·er Jacobsson foundation, Washington, D.C.

EMERGING ARRANGEMENTS IN INTERNATIONAL PAYMENTS— PUBLIC AND PRIVATE

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THE PER JACOBSSON FOUNDATION

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International Monetary Fund Building, Washington, D.C.

FOREWORD

The twelfth lecture meeting in the series sponsored by the Per Jacobsson Foundation took place on Sunday, August 31, 1975. Approximately 400 persons attended the meeting which was held in the International Monetary Fund building in Washington, D.C.

The principal paper, on the subject "Emerging Arrangements in International Payments--Public and Private," was presented by Alfred Hayes, who had retired four weeks previously from the Presidency of the Federal Reserve Bank of New York. Commentaries on the subject and on his paper were offered by Khodadad Farmanfarmaian, Chairman of the Board of the Bank Sanaye Iran, by Carlos Massad, consultant to the United Nations Economic Commission for Latin America, and by Claudio Segré, President of the Cie. Européenne de Placements, Paris. Presiding over the meeting was W. Randolph Burgess, President of the Foundation.

This publication covers the proceedings of this meeting. It includes the full text of the statements by all the speakers, together with their answers to questions asked by members of the audience. The biographies of the principal speakers also appear. These Proceedings are published in English, French, and Spanish and are available without charge from the Secretary of the Foundation. A full list of available titles in this series appears elsewhere in this booklet.

TABLE OF CONTENTS

Opening Remarks

William B. Dale

Ladies and gentlemen and distinguished guests: I bring you greetings and profound regrets from the Managing Director, Mr. Witteveen, who at this moment is chairing a meeting of the ministers of the industrial member countries of the International Monetary Fund for the purpose of discussing and, one hopes, agreeing upon quotas in the IMF. You will excuse him, therefore, for not being able to be here this afternoon.

I also welcome, once again, this session of the Per Jacobsson Foundation taking place here in the headquarters of the Fund. It is our profound pleasure, whenever the Foundation's exercises permit, to host this meeting in the building of the Fund, and to entertain, as best we can afterward, the distinguished persons attending this lecture meeting. Thank you.

W. Randolph Burgess

Thank you, Mr. Dale, for your words of welcome. We are always delighted to be here in such a fine atmosphere. I must say that we appreciate particularly what Mr. Dale and Mr. Witteveen have done to fit this meeting into the schedule. There are so many committees meeting today that we had to be fitted in with a shoehorn!

It is fine to see here so many who have been at these meetings before. I am coming to believe that the Per Jacobsson meetings have become a kind of an addiction to which people, once they have succumbed, are doomed to continue.

There is one gap in our audience today. There are no members of the Jacobsson family here. Erin Jucker-Fleetwood, one daughter, who is an economist, is now preparing a biography of her father, which we hope will be available within the year. It will be an enormously interesting volume. I regret to say that the family of another daughter, Moira--Mrs. Roger Bannister--had a severe automobile accident recently, but is fortunately now recovering. But Per Jacobsson's family is here, I know, in spirit.

Now we come to the program. I do not need to read you the biographies of these distinguished gentlemen. As you look at the program, I think you will agree that we have a team that is versatile in depth. They know both the theory and the practice of these monetary affairs that we deal with. And if the team is headed by someone from the Federal Reserve Bank of New York, that is not very strange, because we have had representatives of that Bank here before, and I confess that it is a matter of pride to me that I came out of that school some years ago.

It is particularly appropriate at this time, when people in the monetary field are feeling around for firm ground, to call on those people who have practical experience. And this team that we present to you today is one such team.

Alfred Hayes was with the Federal Reserve Bank of New York for nineteen years before he retired on the first of August. And he has been a most distinguished president of that Bank. I suspect that about 75 per cent of this audience spends a certain amount of time every three months reading the minutes of the Open Market Committee--and that is one way that you can judge the people who are members of that Committee. You may have noticed that Alfred Hayes is one of the members of that Committee who dared dissent--not very often--but always with a very carefully reasoned presentation of his point of view. And we have here the benefit of his reflections when he is a free man, at least partly a free man, and he can say somewhat what he wishes to say. So it gives me enormous pleasure to call on Mr. Alfred Hayes to speak to us today.

Emerging Arrangements in International Payments— Public and Private

By Alfred Hayes

Per Jacobsson was a towering figure on the international monetary scene for many years. It is thus a great honor for me to have been asked to deliver this year's lecture in the series bearing his name. Since the abandonment of the Bretton Woods system, with which he was so involved, the world economy has functioned without a coherent monetary framework. The uncertainties on the international monetary scene have been enormous, and at times it has seemed as if both private markets and public authorities were almost in a state of shock, as the markets showed extreme anxiety and the authorities lapsed into inaction. The rebuilding of formal international monetary arrangements has made hardly any progress. Such rebuilding is necessary, as I am sure we would all agree, and so in this lecture I would like to share with you my own approach to this difficult task. I would emphasize that these are the personal views of a private citizen, although inevitably they have been shaped by my years of experience as a central banker.*

Coping with floating rates

To begin with, let us take a quick look back at developments of the last few years in an attempt to see whether recent experience has taught us any lessons, and to discern any patterns that might be emerging in international payments arrangements. As many had feared, the cutting of the tie between the dollar and gold in August 1971 had a traumatic effect, both on the dollar and on the entire international monetary system, from which they have not yet recovered. In retrospect, the Smithsonian Agreement in December of that year was doomed to fail, as it provided for no binding obligations to support the new central rates. Confidence had sunk so low that speculative flows kept erupting with increasing frequency and force. A second devaluation of the dollar in February 1973 aggravated the turmoil on the exchanges, rather than restoring calm. In the face of renewed massive speculative movements, the six member countries

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*I am very much indebted to my colleagues at the Federal Reserve Bank of New York, and particularly Peter Fousek, Economic Adviser, for their assistance and cooperation in the preparation of this lecture. As indicated, however, responsibility for the views expressed is mine alone.

of the European Economic Community agreed in March 1973 to let the dollar float, with several other major currencies having started floating earlier. The international community has been learning how to cope with floating rates ever since.

At first the dollar was left entirely on its own, and it did not float but sank precipitously as speculative pressures cumulated. By mid-1973 market conditions had become thoroughly disorderly and exchange trading was grinding to a standstill, especially in forward markets. In the meanwhile, the world experienced the inflationary consequences of violent exchange rate fluctuations. Not only did the U.S. domestic price level feel the inflationary impact of the depreciating dollar, but speculative repercussions of the dollar collapse on world commodity markets heightened the distrust in money in general.

In July 1973 the Federal Reserve was called upon by the U.S. and European governments to resume exchange market intervention, backed by a major enlargement of the Federal Reserve swap network. The very announcement of this policy shift from a free to a managed float of the dollar brought about an immediate recovery of dollar rates. But the dollar remained only lightly managed, the U.S. Government seemed to show little concern over the fate of the dollar, and the feeling persisted that benign neglect was indeed U.S. policy. And so the dollar continued prey to erratic market sentiment, moving up and down with little rhyme or reason, despite a very substantial improvement in its basic position, typified by the 40 per cent increase in U.S. exports in 1974.

Elsewhere, currency management came to be much more substantial. Within the "snake" the commitment to unlimited intervention has kept member currencies on a fixed rate relationship one to another. Among other European currencies, the pound sterling and the Italian lira have been strongly defended by central bank intervention. In Canada and Japan, market intervention has been frequent in order to stabilize their currencies against the dollar.

In recent months, we have seen some further attempts to reduce extreme rate instability. France has rejoined the snake, and Switzerland has expressed interest in joining it. At the same time, in the United States, official resistance to market pressures on the dollar has stiffened somewhat, with the Federal Reserve swap network continuing to play its useful role. Early in the year, market forces had pushed dollar exchange rates to unrealistically low levels against many major European currencies and threatened the outbreak of disorderly markets. Then in February the Federal Reserve, the Bundesbank, and the Swiss National Bank joined in a more forceful, coordinated intervention approach. Although an immediate market turnaround did not occur, the more recent recovery of the dollar may reflect in some degree the wisdom of that decision. And of course the dollar has moved up sharply in the past couple of months. But beyond a reawakened awareness of problems caused by rate volatility, and an apparently growing dissatisfaction with the lack of coherent international monetary arrangements, we have not really moved forward.

A pragmatic approach

As I have said on other occasions, I have always held the view that, once the key element of the postwar system no longer existed, i.e., the link between the dollar and gold, it would not prove possible to agree in advance on a complete new system. The course of the monetary reform discussions of the Committee of Twenty would seem to confirm this. The Bretton Woods Agreement was unique in its origins. It was born in the midst of a world conflict, with essentially only two national protagonists having to reconcile their differences and to hammer out a detailed blueprint for a world monetary system. Other nations can be considered to have ratified the agreement only after it had been formulated and with no alternative in sight.

Such circumstances can hardly be duplicated at present. And so the process has to be an evolutionary one; we have to build gradually on to what we have, on an ad hoc basis. The various blocks of the new system have to be put in place, one by one, as they prove their worth.

Over the years we have gained considerable insight into the workings of the monetary system through the writings of many distinguished experts, including earlier lecturers in this series. The Deputies of the Committee of Twenty established by the IMF in mid-1972 worked hard to prepare a draft outline of reform of the international monetary system. Their work will remain invaluable, even though events forced the suspension of this particular effort. With this body of knowledge and the accumulated experience, it seems tempting to put together a comprehensive set of rules for a world monetary system. Constitution writing comes easy to political scientists and monetary reform drafting to economists. Having been a practitioner in banking, both as a commercial and as a central banker, I find myself advocating the development of broad policy approaches instead.

Broad approaches seem preferable to comprehensive rules for at least two reasons. To begin with, it probably is easier to reach international agreement on broad principles than on detailed rules. Detailed rule-making inevitably involves the reconciliation of too many conflicts of interests and protracted hammering out of the necessary compromises. More basically, problems and institutions do change over time, and specific rules often prove outdated and inadequate, or even harmful. In any case, it is much easier to draft detailed rules on paper than to make them work in practice. At the same time, specific provisions will often be ignored and not invoked, or broken outright if, in the crunch, governments consider them inimical to their countries' vital interests.

Exchange rate stability

The first broad approach that I would like to suggest is that in my view a healthily expanding world economy needs reasonable exchange rate stability. I do not mean rigidity, with exchange rates unchanging despite changing fundamentals, but I do have in mind much greater stability than we have seen in the last two and a half years.

As in other areas, views on exchange rate systems move in a cyclical fashion. During the interwar period, in a reaction to the rigidities of the gold standard, floating rates were seen by many as the way out of the world's economic problems. Then, with the ensuing wave of exchange rate depreciations and beggar-my-neighbor policies generally, the consensus returned to exchange rate stability. After that, in the 1960s, floating rates became fashionable again in many circles.

This was not necessarily a reaction to the Bretton Woods system itself. After all, Bretton Woods did provide a framework for orderly exchange rate adjustments. In fact, going over the debates that preceded and followed the adoption of the Bretton Woods Agreement in 1944, one finds quite a few who felt that the flexible-rate advocates had won the day. As it turned out, exchange rate adjustments under that agreement were not infrequent, although some reluctance to change par values, particularly upward, developed over time. The Bretton Woods experience also, of course, highlighted the question whether a reserve-currency country has any leeway to change its exchange rate. This is probably an issue that will be debated for a long time.

Now that we have had more than two years of experience with floating among the major currencies again, with varying degrees of official intervention, it is not difficult to detect that informed opinion is moving in the direction of exchange rate stability once more.

