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International Monetary Reforms

In retrospect and prospect



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INTERNATIONAL
MONETARY REFORMS

IN RETROSPECT AND PROSPECT

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PREFACE

The reform of the international monetary system has been under debate for more than a decade. The inherent deficiencies and contradictions of the system established at Bretton Woods have been well understood and documented even before this; but the international political will to undertake necessary structural change could not be mobilised. Instead a series of patch work modifications kept the system in operation, albeit not very effectively, until the action taken by the United States in 1971 removed its essential underpinnings.

The dramatic changes in the international economy introduced by the increase in oil prices brought a halt to the work of the Committee of Twenty on Monetary Reform. In retrospect, it may appear that the stoppage was premature and that the return to ad hoc adjustments and changes, such as were agreed by the Interim Committee at their meeting in Jamaica in 1976, was unwise. Certainly there is no consensus that the changes introduced in Jamaica dealt with the fundamentals of the requirements of a monetary system which could service the needs of the evolving international economy, particularly in the context of the more widespread concern for alleviating the position of the poorest countries. Indeed more than one observer has seen in recent developments a movement away from an international monetary system.

In order to assist countries in taking an overall view of the current stage of the dialogue and to put the recent agreements into the wider perspectives encompassed in the New International Economic Order, the Commonwealth Secretariat commissioned a paper on "International Monetary Reforms in Retrospect and Prospect". This paper was considered by Commonwealth Finance Ministers when they met in Hong Kong in September 1976. It is being published as a contribution to the on-going dialogue on this important subject.

The views expressed in the study are those of the author and are not necessarily those of the Commonwealth Secretariat.

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INTERNATIONAL MONETARY REFORMS

In retrospect and Prospect

I.S. Gulati *

This paper is divided into three parts. In the first part the working of the monetary system that was set up after World War II is reviewed in order to highlight the factors which eventually brought about its collapse. In the second part are taken up the major elements of the new monetary system that is sought to be put in place. The last part concentrates on the major questions which remain unresolved.

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The Par Value System: its working and collapse

It was the agreement reached at Bretton Woods in 1944 that governed the international monetary relations since the end of World War II. Under this agreement, each member country undertook to maintain the par value of its currency in terms of gold or the U.S. dollar so that until the par value of currency was changed its exchange rates with other currencies remained fixed. Variations of upto 1% on either side were only allowed. It was also under this agreement that the International Monetary Fund was set up with a view to overseeing the par value system. The system did envisage larger changes in par values but in consultation with the Fund and that too only when the balance of payments of a country was in "fundamental disequilibrium", a situation that was never clearly defined.

Since the par value of currencies was to be set in terms of gold or the U.S. dollar, it naturally followed that the par value of the dollar had to be set in terms of only gold. This naturally placed the U.S. dollar in a class by itself. It also meant that the U.S. obligation, as member country, was to maintain the dollar's gold par value until its balance of payments was in fundamental disequilibrium.

Currency
Reserves

Under the Bretton Woods agreement, gold was given clearly the position of the ultimate reserve asset. The role of the dollar, however, as an international reserve asset was not spelt out though it was clearly identified as the single most important currency. The two sources of international reserves explicitly provided for in the agreement were to be monetary gold - the old stock and annual additions thereto - and the pool of national currencies to be created in the hands of the Fund through quota subscriptions by member countries. (In addition, there was a provision for the increase in the price of gold but it was never invoked, not until 1971 when the system itself broke down). Indeed, it was possibly because the sources of international liquidity explicitly provided for in the system, as originally conceived, proved quite inadequate that the reserve needs of the expanding world trade had to be met very largely by the growth of currency reserves. In the event the growth was predominantly of the dollar reserves and the dollar emerged as the key reserve currency.¹

There lay within this development however the seeds for the destruction of the international monetary system. Professor Robert Triffin predicted in 1960, in his now famous book, Gold and the Dollar Crisis, that with the U.S. stock of monetary gold growing at a slower rate - indeed the U.S. gold holdings fell during eight out of ten years in the 1950's - than her stock of dollar obligations abroad, there was bound to occur a "crisis of confidence" in the dollar. In fact, the 1960's did witness this erosion of confidence in the dollar and as the years rolled by the situation became more and more difficult for the dollar so that ultimately in March 1968 the attempt to maintain the price of gold in the market was given up.² This certainly could not have improved the confidence in the dollar; if anything it was undermined further so that in August 1971 the U.S.A. was forced to withdraw altogether its commitment to

convert even the official dollar holdings of other countries into gold. Later, towards the end of 1971, the dollar underwent its first devaluation to be followed by the second devaluation in February 1973 which lasted only a month, for confidence in dollar never revived. Thereafter, fixed exchange rates among the major currencies were altogether abandoned and the par value system gave way to a regime dominated by flexible exchange rates.

It was inherent in the system that as the confidence in the currency reserves was undermined, the faith in gold reserves would improve - this would happen regardless of the prevailing price of gold in the market - and therefore, make monetary authorities reluctant to part with their gold holdings. Thus monetary gold became increasingly immobile during the period of the par value regime.

