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UNITED STATES GOVERNMENT

Memorandum

TO : Paul McCracken

DATE: August 27, 1971

FROM : Marina Whitman

SUBJECT: Reflections on the International Monetary System

Now that the future shape of the international monetary system has been opened up far wider than before by the President's actions of August 15, the United States faces two sets of fundamental questions: the short-range ones focussed on how (as well as when) to terminate the present state of "suspended animation," and the long-range ones involved in defining the characteristics of the new world monetary order we would like to see take shape and, secondarily, in figuring out what course of action will maximize the probabilities of achieving it.

The short-range questions fall into three groups: (1) Those relating to the decision as to whether the United States does or does not restore any form of gold convertibility. If so, under what conditions and with what qualifications? If not, what alternative means will we adopt in order to fulfill our obligations to the IMF under Article IV? (2) Those relating to the conditions under which we will dispense with the import surcharge. This involves (a) what "package" of actions on the part of other countries we will accept as the maximum quid pro quo and, (b) what actions, if any, the United States itself will take to bolster our trade balance once the surcharge is abolished. (3) The question of what changes in the international ground rules we will press for immediately, particularly as regards the degree and form of greater exchange-rate flexibility. Will we stick with the "Dale proposal" for wider margins and legalized floats in cases of fundamental disequilibrium currently before the Executive Directors of the IMF? If not, will we press for some other reform instead, or simply not press the question at all at the 1971 Fund meetings unless, by some miracle, there is some hope of achieving international consensus on the longer-range questions as well at that time.

All of these are crucially important questions, and ones which cannot wait too long for solution. But they are derivative in nature, and depend on the answers to the prior questions concerning the nature of the international monetary system we would like to see. To answer them on an ad hoc basis, without reference to the longer-range goals on which they logically depend, would be to risk throwing away an opportunity for constructive reform which arises very seldom (about once every 25 years, on the basis of current observation) and which has been purchased at no small cost and risk. For this reason, I shall focus here on the longer-range questions relating to the nature of the international monetary system.

These long-range questions also seem to fall conveniently into three categories. The first has to do with the standard on which the system is centered: will it be a dollar standard, pure or modified, or some form of "international" standard? The second has to do with the nature of the adjustment mechanism or, to put it a little differently, the degree and type of exchange-rate flexibility: where do we want to settle on the continuum between the relative rigidity of the Bretton Woods system at one end and freely flexible rates at the other? The third is essentially an institutional question. How large a role should the IMF play in the new system, as compared to the present (i.e., Bretton Woods) one? And to what extent should the new system depend for its operation on international cooperation and collective decision-making, again using the present system as a reference point? These questions are closely interrelated, of course, but they can usefully be considered one at a time.

I. The World Monetary Standard

The suspension of gold convertibility shifted the world from a de facto to an outright dollar standard. But, since everyone, including the United States, regards the present situation as an interim one, this is a good time to consider the question of what type of standard we want to see installed on a more permanent basis. The costs and benefits to the United States of a world dollar standard have been categorized, analyzed, and weighed so often that only the briefest review is necessary here. Among the benefits generally mentioned are: greater leeway in financing U.S. payments deficits; increased U.S. income from larger purchases of foreign goods, services and securities (assuming that the marginal yield on these additional purchases is greater than the interest cost on our liabilities to official foreigners plus the foregone earnings on that part of our gold stock associated with the reserve-center function); and the improved breadth and efficiency of U.S. financial markets. To this one might add the political prestige and leadership associated with the reserve-center role. On the cost side are usually cited the constraints imposed on domestic policies, particularly monetary policy; the constraint on successful use of devaluation as a means of adjustment; and the burden of supplying the reserve needs of other countries, which implies a concomitant weakening in our own reserve position. Finally, there are the exacerbations of political relationships stemming from resentment of the "special" position of the United States.

Of the alleged benefits listed above, the increased income and the greater efficiency of financial markets are secondary in importance. This is true for the second because the evidence suggests that the major economies of scale have already been achieved, and are not likely to be reversed by a change in our reserve-center role (viz: the rapid growth and U.S. domination of the Euro-dollar market). In other words, I believe that the private international banking function can and will be maintained independent of the reserve-center function, and that it is ample for the maintenance of the breadth and efficiency of U.S. financial markets. The controls we have imposed, and may impose further, on those markets in the effort to maintain our reserve-center position pose a greater danger to their efficient functioning, particularly in view of the high probability of the development of capital controls in many other countries in the absence of meaningful reform of the system. The greater income associated with the reserve-center deficit is, as far as one can estimate it, small not only in relation to U.S. GNP but also, and more to the point, in relation to any significant gap between actual and potential output which might result at least in part from constraints imposed on domestic policies for balance-of-payments reasons.

Thus, leaving political considerations aside for the moment, the question really boils down to whether the greater leeway for deficit-financing outweighs the constraints imposed on U.S. policies by the asymmetries inherent in the reserve-center role. To answer this question, we must decide to what extent these constraints, or asymmetries, are due to the fact that the United States functions as a reserve center and to what extent they are due to other aspects of the U.S. role in the world economy which would not be significantly altered by abandonment of the reserve-center role.

The asymmetries, and associated constraints, usually cited are two: U.S. balance-of-payments policy is constrained by the fact that it can alter the price of gold but not its exchange-rates vis a vis other countries (while the opposite is true for other countries) and U.S. monetary policy is constrained by the fact that we can alter the level of world interest rates but not the differential between U.S. and foreign rates (again, other countries are in the opposite position). In fact, I believe that the first asymmetry is due partly, and the second almost entirely, to factors other than the reserve-currency role of the U.S. The fact that this country sets world interest-rate levels and other countries adjust so as to maintain differentials more or less unchanged is due primarily to the fact that the U.S. financial market dominates other financial markets by virtue of its size and efficiency. A shift to a different world monetary standard would have little direct effect on this situation; it could have an indirect and long-range effect only insofar as it encouraged the development of competing private financial centers, which is not at all obvious. In addition, it is worth noting that most other countries feel it is their monetary policies rather than ours which are constrained by this state of affairs. Their view is that their attempts to alter domestic interest-rate levels or monetary conditions are severely weakened by the large international flows of capital which result; that they are tied, in effect, to a world pattern of interest rates set by the United States.

There are several reasons why it is uniquely difficult for the United States to alter its exchange rate vis a vis other countries. (1) The sheer size and importance of the U.S. as exporter and importer means that a depreciation of the dollar would have a substantial impact on the competitive position of other countries. (2) Other countries would suffer a capital loss from a U.S. devaluation in direct proportion to the amount of dollars (as compared with gold) which they hold in their reserves. For this reason, such a devaluation might be regarded as a breach of faith and could lead to severe disruption of the international monetary system. (3) Under the present system, the only way the United States can devalue unilaterally is to raise the price of gold, a move which, aside from the domestic difficulties involved, will have other effects which may or may not be desirable. Barring such a move, a change in the relative price of the dollar can only be achieved by the appreciation of other countries which shifts the political burden of such a move to them. A concerted appreciation of other currencies would require a higher degree of international coordination than seems possible at present, and non-concerted revaluations are made even more difficult by the fact that a country which moves first will suffer in trade competitiveness vis a vis not only the U. S. but also those other countries which revalue less or not at all.

