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The Machlup Report--A Critical Evaluation

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The Machlup Report--A Critical Evaluation

J. Herbert Furth.

A group of 32 academic economists of the 11 countries associated with the "Group of Ten" has issued a report 1/ designed to supplement the studies on "the outlook for the functioning of the international monetary system" undertaken by the "Group of Ten" 2/ and by the International Monetary Fund 3/ (page 5).

The group was set up under the chairmanship of Professor Fritz Machlup, of Princeton University, as a "countermove to the formation of groups of governmental experts" (page 7), to refute the contention that the advice of academic economists "was practically useless to those in charge of decision-making" (page 6). The participants include some of the most illustrious members of the profession, and the report contains much penetrating observation and analysis.

The report does a good job on what it considers "the primary objective of this undertaking . . . to identify the issues which must be faced and clarified before rational decisions can be made" (page 8). But the question remains whether the report is likely to help policy-makers and policy-advisers "to make rational decisions on alternative courses of action" (page 107). At the risk of being less than fair to the scholarly merits of the report, this review deals only with its merits as a guide for action.

Criteria of international financial policy

The report fails to set forth the criteria which it applies in judging the performance of an international payments system and giving its policy advice.

None of the members of the group favors the present international monetary system (page 66). In support of this position, the report might have discussed the basic functions of an international monetary system and pointing out the ways in which the present system fails to fulfill these functions. It might have compared the level, growth, and stability of international commerce, and of the individual national economies of the major participants in international commerce, under the present system with actual or predictable experiences under other systems that have been tried in the past or might be tried in the future. And it might have considered the question of whether any shortcomings revealed by those comparisons could be corrected by evolutionary developments of the system rather than by revolutionary change.

1/ International Monetary Arrangements: The Problem of Choice, Princeton University, 1964.

2/ Ministerial Statement of the Group of Ten and Annex prepared by the Deputies, released August 10, 1964.

3/ Annual Report for the Fiscal Year ended April 30, 1964, Part II.

Actually, the report does not discuss whether and in what respect the present system has failed in its purpose; on the contrary, it agrees that the postwar development which "has taken place under these monetary arrangements has been highly beneficial to the world" (page 68). Nevertheless, it holds that the arrangements "are becoming increasingly inadequate"; and it accuses them--rightly--of not forming "a simple and logical system" (page 66). But it does not produce any evidence for increasing inadequacy. And it fails to state why logical perfection and simplicity should be identical with optimal functioning. Nor does it consider whether perhaps its logical imperfection and complexity reflect a similar pattern of the international economy, so that a more logical and simpler system might turn out to be at variance with economic and political reality.

Evaluation of the present system

The present international payments system is based on the predominant use of reserve currencies (primarily the dollar) in international payments; the use of these currencies and of gold as reserve assets; and on international arrangements and agencies (primarily the International Monetary Fund) as providers of supplementary liquidity.

According to the report, this system suffers from the following shortcomings.

It "is an erratic and unreliable method of providing for the growth of international reserves" (page 33). The reserve centers have no "lender of last resort to aid them in a crisis" (page 35). It is "even more vulnerable than a domestic monetary system" to variations in confidence (page 35). And the role of a reserve center "as provider of reserve assets may . . . conflict with its role as provider of a safe reserve asset"; hence, it cannot simultaneously provide "increasing liquidity at an appropriate rate" and maintain "confidence" (page 37).

The report is right, needless to say, in stressing that the present system, like all human institutions, suffers from many shortcomings and imperfections. But the report has failed to prove that the shortcomings and imperfections discussed in the report have been serious enough to prevent the system from fulfilling its basic purpose of providing a suitable framework for further continuous growth in international economic activity.

Is the present system "erratic and unreliable"? It is quite true that, theoretically, the system could turn out to work in such a way as to make the supply of reserves purely dependent on the payments balance of the reserve center; in this case, it would indeed have to be considered "erratic and unreliable." Actually, however, the system has a built-in mechanism that tends to offset such erratic fluctuations. The very fact (mentioned in the report) that "confidence" in the reserve currency diminishes if its supply increases excessively, will not only induce reserve

centers to curtail the accumulation of that currency but also enable unwilling holders of reserve currencies to put pressure on the reserve center by threatening or actually demanding redemption of existing balances of reserve currencies.

On the other hand, should the outflow be insufficient to provide for appropriate international liquidity, there will be increased pressure on the reserve center to grant credits or other assistance to the rest of the world, and thereby stimulate the needed outflows.

