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Reform of the
International
Monetary System

with special reference to
the interests of
developing countries
of the Commonwealth

COMMONWEALTH SECRETARIAT

Reform of the International Monetary System

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the interests of developing countries
of the Commonwealth

A STUDY BY
FRED HIRSCH

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FOREWORD

This paper, by Mr. Fred Hirsch of Nuffield College, Oxford, was commissioned by the Commonwealth Secretariat as a background document for the Commonwealth Finance Ministers Meeting in Dar-es-Salaam in September 1973. It is thus a sequel to the study on International Monetary Reform prepared by Mr. A. F. W. Plumptre for the 1972 Meeting of Commonwealth Finance Ministers and published by the Secretariat in October 1972 as the first of the series of Commonwealth Economic Papers.

The Commonwealth Finance Ministers meet regularly, during the week preceding the annual meetings of the International Monetary Fund and the World Bank, to discuss economic and monetary questions of common interest. In 1973 as in 1972, reform of the international monetary system was a subject of major concern to the Commonwealth countries and so featured prominently on the agenda of the meeting. As was noted in the Fourth Report of the Commonwealth Secretary-General (1973) the Commonwealth is strongly represented on the Committee of Twenty, set up by the Board of Governors of the IMF to make recommendations for the reform of the international monetary system, and on the Committee of Deputies which carries on the detailed work. In these circumstances the Commonwealth Secretariat considered that there was special cause for again laying before the Meeting of Commonwealth Finance Ministers an examination in depth of some of the leading issues in the current discussions on international monetary reform.

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The original paper has been revised by Mr. Hirsch in the light of the discussions of the Commonwealth Finance Ministers and at the IMF Annual Meeting which followed in Nairobi. The views expressed remain those of the author, and are not necessarily those of the Commonwealth Secretariat or of Commonwealth Governments.

Commonwealth Secretariat

October 1973.

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REFORM OF THE INTERNATIONAL MONETARY SYSTEM WITH SPECIAL REFERENCE TO THE INTERESTS OF DEVELOPING COUNTRIES OF THE COMMONWEALTH

I INTRODUCTION

The Significance of International Monetary Reform

The 1973 annual meeting of the International Monetary Fund in Nairobi is the first to have taken place on the African continent. It also marks the ten-year anniversary of the placing of international monetary reform on the official agenda. The obstinate persistence of this issue as a preoccupation of governments and financial officials reflects both its complexity and its real importance.

This importance has not always been obvious to the world at large. The problems involved at first appeared theoretical, and then, when the existing international monetary structure broke down under the cumulative strain, the impact on world production and trade was hard to discern. The question was raised whether the enormously difficult task of reconstructing a working rulebook for the international monetary system was necessary for the smooth working of the world economy. In a world of floating rates, the feeling grew, the world economy could perhaps be left in automatic drive.

In the past few months, opinion in world business and political circles on this issue has changed rather dramatically. Serious instabilities in world financial markets have put the vacuum in the international financial order in a new and more threatening light. Calls for progress in the rebuilding of an organized system have been voiced in business circles and by political representatives in many countries. This development is of considerable significance for the task of reform. For this task has long suffered from a lack of sufficient political thrust such as is necessary to override the multitude of technical obstacles and conflicting interests that attend any large task of reconstruction.

International monetary reform has lacked a popular constituency. It is far from certain whether, even now, sufficient political pressure exists to carry a comprehensive and adequate reform to fruition. But the pressure of circumstances has brought a notable movement among all major countries and groups of countries towards a more constructive stance in the official negotiations on a reformed system, in recognition of the importance of attaining a positive outcome.

The significant feature of recent disturbances in international financial markets is that they have occurred in the very largest economies, which had been thought by some to be virtually immune from external shocks under the cushion of floating exchange rates. Smaller countries, and particularly the less developed countries, have always been aware

of their own stake in an ordered and orderly international structure. They have a general interest in a global system that establishes clear-cut rights and obligations, as protection against bilateral and regional relationships in which the balance of bargaining power between powerful and smaller countries is inevitably one-sided.

Besides this general interest, the developing countries have at least three special interests in a reformed monetary order. First, the uncertainty and potential instability of a regime of haphazardly floating rates poses special difficulties for countries that have special ties with a particular financial centre, and that now lack a clear basis on which to maintain their own exchange rate. This is an important problem for a number of Commonwealth countries, and complicates their relationships with neighboring countries whose currencies are linked to different financial centres: the countries involved find themselves in the backwash of the fluctuations of the dollar, the pound and the French franc. Second, developing countries are particularly troubled by the current absence of an international monetary asset with an assured and attractive valuation: in the absence of a suitable store of international value, reserve accumulation by central banks becomes inherently speculative. Third, developing countries have a special interest in the development and extension of an international reserve unit such as Special Drawing Rights. This interest includes, but is not limited to, the persuasive case that exists for a link between SDRs and development aid.