Of the three points just listed, the importance of the U. S. as world trader would be unaffected by a shift in our reserve-currency role and would remain an important constraint on any U. S. devaluation in this mercantilist world. Ironically, however, the progressive weakening of the U. S. trade balance has probably increased the probability that other countries will permit an effective U. S. devaluation. The problem of capital losses incurred by countries holding dollar reserves would obviously disappear if dollars were no longer held as reserves, but a less drastic solution in the form of some type of exchange-value guarantee for dollar reserve balances could also solve this problem. The main relaxation of the devaluation constraint if we were to shift away from the reserve-currency role and the special IMF obligations associated with it would come in connection with point (3) and related political considerations. That is, the United States would then be in a position to take the burden of unilateral devaluation on itself, without forcing the political and competitive risks on other countries. Some countries, of course, would doubtless offset our move partially or fully with devaluations of their own but some, at least, would be much more likely to stand still for a U. S. move than to take the revaluation initiative themselves. This is particularly true in the present situation, where we might well be able to bargain away our special position as a reserve-center, which seems to irritate a good many countries, in return for some type of commitment on the part of others to stand still for a U. S. devaluation.

It is worth noting that the conditions consistent with "fundamental equilibrium" in the U. S. balance of payments, and therefore judgements concerning the magnitude of the U. S. devaluation needed, depend crucially on what view one takes of this country's international financial role, both private and official. If one accepts the "financial intermediation" hypothesis, which sees this country as a "bank" providing liquidity to the rest of the world by lending long and borrowing short, equilibrium in a growing world is consistent with, and in fact, requires a persistent U. S. deficit on all the usual measures. Our reserve-center role is, of course, consistent with this hypothesis, since it means that we are the source of growth of official liquidity (international reserves). It is apparently this official aspect of our "banking" role which is at the root of much of the resentment and erosion of confidence exhibited by other countries today. If we are to move away from our reserve-center role, then fundamental equilibrium requires, over some long run, either balance or a U.S. surplus on the official settlements basis, depending on whether the new order calls for an actual reduction of official dollar balances or simply a cessation of further increases. If we continue our reserve-currency role, there is a paradox: a financial center is expected to meet growing liquidity needs by running a (official settlements) deficit, yet it is just this persistent deficit which other countries interpret as weakness and leads them increasingly to question our reserve-center role. Although continuation of a world dollar standard implies that, in the long run, an official settlements deficit is consistent with equilibrium for the U.S., it appears that in order to maintain such a position successfully we must lead from strength which means, in the immediate future, a vastly reduced deficit or even a surplus. Again, though, movement away from a reserve-currency role need not -- and should not -- imply abandonment of the U.S. role as a source of private liquidity; once confidence is restored, long-run basic balance-deficits, though probably of smaller relative magnitudes than we seem to be experiencing today, would be quite consistent with U.S. payments equilibrium (the French notwithstanding).

On balance, I believe the costs today of maintaining our reserve-center position probably outweigh the benefits: other countries are making it clear that our leeway to finance deficits is running out, and we are left with the dilemma that, in order to restore international confidence in the U.S. as world banker, we must dramatically improve our external position, a dramatic improvement impossible without a realignment of exchange rates made far more difficult by that same reserve-center role. Since the suspension of convertibility, we no longer have the luxury of pretending that the world is still on some form of modified gold standard when it isn't. If we maintain inconvertibility, we are playing double-or-nothing by unilaterally declaring an outright dollar standard, a movement which at best engenders widespread resentment and at worst could lead to a network of controls and restrictions and an eventual break-up into currency blocs. If we restore convertibility, we must either do it at the present gold price, which is likely to leave the growing crisis of confidence untouched, or raise the gold price, which would inevitably restore gold to a position of increased prominence rather than allowing it to continue fading quietly away.

Thus, I believe that a gradual -- not a sudden -- movement away from the dollar as the world monetary standard would be in the interest of both the United States and the world. By gradual, I mean that the first step would be simply to find a way of avoiding any further increase in dollar reserve balances, depending on the type of successor standard chosen, the reduction of existing balances could come later or not at all. At the same time, I believe that a return to gold as the primary reserve medium (and international standard) would be arbitrary and regressive, for numerous reasons so well-known that I shall forbear repeating them here. My preference, then, would be for some form of international managed standard. Before discussing the nature of such a standard in any more detail, let us consider briefly the other two fundamental long-range questions: exchange-rate flexibility and the institutional structure, including the distribution of "the burden of adjustment."

II. The Exchange-Rate System

There appears to be, at least, a growing consensus regarding the need for greater flexibility of exchange rates. This is partly because the Bretton Woods system turned out to be somewhat more rigid in practice (events since May notwithstanding) than had been anticipated and partly because, in a world where governments are taking increasing responsibility for domestic employment, growth, and price-stability goals, inappropriate rate structures are likely to lead not to adjustment via domestic discipline or management of relative rates of inflation but to the imposition of controls, a slackening in the pace of trade liberalization, or a variety of beggar-my-neighbor policies. Such considerations imply the need for greater flexibility to correct situations of fundamental disequilibrium or mis-alignment of rates. The increasing mobility of interest-sensitive capital across international boundaries has led to another basis for flexibility of a somewhat different sort: the need for temporary and presumably self-reversing rate movements as an alternative to controls as a means of providing some insulation of national financial markets from international capital movements and thus some scope for independence of monetary policy in an increasingly integrated world.

The second type of flexibility requirement could be fairly easily met by wider bands within which exchange rates are free to move without government intervention in the form of support operations. Although there is grave doubt as to the efficacy of modestly widened bands under conditions widely perceived as a state of disequilibrium, when speculative flows dominate the scene, under conditions of equilibrium when speculative expectations are absent, a widening of the bands small enough to avoid significantly affecting trade transactions could still provide considerable scope for greater independence of monetary policy. Obviously, there is a direct relationship between the width of the band and the size of interest-differentials which can be offset, but even a modest widening of the type now under consideration could be a useful addition to the tool-kit utilized by countries to achieve domestic economic goals. To be effective, however, widened bands would require an underlying exchange-rate structure generally regarded as consistent with equilibrium, as well as some means of avoiding -- or coping with -- persistent (as opposed to cyclical) differences in interest rates among national money markets which are not offset by differences in risk or other considerations bearing on asset quality.

These considerations bring us naturally to the question of how to ensure the maintenance of "equilibrium" exchange-rate patterns in the face of changing relative conditions, without sacrificing the degree of "fixity" or certainty required to maintain a growing volume of trade transactions. It is clear that timelier and, therefore, presumably smaller exchange-rate adjustments are needed. But even if this view is accepted, two major problems remain. One is to determine the form, magnitude, and frequency of adjustments which will minimize speculative disruptions and maximize the probability of selecting the correct rate, and the second is to find ways of making exchange-rate changes "respectable," that is, of neutralizing the national political upheavals which tend to accompany such changes. The legalization of transitional floats to help in the determination of a new equilibrium rate, as suggested in the "Dale proposal" to the IMF, could be helpful in solving the first problem, but such a reform would be of no use unless countries could be convinced to make use of it, which requires solving the second problem as well. The greater resort to exchange-rate-adjustment, in both directions, in recent years, suggests that countries are to some extent overcoming their reluctance to use this tool. Optimists may conclude from this evidence that the reforms contained in the Dale proposal, combined with some workable solution to the asymmetry problem of the United States, may be enough to ensure a workable exchange-rate system. If one takes a more pessimistic view, and there are plenty of inappropriate rates around to support such a view, the only alternative, which could make everyone adjust with the same degree of alacrity, would seem to be some form of "automatic" or "formula-triggered" adjustment. Such schemes have fallen into disfavor lately, but they might be worth reexaming in the present situation. Of the various schemes, probably some sort of "movable peg" based on a moving average of past rates is simplest and stands the best chance of acceptance (a chance which is still pretty small). Its workability would be enhanced by the wider bands already mentioned but, on the other hand, it might interfere with the use of wider bands for the purpose of managing capital movements, since it would tend to engender speculative flows in anticipation of a parity change whenever a rate moved to one edge of the current band. If a basic decision were made to opt for some such scheme, the details (e.g., the frequency of adjustment of the peg) would have to be worked out carefully with an eye to minimizing speculative activity and interference with trade. If such a scheme is rejected as undesirable or infeasible, we are left with resort to "jawboning" in favor of needed adjustments. The present situation may be salutary in this regard, by demonstrating that international transactions can survive a certain amount of uncertainty. It would probably also be effective if the United States were to lead the way, or at least join the ranks, in rate-adjustment.