It would be interesting indeed to analyze recent international financial developments in order to find out how far this mechanism has worked satisfactorily and how far it needs further improvement. A superficial examination of available statistics shows, for instance, that in the past 6-1/2 years of heavy U.S. payments deficits (December 1957 through June 1964), foreign official holdings of short-term dollar assets rose by $4.2 billion; in the preceding 6-1/2 years of an often acute "dollar shortage," they rose by $4.35 billion. Do these figures support the statement that the accumulation of dollar reserves depends upon the U.S. payments balance?

Is there a "lender of last resort" for reserve centers? The report concedes that reserve centers can be assisted by the International Monetary Fund and other international financial institutions but believes that this cannot be done "to the same extent that a national central bank can assist its commercial banks" (page 35).

But the report fails to pose two revelant problems: first, whether the assistance a central bank can give to its commercial banks without disrupting the economy is really greater than that offered by the IMF; and second, whether a reserve center is likely to need as much assistance as a commercial bank. Might not in both cases the granting of marginal assistance be all that is needed as well as all that is possible?

Moreover, any genuine insufficiency of resources of existing international "lenders of last resort" could easily be remedied by a variety of measures, including an increase in IMF quotas and such devices as the existing General Arrangements to Borrow. Such resource expansion would not require any change in the basic features of the present international payments system.

Finally, the report fails to present any empirical evidence for an insufficiency of resources of "lenders of last resort." Has the assistance granted by the IMF to Britain in 1956 and again in 1961 been insufficient? Has the United States been hampered by an insufficient quota, or by insufficient resources of the IMF to provide for drawings? Is there any reason to believe that the "moderate" increase in IMF quotas recommended by the "Group of Ten" will prove insufficient--or if it did, that the IMF would stubbornly refuse to do anything about it?

Is the international system more vulnerable than a domestic monetary system? It is true that the international system is very different from a domestic system: internationally, under the present system, no means of payments has "legal tender" character; all international means of payments are accepted in settlement of transactions or held as working balances and reserves by purely voluntary action of the--private or official--participants in the system.

But this does not necessarily mean that the system is more vulnerable. In contrast to the multitude of domestic currency holders, the holders of international reserve assets are indeed--as the report states--"a handful of monetary authorities" (page 35). These authorities do not act on impulse. They are rational and responsible institutions, which are most unlikely to wreck the international payments system either by panicky behavior or (as the report seems to fear) because of "political considerations." In fact, central banking cooperation has recently been remarkably free from political interference. Hence, the small number of large holders of dollar reserves reduces rather than increases the vulnerability of the dollar.

Does the increase in currency reserves reduce confidence? The report believes that a reserve center faces a dilemma: either it permits foreign countries to accumulate its currency in consequence of its payments deficit; in this case "confidence may after a point be diminished." Or it eliminates its deficit and enhances confidence; then "liquidity may be reduced" (page 37). This may indeed happen but it need not happen. First, an increase in foreign holdings of reserve currencies does not necessarily mean a payments deficit of the reserve center (unless, inconveniently, such an increase is defined as a payments deficit). Second, confidence in a reserve currency is not necessarily inversely related to the volume of foreign holdings.

Three years ago, this reviewer tried to destroy the myth that every outflow of a reserve currency means a deficit of a reserve center.

> "In a modern economy, domestic means of payments consist exclusively of claims against the central bank (cash) and claims against commercial banks (deposits). Nevertheless, nobody believes that domestic means of payments can be increased only if the central bank and the commercial banks continuously run deficits. Actually, these means of payments are increased by the banks exchanging short-term claims on their customers against their customers' claims on themselves.
>
> "Internationally, means of payments can, and should, be created in the same way. During most of the 19th century, the leading London financial institutions created liquidity by granting credits to foreigners and accepting foreign bills of exchange. These actions did not represent continuous deficits in the international payments of the United Kingdom; on the contrary, they made the United Kingdom the strongest financial power of the world.

"Similarly, between December 1953 and December 1960, the financial institutions of the United States acquired short-term claims against foreigners totaling $2.7 billion and in turn increased their liabilities to foreign private customers by $2.7 billion. The creation of these liabilities increased the international liquidity of the rest of the world without inflicting a deficit on the United States or reducing its net international liquidity.

"There is no reason for this process to stop. In fact, it has recently been supplemented by a similar behavior of the U.S. monetary authorities. For the first time since the 'thirties, the U.S. monetary authorities have acquired official holdings of foreign convertible currencies; in other words, they have exchanged short-term claims on foreign monetary authorities for short-term liabilities to these authorities. These transactions have increased the gross liquidity of all parties involved, without creating a deficit or reducing net liquidity for any of them. Similar transactions will take place when the IMF receives permission to "borrow" from its member countries, i.e., exchange short-term claims on its members for short-term claims on itself." 4/

Professor Kindleberger, in a dissenting statement (pages 119-120), also tries in vain to persuade his colleagues that a "swap of exchange between two reserve centers" increases the reserves of both countries without, in any meaningful sense, constituting a payments deficit.