A system of freely floating exchange rates has--I have to admit--a beautiful simplicity on paper. For one thing, it seems to do away at one stroke of the pen with many difficult problems, including policy actions to achieve international adjustment and the need to provide for monetary reserves, and it does help to insulate individual countries from imported inflation. More important perhaps to those of us who see great virtues in the market mechanism, the idea appeals to our philosophical approach to economic policymaking. But despite these surface attractions, I must conclude that a freely floating exchange rate system is an illusion.

To those who are attracted by the free market aspect of the freely floating exchange rate proposition, I would emphasize that exchange rates are not like other prices, because currencies are not commodities or simple financial assets, but are crucial economic variables that help to shape the economic welfare of each country and thus have to be the responsibility of governments.

Recent experience would seem to confirm that if exchange markets are left on their own or are only lightly managed they not only fluctuate widely but may be expected only too often to set exchange rates far from any likely equilibrium levels. There are essentially two reasons why exchange rate changes under such circumstances tend to overshoot equilibrium. To begin with, I am convinced that, in this imperfect world, speculative capital movements under freely floating rates are and will on balance be destabilizing rather than stabilizing. At the same time, because trade adjusts to exchange rate changes only with considerable delay, freely fluctuating rates are likely to continue to swing beyond the equilibrium point, while the adjustment is taking place.

As I see it, reasonable exchange rate stability is essential for a variety of reasons, both international and domestic. Exchange markets themselves function much better in the absence of wild and erratic fluctuations of the kind we have seen in our most recent experience with floating rates. In such an atmosphere of uncertainty, professionals become reluctant to assume the risk of taking positions and consequently markets become thin, particularly the forward markets. At the extreme, market transactions can evaporate to almost nothing when the markets see they are operating entirely on their own, without any official guidance. Excessive rate movements also tend to lead to market abuses, and in recent years we have seen how these in turn can lead to losses in exchange markets even among the soundest of banks, thus aggravating strains in the international banking system.

Some evaluations of the recent experience have emphasized that international trade and investment flows have continued to flourish, notwithstanding the exchange market turmoil. This is quite true, but I do not believe the evidence of a favorable atmosphere for trade and investment is conclusive. In a period of rapidly rising prices, the higher costs of international business that stem from large rate fluctuations are passed on relatively easily. In a less inflationary environment such higher costs could well prove burdensome enough to hamper international business. I have particularly in mind the effect on smaller firms that may not be well equipped to cope with the problems of rapidly changing rates. Beyond this, I fear that wide fluctuations in exchange rates could slow the growth of international transactions, not just trade but also long-term capital flows, simply by generating such great uncertainties as to foster a shying away from international involvement and to lead to more and more inward-looking, domestic-oriented, business decisions. While so far there is little concrete evidence of such tendencies, there are scattered indications and trade reports that suggest that this may be happening to some extent already.

A similar inward-looking tendency could develop at the governmental level, and not just in private business. As we saw in the interwar period, and also to some extent recently, wide swings in exchange rates tend to exacerbate international frictions and to multiply controls on international exchanges, including restrictions on trade. A rate decline permitted or even fostered by benign neglect in one country, for example, may be interpreted in other countries as a device to gain a competitive edge. Some signs of a reaction along these lines were visible in Europe during the dollar's weakness earlier this year. If such developments were to grow in scope, the international climate could then easily degenerate to the point where fragmentation rather than cohesion became the dominant tendency in the world economy, and free trade was seriously threatened.

Domestically, large changes in exchange rates have profound effects on economies that are significantly involved in foreign trade. In my country, because of our relatively small external sector, these effects had been ignored by many at some considerable cost, but now that the relative importance of this sector has grown rapidly, the awareness of this interconnection has increased. As other countries have learned long ago, there is no way of escaping these effects except through withdrawing into a closed economy. The effects of exchange rate changes on the allocation of domestic resources deserve particular attention. By changing the profitability and competitiveness of broad segments of the economy, whether export industries--actual or potential--or import-competing industries, exchange rate changes can set off powerful forces toward external balance when that balance has been disturbed. By the same token, if exchange rates move away from likely equilibrium levels for any protracted period of time, a misallocation of resources and subsequent structural maladjustments result. Thus, if a currency remains undervalued, resources will be drawn into newly competitive export and import-substitute industries that will subsequently become redundant when the exchange rate moves back. Or, as we have seen recently in several countries, including the Federal Republic of Germany and

Switzerland, if a currency rises too rapidly, disruption and unemployment in the affected export industries can be most serious. Developing countries are particularly vulnerable to extreme rate movements because of their large external sectors and because they generally find it beneficial to link their exchange rates to one of the major currencies. In periods like the recent past they become seriously exposed to violent swings in exchange rates that are generally not of their making.

The inflationary consequences of excessive exchange rate swings are also serious. As rates are driven far from underlying equilibrium levels, the countries whose currencies are depreciating suffer unnecessary inflation. From the point of view of the world as a whole, such inflationary impulses would be reduced to zero, if countries whose currencies are appreciating experienced fully offsetting deflationary pressures. However, since modern-day economies have price and cost structures that are by and large not as flexible downward, these offsetting movements do not occur. The system seems to be asymmetrical and thus can be said to have an inflationary bias. The experience since March 1973 appears to have borne this out.

This asymmetrical behavior between appreciating and depreciating countries at one point in time can also be expected to occur in an individual country over a period of time, as its exchange rate moves up and down. Following a depreciation, costs and prices will go up. Following an appreciation, however, its costs and prices cannot be expected to decline significantly, and certainly not by the full amount of the previous increases. With excessive flexibility in exchange rates, we could thus have a "ratchet" effect that could become a strong inflationary force in its own right. To me this is particularly troublesome, since I regard the current political and social climate, reflecting the revolution of rising expectations, as the prime cause of modern inflation and thus believe that the world economy today has an inherent inflationary bias. We shall continue to face recessionary episodes, of course, but inflation will remain the primary danger for the foreseeable future.

Balance of payments adjustment and exchange rate changes

In expressing my preference for greater exchange rate stability, I do not exclude exchange rate changes from playing a role in the adjustment process. The question of balance of payments adjustment has held center stage in the international monetary arena for many decades. Much has been written on the subject, ranging from learned treatises to specific prescriptions. We have learned much, but there still seems to be no easy solution. There hardly can be, for what is involved is the reconciling of potentially conflicting national objectives among individual countries, on the one hand, and policy objectives within individual countries, on the other hand. Under the theory of the gold standard or of freely fluctuating rates, these conflicts are resolved automatically. That is probably the reason why these two divergent approaches continue to attract some support. In reality, however, there is no automatic way out. We have to look elsewhere.

Every imbalance involves two sides, and so it is only natural that we search for symmetry between adjustment actions by debtor countries and by creditor countries. By and large, in monetary history the natural pressures to adjust have been greater on debtor countries. As a result, the search for better adjustment mechanisms has concentrated on constructing balancing pressures on the creditors. The "scarce currency clause" of the Bretton Woods Agreement was one such attempt. Not surprisingly, national viewpoints on this subject change as countries' seemingly long-term payments positions shift. Thus, the United States, in the early 1940s as a creditor country, was concerned with the need for some discipline on debtors, but as its key-currency role developed, it became preoccupied two decades later with the need for good creditor behavior by others. The new creditor countries, on their part, became concerned with what they regarded as undisciplined U.S. conduct. This should be a salutary reminder that a balanced viewpoint is necessary and that we should not be overly influenced by the issues of the day.

In approaching this question it is essential to differentiate between various origins of major payments imbalances. Large structural imbalances clearly require corrective and supportive action by creditors. Such was the situation at the end of World War II, and the United States recognized it and acted accordingly. Similarly, the current imbalance between the oil exporting and oil importing countries calls for continuing expansion of imports by the members of the Organization of Petroleum Exporting Countries (OPEC) and more financing of the oil consumers' deficits by the OPEC countries. Major structural imbalances are generally so dramatic as to bring forth some adjustment action by creditors almost naturally. If such actions should turn out to be insufficient, deficit countries would probably be justified in taking some protective measures. Such measures would have to be tailored to specific situations, and so I see no need for the development of detailed rules on this score.

In the inflation-prone world that I see, the other main type of basic payments imbalance is associated with the varying degrees of success, or lack of success, that individual countries have in keeping inflation under control. The situation where a leading country develops huge surpluses as a result of a severe domestic slump probably need not concern us. Instead, we have to expect surpluses by the more stable countries and deficits by others. In this situation it is unrealistic to expect the creditors to inflate in order to catch up with the debtors, and wrong to require them to do so. The burden of domestic adjustment should thus be on the debtors, assuming the creditor countries have no significant protective measures or other restraints on their outpayments and no special measures favoring their exchange receipts.

Turning to the various alternative methods of adjustment, national policymakers cannot ignore the fact that domestic economic policies have external as well as internal effects. This obvious point needs to be emphasized, in today's world of interdependent economies perhaps more than ever, because it often seems much easier to acknowledge in the abstract than through action. Nevertheless, I believe we should not overestimate the rôle that coordination of national domestic policies can be expected to play in the adjustment process. All countries now have such a high commitment to domestic policies that any adjustment exclusively for external reasons would only be marginal, lest it jeopardize domestic goals. In any case, it seems to me that the successful pursuit of economic growth with reasonable price stability--the almost universal domestic policy goal--should of itself contribute to the minimizing of payments imbalances.

Obviously, though, imbalances will develop, reflecting differing internal cost and price trends, as well as other fundamental factors. In such circumstances, therefore, exchange rate changes probably have to be relied on to help keep the world economy in equilibrium.

The question then is what is the best set of arrangements for facilitating such changes. Such arrangements have both to minimize the reluctance of most countries to see their rates change and to reconcile the often conflicting national views as to proper rate relationships. The Bretton Woods Agreement chose adjustable par values, but with all the turmoil of recent years, I doubt that this approach is possible at the present time. At this point, firmly managed floating would seem to offer a better possibility, not only for achieving greater exchange rate stability, but also for making equilibrating exchange rate changes as they are needed.

I have already emphasized that in the last two and a half years the approaches to managed floating have varied greatly. Some currencies have been heavily managed, some only lightly, but there seems to be growing recognition of the need to develop a better managed float, and there has been groping in that direction, such as the agreement on a more forceful intervention approach on a concerted basis reached early this year by the central banks of the Federal Republic of Germany, Switzerland, and the United States. Guidelines for floating have been prepared within the IMF, spelling out the various contingencies, but we seem to be far from reaching full international agreement on specifics

I myself remain skeptical whether detailed, universal guidelines are possible or even useful. It is quite easy to agree that official intervention should minimize short-run disturbances and preserve orderly markets. Similarly, at the other end of the spectrum, it does seem reasonable to say that official intervention should not prevent orderly rate adjustment required by changing fundamentals. But in between, views will differ widely.

My approach, as I have already indicated, is to avoid the wide swings of the kind that we have had in the last two and a half years: not just the daily swings in bilateral relationships of major currencies that on occasion have exceeded 1 per cent, or the weekly swings that have been as high as 5 per cent, but also the wide ups and downs of 15 per cent or more over the course of a few months. These swings have largely reflected the great uncertainties on the world financial scene that were first set off by the breakdown of the Bretton Woods system and then spurred by the oil crisis. I doubt that such short-term swings serve any economic purpose.