III. The Institutional Setting

Many people are concerned that the President's moves of August 15, and the situation which resulted, spells the demise of the IMF. Whether this is so or not depends on the use to which we -- and the world -- put the new freedom to change the order of things. An unmitigated dollar standard would doubtless vastly reduce the role and effectiveness of that institution, as would complete flexibility of exchange rates. This is, in fact, one reason -- though by no means a primary one -- for opposing both these alternatives. On the other hand, by setting up a more effective and more truly international monetary system, which reduces the need for countries to operate outside the rules, the role of the Fund could be vastly enhanced. And such an enhancement is highly desirable. The economic advances of the postwar era have been accompanied by a vast increase in international economic integration. Either the world will reverse this integration, at great economic as well as political cost to all nations, or it will learn how to pursue domestic economic goals in a framework of international interdependence by increasingly sophisticated techniques of international coordination and management. A cooperatively managed international reserve asset, produced not by one or a few countries but by all together under the aegis of an international institution such as the IMF, would not only be consistent with a system of international monetary cooperation but would represent a major step toward its creation. Such an international fiat money would avoid two difficulties of both the gold and the dollar standards: the fact that the rate of reserve-creation is arbitrary and often unrelated to the growth of world reserve needs, and that those countries which produce the reserve money are in a special position, enabled to reap seignorage gains by virtue of their monopoly on the creation of international money. With an international reserve asset produced collectively under the aegis of the IMF, the seignorage gains could be distributed widely according to some agreed-on and hopefully equitable criterion.

If the IMF were to play a much larger role in reserve-creation and reserve-management, the resulting enhancement of its position would enable it to play a much greater role also in determining the actual -- as well as the theoretical -- ground rules for the international monetary system, and to develop effective sanctions against those who violate the rules. Among other things, this would give the Fund a larger voice in determining the distribution of the burden of adjustment to situations of disequilibrium, a burden whose distribution today depends on the ad hoc considerations of international bargaining and power politics, but generally with a strong tendency to impose the bulk of the burden on deficit rather than surplus countries (with the exception, at least until recently of the reserve-center country). Such a new international responsibility would bring with it, of course, a new problem: that of determining how the adjustment burden ought to be distributed. The classical answer is that under conditions where deflationary pressures predominate, surplus countries should bear most of the adjustment burden, whereas under conditions of generalized inflationary pressure it is the deficit countries which should do the bulk of the adjusting. To the traditional weakness of this criterion -- that it fails when the world picture is mixed, with inflationary pressure in some countries coinciding with stagnation and deflationary pressure in others -- a new one has been added: the case of "stagflation," which appears to plague an increasing number of countries in recent years, confounds the standard criterion completely. But, while developing a criterion for distributing the burden of adjustment which is both appropriate to the complexities of today's interdependent world and equitable enough to win acceptance is a formidable challenge, it would surely be better for the world's economic welfare if some rational solution were sought than if the decision is made arbitrarily and by default.

Finally, the fact that the international reserve asset is issued by an international organization in which all participants have a voice, rather than by a country over whose policies other nations have no direct control, would tend to increase that asset's acceptability. It would not, of course, eliminate the problem of confidence which arises whenever any money becomes too plentiful in relation to demand, but it would prevent this problem of confidence from being compounded by political considerations. Such an international reserve asset would provide a partial solution to the "nth country" problem, by enabling every country to alter the value of its money in relation to the international standard and by making it possible (as does new gold production) for every country to run a payments surplus (increase its stock of reserve assets) to the extent that new reserves are being created. It would not, however, ensure compatibility of desired balance-of-payments structures. It would not, for example, make it possible to satisfy the apparent desire of all countries to run trade surpluses simultaneously (or, to be more precise, the desire of the developed countries collectively to run a larger trade surplus than they are willing to finance via loans and grants to less-developed nations).

Such an internationally managed reserve standard would not be a panacea for the world's economic ills. It would leave many problems unsolved and would risk exacerbating others by laying them bare for all to see, and by forcing the substitution of explicit and collectively agreed solutions for implicit and arbitrary ones generated by the system itself. It would, at least in its complete form, require a higher degree of international coordination than the nations of the world have so far been willing to undertake. But it could be approached gradually, a step at a time, and the momentum of that effort might itself be enough to prevent the international monetary system from breaking down into a fragmented system of discriminatory blocs and spreading controls, which increasingly threatens to become the most probable alternative.

IV. Summing Up

Recapitulating briefly, the actions taken by the United States in this interim period should be directed toward the following longer-range goals for the international monetary system. (1) The new arrangements should restore to the United States some degree of meaningful control over its exchange rate, enabling it to achieve the realignment of rates required for the improvement of its competitive position. Such an improvement in our trade and payments positions will, in turn, enable us to maintain our leadership in the liberalization of the international trading and financial system from a position of strength rather than of weakness. (2) In return for (1) we should agree to a movement away from the dollar standard toward some system of internationally managed reserve money, be it SDRs, a "unit" composed of gold, dollars, and other existing reserve assets in fixed proportions, or something else. Initially, it would be sufficient to abjure further increases in official dollar balances; later, if other countries desire it, provision could be made for funding part or even all of existing official dollar balances beyond those required as working balances. (3) The system should provide for greater flexibility of exchange rates, both as an instrument for managing international flows of liquid capital and as a means of adjusting situations of persistent or fundamental disequilibrium. Efforts should be made to ensure that such measures of increased flexibility are actually used, and not merely available. At the same time, the greater flexibility should still be grounded in some system of parities and government management of exchange rates, both because some type of intervention is inevitable and in order to avoid a degree of uncertainty which would significantly hamper trade transactions. (4) The new system should continue the de-emphasizing of the role of gold in the international monetary system. For this reason, I would prefer not to follow the suggestion of the IMF that a realignment of exchange rates be accompanied by a small rise in the gold price (and, presumably, restoration of some form of convertibility). If, however, such a move is the only way we can achieve exchange-rate realignment, it is probably worth the price, as an interim situation. I would urge, however, that any restoration of gold-convertibility be as limited and qualified as possible, and that the movement away from the dollar standard be undertaken in such a way to ensure that the new international reserve asset dominates gold as the primary source of new reserves. This could be achieved by making the new asset highly attractive in terms of yield, by arranging a commitment on the part of all countries not to increase the gold portion of their reserves or by some other means. (5) We should seek international agreement and adherence to the principle that solutions in terms of exchange-rate adjustment or international coordination and management are always to be preferred to solutions in terms of national or regional controls on or barriers to international transactions.

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PM
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MEMORANDUM

THE WHITE HOUSE

WASHINGTON

August 24, 1971

FOR: THE HONORABLE JOHN B. CONNALLY
THE HONORABLE ARTHUR H. BURNS
THE HONORABLE GEORGE SHULTZ
✓ THE HONORABLE PAUL McCRACKEN
THE HONORABLE PAUL A. VOLCKER

FROM: PETER PETERSON PGP

While I was in New York last week, Gabriel Hauge collected a group of outstanding economists, bankers and investment bankers as a way of giving me some independent inputs on their reactions to the President's new Economic Program and, in particular, the international economic and monetary aspects of it.

Their overall reaction to the program was very favorable -- "bold", "breathtaking", "a real power move", and to John Connally's subsequent press conferences as "brilliant".

There probably isn't anything new here for most of you, but given the quality of the men Gabe collected, I found it a useful set of inputs on the important questions of where we go from here on the monetary, the surtax and the trade fronts.

1. The problem with the various arrangements to provide more "flexibility" (wider bands, for example) is that they don't provide flexibility over any real period of time. If, before long, the true parity should lie outside the band, you get back to the fundamental question of setting exchange parities in a fair and timely way.