The myth that confidence in a currency is inversely proportional to the volume of its circulation seems to die equally hard. Confidence in a bank is not shattered when its deposits grow but only when its management gives cause for anxiety. Similarly, foreign holders of a reserve currency will not, as a rule, become apprehensive merely because their holdings expand in conformity with the needs for financing an increased volume of international commerce and for holding additional contingency reserves. They usually become concerned only if they assume--rightly or wrongly--that the management of the reserve center behaves incautiously. Such concern could indeed become a nuisance or worse if foreign holders objected to justifiable expansionary policies of the reserve center. But the report does not cite a single instance of undue alarm about an increase in the international circulation of a reserve currency that was appropriate in the light of international liquidity requirements. If foreign central bankers today express apprehension about a further accumulation of dollar holdings, they do so because they share with the U.S. authorities themselves a deep concern about the U.S. payments balance. Once equilibrium in the current and long-term accounts of the U.S. payments balance is restored--as it must be in the long run, regardless of the dollar's reserve currency status--further appropriate increases in the

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4/ "The International Position of the U.S. Dollar," in: Current Problems of International Monetary Policy, Vienna (Austria), 1961.

international circulation of the dollar will no more undermine confidence than the rise in that circulation did in the years of the European Recovery Program and President Truman's "Point Four" program, which preceded the era of excessive U.S. payments deficits.

Does the system have offsetting advantages? Whatever the system's shortcomings may be, the report fails to consider any offsetting advantages. In fact, it announces that "since none of the conferees preferred the present system to all proposed alternatives, no statement of propositions supporting its maintenance was prepared" (page 66).

The report discloses that some participants consider the system "too rigid, because they regard its provisions for supplying monetary reserves as inadequate" while "others consider it too loose" (page 68). Could it not be that a system which some critics accuse of generating too much liquidity while others accuse it of generating too little, may actually be generating just about the right amount?

More importantly, the report fails to consider three basic advantages of the present system.

First, the system permits, within rather wide limits, domestic monetary policies to remain independent of payments considerations. Such independence is impossible not only under the gold standard but also--despite the contrary views of its adherents--under a system based on flexible exchange rates. Under such a system, any domestic expansionary policy that results in a payments deficit automatically reduces the external value of the currency of the expanding country; hence, any such policy may well generate a price-wage spiral as the depreciation of the currency raises the prices of imported and import-competing as well as of exportable commodities and services. Avoidance of even moderate and temporary payments deficits could thus become a major factor influencing domestic policies under such a system, just as it used to be under the gold standard.

Second, the present system maintains the identity of international means of payments and reserve assets, and thus makes possible simple, immediate, riskless, and costless shifts between private and public holdings of international means of payments. Excessive amounts of reserve currencies flowing into the hands of foreign bankers, merchants, or investors can be immediately absorbed by their central banks, and eventually sterilized, if need be, by means of the international arrangements (swap drawings, IMF transactions) established for that purpose. Similarly, a deficient volume in actual circulation can immediately be replenished by foreign central banks, if need be with the aid of the same international arrangements. In the case of the gold bullion standard or of a system based on some reserve asset issued exclusively to central banks by an international super-central bank, all these processes would be more complicated and costly.

Third, if central banks of surplus countries might at times have to use restraint in converting reserve currencies into gold in order to avoid a breakdown of the system, such restraint, irritating as it may be to those central banks, could fulfill a valuable function. It would remind the surplus countries of their co-responsibility for preserving equilibrium in international payments, and prevent them from trying to shift an excessive part of the adjustment burden to the deficit countries. Again, neither the gold standard nor a super-central bank system would automatically put a similar responsibility on the surplus countries. Only a flexible-exchange system, under which a payments surplus could generate deflationary pressure, would have a similar advantage.

Major problems

The report discusses "three major problems concerning the present international monetary system" (page 24). These problems concern the payments adjustment, the volume of international liquidity, and confidence in reserve media. All these problems, but especially the last one, are connected with the alleged "overhang" of dollars "held as reserves by other monetary authorities." (Page 35.)

The problem of payments adjustment. The discussion of this problem is excellent as far as it goes. But the report fails to stress the basic difference between adjustment problems facing countries that enter the international capital and money market only as debtors and whose currencies are of only local importance; non-reserve countries that have internationally important capital and money markets, and whose currencies are to some extent used in international transactions; and reserve centers.