My view of cyclical rate changes is similar. To the extent that business cycles in major industrial countries are not simultaneous--and for the sake of world stability we should probably hope that they will not be as closely synchronized as happened in 1972-75--there will be cyclical imbalances. Such imbalances, it would seem, are best bridged by reserve changes and credit extensions. To call into play equilibrating changes in trade flows through exchange rate changes does not appear appropriate, since they would shortly have to be reversed, causing some waste in domestic resource allocation. In any case, the duration of cyclical imbalances would generally be too short for the effect of rate changes on trade flows to show results in time. My own preferences, therefore, would be to minimize cyclical exchange rate changes to the extent possible. In summary, I would like to see a firmly managed float that would involve forceful dealing with the market whenever necessary and would allow significant exchange rate changes only in line with changing fundamentals.

Regarding rate changes that are needed to correct basic disequilibria, we face the problem of time lags. As was confirmed in recent experience, the time lags between exchange rate changes and changes in trade flows are quite lengthy, particularly in an inflationary environment. As a result, exchange rates--if left on their own--will tend to continue to move in one direction even after an equilibrium rate has been reached, since the adjustment process will still be going on. This, in the terminology of economists, is the famous "J-curve" problem. Ideally, it seems to me, official intervention should step in at the appropriate point.

The difficulty, of course, is to determine what appropriate equilibrium rates are and to differentiate on a day-to-day basis between shorter-run movements and fundamental trends. Since I do not believe that detailed rules would really be of much help, I would hope that the tendency toward greater rate stability--that I see and welcome--would develop bit by bit as the monetary authorities gain more experience. The very close international consultation and cooperation that will be required should not be beyond reach, particularly in a key-currency world that I see developing, as I shall enlarge upon a little later.

International liquidity, the Euro-currency markets, and official credit facilities

A world of managed floating, just like a world of adjustable par values, obviously has to provide for international liquidity. I have long felt, however, that in the discussion of international liquidity in recent years too much emphasis has been placed on increasing it in some quasi-automatic manner in line with the growth of the world economy. Even a monetarist would surely agree that the role of international reserves in the world economy is different from the role of money in the domestic economy. The primary role of international reserves is to help bridge temporary imbalances in international payments and to provide confidence that such imbalances will indeed be bridged. Payments imbalances do not necessarily grow automatically in step with the growth of world trade. Over the years, however, comparing reserves with imports has become such a widespread custom that for reasons of confidence one cannot ignore it completely.

But there are other factors that help determine the need for international liquidity, and in total these may well be more important than the growth of world trade. Of these factors, I would emphasize confidence in the system in general and in the major currencies in particular, and the connected volatility of short-term capital movements. The predominant private and official attitudes to inflation are also crucial. In a world prone to deflationary pressures, international liquidity should be relatively plentiful to help to offset deflationary tendencies. In contrast, in an inflation-prone world, we must strive to avoid creating too much liquidity.

Against this background, two current tendencies toward excessive liquidity creation--through currency diversification and through the Euro-currency markets--are especially worrisome. Dr. Otmar Emminger, the Vice President of the Bundesbank, discussed both these tendencies in his Jacobsson lecture two years ago, and they seem to have become more pronounced since. The diversification of currency reserves out of the U.S. dollar is of course relatively small in magnitude. To a large extent it reflects continued skepticism regarding the stability of the dollar, particularly on the part of the new international wealth-holders, the OPEC countries. Since I am hopeful of the dollar's future, I believe this problem will remain a limited one. But it is troublesome and needs careful attention from all the parties concerned.

The problem of liquidity creation through the Euro-currency markets looms much larger. In recent years the Euro-currency markets have developed to the point where private credit is available to deficit countries with relative ease. This tendency has been accentuated through the placement by surplus countries, most notably of course the new OPEC creditors, of a major share of their reserve increases in these markets. This development has facilitated the financing of oil-related deficits, but it has been a mixed blessing.

The new ease in Euro-dollar financing of balance of payments deficits, creates, as the Fund's Managing Director, H. Johannes Witteveen, has put it, "a serious gap in the world's anti-inflationary defenses" by making possible "a combined growth of international liquidity [for the creditor countries] and international credit" [for the debtor countries]. Related to this is the possible impairment of the stability of the Euro-currency credit system. Quite aside from the question of how well adapted these credit markets are for evaluating credit standings of private borrowers, I wonder how well equipped they are for lending to governments on the huge scale that we have seen recently. Such large-scale lending seems particularly questionable to me when it takes place in a framework of minimal supervision and regulation by the authorities and when it is characterized by large but sporadic injections of funds.

Like others, I have worried about these problems and believe that international agreements to minimize them would be most timely. What I have in mind is a twofold approach. First, some further limits on placements of reserves in the Euro-currency markets by monetary authorities would seem to be needed. The central banks of the Group of Ten countries have already agreed to limit their placements in the Euro-currency market. The possibility of widening this agreement to others would be well worth exploring.

Second, there is the even more difficult question of influencing the size of the Euro-markets through actions by the various monetary authorities, either through open market types of operations or by introducing some kind of reserve requirements into the market mechanism. Euro-market operations akin to domestic operations are technically feasible; in the 1960s the Federal Reserve on several occasions placed funds in the Euro-dollar market through the Bank for International Settlements (BIS), and in 1971 the Export-Import Bank and the U.S. Treasury absorbed dollars from that market. Such operations, of course, would require the closest possible cooperation among the authorities involved and possibly would involve some difficult decisions. As to reserve requirements, I realize that introducing such requirements in the present principal centers of that market would lead to its mushrooming elsewhere. The simultaneous agreement of the authorities of all potential financial centers is probably not in the cards. This loophole could be substantially narrowed, however, by establishing such requirements for the banks of the main financial countries wherever they would be operating outside of their nations' borders. Notwithstanding the problems involved, these questions appear to me to warrant further study.

In discussing international liquidity I have always stressed that the concept covers not only owned reserves but also access to additional reserves through official credit facilities. The volume and variety of official international credit facilities, at the IMF, within the European Economic Community, the Federal Reserve swap network, have grown very substantially over recent years. The common characteristic of all these official credit facilities is that they provide international liquidity where and when it is needed and presumably in appropriate amounts.

Permit me to say that I am particularly proud of the Federal Reserve swap network, in the development of which I was involved from its inception. From modest beginnings in 1962 it has grown to a total facility of almost $20 billion, linking the Federal Reserve and 14 other central banks and the BIS. Over the years, total drawings under the network have come to $30 billion. Of this total, $14 billion were drawings by the Federal Reserve, and $16 billion drawings by its partners. The swap lines can be mobilized promptly in case of need, be it a relatively routine market intervention or the countering of a major crisis.

The short-run nature of the swap credits has generally been well preserved. When repayment did not prove possible through the reversal of the original payment or market pressure that led to a drawing, swap credits were refinanced through medium-term facilities or in some cases paid off with existing reserves. The network has turned out to be a major contribution to the international monetary system. In general, it is fair to say that is has proved its worth under both fixed-rate and managed-float arrangements to date. I have no hesitation in saying that it will remain an indispensable feature of our monetary arrangements as they continue to evolve. It might well have an even bigger place in the future than it has had in the past, whether through enlargement of the facilities or more active use thereof, or both. Moreover, there may be room in the evolving system for somewhat greater use of bilateral medium-term financing, not necessarily at the central bank level, than there has been in the recent past, to supplement the resources of the IMF.

The role of the dollar

The U.S. dollar became the world's leading currency not through some grand design, but through the development of natural forces, the growth and relative stability of the U.S. economy, and the expansion and relative openness of U.S. financial markets. It is therefore not really surprising that the dollar is still the major world currency notwithstanding the end of the Bretton Woods system and the travail of the dollar in the world's exchange markets. Since I do not believe that a complete restructuring of the world monetary system is feasible, for technical as well as political reasons, I see the dollar remaining as the primary reserve, trading, and intervention currency for the foreseeable future.

Before the eruption of the oil crisis in October 1973, the so-called dollar overhang loomed large among the pressing international issues. Then, as oil importing countries found their large dollar-reserve cushions a blessing rather than a burden, this issue seemed to dissolve. Nevertheless, the question of a dollar overhang still appears to be on people's minds as they look ahead. If there is a dollar overhang, it probably is not as large as it seemed a few years ago. I doubt, therefore, that drastic surgery would be necessary, especially if the United States gets its balance of payments under control, as it has to. It remains true, however, that dollar exchange rates will continue to be heavily influenced by decisions taken outside of the United States, in view of the dollar's status as a world currency.

Painstaking efforts led to the establishment of the SDR, and the SDR will doubtless remain a part of our international monetary arrangements. It seems doubtful, however, whether its importance can increase very much. For one thing, I cannot visualize how the SDR could be used as a medium for market intervention by the various monetary authorities. For another, there has recently been some evidence of its appeal as a numeraire, or unit of account. But I would not expect further major expansion of its use in this manner, if we can avoid periodic crises of confidence in the dollar, and I would hope that as time goes on these can be minimized. As to the SDR's role as a reserve asset, this could in theory be enlarged should the world once again need to supplement the existing stock of international liquidity. But looking ahead, mainly because I fear that inflation rather than deflation is the long-run danger, I would judge that excessive liquidity rather than shortage of liquidity would be the primary concern. Thus on this score alone I see little reason for additional SDR creation for a long time to come. More significantly, I wonder how much scope there is for an internationally issued paper asset in today's world. The use of SDRs as the world's main reserve asset is, of course, intellectually attractive. Translating this into practice, however, involves enormous pitfalls. The political aspects seem particularly difficult, involving as they do the role of reserve currencies as well as the question of national sovereignty in general.

Gold has long been viewed by many as a "barbarous relic," and demonetizing it and phasing it out of the system completely seem to have a good deal of appeal in some quarters. I doubt, however, that this is a very realistic approach. Gold, as I have stated on an earlier occasion, still represents the most cherished form of monetary reserve in a great many countries. And so gold will probably continue to have a place in our monetary arrangements. In recent years the almost complete immobilization of gold as a reserve asset has aroused concern. Today, it is no longer as completely immobilized at the official price of $42.22 as it was before it could serve as collateral for central bank loans. But whether it could or should be completely mobilized anywhere near current market prices is a very difficult question indeed. The world economy is hardly in a position to absorb, without severe inflationary effects, the huge increase in international liquidity that would thus be brought about.

The whole debate between those in favor of demonetizing gold and those for increasing its role again strikes me as the financial equivalent of arcane theological arguments. As in other issues, I take a pragmatic approach. While gold can hardly regain its earlier position, it is a respected monetary asset and it can be a valuable component of reserves even if it is not very actively in use.

In foreseeing the continuation of a multiple-reserve-asset world, I recognize the inherent problems of such an arrangement. The difficulties have been discussed for a good many years, in the international field at least since the existence of the gold-exchange standard was formally recognized in the 1920s. Since I do not believe that we can reduce the number of reserve assets to one alone, I tend to hope that the various reserve assets would not diverge too greatly in their usefulness and attractiveness. In practice, this means that the dollar has to regain a greater degree of the world's confidence and to maintain it.

In the consideration of the reserve-currency role of the dollar, the point has been made in the United States that such a role imposes excessive burdens on the country. To me this has always seemed to reflect a lack of understanding of the very close link between the health of the U.S. economy and of the world economy. The dollar's reserve-currency responsibilities should not hamper the pursuit of domestic policies in the United States to foster steady growth with reasonable price stability. The external and the internal objectives are essentially the same--a strong and dependable dollar.

It is perfectly true, of course, that the U.S. economy, like others, may find itself in cyclical situations when domestic and external policy objectives seem to be in conflict. I have in mind recessionary periods that coincide with rising payments deficits. If fundamental equilibrium is not in question, such cyclical deficits are not inappropriate and international monetary arrangements should provide the necessary temporary financing. Of course, should domestic antirecessionary policies be pursued to excess, they would harm the reserve-currency role of the dollar. But by the same token such extreme policies would do long-term harm domestically, weakening the internal value of the dollar. Our domestic and external policy objectives should reinforce each other, and not be in conflict.

