treatment. Less developed countries need development aid from the World Bank, and in order to obtain such aid they have to belong to the Fund and behave according to Fund rules. There is nothing wrong with this, I admit. But it would be very sinful for them, that is, the less developed countries, to resort to illegal practices, such as multiple currency practices in case of necessity, for instance, if they want gradual, instead of abrupt, rises in the domestic price of oil. On the other hand, Mr. Chairman, major countries can resort to all sorts of tricks which are admittedly illegal. Proposals have now been made that such illegal practices should be legalized by amending the rules to suit the circumstances. The so-called independent national monetary policy of the developed countries must be respected; but that of less developed countries can be ignored. In such a world, Mr. Chairman, has one any right to expect international democratic monetary order? Thank you.

* * * *

MR. WALLENBERG: Thank you, Dr. Puey. You have certainly added another dimension to this very interesting and critical problem that we are dealing with today. We are going to have a short intermission, and I hope that many question cards are going to be filled in during this time.

Our next speaker is Dr. Saburo Okita, President of the Japanese Overseas Economic Cooperation Fund. He has been most helpful, I must add, in the original planning of this meeting, and I take this opportunity to express our great gratitude to him. Dr. Okita.

Commentaries

Commentaries on Conrad J. Oort's and Puey Ungphakorn's presentations were offered by Saburo Okita of Japan and William McChesney Martin of the United States. The texts of their statements follow, beginning on this page and on page 97, below.

Saburo Okita

MR. CHAIRMAN, LADIES AND GENTLEMEN: This is a somewhat embarrassing opportunity for me to speak before this distinguished gathering of monetary experts and financial magnates.

I was in Nairobi last year and became somewhat involved in this memorial lecture to be held in Japan. I made a few comments, but I did not expect that I would be involved so deeply as to be one of the commentators today. My background is mostly in the economic field and not very much in the financial and monetary field. Therefore, today I shall make my comments more on a nonmonetary basis than on the purely monetary aspects.

To begin with, the two papers are excellent, with very appropriate balance between the technical and the basic policy considerations. The two papers, by Dr. Oort and Dr. Puey, have shown a contrast in their emphasis, the former emphasizing managed floating and the latter emphasizing a stable but flexible par value system. Apart from the difference of the standpoint which Dr. Puey has introduced in his paper and in his statement today, that is, the aspect of the developed countries' point of view and the developing countries' point of view, I personally consider that at this stage of instability in the world economy—oil, food, inflation—there is probably no alternative but to follow the present course of more or less managed floating, or semimanaged floating, coupled with international surveillance. This is the practical world we are living in and so long as we do not know how long this transitional period will continue into the future—but at least for some years to come—we will have to live in a world currency system of managed floating. There are other problems related to the north/south relationship which I will refer to later.

After reading the two papers, I have the feeling, that although they deal very well with the current problems, there is something missing—the two papers do not go into long-term international capital movements, including direct investment as well as the portfolio type of international investment. This aspect needs to be discussed in future in more detail, especially because of the possibility of very large-scale transfers of capital among nations. When we look at this particularly from the Japanese point of view, we feel that future prospects and problems of the transfer of long-term investment and capital, including petrodollars, should deserve attention.

In order to be able to have a somewhat more stable international monetary system, we must take into account the violent or two-digit inflation which we have not experienced for 25 years or so but which we are now facing. The violence of this inflation has created many domestic economic and political issues. But it will also have very many international repercussions. Dr. Puey's paper makes reference to this aspect. The question is whether we should live with inflation or whether we should fight it to the last ditch. This is the question to which no economist, no person can make a firm answer. We may have to live with a somewhat lower degree of inflation than the present one. But when we face the lack of stable national key currencies or the gold standard system, we have to introduce some reliable standard. This was, I think, the case for the SDR and so far, although much has been expected from this system, we are not very sure about the functioning of this new standard—especially when the rate of inflation turned out to be rather high compared with the rate of inflation existing when the SDR system was introduced.

This situation reminds me of a proposal made by Professor Jan Tinbergen and a few other economists some 10 years ago at the first UNCTAD meeting, namely, the commodity standard—the basket of key commodities traded in the world market. Now we have the SDR—the basket of major currencies which are influenced very much by their respective national inflation. The basket of key currencies or the basket of key commodities—which is more dependable as the standard of value? These are rather basic problems but we cannot neglect such fundamental questions because the problems we are facing now are so far-reaching.

Now, let us come to the north/south relationship. Especially in his concluding remarks, Dr. Puey forcefully mentioned the relevance of the existing order in rich countries to the problems of the developing world. I think this is a question we have been facing for more than a decade, especially since the idea of UNCTAD (United Nations Conference on Trade and Development) was introduced by Raul Prebisch's report some 10 years ago. The argument at that time, as I remember it, was that there were free market mechanisms, free competitive systems, and nondiscriminatory treatment in trade. It looked very fair on the surface but it was rather unfair in substance. This case may be similar to playing a golf game without a handicap. There are differences of skills, differences of strength, and to play with a handicap is a much fairer game.