As a result of the establishment of the Committee of Twenty as the forum for the reform negotiations, the developing countries have developed an influential position in the outcome of the exercise. This marks an important advance. In their new capacity as full partners in the bargaining process, the developing countries are not only in a position to safeguard their own interests and to assure that a truly universal approach is taken. They also have the opportunity and the responsibility to consider the requirements of the reformed system as a whole. It has become evident that the benefits of an adequately reformed system are not attainable unless participants in it accept certain restraints on their own freedom of action which they could otherwise pursue. For the developing countries in particular, these restraints are likely to be outweighed many times over by the benefits of a suitably reformed international system. The responsibility that developing countries share with other parties to the negotiations to undertake certain commitments as part of the collective undertaking is therefore in the clear interests of the developing countries themselves.

Design of this Report

The current official negotiations present all the countries involved with matters for decision that are of considerable intricacy and great

importance. The aim of the present report is to provide countries of the Commonwealth with an additional basis for assessing the implications of these decisions from the standpoint of their own interests, including their interests in achieving a favourable global climate for pursuit of their national objectives.

In these as in all complex negotiations, intensive focusing on the immediate technicalities makes it difficult for the authorities whose decisions are sought – and perhaps still more difficult for those involved in the heat and burden of the negotiations – continuously to view matters on the bargaining table in the full perspective of the substantive problems they are intended to solve. This report is designed to provide such a perspective. It assesses the requirements of a workable international monetary order by reference to the issues under consideration in the official negotiations. But in maintaining the reference point of the goals in view, this report also attempts to direct attention to points at which the drift of the negotiations appears inconsistent with those goals.

The high importance of securing international agreement on this issue brings inevitable pressure for compromise and accommodation among the divergent initial positions held by the various parties to the negotiations. Such compromise and accommodation is inescapable. But it is equally important to step back and assess the proposed arrangements that emerge from such negotiations in terms of the real world problems with which the agreed system will be confronted. Against the damage to international confidence and cooperation that would result from no agreement, there also needs to be weighed the damage that could result from agreement on a new regime that proved inadequate to the task – whether by remaining dormant, or by being implemented and abandoned under pressure, or by having continuous resort to its exceptions and escape clauses. The long-term damage to the world economy and to international cooperation of a failed reform could be very serious.

This report undertakes a substantive assessment of the issues under four main headings. Section II covers a brief general review that relates the new needs of the system to the provisions of the existing regime of Bretton Woods. Section III covers the exchange rate regime and payments adjustment. Section IV discusses the form of reserve settlements and reserve assets, covering in particular the role of SDRs, the problem of foreign exchange reserves, and the link between SDRs and development aid. The final section covers organizational issues on international monetary management at the top level.

II AN UPDATED BRETTON WOODS?

A widely held view on the background and rationale of reform is that the international monetary system designed at Bretton Woods at the end of World War II served the world well for the first postwar generation, but that a new system is now required to cope with the changed requirements of the 1970s and beyond. It follows from this approach that the amendments required in the new system should be based on the evolving changes that have taken place in the structure of the world economy. The most important of these changes has been the diffusion of economic strength among at least the major countries, with a corresponding decline in the relative economic strength of the United States. This in turn has entailed a need for the United States itself to initiate adjustment in its own competitive position, thereby creating a need for a truly universal world payments mechanism to replace the system in which the United States was not merely passive but lent its great strength to accommodate the adjustments needed by other economies.

This view of the problem reflects the undoubted change that has taken place in the balance of global economic power. But in its historical retrospect this view is misleading in a way that has the effect of understating the extent of the adaptive adjustments that are now required to fit contemporary circumstances. In fact, the international monetary system as laid down in the Articles of the IMF has never been in full operation. For the first decade and more after World War II, all but a handful of countries maintained inconvertible currencies and made extensive use of restrictions on current trade and payments. After a brief period in the late 1950s in which the shifting balance of economic power between the United States and the other main trading countries produced a moment of equilibrium in the exchange markets, the monetary system entered the trials of the 1960s. In this period, significant adjustments in payments positions were again called for, but willingness to adjust the exchange rate was resisted for many years by each of the major economies in fundamental disequilibrium – Germany, the United Kingdom, Japan and the United States itself. These long delays in exchange adjustment involved a series of derogations from the spirit and ultimately the letter of the IMF Articles, culminating in the currency realignment of August-December 1971 which brought the system down with it.

The fact that the system of the IMF Articles was never fully in place in the first quarter century after World War II, a period of exceptional economic success for the world economy, must not be seen in denigration of the Bretton Woods agreement and what flowed from it. For it is now possible to see that the true significance of that agreement was the commitment it embodied among national authorities to concede at least that minimum degree of international cooperation as appeared necessary to further broad national interests that manifestly

required collective action; and above all, to check any backsliding and retrogressions safely before the point at which they threatened to set off a self-aggravating chain of mutual damage. This important negative achievement underlay the series of expedients and ad hoc responses of monetary authorities to the pressures that developed from 1960 onward. In this categorisation must be included the negotiation of the SDR facility itself, representing a major response to only a part of an inter-locked problem. The recognition by major governments and financial authorities of their common interest in avoiding a mutually destructive *sauve qui peut* remains an important safeguard for the health of the world economy.