Recognizing this is a necessary step in moving beyond the attitude toward external aspects of the U.S. economy that has come to be known as benign neglect. In the last couple of years this posture has been mainly reflected in the U.S. approach to the management of exchange rates, although here, with some hope, I seem to detect a beginning of a change toward support of greater rate stability. In broader terms, benign neglect has contributed to the ebbing of confidence in the dollar by weakening the credibility of the United States' interest in continuing the reserve-currency role of the dollar. I recognize that it will take some time before confidence in the dollar is re-established, for the shock effects of recent years have been too powerful to disappear quickly. But I am hopeful that in the United States we have made enough progress in eliminating the worst of the inflationary excesses from the domestic economy to begin to restore confidence in the dollar internationally. Restoring that confidence is, of course, a precondition for a satisfactory functioning of the dollar as a reserve currency.

The U.S. dollar can best fulfill its role as the world's primary reserve currency if it is linked particularly closely with a few other key currencies. The management of floating rates is already evolving in the direction of certain groupings of currencies. Thus we have, on the one hand, the European currencies associated with the snake, and on the other hand, currencies more closely associated with the dollar. This would seem to be occurring in realistic acknowledgment of the special roles of certain key currencies. You will recall that more than 30 years ago John H. Williams of Harvard and the Federal Reserve Bank of New York emphasized the difficulty of treating all currencies as if they were equally important, and advocated the key-currency approach to monetary stabilization.

The discussion of key-currency arrangements has from time to time been put in terms of currency blocs. I personally would prefer to avoid that term; to me it has too much of a defensive, inward-looking connotation. Instead I would like to think of a few key countries working closely together, while other countries would become variously associated with each, forming groups centering on these key currencies. With a small number of key countries, it should not be impossible to reach a working arrangement on managing appropriate exchange rate relationships among the groups. It is through such an arrangement that I see the best hope of advancing toward the strongly managed, relatively stable but adjustable, exchange rates that I believe are necessary.

Specifically, I foresee the need for a firmly managed floating-rate relationship between the currencies in the European group and the dollar group of currencies. Within each group, pleas for rate stability are already being increasingly recognized, and at present a growing interest in greater stability in exchange rate relationships *between* the two groups can be discerned. Once the governments reached agreement on such a special relationship between the two groups, the central banks would be in a position to carry it forward. Under unusual market pressures the key rate could be moved, but at the same time the fundamentals would also be borne in mind. There are obviously a great many obstacles still to be overcome before we fully move to such an arrangement. But it would benefit the world economy in general and not just the countries immediately involved. As Dr. J. Zijlstra emphasized in his speech at the BIS annual meeting this year, it would be "a nucleus around which a whole system of exchange rate stability could be approached."

Short-term capital movements

Volatile short-term capital movements brought about serious difficulties in the world economy over the last fifteen years. Such capital flows were the immediate cause of the end of the Bretton Woods system and of the excessive swings in major exchange rates since. The original Bretton Woods concept foresaw a problem in this area and solved it on paper by not providing for freedom of capital movements, and in fact assuming that short-term capital movements would be strictly controlled. Reality turned out to be different: controls on outward capital movements in the major countries were essentially removed, and the rapid growth of the industrial countries together with the internationalization of financial markets set the stage for huge flows of funds across national borders. As confidence in major currencies waxed and waned, speculative movements, including leads and lags, gathered force. At the same time, with the increasing reliance on monetary policies in one major country after another, interest-rate differentials between the main financial centers periodically widened and set off flows of interest-sensitive funds. Such flows in turn often triggered speculative flows.

To handle such large volumes of funds, after they have been nurtured by underlying conditions, is of course extremely difficult. The remedy clearly has to focus on the sources of such disturbances. Restoring confidence in currency values that will not change capriciously is the logical starting point. Being an optimist, I can see some hope that with closer management of floating rates and a redoubling of efforts toward more rational domestic policies, we are moving in the right direction.

Interest-sensitive movements of funds, for their part, can be minimized by closer coordination of monetary policies among the major countries. We have had some progress in the coordination of monetary policies in recent years. Most recently, in the handling of monetary-policy responses to the recession this spring, we saw an increased readiness among the major industrial countries to discuss monetary-policy steps in advance. This is a possible harbinger of developments to come. It seems to me, however, that it will not be easy to advance such coordination much beyond adjustments in the *timing* of policy moves.

I am somewhat more hopeful of reducing interest-sensitive capital flows through lessening the burden on monetary measures in domestic stabilization policies. Central bankers have for a long time been pleading for greater support from fiscal policy both in restraining inflation and in cushioning recession. I remember well the numerous occasions when I called for a better mix of fiscal and monetary policies over the last two decades. Have we made any progress? I am not sure, although I think I see some signs here and there of some forward movement. Politically it has always been easier to achieve fiscal flexibility in recessions than in fighting inflation. The recent wave of double-digit inflation, however, appears in a number of countries to have strengthened the resolve against inflation. In this connection, I am particularly heartened by what I consider a significant improvement in budget making in the United States during this past year and by the more realistic attitudes of key legislative leaders in this country to the dangers of excessive budget deficits.

But even if more flexibility in fiscal policies enables central banks to conduct more moderate policies, and if we manage to restore confidence in the major currencies and to maintain it better than we have done in the past, we can hardly hope to eliminate destabilizing capital movements completely. The question then is whether erratic capital flows can be allowed to dominate domestic economic measures or exchange rates. Having posed the question in this way, I can answer with little reluctance, but also little enthusiasm, that they cannot. In short, absolute freedom for short-term capital movements is probably not attainable. In special--though I would hope only extreme--circumstances, controls will continue to be necessary. I have come to believe this even though I know that controls are by and large inefficient, are technically difficult to set up without impinging on current transactions, and, once imposed, are not easy to remove. In any case, I think we are more likely to avoid capital controls if we establish reasonable confidence in currency values, than if we encourage a pattern of wild exchange rate swings such as we have experienced in the last few years.

Strengthening international cooperation

In conclusion, I would like to say a few words on international cooperation. In a world economy of sovereign states, shortsighted nationalistic tendencies will inevitably come to the fore from time to time. Looking back on the entire post-World War II period, I am encouraged by the fact that we have not done as badly as we might have. On occasions we have moved to disarray, most recently during the height of the oil crisis, but we have managed to pull away from the brink each time.

Looking ahead, I am optimistic. The Bretton Woods system may be dead, but its spirit of cooperation is alive. While I am skeptical of efforts to create automatic disciplines and mechanisms to enforce good behavior, I believe much can be done by proceeding informally and fostering cooperation rather than trying to impose it. At the same time, I would stress that broad international codes of conduct are essential in the economic and financial sphere, as well as the political, even though I recognize the fragility of such codes.

Earlier I pointed out that in my view the emerging monetary arrangements have to focus on a nucleus of key currencies. Cooperation among the key-currency countries will have to be particularly close, as will the cooperation within each grouping surrounding a key currency. But this should not reduce the need for cooperation in the world in general; on the contrary, it should increase it. Thus, while the OPEC countries have formed firm bonds among themselves, and the oil importing industrial countries are striving to do so on their part, both groups do have mutual interests, and cooperation should serve both much better than confrontation.

Both groups of countries also have responsibilities toward the oil importing developing countries. While these countries need a healthy international monetary framework just as all others do, their immense needs for development grants and capital have to be treated separately. I have thus not dwelt on this issue, but I do want to say that I feel quite strongly that the richer countries of the world, including the United States, should considerably increase their efforts to aid the poorer ones.

Over the years, I have witnessed at first hand how well central bankers have learned to work together. The BIS, where Per Jacobsson first exerted his international leadership, has long served as a vital forum in this respect. The willingness and desire to cooperate, and indeed at times the stark necessity of doing so, can--and have--resolved many an apparently irreconcilable conflict. For their part, governments have no choice but to keep forging closer links at their level. The benefits of outward rather than inward-looking policies are not always easily understood by the public at large. In each country, leading private citizens, including distinguished members of the Per Jacobsson Foundation, recognize, I know, their responsibility to help develop broad political support for such cooperative international policies. All of us have to redouble our efforts in this direction. In today's world economy, interdependence is a vital reality that we cannot afford to overlook.

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MR. BURGESS: I think one can tell from the response of the audience that this was a statement very well received. It was a comprehensive statement, with a great many points of impact. One advantage of sitting up here is that you can watch the response of the audience. That is particularly interesting when you know so many people in the audience and know what they have said or what they may have been thinking. I think that Mr. Hayes has given us a good point of departure for the discussion, which I hope will follow.

Let me remind you that the back page of the program has a slip for questions. I hope that, as the meeting proceeds, listeners will write down and hand in questions that will carry this discussion still one stage further. Now we go ahead with our more formal discussion.

Our next speaker comes from Iran. The outline of his career, which has been extraordinary, is before you, so I do not propose to read it. It is enough to say that here is a man who has had very broad practical and theoretical experience. I welcome Mr. Khodadad Farmanfarmaian, who will speak to us now.

Commentaries

Commentaries on Alfred Hayes' presentation were offered by Khodadad Farmanfarmaian, Carlos Massad, and Claudio Segré. The texts of their statements follow.

Khodadad Farmanfarmaian

Introduction

The Board of Directors of the Per Jacobsson Foundation should be congratulated for asking Mr. Alfred Hayes to give this year's commemorative lecture. To honor a man of the stature of Per Jacobsson it is only fitting that a person of such great distinction should be selected for the task. I consider it a great privilege to join this distinguished gathering in paying tribute to Per Jacobsson and to participate in these proceedings.

I intend to make some general remarks on international monetary reform and follow that by specific comments on the paper presented by Mr. Hayes. While I speak as a private individual, my views inevitably reflect the position of the less developed countries. However, in expressing and stressing the philosophy and the attitudes of Third World countries, I believe a contribution can be made to a better understanding of the present debate on the reform of the world monetary system.

General remarks

For the Third World countries the current monetary reform will critically redefine and reform their relationships with the advanced industrial nations. A changed international monetary system will greatly affect their chances of achieving greater equity and justice in these relationships, and just as important, will determine in great measure the continuation, speed, and stability of the future economic progress of the developing countries. Thus, any future international monetary arrangement or system, if it is to be viable, that is, if it is to be supported wholeheartedly by the Third World countries, should be deliberately designed: (1) to reflect in its structure and operations a fundamental bias favoring the economic growth of developing countries, and (2) to allow these countries much greater representation and more effective participation in its management.

The Bretton Woods Agreement in its design and evolution failed to address itself directly to the problems of the less developed countries. It lived its remarkably long life because it met reasonably well the needs of the advanced industrial countries, especially with the assistance of other auxiliary arrangements such as the Marshall Plan and various swap agreements. Bretton Woods has subsequently been abandoned by the advanced industrial countries since they deemed it inadequate to cope with certain changes related to their own domestic economies, such as the massive and growing deficits in the U.S. balance of payments in the 1960s and the divergence of policies and attitudes among industrialized countries regarding such issues as the nature of reserves, liquidity creation, the role of gold, and the adjustment process.

Both during and after the Bretton Woods era, the needs of the less developed countries have been, at best, considered a residual concern and often have been patently ignored. In the turmoil of the past few years they not only suffered neglect, but also the "whiplash" effects of the unilateral decisions of the world industrial and monetary powers. Economic and financial decisions or impulses generated in the industrially advanced countries cause wide fluctuations, severe adjustment problems, and adverse consequences in the economies of the less developed countries.