In international economic transactions, including trade and monetary transactions, we may have to consider this aspect. The international free market mechanism, supported by a monetary system to encourage free exchange, sometimes brings about adverse effects, especially on the weaker economies. There must be some consideration given to this aspect—how to remove the danger that the rules of play among rich countries may adversely affect the weaker partners. There must be some kind of transfer—real transfer—of resources, and the monetary system should be in line with, at least not hinder, such real transfer of resources.

We sometimes feel, in the dynamic international division of labor in the future, there should be more transfer of industries from rich countries to poorer countries. We noticed here in Japan a very large shift, say, of textiles, from exports to imports. We imported last year $1.7 billion of textile manufactures, half of which came from developing countries. In Europe there are some 14 million foreign workers to make up the labor shortage. It may be more desirable to transfer industries to areas where the labor supply is abundant, rather than to transfer the labor force into rich countries. We probably should also encourage the transfer of resources through petrodollars. The higher price of oil is, in a sense, a forced saving on the part of rich countries. And if this forced saving is utilized in the interest of more balanced world economic development, this may have its advantage. This is really just my rule of thumb, but if oil producing countries could spare, say, about one third of their extra earnings for the development of the developing countries, while the richer countries maintain their level of development assistance at least at the current level, then this would bring about a very different picture of the world economy as a whole. I think these are some of the possible and desirable directions of the changes in the world economy. As Mr. Witteveen mentioned this afternoon, for any monetary reforms there must be sensible objectives, eventual long-term purposes, and reforms should be in conformity with the purposes and objectives of changes in production, distribution, and trade, that is, in the real world. These are some of the thoughts, not questions, I have had in reading the two excellent papers and in listening to the presentation of those papers. Thank you very much.

* * * *

MR. WALLENBERG: Thank you, Dr. Okita. You have emphasized certain points that have been very helpful for our discussion, and I am grateful to you.

And now, finally, I want to call on Mr. William McChesney Martin, former Chairman of the Board of Governors of the Federal Reserve System of the United States. He is also an early and constant supporter of this Foundation and one of our Directors. This is the second time that we have persuaded him to share his thoughts with us. The earlier occasion was in Basle when he spoke, most fittingly, on the subject "Toward a World Central Bank." His words then were prophetic; let us hear what he will prophesy now.

William McChesney Martin

MR. CHAIRMAN AND PARTICIPANTS IN THIS ELEVENTH ANNUAL LECTURE MEETING OF THE PER JACOBSSON FOUNDATION: This morning in the hotel a fellow who knows that I have been retired for nearly five years came up to me and said, "I wonder why you are on this program? I suppose you are here as an elder statesman." I thought for a moment and I said, "I can't qualify as a statesman, but I'm certainly elder." I am very happy to be here because I like Japan and I like the

Japanese, and the quality of the two papers that we have at this meeting is an encouragement to all students of international monetary affairs.

I think that Dr. Oort has prepared a really brilliant, talented paper in the area. I am not sure that I agree with a lot of his points, but I do not think that is important. His paper is comprehensive, it is thoughtful, it is provocative, it is stimulating, and above all it is constructive. And I do not know how we can ask for more in a discussion of "Steps to International Monetary Order."

Dr. Puey early in his remarks referred to the confusion there is around and I certainly subscribe to that. I think there is more confusion than I have seen for a long time and, in the international monetary area, I have a cartoon on my desk which encourages me very much. The cartoon shows two older men in a club arguing about monetary reform and one of them is obviously exasperated with the other and he points his finger at him and he says, "All I can say to you is, if you're not confused, you are not very intelligent." But under this confusion there is some very serious thinking going on and I am sorry that Dr. Oort's paper and Dr. Puey's do not, in my judgment, come to grips with the current situation. Now as an elder statesman, if I can call myself that having just denied it, I have watched what has been going on with great interest and I have been increasingly worried about the course that we are following.

I can speak freely these days and I do so. I do not have the slightest doubt that the world is currently in the throes of a world recession that is the most serious probably since 1929–30. Now I make it clear when I say this that I am not talking about depression. I am talking about recession and there is no reason at all, at this juncture, why we should let this recession become a major depression. We have the tools and the competence and the capacity to avoid that. But if we keep arguing about whether we are in a recession or a slowdown, I think that we will find that it will sneak up on us when we are not aware of it. And that is why I think it has to be recognized.

The world has been going too fast. That is the basis of our inflation. Like the modern automobile, the economies of the world have more power than they can use if you step on the throttle and never use the brake. And in all the economies of the world, we have become very adept at stepping on the throttle, and we do not have as safe drivers a we might have, and the result is that we have abuses of credit that have been characterized by the failure of several banks and indicate, I think, that the abuse of credit could be carried like a rubber band to the point where it snaps. Now we can deal with these and we have dealt with them, but nevertheless this is something that ought to concern all of us. I was looking at Dr. Oort's paper in particular and I am picking out certain things that I like. He said that he was not going to give us a manifesto or a Magna Carta. I rather wish he had.