But just as this achievement of Bretton Woods takes on growing stature with the passage of time, in which the contrast with the sorry experience of interwar years grows the more impressive, so the perspective of time illuminates the instrumental inadequacy of the original Articles – which were themselves, of course, the result of major compromise – to implement the broad objectives then laid down.

Thus the wise objective of stable but adjustable exchange *rates* did not find reflection in a mechanism that could be relied on to implement it. The chosen regime of periodically adjustable *parities* manifestly failed to do so. Parities for each currency were set in terms of gold (and latterly SDRs) with provision for limited variation in exchange rates within prescribed narrow margins around the parity. In addition, exchange rates could vary as a result of adjustments in a country's own parity, and in the parity of other countries. Thus stability in a country's own parity did not provide stability in its effective exchange rate, and the abrupt nature of adjustments in parities created instability in movements in exchange rates over time. As a result, exchange rates have been in turn either stable but rigid, or flexible but unstable. This mechanistic inadequacy has still not been fully confronted in official discussion, and the same inadequacy threatens to carry over into the new system.

The Bretton Woods objective of strengthening the base of international liquidity and initiating a degree of administered control over such liquidity marked a major step forward, which was carried further with the establishment of the SDR facility in 1969. But these innovations were limited to the provision of new facilities. Their impact was overwhelmed by variations in reserves in the form of foreign exchange, including balances held in new, appreciating reserve currencies and in Euro-currency markets. Only minimal regulation has been applied to this sector of reserve holdings, and as a result, the role of reserve currencies has increased, rather than diminishing in line with official intentions. These inadequacies in control over international liquidity are now better understood. But there remains a marked reluctance among many individual countries to accept the restraints and disciplines that establishment of effective control over the world reserve system would require.

III THE EXCHANGE RATE REGIME AND PAYMENTS ADJUSTMENT

The Bretton Woods objective of stable but adjustable exchange rates sought to provide for adjustments in exchange rates to accommodate countries' domestic needs while avoiding unnecessary fluctuations produced by either aggressive national policy actions or spontaneous excesses of the market. This objective was and remains sound. The still unresolved problem is how to implement it. In this aspect, for the reasons explained below, the particular changes in the system on which official negotiations have focused are of doubtful adequacy to fulfil their intended task. The view taken in this report is that the objective of controlled flexibility of exchange rates is the proper one; but that different and in some respects more extensive innovations than those that have hitherto received serious official consideration are needed to achieve it.

The objective of controlled flexibility has frequently been assailed from both sides. On the one side, the appropriateness and even the propriety of adjusting exchange rates was widely questioned in official circles in the critical years 1960-66. In this period the exchange adjustment mechanism of Bretton Woods became almost entirely passive, at least for the large economies. On the other side, in academic and other private circles, still stronger doubts have frequently been expressed about the wisdom of attempting to exert any official restraints on the free fluctuation of exchange rates in response to market forces.

Both these extreme positions have now been put to some test. The attempt to maintain exchange rates rigid in the face of major changes in the conditions of competitiveness among countries was eventually seen to involve excessive costs, in the first instance for the economy with the misaligned currency, and subsequently also for the international community in the shape of payments restrictions and distortions in domestic purchasing power. But the adjustment of exchange rates under the Bretton Woods mechanism, by a substantial step adjustment in parities, in turn set off increasing speculation on further such changes. This exposed the defect in the active use of the Bretton Woods exchange mechanism, its stimulation of disruptive speculation.

The Smithsonian Agreement of December 1971 included, as a compromise and interim expedient, a widening of the permitted margins for exchange rates to fluctuate around parity from one per cent to $2\frac{1}{4}$ per cent on either side of parity between individual currencies and their intervention currency such as the U.S. dollar. This did not provide sufficient protection on its own against a renewal of overwhelming speculation. The Smithsonian parity system cracked in June 1972 with the floating of the pound sterling, and finally crumbled with the floating of all major currencies in February-March 1973. An attempt has continued to be made to maintain a stable band of rates between the currencies of members of the European Economic

Community, but the significance of this has been limited by absence of the two currencies in potential disequilibrium – the pound sterling and the Italian lira – and by the recurring revaluations of parities within the EEC band (or "snake").

For an initial period in the second quarter of 1973, the regime of virtually universal floating rates seemed to be functioning smoothly and satisfactorily. It was at this time that it was increasingly asked whether an organized international monetary system was needed at all. The market honeymoon was a brief one. In midsummer, sharp and sustained movements in major currencies carried exchange rates to levels that appeared unjustified on any analysis of the underlying competitive positions. This was a situation in which the mechanism of floating rates should have generated its own corrective, and for a time, exchange authorities made efforts to limit their intervention, in order to attract stabilizing speculation from market sources. Such stabilizing speculation did not emerge. The foreign exchange market witnessed the phenomenon observable in the experience of many developing countries in commodity markets: movements in market prices are far larger than analysis would suggest to be necessary, before inducing a reversal of a trend that is firmly underway.

