PUBLIC AS OF JANUARY 1, 2009

L.5.2 RFD 439

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

September 17, 1963

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September 17, 1963.

Some Comments on Prospective Needs for International Reserves 1/

Robert L. Sammons

I should like, in my remarks, to deal with the so-called dilemma of the dollar exchange system, which can be stated simply as follows:

a. The world needs a continually growing amount of official international reserve assets to meet the enlarged liquidity needs of an expanding world trade.

b. Under present circumstances, only gold or short-term U.S. dollar claims are acceptable by most countries as reserves.

c. The supply of gold cannot be depended upon to increase rapidly enough for this purpose; even the relatively high recent rate of output has not been sufficient, and has had to be supplemented by the use of reserve currencies.

d. But dollars can only become part of the stock of international reserve assets when they are transferred from U.S. to foreign hands--that is, when the U.S. has a balance-of-payments deficit.

e. The dilemma is that the longer that deficit continues, the weaker confidence in the dollar becomes--and even its acceptability as a reserve asset could be threatened--as indeed, to some extent, it already has.

Obviously, there is some element of truth in this picture. But I should like to present some evidence for a view that this dilemma, while not an impossibility for some time in the future, is not yet facing us--and is not likely to be for at least the next ten years or longer.

To begin with, let us keep in mind the main purpose for holding official reserves of gold or foreign exchange. It is not, as seems to be implied by much of the discussion, to lend confidence to the domestic or international value of a currency--though it may have that effect, at least to some extent. For this purpose, the trend of a country's balance of payments is far more important; U.S. reserves are still quite large, relative to those of other countries, but we have seen confidence in the dollar greatly weakened by a prolonged balance-of-payments deficit. And the French franc has been a strong currency, in spite of two postwar devaluations, not because French reserves are large, but because the balance of payments has been strong, which means, of course, that reserves have been growing.

1/ Remarks delivered to Federal Advisory Council on September 16, 1963.

The principal reason for holding reserves under the present system of national, independently managed currencies linked together by fixed exchange rates has two facets:

a. Monetary and other economic policies simply cannot be geared solely to the goal of balance-of-payments stability, come hell or high water. This was not fully the case even under the nineteenth century gold standard, and it is much less so today.

b. But even if balance-of-payments considerations are given a high priority in policy formulation, policy changes require time to be decided, implemented, and to become effective. In the meantime, some flows of international reserves will occur.

Clearly, the higher the relative priority given to domestic requirements, when these conflict with the goal of balance-of-payments equilibrium, the longer the time it will take to achieve the latter--and the greater the amount of reserves that will be needed to finance the balance-of-payments deficit in the meantime.

But, paradoxically, if the determination to maintain the exchange rate structure is given a very high priority in itself (because only under a fixed rate system can a sustainable, reasonably stable, and satisfactory rate of economic growth be achieved), too large a volume of reserves might be counter-productive. This line of argument runs as follows:

If fixed exchange rates are to be maintained, the public must be convinced that they will be maintained. Prolonged balance-of-payments deficits, regardless of how they are financed, tend to reduce confidence in currency parities. It is, therefore, desirable to follow policies which tend to restore equilibrium within a reasonable time, which means that less reserves will be used than if deficits are allowed to persist. In other words, a relative lack of reserves will induce countries to adopt equilibrating policies sooner than they otherwise would.

The restoration of equilibrium without prolonged and large reserve changes will also act to reduce the amount of reserves "needed" in another way. The evidence which will thus be provided that governments are prepared to follow policies conducive to stability in international payments and exchange rates will, over time, build up public confidence in the system and give increasing public sanction to the practice of carrying relatively smaller amounts of reserves.

The longer a balance-of-payments deficit persists, the greater will be the degree of maladjustment, and the greater the problem for an economy in making the inevitable adjustment (assuming devaluation is to be avoided). Therefore, while trying to achieve reserve goals that will permit the financing of payments deficits that are pretty clearly short-term and reversible, there is much to be said for not having such large reserves that inevitable adjustments are postponed too long. (As a case in point, consider the position of France in 1956-57.)