   In other words, if one first has a better way of making parity adjustments, then various approaches like wider bands help provide needed flexibility in making parity changes more gradual, and therefore less painful. There seemed to be widespread agreement that wider bands, by themselves, were not enough.

2. The current methods of setting exchange rates provide for a great deal of "international one-upmanship" and "economic ultra-nationalism".

   There was much more agreement than I would have expected that the international monetary system cannot stand the kind of undervaluation we have seen with the yen and the mark. The group agreed that the IMF must play a much more active role in the setting of exchange rates.

   However, there was not agreement on how this should be done. Some felt that a process by which rates are set almost automatically will turn out to be the best approach both economically and politically, since politicians at home could then be shielded from the political heat.

   Others felt that the IMF should lay out presumptive criteria by [illegible] it would take an active role in assessing the validity of current [illegible]

   I asked what reason they had to believe that other countries would [illegible] this kind of active multilateral role on something as sacred as a [illegible] exchange rate. The answers were generally that the kind of [illegible] we are now in demonstrates the need to do something vastly different [illegible] what we have been doing, and that countries would be willing to [illegible] this if they thought the US would make some concessions.

   I asked what the concessions were:

3. There was a stronger feeling than I had expected that the US should keep its mind open about changing the price of gold. The theory was [illegible] seem to be asking for an awful lot in the way of exchange rate changes and it would be much more palatable politically -- and we would [illegible] -- if we devalued some and they revalued some. In other words, our suffering some would make significant realignments more palatable to them.

There was agreement that changing the price of gold would present some political problems generally, and on the Hill in particular. However, even those most aware of the Congressional objections felt that if the total package of what we got in return were a good enough one for the US, these objectives could be overcome.

To handle the specific political problem of South Africa and the Soviets making profits on gold, one of the men had a proposal (attached) whereby there would be no more additional gold introduced into the international monetary system -- so the price increase would apply to existing reserves only.

4. Then, I asked what they were saying about gold and its future role. The answers were surprisingly uniform:

   a. The US must never allow itself to get back into a fractional gold reserve system. The group universally admired the President's decision to close the gold window.

   b. Most felt, however, that we should not underestimate the role of gold in any future international monetary system -- since it had great symbolic significance and would create a sense of continuity and confidence in any new system.

   c. Virtually everyone seemed to agree that the US would, on balance, benefit from moving away from the dollar as the reserve currency to an internationalized or composite reserve. ("While it's a license to print money, it also buys us a lot of problems.") Most felt this new reserve should be some combination of gold, SDRs and dollars, or long-term commitments to pay dollars.

   d. There were different notions about how the various parities could be pegged in such a system. Some saw a kind of composite being used, perhaps an average of the dollar, the mark and the yen. Others talked about expressing parities as a certain number of SDR "units", etc.

5. There was unanimity that the large overhang of dollars was something we had to contend with, and without killing the Eurodollar. Suggestions included a special tranche for any country that wanted to exchange any or all of its dollars, buying some portion of the dollars with gold, long-term notes to soak up some of these dollars, etc.

6. There was also a good deal of agreement that this was the kind of situation in which one could remove investment controls -- either immediately or on a planned basis.

7. The biggest dilemma and controversy seemed to center about timing and the delicate balancing of serious risks of moving either too soon or too late.

   For example, virtually everyone felt that the longer the import surcharge was left on, the harder it will be to remove in terms of our domestic industries and politics. "It's like a little dope. It's easy to get used to and hard to get off of." Also, the longer it is left on, the more likely are trade retaliations. We were cautioned not to underestimate the talent of these countries to fight back on the monetary front (two-tier systems to punish our trade, controls on our investments and even investment income, and the trade front -- their imposing their own import surcharges, etc.

   On the other hand, those who cautioned against waiting too long also agreed that it was quite unlikely we would get the major exchange rate realignments we needed in a hurry.

   The best balance, they felt, seemed to be to show some openmindedness on such questions as changing the price of gold, an international reserve currency, etc. (thus showing an inclination to cooperate) but to "hang in there" until we got a significant exchange rate realignment.

STRICTLY PRIVATE AND CONFIDENTIAL

The arrangement for an increase in the official dollar price of gold is presented below:

1) As a quid pro quo the United States should require that the two-tier gold price system adopted in March 1968 remain in effect permanently. To achieve this, an international understanding should be negotiated under which the major countries would support the formal adoption of the two-tier system as an amendment to the IMF Articles of Agreement.

2) On condition that the two-tier gold price system remains a viable instrument, the United States announces an increase in the official dollar price of gold, say, to $40 per ounce -- a 14.3% increase.

3) The existing arrangements which provide for the IMF purchase of newly-mined gold from South Africa as an additional source of monetary reserves would be immediately and "permanently" suspended.

4) Until legislated by Congress, the dollar "float" would continue. However, this should not preclude interim upvaluation of major currencies and removal of the import surcharge (and other measures), all on a tentative basis, subject to Congressional action.

5) Such an approach might be politically palatable to the Congress, for it:

(a) demonetizes future newly-mined, commodity gold;

(b) withdraws the $35 floor from the free market gold price -- of major interest to Congressman Reuss.

(c) requires that S. African and Russian commodity gold henceforth receive only the free market price -- which would almost certainly decline, since there would be no direct or indirect central bank intervention in the free gold markets to prevent it. Only gold already monetized would be eligible for the $40 price.

6) It may be recalled that before the purchase arrangements with South Africa were negotiated, the market price for gold actually dipped somewhat below $35 per ounce. The medium- to long-term outlook for newly mined gold on the private market is favorable in view of the continued rapid expansion of industrial demand for gold. However, the free price of gold should remain soft for at least a few years.

Thus, the powerful political objections of the United States concerning the windfall gain for the USSR and South Africa would be entirely satisfied; both countries would have nowhere to go with their gold except to the free market. Further, the objection which rests on economic grounds, namely, the inflationary impact of a windfall to private gold holders and speculators would also be resolved. Private holders, too, would gain no windfall, since they, like the USSR and South Africa, would be subject to the free interplay of demand and supply on the private gold markets. Although there might be an initial psychological tendency for the private gold market to respond upward to an announcement of an increase in the official gold price, expectations would not be validated: it is only through the actual intervention of monetary authorities into the gold market (direct or indirect) that the free market price of gold could be pushed upward. Should there, nevertheless, be an immediate tendency for the private market price of gold to increase, it would not be long before the reality of the situation caught up with speculators.

7) The enforcement of the formal two-tier system does not present difficulty. The International Monetary Fund receives monthly reports from its membership which specify precisely the composition of their official reserves as between gold, dollar, DM, etc. These reports are secret but available to the Fund to meet enforcement requirements. The Fund could easily detect <u>any</u> unexplained change in any of its members' official gold holdings. Should an IMF member country attempt to purchase gold outside the official system at a lower free market price, it would not be able to conceal this from the Fund, for there would be no corresponding

drop in gold holdings of other central banks.

8) It is important to note that the United States commitment to "freely buy and sell gold", as defined in IMF Article IV, Section 4 (b), limits the United States obligation only to gold transfers "for the settlement of international transactions". This obligation of the United States refers only to the settlement of payments imbalances between central banks; the United States is not legally responsible for freely converting gold when the gold arises directly or indirectly from newly mined supplies. Accordingly, on detection of unexplained changes of IMF member country gold reserve holdings, the United States could legally refrain from engaging in purchases and sales of gold with that country. There can be no evasion of this control: Once official gold holdings are established by the Fund at a certain date, the amount of gold physically held for monetary purposes would be permanently frozen in total for the monetary system as a whole. Should the United States not return to gold convertibility of the dollar, the IMF could directly assume the responsibility for ensuring that no "outside" gold enters the monetary system. A special arrangement with Switzerland could be worked out consistent with this arrangement.

