
CHAPTER I

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.