Since we are not given to foresee the future, the next best thing is to see what guidance we can get from the past. And the past that we might look at for our purposes here is the decade ended with 1962; a decade, incidentally, when the strains on the international payments system were rather heavier than we might hope they will be in the future. This was a decade that included the unwinding of the Korean boom; the Suez crisis; the varying fortunes of the cold war (Berlin, Cuba, Laos, etc.); the return to convertibility; changes in exchange rates for such major currencies as the French franc, the mark, the guilder, and the Canadian dollar; the shift from dollar shortage to dollar glut. In spite of these events, as we shall see, large sustained reserve losses were avoided by most countries in the non-reserve currency group, excepting those in which subsequent devaluation indicated fundamental rather than cyclical or other temporary disequilibrium.

For the major European countries, for instance, the largest continuous declines in reserves generally did not amount to more than about 15 per cent of the amount of reserves held at the end of 1962. The major exceptions were France and the Netherlands; the former was forced to devalue and, as I have already intimated, might have been better off in the long run if it had had less reserves, and had therefore been forced to take corrective measures sooner. (And perhaps without such drastic political changes as actually ensued.) Netherlands losses in 1956-57 amounted to 27 per cent of its present holdings, but the subsequent improvement in that country's balance-of-payments position was so strong that it led to an upward revaluation of the exchange rate in 1962. Most other European countries could suffer losses from six to 12 times as large as the maximums suffered in the last decade without running out of reserves. One is led rather irresistably to the conclusion that European reserves--certainly considering the area as a whole--are sufficient for a substantially higher volume of trade than at present, and hence do not need to be augmented, at least for quite a few years in the future.

Canada lost reserves in the period October 1961-May 1962 equal to about 25 per cent of its end-1962 holdings, but during the previous decade (with a flexible exchange rate) variations had not run in excess of 5 per cent of its present holdings. Japan also suffered large reserve losses on several occasions during the decade, but each time clearly as the result of an unsustainable rate of domestic expansion. More recent experience indicates that the Japanese authorities have had increasing success at limiting their reserve losses, both in magnitude and duration. Both of these countries could probably be said to need more reserves than they have at present, but perhaps, say, two billion dollars for both of them together could cover reasonable requirements for, say, the next ten years.

The underdeveloped countries present a different picture. Many of them have undergone large and protracted reserve losses; fewer have regained all or part of such losses. Since these are countries which are, by definition, short of capital, the cost of building up reserves--which is a form of investment--appears relatively high. Moreover, their balance-of-payments problems are frequently of such grave order as to be amenable only

to the solution of currency devaluation. For these and other reasons, it is not likely that these countries, in the aggregate, will increase their reserves significantly in the next decade, regardless of the total amount of gold and/or reserve currencies that might be "available" during that period. Thus for purposes of our exercise, we would be safe in assuming no "demand" for reserves, on balance, by these countries over the next decade.

Let us now look at the two reserve currencies. First, the dollar. Our reserves (adjusted for IMF transactions) declined by $7.6 billion between their peak at the end of 1957 and December 31, 1962, 47 per cent of the balance on the latter date. (The total "deficit," as customarily measured, in the same period, was $15.7 billion, about equal to present reserve holdings.) Unless the U.S. balance-of-payments deficit is ended, or reduced to a very small amount, it is difficult to see how any additional amount of reserves available to the United States would help in making the present situation more viable. One is tempted to speculate, even, on whether the present situation would be significantly different if the United States had had, say, $30 billion at the end of 1957 instead of $23 billion.

But in any event, it is hard to foresee the likelihood, or even the need, for the United States to increase its holdings of gold over the course of the next decade. It now appears almost certain that the deficit will not end in the next year or two; presumably some further gold losses will be inevitable, as well as further increases in our short-term indebtedness to foreign countries, either payable in dollars or in the currencies of the creditors. If we make the not unreasonable assumption that our balance of payments would be in equilibrium over the next decade as a whole, this would then mean a surplus, on balance, in the closing years of the decade. If this occurs, foreign countries will undoubtedly meet a substantial part of their corresponding deficits by drawing down their dollar balances, and the United States would undoubtedly be willing to consider expanding its holdings of foreign currencies. Indeed, this is already contemplated under the Federal Reserve program of foreign currency operations. There would thus be some reduction in gross total reserve holdings of the entire world, but, under the assumption stated, not to levels below those prevailing at present.