9) To recapitulate, the effect of an official gold price increase operating within the formal two-tier gold

price system is principally to place a permanent end to the dual function of gold as a commodity and gold as a monetary asset. Henceforth, any increase which might be deemed necessary for international liquidity in respect to gold could arise only from a new round of increases in the official price of gold. The effect is to permanently demonetize future gold production while maintaining the monetary function of gold under a "grandfather clause" only insofar as gold is already held as monetary reserves.

CM: 8-20-71

A Draft Proposal for Strengthening the International Monetary System

At the time of this writing, most of the major foreign exchange markets of the world are closed. The President has suspended gold redemption of the dollar and strongly suggested that other governments revalue their currencies. Accompanying the suspension of gold redemption is a surcharge tax on U. S. imports, a wage-price freeze and other measures. It is by no means clear on what basis exchange trading will recommence in the week ahead.

Regardless of the first solution that is found to the present crisis, however, what is certain is that new permanent arrangements must be found for adapting the world economy to the cyclical and secular pressures that come to play in different countries with different force. The Bretton Woods system has staggered to a standstill, and now it must be operated upon to remedy its weaknesses or replaced with something more viable.

It is possible that there exists a wide consensus among policy makers in many countries concerning at least some properties of a desirable international financial system. Among these properties would be the following: (1) it should contribute to the capabilities of national governments to maintain high levels of employment and economic growth and (2) it should contribute to the maintenance of a liberal system of trade and investment.

The Bretton Woods arrangements from the beginning, involved a third objective which all too often has proven inconsistent with the other two. That objective was exchange stability. The authors of the IMF Charter clearly envisioned the system they were designing as a facsimile of the gold standard with the Fund constituting an addition to international reserves. The provisions for exchange rate adjustment were a compromise to satisfy Europeans, primarily the British, who deeply feared the development of a dollar shortage. In fact what evolved from the design was the dollar exchange standard, even though this was one of the events the creation of the Fund was specifically expected to prevent. The revival of the international capital markets in the 1950s led to the disorderly international money flows of the 1960s whenever cracks appeared in the frozen block of exchange rates, and all too often this brought on efforts even more tightly to freeze the package. Trade and capital controls again and again were used to shore up a brittle system of exchange rates.

The simple fact is that fixed exchange rates are not the right financial structure for our time. They were tolerable during the Victorian era, when the modern world economy was forming, partly because in the onrush of technological development the linkages between national economies were incipient, partly because of almost universal economic buoyancy for substantial periods of time, especially in the latter part of that era, and partly because an unusually high degree of international capital and labor mobility facilitated the international adjustment process. Since the First World War, in periods when it has been in effect, the system of fixed exchange rates has, by and large, worked badly. Established in 1926 and 1927 among the major trading countries, it collapsed in 1931. Restored again after the Second World War it has been quite disorderly for 20 years and it has been an especial burden on the United States since 1957.

For several reasons the dollar became in the 1950s and 1960s the prime source of growth in international liquidity. One reason was that the "conditional liquidity" provided by the IMF was never a good substitute for unconditional reserves. Another was that, at $35 per ounce, the gold supply, in spite of important new discoveries, grew at only a fraction of the rate of growth of world trade. Still another was that U.S. balance of payments deficits made the supply of dollars to other countries plentiful. And another was that the weight of the U.S. in world trade made the dollar the vehicle currency of most transactions.

But the role of world banker has been a costly one. In simple money terms, the activities brought us, on an annual average through the decade of the 1960s, short-term balances from foreign governments and central banks of some $13.5 billion. Even if we should assume that all of these credits made possible investments abroad which yielded Americans a net return of, say, 12 percent, the average annual income from such "banking" was no more than $1.6 billion per annum. And keeping the bank window open brought on restrictive demand policies in this country in the Eisenhower era which were wholly relieved only after escalation of the Viet-Nam war and which has become acutely costly again in 1970-71. If the $520 billion GNP of 1961, say, was repressed only 1 percent by anti-inflationary policies necessitated for protection of the international value of the dollar the annual national cost to the U.S. of the exchange rate system was $5.2 billion. And in 1971 if 1 percent of the GNP is sacrificed through unemployment and inefficiencies engendered by trade restrictions, the annual cost is $10 billion.

The orders of magnitude of these gains and costs suggest that in simple aggregated terms, the business of international banker has been a bad one. Qualitatively it has been much worse, since those who pay the costs of protecting the dollar are often ultimately consumers who bear the costs of import restrictions, and the unemployed who bear the major costs of recession, and those who spend the largest proportion of their income on consumption and who are the first to become unemployed are the poor.

Furthermore, weakness in the dollar has weakened America's capability for leadership among governments of the free world. It has caused us to go hat-in-hand to request favors that would have been unnecessary in a reasonable system of exchange rates. On some occasions it has warped even our own view of the concept of "fair share" in international undertakings. "Fair shares" should depend on national interests in an undertaking and on ability to forego that income that will cover costs. They should not depend on a stubborn trend in the balance of payments. The international accounts should adjust to what nations want to be, not vice-versa.

The international financial arrangements that are right for the 1970s involve a substantial degree of flexibility in international exchange rates. Disparate rates of population growth, technological change and capital formation in various countries, together with disparate national policies toward cyclical and secular disturbances create stresses and strains on a system that cannot be accommodated by small adjustments in rates of economic expansion alone. And the employment of restrictions on trade and investment to repress such disequilibria are but expensive delaying tactics when the disequilibria are protracted. The population movements of the late nineteenth and early twentieth centuries are no longer available to alleviate the distress accompanying curtailment of a deficit. Adaptation in the international exchange rates, however, by realigning all costs and prices denominated in our currency relative to those denominated in others, can extend the role of relative prices and the market place to allow them to contribute powerfully to bringing about the required adjustments.

Too often the argument has been put forward that an acceptance of flexibility in the international exchange rates would be a step backward in the course of monetary evolution. While there is doubtless wide agreement in that some future era where political consensus will make possible a uniform set of monetary and fiscal policies among the nations, and labor and capital mobility will be such that this can be applied without enduring hardship on any region of the world, a single currency, or fixed rates of exchange between national and regional moneys will be both desired and easy of attainment. But this world is not ours. In ours, international political consensus is still limited and fragile, labor mobility is restricted, and national sovereignty is jealously defended. In this world adaptability in the prices of the national currencies is an instrument to be sought for its power in bringing accommodation among national differences.

American economic history already reveals that such arrangements are capable of evolving into a unified system of fixed parity exchanges when the appropriate conditions are fulfilled. In nineteenth century America differences in the pace of regional development and frequent disturbance of established patterns by new technology, migrations, and investments required that the system of interregional payments have a high degree of adaptability. And although the currency everywhere in the land was the dollar, the value of the banknotes of the regions exchanged at varying premia or discount. Even after the widespread acceptance of demand deposits in the nation, domestic "exchange" in one region on another was bought and sold at a varying price. In fact, not until the preponderance of the federal government, armed with the income tax after the First World War, imposed a near uniform fiscal policy on the land, and the development of the Federal Reserve System laid the groundwork for an effectively uniform monetary policy, was universal interregional collection of checks at par in the United States a viable objective.

In the world of international finance it is not necessary that exchange rates be so flexible as to accommodate every potential seasonal, or even annual imbalance. International reserves can play a highly useful role in buffering temporary inequalities in international flows of payments and receipts. But the imbalances must not be allowed to become so protracted that substantial disturbance must accompany the resolution of the disequilibrium. Gradual and cautious drift in the exchange rates will do, provided the drift is well guided.

In guidance, it is imperative that market forces provide the lead. A system of rates of exchange in which the rates change gradually but persistently in response to market pressures may be called an "adaptive" system of rates. Adaptive rates must be sensitive, and they must reflect market tendencies.