Reverting to currency reserves, more specifically dollar, whatever the liquidity needs of the par value system, the dollar could not have emerged as the major source of international liquidity until and unless the U.S.A. either ran a balance of payments deficit or made investments abroad or, of course, did both in some combination.³ If the U.S.A. were not so prepared the world monetary system would have been forced to find a different (and probably better) solution to the problem of liquidity shortage. In any case, the use of a national currency as a major source of reserve assets for the world introduced, as Professor Triffin has pointed out, "a highly erratic and unpredictable factor both in the much vaunted mechanism of balance of payments adjustment and in the actual pace of growth or contraction of the world reserve pool".⁴ It also placed on the reserve currency country obligations that it ultimately found to be onerous, notwithstanding the gains that accrued to the country concerned, in the form of real resource transfer.⁵

Fund,
International
Liquidity and
SDRs

Right at Bretton Woods, there was a proposal - the Keynes Plan (1943) - for the creation of deposit liabilities by an international agency, to be called International Clearing Union, to extend credit to countries in deficit, which would be accepted by countries in surplus as international reserves. The proposal was found unacceptable however and instead, as was stated above, it was decided to create a pool of national currencies with the Fund by quota subscriptions. The Fund was supposed to exchange limited amounts of the currencies of the surplus countries in the pool against national currencies of countries in deficit.⁶ Subsequently, attempts were made to expand international liquidity further by various arrangements,⁷ including the increase of the members' quotas with the Fund. The first such quota increase took place in 1958. In 1969, an agreement was however reached for the creation by the Fund of deposits, to be given the name Special Drawing Rights (SDRs), to the tune of \$9.5 billion over a 3-year period, 1970 to 1972. These deposits were to be denominated in gold and allocated to the members in the same proportions as their quotas. By deciding however, to allocate the SDRs to members according to their quotas, the Fund was being denied the discretion to use these deposits to meet the liquidity needs of the member countries, as and when they were in balance of payments deficit. On the other hand, it was being left to the member countries to decide when and where to use these deposits. Naturally, as Professor Machlup has pointed out, it meant that while the part of the newly created SDRs going to deficit countries "will have a quick first round of spending", "a large part of these unearned reserves will never be used in even a first round of spending".⁸

It is important to note also that when it was agreed to create SDRs the ratio of total international reserves to world imports had already declined from 0.74 in 1954 to 0.33 in 1968, even though the nominal value of these reserves had risen by 39 per cent during this period; of this nominal increase, almost two-thirds were in the form of reserve currency holdings. Clearly, in spite of the contribution of currency reserves to world liquidity, the growth in reserves had not kept pace with the growth in world trade. What the agreement to create SDRs actually sought to do was to so supplement the total world liquidity that SDRs, together with the likely increases in other reserves, would keep the ratio of total reserves to world imports more or less constant over the next 3 to 5 years.⁹ Thus the target of \$9.5 billion set for the creation of SDRs during 1970-72 was quite a modest one; still it was considered enough to prevent the dependence of the world monetary system on the creation of currency reserves from increasing further.

In actual fact, the increase in total international reserves between 1969 and 1972 turned out to be so very large that it completely eclipsed the creation of SDRs. As against \$78 billion at the end of the 1969, the total international reserves stood at \$92.4 billion at the end of 1970 and \$158 billion at the end of 1972. After allowing for the decline in monetary gold, the increase in currency reserves was seven times larger than the SDRs created during these three years.

During 1973, international reserves expanded by a further \$24 billion.¹⁰ So even before the sharp increase in oil prices in the last quarter of 1973, a phenomenally large expansion had taken place in international reserves, nine-tenths of which were fed from the expansion in currency holdings. During the years 1974 and 1975, the increases in international reserves were of the order of a further \$36 billion and \$18 billion respectively. Of this \$54 billion, 15 per cent was accounted for by the increase in the members' reserve positions with the Fund and the balance by currency holdings. In the face of such substantial, but unforeseen¹¹ increases in currency - largely dollar - reserves, the creation of SDRs became virtually a non-event, in quantitative terms at least. Its larger significance lay however in that for once the international community, particularly the influential group of ten industrial countries, could agree to the creation of credit under international auspices.

Increase in
Liquidity,
1971 - 75

While the international reserve increases of the world during the past five years, 1971 to 1975 (both inclusive), were fed to the extent of more than nine-tenths by currency reserves, the underlying forces were not the same throughout these years. To identify the different forces we must divide the quinquennium into two parts: (1) 1971 to 1973, the period before the sharp rise in oil prices and (2) 1974 and 1975. The increase in reserves by \$89 billion in the first part of the quinquennium accrued very largely to the industrial countries, other than the U.S.A. and the U.K. The increase by \$54 billion in the second part accrued almost entirely to the oil exporting countries. But while the latter is easily explained in terms of the sharp improvement in the export earnings of the oil exporting countries much of which they could not absorb in increased imports,¹² the former cannot all be explained in terms of changes in the balance on current account of the deficit industrial countries, viz., the U.S.A. and U.K. There also took place sizeable movements of short-term capital between the industrial countries during the first

part of the quinquennium when the dollar was under considerable speculative pressure, the pressure that led first to its being taken off gold and later to its being floated.¹³

The important point to note, in the present context, is that while during the first part of the quinquennium it was the weakness of the dollar that led to the expansion of dollar liabilities abroad, in the second part of the quinquennium the increase in the dollar holdings abroad was a reflection of its newly acquired strength. The dollar gained strength from the fact that the world's new principal creditors, viz., the oil exporting countries, desired to keep their surplus earnings largely in the form of dollar holdings.

Another, but related, aspect of the growth of international reserves in the second part of the quinquennium, 1974-1975, was that the rise in the reserves of the oil exporting countries did not cause a decline in the existing reserves of the major oil importing countries. Instead, new reserves were created chiefly through a process involving (1) placement of reserve deposits in the Euro-currency markets or the United States by the oil exporting countries; and (2) borrowing from those markets by the oil importing countries. In the circumstances, it was possible for the reserves paid out by the latter to be fully replenished through borrowing, so that virtually the entire growth of reserves of the oil surplus countries could come from the creation of new dollar reserves.¹⁴

The Advent of Managed Floating

The circumstances in which the dollar was first taken off gold and later made to float have been referred to already. With the floating of the dollar in March 1973, went completely overboard the par value system that was set up in 1944. A variety of exchange regimes came to be adopted thereafter. Although the majority of the countries have since continued to 'peg' their currencies, the countries which have taken to floating (independently or jointly) account for some 70 per cent of the world trade. All industrial countries belong to the latter group. On the other hand, the developing countries overwhelmingly have tried to keep a fixed link, largely with the currency in which they traditionally intervened in the exchange market. A few, however, of the developing countries have chosen instead to use 'composite pegs', either their own or the SDR, which too had been delinked from gold and linked instead to a composite basket of 16 major currencies in mid-1974. This latter group of developing countries, though numerically smaller, accounts for almost half the trade of the developing countries as a group. Thus even though the majority of the countries continues to operate on the basis of fixed exchange rate (here, however, one must be cautious in the use of the term 'fixed exchange rate' because even when a currency is pegged either to a currency which itself is floating or to a composite basket of floating currencies, the exchange rate of the pegged currency cannot strictly be considered fixed), the fact cannot be overlooked that the countries accounting for the bulk of the world trade have now been floating for almost three years.