What all this amounts to is that, if the U.S. balance-of-payments problem is solved, the present level of U.S. reserves, plus whatever amounts of foreign currencies we may decide to acquire, will probably prove to be adequate for quite a few years to come. Aside from our status as a reserve currency, our reserves are relatively high when measured by usual tests--percentage of annual imports covered by reserves, for instance.

And there are only two ways that foreign reserves can be withdrawn from the country--one is in gold and the other is in the form of goods and services. If they are withdrawn in the latter form, we have nothing to fear; as a matter of fact, in our present state of underutilization of

resources of capital and labor, that would be an eventuality greatly to be desired. And the impossibility of withdrawing them all in the form of gold must be apparent to everyone, including the owners of the reserves. Therefore, if we avoid inflation, and other foolish policies that would cast doubt on our intention, or ability, to maintain the real value of our currency (such as, for instance, the imposition of exchange controls), there seems to me to be little or no reason to doubt the validity of the conclusion I have just stated.

The problem of the United Kingdom is, again, a different matter, and the situation of that country is quite different from that of our own. Reserves are far lower in relation to imports, and in relation to liquid liabilities to foreigners, than in the case of the United States. Moreover, the country has been subject to sharp fluctuations in reserve movements in the past decade; the largest continuous decline in reserves, from June 1954 to September 1957, was over half of present holdings. The peculiar nature of the political relationship between the United Kingdom and the holders of most of the sterling balances; the great willingness, perhaps born of necessity, of the United Kingdom to adapt domestic policies to external consideration; the continued existence of exchange controls on capital movements; these and many other factors make it difficult to apply similar criteria in evaluating reserve needs of the two countries. Yet it is difficult to escape the conclusion that both Britain and the rest of the world would be better off if Britain had larger reserves of gold and/or dollars, a figure of $5 billion has sometimes been mentioned as a target, some $2 billion in excess of present holdings; by ten years from now, a somewhat larger amount would presumably be needed.

There are other reasons, not already alluded to, for estimating requirements of additional reserves over the next decade in a conservative manner. Among the more important of these are:

a. The increase in IMF quotas, of which the gold tranches are virtually automatically available, and along with these, the adoption of the borrowing scheme, which ensures massive U.S. access to Fund resources if needed.

b. The emergence of a network of arrangements for bilateral credit and drawing facilities between monetary authorities--the Basle credits, the Federal Reserve swaps, the Roosa paper, etc.

c. Increased recognition, on the part of major countries, that international effects of domestic policies have to be taken into account in the administration of reserve holdings. This applies especially to those countries which happen to be in surplus position.

d. Increased recognition of the need to avoid prolonged large payments deficits if the beneficial effects of the disciplines of a fixed exchange rate system in

> stimulating productivity increases and restraining inflationary cost increases are to be realized. The accumulation of reserves beyond levels consistent with possible adverse payments swings of a cyclical or other temporary nature may be undesirable because it may later enable a country to evade these disciplines. I have already referred to the case of France in 1956-57 as an example of this; the history of the underdeveloped countries is also replete with examples.

If the world's need, or demand, for reserves for the next decade could be limited to the amounts I have suggested--or even double that amount, which would still be in the neighborhood of $10 billion, there should not be much difficulty in meeting these needs without drastic changes in the present institutional arrangements. Gold production alone could easily provide $1 billion or more a year, if the present widespread private hoarding of gold could be brought back to more or less normal proportions. Some additional increment to foreign holdings of dollars is certainly not out of the question, if only the rate of such accumulation can be slowed. And a willingness on the part of the United States and perhaps some other countries to hold currencies other than dollars or sterling could add some welcome flexibility to the system.

Gentlemen, this has been an extremely speculative exercise I have led you through. But the central bankers of the world are frequently accused of not facing up to this problem of the need for a larger and growing stock of reserve assets in the world. And I thought it might be interesting for you to know that we do, in fact, face up to this problem, and to give you just a bit of the evidence that has led most of us to the conclusion that this is not yet a problem calling for any drastic changes in the present mechanism of the international payments system.

September 17, 1963.