Countries of the first type can solve all adjustment problems by one of the four "classical" methods that create or extinguish international price and cost differentials: monetary and fiscal expansion; monetary and fiscal restriction; currency appreciation; currency depreciation.

If countries of the second type try to correct imbalance by means of changes in the par value of their currency, such changes may cause disruptive capital flows. But as long as their external disequilibrium remains modest, or as long as their current balance is in equilibrium, they may balance their accounts by reversing destabilizing or inducing stabilizing capital movements, say, by selective fiscal measures such as the proposed U.S. Interest Equalization Tax, or, conversely, the proposed German tax on borrowings from foreigners. 5/

5/ Fiscal measures interfering with disruptive international capital flows may actually improve rather than hamper the international division of labor, and are therefore not subject to the objections raised against interference with international movements of goods and services (see this reviewer's paper "The U.S. Balance of Payments--Present and Future," Federal Reserve Bank of Philadelphia Business Review, June 1964, pages 14-15; and D.A. Snyder's paper "Capital Controls and U.S. Balance of Payments, "A.E.R., June 1964, pages 351-358).

Finally, if a reserve center were to make autonomous changes in the par value of its currency, such changes would almost certainly destroy the reserve character of the currency. Since a reserve center, however, is almost by definition a central international capital market, it will usually have a good chance of restoring equilibrium by influencing capital flows, say, by fiscal measures of the type just mentioned. If this proved impossible it might have no choice but to appeal to non-reserve countries for more adequate adjustment measures on their part.

In practice, serious economic problems will arise only for deficit countries. As long as all countries have tariffs and other import barriers, a surplus country will always be able to eliminate an unwanted payments surplus by unilaterally reducing its tariffs or lowering other import barriers. Such steps may prove politically difficult but they would have no serious adverse effect on the country's domestic economy, and they would actually stimulate world commerce. The converse possibility of trying to correct a payments deficit by raising tariffs or import barriers would, needless to say, be inconsistent with the policy goal of expanding international commerce (page 38).

The possibility of selective fiscal measures designed to correct disequilibrating capital flows should, incidentally, dispose of the objection made to the reserve currency system in Sir Roy Harrod's dissenting statement (page 115). Sir Roy complains that the present system "compels the U.S. and U.K. authorities to have higher interest rates than are compatible with their growth policies." Such compulsion could be avoided by selective fiscal measures (possibly including subsidies as well as taxes) that isolate the deficit country's capital market from the influence of higher interest rates prevailing in surplus countries--assuming that higher interest rates were not required to meet a threat of domestic inflation.

<u>The problem of liquidity needs</u>. The report's discussion of this problem should be put into proper focus by some analysis of the functions of international liquidity. While changes in domestic liquidity directly affect the decisions of bankers, businessmen, and consumers, changes in international liquidity--defined as the sum of reserves and credit facilities available to monetary authorities--influence the behavior of the economic community only indirectly, through the policies of the monetary authorities. As long as these authorities do not feel hampered in their policies by concern for deficient or excessive liquidity, changes in their international liquidity need not lead to policy changes and should be of no economic significance.

Hence, the problem of international liquidity needs is interesting only in the extreme cases of liquidity shortages or liquidity excesses. The report does not contend that either of these extreme conditions is either prevalent at present or poses an imminent danger for the foreseeable future; or that the reserve centers are unaware of the need to avoid such conditions. Hence, the problem of liquidity needs is not particularly urgent, and the dominant role played by that problem in the report's discussions seems unwarranted.

The problem of confidence in reserve media. The report's discussion of this problem is vitiated by its dependence on what may be called the gold superstition. The report assumes throughout that a fiduciary reserve asset is judged primarily according to its gold "base," and that confidence in a reserve asset is therefore undermined whenever the ratio between the issuing institution's gold assets and its liabilities is declining. 6/ In its criticism of the present system, it states four times (pages 74, 81, 89, 94) that "the system necessitates a progressive increase in the ratio of the liquid liabilities of the reserve-currency countries to their gold holdings."

Actually, all observers except a few gold-standard adherents are agreed that financing an ever expanding volume of world commerce will require continual increases in reserve assets at a faster rate than can be expected from the prospective increase in the availability of monetary gold (see, e.g., pages 31 and 56). Hence, the ratio between the fiduciary reserve assets and their gold "base" is bound continually to decline. If such a decline were necessarily to impair confidence in the fiduciary reserve asset, no international payments system based on such an asset would be viable in the long run, and a return to the gold standard would become inevitable.