Floating exchange rates have not been entirely free however because virtually all the floating currencies have been subject to varying degrees of management through official interventions. Whether the system of managed floating that has prevailed over the past three years or so has been more effective than the par value system would have been in coping with the various developments of this

period, however short, is a matter of judgement. It was during this period however, that the oil prices were quadrupled and the industrial countries, which also are now the countries with floating currencies, had to go through a very severe recession, with no less serious repercussions on the economic activity in the developing countries, even though the latter had pegged their currencies. Alongside, fluctuations in exchange rates during this period were quite erratic and expansion in foreign exchange reserves was, as was pointed out above, quite phenomenal. All the same, allowance has to be made for the fact that during two out of the three years that exchange rates have been floating the demand for additional reserves derived very largely from the extra-ordinary surpluses accruing to the oil exporters. On the other hand, as was stated above, a good part of the large expansion that took place in the foreign exchange reserves of the world during 1971 and 1972 (i.e., in the two years immediately preceding) when fixed exchange rates prevailed can be attributed to the pressure of speculative demand generated by large movements of short-term capital. But that represented an unusual phase, indeed the dying phase as it turned out, of the fixed exchange rate regime. So on the experience of this short period of exchange rate rigidity followed by flexibility, it is difficult to reject or accept the claim that exchange rate flexibility leads to economy in liquidity.¹⁵ If one took the period, 1950 to 1969, when the fixed exchange rate regime was firmly entrenched, the international reserves grew at the average annual rate of less than 3 per cent¹⁶ which cannot, by any means, be considered large, as compared to 22 per cent average growth in the following five years. Thus only when doubts arose about the future of the regime itself that the reserve needs of the system shot up. So, could not one claim that the normal reserve needs of even a fixed rate regime can be quite modest?

Relative
Scarcity of
Gold
Inevitable

The principal problem of the par value system lay not however, in that it was a system of fixed exchange rates but in that under it while gold was to be the ultimate reserve asset, one or few national currencies were to meet the expanding requirement of the system for reserve assets over time. The creation of such currency reserves involved as, Professor Triffin the "losses of Sovereignty" for both the creditor and debtor countries.¹⁷ Apart from the one (or few) reserve generating debtor countries (Triffin is concerned about in this context), there are also a very large number of other debtor countries who have to search around for credits, largely bilateral, with a view to financing their balance of payments deficits. In this case, the threat to sovereignty is even more real and immediate.

Much more damaging to the system, however, was the likelihood of the currency component of the international reserves becoming over time relatively much less scarce than gold. This would make the creditor countries want to hold as much of their reserves as possible in gold. At the same time, the debtor countries would want to hold on to whatever gold they have in their monetary reserves. True, one way of meeting this problem was to raise the price of gold from time to time. But the danger was that once the expectations of a price rise start building up they would accelerate speculation. Indeed, one possible explanation why the provision in the Bretton Woods agreement for raising the price of gold was kept in cold storage for all these years could be this.

Emergence of
Euro-dollar
Market

A review of the international monetary developments since World War II will not be complete if it does not refer to the astonishing growth of the Euro-dollar market, particu-

larly in recent past. (Euro-dollar is the term used for all deposits denominated in foreign currencies, with dollar accounting for about three-fourths of the total). By the end of 1975, when official holdings of currency reserves amounted to \$170 billion Euro-dollar deposits exceeded \$250 billion; they amounted to \$150 billion at the end of 1973, \$60 billion at the end of 1970 and only \$1 billion ten years earlier. Of the total traceable international bank lending today, Euro-dollar market lending is said to account for 70 per cent. Lately, this market has been used also by the Central Banks for the placement of their surplus reserve holdings. More recently, oil exporting countries have used this market in a big way. The end result has been that of the increase in official holdings of foreign exchange in 1974, one-half was accounted for by official holdings of Euro-dollars, with the dollar denominated holdings taking up 95 per cent of the increase.¹⁸ Of course, while the countries with surplus reserves made placements in the Euro-dollar market, the deficit countries went to it to borrow and these included some developing countries as well, though most of the latter were relatively higher-income countries.

The point of immediate relevance however is that the Euro-dollar market which has by now grown, almost unfettered by regulations, to an enormous size and plays a significant role in balance of payments financing has also been the principal channel of short-term capital (hot money) flows across national frontiers. These flows had possibly the most de-stabilising impact on exchange rates, particularly during the period 1968 to 1973.

An Overview

What is the sort of picture that emerges from the above review of the international monetary developments over the past quarter century or so? The par value system set up at Bretton Woods collapsed under the weight of its own creations, viz., the monetary gold and dollar reserves. Gold which had been given the pride of place as the basic reserve asset of the par value system had virtually been immobilized as a monetary reserve. Its official price was found to be low both because it had become relatively more scarce as a reserve asset for the monetary authorities and also because the non-monetary (including speculative) demand for gold had been rising all along and at a much faster pace than its output. As for the dollar reserves, those who had collected these reserves in sizeable quantities were unhappy. But no less unhappy became those who owed them. When he took the dollar off gold in August 1971, President Nixon told the U.S. Congress: "The time is past for the United States to compete with one hand tied behind her back".