European Views About the U.S. Payments Problem 1/

Samuel I. Katz

Perhaps the most important single fact to remember in trying to understand the views of continental European central bankers about the United States payments problem is to realize that all of them have faced balance of payments difficulties and have overcome them. All the European economies are highly dependent on foreign developments, and these bankers have lived through periods of international financial difficulties, both since 1945 and in earlier years. They have faced major exchange crises and have mastered them.

How recently European officials have faced major decisions in the field of the balance of payments is illustrated by the fact that, except for Switzerland, each of the major European currencies at present considered to be strong and sound and well-managed was devalued against the United States dollar by substantial amounts - from 12 to 31 per cent - in 1949. On the two strongest European currencies at this moment, the D-mark was devalued by 20.6 per cent in 1949 and the French franc from 1949 to 1958 was devalued three times - by a total of 45 per cent.

European officials have every reason to be proud of their management of their currencies. They have been able, in the face of recent devaluations, to rebuild foreign confidence in their currencies. As a result, over a period of less than five years, their currencies can look the dollar in the face, and the dollar is beginning to have some difficulty in looking back at these European currencies.

Against this background of recent achievement, and against a long history of coping with international payments difficulties, the continental European bank officials have come to three main conclusions which really shape their views about the U.S. payments situation:

Point 1. That each country can, and should, by itself cope with its own payments difficulties. The Europeans place responsibility for any country's payments difficulties directly on that country, and nowhere else.

Point 2. That the surplus countries of Europe have done about as much as they intend to facilitate international payments adjustment and that the result of the job must be largely done by the United States itself.

This view seems to be based primarily on the general European fear that inflation in Europe may already have gone too far and they want no more. Furthermore, Dr. Holtrop has maintained that the deficit countries

1/ Paper presented to the Federal Advisory Council, September 16, 1963.

have the greater responsibility so far as wage and price developments are concerned because "any increase in labor costs in [deficit] countries would put a heavier burden on the surplus countries by requiring them to accept a correspondingly larger measure of cost inflation in order to restore international balance of payments equilibrium in a system of fixed exchange rates.2/

Point 3. That efforts by the United States in the field of fiscal and monetary policy to solve the twin problems of excessive unemployment and payments imbalance have, in the words of Dr. Holtrop, "been used over a rather narrow range." 3/ This opinion is based on his view that the United States should deliberately use "economic policy instruments like those applied in various European countries" with such success. 4/

These general views lead European bankers to make policy recommendations in two major areas of financial policy which differ in part from actions taken by United States agencies or from views expressed by United States policy makers. In the field of international financial policy, the continental European officials agree with the United States administration (though perhaps not with the academic community) that there is at present no world liquidity problem but only a United States balance of payments problem. More important from an action point of view, the European bankers seem to agree among themselves that only after the United States deficit has been brought under control should a reform of the international payments mechanism be considered.

In the field of United States domestic financial policies, the Europeans have been outspoken in urging more vigorous use of both fiscal and monetary policy by this country. What most Europeans seem to have in mind is greater reliance upon fiscal policy (that is, budget deficits) in order to reduce unemployment at the same time that stricter monetary restraints are utilized to curb the outflow of United States capital.

In the monetary field, these officials seem to have in mind measures to bring United States interest rates (not only short- but also long-term) closer to European levels, which in the long-term field are running at around 6 per cent in several major European countries. In addition, they apparently would also welcome direct checks to United States lending abroad along the lines of foreign credit rationing in effect now in Switzerland and in virtually all other European countries except Germany, where particularly high interest rates and the capital market structure make such rationing unnecessary.

2/ International Financial News Survey, International Monetary Fund, May 18, 1962, p. 150.

3/ Bank for International Settlements Thirty-Third Annual General Meeting, June 10, 1963, speech by Dr. M. W. Holtrop, p. 4.

4/ The Netherlands Bank, Report for 1962, (English Edition) p. 26.

Well, what is wrong with this European analysis of United States fiscal and monetary policy? I would suggest that, to an American, the Europeans have an unrealistic view of how we do things over here. In the fiscal sector, fiscal policy in the United States is not something determined largely by the Executive and rubber-stamped by the Legislature, as it is in Europe, and there is no point in formulating economic proposals as though it were. In the monetary sector, security yields and other market interest rates in this country are probably not as directly responsive to official actions as they are in Europe. We work out our monetary processes through financial markets which in complexity, breadth and freedom are not fully understood by many of our European friends.