To consider just one example: the devaluation of a major reserve currency diminishes the small reserves of the less developed countries, at the same time causing larger imbalances in their trade and payments positions. Inflation generated in the devaluing country is virtually exported to them, and the anti-inflationary measures taken in the devaluing country also severely reduce the flows of credit and capital to developing countries. The restriction on credit and capital flows to the less developed countries is exacerbated when at the time of devaluation the prevailing political mood in that country is adverse to aid and international assistance. All of these factors adversely affect development projects and programs in the less developed countries.

The whiplash effect of the unilateral and bilateral economic and monetary decisions of the advanced industrial countries on the trade and development of the developing countries has been particularly severe in the post-Bretton Woods years. The developing countries have been so deeply affected that now--even if their welfare and progress were to become a central concern of new international monetary arrangements--they would still insist on having a strong voice in forging a new world monetary system and press for full participation in its management.

The economies of most developing countries are extremely vulnerable to changes in international trade and financial conditions. Consequently, they need more than others a system of external monetary relationships which will be reliable, durable, and reasonably predictable without being inflexible. This requires an international monetary system managed and supervised by a properly constituted international authority.

Continued ad hoc or bilateral or limited multilateral arrangements between major industrial powers or between blocs formed among them is perceived by developing countries as major obstacles to the growth of trade and economic development. Thus, the present position of the United States, as stated by the Secretary of the Treasury before Congressional Subcommittees on July 21, 1975, that each nation be free to choose among exchange rate systems that which suits it best and only allows the IMF to receive information and to consult on the international implications of policies of the member nations, leaves much to be desired.

In reflecting on the nature of this policy as related to the needs of the developing countries, an old French saying comes to mind: "In relations between the strong and the weak, it is freedom that oppresses and law that liberates." The developing countries wish to have the rule of law with proper due process governing their relationships with the major industrial powers.

For the developing countries, interdependence is a stark reality. Their survival and progress depend on the economic stability and prosperity of the advanced industrial countries. They recognize this fact fully and are willing to act accordingly. They know they must cooperate with the industrial world not only in the monetary sphere but in other fields as well.

The present international economic system has *not* served the world well--certainly not the Third World. It needs to be reformed. This is an inescapable requirement forced by many pressures beyond which, as Harlan Cleveland put it in a recent article, "is the power of poverty itself," and, he said, "the politics of human needs has equity--and time--on its side."

Broad characteristics of a reformed monetary system

Let me summarize what I think should be the broad characteristics of a reformed international system:

(1) It should be truly international in nature, with its provisions observed by and binding on all member nations; (2) the relationship between member nations, i.e., their rights and duties, should be well defined; (3) the system should be stable, with built-in flexibility to be able to adjust to changing economic circumstances without breaking down; (4) it should allow for fair representation and effective participation of Third World countries in its policymaking mechanisms and day-to-day management; and (5) it should be designed to spur the flow of credit and capital to the less developed countries to facilitate their trade, particularly their exports to industrial countries.

The broad characteristics listed above are used as a framework to guide my comments on Mr. Hayes' paper.

Comments on Mr. Hayes' paper

I consider Mr. Hayes' paper a valuable contribution to the recent discussions. He presents a wealth of experience and penetrating analysis which is difficult to question. I certainly support some of his conclusions, and where I differ from him, as I do on some of his major conclusions, it derives from my philosophical departure rather than any defect in his reasoning.

To begin with, I certainly agree that efforts to rebuild international monetary arrangements have not progressed much, but the ad hoc procedure of trial and error proposed by Mr. Hayes may not necessarily be the best available approach. We have already had long experience and have accumulated a great deal of knowledge regarding monetary problems. Where the basic difficulty lies is not in lack of information and experience but in the absence of a common philosophy and a common purpose. This inevitably accounts for the rigidity of the positions on various issues, especially of some of the advanced industrial countries. Therefore, I believe that there is a need for conceptual leadership to change the status quo rather than trial and error efforts to tinker with new machinery.

Mr. Hayes expresses with good reason a preference for broad approaches as against comprehensive rules. Clearly comprehensive rules and technical details as a code of behavior among nations is impractical. But agreement on broad principles can also prove useless if the parties concerned have no better guide to their conduct than a requirement to explain to each other why they deem their actions to be in their national interests and incidentally in accord with very broad multinationally agreed principles. Perhaps a position in the middle of the two extremes, where broad approaches are combined with some concrete rules is more appropriate.

The first broad approach he suggests is the need for reasonable exchange stability--a degree of stability much greater than that experienced in the last two years. After surveying the past, he concludes that the trend of informed opinion is also moving in that direction. On this point I agree with Mr. Hayes.

What follows is his rejection of the freely floating exchange rate, which he considers an illusion which works beautifully only on paper. A whole sequence of powerful arguments is subsequently presented by him showing the shortcomings of the unmanaged or lightly managed foreign exchange markets, which inevitably support his proposal for greater exchange rate stability. I present a brief outline of his arguments below:

- Where exchange markets are left on their own or are lightly managed, wide fluctuations of rates that are far from likely equilibrium levels result, owing to the destabilizing effects of speculative capital movements and the lag in trade adjustment to exchange rate changes.

- Wide exchange rate fluctuations lead to widened bid and offer margins and reduce market depth, resulting in market abuses and exchange market losses, thereby straining the international banking system.

- Wide exchange rate fluctuations could slow the growth of international transactions and hurt trade and long-term capital flows by creating uncertainties.

- Wide swings in exchange rates can lead to exchange controls and trade restrictions in other countries.

• The effect of wide fluctuations of exchange rate on the domestic policies of those countries which are greatly dependent on foreign trade can be profound, especially in terms of wastes resulting from misallocation of resources caused by exchange rate movements away from equilibrium levels for a protracted period of time.

• Developing countries are deeply affected by wide fluctuations in the exchange rates of currencies to which they are linked because of their large external sectors.

• Excessive swings in exchange rates are serious, since in downswings the countries whose currencies are depreciating suffer inflation, and because of rigidities in price and cost structure others do not experience appreciation; for the whole world, this asymmetrical behavior leads to a "ratchet" effect, creating an automatic inflationary bias that unnecessarily adds to the force of the already existing world inflationary tendency resulting from the revolution of rising expectations.

The implication of wide exchange rate fluctuations as presented by Mr. Hayes inevitably leads to the conclusion that exchange rate stability is desirable--a conclusion which is difficult to contest.

Balance of payments adjustment and exchange rate changes

In his discussion of the balance of payments adjustment and exchange rate changes, while not excluding the latter from playing a role, Mr. Hayes does not believe that in reality the adjustment mechanism can be automatic. He also concludes from monetary history that the national pressures to adjust have been much greater on debtor countries and consequently, the search for better adjustment mechanism has concentrated on directing pressures on creditors. It is perhaps interesting to note here that the disenchantment of many of the less developed countries with the IMF derives from that agency's overt role in passing the pressure of the creditor countries for adjustment to these countries as debtors through various types of stabilization programs.

In regard to "large structural imbalances" such as the situation after World War II and the recent imbalance between the oil exporting and oil importing countries, Mr. Hayes believes that adjustment of such imbalances requires action by creditors as, in fact, both the United States in the former case, and the member countries of the Organization of Petroleum Exporting Countries (OPEC) in the latter case, have acted. Should creditors fail to take appropriate action to help rectify such imbalances, deficit countries would be justified in taking protective measures.

During inflationary times when a country develops huge surpluses as a result of domestic slump or stability, Mr. Hayes states it should not be required to inflate its economy for the purposes of adjustment and the burden of adjustment should be left to debtor countries. With regard to cyclical imbalances, he does not consider exchange rate changes as appropriate and believes that these imbalances should be bridged by reserve changes and credit extensions.

On the correction of basic disequilibrium, first he calls to our attention the difficulty of time lags between rate changes and trade flows and the susceptibility of exchange rates to continue to move on, if left unattended, and indeed the problem of discerning the appropriate equilibrium rates. Then he suggests that these problems will be automatically handled, given the desire for stability, with close international consultation and cooperation and accumulation of experiences by monetary authorities.

Finally, Mr. Hayes suggests that when imbalances reflect differing internal cost and price trends, exchange rate changes should be relied upon to keep the world economy in equilibrium. It is here that he proposes the use of firmly managed floating as the best mechanism of adjustment in the present world circumstances. He expresses skepticism as to the acceptability of detailed guidelines for the management of floating rates, such as the one prepared by the IMF, and feels that agreement can be achieved on the basis of two broad principles: (1) that "official intervention should minimize short-run disturbances and preserve orderly markets" and (2) that "official intervention should not prevent orderly rate adjustment required by changing fundamentals."

To summarize Mr. Hayes' views on balance of payments adjustments and exchange rates, he believes that exchange rate stability is essential, that significant exchange rate changes should only be allowed in line with changing fundamentals, and that the best mechanism to achieve this is through firmly managed floating without detailed guidelines with reliance on international consultation and cooperation.

I cannot help but feel that much of Mr. Hayes' analysis and conclusion and indeed his basic proposal for handling balance of payments adjustments is addressed exclusively to the problem of the industrially advanced countries, leaving the problem of the less developed countries altogether unattended. On one issue the less developed countries fully support the position of Mr. Hayes, and that is the need for a stable but adjustable exchange rate. However, on his main proposal, I believe they will dissent because of the following reasons:

(1) Can managed floating ever be "pure" in the sense that its management can be based on "impersonal" or "nonnational" or "universal" considerations and indices? Obviously national political considerations always intervene, regardless of how well intended and disciplined the monetary authorities may be. Thus, there is a natural tendency in our imperfect world for unmanaged float to become "polluted" and even "dirty."

(2) The developing countries harbor deep suspicions founded on their past and especially recent experience with the unilateral and often careless behavior of the advanced industrial countries on issues that concern their welfare. They will be reluctant to leave their fortune and future in the hands of the money managers and the fiscal authorities of the industrial countries; to the developing countries it is very important who decides the fate of their international payments position, trade, and economic development.

(3) They prefer to have well-defined international monetary relationships with the industrial world with clear codes of conduct and procedures for adjustments.

(4) They also wish to have effective participation in the management of the adjustment procedure.

(5) Because of the urgent nature of external payments, trade and development problems, the developing countries cannot afford to wait for the monetary authorities of the industrial world to gain experience with their new devices. The use of these devices may well lead to severe misallocation of resources in the developing countries and corrective action may be delayed because of natural inertia or resistance to change which is inherent in the institutions and politics associated with such multinational devices.

Perhaps my comments on the adjustment mechanism can best be concluded by quoting a passage from the 1975 Annual Report of the IMF in which the concern of the developing countries with managed floating is expressed: "For the developing countries that have continued to peg their exchange rates, floating of the major currencies has introduced a new type of uncertainty into their exchange rates and balances of payments, against which they find it difficult to protect themselves."

The IMF has, however, concluded that in similar circumstances such as those in the last few years, uncertainties associated with floating "are not necessarily greater than those that would be involved under a par value system." This view of the IMF is a conjecture and cannot be sustained a priori. Under a par value system, rate fluctuations are not automatic and are less frequent and more predictable since they are generally effected after some international consultations.

International liquidity

Mr. Hayes believes that liquidity or reserves are required to bridge temporary imbalances in external payments and to provide confidence that such imbalances can be bridged. The need for liquidity, however, he maintains is also determined by confidence in the system, the currency of reserve, volatility of short-term capital movements, and general attitudes to inflation. As a general rule, he states that under deflationary circumstances liquidity should be made abundant and conversely, in inflationary times liquidity creation should be restrained.