In the foreign exchanges, as in commodity markets, excessive movements in prices can set up their own cycle of instability. For the industrial countries, excessive depreciations and appreciations can have perverse effects on the trade balance, exacerbating inflationary problems in the over-depreciating countries, and shielding the over-appreciating countries from the domestic effects of rising commodity prices. For the developing countries, the wide and excessive divergence in rates for the currencies of major centres has brought haphazard shifts in import and export prices, as well as administrative problems of exchange support. There has therefore been a general welcome for the resumption by the major countries of official intervention to check excessive movements in market rates, with the help of an expanded network of swap credits. But the stabilizing influence of this readiness to intervene is limited in a number of ways as long as it remains entirely ad hoc in character, providing no frame for market expectations.

Probably the first need for a reformed international monetary system, which could be dealt with ahead of other aspects requiring more extensive preparation, is to establish a convincing operational framework for exchange rates to be in fact, and not only in name, stable but adjustable. The key ingredient for this difficult task is to provide for the possibility of continuous adjustment by small amounts in exchange parities, or in the range of potential rate fluctuation, while limiting the scope for market movements at any moment of time within the specified band around the parity, or its equivalent under managed floating. An approach of this kind foregoes "stability in the small" in

the interests of better safeguarding "stability in the large". In fact little is sacrificed, because the significance of stability in the small in the shape of set parities is lost when changes in parities either take place frequently in sizeable steps, or if parities are frequently abandoned in favour of floating rates. And when parities of other currencies are changed, as noted above, a stable parity may no longer involve a stable effective exchange rate. An attempt to maintain set parities may therefore involve the sacrifice of the substance of exchange stability for its form.

The strongly expressed preference of developing countries for stability of exchange rates should be attainable to the extent of achieving reasonable stability over time, i.e. avoidance of extreme fluctuations. Institutional stability – fixity of parities in the short term – is likely to be a hindrance rather than a help in attainment of the substantive objective.

On this key point there appears to be a danger that official negotiations may be becoming engrooved on the wrong line. The broad pattern of reformed arrangements on which attention is focusing contains the following main elements: (i) parities would be generally re-established, probably set in terms of the SDR, and perhaps maintained by multi-currency intervention; (ii) margins around these parities would be wider than the one per cent permitted in the Articles and perhaps wider also than the $2\frac{1}{4}$ per cent agreed at the Smithsonian, which was however expressed against the intervention currency (allowing double the margin between third currencies); (iii) pressure on countries to adjust their parities would be exerted on an at least partly formalized basis, through the use of statistical indicators, or more judgmental assessments, to trigger active consideration of a parity change; (iv) these pressures would be applied in a progressive manner and would be backed by possible sanctions against the offending country, including new sanctions against surplus countries; such sanctions would be applied on aspects such as interest rates on reserve holdings, convertibility of foreign exchange balances, and perhaps also allocation of SDRs; (v) where establishment of a new parity or maintenance of the existing parity involved excessive risks, particularly of market speculation, provision would exist for resort to floating rates as a transitional or exceptional measure.

While a regime of this kind attempts to deal with the problem of undue rigidity and tardy adjustment of parities, it offers little protection against the other endemic problem of a system of parity adjustment by substantial steps – the problem of anticipatory speculation. Indeed, unless parallel innovations are introduced in the form of parity change, the pressure for adjustment introduced by use of statistical indicators or formal international assessments is itself likely to intensify the speculation problem. The exchange rate regime could then become one dominated by its exceptions, with prolonged resort to floating rates.

Unless agreement was also reached on rules or guidelines for management of rates of floating currencies, a regime of this kind would paradoxically contain no criteria for limiting fluctuations in those circumstances in which limitation was most necessary. It is encouraging that formulation of rules or guidelines for floating is now being given increased attention in the reform discussions.

Rather than a new exchange rate regime that risks gravitating between short-term fixity and unbounded flexibility, the objective should be to establish a system of continuous but limited flexibility. A variety of technical arrangements can be envisaged for such a system. Three alternative bases for such mechanisms – which certainly do not exhaust the list of possibilities – are as follows:

Alternative (1) Managed Floating Subject to International Regulation

Central parities would not be restored; exchange rates would be allowed to fluctuate subject to acceptance by Fund member countries of responsibility for checking excessive fluctuations in their currencies; the overall thrust of such intervention, as distinct from the daily operations, being coordinated in an international forum. A major criterion for coordination of exchange intervention would be the formulation of international guidelines for a permissible range in movement of member countries' basic payments balances (which in this regime would have distinct advantages over reserves as a target indicator). Thus statistical indicators and analytical assessments could play a comparable role to that envisaged under the new parity regime, with the benefit of more effective defence against anticipatory speculation.

Alternative (2) Moving Parity Zones

Central parities would be re-established, but countries would be free to change these parities at their discretion within an internationally agreed zone, of say ten per cent width. The permissible zone for each country concerned would be renegotiated in an international forum at periodic intervals. This system would require a relatively wide band for fluctuation of market rates around parity (distinct from the permissible zone for the setting of the parity), and the smooth working of the system would require frequent movements in parity well before the market rate had approached the limit of the band.