I have my doubts about the "stable but adjustable" paper of the Group of Twenty and Dr. Oort's comments have pretty well crystallized my thinking along the lines that he has thoroughly enunciated, that is, managed floating under internationally accepted rules as preferable to stable but adjustable rates as a reform of the Bretton Woods system. But what is really involved here is much more important than this. What is really involved is that the reason we have arrived at this point is because all governments have been trying to avoid any unemployment and I certainly subscribe to that—none of us wants unemployment. But in an attempt—in my judgment a fruitless one—to avoid any unemployment we have turned our back on the idea that fiscal and monetary policy could discipline economies and we have gradually accepted the thesis that it is all right for any country to stimulate its own economy as much as it wants regardless of what happens to its balance of payments, that it does this in its national interest, and in this sense we are returning to the beggar-your-neighbor policy of pre-Bretton Woods. And I deplore this. I think this can only lead to real difficulty over a period of time. Now what has happened—I mentioned the abuse of credit—what has also happened in this is that we have blamed the fixed exchange rates for problems, all of which could have been avoided if individual governments had had the courage and the capacity to discipline themselves instead of following along just idly and saying we will lose office if we do not follow this way. The result is that we are still fighting the battle of the 1930s, when the world has changed. I hope no one in this audience will think that I am in favor of unemployment.

Dr. Oort refers to the masochistic use of deflation in order to help the sort of situation that we get into. I have no desire to be masochistic, but I am one that no longer believes in the Phillips curve. I no longer believe that the Phillips curve works except for a limited period of time. The trade-off between unemployment and inflation is not a real one and because we believed there was such a trade-off and have been unwilling to accept the discipline of resisting inflation, we are headed for more unemployment than would have occurred if we had recognized the importance of sound money in maintaining employment.

What has happened is that when the Germans decided to float and the United States embarked on its new economic policy, there was initially a hope that we could correct things in the Smithsonian Agreement—we had a determination by a group of major countries of exchange rates one in relation to another, and there was a period of hope that maybe international cooperation around this could be re-established. That hope has proved a delusion. We did not go to work on the Smithsonian Agreement, and the result was that the United States devalued a second time. The second time the United States devalued it destroyed the last anchor in the old international monetary order, and I personally believe that with this the era of international monetary and financial cooperation, envisaged in the Bretton Woods Agreement as an era, ended.

Now I am not suggesting that this is necessarily the end of the world, but I think it has to be put in the perspective of what we are trying to do. The foreign minister of an important country said to me about six months ago: why do we need to move toward an internationally stable monetary order—why do we need it? Business is better than it has ever been, foreign trade is holding up very well. True, we do not have very good governments, but we are all doing extremely well. Why do we have to worry about it?

Well, why we have to worry about it is becoming clearer every day. Because over a period of time you do not have any possibility of maintaining growth on a sustainable basis unless you have sound currencies, and today our sound currency concept has pretty well gone by the boards. Money is, of course, a medium of exchange, but it is also a store of value, and my own conviction is that today no one really wants to save money as a store of value in anyone's currency, and the result is that the world is starved for capital as it has never been starved before. Let me give you one figure. An American economist of note who has been an advisor to the current administration and I worked on some figures on this and I think they are approximately accurate. Our calculation demonstrates that in 1965 the retained earnings of American corporations were $19.2 billion, and in 1965 prices the retained earnings in 1973—and do not forget that it is out of these retained earnings that in large measure we financed our growth—in 1973 these retained earnings in terms of 1965 dollars were less than $2 billion. And if that isn't an evidence of capital starvation I don't know what is. And capital starvation, I insist, can only be cured through the saving and investment process. No central bank can print money and make capital. If you do not save money and invest it you are not going to get capital formation.

Now your professional economist says, well, but the level of savings is not too bad in arithmetical terms. I insist that there is a qualitative element in savings as well as a quantitative one, and that saving in the last two years has become largely fear saving—that is, saving to make a quick turn, to acquire a company, to mark up prices here and there, and get a quick profit. That saving in a bona fide sense of saving as a store of value has gone by the boards.

That in essence is my own thinking today and I think that the Western world, and the whole world, is going to have to come to grips with this problem. I think we *will* come to grips with this problem. I am not pessimistic. I think that President Ford has embarked on a good anti-inflation program. I am not sure I agree with all of it; none of us would agree with anybody's anti-inflation program. But he has declared war on inflation as the number one enemy and however inept, politically, some things may be, this is a real step in advance. And having declared war on inflation as the number one enemy, it seems to me that if his program turns out to be less than adequate, as it may, there is every indication that something further will be done and that we will have to look at stopping inflation along a great many broad lines. Let me simply say that in this area of unemployment, where I have worked for a good part of my life, we talk in the United States about 4 per cent as being full employment. My own judgment is today that the rate is closer to 6 per cent full employment. That is not suggesting that I want anybody to be unemployed or that I like unemployment. But with the number of married women that there are in the working force and the teenagers that there are, we have to revise our whole statistical approach. And this is another factor that comes into it.