One such system is that one in which weekly official exchange rate parities are calculated from a weighted moving average of recent market rates. In each week the market rate is stabilized to small limits, perhaps ± 1.5 percent around the official parity, but protracted pressure on the market rate in one direction drags the parity after the market's lead. Calculations show that when the weights applied to the dated elements in the moving average are uniform, the parity can adapt, during as many time points as enter its average, by twice the width of the band of fluctuation. Thus a weekly parity calculated as the moving average of the market rates of the preceding 26 weeks (6 months), when the market rate is constrained to movements ± 1.5 percent each side of parity, could in 6 months move a maximum of 3 percent.

The strengths of such a system are that while market exchange rates are always subject to close control and cannot "run away," the continuous, if gradual response of parities to market forces insures that the parities cannot diverge far or for long from market equilibrium rates. Sudden and discrete changes become unnecessary, or at least rare. And the temptation of market participants to "bet" on discrete exchange rate adaptations is usurped. The rates are constantly open to movement downwards as well as upwards, but the capital gain to be obtained on a right "bet" in either direction is, in the example cited, at best at the rate of 6 percent per annum. As a mechanism of international adjustment, however, changes of much less than 6 percent per annum can be powerful elements in adapting economic activity. Changes in the dollar-yen exchange rate of 3 percent per annum over the past 4 years would certainly have prevented the present gross degree of undervaluation on the yen.

Even with adaptive rates, nonetheless, it is important to retain the approach to removing a fundamental disequilibrium that was in the IMF Charter. That approach is that when there is multilateral agreement that a set of rates is wrong, they are changed by mutual consent. Any set of adaptive rates constrained by historical data will lag in its response to rapid reversals of forces such as at business cycle turning points. At such times, it may be necessary to "fudge" the rules and accelerate the tendencies of the parities. Under a set of truly adaptive rates, however, such more or less discrete changes must be less frequent and less violent than under a regime of parities that is rigid over long time intervals.

It is of great importance that the adjustments in an adaptive system be as automatic as possible. The Bretton Woods system has been disorderly and intolerably rigid in part because exchange rate adjustments have been left to the discretion of governments of member countries. The rule that the IMF must approve such changes has not been very effective where the major financial powers are concerned and at best has probably exercised some restraint on competitive devaluations. The framework that has made exchange rate adjustments discretionary and only justifiable when there is evidence of a "fundamental disequilibrium" has insured that rate changes have been delayed until the change required was substantial, and hence disruptive of trading and investment plans, and it has recurrently created the well known openings for "one-way bets" in which market participants have been able to anticipate the direction of forthcoming shifts and make massive shifts of their assets in order to profit -- or at least avoid loss -- thereby. A system of discretionary changes unavoidably involves lags and unavoidably involves contention among those responsible for the discretionary decisions.

The Council of Economic Advisers has earlier looked favorably on a system in which the rules for exchange rate adaptations would be presumptive only. This was a half-way house between automaticity and discretion. But a presumptive system raises more questions than it solves. In the arrangement, governments would exercise discretion as to whether the adaptive rules, which would be presumptive only in any period, were to be followed. If the U.S. dollar were the exchange rate numeraire in any such system, the arrangement would seem to deny the U.S. any discretion. We would continue to be in substantial degree at the mercy of policy decisions by others. If gold, SDRs, or some composite of currencies should be the numeraire, then the question becomes one of how discretionary decisions of participating governments are to be coordinated. Nor would coordination ever be easy. Any set of rules which makes current adaptations dependent on past data in some degree implies that this week's decision will be influential for some significant future. The present international crisis affirms once more the tendency governments have to seek undervaluation and avoid over-valuation of their currencies. Continuous negotiations over the exercise of discretion would not foster either amity or an equilibrium set of exchange rates.

An automatic rule can be made as sensitive or insensitive to current pressures as is desired. A priori, a moving average of market prices, averaging over a period about 6 months to a year long and weighting the weekly prices in inverse proportion to their age, is attractive. Changing the weights or the period will influence the sensitivity of parity rates to turning points and fundamental changes.

The choice of a numeraire for exchange rates is of enormous importance to the United States, no matter what system of adjustment is forthcoming. Making the dollar the center of the system has placed the U.S. in a position of dependence on the decisions of others which must not be repeated. If a system in which governments exercise some discretion emerges and the dollar is in a keystone role, it is clear that other governments will permit their currencies to depreciate vis-a-vis the dollar to eliminate their deficits but that they will resist appreciations to eliminate their surpluses. It would be only a matter of time until the present unsatisfactory set of circumstances was repeated. Even in a regime with acceptance of a high degree of automaticity in the responses, if the dollar were the numeraire, the degree of flexibility vis-a-vis other currencies permitted for the dollar would be only half that permitted for other participants, and this is not acceptable.

The step that would be a "great step forward" in the evolution of international monetary institutions would be to constitute SDRs the numeraire of the exchange rate system. It is no more necessary for the numeraire to be traded in the markets than it is that the metal bar in the Bureau of Standards that constitutes "one foot" be used by carpenters. Currencies with parities in terms of SDRs would have implicit cross-parities among themselves. SDRs, however, are still a novelty in international finance, and gold or some composite of national currencies may be all that is acceptable. What is important is that the numeraire be the currency of no single nation.

The numeraire of the system is one thing and the reserves with which governments will carry out stabilizing operations are another. Since 1947 gold and dollars, supplemented by sterling, francs, and a few other currencies, and the "virtually automatic" tranches of IMF drawing rights have constituted the bag of international reserve money. The explicit cessation of gold sales by the U.S. does not divorce the dollar or the international monetary system from gold. Official stocks of gold remain tradeable among governments at official parity exchange rate prices, and IMF drawing rights, SDRs, and dollars are available for reserve purposes as before. If several major countries float relative to the dollar, however, the dollar's role in the composite reserve structure will be subject to vacillation, and Gresham's Law seems likely to put a premium on SDRs and gold as instruments to be sought and firmly held by governments.

In view of the advantages to the U.S. of extracting itself from the world banker role, it will be desirable to work for a system in which dollars officially held by foreigners are turned in for SDRs or credit in some mutual settlement fund, making these new instruments the medium for international reserve assets. But the whole matter of reserve media will require the best thought we can give it.

E. Solomon
8-22-71

The International Monetary System: Opportunities and Options

Summary

1. Bretton Woods System has ended. It cannot and should not be revived without fundamental changes. We should seize the opportunity to establish a stronger and sounder system viable for decades ahead.

2. Three basic issues involved -- all related:

   Need to remove dollar's overvaluation and realign rates.

   Need to eliminate dollar's role as reserve currency asset and as unit of account for official settlements.

   Need to ensure that future rates move flexibly.

3. Immediate operational issue is dollar rate realignments, but how accomplished can be crucial to getting other two reforms, soon, and hence to avoiding recurrence of "crisis."

4. Passive float unlikely to achieve required realignment. But for same reasons adequate negotiated changes may be difficult to get. Will we be asked to offer some formal symbol of devaluation of dollar relative to gold? If clearly so, should we not retain entire initiative and go the whole way via formal devaluation? The latter would preserve all our other potential "concessions" to negotiating overall reform of system.

The International Monetary System: Opportunities and Options

I. Introduction

A sound international monetary system is not an end in itself: it is a means by which we foster a growing volume of international trade and investment. Likewise, no element in any system is an end in itself but a means toward the broader goals.

The system designed at Bretton Woods in 1944, and amended in bits and pieces since then, has served the free world well for 25 years. But increasing strains have emerged over the past 5 years and with the closing of the gold window on August 15 the system as originally conceived has ended. It is quite unlikely that the pre-1971 order can be restored without fundamental changes.