Two current tendencies leading to excessive liquidity creation, one through reserve currency diversification and the other through the Euro-currency markets, are discussed. He believes that the first is small in magnitude and with the strengthening of the dollar it will be controlled. The second problem he fears is much more worrisome. Euro-currency markets have provided credit with relative ease to deficit countries--a tendency which has received further impetus from the placement of the new OPEC reserves in the same markets. He suggests Euro-currency activities should be minimized by limiting placement of reserves and by imposing a reserve requirement on the banks engaged in Euro-currency lending in other countries.

Unless compensatory opportunities are provided, these proposals will hurt both the OPEC and the less developed countries in general. The Euro-currency market has provided an opportunity for the OPEC countries to have a limited hedge against the recent downswings of the dollar rates and provided for them a better possibility for proper management of their reserve portfolios. Surely, the desire to keep the option to diversify their reserve holdings is understandable, particularly in the light of suggestions which have gained some currency in the United States to "identify" OPEC funds, leading to apprehension in the monetary circles in the OPEC countries that their placement in the United States could be subject to possible blockage.

To the less developed countries in general the Euro-currency market has provided a source of short-term and medium-term capital which have been crucially important for their balance of payments adjustment and economic development. Were these sources of funds to diminish, in the absence of additional capital from elsewhere, the financial position of the developing countries would deteriorate further.

Mr. Hayes does not believe the dollar overhang is as large as it seemed to be a few years ago and no drastic surgery is required if the U.S. balance of payments position improves. Here, it is important to note that while the size of the problem is smaller now, reflationary policies in the United States which can lead to a worsening of the U.S. balance of payments deficit can amplify the overhang problem. The difficulty is in the nature or the root of the problem of the dollar overhang, namely, the overwhelming predominance of the dollar as a reserve and trading currency. It is perhaps the need for the diversification of reserve assets and the reluctance to depend so heavily on the dollar that has motivated many developed and developing countries to search elsewhere for balancing their reserve portfolios.

Since gold has lost its position as a universally accepted reserve asset and its monetary role is being phased out of the international monetary system, the remaining options for reserve asset diversification is limited to one or two European currencies and the SDR. Before discussing the SDR, however, one comment on gold is essential. Any substantial increase in the price of official gold will increase international liquidity--unevenly among a few countries--and will cause further inflationary pressure, which is in the interest of neither the developed nor the developing nations of the world.

Mr. Hayes is skeptical whether the role of the SDR as a unit of account can become substantially greater than it is at present and he considers that its further expansion as a reserve asset will be inflationary. The global need for liquidity is a subject which requires much closer examination by the IMF and its auxiliary committees, particularly in respect of the needs of the less developed countries as well as developed debtor countries. What requires priority at this time is a reexamination of the regulations governing SDRs and their allocation with a view to promoting further flow of financial resources to the developing countries. The Committee of Twenty thus has proposed a "link" between development finance and SDRs through its direct allocation to international and regional development finance institutions as a new and automatic source of development financing.

Mr. Hayes prefers a world of key-currency arrangements where there is "a firmly managed floating-rate relationship between the currencies in the European group and the dollar," with other currencies forming "associations" with one of the key currencies. He believes that such arrangements offer the best solution for stability and orderly adjustment of exchange rates.

The basic concern with this approach is the possibility that under certain political or economic circumstances associations may become blocs, with special protective and restrictive policies in trade and external monetary relationships. This, if it happens, is certainly a step backward. When nations do not have binding obligations to behave according to international rules, it is much easier for them to pursue their selfish individual or bloc interests.

On short-term capital movements, Mr. Hayes believes that by restoring confidence in currency values, firm management of floating rates, increased efforts toward more rational domestic policies, and closer coordination of monetary policies among the major countries, the type of difficulties experienced in the last fifteen years can be minimized. These recommendations are pious hopes and are no solution to the erratic and destabilizing movement of short-term capital flows across borders. Mr. Hayes himself concludes that "absolute freedom for short-term capital movements is probably not attainable" and that in special cases restriction of short-term capital flows is essential. Some restrictions on short-term capital flows seem necessary to maintain stability in foreign exchange markets; but if they were to be imposed arbitrarily by individual monetary authorities, such measures will prove to be counterproductive and will lead to greater volatility of exchange markets. These restrictions will prove more effective if they are based on agreements between central banks in consultation with the IMF.

Summary and conclusions

The cornerstone of Mr. Hayes' proposal is the necessity of rate stability in foreign exchange markets. He proposes that this can be best achieved by "a firmly managed floating-rate relationship between the currencies in the European group and the dollar group of currencies." He believes that the smooth working of this scheme can best be assured by consultation among governments on domestic economic policies and greater cooperation among the monetary authorities of nations.

In commenting on his thoughts, I fully agree with his goal of achieving exchange rate stability but depart from him in his selection of mechanism. As I have indicated, a clear set of rules agreed upon internationally, supervised by an international institution, and managed by all nations affected by it is essential. To put it in more concrete terms, in place of a firmly managed float among key currencies, I propose an exchange rate regime based on stable but adjustable par values with the SDR as the main reserve asset, and a greater degree of symmetry in the adjustment process.

Mr. Hayes and I both believe that the cooperative international spirit of Bretton Woods, for which Per Jacobsson worked so hard, is alive and still serves as the basis upon which to build a new world monetary arrangement.

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MR. BURGESS: Thank you very much, Mr. Farmanfarmaian, for adding a great many points of emphasis to our discussion. I will now call on Mr. Carlos Massad, formerly the head of the Central Bank of Chile.

Carlos Massad

I consider it a great honor to have been invited to comment on Alfred Hayes' Per Jacobsson Lecture. Not only because those two names are, and will always be, among the most important contributors to the development of international and central banking, but also because the subject matter of today's lecture is of great importance to an understanding of the changes that are taking place and their implications.

I am in basic agreement with most of Alfred Hayes' comments, perhaps as a consequence of sharing his biases as a central banker. I prefer a pragmatic, as opposed to a dogmatic, approach. I share the belief that a new monetary system can only be built block by block and that broad approaches are better than detailed rules. I share Hayes' view that exchange rates cannot be left alone, and perhaps I could add some additional arguments on this matter. For example, empirical evidence indicates that exchange rate fluctuations are positively correlated with inflation rates; as Hayes points out, "wide swings in exchange rates tend to exacerbate international frictions and to multiply controls," but this implies that the larger the "disequilibrium," the less efficient floating rates will be, a view that is contrary to the accepted belief that floating rates work better in disequilibrium situations.

I also share Hayes' view that one ought not to overestimate the role that coordination of national domestic policies can be expected to play in the adjustment process, although I would add that one should not underestimate it either. Again, I share his views on the need to look for some way of regulating the expansion of the Euro-currency market in order to avoid excessive liquidity creation. Here, however, my own inclination would be to place substantially greater emphasis on the need for international surveillance of the liquidity expansion that takes the form of official international credit facilities. As Hayes points out, such facilities are a form of liquidity, but because they are often available only to a few countries and not to others, they tend to redistribute the burden of adjustment, or at least the timing of adjustment, against those countries, large or small, excluded from the facilities. Furthermore, I am in agreement with Alfred Hayes on the danger of the full mobilization of gold at near current market prices, and on the fact that, if many monetary authorities consider gold as a valuable international asset, gold will have a presence, and perhaps a relatively important one, in the system.

My agreement with many of Alfred Hayes' remarks, however, does not necessarily imply an agreement with the general picture that emerges from them.

The block by block approach to monetary reform may be unavoidable. But this circumstance should not prevent the international community from deciding beforehand on the general shape of the edifice that should be built out of the blocks, if it wishes to avoid the danger of being surprised--perhaps unpleasantly--by the outcome. I am far from saying that the present blocks that are being put into place--either by international agreement or *de facto*--do not lead in the direction envisaged by Alfred Hayes. On the contrary, I do believe that the system is moving in the direction of reducing the relative importance of SDRs and of stimulating the appearance of groups of key currencies. As a matter of fact, floating, managed or not, increases the relative demand for currencies in reserve composition and also tends to increase the private demand for foreign assets, thus causing an increase in the demand for currencies. As a result, the relative demand for SDRs in reserves tends to go down.

As Hayes has pointed out, the management of floating rates is evolving in the direction of certain groupings of currencies; it may perhaps continue to evolve in the direction of a few key countries working closely together, while other countries become associated with them in various ways. A small number of key countries could reach agreement on arrangements to manage exchange rate relationships among the groups. But the consequences of such a development may not be as desirable as they seem.

In the first place, the group of key countries would have to agree on forms of reciprocal credit arrangements, perhaps through an expanded network of swaps, to ensure that there could be appropriate intervention in the market. That is, the group of key countries would create their own international liquidity, leaving no room for other forms of liquidity creation and perhaps ignoring the rest of the world so far as liquidity distribution is concerned.

There is then no guarantee of an orderly process of liquidity creation. Here, let me add that like Hayes I consider simple comparisons between world trade and liquidity to be very crude, and even misleading. Such simple comparisons are not made any more at the domestic level, where we have learned long ago that velocity is not constant, even though it may be a stable function of a few variables. I believe the same is true in the international sphere. An orderly process of liquidity creation and an appropriate regulation of liquidity growth are, in my view, very important building blocks for the system as a whole.

Furthermore, the grouping of key countries in exchange rate management would stimulate asset diversification in reserve currency holdings, with the well-known dangers of instability and short-term capital movements. Of course, this particular development might be inhibited if one of the key currencies became overwhelmingly important in the group. But the situation is now substantially different from that prevailing at the time of Bretton Woods, and several currencies might compete for the place of honor. If so, the degree of international surveillance of the policies of the key countries required for the smooth operation of the system might become unacceptable. Without surveillance, however, changing conditions in different key countries might lead to domestic policies which could result in strong disturbances being transmitted through the system to the rest of the world.

Diversification of currency holdings is no longer a minor element in the picture. Insofar as currencies are an increasingly important part of reserve holdings, I would expect this diversification to continue, since it is unlikely that in the foreseeable future the recent experience of exchange rate instability will be forgotten. My guess is that it will take a long time before there is any strong faith in the stability of exchange rates. One pointer in this direction is the growing tendency to look for a more stable numeraire, in the English sense of that French word. Thus, some institutions in the private sector have begun to use the SDR for the purpose, a heresy which, like others before it, may after all lead in the end to reform. In fact, the time may come when the private sector begins to create SDRs through the well-known multiplier effect, while the official sector tries to move in the direction of reducing the importance of SDRs in monetary affairs. Euro-SDRs may be in the making.

A system of key countries working together will not necessarily contain a stimulus to adjustment unless one was already in existence. Adjustment may have to depend upon direct negotiations between the key countries involved, with all the friction such a method would imply. Of course, an alternative would be to negotiate a system of adjustment and of distribution of burden; but, if such a negotiation were successful, the core of the monetary reform would in fact have been established. In any case, adjustment, like liquidity creation, is a matter of the utmost importance for the whole international community, and every country would certainly wish to participate in the negotiations to make sure that its interests were duly taken care of.

The system which seems to be emerging does not contain either appropriate incentives for adjustment, or proper guarantees for the regulation of liquidity creation and distribution. If these difficulties are to be overcome, the system must, in my view, contain other features. We may perhaps have to go back to the discussions in the Committee of Twenty to find them; and they must include, at the least, asset settlement and liquidity creation through the allocation of SDRs. SDR allocation need not lead to excessive liquidity creation insofar as other forms of liquidity expansion are under control.