Now where I end is not a whole lot different from where I was when I talked about the possibility of moving toward a world central bank a few years ago. I believe we need a stronger International Monetary Fund, one that has more teeth, and when we talk about managed floating rates it can be managed just as well as the old par value system can be managed. But it has to be managed, and unless we are willing to pool a little bit of our sovereignty—and don't forget that the only reason for sovereignty is in order to have prosperity and to have defense—I think the time is here when maybe it will not be possible to have defense and economic prosperity individually, unless we are willing to manage currencies generally in a more direct way than we have been doing. We can do this and we are not at that point now.

Dr. Oort said that this is a castle in the air, at least in the global sense, and then he made a good case for the European Community and this encouraged me very much. But the point that I am driving at here is that I do not think it is possible or feasible to get to this point now. But I am very much afraid that we may find that things will get considerably worse and when they get worse I think governments will move very rapidly. I do not think they are any different from anybody else on that. I am not suggesting or hoping that they get worse, I am simply saying that if you look at the real estate picture in the United States, which I know a little something about, the cost of materials, the cost of labor, has gone up to such an extent that the occupier, or the renter, or the purchaser of a house simply cannot afford it at the present level. Therefore either the builder has to lose or the occupier has to be given a mortgage at 30–40 years that he will never be able to sustain, and that is not a very happy situation to look at.

We have a loss economy as well as a profit economy, and we have been trying to avoid the necessity of taking any losses. I think you have more discipline in Japan than most of the countries of the Western world. But you are in exactly the same position on this at the present time. And all I suggest is that, after having read Dr. Oort's paper, I am more on the side of managed floating rates than I am on stable but adjustable rates, granting the difference that he makes in his paper, very clearly, and that it is a matter of degree with respect to reform of the old par value system.

But I say to you that we have to go back to the original Bretton Woods concept, i.e., international monetary and financial cooperation directed toward achieving multilateral, nondiscriminatory trade and convertible currencies. We may perhaps do this, as Dr. Oort suggests, step by step in small groups but it is my view that we must eventually do it on a global basis if the world is going to have the prosperity that it needs and trade relations which will buttress world peace. I simply close by saying to you that the peace of the world and the prosperity of the world go together and I believe that eventually there will be enough common sense so that we will see this and not worry so much about the fact that we have given up a tiny bit of sovereignty to an international organization. Thank you very much.

* * * *

MR. WALLENBERG: Thank you very much. I know that we all are grateful to you for your very fine talk. It was very interesting and very good and very, very thoughtful. It gave us a lot of food for thought. Even if you did not want to prophesy, I think that you showed the old quality of vision. We can only hope that people, particularly politicians, are going to follow the advice that you have given.

Questions and Answers

Following the formal presentations, the speakers answered written questions from the audience. Some of these questions, and the answers, as well as further commentary from the speakers, are given below.

DR. OORT: I have a great many questions here that cannot possibly all be answered, so I will try to bunch them together and see if I can say anything sensible about them. In a sense, Mr. Chairman, it has been made very easy for me because several of the questions are diametrically opposed and since I am in the middle I should be just about right. I will just read the two diametrically opposed questions to you to begin with.

Why not go all the way to a freely floating system since the managers of floating may well upset market trends on account of imperfect information?

That is one thesis—do not do anything about it, just float and do not manage.

Are you not worried in a system of managed floating that, in particular, the longer-term investments will be hurt by uncertainty, because currency relations will not at all times correspond to the fundamental relationships between currencies but may deviate from them?

Now if I have to choose between the two, in principle, I am closer to the first question than to the second. I believe in fact that managing the exchange rates should be management in the margin. It should really be not very much more than day-to-day smoothing, perhaps some intervention to take care of seasonal factors in the balance of payments, perhaps dampening down of whatever we recognize as clearly being speculative capital movements. But my own tendency would be to keep the management, particularly intervention in the exchange markets, to the very minimum and in general to let the exchange rate pretty much float as it is on the markets and let the market learn. After all, most of our prices float in this world; most markets take care of themselves, and I see absolutely no reason why exchange rates should not be able to take care of themselves, except as I said, for day-to-day smoothing operations that may be necessary to keep the market running smoothly.

So in principle I am pretty close to the first question that says the managers are not wiser than the market, so let the market do its work. But that does not quite absolve me from answering the other question, namely, does not that hurt longer-term investment in the international monetary system? I really believe that the question of long-term investment—a long-term international capital movement—does not even enter into the question of the exchange rate regime at all, because there is uncertainty connected with long-term investment whatever exchange rate regime we have.

When long-term investments were made in 1970, the uncertainty then prevalent was in fact much larger than it probably will be, I hope, in the coming years ever again. Nobody at that time expected a 20 per cent dollar devaluation—it is even more than that now. But it still happened, and that was under a fixed exchange rate system. So I do not really believe, although it sounds logical, that managed floating introduces more uncertainty for longer-term investment decisions. In fact, I think, that is a faulty argument. In fact, long-term investment is subject to uncertainty because the world is subject to uncertainty in the long run.