Actually, the development of domestic money shows that the economic community is prepared to accept a steadily declining ratio between money and its gold "base," provided only that money is not created in excess of liquidity needs. There is no reason to assume that the major central banks whose behavior determines the working of the international payments system are less sophisticated than commercial banks, businessmen, and consumers have proved to be.

Apart from this fundamental objection, the report's discussion is vitiated by the belief of "some" participants "that the United States might suspend gold sales to monetary authorities at the first sign of 'run' on its gold stock" (page 59).

The spokesmen of the U.S. monetary authorities, including especially Chairman Martin, have repeatedly stated that the United States would use its gold holdings "down through the last bar of gold, if that be necessary" 7/ in settlement of international transactions;

6/ The gold superstition is fostered by the use of the term "gold-exchange standard" for the present international payments system. In order to avoid such bias, this reviewer has consistently advocated the use of the term "reserve currency system," which has the added advantage of being more descriptive of the system's essential feature.

7/ Speech of Chairman Martin, Pittsburgh, Pennsylvania, December 28, 1962; published in Journal of Finance, March 1963.

but apparently "some" participants in the study group believe that they know better. The report does not indicate why their opinion should carry greater weight than the word of the responsible representatives of the United States.

The problem of a dollar "overhang." The report assumes, like all too many other recent discussions of the international monetary situation, that the accumulation of liquid dollar assets in the hands of foreigners has reached unsustainable dimensions (see, e.g., pages 31-32)--without presenting any data substantiating that assumption.

Actually, net foreign holdings of short-term dollar assets (i.e., U.S. short-term liabilities to foreigners minus U.S. short-term claims on foreigners, including claims and liabilities reported by both banks and non-financial institutions, but excluding claims and liabilities of international and regional institutions) rose between the end of 1958 (when convertibility of the major European currencies was restored) and mid-1964 from $11.8 billion to $12.9 billion, or 9 per cent; gross foreign holdings rose from $15.1 billion to $22.1 billion, or 46 per cent. But the volume of world trade (exports plus imports) rose between 1958 and the first half of 1964 from $196 billion to $304 billion, or 55 per cent. In other words, world trade rose somewhat faster than foreign gross holdings of dollars, and six times as rapidly as foreign net holdings! Nobody has ever contended that foreigners suffered from excessive dollar holdings in 1958; it is hard to see that these holdings on the whole could be deemed excessive today.

Incidentally, these figures also show that, in contrast to an erroneous but almost generally held belief, the United States had to finance its payments deficit in those 5-1/2 years predominantly by means available to non-reserve countries as well as to reserve centers--i.e., by drawing on its monetary reserves, including its gold-tranche position in the International Monetary Fund ($6 billion) and on its international credit through receiving advance repayments on its claims on countries that moved from a deficit to a surplus position and selling to foreign countries longer-term securities, including "Roosa-bonds" denominated in foreign currencies (together $5 billion).

Nevertheless, while the net international liquidity position of the United States deteriorated, its total net international asset position continued to improve: between the end of 1958 and the end of 1963, the surplus of U.S. holdings of foreign assets regardless of liquidity--but excluding U.S. Government claims on foreign countries, which may be considered to be largely of questionable quality--over all U.S. assets held by foreigners increased from $6 billion to $15 billion. The report might well have wondered whether some of the recent attacks on the international role of the U.S. dollar might not reflect foreign concern about excessive strength rather than about the alleged weakness of the international financial position of the United States.

But what about the regional distribution of recent increases in foreign short-term dollar holdings? 8/ Net holdings of the not fully industrialized world rose from $2.2 billion to $2.8 billion but a surfeit of dollars can hardly be detected in those quarters. Net holdings of Japan actually declined, from $0.7 billion to a slight net debit position; this fact, as well as its efforts to increase its borrowings, and its repeated protests against the imposition of the interest equalization tax on U.S. lending to Japan, clearly demonstrate that its dollar holdings are not excessive. Canada's net holdings also declined from $1.8 billion to $1.1 billion; and its attitude towards access to the U.S. capital, credit, and money markets (and toward the IET) parallel that of Japan. Britain's net holdings rose from $0.8 billion to $1.2 billion; this might be considered too large an increase if it were not known, first, that Britain's foreign-exchange position still is generally considered to be too weak rather than too strong, and second, that virtually all of these holdings are in private hands and thus obviously not considered excessive by their owners; official U.K. holdings of foreign exchange (presumably mainly if not exclusively dollars) are not only negligible but actually dropped slightly. And the net holdings of Continental Europe, excluding only France and Germany, remained about unchanged at $4.1 billion.