In addition, there are, I would suggest, at least four important areas where European views about what the United States should do appear to be one-sided. In the first place, one can agree that United States and European interest rate levels should be brought more closely together. But this shift could be accomplished as effectively by bringing down interest rates in Europe as by raising U.S. interest rates. You will recall that the late Per Jacobsson warned in a speech last February against a rise in interest rates in the United States because he preferred to have money rates on both sides of the Atlantic brought closer together by "a more plentiful money supply and lower interest rates in Europe" rather than by "tighter money and higher interest rates here in the United States". 5/

The fact remains that the United States economy generates a large flow of savings, and these savings are available to meet demands at attractive rates in United States markets of both United States and foreign borrowers. There seems to me to be something of a paradox in action recommendations which would have United States financial markets operate as though we were a capital-deficit and not a capital-surplus country.

Secondly, European financial spokesmen frequently fail to consider European trade policies in the light of their payments surpluses and in the light of domestic inflationary dangers within Europe. As you know, United States producers can lay down coal in the Ruhr cheaper than the Germans can dig it up and American farmers can produce a wide range of agricultural products at economic costs (note, I say, economic costs and not subsidy prices) very substantially below the economic costs of marginal production in most European countries. Surely it is a strange economic doctrine that considers a country non-competitive internationally when many of its most competitive commodities are artificially excluded from European markets.

5/ Per Jacobsson, "The Role of Money in a Dynamic Economy", International Monetary Fund mimeo, February 19, 1963, p. 9.

Thirdly, beyond the narrow economics of the United States payments problem is a heavy burden of governmental payments made for security and economic reasons. These are burdens which seem inherent in world leadership, burdens which the European countries themselves used to carry in a much larger degree than they now do. To An American, it looks as though several European countries want to continue to free-ride on the efforts of the United States, long after their improved economic position would permit them to shoulder more of this burden of leadership.

Finally, let's look at this remarkable European recovery. European leaders naturally tend to emphasize the hard work and the sound policies which underlie this performance. Let me present an alternative description of what happened.

In the early post-war years, U.S. aid made possible the balance-of-payments financing of a rapidly accelerating rate of capital expenditure to rebuild Europe's industrial capacity. In 1949 favorable exchange parities were established. At first, these new parities were not really tested because domestic needs for goods were urgent and output was not available in volume for export sale.. Efforts of the monetary authorities to maintain reasonable price stability and the drive of European businessmen to reacquire a foothold in export markets contributed to the development of a competitive atmosphere conductive to efficiency and technical modernization. As a result, the major European countries experienced a sustained expansion in export sales and export sales, in turn, provided the spark for still further domestic industrial expansion.

Two further developments in 1957-58 contributed to this recovery. First, the emergence of the Common Market sparked an inflow of foreign capital, attracted by the sales prospects within the Common Market and by the increased discrimination against outside goods to be expected as European integration proceeded.

Secondly, in the course of 1957 and 1958, the steady decline in the prices of primary products imported by Europe from temporary post-war highs to levels consistent with more normal world supply positions gave all European countries a very large windfall in their balance of payments and also contributed to the stabilization of domestic prices which occurred in 1958. This windfall was very similar, you will remember, to what happened after 1926 when Europe's economic position was strengthened when more normal supply conditions for primary products were reestablished after World War I.

I am not saying Europe's recovery was all good luck. Good luck often accompanies good management, just as bad luck so often accompanies bad management. Europe's management was good, and the rewards have been generous.

What I am trying to say is something different. The result of this chain of events - of the combination of good management and good luck - has been to create a basic shift in Europe's economic position with the rest of the world which European leaders have been slow to recognize. The Europe

of 1963 is not the Europe of 1949, but Europe's sharing in the burden of international leadership is not so very much larger in 1963 than it was in 1949 when you look at the defense burden, the grant aid commitments (outside closely-supervised former colonial areas) and the willingness to make European savings available to the outside borrowers in volume at attractive costs.