So the demise of the par value system was only to be expected with just the developing countries shedding tears though not because they were the beneficiaries of the system in any substantial way but largely because its going away would add to their uncertainties. There can be no difference on the view that floating of the major currencies over the past three years introduced, as the IMF Annual Report 1975 put it, a new type of uncertainty into their exchange rates with these major currencies and thereby in their balance of payments against which too the developing countries might find themselves almost helpless.

CHAPTER II

The Jamaica Agreement

International Exchange arrangements that have been operating since March 1973 were stop-gap arrangements meant to fill the void created by the collapse of the par value system. The dominant characteristic of these exchange arrangements has generally been described as managed floating under which monetary authorities of the floating currencies intervened in the exchange market. Still as the IMF Annual Report 1975 points out, very short-term movements in exchange rates have been quite sharp and erratic on a number of occasions, during the past three years. Even movements of somewhat longer duration were probably in some cases greater than could be justified on the basis of changes in the underlying economic conditions.

Though the exchange arrangements of the past three years were not strictly legal in the sense that they did not conform to the tenets of the one and only international monetary system that was still supposed to formally prevail, mutual inter-country consultation and cooperation, among the Group of Ten in particular, was continued. Even the Fund came out with its guidelines on floating. Efforts to provide a new framework for international exchange arrangements also continued and an agreement was reached in January 1976 at Jamaica.

Floating
Legalised

According to this agreement, while member countries are given the freedom to adopt the exchange arrangement of their choice they must at the same time "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates". The members are also required to avoid manipulation of exchange rates either to prevent effective balance of payments adjustment or to gain an unfair advantage over other members. To ensure their compliance, the Fund has been asked to exercise "firm surveillance over the exchange rate policies of the members" and to adopt guidelines with respect to these policies.

Thus while the Jamaica agreement can be said to ratify the system of managed floating which had already come into existence, it does allow for the possibility that the international monetary system might one day get back to a par value system with stable but adjustable exchange rates. But that could happen only if a large majority, 85 per cent of voting power, decides that conditions exist for such a system to work satisfactorily. Even then however, any member country retains the freedom to maintain for its own currency different exchange arrangements of its own choosing.¹⁹

Of the other main points, which the agreement at Jamaica covered in addition to the exchange rate arrangements, one was the monetary role of gold and the other was the role of the SDRs. Both of these points, as we shall see presently, are closely inter-related. Then there was the agreement on the increase in the members' quotas in the Fund.

Gold Clauses

A number of decisions were taken on the future monetary role of gold. It was agreed that the official price of gold will be abolished. When the dollar went off gold in

early 1971, the official price of gold meant virtually nothing but since March 1973, even the fiction of an official dollar price of gold was done away with. Still the monetary authorities were continuing to value their gold holdings at the 1973 dollar price. What was now endorsed at Jamaica was to abandon this practice of valuing monetary gold at a price other than the market price.

The much more important decision on gold was that it would no longer be the common denominator of the par value system (i.e., if any were established); nor were the SDRs to be denominated in gold. In fact, the value of SDRs was already being expressed, for two years now, in terms of package of 16 major currencies. These are the currencies of countries with a share of world exports in excess of 1 per cent on average over the five-year period from 1968 to 1972.

It was agreed at the same time to dispense with the obligation to use gold in transactions with the Fund. This included the requirement so far to pay 25 per cent of the quota in gold. So the quota increase agreed upon at Jamaica did not carry the gold obligation.

It was decided also that the Fund will gradually dispose of its gold holding. A beginning in that direction would be made by disposing of one-third of the Fund's gold in the first four years, half of it by sale in the market and half by restitution to members. The profit made on the portion sold would be set apart in a Trust Fund for giving balance of payments assistance to countries with 1973 per capita income of SDR 300 or less.²⁰ As for the balance of two-thirds of the Fund's gold holding, there would be enabling provisions for its disposal also but actual disposal would be done on the basis of 85% majority decision. One of the possibilities envisaged is that the Fund might decide, by 85% majority of course, to use the profit on sale of this remaining two-thirds of its gold for the general operations of the Fund and at the same time increase correspondingly the quotas of all the countries.

The underlying purpose of the various decisions reached on gold was undoubtedly to effectively reduce the monetary role of gold. In this context, a formal note also was taken at Jamaica that the Group of Ten had already agreed not to peg the price of gold and also not to increase the total stock of gold with the Fund and the monetary authorities. But it could not be overlooked that (a) this agreement among industrial countries was subject to review after two years and (b) since in the changed situation, i.e., after the abolition of the official price of gold, the members were free to deal in gold, there was nothing to prevent the principal holders of monetary gold from agreeing after two years to peg the price of gold. Even if the U.S.A. does not join this group, the others with 60 per cent of monetary gold will be strong enough to make an effective start towards pegging gold. Whatever one may think of the eventual fate of gold as a monetary reserve, the prospect of a serious attempt for a return to gold in the near future cannot therefore be ruled out altogether.

Misgivings of the Poor

The developing countries too were not very happy with the agreements reached on gold. They were concerned that the decision to abolish the official price of gold would, by enabling the monetary authorities to revalue their holdings, lead to an unjustified increase in international liquidity in the hands of countries least in need of larger resources. According to the prevailing market price of gold, the total volume of international liquidity could easily expand as a

result of the gold revaluation by about 40 per cent. The distribution of the new liquidity thus created would be extremely regressive since the bulk of it would accrue to industrial countries which together accounted for some 84 per cent of the monetary gold towards the end of 1975. Even from the narrow point of view of balance of payments needs, while the worst sufferers of the past few years have been developing countries (the current account deficit of the non-oil exporting developing countries in 1974 was \$28 billion as against the deficit of the industrial countries of \$11 billion; in 1975 while the industrial countries showed a collective surplus of \$15 billion, the non-oil exporting developing countries showed a rise in their deficit to \$35 billion) the gains in liquidity from gold revaluation are to go largely to the developed countries, and even among them to the ones with large gold stocks.