Alternative (3) Discretionary and Regular Parity Changes, Wide Margins

The least formalized parity system consistent with reasonable safeguards against disruptive speculation would contain elements such as

the following. Margins around parities would be wider than contemplated hitherto – e.g. the equivalent of five per cent in terms of the intervention currency, giving a band width of ten per cent, and more in the event of multiple currency intervention applying to all currencies (i.e. if countries maintained their rates by intervening in the currencies of all their partner countries, rather than against a single third currency such as the U.S. dollar). No formal arrangements for parity changes would be laid down, but in order to avoid the build-up of anticipations of substantial step changes, the general practice would be adopted of announcing parities at regular intervals, e.g. weekly. An announcement could take the form of no change, but the system would require a routine of frequent changes – typically by small fractions of one per cent – in order to remove the rationale for speculative expectations that the initiation of a change was a sign of a forthcoming one way movement. The aim would be to keep the market rate well inside the moving exchange margins. National parity changes would thus be made by national authorities on a discretionary basis. These would be subject to overall review in an international forum, using the same general criteria that are envisaged for overview of parity adjustment in less frequent steps; but in this case the review would apply to the net change in parity effected over a substantial period, e.g. six months, or up to a maximum percentage, rather than applying to the individual parity changes, which would be at the discretion of the national authorities. In this case and in Alternative (2), technical cooperation between exchange authorities would be needed to implement the respective parity changes.

It is important to note that while each of these alternatives would involve continuous changes in parities, or in the weighted average of exchange rates in the case of managed floating, such continuous movement no longer necessarily involves any exacerbation of even short-term fluctuations in rates of particular currencies. Countries are now increasingly focusing their attention on the effective exchange rate of their currency against the currencies of their trading partners together; and stability in the rate between their own currency and any other single currency, e.g. the U.S. dollar, is not to be expected even from the maintenance of a fixed effective exchange rate on their own part. What this amounts to is that in conditions in which changes in parity by various countries become a regular occurrence, a fixed effective exchange rate on the part of any single country loses operational significance, even in day-to-day operations.

Controls on capital movements may well be judged desirable by individual countries in order to provide insulation from external influences of a variety of kinds, and use of such controls should therefore be largely at the discretion of individual countries. But it would be unwise, and against the lessons of experience, to rely on capital controls as a shield for an exchange rate regime that is itself severely exposed to speculation.

The interest of developing countries in securing an effective regime of exchange rate adjustment is essentially indirect. Together with the smaller industrial countries, the developing countries already have effective freedom of action in adjusting their own exchange rates. Their interests in this aspect of the reform lie primarily in the avoidance of both excessive fluctuations in the currencies of the main financial centers and trading countries, and of undue rigidities. As has been amply demonstrated in recent years, such rigidities impede the ability of the developed countries to maintain open import markets, and they induce restrictions on flow of capital and aid, as well as building up crises for the future. The prime interest of the developing countries in the exchange rate regime is therefore that it should operate smoothly, and be well safeguarded against breakdown.

IV THE RESERVE REGIME

The interest of the less developed countries in future arrangements for reserve settlements and reserve holding is direct, substantial and many sided. These countries have a special interest in the development of a reserve system on a deliberative and organized international basis. They have a special interest in regular allocations of Special Drawing Rights from a number of standpoints:

- they have traditionally had disproportionately low holdings of gold;
- they have a potentially high need for reserves;
- they feel an increasing need to avoid dependence on a single reserve centre;
- they suffer from the absence of an international reserve asset with a stable valuation base;
- and the developing countries are of course the potential beneficiaries of a link between international reserve creation and development aid, a facility which is a wholly appropriate feature of an international reserve system.

These considerations are developed further below. What also needs to be emphasized is that a fully fledged SDR system can be expected to emerge only in so far as it provides a basis for attaining effective regulation over global monetary reserves. This is the rationale of a full SDR system and its only sound foundation. Such regulation necessitates in turn the acceptance, by countries participating in the system, of commitments to limit their holdings of reserves in forms other than SDRs. For in the absence of such limitations, there can be no assurance or expectation that regulation of the supply of SDRs will regulate the level of world reserves as a whole. One may recall the experience of the SDR system in its first phase, 1970-72, when SDR allocations were overwhelmed by an explosion of foreign exchange reserves in the form of U.S. dollars and other currencies held in national centres and in Euro-currency markets. This experience

provides a clear forewarning of the need to integrate the SDR system with the practices of countries in the holding of their reserves as a whole.

Gold

The logic of events is gradually transforming the effective character of official holdings of gold. They are being transformed from their original function of readily useable reserves to the different function of long-term assets, having an essentially investment character rather than monetary character. This evolution should in time receive formal recognition. Meanwhile, gold retains a monetary status in form but not in substance. The present arrangements under which leading central banks have agreed to avoid either sales or purchases in private gold markets have the disadvantage of freezing official gold holdings in both their monetary use and in their use as investment or commodity assets. This has led to strong pressure to permit countries, in effect, to liquefy their gold holdings by sales to the market. This suggestion has attracted growing support. Its implementation would yield both immediate practical benefits, by deflating speculative expectations in the gold market, as well as by absorbing private liquidity in the form of currency balances. More important would be the long-term benefits in the recognition of the changed character and function of official gold holdings. The very large and now clearly excessive holdings of gold in the I.M.F. provide a convenient source of substantial market sales from the official sector. By contrast, use of the free market gold price as a basis for gold settlements between monetary authorities, as has been suggested in some quarters, would constitute a backward step. It would involve a *de facto* increase in the official gold price, albeit by haphazard amounts that could introduce a new element of speculation in official reserve management. It is very doubtful whether such action would be consistent with an increasing role for SDRs. Such action would not be a complement to a move to an SDR standard, but rather an alternative, albeit of a rather dubious kind.