The case for redundant world dollar holdings must therefore rest exclusively on the rise in the net dollar holdings of France, from $0.5 billion to $1.5 billion, and of Germany, from $1.7 billion to $2.3 billion. But the rise in French holdings becomes less spectacular if it is remembered that 1958 was, for France, a year of foreign-exchange crisis: at the end of 1955, French net holdings amounted to $1.1 billion. The increase in net dollar holdings between 1955 and mid-1964 was only a small fraction of the increases in its foreign trade, from $9.6 billion to $19.6 billion annually, and gold reserves, from $0.9 billion to $3.5 billion.

Germany's net short-term dollar holdings, large as they are, have been reduced by $1 billion since the end of 1960, by using the means readily available for such purposes under the present system. Moreover, the rate of increase in Germany's holdings between 1958 and mid-1964 was again much lower than that in its foreign trade (from $16.4 billion to $29.5 billion annually) or its gold reserves (from $2.6 billion to $4.1 billion). Hence, unless French dollar holdings were excessive in 1955, and German dollar holdings were excessive in 1958--and in those years nobody thought so--they could not be considered redundant in mid-1964, in relation to either the foreign trade or the gold reserves of those countries.

But even if it could be assumed for argument's sake that the present French or German dollar holdings were larger than required for working balance, reserve, and investment purposes, and that therefore parts of them should be considered credits rather than liquid funds:

8/ Breakdown of dollar holdings between official and private holders is not available for areas or countries.

should the present payments system be condemned because it had facilitated such implicit credit extension? Would it really be detrimental to international "confidence" if a reserve center could expect from its "correspondent banks" a kind of reciprocal automatic overdraft facility, in case of need, especially after the center itself had, in the most recent past, extended--and in large part, perhaps rashly, forgiven--much larger credits to those same "correspondents"?

Memory of nations is short, and gratitude for past favors has no place in international financial relations. But those economists--and politicians--who condemn the present payments system for allegedly undermining confidence by its ability to create dollar reserves would do well to remember that this ability saved the free world's economy in the first postwar decade--and may well have to do so again.

Proposed approaches to international payments reform

The report concentrates on four major approaches to payments reform: "the Semiautomatic Gold Standard, Centralization of International Reserves, Multiple Currency Reserves, and Flexible Exchange Rates" (page 70). The report's analysis includes, for each approach, a criticism of the present and of alternative systems as well as a description of the proposed arrangements.

In the opinion of this reviewer, the criticisms of the alternatives proposed by others are in each case more convincing than the defense of the proponents' own plan.

Semi-automatic gold standard. The proposal of a return to the gold standard frankly attacks not just the present payments system but the entire framework of modern monetary and economic policies, which is designed to promote economic growth and "maximum employment, output, and purchasing power" under conditions of reasonable price stability and payments balance. It advocates an immediate increase in the price of gold "by an amount sufficient for the United States to pay off its obligations to foreign monetary authorities" (without mentioning that even at the existing price U.S. gold reserves are still large enough to cover U.S. obligations to foreign monetary authorities). But in the future increases in money supply are to be kept strictly within the limits set by gold production. In particular, all settlements among monetary authorities are to be made "exclusively in gold" and the domestic money supply is to move not only "in the same direction as changes in the countries' gold reserves" but also "by an amount no smaller than the amount of the gold loss or gain" (page 78).

The proposal obviously would turn the clock of economic policy back by more than a century. Any further comment would be superfluous.

Centralization of reserves. This alternative embodies the basic elements of the "Triffin Plan," with some recently proposed refinements or amendments. The analysis claims as one of the plan's main advantages that it would facilitate the devaluation of reserve currencies (page 82). Obviously, this would be an advantage only if such a devaluation were deemed absolutely necessary: under any international payments system based on fixed exchange rates, a change in the value of its most important currency would be a rather serious matter. The report makes no effort to demonstrate the need for such devaluation. But if this need is not proved beyond reasonable doubt, any arrangement that facilitates such devaluation would introduce an element of unnecessary instability into the system. In this reviewer's opinion, this would be a clear disadvantage rather than an advantage.

Two further points may be added to the criticisms of the plan discussed in the report.

First, the plan could lead to a divorce between national monetary and fiscal policies: monetary policy would tend to be dominated by the proposed international super-central bank while no international focus for fiscal policy has been proposed (presumably because such a proposal would be unacceptable).