A word on the less developed countries. I am firmly convinced that they have more to gain from a system that takes care of their interests than from repeated pleas for assistance. The result of such pleas is only too obvious. I believe that it is in their interest for a system to be put into place by international agreement; an established system is the best protection for the weak. Hence, I would expect the less developed countries to press for reform in the sense given to the term by the discussions of the Committee of Twenty.

Central bankers are usually proud, and rightly so, of their conservatism in financial matters. The trouble is that one no longer knows what conservatism is. It is not a belief in preserving the status quo, for no one seems to like the present situation. It is not a desire to go back to the old system, for everybody recognizes its limitations. Perhaps conservatism now is a feeling that it should be proper to go back to the discussions and approaches of the early years of this decade in search of a general design that could be used for putting each new building block in place. In such a task, international institutions, and in particular the IMF, which owes so much to Per Jacobsson, have a decisive role to play. And so have central bankers, particularly those few who, like Alfred Hayes, have the insight, the knowledge, and the experience and can leave behind, with pride, the pressures of daily decisions.

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MR. BURGESS: Thank you very much, Mr. Massad. Your comments have added a feeling of faith and a feeling of practical courage to our proceedings.

I will now call on Mr. Claudio Segré to continue the discussion.

Claudio Segré

I am very honored and pleased to be here today and I should like to express my sincerest thanks to the Directors of the Per Jacobsson Foundation for this unexpected and most flattering invitation.

At no time have I been directly associated with international monetary negotiations but my interest in them--and my frustrations--have certainly paralleled those of the keenest participants. The week after I entered private banking, sterling was devalued and close behind came the gold crisis, the French franc devaluation, August 1971, February 1973, and a series of other events and nonevents that marked the progressive dismantling of the international monetary system.

Trying to keep afloat in this storm has been a traumatic experience and I warmly welcome, therefore, Mr. Hayes' plea that monetary reconstruction is urgent and should not be delayed. As a matter of fact, I cannot find fault with the major points of his lucid and convincing analysis. Our divergences concern less what he says than what he leaves unsaid, particularly at the normative level.

Mr. Hayes has given us an evolutionary framework based upon two pillars, the re-establishment of the dollar's health and an improvement in international cooperation. This is an essentially aristocratic approach: the authorities of the key-currency countries would receive a vote of confidence and be asked to use their wisdom in steering the world's monetary course through the rocks of inflation, deflation, and conflicting national interests.

As it is the duty of the opposition to oppose, I will start by saying that the market is not going to be very impressed with mere convergence on broad policies, as suggested. I fear that, after the total collapse we have experienced, the public would not be sufficiently reassured without clear indications that major countries are willing to accept a greater degree of restraint on domestic policies in the interest of orderly international monetary relationships, i.e., to submit to certain rules. Yet, precisely on this point Mr. Hayes has encouraged no wild hopes.

Let me go now to more specific comments following the order of the presentation we have just heard. On exchange rates, I believe that a consensus will emerge on the need for greater stability. Few will quarrel with Mr. Hayes' call for a "firmly managed float that...would allow significant rate changes only in line with changes in fundamentals." The wide swings of the exchange markets have taught us several lessons. The first one is that large divergences between market rates and any reasonable estimate of the underlying fundamental parities cannot fail over time to discourage and distort international trade and investment. The second one is that floating rates have not acted as a brake on speculative capital movements, far from it. The third one is that the end of the par value system has not meant the end of the accumulation of reserve-currency balances: thus the inflationary creation of internal liquidity continued, while the effects of exchange rate instability on the prices of imported goods spread throughout domestic price structures and became embedded in them.

Agreement on the management of floating rates could be one element--and a significant one--in future arrangements, but it would concern merely the market expression of more fundamental phenomena, the adjustment process and the evolution of reserve currency balances. While I accept Mr. Hayes' analysis of the role of exchange rates in the adjustment process, I miss more positive suggestions on the problems of asymmetry in adjustment and of liquidity creation by the reserve-currency countries. The reason is probably that no arrangements are emerging and that, in fact, even the reform outline prepared by the Committee of Twenty seems to have gone by the boards.

I am painfully aware of the serious conceptual and technical problems involved in restoring convertibility even of a limited kind. I believe, however, that no reform effort will be significant until it has tackled this problem which lies at the heart of our past and present difficulties. If inflation wrecked the Bretton Woods system, as Dr. Emminger suggested in his Per Jacobsson lecture two years ago, it did so not because of the existence of a par value system but because the reserve currency countries could finance their deficits painlessly and in practically unlimited amounts.

The position of the United States is unique because of the disproportion between the small weight of the external sector of the economy and the enormous weight of the dollar in world trade and finance. Benign neglect was obviously a misconception and Mr. Hayes rightly points out that domestic and external policy objectives should reinforce each other, the common aim being a strong and dependable dollar. From that point on, however, our roads diverge: he hopes that the restoration of the dollar's health will permit the United States to continue acting as the principal reserve center, while I hope that the newly found vigor of the dollar will allow the United States to consider unemotionally steps toward the reduction of such a reserve role. This new approach would help satisfy the legitimate desire of the United States for a better control over its exchange rate and a greater autonomy in monetary policy.

It is fashionable today to question the existence of a dollar "overhang": this seems to me to be an exercise in semantics because the fact is that large-scale conversions of dollar balances either at the initiative of foreign holders or through massive U.S. capital exports, such as occurred last year, are an ever-present danger. Further, some of today's biggest holders of foreign currency balances are understandably concerned about keeping "politically exposed" assets and are therefore less likely to heed the call for cooperation than were European countries and Japan at the time the "overhang" was concentrated in their hands. I cannot, therefore, share the opinion, recently presented by authoritative Congressional committees, that no action is warranted to stabilize such dollar balances. Hopefully, if world inflation abates, part of them will be consolidated into longer-term investments. But a multi-reserve-asset world awash in liquidity will continue to be plagued by exchange rate instability. This in turn will give rise to competing currency blocs which may at times cooperate but may at other times take a defensive and inward-looking attitude. Thus I would place near the top of my list arrangements to encourage the gradual retirement and/or the optional substitution of reserve currency balances by means of an SDR account lodged in the IMF.

The problems of stabilizing currency balances is not unrelated to the origins and role of the Euro-currency market. As a banker, I am not unfamiliar with the pretty cold attitude of the authorities toward this favorite whipping boy: such an attitude only seems to become more mellow when there are substantial stand-by loans to be raised, with no questions asked. A few remarks are in order on this point. First of all, the Euro-market has helped stabilize liquidity balances by offering foreign holders investments more profitable than treasury bills. Secondly, the excesses of the market, as Mr. Hayes rightly points out, have stemmed from central banks depositing funds in the market and governments and public bodies indulging in massive borrowing. Thirdly, the recycling of OPEC funds through the Euro-market was in fact inevitable: as Governor Carli recently pointed out, "The lack of official initiatives has made it necessary to multiply liquidity through private channels and has weakened the determination to control them effectively." Thus the Euro-market has enabled oil importing countries other than the United States to play the game which permits surplus countries to accumulate reserves without any corresponding loss by the deficit countries. It is easy to see that this mechanism closely resembles in its consequences the liquidity creation resulting from the deficits of reserve currency countries. Even so, recourse to the Euro-markets was in my opinion a lesser evil.

To conclude on this point, I would certainly support Mr. Hayes' plea for moderation on the activities of central banks in the Euro-market but would look at his second point, reserve requirements, with a healthy degree of skepticism. Beside being extremely difficult to administer, such a measure would appear belated and unnecessary in view of the more conservative liquidity policies of the Euro-banks after the costly experiences of 1974. I would be much happier if the agencies entrusted with the surveillance of the Euro-market sought to influence liquidity as appropriate by engaging in full-fledged open market operations and by coordinating the timing of Euro-currency borrowing by governments and other public entities.

When we come to the problem of international liquidity we find Mr. Hayes facing squarely the two central questions--how much and in which form. I share his thinking on the irrelevance of a mechanical calculation of the appropriate level of liquidity and on the present adequacy of *gross* reserves. However, the picture is less reassuring when we examine individual *net* reserve positions, after deduction of short-term indebtedness. This essential step--often curiously omitted--reveals that several major trading countries will find themselves dramatically strained if and when the world economy expands again at a normal pace. We have there the making of a new series of exchange market crises: I submit therefore that this is no time for complacency and that funding arrangements to restore the liquidity and indeed the solvency of these countries are urgently needed.

On the other question, the form and source of liquidity, I am worried by Mr. Hayes' faith in the viability of a dollar-based reserve system. Surely in the 1950s and early 1960s the system helped to keep the world economy on a path of balanced expansion, but we cannot be blind to the fact that conditions that made this possible then do not exist any more. While the transition must be gradual, I see the need for an effort to place a revamped SDR in a position of primary importance among reserve assets. My case rests on the political and economic desirability of freeing the international monetary system from dependence on a given country's balance of payments evolution, whether that country be the United States, the Federal Republic of Germany, or Saudi Arabia. A new departure would certainly involve "enormous pitfalls" as we are being warned, but can this be worse than the turmoil we have been through? The work done by the Committee of Twenty on this central issue, as on many others, has been constructive enough to deserve a better lot than relegation to the present limbo.

Mr. Hayes has given us a statesmanlike program for survival. However, overcoming the present deep-rooted confidence crisis requires a stronger sense of direction; in fact, it requires proof that a new international monetary order, and not merely ad hoc arrangements, is the objective we have in view. We can pay no better tribute to Per Jacobsson than continue in his footsteps to seek an international monetary system with clear objectives and disciplines and a strong, impartial, and flexible IMF having at once the role of a financial agency, of a conscience, and of a continuing forum for discussion.

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MR. BURGESS: Thank you, Mr. Segré. I hope you all wrote down that last sentence. I think it deserves to be specially noted in this setting.

Questions and Answers

Following the formal presentations, Mr. Hayes and Mr. Farmanfarmaian answered written questions from the audience.

MR. HAYES: First, there are several questions about the SDR.

Can you specify the difficulties you mentioned with respect to greater reliance on SDRs in the future and the creation of additional ones?

It is a truism that nearly all international solutions involve enormous pitfalls. In what respect are those related to SDRs as reserve assets more difficult than normally prevailing?

My feeling on SDRs is strongly influenced by the fact that the SDR is so involved now in the plans and desires of the developing countries for some kind of participation in newly created liquidity. And I see a fundamental conflict between the general idea of an SDR as simply an additional form of international financial monetary asset and the idea of an SDR as a means of conveying much needed development assistance to the poorer countries of the world. I have a very hard time reconciling those two elements. And I would rather try to avoid that conflict by concentrating on development as a separate subject and on reserve assets as a separate subject. I know that this is a controversial area, but that is the way I feel about it personally.

I have a question on the dollar overhang.

Of course, there has been an overhang; and there still is some overhang. The only question is how big a problem it is. It looked like a pretty big problem a few years ago. But it only took the oil crisis to demonstrate that there was quite a noticeable absence of a dollar overhang problem for a period. Nearly every oil importing country was wondering where it was going to get sufficient funds to meet huge balance of payments deficits. And there was very little talk for a while about an overhang.

As I said, I think it is not a major problem unless we behave very badly. Of course, if the kind of faith in the dollar that I hope and expect to see restored is not in the cards, then obviously the dollar overhang is a very serious problem, and we will have to move in the direction of replacing the dollar as a major reserve asset.

Perhaps I can lead from that into a comment or two on some of my colleagues' remarks here, as to the role of the dollar and the stress I put on trying to maintain the dollar as the major reserve currency, and as a major form of reserve asset.