I would also like to say just one thing more, and that is, let us look at the alternatives. If we want to get rid of uncertainty, in the real world we have to accept controls. And I think that if you look at the real world and if you question businessmen and bankers, practically all of them will say that the one thing that really hurts international investment is controls, or even the threat of controls, much more than exchange rate uncertainty. So my answer to the second question would be: No, I do not believe that managed floating really hurts long-term investment more than the uncertainty that is inherent in the international monetary system as such.

I have another question here that comes very close to the subject of Mr. Martin's very impressive speech. The question is on inflation. I will read it to you. *If you agree that our principal difficulty today is the* *rampant inflation in the leading industrial countries, would you no agree that our primary aim should be to get our house in order rathe than to seek a major change in the monetary system itself?*

Well, of course. But I do not think the two are mutually exclusive. do not think the two have very much to do with each other, except as noted in my answer to the first part of the question, it is very urgen that we put our house in order. I could not agree more with Mr. Martin who has just made an impassioned appeal for putting our house i order. But I do not think that is contradicted by, or is inconsistent with a change in our exchange rate regime. In fact, if you read last year' paper that was presented to the Per Jacobsson Foundation by Dr. Em minger, I think he made a very convincing case for the fact that fixe exchange rates in the past have been a major cause of inflation in th world.

In particular, when the reserve currency countries went into defic and when they financed their deficit by creating international reserve dollars in particular, that spread inflation to the rest of the world. Th would not have happened if the dollar had been floating. Consequentl my thesis would be, yes, of course, we have to put our house in orde This is not inconsistent with, but is helped by, a system of manage floating, rather than by sticking to unrealistic par values too long as w have in the past.

Does not managed floating have an inflationary bias?

I do not really see that it does. As I said, I think that the fixed p value system did have an inflationary bias as we are all too much awa of, looking at very recent history. A floating system has an inflationa bias? I do not see why. An exchange rate is after all a dual thing. Whe an exchange rate of one country goes up, it means that the exchan rates of all other countries go down. If it is inflationary on one side the fence, it is deflationary on the other side of the fence. I cann possibly see why a managed floating system would, in any sense, l inflationary.

Of course, it is always said, but I think it is a completely faulty arg ment, that forward coverage is an element of cost and that consequent it is added on to prices and this means inflation. I think that is ju entirely faulty. It is a reasoning that is obviously wrong, because fc ward coverage might be either a forward discount or it might be a fc ward markup. When you cover today in forward dollars you get a discount. It is not a cost, it is a benefit. In other words, it depends entirely on whether the expectations of the market are such that a particular currency will go down or go up, as to whether this would be an advantage or disadvantage to the trader who has to pay or has to be paid, say, six months from now. It is not a net cost: it may be a cost to the one and a benefit to the other just depending on how the market at that particular time works. But it is not a net inflationary element in the international monetary system.

A last question, Mr. Chairman, that I would like to answer. I have some more that perhaps, if we have time afterward, I could come back to. The question is: *What would be the form and terms of international surveillance of managed changes in exchange rates?*

This matter has been discussed at length in the Committee of Twenty and in the Executive Board of the Fund. In the last Annual Report of the Fund you will find the results of those studies and of those discussions in the form of the so-called Guidelines for Floating. One of the most important elements of those Guidelines is that countries have agreed, and I am very glad that they have agreed, that the Fund should be able to take the initiative in telling a country if its exchange rate is getting out of line with what the Fund considers a range of reasonable estimates of the medium-term norm for that exchange rate. In other words, the range of what the Fund thinks that in the long run the exchange rate of that country should do. The Fund can make representations to that country, can get into a dialogue with that country, and see that it manages its exchange rate according to what the Fund and the country together think should be a reasonable range of its exchange rate in the longer run. This sort of thing, I believe, is the procedure we should enter into in the coming years in order to manage exchange rates on an international as well as on a national level.

I think, Mr. Chairman, I might just stop here and take the other questions, if we have time, later on.

* * * *

DR. PUEY: Mr. Chairman, the first question: *You refer to the illegal practices which distort the international monetary order. Would you elaborate the recent examples and comment on them?*

I must say that I did not say that there were any illegal practices tha distort the international monetary order. I only said that here were ille gal practices on the part of developed countries. For example, in 197 the lira and the franc split markets—there were two markets, one fo trade and one for finance. Another thing, which is now generall accepted, was that floating is not provided for in the IMF Articles o Agreement and that therefore it was illegal. Not that I do not agre with floating now; I said both in my paper and in my oral presentatio that floating is necessary and that managed floating is necessary, but do not like to have managed floating as the ultimate aim, that is wher our difference is.

What kind of transitional measures do you recommend to be take in order to attain the stable but adjustable exchange rate system?

Briefly—and I have listed seven measures in my oral presentation— we must control inflation; we must float under management and guid ance; we must try to get rid of volatile funds and the dollar overhang we must try to use SDRs; and we must regulate Euro-currency market and recycle petrodollars. These are the things I advocated as transi tional measures before we could come to a stable but adjustabl exchange rate system.

You mentioned that the Euro-market should be regulated. What kin of regulations do you envisage?