At the same time the United States has continued to carry about as heavy a load in the 1960's as it had in 1949, even though Europe and Japan have reemerged as major industrial competitors and even though American industry has had to bear the competitive burden which the 12-31 per cent European devaluations in 1949 placed upon it by a stroke of the pen of western financial leaders as well as the consequences of U.S. domestic price and wage advances, especially in the middle 1950's.

In these circumstances, it is small wonder that there is an American balance-of-payments problem and that it is proving to be a stubborn one. Earlier, the world's dollar shortage was eliminated and convertibility achieved in large measure because the surplus country, the United States, determined to do so.

In my judgment, a liberal and constructive rectification of the present world's payments imbalance depends upon equally enlightened and self-interested policies on the part of the European surplus countries, policies which, I am afraid, they have been prepared to accept only very slowly. The more slowly Europe moves, the more difficult it becomes for the United States as a deficit country to avoid actions which are restrictive, are undesirable for our domestic economy and give us less basis for hope for further advances in the economic integration of the western industrial nations.

September 17, 1963.

Some Problems of International Payments Reform [1/]

J. Herbert Furth

Ever since Professor Triffin published his pioneering work on gold and the dollar three years ago, programs for reforming the international payments system have become the fashion of the day.

It would be an unwarranted waste of this Council's time if I tried to discuss all the questions raised by those programs. I shall, instead, concentrate on three problems: First, does international payments reform appear to be needed at present, or in the immediate foreseeable period, or in the more distant future? Second, if a reform is needed, should it aim at a basic change or merely at technical modification of the existing system? Third, if the system may have to be modified, in what direction should we proceed?

Timing of reform

As both Mr. Sammons and Mr. Katz have pointed out, the prevailing opinion in Washington (although not in New Haven, Cambridge, or Chicago) holds that no payments reform is needed, or could usefully be undertaken, at this time. It is true that the international payments situation presents serious immediate problems; but these problems could not be solved by changes in the international monetary mechanism.

The most vital of these problems, needless to say, is the large and persistent deficit in U.S. international payments. Some observers believe that the adverse effects of that deficit on the U.S. and the world economy at large could be avoided by a massive increase in world liquidity; in other words, by virtually unlimited international credit facilities. As long as the United States was in external balance, every responsible U.S. economist opposed unlimited credit to deficit countries since such credit would not only permit perpetual inflation in the deficit countries but also transmit inflation to the surplus countries. Now that the U.S. has been in deficit for six years, some U.S. economists -- quite understandably -- show greater sympathy for the idea of virtually unlimited international credit. It is true that neither the United States nor the rest of the world would be in serious danger of disruptive inflation if, say, the European surplus countries or the IMF decided year after year to finance a U.S. deficit of $3 billion. But obviously, what is credit for the United States must be credit for the rest of the world. And while the U.S. payments deficit is, for rather unique reasons, not associated with domestic inflation, most deficits are. It would hardly be feasible to establish a system that would perennially finance the U.S. payments deficit but not the deficits of the less developed countries. And if every country could count on having its deficit automatically financed, the amounts would soon increase in geometrical progression.

1/ Paper presented to the Federal Advisory Council on September 16, 1963.

While there is general consensus on the lack of immediate urgency of a program for payments reform, there is perhaps less agreement as to whether such reforms may not be needed within a few years, once the U.S. payments deficit is eliminated. Some observers argue that right now the outflow of dollars resulting from the U.S. deficit keeps reserves in the rest of the world at an adequate level but that an international liquidity shortage will arise as soon as this source of dollars dries up. This is indeed possible but it seems unlikely. Once U.S. payments balance is restored, all international uncertainty about the dollar will vanish. In consequence, a large amount of gold will come out of hoards and speculative holdings, to replenish monetary reserves; and if this should not be enough to maintain international liquidity, private lending can be expected to bridge the gap.

In the long run, however, the growth of world commerce will certainly require larger reserves, even though there is no reason to assume that reserves have to increase in exact proportion to the rise in commerce. And it seems likely that gold production alone may not suffice to satisfy all needs, while increased use of national currencies as reserve assets may also have definite limits. For the long run, therefore, some potential need for increasing the ability of the payments system to create international liquidity can hardly be denied. The main question is whether increased liquidity could best be provided by some radical reform, such as a return to the pre-1914 gold standard, or the abolition of fixed exchange rates, or the establishment of an international super-central banking institution; or rather by improvements in the present system.