Foreign Exchange and SDRs

Provided that a firm commitment to a predominant reserve role for the SDR is made, the measures required to accommodate official gold holdings need be neither complex nor troublesome. The far larger problem in the regulation of global reserves is posed by present and potential reserves held by countries in foreign exchange. Developing countries, and many others, have been inclined to resist suggestions that their foreign exchange reserves should be subject to certain agreed limits. They have placed considerable importance on maintaining freedom of action over their reserve holdings. These

reactions are a natural response to the difficulties in which countries have found themselves in recent years in managing their reserves. The depreciations in exchange value of the traditional reserve currencies, U.S. dollars and pounds sterling, have imposed significant exchange losses on developing countries and others with proportionately large foreign exchange holdings. These countries have been able to avoid or limit further losses only by diversifying reserves into stronger currencies and by taking advantage of higher interest rates available in Euro-markets.

These responses are fully understandable and entirely rational for individual countries in the absence of an acceptable alternative that would show them equal advantage. So long as no such alternative exists – which is the actual situation at present – it is unrealistic to expect the movement toward diversification of foreign exchange reserves to be checked. But it would be equally unwise for the small countries that have most to gain from a collective reserve system to weaken the chance of this being established, by reluctance to accept the individual commitments necessary for the success of the collective enterprise. Thus it is important for developing countries to distinguish between the losses they would incur in giving up freedom to hold reserves in the form they choose in *present circumstances*, with the very different balance of advantage resulting from an effective switch from their present foreign exchange holdings which have to be earned or borrowed, to reserves in the form of SDRs made available on a more favourable basis.

In the absence of an effective international agreement by all countries concerned, to keep strict limits on official holdings of foreign exchange, it would be difficult to be confident that SDRs would acquire a major role in world reserves, and that an assured basis for regular allocations of SDRs would be achieved. Expressions of collective intent that the reserve system should move progressively on to an SDR basis are not a substitute for the commitments that individual countries have to make in order to provide the necessary conditions for this desirable development.

The chief such commitments concern the limitation of official holdings of foreign exchange and undertakings to convert excess holdings into SDRs. One possible form of such commitments is negotiation of permissible working balances, either country by country or according to some formula. But it might be both more effective and more feasible to eliminate the need for official working balances altogether. This could be done by putting the mechanism of exchange support on an overdraft basis, with necessary balances being supplied by creditor central banks under credit lines, and the balances being settled at regular (e.g. monthly) clearings. Such a mechanism would involve a bigger break in habits of reserve managers than would limitations on working balances; but a psychological break of this kind may be

needed if the big step of moving to an SDR reserve system is to be accomplished.

Swaps in the IMF?

A system of this kind could be associated with a streamlining of credit facilities in what is now the General Account of the Fund. One possibility would be to grant a new facility to all Fund member countries, to draw up to their whole quota for the purpose of offsetting payments outflows that were judged to be both temporary and reversible. Such drawings would be without policy conditionality. Repayment might be within a maximum of say one year, and the interest rate set in relation to rates in major money markets. All Fund members, including developing countries, would thereby be provided with facilities comparable to those currently enjoyed by major countries through central bank swap arrangements. A new IMF facility of this kind would also provide countries with a substitute, on advantageous terms, for the balances they have traditionally held in reserve centres; a further substitute for these balances would be provided by the additional allocations of SDRs that would become available as global reserve growth in other forms was brought under control.

Consolidation

Control over accumulation of new reserve currency balances would also need to be flanked by consolidation of the large existing balances held in reserve centres. Consideration has been given to the opening of a special SDR "substitution account" for this purpose. Fears have been expressed by some developing countries that the great expansion in the size of SDR issues that would result from substitution of SDRs for existing foreign exchange balances might prejudice the supply of new SDRs through allocations. Yet substitution of SDRs should help to reinforce the provisions necessary to regulate the growth of foreign exchange reserves, so that these fears seem to be misplaced. Far the biggest discernible threat to future SDR allocations is that uncontrolled growth in reserves in other forms will leave no need and no room for additional SDRs. By helping to contain this threat, consolidation of reserve currency balances into SDRs should therefore strengthen the basis for future SDR allocations.

SDR Interest Rate and Valuation

A switch of reserves from foreign exchange to SDRs appears unattractive to many countries in present conditions because of the loss in interest earnings that would be involved. This is a particularly

important consideration for developing countries. It has therefore been generally accepted that expansion in the role of the SDR would necessitate an improvement in its attractiveness as a reserve asset. This improvement should probably extend both to the interest rate and to the basis of valuation – e.g., whether the SDR should be valued in terms of some sort of weighted average of major currencies.