However, it is the lack of a firm provision in the Jamaica Agreement which could bind the monetary authorities both not to peg the price of gold and also to reduce their stock of monetary gold gradually that will turn out to be decisive for the future monetary role of gold. Even if the major holders of monetary gold do not decide after two years to peg the price of gold, the fact that they will still be holding large quantities will be enough to keep them pressing for a continuing role for gold in the world monetary system. It is in this context that the matter of the massive injection of liquidity through gold revaluation into the international monetary system assumes very much larger significance.

The Role of SDRs

It was agreed at Jamaica that hereafter the SDR, and not gold, will be the principal reserve asset of the international monetary system. It is significant however that no steps were envisaged to enlarge the volume of SDRs, either immediately or in the foreseeable future. One major argument, spoken or not, against any such enlargement in the supply of SDRs is not difficult to surmise and that must have been the existence already of such large international liquidity, particularly after the revaluation of monetary gold. So right at the outset gold came in the way of SDRs. Already, the SDRs in existence were too small a percentage of total global reserves (only 4.5% in 1975); with gold revaluation the percentage will be even smaller (less than 3%). In the circumstances, it is only a bold person who would expect that the SDRs could still play a pivotal role in a system of international liquidity control, even though they were not - in terms of quantity - the main reserve asset.²¹

It is true that several provisions were made at Jamaica to make SDRs more extensively usable from immediate effect. It has already become the Fund's unit of account. Members will hereafter have full freedom to engage in transactions in SDRs with each other without limitation and also without having to meet the test of need that was being applied in the past. There will also be greater scope for other official entities to hold and use SDRs in a broad range of transactions. At the same time, the possible uses of SDRs in the operations and transactions of the Fund will be expanded.

It is true also that even outside of the monetary system, the SDR unit is coming into use in a variety of ways. For example, airlines are adopting the SDR for calculating air fares and banks are floating loans denominated in SDR.

All the same, it is difficult not to feel that the faith professed at Jamaica in SDR becoming the principal reserve asset of the international monetary system was not matched

by adequate concrete steps in that direction. The path leading towards that objective is going to be therefore quite a difficult one and gold will possibly be the principal obstacle to be reckoned with. But as we note below there could be another impediment which might arise from the attitude of the reserve centres of the new system.

Quota
Increase

Though it was not strictly a part of the reform package, it was decided also at Jamaica that the quotas should be raised by 32.5 per cent from SDR 29 billion to 39 billion. However, since this increase in quotas could take time to come into effect, it was agreed to increase temporarily the credit tranches by 45 per cent so that access to credit for all members was increased immediately. As was stated above, it will no longer be necessary for the members to pay 25 per cent of the quota increase in gold. This 'gold portion' may be paid in SDRs, in the currencies of the other members specified by the Fund, subject to their concurrence or even in the members' own currency without an obligation to repurchase.

Reserve
Currency
Role

It was in this context of the increase in quotas however that it was underlined that since an important purpose of increasing quotas was to strengthen the Fund's liquidity, an obligation should be placed on all members to make arrangements so that their currencies in the Fund are usable in Fund transactions. Since in actual practice, only a few currencies could be expected to become usable in this sense, the Fund developed the concept of a "freely usable currency" which (1) was in fact widely used to make payments in international transactions and (2) was widely traded in the principal exchange markets. Naturally, only a few currencies will meet these two tests. But all members will have the obligation to exchange their currencies purchased from the Fund, or needed to make repurchases, for the freely usable currencies.

In the context of the reform of the international monetary system, the concept of a freely usable currency is not materially different from the old concept of the reserve currency. Not that the reserve currencies would not be there or that their role could altogether be extinguished, but the formal introduction of the concept of a freely usable currency does enrobe a few currencies - the U.S. dollar in particular - for playing the role of reserve assets of the Fund and the monetary authorities and this time this privilege will be enjoyed by the reserve currency countries without the obligation which they had to enter into under the Bretton Woods system, namely to keep their exchange rate stable. So the reserve currency countries have everything to gain under the new system and nothing to lose. In the circumstances, they too are bound to oppose any substantive expansion of SDRs or even other forms of multilateral liquidity. The anti-SDR lobby is going to be strong indeed hereafter.

With gold stocks of the monetary authorities likely to remain virtually frozen in spite of revaluation, with no expansion in the volume of SDRs, and with only the reserve positions of the members likely to increase by SDR 2.5 billion in a period of at least three years, the field is open entirely to the reserve currencies. In this connection it is relevant to recall that already during the past three years of managed floating more than nine-tenths of the total increase by \$78 billion in international reserves was accounted for by currency reserves, by and large dollar reserves.

An Overview
of the New
Package

So we can now put together the major pieces of the new international monetary system as conceived at Jamaica. To start with the exchange rate, the members will have the freedom to choose the exchange arrangement of their liking but they are obliged to collaborate with the Fund and among themselves to maintain orderly exchange arrangements and to promote a stable system of exchange rates. The Fund is given in this connection the authority to exercise 'firm surveillance' over the exchange rate policies of members. As for international liquidity to buttress the new system, while it is sought to reduce the monetary role of gold - the formal abolition of the official price of gold and the reduction of the Fund's gold holding by one-third are two major steps taken in that direction - it appears unlikely that the position of gold will be affected considerably. In fact, with revaluation of monetary gold, the proportion of international reserve accounted for by gold will immediately go up from 18 per cent in 1975 to nearly 40 per cent. The SDR, with all the pious talk of members' obligations to make it the principal reserve asset, will be in limbo. Whatever liquidity needs are not satisfied by the revaluation of gold held by monetary authorities will be met (to some extent no doubt, by the Fund but) very largely through the creation of currency reserves.