"Radical" reform proposals

Return to the gold standard has particular appeal to old-timers (like me) who spent their youth under the pre-1914 gold standard and fondly remember the advantages rather than the disadvantages of that system. There are two basic objections to such a return, however.

First, the present physical volume of monetary gold could cover international payments needs only if the price of gold were to rise substantially: advocates of a return to the gold standard speak of tripling the dollar price. And since we cannot expect that gold production even under the influence of a higher gold price would expand sufficiently to let gold alone finance a rapidly and continuously expanding volume of world commerce, the supply of gold would continuously lag behind demand, and every few years further increases in the gold price would become inevitable. Such periodic revaluations would completely undermine confidence in the national currencies.

Second, the exclusive use of gold as an international payments medium would make economic sense only if all countries decided again to subject themselves to the full discipline of the gold standard, with all its consequences for domestic and international monetary, fiscal, and economic policies. Subjection to that discipline may or may not be a good idea in itself. But even the most convinced supporter of the gold standard should recognize that the idea could not be realized under present social and political conditions. Thus, return to the pre-1914 gold standard is not a realistic program.

A second alternative would be, instead of reimposing the rigidities of the gold standard, to make the present system more flexible, by abandoning fixed par values and establishing freely fluctuating exchange rates. In that case, large international reserves would no longer be needed: the market would at any moment tend to equate demand for and supply of every national currency in terms of all other currencies. The Federal Reserve staff discussed this problem last year in a paper submitted to the Joint Economic Committee. 1/ The conclusion was that, at least for a reserve currency such as the dollar, complete fluidity of exchange rates would interfere with international long-term credit transactions, would reduce rather than increase the level of world trade and investments, and would destabilize rather than stabilize domestic economies. While many eminent economists are of a different opinion, I believe that these conclusions still hold true.

A third alternative would avoid both the excessive rigidity of the gold standard and the excessive fluidity of a system based on freely fluctuating exchange rates, by establishing a supra-national central banking institution. Supporters of this movement like to cite the experience with domestic central banks, which did away with the excessive rigidity of a monetary system based on metallic circulation as well as with the excessive fluidity of a system based on uncontrolled creation of bank credit.

But a central bank can operate successfully only insofar as it determines a country's monetary policy. If the world were a single economic and political unit, the establishment of a world central bank would indeed be essential. As it is, such a bank would be in continual conflict with the national monetary and non-monetary economic policies of the member nations. It would either become a world dictator of monetary, and thus indirectly also non-monetary, economic policies; or more likely, it would be made impotent by contradictory measures of member governments. Thus, establishement of such an authority under present social and political conditions seems as unrealistic a program as a return to the gold standard.

The only realistic alternative, therefore, appears to be a moderate and gradual improvement of the present international payments system, which is based on gold as a traditional reserve asset, on the so-called reserve currencies as virtually exclusive means of international payments and (together with gold) as reserve assets, and on supra-national institutions as limited lenders of last resort.

1/ STATE OF THE ECONOMY AND POLICIES FOR FULL EMPLOYMENT, Hearings before the Joint Economic Committee, Congress of the United States, Eighty-Seventh Congress, August 7-10, 13-17, 20, 21, and 22, 1962, pages 647-661.

"Moderate" reform proposals

Two "moderate" plans have recently been attracting attention. One of them was proposed a year ago by the Chancellor of the Exchequer, Reginald Maudling; and the other one was recently unveiled in a public address by a director of the Netherlands Bank, Professor Posthuma.

Both plans are designed, in substance, to prevent central banks from shifting their international reserves out of dollar holdings into gold. Mr. Maudling wants to give central banks an opportunity to convert excess holdings of foreign currencies into balances in a new type of international account; these balances would be guaranteed as to their gold value and could be used to settle payments deficits with central banks of other member nations.