The current interest rate of $1\frac{1}{2}$ per cent paid on accumulations of SDRs above allocations, and payable on net use, bears no relation to current market conditions. It is in fact based historically on the rate established in the negotiation of the IMF's General Arrangements to Borrow in 1961. The U.S. Treasury bill rate had then averaged about $2\frac{1}{2}$ per cent in the preceding four years; in the past four years it has averaged about $5\frac{1}{2}$ per cent.

An improvement, and clarification, is also needed in the valuation of the SDR. The current valuation defined in weight of gold has proved unsatisfactory and is currently impeding the use of SDRs in settlements. The value of the SDR is tied to the official valuation of gold, which has become an arbitrary and disputed magnitude. It reflects, on one interpretation, the haphazard extent to which changes in relationships between currencies happen to take the form of a formal devaluation of the U.S. dollar rather than appreciation in the parity or the market exchange rates of other currencies. On another interpretation, it reflects the par value of the currencies of other countries which claim to have "captured" the gold price through the (better) maintenance of their par value obligations.

In order to avoid arbitrariness or uncertainty of this kind in the value of the SDR in terms of currencies, it is probably necessary to base the SDR valuation on some weighted index of all currencies. If the SDR was given a constant value in terms of currencies as a whole, its worth would maintain a middle position between the weakest currency and the strongest. Because such a position might make the SDR appear unattractive vis a vis the strong currencies, if these held their place for substantial periods of time, it might be preferable to give extra weight to strong currencies in compilation of the index of SDR valuation, so that the SDR showed some long-term appreciation against currencies as a whole. The SDR interest rate could then safely be kept significantly below the average rate in world markets, though almost certainly not so far below as currently prevails with the rate of $1\frac{1}{2}$ per cent.

A "hardening" in the characteristics of the SDR through either its valuation base or its interest rate has generally been resisted by developing countries. These countries tend on balance to be net users of SDRs, and expect to continue in that position, so that they would incur additional burdens from an increase in the SDR interest rate or appreciation in its currency value. Considered in isolation, this policy

position against a hardening of the SDR is well founded, and the developing countries will be well advised to maintain it.

But it is equally important to recognize that maintenance of a "soft" SDR is very much a second best or third best way of protecting the position of the developing countries. Many individual developing countries have creditor positions on SDR account, and these include some of the poorest countries; equally, the largest net users of SDRs have been rich industrial countries. Moreover, the softer the terms of the SDR, the less is the likelihood of the SDR developing a major role with an assured basis for allocations, in which the developing countries have an important interest.

The Link with Development Aid

The most efficient way of protecting and improving the position of developing countries through the SDR mechanism is the direct way – by establishing a link between allocation of SDRs and the flow of resources for use in development aid. Such a link is both feasible technically and fully justifiable in principle.

This justification has sometimes been disputed on the ground that creation of reserves should be kept separate from transfer of real resources. But such separation would introduce a new principle into reserve creation. Resource transfer has been involved in both the acquisition of gold from countries with gold mines and in the acquisition of foreign exchange from countries with reserve currency printing presses. It is a clear advantage of reserve creation through an instrument such as SDRs that it saves the real resources that are involved in gold mining, and avoids the potential instability and eventual overburdening of the position of national currencies that are involved in the growth of foreign exchange reserves.

In these ways, a fully fledged SDR scheme offers a collective benefit for the world as a whole. It is fully appropriate for the international community to take the deliberate decision to use this collective saving yielded by the common enterprise for a collective purpose. Since all the developed countries are agreed in principle on the collective purpose of increasing the supply of development aid, it is entirely rational and sound that a part of the collective saving from international reserve creation should be used to that end.

A development link for SDRs should therefore not be seen as a dubious intrusion into the scheme or a practical political necessity to obtain the support of the developing countries. In its implementation of an agreed collective purpose, the development link broadens the rationale of the SDR scheme itself. It is therefore encouraging that support for such a link is now widespread.

There remains the question of the appropriate form of the link – a question almost as controversial as the propriety of the link itself. Among individual developing countries, there is a natural instinct to prefer a link directly through their own SDR allocations, rather than through the intermediary of one or more international development institutions. In negotiations over these questions, care must be taken to preserve the principle on which a preferential allocation of SDRs to developing countries can be soundly based – namely, the global collective interest in adding to the resources of countries that need them most and are willing and able to put them to constructive developmental use. A formula that simply added a supplement to the SDR allocations of all developing countries and distributed it to them *pro rata* according to IMF quota would not be consistent with this principle. It would involve unavoidable anomalies as between countries on the border of eligibility, and these anomalies would be likely to increase over time, as the original classification of eligible countries became less suited to changing circumstances. In addition, the weak connection between such a formula and development needs and potential would not be lost on the industrial countries. These countries would on that account be likely to have fewer inhibitions in keeping the funds channelled through such a link to a minimum.