The answer is given in detail in my written statement. I would like t state, in brief, that if the reports that we have read are correct the there are institutions that are dealing in the Euro-dollar market in th same way as in other financial markets—borrow short and lend long— and therefore they should be under some kind of regulation in the sam way as central banks in the national context try to regulate commercia banks.

But there is more than that in the Euro-dollar market. We must tr to come to an agreement internationally before any kind of regulation can be set up. In other words, you need to attack on both sides: inter nationally—so as to strengthen international cooperation in order t bolster security in dealing in Euro-dollars—and nationally—with th requisite measures.

How would speculative attacks on stable par values be dealt wit under your preferred system?

I cannot answer this question adequately because I have not studied the matter well enough. But I would say that in my preferred system there is room for floating in particular cases, as the Committee of Twenty has advocated. There may be other measures in order to avoid and prevent speculative attacks. I am afraid I cannot answer this question adequately except to say that there might be a loophole for managed floating as in particular cases.

How can SDRs be made more widely acceptable and usable in private transactions?

Perhaps the person misunderstood me about mentioning private transactions in connection with SDRs in my paper. In fact, I meant to say that the acceptance of SDRs in private transactions will take a long time to come. We cannot do it yet. But, in the meantime, we have to try to bolster the status of the SDR, so that it becomes the main numeraire and reserve asset. It may take another ten years perhaps before private transactions could be quoted in SDRs.

The quality of politicians is a problem not only in international finance but in many other fields. How can you reconcile the conflict between the need to supervise politicians and the demand to respect sovereign power in less developed countries?

I do not know the answer to this question. All I wanted to say is that if you look at it carefully and objectively, you will see that the little amount of sovereignty that Governor Martin referred to has been conceded by less developed countries because we usually behave well in the International Monetary Fund according to IMF rules. The point that I was trying to make was that the developed countries are the *enfants terribles* of the IMF. Thank you.

* * * *

MR. MARTIN: I have one question which I think I pretty well answered in my talk. *Can there be any monetary order while the major trading countries are suffering from serious inflation?*

I agree with Dr. Oort that managed floating is not inconsistent in attempting to restrain inflation. But my thesis, in a simple way, is that you cannot have high levels of employment on a sustainable basis unless you have reasonable stability in prices, in other words, the idea that inflation can be a trade-off, as in the Phillips curve. I think th next three to five years are going to demonstrate that this does not work

* * * *

MR. WITTEVEEN: Mr. Chairman, there was one question addressed t me which perhaps can be a starting point for just a few concludin remarks. The question was, in essence, *whether due to the current infla tion and imbalances in balance of payments, steps to international mone tary order do not look very dark. Is it possible to establish an order?*

I would like to say in reply that we certainly face very serious prob lems in the world today—inflation, recessionary tendencies, and ver large disturbances in balance of payments. Therefore, the problems an the difficulties are extremely serious. But what I think is very impor tant is that we should meet and try to overcome these difficulties b cooperating internationally, and that we should avoid meeting thes problems by trying to shift them from one country to another, by fall ing into what we have learned to call, since the time of the grea depression, a beggar-my-neighbor policy. This kind of internationa cooperation, I think, is very essential, and it seems to me that in all th speeches we have heard this afternoon there was agreement on tha point—on the need for that kind of international cooperation. That i perhaps even more important than the difference between manage floating or stable but adjustable rates.

In fact, probably it depends more on how we manage, how w adjust, and how we stabilize than on the difference between the two sys tems. In fact, perhaps we could say that in the present system of man aged floating quite a number of countries manage their currencies i such a way that for a certain time they keep them stable and then the adjust them when the situation becomes different. But what is essentia is that all this is done in effective international cooperation. This wa brought out very clearly by all the speakers. Dr. Oort emphasized th point that in order to be able to do this, of course, we need a certai political willingness.

Mr. Martin made a very important remark. He said that in the pres ent world why could not countries give up a tiny bit of sovereignty t an international institution? I very much agree with that point of view and I would like to add, coming back to what I said in the beginning that what is very important about the Fund, what makes it in the present world a rather exceptional, rather unique institution, is that the founding fathers at Bretton Woods gave a tiny bit of the sovereignty of their individual countries to the Fund.

The Fund is able in its still limited field to take certain decisions by majority which bind its members. It is a small field and of course in many important aspects the major countries remain quite independent. Nevertheless, it is a beginning from whence we, I hope, can continue to work toward more effective international cooperation.

I agree very much with one remark in this respect that Dr. Puey made. We need freer and franker discussions in order to bring about this result. I think that is very true, and it is not easy, because in international discussions there is an understandable and also useful tendency to be very polite. Politeness is necessary, but there is always a danger that this means that discussions remain too kind and insufficiently critical. And if we really want to arrive at coordination then we have to learn to be critical of each other's policies, to really discuss the issues. It can be done politely, but it should be done effectively.

I think that is probably the main purpose of this new committee that has now been established and which held its first meeting in Washington last week. The Interim Committee is not a very inspiring name, of course, but nevertheless it can be of importance. It can be a step to international monetary order, for here we have a committee of ministers who have the responsibility, who have to make the decisions. Twenty ministers representing all the 126 member countries of the Fund, who have been given the task of overseeing the functioning of the system, of working for this coordination, and of taking the political decisions that are required.