Mr. Maudling's suggestions have not found much support. Balances with a new untried institution, even if they enjoyed an exchange guarantee, would not seem much more attractive than holdings of currencies. Moreover, Mr. Maudling realizes that in order to make his plan acceptable to both creditor and debtor countries, the amounts involved would have to be quite modest, and involve only a small fraction of the outstanding dollar and sterling balances held by foreigners. Thus, it would have a negligible impact on the working of the international payments system.

Professor Posthuma wishes to avoid disruptive shifts between gold and reserve currencies in the holdings of central banks by requiring member countries to maintain a fixed relationship between these two types of reserve assets.

This would indeed allay fears that some major foreign central bank might suddenly convert all its dollar holdings into gold and thus start a run on the dollar. (The United Kingdom, in contrast to the United States, does not permit foreign central banks to convert sterling holdings into gold; but it faces the analogous problem of having to redeem outstanding sterling balances in dollars.) This is a purely theoretical fear, however, since no major central bank is likely to act recklessly in a way that would destroy the present payments system. Moreover, the price to be paid for the elimination of that remote danger would be to make the rise in international reserves again utterly dependent on gold production, since no central bank could add to its dollar (or sterling) holdings more than in proportion to its increases in gold holdings.

Incidentally, relationships between reserve currencies and gold have become much less critical since the price on the London gold market has been kept under control by the working of the so-called gold pool of the major central banks. As long as foreign private holders of dollars cannot directly ask the U.S. Treasury for conversion of dollars into gold, and as long as the major foreign central banks continue their present cooperation, the payments system does not seem to be in any serious danger of a run on the dollar, barring unforeseeable catastrophes. Moreover, if a run should develop, existing arrangements through the International Monetary Fund and through the network of Federal Reserve swaps with foreign central banks seem to provide ample protection.

Gradual increases in international liquidity could be supplied in case of need, without requiring new international institutions or agreements, by an extension of the reserve currency principle together with further expansion and better utilization of the resources of existing international institutions, and especially the IMF.

Increased use of national currencies is the long-term rationale of the re-entry of the Federal Reserve System into foreign exchange operations and of the more general program presented last fall by Mr. Roosa. 1/ According to the Federal Open Market Committee's authorization of February 13, 1962, 2/ the long-run purpose of our foreign exchange operations is to prepare the way for reciprocal holdings of currencies, in case such holdings should become necessary in the future to meet the needs of expanding world commerce. The mechanism envisaged is similar to that of the pre-1914 London money market. Contrary to the theory of the gold standard, most payments surpluses and deficits were not financed by gold shipments, but by changes in the country's position in the London money-market: a deficit meant that the country incurred money-market debts, a surplus that is acquired money-market assets. Similarly, payments surpluses and deficits could now be financed by changes in the country's holdings of dollar (and sterling) assets, reinforced by changes in U.S. and U.K. holdings of assets in the foreign currency in question--at least as long as there is no persistent tendency to continuing large surpluses and deficits of one particular country.

Such a mechanism would be supplemented by increased reliance on the use of IMF resources, foreshadowed by the decision of the U.S. Administration to enter into a modest stand-by arrangement with the IMF. Increased reliance on the IMF by member countries, however, would require at least two changes.

First, the IMF quotas would have to be raised from time to time, corresponding to the expansion in world commerce; such increases were, in fact, foreseen by the founders of the IMF, who provided that quotas be reviewed every five years. The Borrowing Arrangements among the ten major IMF members might have to be similarly expanded so as to enable the United States to make effective use of its larger drawing rights.

Second, drawing rights might be made more easily usable through greater automaticity for drawing up, to say, one-half of a country's quota. Some problems connected with such reforms require further study: for instance, the question of whether IMF drawing rights should be made directly transferable between members; or whether reserve currencies should be given increased acceptability in the case of voluntary repurchases of IMF drawings by other members.

The forthcoming Annual Meeting of the IMF will provide an opportunity to initiate technical studies of these and other aspects of payments reform. These studies will be the more useful, the better they conform to the principle of gradual evolutionary change and the more strongly they resist the temptation of trying to realize utopia.

1/ Assuring the Free World's Liquidity, Business Review Supplement, Federal Reserve Bank of Philadelphia, September 1962.

2/ Board of Governors, Annual Report for 1962, page 58.