A link that was in keeping with its underlying rationale might take either of two forms, or possibly a combination between them. In both cases it is assumed that a part of the SDR allocation would continue to be allocated to all participants according to quota:

- (1) Allocation of the aid SDRs to the World Bank group and the regional development banks, on the lines that have been frequently discussed.
- (2) Allocation of the aid SDRs directly to developing countries according to a new formula varying positively with population and negatively with per capita income. Thus the smallest countries with very low income per head would have their special need recognised; and more advanced developing countries that have not in the past been considered eligible for concessionary development finance would receive support at a reduced per capita rate, and would have the size of their population taken into account in determining the amount of their special allocation. Distribution on this basis would transfer to the international sphere the general principle of the negative income tax, which is finding growing favour in a number of industrial countries in the combating of domestic poverty. Use of per capita income as a criterion for allocation would also introduce a reasonably smooth progression into the extent of eligibility, avoiding an arbitrary cut off for countries placed outside the eligible group.

A form of the link that has been discussed by the developing countries in their Group of 24 would to some extent combine the two principles outlined above. Under this scheme, allocation of aid SDRs would be direct to countries, in proportion to quota; but the least developed

countries would receive an additional special allocation; and release of all aid SDRs would be subject to confirmation by the International Development Association that the funds would be used for sound development purposes.

V ORGANISATIONAL ISSUES

The discussions and negotiations on international monetary reform that have taken place in the past year have been carried out by the specially created Committee of Twenty, meeting at both ministerial level and deputies level. A final judgment of the success of this organisational innovation must await the outcome of the reform exercise. But there is no doubt that the formation of the committee has filled an important gap in the previous administrative structure of the IMF.

From the IMF's earliest beginnings, knowledgeable observers have believed that its influence would be enhanced if officials with immediate responsibility for policy in their own countries could be associated more closely with the direction of the Fund. This was the basis for the strong conviction held by Maynard Keynes that the Executive Directors of the Fund should not be professionalized as full time residents. Keynes envisaged that they should be high officials in their own administrations attending periodic meetings of the Fund executive board, meetings which would thereby concern themselves with the main general lines of policy. In the event this solution was rejected – though one or two countries tried initially to carry out its spirit in selecting their own appointees. The Fund's executive board consists of full time directors and alternates; it meets very frequently, and is concerned with matters of detailed administration.

The limitations of this arrangement became more marked with the growth in the Fund's membership, which made the Board of Governors of well over one hundred persons an essentially ceremonial and validating authority. A gap developed between the Executive Board, knowledgeable and expert on technicalities but somewhat remote from the centre of influence in national administrations, and the unwieldy Board of Governors consisting of finance ministers and central bank governors.

The formation in 1961 of the Group of Ten, consisting of ministers and high national officials of the major industrial countries, was in part a response to this vacuum. The Group of Ten had manifest advantages in compactness of size and in authority of its participants: but it was indefensible in its composition, excluding as it did all primary producing countries; and it had no formal place in the Fund structure. This exclusive association inevitably provoked in time the formation of other groupings to give voice to the excluded countries, and probably in-

creased the influence of UNCTAD as well as subsequently leading to the formation of the Group of 24.

The Committee of Twenty represents in a sense the distillation of these rival groupings, with its own established place in the Fund structure. But its immediate task is limited to the negotiation of monetary reform.

A further development along this line that has been proposed is to draw on the experience and membership of the committee to create a "Superboard" in the regular functioning of the IMF. Thus the regular IMF Executive Board could hold periodic meetings, e.g. quarterly, to consider major issues of policy; at these meetings, officials of the level of deputies of the Committee of Twenty would normally attend, perhaps as Executive Directors alongside the "permanent" director. It could be left to individual countries and "constituencies" to determine their own arrangements for representation, according to their circumstances and the personalities involved. A variety of other formal procedures can be envisaged to produce a similar arrangement. The matters to be discussed at such high-level meetings would include not only developments in global reserves and their implication for SDR allocations, but also reviews of the situations of the major countries as a basis for the collective review of the exchange rate structure. These reviews would in turn lead to the assessments, pressures and possible sanctions that were provided for under provisions of the exchange rate regime.

Any important organizational innovation raises sensitive issues and acute controversy. The concept of the IMF Superboard, meeting quarterly or perhaps more frequently, offers several clear advantages, and is perhaps the most effective means of meeting the complex of requirements involved that can be envisaged. It would maintain the universal character of top level decision making in the international monetary system, and it would open the possibility for formation of more compact but still representative top level bodies in the form of subcommittees or steering committees. It would integrate the high-level decision body with the Executive Directors of the Fund; and it would integrate the work of the Fund staff. In these ways, a solution to an organizational problem that has dogged the Fund from its beginnings may be in sight.

At the same time, this solution would have clear advantages of efficiency over an alternative proposal for making the IMF more responsive to national political forces – viz, politicisation of the Fund's management through several appointees representing major countries or groups at the level of deputy or assistant managing director.

An IMF Superboard would have one additional benefit. It would help to concentrate the work of the Fund more intensively on the particular problem of helping to accommodate the external effects of the domestic

actions that result from the policies adopted by the Fund's member countries. It is in the reconciliation of such domestic policies, rather than in attempting to exert major influence on these policies themselves, that the future of the Fund almost certainly lies in the period ahead.

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