Whether these currency reserves are created directly by the monetary authorities of the reserve centres, or indirectly through the Euro-dollar market which, as already stated, is by now very strongly entrenched is a different matter. But there can be no doubt that this market is going to play quite an important role in balance of payments financing in the coming years. The parallel with the 1944 Bretton Woods arrangement can still not be missed in so far as the reserve centres are concerned. Then too the dollar's reserve currency role was not spelt out clearly. And because the role of the reserve centres was not clearly spelt out no provisions were made for controlling the creation of reserves by them. The problem of inequitable distribution of the real resource transfer involved in the creation of currency reserves was, of course, far from the minds of the authors of the Bretton Woods agreement. But what about the international policy makers of 1976? They too have avoided facing squarely the question of reserve creation by the reserve centres. In the current context, they seem to have closed their eyes also to the virtually unregulated activities of the Euro-dollar market. These matters are highly pertinent regardless of one's position today on the inequity of real resource transfer involved in these operations.

Sop for the
Poor

The one decision at Jamaica that made some attempt at correcting the highly regressive distribution of the gains arising from the working of the international monetary system concerned the establishment of the Trust Fund out of the profit on the sale of one-sixth of the Fund's gold for giving balance of payments assistance to the low-income developing countries. Assistance out of this Fund is however unlikely to amount to more than \$500 million a year over the next four years. Compare this with the estimated balance of payments deficit of the non-oil exporting developing countries of \$35 billion for 1975 and their projected deficit of \$32 billion for 1976.²²

Another measure decided upon at Jamaica with developing countries specifically in mind was the liberalization of what is called the Compensatory Financing Facility designed to assist primary produce exporters faced with a sudden decline in export earnings. Liberalizing changes have been made (1) to take account of the effects of inflation and

(2) to increase access to compensatory financing by raising the quota related limits. This assistance, though linked to quota, was over and above a member's access to credit branches. This decision too will perhaps alleviate somewhat the position of the developing countries but, to keep one's perspective, it is necessary to note that in the 12 years of the facility's existence the total balance of payments assistance extended under its auspices added up to a little over \$1 billion. So, even a several fold increase in this facility could not play more than a marginal role in providing balance of payments support to the non-oil developing countries.*

In the circumstances, it will not be an unfair assessment to say that the new monetary arrangements agreed upon at Jamaica go hardly any distance to meet the balance of payments problems of the poor three-fourths of the world. Their struggle for much more equitable monetary arrangements has, therefore, to go on.

* in 1976 drawings from this facility amounted to \$ 1.7 billion.

CHAPTER III

Agenda for the Future

What is it that remains to be done now that the new monetary system, as the U.S. Treasury Secretary William Simon called it, has been ushered in?

The significance of the Jamaica decisions, it appears to us, lay less in that in a new and fundamentally different situation which had emerged with respect to exchange rates the Governments could at last agree to give every country the freedom to choose its own exchange arrangement. The significance of the Jamaica decisions lay really in that the Governments sought to sweep under the carpet the major questions relating to liquidity, including the apportionment of the gains of liquidity creating.

Creation of New Reserves

Whatever may be one's assessment of the liquidity needs of a monetary system based largely on floating exchange rates, as opposed to the liquidity needs of a par value system, the fact cannot be ignored that at the time of the Jamaica Agreement the ratio of total monetary reserves to aggregate imports, after revaluation of monetary gold, could not have been higher than 0.30. Compare this to the corresponding ratio of 0.70 in the early 50s and 0.50 in the early 60s. Now, it is certainly possible that the reserve needs of the new monetary system will be lower not only because of the flexible exchange rates but also because of the far greater access, now than ever before, to international capital market for balance of payments financing. Let us accept that the reserve needs will be lower hereafter on both these counts. Let us also assume that the ratio of reserves to imports need be only around 0.25. If world trade expands hereafter at the rate of only 5 per cent in real terms - the lowest rate in any one year since 1970 - the ratio of 0.25 will have been reached in 1979. If we assume instead that the average rate of growth of world trade in real terms will be 8.5 per cent as in the 1960s, then the ratio of 0.25 will have been crossed in mid-1978.

In the above calculations, no allowance is made for the increase in price of either traded goods or gold. The gold price will have to keep rising at two and a half times the rate of increase in world trade, in terms of value, in order to keep the ratio of reserves to world trade constant. This, of course, assumes that gold revaluation alone carried the responsibility of augmenting the monetary reserves - an assumption which goes absolutely contrary to the proposed objective of reducing the monetary rate of gold. There is, at the same time, another aspect of a continuing gold revaluation which is that once the expectation of price rise is built in, it will immobilize the monetary gold stocks and therefore increase the need for non-gold reserves.

So the question of the non-gold component of monetary reserves will be important even under the new monetary system. This brings us to the SDRs. At Jamaica, the matter of expanding the SDRs was simply not mentioned. Right from the start of the discussions on SDRs in mid-60s, the ghost of inflation was always haunting the deliberations. The increasing needs for liquidity have come to be met in the process by either the deficits of the reserve centres or,

more recently, the creation of credit by the Euro-dollar market. Both of these sources of credit are subject however to virtually no international control and regulations. But the lesson has still not been drawn that the creation of credit under proper international auspices would be far more restrained and therefore much less inflationary as well as destabilising. The point remains that while everybody seemed to agree that the SDR should be made the principal reserve asset of the new monetary system, the one concrete step necessary to ensure this viz., the continuing expansion of SDRs, controlled but adequate, to meet the genuine non-inflationary needs of the world trade under the new monetary system, was completely omitted.