Second, the proposal fails to indicate the criteria which would be used under the plan to avoid "world inflation and deflation"; or to outline the process of determining "the volume as well as the allocation of the resources" of the new super-central bank, which under the plan "will be decided not automatically but in relation to current conditions" (pages 85-86). The plan merely states that such "criteria and procedures can be developed and implemented." This unsupported statement is hardly a sound basis for a radical innovation.

The multiple reserve-currency system. The approach is the least revolutionary of the four, and could find some support in occasional statements of U.S. officials.

Nevertheless, a system under which all major countries were to hold the currencies of all other major countries as reserves, would basically suffer from the same disadvantages as the present system while lacking one of its main advantages: the unity of means of international settlement and of reserve assets. Holding reserves in a great variety of currencies rather than in one (or at most two) of them would not only complicate the management of reserves but also increase the danger of disruptive shifts among the reserve currencies.

As a modifiction of the system, the report mentions the "composite currency reserve unit" recently proposed by Dr. Bernstein; a similar proposal is to be considered by the Study Group on the Creation of Reserve Assets, recently established by the "Group of Ten" (Annex to the Ministerial Statement, Sections 38-42). But such a system actually would be different in

character from the multiple reserve-currency approach: in contrast to the voluntary acceptance of individual reserve currencies, the participating countries would oblige themselves to accept and use the composite unit. Hence, the system would be closer either to the gold standard--if the amount of composite units in circulation were to be regarded as fixed--or alternatively to a system of centralized reserves--if the agency creating the reserve unit were given the responsibility of adding continuously or periodically to the volume in circulation. Hence, this approach would be subject to the same criticism as those two systems.

The report fails to mention one variant of the system which not only is fully compatible with the existing payments mechanism but has already been put into operation. A reserve center may be willing to hold other convertible currencies as part of its reserves--as the United States has been doing, albeit on a very modest scale, for the last four years. Such action does not complicate settlements among, or reserve holdings of, the non-reserve countries, and cannot lead to disruptive shifts among reserve assets. The decision of the Federal Reserve System of February 13, 1962, to re-enter the field of foreign-exchange operations had the express purpose of providing a means whereby, in the long run, "reserve holdings of foreign currencies may contribute to meeting needs for international liquidity as required in terms of an expanding world economy" 9/.

Flexible exchange rates. The problems posed by this proposal go to the very roots of international monetary theory and policy, and it would have been impossible even to enumerate all arguments for and against the scheme within the framework of a relatively brief report. In fact, the criticism of the flexible exchange-rate system included in the analysis of the "centralization of reserves" proposal may be considered the best refutation possible in such narrow space (pages 83-84).

But three points might be added to that criticism.

First, it is not true, as the advocates of flexible rates maintain, that "exchange-rate flexibility will free monetary and fiscal policies for domestic purposes" (page 97). As explained above, any policy that results in a substantial change in exchange relations might well tend to threaten either inflationary or deflationary repercussions on the domestic price system. Only if the policy goal of "a reasonably stable price level" (page 39) were abandoned, could rate flexibility be sure to free monetary and fiscal policies from international payments considerations.

Second, it is not true that "uncertainty" concerning future exchange rates will not impede foreign trade or foreign investment "because hedging on forward markets will eliminate this obstacle at a negligible cost" (page 97). Such hedging is possible only for short-term commitments--not for long-term debt transactions 10/.

9/ Authorization Regarding Open Market Transactions in Foreign Currencies; reprinted in the Annual Report of the Board of Governors for 1963, p. 51.
10/ Direct investments and other equity transactions need no hedging since they do not create obligations repayable in a fixed amount of money.

The proposal assumes that in the case of long-term commitments exchange-rate fluctuations will not matter "since the expectation of a fall in the price of a foreign currency is typically associated with the expectation that prices will rise in that country more than in others" (page 97). But this belief is unwarranted. Under a universal system of freely fluctuating exchange rates, nobody could tell in advance whether the currency of the debtor or that of the creditor would be more likely to depreciate or appreciate against the other in the long run. Hence, selection of either currency as the basis of a long-term contract would be something of a gamble for both parties. An expectation that exchange-rate fluctuations would "typically" be exactly proportionate to changes in domestic price levels could be based only on oversimplified purchasing-power parity theorizing.