We have to see how this committee will work. There are doubts about that, I don't deny it. It could perhaps take away something from the Executive Board, and nobody would like that. But it could be very useful—it could add strength to the Fund. And in this first meeting we had last week I think the Chairman of the committee underlined, quite rightly, that this committee should concentrate on really important political decisions and differences, and in order to do something about it there, we would need free and frank discussions. That is what we should aim for. That is certainly what the Chairman would like, that is what I would like. I hope all the ministers will be willing to go along in that, with all the difficulties that this will bring about, but I think in the end it will be very beneficial.

I would like to conclude in expressing once again my hope and my trust that we can develop this international cooperation despite all the difficulties and all the frustrations that we have. If we persevere patiently in that way we can overcome our difficulties. Thank you very much.

Concluding Remarks

MR. WALLENBERG: I think that time has been running on. I am quite sure that I speak on behalf of everybody here when I say that we are very grateful to our speakers, who have demonstrated deep thought and who have put in a lot of very thorough work to support all that they have said to us today. And we are also very grateful to the audience which has shown such a lively interest in the topics discussed and has contributed to the proceedings with such good questions. Above all, we are very grateful indeed to the Federation of Bankers Associations of Japan for giving us such a wonderful welcome here.

The proceedings of this meeting will be issued in English, French, and Spanish, and will be published in due course. Would those wishing to receive this publication please hand their names to one of the Officers of the Foundation, Mr. Gerstein or Mr. Williams.

I am quite sure that the discussions today have been of such profound significance that they are going to be used in the very important discussions referred to by Mr. Witteveen that lie ahead in the forum of the Interim Committee—and probably other committees too. They will be trying to work out some kind of pattern for international cooperation of which we are in such dire need in this world confronted as we are by such tremendous problems.

We are now going to proceed to the reception, which is being held in the Bankers Club. But before declaring this 1974 meeting over, I take it that I have your authority to send a cable to Mr. Randolph Burgess conveying your greetings and best wishes.

I hereby wish to conclude the 1974 meeting of the Per Jacobsson Foundation. Thank you all very much indeed.

Biographies

Conrad J. Oort is currently Treasurer-General at the Department of Finance of the Netherlands Government, having held this post since 1971. Immediately before this assignment, he had been Professor of Economics at the University of Utrecht for over ten years, with a year out as Guest Professor of Economics at the University of Michigan. He was also in the Ministry of Economic Affairs at The Hague, 1958–60.

During the period 1960–71, in addition to his academic responsibilities, he was an Advisor to the Minister of Economic Affairs, a member of the Social and Economic Council, an Advisor to the Netherlands Railways, and a board member of several research organizations and professional journals. In connection with his present governmental duties, he also serves as an Alternate Governor of the International Monetary Fund for the Netherlands, was a Deputy in the Committee of Twenty, and is Chairman of the European Economic Community's Monetary Committee and a member of Working Party III of the Organization for Economic Cooperation and Development.

Dr. Oort received his Ph.D. as well as his LL.M. from the University of Leiden. From the University of Chicago he received an M.A. in Economics. He has written widely on transport economics and European economic integration.

Dr. Oort was born in Leiden in 1928. He is married and makes his home in Wassenaar, The Hague.

Puey Ungphakorn is currently Chairman of the Council of Economic Advisers to the Prime Minister of Thailand. He is also serving as a member of the Legislative Assembly and holds the position of Professor of Economics, Thammasat University.

He has had a varied career as Economic Counsellor to the Royal Thai Embassy in London; Budget Director; Governor of the Bank of Thai-and; and member of the Executive Committees of the National Economic Development Board and the National Education Council. He has also served as Dean of the Faculty of Economics of Thammasat University; visiting professor, Woodrow Wilson School of Princeton University; and visiting fellow, Wolfson College, Cambridge. He is affiliated with a number of economic and educational groups as trustee, governor, or chairman.

Dr. Puey was born in Bangkok in 1916 and holds degrees from Thammasat University and the London School of Economics, where he received his Ph.D. He is married and has three sons.

Saburo Okita has, for almost his entire career, been closely associated with Japanese government economic planning and policies. For some years he was with the Economic Planning Agency, heading a number of its different departments and bureaus.

In 1973 he became President of the Overseas Economic Cooperation Fund, a post he holds at this time. He is also President of the International Development Center of Japan and Chairman of the Japan Economic Research Center.

Dr. Okita has represented Japan at many international meetings and conferences, notably those of the United Nations Economic Commission for Asia and the Far East, the Colombo Plan and various Asia-Africa conferences, and has made many research trips in the Western Hemisphere and Asia for the study of economic planning. He was also a member of the Pearson Commission on International Development in 1969/70.

Dr. Okita, who was born in 1914, received his degrees from Tokyo University. He has published, among other titles, "Essays on Japan and World Economy" (1971) and "Challenges in the Era of Internationalism" (1970), and numerous articles.