True that it was agreed in Jamaica to increase the quotas in the Fund by 32.5 per cent and that, as a consequence, increased Fund credit will be available to members. But let us not ignore the difference between Fund credit and other liquidity including SDRs, namely that the Fund credit, even in the first credit tranche, has a certain measure of conditionality attached to it.²³

Now if monetary gold, in spite of its immediate revaluation after the Jamaica Agreement, remains immobilised and since the SDRs have been assigned no role to meet the increase in the liquidity needs of the new monetary system, it follows that these needs will have to be met entirely out of the creation of what the Fund has now chosen to call freely usable currencies but which are really the same as reserve currencies at the old system. True, all the members agreed at Jamaica that the Fund should try to make use of as large a number of currencies in its operations and transactions in the future as possible; it is most unlikely however that more than a few currencies will actually be so used by the Fund.²⁴ What is no less important is that even between the few freely usable currencies, there is nothing in the new system to prevent the emergence once again of one dominant currency. In fact, under the new system where there is no obligation to convert one's currency holding abroad into gold, the reserve currency country need not be unduly perturbed at expansion of its currency liabilities abroad. Of course, this lack of concern might not ultimately be shared by the creditor countries which are accumulating reserves in the form of liabilities of one country, however economically strong and powerful the latter might be and however voluntary those accumulations may have been to start with. Even if these creditor countries do not have the choice then of converting their reserve currency holdings into gold the problem of impaired confidence in the accumulations of the reserve currency could still emerge. That indeed is probably going to be the soft part of the new system's underbelly.²⁵ But that precisely is the sort of situation which might well lead to a clamour for the return to gold as the principal reserve asset and to the virtual repetition of the scenario that evolved during the period, 1945 to 1969.

Regulation of
Euro-dollar
Market

To the extent that, on the one hand, balance of payments finance is provided by the Euro-dollar market and, on the other hand, monetary authorities keep their surplus reserves in that very market, it will be extremely important for the smooth functioning of the international monetary system that the Euro-dollar market works on an even keel. Its destabilizing impact could otherwise be large indeed. The question of international control over this market is therefore something that cannot be avoided for long.

As for the transfer of real resources involved in the creation of reserves, its regressive impact is bound to become more serious than in the past. The more the international monetary system relies on the creation of liquidity by a few countries, which are also usually the strongest and the richest, the more regressive is the resultant real resource transfer. As for the revaluation of gold, its regressiveness in the context of the present distribution of monetary gold is too obvious to stress.

There is however only one possibility, somewhat remote though, of some alleviation and that can eventuate if the oil exporting countries choose to deploy their reserve holdings differently than in recent past. The international monetary system, knew as much as the old one, gives these countries with surplus very little choice with respect to the placement of their reserves. Today, they face a monopsonistic credit market where few borrowers - with one very strong borrower in the lead though - can virtually dictate their terms to the lenders. But it is not difficult to devise a system, at the all-world level or at the group level, which would give these countries the opportunity to diversify their reserve placements. In the process, the inequalities as well the inefficiency of the real resource transfer involved in reserve creation to-day can also be reduced.²⁶ However, as things stand today, whatever transfer of real resources is involved in the creation of additional international liquidity will be very regressive under the new system.

It should be added also that the creation of international credit in the form of SDRs which are allocated in accordance with the present quotas in the Fund could, by no standard, be considered progressive with respect to real resource transfer. Still this method of creating additional liquidity whereby about one-quarter is allocated to the developing countries is less regressive than when the entire liquidity is created, directly or indirectly, on the basis of the deficit of one or two rich reserve centres. There can be no question therefore about where the interests of the developing countries would lie between SDR-based liquidity allocated on the basis of the quotas in the Fund and the liquidity created by the reserve centres or the non-resident branches of their commercial banks.

The Jamaica Agreement spoke about making SDRs the principal reserve asset, but not the only reserve asset, of the new monetary system. Therefore, even if it were possible to agree, in the near future, on an active role for SDRs in providing additional liquidity, it is unlikely that the SDRs newly created will meet more than a fraction of the additional liquidity needs of the system. So the problem of regressive resource transfer will still remain with us, and in quite a big way. Therefore, the problem of devising a more equitable as well as more efficient system of reserve creation will have to stay on the agenda for world monetary reform.

Conclusion

To sum up, Jamaica can at best be regarded as the beginning of reform. It must be followed up by decisions on gold, SDRs, reserve currency creation and the control of Euro-dollar market. Reform efforts over the coming months, and possibly years, must concentrate on these major issues and not get bogged down with less important issues. The major issues identified in this paper are also, we believe, the issues that should be of concern to the developing countries.

If demonetisation of gold can be accelerated, it should brighten the prospects of SDR creation and the more the liquidity needs of the new World monetary system are met through the creation of SDRs, rather than reserve currency creation the less regressive will the real resource transfer be. The international regulation of reserve currency creation, whether by monetary authorities or in the Euro-dollar market, should also serve the same purpose. One must add, however, that this order of priority will only ensure the minimum for the developing world. The developed world could do a lot more for its developing counterpart within the framework of the new monetary system if they were more generously disposed than to-day when even the minimum appears to elude.

NOTES AND REFERENCES

1. Herbert Grubel recounts this development as follows: "In the absence of an orderly provision of reserves by international agreement, the world developed a temporarily very successful gold exchange standard by accident. The United States emerged from the Second World War with an overwhelmingly dominant economy in terms of production, capacity and national wealth, including reserves of monetary gold. In the eyes of the rest of the world dollar holdings were more desirable than gold, since they were readily exchangeable into the metal and brought interest to their holders. During the 1950's U.S. balance-of-payments deficits were welcomed as a source from which the reconstructed nations of Western Europe could replenish their depleted stocks of international reserves. They did so, holding mostly dollars but also exchanging some of them for gold, thus reducing the U.S. gold stock. It has been argued and it is possibly correct that these deficits made possible the widespread return to convertability in 1958 and that they made a significant contribution to world prosperity after 1950. The United States had thus, without formal international agreement taken on the role of a World Banker and helped to sustain an efficient monetary system". International Monetary System, Efficiency and Practical Alternatives, Penguin Modern Economic Texts, 1969.

2. It was then decided to withdraw the support of monetary gold to the price in the market. Instead, a two tier system of pricing was announced. Thereby, the price of monetary gold remained fixed at the old level of \$35 an ounce but the price of non-monetary gold was left free to find its own level. The implications of this as well as subsequent developments with regard to monetary gold were reviewed by the present writer in his articles, (1) Changing Role of Gold (2) The Price of Gold (3) World Monetary Crisis and Underdeveloped Countries published in The Economic and Political Weekly of January 1970, January 1971 and October 1971 respectively.