Finally, the proponents of exchange-rate flexibility overlook that long-term planning, whether private or public, requires a reasonably stable standard of value to be used as unit of account. If neither the domestic currency nor an internationally recognized "key" currency can be used for that purpose, business and government planners will be tempted (or compelled) to return to the use of gold as the traditional "stable" basis of accounting; the report itself rightly refuses even to consider the practicability of the only other possible alternative, that of a "Commodity-Reserve System" (pages 70-71). In this way, a system of universal flexible exchange rates would, slowly perhaps but inevitably, pave the way for a restoration of the gold standard. As usual, unlimited freedom would lead back to servitude. 11/

The proposed variant of limiting flexibility of exchange rates either by permitting government intervention or by establishing some maximum margin (pages 98-100) would combine the disadvantages rather than the advantages of fixed and flexible exchange rates. Like the present system, it would fail to provide a mechanism for automatically "balancing" a country's international accounts; and like a system based on unlimited flexibility it would fail to provide a stable means of settling long-term international obligations or a stable unit of account for long-term planning. Hence, the "convergence of opinions" of the participants towards "some form of limited flexibility" of exchange rates (pages 105-106) merely proves that a compromise acceptable to a committee is as often an unhappy as a happy medium.

The report's policy consensus

The report has made an effort to achieve a "consensus on policy," and has arrived at four agreed propositions. But three of them are trivial and the fourth is of doubtful validity.

11/ Needless to say, these objections are not directed against flexible exchange rates for individual (peripheral) countries.

It hardly needs many months of hard work of 32 of the world's most eminent economists to reach the conclusions, first, "that balance-of-payments disturbances differ substantially in source and duration" (page 101); second, "that adjustments of payments imbalances of an enduring kind should be initiated promptly" (page 102)--the report concedes that it is "difficult and highly uncertain" or even "hardly possible" to know "at a sufficiently early stage" whether a payments imbalance is of an enduring or non-enduring kind (pages 50 and 103)--; and third, "that the financing of reversible disturbances requires the use of official reserves (save under a system of freely flexible exchange rates)" (page 102).

The fourth proposition "that the protection of the large outstanding foreign-exchange component of the world reserve pool against sudden or massive conversions into gold should receive a high order of priority," (page 102) may at first glance sound sensible. Nevertheless, it is unwarranted.

Obviously, sudden massive conversions of reserve currencies into gold would threaten to undermine the existing system. But every central bank in the world is aware of this danger. Ever since a few central banks helped to precipitate the Great Depression by putting an end to the inter-war gold-exchange standard, not one of them has attempted sudden massive conversions of reserve-currency holdings. In fact, the report itself states that they have "held on to their dollar balances and taken on additional holdings because they are unwilling to incur the onus of precipitating a crisis" (page 62).

Since every central bank is indeed unwilling to precipitate a crisis, formal protection against such an unlikely contingency is--as some participants have recognized--not "an urgent problem" (page 61). Hence, this problem need <u>not</u>, from the point of view of present policy requirements, call for "a high order of priority" (page 102).

In order to guard against the alleged danger of massive conversions into gold, the report proposes to permit dollar holders to convert their holdings "into gold-guaranteed deposits with the IMF" (page 105). But if any major country took such action, holders of dollars, in the United States as well as abroad, might well take it as an indication of impending dollar devaluation. The result, needless to say, could be a run on the dollar of unprecedented magnitude; in such case, the proposal would be more likely to bring about than to avoid the danger of "international financial disorder" (page 104).

Conclusions

The present international payments system--although, in this reviewer's opinion, the least unsatisfactory of all that have so far been tried or proposed--poses indeed a great number of serious problems. But the report fails to draw attention to some basic difficulties that have to be overcome if any international payments system is to become a more perfect means to achieve the "general goals" of economic policy outlined in the report (pages 38-40).

These difficulties do not primarily concern liquidity needs and types of reserve assets. Rather, they involve the question of how national entities (public authorities and private enterprises) must act in order to permit the maintenance or restoration of international payments balance, without hampering the pursuit of domestic policy goals.

The report correctly states that, at least for the approaches involving a centralized-reserve or a multiple-currency plan, "closely coordinated decisions by the leading monetary authorities would be required for the successful functioning of such a system" (page 57). Actually, such coordination would also be necessary under a flexible-exchange system (in order to avoid chaos in exchange markets), or under the gold standard (in order to avoid disruptive gold flows); and (needless to say) it is equally important under the present system. But what are the conditions, the limits, the processes of such coordination; and how can international coordination be reconciled with domestic policy determination?

"Closely coordinated decisions" can be reached only when there is agreement on basic purposes of policy, on "rules of the game" for the participants in international monetary arrangements. But what kind of agreement can we expect to be possible as between developed and less developed, "laissez-faire" and interventionist, surplus and deficit, "open" and "less open" (page 44) economies? And how can any rules be policed within a system of national sovereignty?

By its failure to discuss any of these questions, the report reveals the gaps in our knowledge. But in so doing, it challenges all of us to go on with the task of reconstructing the theoretical basis of international monetary policy.