The free world now has the task, and the opportunity, of designing and installing a new and stronger system for the future. Any set of arrangements devised now must provide integrated answers to each of three major and related questions:

A. Exchange rate realignment. The immediate operational issue is to realign foreign exchange rates among the major trading nations and in particular to correct the general overvaluation of the U. S. dollar. This change should be large enough to give promise of a clear basic balance in the U. S. payments position. The question is "How should this realignment be accomplished?"

B. The stock of international money. The stock of international money required to facilitate world trade and payments has hitherto been provided from five sources: gold, (about $38 billion), U.S. dollar liabilities ($30-40 billion), special drawing rights ($6 billion), member country reserve positions in the IMF ($7 billion), and United Kingdom sterling liabilities ($6 billion). The U.S. dollar has served as the unit of account in which all transactions in international money have hitherto been denominated. It has also served as the principal medium of exchange for official and private international settlements. Finally, together with our loss of gold, it has provided the bulk of the required growth in international money. The questions here are: "What provides these functions in the future?"; "How does the world obtain the necessary increase in the stock of international money required by growing trade and payments?"

C. The international adjustment process. The stock of money available to individual nations provides a buffer which can finance or absorb an imbalance in its payments with other nations. An international system also requires a smooth set of adjustment processes through which any nation suffering a basic imbalance can correct it. The question here is: "Which set of rules regarding future exchange rate changes will provide the smoothest adjustment process?"

There are many possible answers -- some better than others -- to the questions raised by each of these issues. The acceptance of any one solution in one area precludes some of the possible solutions in other areas. Before we embark on a particular course of action designed to answer questions regarding the realignment of rates, we should at least know where we want to go on all three fronts. Better still, insofar as this does not affect progress on one front we should move on all three fronts simultaneously. The present opportunity for overall reform rather than piecemeal patchwork is too great to be given up without considerable thought.

II. The Present Need for Exchange Rate Realignment

In pursuing exchange rate realignment we can follow one of three basic strategies:

1. We can leave matters as they now stand and hope that market forces will operate to realign exchange rates into a realistic pattern. The alternative is theoretically appealing. It solves the problem of the degree of realignment automatically. It also solves the problem of the future adjustment of exchange rates. Finally, it minimizes the need for a large stock of international money and thereby reduces the problem of responding to this issue. The catch with this solution is that other nations may not now permit their exchange rates to move relative to the

dollar. In short, they would not permit a true "float" that reflects underlying market forces. The tools at their disposal are numerous -- among them,

(a) exchange controls

(b) multiple exchange rates,

(c) devices to retaliate against our 10 percent surcharge.

We will see in the coming weeks just how far and fast the exchange-rate of the dollar will be allowed to float downward. Japan was the only major market open last week -- and they held the dollar within its previous parity, even though this required the Bank of Japan to purchase $2.5 billion. Many European nations are planning to support at least the "trade" dollar at pre-August 15th rates.

For reasons given below there is a powerful reluctance abroad to letting their currencies appreciate relative to the dollar. If this is true, then pursuing a continuing "float" as our only course of action is not likely to produce the degree of realignment we need. Indeed, it may end up producing results nobody really wants in the long run -- such as multiple exchange rates, exchange controls and discriminatory trade barriers and practices.

2. The second alternative is for us to enter into negotiations with our major trading partners to realign exchange rates to a new

pattern that is compatible with U.S. external equilibrium, The purpose of the negotiations would be to induce countries with undervalued currencies to raise them by some appropriate amount relative to the U.S. dollar. There are reasons to believe that such concessions will not come readily. This reluctance on the part of many nations to revalue, stems from many considerations:

(a) Revaluation hurts exports. In some countries such as the Common Market where agricultural subsidies are denominated in U.S. dollars, it also hurts farmers. While there are countervailing benefits to other segments of a revaluing economy (such as importers and tourists who go abroad) these benefits are far less visible politically than is the hurt felt by the sectors which suffer.

(b) Revaluation reduces the value of a nation's stock of monetary assets. Gold holdings fall in value to the extent of the revaluation. Dollar holdings are unchanged in dollar terms but are worth less in terms of the national currency. In short, there is a net balance-sheet loss.

(c) A frequently cited reason for revaluation reluctance is the question of national pride: "Why should we move, while you stand still." It may not seem logical but it is nonetheless real.

(d) Finally, when one nation revalues relative to the dollar -- which it may be perfectly willing to do -- it is thereby forced to revalue relative to all other nations which do not revalue. The latter is a move many nations are understandably reluctant to make.

For all or some of these reasons, many nations search hard for alternatives to voluntary revaluation. Exchange control and multiple exchange rates (one rate for the trade dollar and another rate for the capital flow dollar) are just two of many available devices. Another device is to ask the U. S. to control its outflow of investment dollars. Yet another is to ask the U. S. to discipline itself domestically. Finally, on the exchange rate front, one device for minimizing the effects of revaluation economically and politically, is to ask that the United States "share" the burden tangibly and visibly by devaluing the U.S. dollar relative to gold.

Negotiations could lead us smoothly, and in an uncomplicated way, to a new pattern of international exchange rates that are appropriate. If this is the case, we will return to the pre-1971 pattern of stable exchange rates, repeg the price of gold at $35 an ounce, and offer the rest of the world the limited convertibility we have been offering to date. But the chances of this happening are not large. The reluctance to let rates float without negotiation also implies a reluctance to revalue simply and smoothly. Each country will require concessions from us, such as the removal of the import surcharge, and in addition will require assurances that third and fourth countries will revalue to greater or lesser degrees. In addition, we will undoubtedly be asked to share the "burden" imposed by realignment through a promise to repeg the price of gold at some level higher than $35 an ounce. Thus part of the negotiated package would include an undertaking to get and implement legislative approval for a change in the price of gold. If the last requirement is true, then a third alternative method of achieving more realistic parities must be considered -- namely unilateral devaluation of the dollar relative to gold.

3. Unilateral devaluation. If we are going to face the need to get legislative approval for changing the price of gold as part of a "negotiated" package it might well prove to be better to forget negotiations as such and proceed first to the task of obtaining congressional approval for this action. Since the dollar is already floating, and since we want the exchange values of several other currencies to rise relative to the dollar, the delay involved in getting legislative approval will do no harm. With the approval in hand we could announce the classic form of devaluation relative to gold. A devaluation of 10 percent can be legally accomplished ~~without~~ by informing the IMF. A larger devaluation, e.g., 15 percent would require IMF consent. We could then remove the ~~border tax~~ surcharge against all nations, other than those who deliberately follow suit and ask for formal devaluation of their currencies simply in order to maintain an undervalued situation. Under this method the initiative would be wholly with us.

We could also take steps on the other two fronts at the same time, namely the future basis for providing the stock of international money, and the future basis for providing for smoother adjustment processes.

III. The Stock of International Money

How we deal with the exchange realignment problem affects the way in which we can later deal with the international stock of money question, although only partially. In any case, the U.S. must now face up to a basic issue: "Does it wish to retain its previous status as a reserve asset currency?" This is a broader issue which is examined later.

Outside the broader issue there are narrower ones. If negotiation can be accomplished without promising to change the gold price of the dollar after new stable parities are reestablished, the realignment of currencies has only a minor effect on our freedom to deal with longer range issues. Countries who hold dollars, which fall in value relative to their domestic currencies, will be less eager to hold dollars in the future. However, the dollar will probably be used to the same extent as before as an international medium of exchange for private transactions. Preferences as between gold as an asset and the dollar as an asset will be substantially unchanged.

If, however, the gold price of the dollar is changed as a result of a negotiated package, or as a result of a unilateral devaluation on our part, future preferences as between gold on the one hand and dollars on the other as an international asset will be substantially altered unless other actions are taken at the same time.