Now, I hasten to add that I do not intend to demand an exclusive privilege for the dollar. Quite the contrary. If other countries with very strong economies and strong currencies want to take part in the reserve-currency role, I think that is eminently appropriate. I must confess that in most of the dealings I have had with representatives of the central banks of various industrial countries, I do not detect a burning desire to get into this business in a big way. So I do not think that we are monopolists who are crowding everybody out.

But my reason for advocating the continuance of the dollar's role is a very pragmatic one. The fact is that the world is used to using dollars as a reserve currency. It is a very convenient mechanism that has served world trade and investment well. And it is handy to have the intervention currency the same as the reserve currency and the same as the most widely used trading currency. I can see real advantages in continuing that. Certainly, from a mechanical point of view there are great advantages in using the dollar for intervention as compared with using SDRs for that purpose.

But I agree that it depends upon our performance. And people may well take the position that I am too optimistic on the future of the dollar. I have worked hard to try to do what little I could over the years to help it. I have to admit, as I look back on recent years, that it has not been a wholly successful effort. On the other hand, I see signs now of considerable growth of confidence in the dollar again.

I think I ought to say, too, at this point that I fully understand the uneasy feeling on the part of many countries that perhaps they are being left out and that some relatively exclusive club is "calling the shots." And I can understand that that impression is a little annoying. No one likes the idea of not being a full participant.

All I would say to that is that as a practical matter, in the world exchange markets, there is a relatively small number of currencies that play a tremendously dominant role in the handling of international trade and investment transactions.

Different currencies are now beginning to come up in the world and are becoming more important in that respect. I would think that over the years the number of important trading currencies that would logically get into any inner circle of decision making would naturally expand. But I do not think it is really practical to feel that all international financial arrangements have to be made on a universal basis. I just do not believe that that is going to prove wholly workable. In fact, as I have indicated in my paper, I think you can often get farther by having some very effective arrangements among a few countries, the beneficial effects of which tend to fan out very rapidly to other smaller countries which are closely tied in one way or another to some of these stronger countries.

You stated that you felt that speculative capital flows were an essentially destabilizing influence on exchange rates in the world monetary system under freely floating rates. Could you elaborate on your reasons for holding this position?

First, let me say that I do not hold myself out to be a foreign exchange trading expert. But I have the feeling, having lived through the last few years, that this destabilizing influence was at work. And my most competent foreign exchange trading advisors have tended to support that conclusion. But I cannot go very far beyond that, because I am not sufficiently expert in the field.

Could you say a bit on the private side of your topic? In particular, how can one reconcile a generally wide support of floating by bankers and businessmen with the bias toward inflation and the other risks to the private economy which you have described?

I think, as I said in my paper, that there has been a kind of vogue for floating. And there has been a certain lack of understanding of it, too. For a long time there was a myth that free floating was prevalent. Now, there has in fact been practically no free floating since 1971. I checked the figure for the total amount of intervention some months back. It is not accurate or up to date, but there has been something on the order of $50 billion of official intervention among the major trading currencies, which is a long way from free floating.

I think that some bankers and businessmen may favor floating because the more sophisticated you are and the more skilled you are in trading, the more you may profit from greater exchange rate flexibility. And some of the smarter and bigger organizations undoubtedly have handled the opportunities well and pretty profitably. But that does not necessarily mean it is a better system for the world in general to operate on. I am thinking particularly of smaller businesses, when they have to try to calculate what is going to happen to their export business or what will happen to their foreign investments. So I am not surprised that there are differing views on this subject. There are always going to be some people who like a system that gives a little more chance for a speculative killing, and there are others who like stability. I happen to be one who likes more stability.

If the dollar should continue to strengthen, should the U.S. Government begin to buy and hold foreign currencies as reserve assets?

I certainly see no reason myself why they should not, in principle. As a matter of fact, there have been periods when we have done just that. I see no reason at all why it should not happen again in the future.

I have learned in the Federal Reserve that you never try to predict exactly what you are going to do in the next few months. And because I am not in the Federal Reserve any more, I have no idea what the U.S. Government's attitude will be. In any case, I have no idea whether such accumulation of currencies is likely. But I see no reason why it should not happen if the authorities feel that the exchange rates are such that currency purchases would constitute a reasonable stabilizing measure. That is really the criterion to use. If the dollar gets to a point where it seems to be stronger than it ought to be in relation to fundamentals, then obviously it is a good time to pick up some of the other currencies that are rather more attractive.

I will hazard a guess, as a purely personal comment. For some months I have been a strong believer that the dollar was severely undervalued; and some of you whom I met in Europe a few months ago shared this opinion. Although the dollar has come back 10 per cent or so, I guess I would place my bet on its being still relatively undervalued. But that is a purely personal guess.

I might finally say something about the understandable hunger of people for a clearer view of a new structure to come out of all these discussions of new international financial arrangements.

I can sympathize with what some of my fellow panelists have said about that. They were a little unhappy that I was advocating what must look perhaps like a somewhat pedestrian and haphazard building of a new system, in preference to seeing very clearly just where we are going. And I must say that the reason for my view on this is that I cannot see any practical possibility of agreement on a full-blown, rather detailed system. As I said in my speech, I have great respect for the efforts that have been made in the Committee of Twenty and the Group of Ten before them. But I have not had the feeling that they are on the point of producing a new full-scale, well-structured international system. I would rather work along in a somewhat more pragmatic manner and try to make a little progress here and there. I have mentioned exchange stability, adjustment processes, and use of credit facilities as the kind of thing on which I think we can reach agreement to some extent and make progress. Then, over the next few years we may begin to see this new structure taking shape. But I do not see it sufficiently clearly now to want to advocate a detailed blueprint at this time.

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MR. BURGESS: I think that that was a very useful addition to Mr. Hayes' prepared statement. It gives one a sense of real operations in a real world, and what can and cannot be accomplished.

Now--I think that Mr. Farmanfarmaian has a question to answer.

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MR. FARMANFARMAIAN: I have been asked this question.

You advocate formal rules universally applicable. In what way could or should the rules be different from the Bretton Woods system?

I am not sure whether the position that I would advocate is that far apart from the Bretton Woods system because of the simple belief that you cannot leap to reforms; that it is easier to move from Bretton Woods to something closer to it than something too far away from it.

In simple terms, what I propose is fixed exchange rates--although adjustable--with the structure of the IMF reconstituted to increase more effective participation of the developing countries and probably with closer supervisory and consultative powers over the adjustments that are necessary among the monetary authorities in the world.

The role of gold, as I stated, would not of course be the same as Mr. Hayes has stated; it would not be the same as it was under the Bretton Woods system.

MR. BURGESS: Thank you, Mr. Farmanfarmaian.

Concluding Remarks

MR. BURGESS: If there are no more questions, this then concludes the formal part of our meeting. I should, perhaps, add that the texts of the main speeches and the comments will all be published, although it may take a little time to get them out. You may have noticed in your program, on the last page, a list of the Proceedings of the eleven years that this organization has been operating. When we get the results of this meeting in print, we will have produced twelve years of very solid contributions to monetary problems. All of them are not available now in all languages, because they have been very popular. But there are still some copies available in some languages. They are printed by us in English, French, and Spanish, and the texts of the speeches have been printed in about seven or eight other languages by banks and bankers' associations in a number of other countries. So the activities of this organization have resulted in an extremely useful minor library that is available throughout the world.

You will notice from your program that the Managing Director of the IMF has asked us to take part in a reception at the conclusion of this meeting. There we will have a chance to meet each other and to meet the speakers. The reception will be held here in the Atrium. The meeting is now adjourned, and we hope to see you all at the reception.

Biographies

Alfred Hayes retired on August 1, 1975 from the Presidency of the Federal Reserve Bank of New York, a post he had held since 1956. During the same period he was Vice Chairman of the Federal Reserve Bank's Open Market Committee.

Mr. Hayes has devoted his entire career to banking. After leaving university in 1933 he joined the then City Bank Farmers Trust Co. in New York. In 1942 he became a member of the New York Trust Company, serving eventually as Vice President in Charge of the Foreign Division. From this post he moved to the Federal Reserve Bank of New York as President.

Mr. Hayes, who was born in 1910, was educated at Harvard College, at Harvard School of Business Administration, at Yale University and, as a Rhodes Scholar, at New College, Oxford. He is a member, inter alia, of the Council on Foreign Relations, the Pilgrims, and the Economic Club, of which he was President for one year. He is married and makes his home in New Canaan, Connecticut.

Khodadad Farmanfarmaian was born in Tehran in 1928 and received academic degrees from the American University of Beirut, the London School of Economics, Oxford University, Stanford University, and the University of Colorado. He was a member of the faculties at the University of Colorado and at Brown University and was a Fellow at Harvard during 1955-57 and at Princeton during 1957-58.

Returning to Iran, he entered into government service, first as Director of the Division of Economic Affairs of the Plan Organization which he subsequently served as Managing Director. He was at various times also a member of the High Economic Council and of the Council for the Attraction of Foreign Investment and was Chief of the Science of Banking Institute. In 1964 he was appointed Deputy Governor of the Central Bank of Iran and was Governor from 1968 until his retirement in 1970.

Mr. Farmanfarmaian is currently Chairman of the Board of the Bank Sanayē Iran in Tehran.

Carlos Massad has been active in national and international monetary affairs for most of his career.

For the period 1953-64 he was associated with the Institute of Economics of the University of Chile, and was appointed Director of the Institute in 1962. He became Professor of Monetary and Banking Theory and Policy at the University in 1963.

Beginning in 1964 he served the Central Bank of Chile, first as Vice President and, from 1967 to 1970, as President. During this period he was also Governor of the International Monetary Fund and the World Bank for Chile. He was Chairman of the Board of Governors of the Center for Latin American Monetary Studies during 1968-70 and was also the Vice Chairman of the Chilean Planning and Development Association.

In 1970 Mr. Massad was elected as an Executive Director of the International Monetary Fund, a post he held for four years. He was a delegate to the Committee of Twenty on international monetary reform, to Technical Groups of that Committee, and to the Inter-Governmental Group of Twenty-Four, as well as being, until recently, a member of the Joint IMF/IBRD Development Committee. He is currently Consultant to the United Nations Economic Commission for Latin America at its Santiago headquarters.

Mr. Massad, who is 43, was educated at the University of Chile and at the University of Chicago. He is married and has five children.

Claudio Segré, born in Rome in 1932, is a law graduate of the University of Rome and received a Ph.D. in Economics at Yale University.

After a career of research and teaching in Italy, he joined the EEC Commission in 1959, where he was, until 1967, Director of Research in the Directorate General for Economic and Financial Affairs. His responsibilities there ranged over such issues as integration of capital markets, coordination of export credit policies, assistance to less developed countries, policies on industrial concentration, and tax harmonization. Mr. Segré was Chairman of the "ad hoc" committee of experts which, in 1967, presented the report on *The Development of a European Capital Market.*

He has acted in a consultative capacity both to the Inter-American Development Bank and the U.S. Federal Reserve Board. He has lectured widely both in Europe and in the United States, and has been a visiting professor at the University of Geneva.

As a frequent contributor to economic journals, he is the author of a number of papers in the field of economic theory as well as on monetary and capital market problems.

In October 1967 he became a partner of Lazard Frères & Cie, Paris, as well as President of Lazard S.A., a joint subsidiary of the three Lazard houses of Paris, New York, and London. He resigned from Lazard in 1973 in order to devote himself to independent activities in the same field and is now President of Compagnie Européenne de Placements, Paris.

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11