William McChesney Martin, a Director of the Per Jacobsson Foundation, was also the main speaker at the Foundation's 1970 lecture on the subject "Toward a World Central Bank?"

He was for nearly twenty years Chairman of the Board of the Federal Reserve System of the United States, before that being Assistant Secretary of the Treasury and, earlier, President of the Export-Import Bank and President of the New York Stock Exchange.

Since leaving the Federal Reserve Board, he has undertaken a num ber of corporate and foundation directorships and trusteeships. He ha also been Chairman of the Committee to Reorganize the New Yor Stock Exchange.

Mr. Martin, who was born in St. Louis, was educated at Yale an Columbia Universities and the Benton College of Law. He has honor ary degrees from a number of universities and is a holder of the Legio of Merit.

The Per Jacobsson Foundation

Sponsors

HONORARY CHAIRMEN

EUGENE R. BLACK *(United States)*, former President, International Bank for Reconstruction and Development

MARCUS WALLENBERG *(Sweden)*, Chairman of the Board, Skandinaviska Enskilda Banken

CHAIRMAN

W. RANDOLPH BURGESS *(United States)*, Director, Atlantic Council; former United States Ambassador to NATO

HERMANN J. ABS *(Germany)*, Chairman of the Supervisory Board, Deutsche Bank A.G.

ROGER AUBOIN *(France)*, former General Manager, Bank for International Settlements

WILFRID BAUMGARTNER *(France)*, former Minister of Finance; Honorary Governor, Banque de France

S. CLARK BEISE *(United States)*, member of Board of Directors, Bank of America National Trust and Savings Association

B. M. BIRLA *(India)*, Managing Director, Birla Brothers Private Limited

RUDOLF BRINCKMANN*

LORD COBBOLD, P.C. *(United Kingdom)*, Lord Chamberlain; former Governor, Bank of England

MIGUEL CUADERNO *(Philippines)*, former Governor, Central Bank of the Philippines

R. v. FIEANDT*

MAURICE FRERE*

E. C. FUSSELL *(New Zealand)*, former Governor, Reserve Bank of New Zealand

ALY GRITLY *(Egypt)*, former Chairman, Bank of Alexandria

EUGENIO GUDIN *(Brazil)*, President, Instituto Brasileiro de Economia, Fundação Getúlio Vargas; former Minister of Finance

GOTTFRIED HABERLER *(United States)*, Professor Emeritus, Harvard University; Resident Scholar, American Enterprise Institute

VISCOUNT HARCOURT, K.C.M.G., O.B.E. *(United Kingdom)*, Chairman, Morgan Grenfell & Co., Ltd.

GABRIEL HAUGE *(United States)*, Chairman of the Board, Manufacturers Hanover Trust Co.

CARL OTTO HENRIQUES*

M. W. HOLTROP *(Netherlands)*, former President, Bank for International Settlements and De Nederlandsche Bank N.V.

SHIGEO HORIE *(Japan)*, Chairman, Japan Institute for International Studies and Training; former President and Chairman of the Board of Directors, The Bank of Tokyo, Ltd.

CLARENCE E. HUNTER *(United States)*, former United States Treasury Representative in Europe

Publications

roceedings

1964 *Economic Growth and Monetary Stability*
Lectures by Maurice Frère and Rodrigo Gómez (stocks exhausted)

1965 *The Balance Between Monetary Policy and Other Instruments of Economic Policy in a Modern Society*
Lectures by C. D. Deshmukh and Robert V. Roosa (stocks exhausted)

1966 *The Role of the Central Banker Today*
Lecture by Louis Rasminsky; Commentaries by Donato Menichella, Stefano Siglienti, Marcus Wallenberg, and Franz Aschinger (available only in English; French and Spanish stocks exhausted)

1967 *Economic Development—The Banking Aspects*
Lecture by David Rockefeller; Commentaries by Felipe Herrera and Shigeo Horie (available in French and Spanish; English stocks exhausted)

1968 *Central Banking and Economic Integration*
Lecture by M. W. Holtrop; Commentary by Lord Cromer (available only in English and Spanish; French stocks exhausted)

1969 *The Role of Monetary Gold over the Next Ten Years*
Study by Alexandre Lamfalussy; Commentaries by Wilfrid Baumgartner, Guido Carli, and L. K. Jha (available in English, French, and Spanish)

1970 *Toward a World Central Bank?*
Paper by William McChesney Martin; Commentaries by Karl Blessing, Alfredo Machado Gómez, and Harry G. Johnson (available in English, French, and Spanish)

1971 *International Capital Movements—Past, Present, Future*
Paper by Sir Eric Roll, K.C.M.G., C.B.; Commentaries by Henry H. Fowler and Wilfried Guth (available in English, French, and Spanish)

1972 *The Monetary Crisis of 1971—The Lessons to Be Learned*
Paper by Henry C. Wallich; Commentaries by C. J. Morse and I.G. Patel (available in English, French, and Spanish)

1973 *Inflation and the International Monetary System*
Paper by Otmar Emminger; Commentaries by Adolfo Diz and János Fekete (available in English, French, and Spanish)