One action which can resolve not only the international stock of money issue, but the U. S. position in it, is the following: after the change in the price of gold is accomplished, we could undertake to offer to dollar holders throughout the world, that they may surrender any dollars they wish to the International Monetary Fund in exchange for SDRs which would have the same gold value as their previous dollar holdings had at the $35 an ounce price. We would in turn give the IMF long-term bonds, in an equivalent amount, and bearing interest at the nominal SDR rate. This would probably serve to replace the new U.S. dollar with the SDR unit as the unit of account in which international official transactions are denominated. Many private and some official dollar holders will continue to hold onto dollars in spite of this opportunity to exchange them for SDRs, and can be assumed to prefer dollars even at the new gold value to the alternative available. Thus it is entirely foreseeable that the dollar will continue to serve the world as a medium of exchange.

Over the long-run future the United States would gradually redeem the bonds issued to the IMF, and the IMF, in turn, would acquire whatever bundle of convertible currencies the U. S. used for this redemption purpose. These would, of course, have to be derived by the U. S. through surpluses in its balance of payments.

After these events have taken place the official holdings of international money could consist entirely of gold held by each nation, SDRs in the Fund held by each nation, plus drawing rights on the Fund. (Presumably the United Kingdom directly or in concert with its European partners could take steps to fund its overseas sterling liabilities at the same time.) Future growth in this stock of international money could be arranged for by systematic issues of more SDRs as and when needed, to be backed by deposits of national currencies.

Whether increases in the monetary holdings of gold will be permitted in the future is a relatively minor issue. There would be some sentiment against allowing the major gold producers a windfall through a higher support price for their product. (After all we do not grant this favor to the primary products of developing countries!) If this sentiment prevails future gold output would of course have to find an outlet in the private market. Also, in this case, "gold speculators" whether nations or individuals will not have benefited in any way relative to dollar holders.

Will the United States lose or gain by giving up its pre-1971 role as provider of reserve assets to the rest of the world? One answer to this question is that the U.S. will gain by surrendering this role. At most, the gross financial gain from being the world's banker does not exceed $2 billion per annum. This maximum is calculated as follows: assume all of the dollars held abroad (and this is an unrealistic assumption) are involuntarily held. This amounts at most to $30 billion. Assume we have used the foreign currencies derived from the sale of these dollars to acquire lucrative direct investments which yield 12 percent per annum. The net gain to us is the difference between this 12 percent per annum gain plus the interest costs associated with the dollar liabilities, i.e., about 6 percent per annum on average, or $1.8 billion per year.

On the cost side we must count all losses of potential output in economic activity in the United States associated with periods in which domestic policy is tighter than it otherwise might be because of balance of payments considerations. Even if this were just 1 percent a year it amounts to $10 billion on a trillion dollar economy.

On the non-economic side our service as world banker has probably provided an equal amount of joy and sorrow -- but this is not measurable -- not even crudely.

In any case, our role as world banker -- or as a reserve currency -- is regarded as a special and valuable privilege by others. We could exchange it for some real privileges -- and in the process establish a new world order in international monetary relations.

By giving up the dollar's role as a reserve asset-currency we would automatically give the rest of the world the assurance it needs that it cannot again be flooded by unwanted dollars.

In return we should demand two firm assurances which we will need:

(a) An assurance that we will not be confronted in the future by requests to convert dollars into other reserve assets. (This can be accomplished by the actions outlined earlier on page 9.)

(b) An assurance that the fixed rate system established at Bretton Woods will be replaced by one in which all exchange rate parities including the dollar's will be allowed and indeed encouraged, to change flexibly, and in both directions, in response to observed movements within wider bands. (See Appendix 1 to this memorandum.)

IV. Dismantling Existing Defense

When the dollar's present overvaluation is eliminated and the basic reforms just outlined are achieved we can offer to dismantle the small but numerous "protectionist" programs we have installed in defense of the previous disequilibrium rate. In addition to the recent surcharge these include several investment restraints; "Buy American" regulations; and most of the voluntary and mandatory restraints on imports. Realistic exchange rates now and adaptive future changes in rates can accomplish in an efficient, impersonal and nondiscriminatory way what these directed and hostility-generating measures never were successful in achieving.

Appendix I

An adaptive system that would be a great step forward would retain the concept of official parity exchange rates and limits on market rate variations about the parities. But the parities would be reset frequently, perhaps each weekend, and would be directed by a moving average of recent market experience. Specifically a parity rate might be calculated as a moving average of the weekly market rates of the preceding ~~52~~ 26 weeks (6 months). Support operations might take place 1.5 percent either side of this rate parity. Such a parity would be reasonably responsive to changes in the payments structure, and it could be made more so by increasing the weighting of data. But it would never run away. At most it could change by 3 percent per annum vis-a-vis its numeraire. In view of the opportunity for rate changes within the band and for the parity itself to move either upward or downward, speculation on the exchange rate would be risky. And the exchange rate itself would at best yield speculators 3 percent per annum on their investment in terms of the numeraire and 6 percent in terms of other national currencies. Timely rate changes could be obtained without the disruptiveness which speculation and action to protect assets has created in the past.

In unusual circumstances, even these rates might lag undesirably behind the onrush of change. Then the predictability of their course would stimulate capital movements aimed at adding the foreseeable benefit of exchange appreciation to the return obtainable on investment in the appreciating currency. To meet such circumstances, the concept of "fundamental disequilibrium" and amendment of rates through multilateral agreement that has made the IMF system tolerable should be retained. The adaptive character of a set of weighted moving average parity rates with a somewhat widened band, however, will ensure that discrete changes in the system are rare and much smaller in magnitude than those that have been necessary under the regime of fixed parities.

The principle of multilateral consultation over rates was established at Bretton Woods to discourage individual countries from engaging in competitive currency depreciations. To discourage governments from entering exchange markets for purposes other than fulfilling exchange stabilization operations, governments should be required weekly to report their intervention activities to the IMF, specifying currencies purchased and sold and the prices in the transactions. The IMF Charter, in the revisions it would undergo, would bar, and therefore create at least a moral sanction against, intervention at other than near support prices.

The choice of the numeraire of an adaptive exchange rate system is of special importance to the United States. In particular the numeraire should not be the dollar. If negotiations toward an adaptive system failed and significant elements of governmental discretion in rate setting were introduced, the placing of the dollar in the central position would again impair our freedom of action. Either we would be party to all discretionary decisions or none, and in the end other countries would likely be more free to depreciate relative to the dollar than we would be vis-a-vis some or all of them. Even in a fully adaptive system the numeraire's freedom of movement is prescribed. For when deutschemarks stabilized on the dollar are appreciating the full band width while, say, the pound is depreciating, the deutschemark-pound rate varies twice the band width. This can be true for any pair of non-numeraire currencies against each other. The numeraire, however, never raises more than the width of the band against any currency. In view of the reserve role suggested for SDRs earlier it would be natural for SDRs to be the numeraire of the system.

Adaptive exchange rates would not preclude the dollar's continuing to function as the vehicle of private transactions. Indeed, all the more, in a world in which most rates slowly change, traders would be drawn to the extensive use of a few currencies. Nor need the system impair the further development of the young Euro-dollar market which has vastly increased the international mobility andk efficiency of capital.

Not all countries would choose to implement adaptive rates vis-a-vis all others. Some of the currency areas that have coalesced in the past would doubtless survive. The EEC countries might decide to proceed toward monetary union and adapt their currencies uniformly relative to the rest of the world. Countries closely bound by economic ties to France or Britain might choose to follow those currencies whether or not they were part of an EEC bloc. And a number of Latin American neighbors of the United States might well choose continued fixity relative to the dollar. These arrangements are subject to negotiation and are tolerable in an adaptive rate system in the degree that the countries involved are prepared on the basis of traditions and institutions to engage in the policies essential to exchange rate fixity. Since, with the exception of the EEC countries and the U. K., the relationships mentioned are usually that of satellite economy to market center, ruptures in the relations that result from inadequate adaptation are not widely disturbing.