3. Referring to the rather large U.S. balance of payments deficit in 1970 - \$10.7 billion - the London Times of May 17, 1971 complained that "Americans have gone on spending, investing and soldiering abroad as if the nation were still the overwhelming economic power that it was immediately after World War II". The point of the comment was that U.S. was able to spend and invest abroad not because it was any longer that dominant economically as immediately after World War II but on the basis of the savings of other nations wishing rather to hold dollars in official reserves than to allow their currencies to appreciate in terms of the dollar. Indeed, the phenomenal expansion in reserves during the period, 1968 to 1973, was due entirely on this latter account.

4. Robert Triffin, International Monetary System, Yesterday, Today and Tomorrow (1968) Random House, New York, p.87.

5. There is a strong tendency in some circles, however, to play down the gain accruing to a reserve centre from the acceptance abroad of its short-term liabilities as reserves. (See for instance) H.G. Johnson, Theoretical Problems of the International Monetary system in R.N. Cooper (xx.) International Finance (Penguin 1969). However, as Grubel (Op-cit) points out the real resource transfer involved in the process is not only regressive but inefficient.
6. As F. Machlup has pointed out, "the 'sale' of currencies of countries in surplus, out of the Fund's holding, against currencies of countries in deficit, with the obligation of the latter countries to 'repurchase' their own currencies with convertible currencies is only a lending operation described in fancy terminology" and it reduces the Fund to a warehouse or cloakroom. The Cloakroom Rule of International Reserves: Reserve Creation and Resource Transfer, in R.N. Cooper, International Finance, (Penguin 1969).
7. Triffin speaks in this context of the 'bewildering overlapping' of quota increases, general arrangements to borrow, bilateral swaps, swap standbys and the rest. Op. cit; p.59.
8. F. Machlup, Op. cit., p.350.
9. Proposal by the Managing Director on the Allocation of Special Drawing Rights for the First Basic Period, IMF, International Reserves, Needs and Availability, 1970.
10. Revalued in terms of SDR, the increase in total international reserves works out to be rather misleadingly small for 1973. H. Robert Heller, International Reserves, Money and Global Inflation, Finance and Development, March 1976.
11. Who knows, if these had been foreseen, the SDRs might never have seen the light of the day.
12. The combined surplus on current account of the major oil exporters rose to an estimated \$70 billion in 1974 compared with \$6 billion in 1973. As a result, they added more than \$50 billion to their net international financial position including \$37 billion of net additions to their official reserve assets.
13. According to Tom de Vries, "it took three speculative waves of unimaginable proportions, with the counter value of billions of dollars moving from one country to another in a single day, sometimes in a single hour, to finally move the World in March 1973 to flexible exchange rates, at least for an interim period". Jamaica or the Non-reform of the International Monetary System, Foreign Affairs, April 1976.
14. IMF, Annual Report, 1975, p.14.

15. In theory, however, this is precisely what one would expect to happen because while under the fixed exchange rate regime a country must have sufficient amount of international reserves to support a given rate for its currency in the market by purchasing its excess supplies, under a flexible exchange rate regime the country concerned would need only as much of the international reserves as are required to moderate the movements in rate, if one assumes that intervention is not altogether ruled out. If intervention is ruled out altogether, the need for international reserves goes away altogether, for then the market is free to determine the exchange rate. But the latter is hardly practical politics.
16. International reserves expanded at the average annual rates of 2.3 per cent and 3.1 per cent respectively during the decades, 1950-59 and 1960-69.
17. International Monetary System, Yesterday, Today and Tomorrow, p.59. "Losses of sovereignty" were involved in such a system, "(a) for the creditor countries by the accumulation of dollar or sterling reserve claims, which contribute inevitably to the financing of United States or United Kingdom deficits and policies in which they have no voice and with which they may thoroughly disagree; and (b) for the debtor countries by the constant threat of sudden and massive conversions into scarce gold metal of the indebtedness piled up by them toward other central banks over the course of many years past".
18. I.M.F., Annual Report, 1975.
19. The new Article IV makes it clear that the new exchange arrangements may include i) the maintenance by a member of a value for its currency in terms of the special drawing rights or other denominator other than gold selected by the member, or ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members or iii) other exchange arrangements of a member's choice. In his statement before the House Sub-Committee on International Trade, Investment and Monetary Policy, the U.S. Treasury Secretary, William Simon, while explaining the Jamaica agreement observed that should it be decided at any time in the future by 85% majority to return to the par value system "the United States cannot be required to establish or maintain a par value for the dollar". It is quite clear therefore that the U.S. is, for the present at least, firmly opposed to even the idea of a return to a fixed rate regime.
20. To be precise, while the proportion of profit corresponding to their share of total quotas in the Fund will be given to all the developing countries, to each in the proportion of its quota, the balance of the profit will go to the Trust Fund to which only low income countries will have access.
21. H. Johannes Witteveen, the Fund Managing Director, has expressed this hope however. IMF Survey, June 25, 1976.

22. These are the Fund forecasts. H. Johannes Witteveen, IMF Survey, May 3, 1976.
23. To a member in need of credit i.e. when it wants to finance a balance of payment deficit, a dollar of SDR should be always preferable to a dollar even in the first credit tranche with the Fund.
24. In fact, Johannes H. Witteveen said so already. IMF Survey, April 19, 1976.
25. As Tom de Vries (Op.cit) puts it, "no matter how responsibly the U.S. authorities behave in managing the dollar, the world (i.e. including even the influential group of industrial countries other than U.S.A.) is unlikely to put up indefinitely with a system under which these benefits (the benefits of reserve creation) flow almost exclusively to the United States". (Parentheses ours).
26. A monetary arrangement among the developing countries which gives the oil exporting countries adequate voice to assure them of the safety as well as remunerativeness of their placements would not only help in rectifying the present imbalance in the transfer of real resources but also provide an alternative avenue for the placement of their reserves to the oil exporting countries.

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