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THE INTERNATIONAL MONETARY SCENE DURING
THE SIXTIES AND SEVENTIES

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**THE INTERNATIONAL MONETARY SCENE
DURING THE SIXTIES AND SEVENTIES**

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PREFACE

Many far-reaching and fundamental changes have taken place in the post-war world monetary system (Bretton Woods System) in the last two decades or so. The salient features which were underlined at Bretton Woods (1944) got gradually eroded and many contradictions got built up into the system during the course of its functioning. The breakdown of the Bretton Woods System in the early 1970s led to a series of developments which ultimately culminated in the emergence of the Managed Floating System.

This work which aims at reviewing these developments is, in a sense, a critical commentary from Bretton Woods (1944) to Jamaica (1976) and it was undertaken under the valuable guidance of Dr. S. V. Bokil. At the very outset I must acknowledge my indebtedness to Dr. Bokil, who supplied me the necessary framework to operate. But for his penetrating comments, valuable suggestions and subtle analysis of certain intricate aspects of this interesting subject, this theoretical work would not have assumed this present shape. But I must hasten to add that for all the technical deficiencies and factual errors that may have crept into my work I am solely responsible for it. Besides I owe a great deal to Dr. Bhagwan Bapat, who was a constant source of inspiration and encouragement and offered me all possible help. I must express my deep sense of gratitude to these two

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Professors and other faculty members for having inculcated in me a spirit of critically looking at things and persons.

I am very much grateful to the Director and Joint Director of the Gokhale Institute for having selected me under UGC's Faculty Improvement Programme and offered me a fellowship which enabled me to undertake this work. Moreover I must mention that the academic environment pervading in the campus worked as a major stimulating factor behind this work. I also express my thanks to the Library Staff of this Institute who extended me an excellent cooperation.

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INTRODUCTION

This work is a critical study of the functioning of the Bretton Woods System (BWS) during 1946-1971 and subsequent developments in the international monetary field. Such a study is a truly challenging one in view of the vast literature available on this fascinating topic where there is hardly a top economist who has not made his contribution. We shall therefore try to analyse the issues that have been debated in this literature and try to grasp their significance along with the important developments that have occurred in this field during the 1960s and 1970s.

To accomplish this task we first examine the nature of international money and the essential features of an ideal world monetary system (WMS). In the light of those requirements of WMS, we analyse the arrangements made under the auspices of the IMF for the post-war international monetary order. We then examine how BWS actually functioned during 1946-1971 and why it ran into serious troubles. The collapse of the BWS in 1971 and the emergence of the era of managed floating rates coupled with the international oil crisis have put the world at a point of no return. We shall try to grasp the significance of the problems these momentous developments have given rise to. We shall conclude with our assessment of international monetary scene as it looks to us at present.

CHAPTER 1

NATURE AND SIGNIFICANCE OF INTERNATIONAL MONEY

1.1 Money has come to play a more fundamental and unique role in our present day economy and the modern economy can be rightly described as money economy. It not only acts as a medium of exchange to make the economic system run smoothly, but also serves a temporary store of value. By enabling the community to save real costs in terms of information and search, money plays a truly productive role. Since the act of saving is independent of the act of Investment in a modern, monetary economy there should be an effective financial inter-mediation for canalising the real savings of the community into productive channels. This task could be accomplished only when the stability of the value of money is maintained. Thus a national currency is required to remove all inconveniences of the barter and assist economic activity within the domestic sphere. It can be stated here that similar economic "benefits accrue to the world economy from having an international money which serves as a convenient unit of account, medium of exchange and temporary store of value in transactions involving internationally traded goods and assets".* Therefore an ideal international money is a must for facilitating multi-

* Grubel, H.G. The International Monetary System: Efficiency and Practical Alternatives (Third Edition). Penguin Books (1977), p. 152.

lateral trade and the flow of Investment among the countries of the world. In a sense, a well functioning world monetary system by assuring efficient exchange would maximize world welfare.

1.2 In each and every country, the task of issuing and controlling the money supply rests with the respective central Banking authority. Since many member countries are not willing to surrender their national sovereignty to a super world organisation, on the international plane, a World Central Bank has not emerged yet. In the absence of a World Central Bank, the responsibility of issuing and organising the world money is entrusted with the key currency country (or countries). A key currency country is one which must have a solid economic base and enjoy a substantial amount of current account surplus. (The latter as an indicator of the economic performance of the country would enhance the value of the key currency.) It should be also a large trading nation and World Banker. It must possess a deep and broad money market and offer a wide spectrum of assets of varying maturity and returns to the prospective money holders. In a sense, the key currency country borrows short and lends long and the confidence on the currency issued by the World Banker is very vital for the efficient functioning of the system.

1.3 In the actual operation of the system, the key currency country by running into deficits* releases the necessary

* These deficits are called "deficit without tears" since it can issue a paper claim (IOU) against itself.

international liquidity to meet the requirements of the world economy. In this process of creating an international money, it enjoys the special privilege called Seigniorage Benefit¹ by which it can pre-empt the real resources flowing from the rest of the world. At the same time it is also handicapped by the lack of exchange rate autonomy which other countries would enjoy. As the country of nth currency in the world it allows the value of its currency to be maintained by the intervention policy of the rest of n-1 countries.²

In our proposed study of the functioning of the Bretton Woods System (BWS), we would see how the U.S. (and to a lesser degree the U.K.) emerged as a reserve/key currency country and effectively played the role of World Banker supplying international liquidity, and how the system based on Gold Exchange Standard principle ran into increasing difficulties in the late 1960s and ultimately collapsed in the early 1970s.

Before making a critical review of those significant developments, let us first spell out the salient ingredients of a good world monetary system (WMS), because a well organised WMS is an essential prerequisite for fostering economic prosperity and maintaining the financial equilibrium of the world economy.

1.4 Essential Features of a Good WMS

(i) It must ensure an adequate amount of international liquidity (viz. internationally acceptable money and/or credits convertible into money) to satisfy the growing requirements of

world trade. This implies that it should contain a mechanism of liquidity creation which would ensure a secular expansion of liquidity to keep pace with the expansion of world trade.

(ii) It should provide for an effective and equitable adjustment mechanism i.e., there should be a readiness on the part of the member countries to introduce appropriate changes in the rate of exchange, when serious and persistent Balance of Payments (BOP) imbalances develop in their economies. The burden of adjustment should also be equitably distributed among the surplus and deficit countries.

(iii) Efforts must be made for controlling and regulating the growth of world reserves. Of course, unless there is a super World Central Bank (capable of issuing international money) exists, complete control over international liquidity would be impossible.

(iv) It must maintain faith and confidence in the stability of international money. If the system ensures adequate liquidity and provides an effective adjustment mechanism, confidence can be automatically restored.

(v) Since most of the Third World countries [excepting the oil rich Organisation of Petroleum Products Exporting Countries (OPEC)] are steeped into poverty and underdevelopment, a provision shall be made for effecting the transfer of real resources from the affluent nations to the impoverished Less Developed Countries (LDCs) of the world.

In essence, an ideal international monetary system must create an environment where liquidity problem, adjustment problem and confidence problem will not occur.

In the light of the above characteristics of a good WMS, we shall analyse the functioning of the BWS during the 1960s and early 1970s and also the emergence of a new or non-system after 1973.

CHAPTER 2

THE BRETTON WOODS SYSTEM (BWS)

2.1 The Bretton Woods Conference (1944) gave birth to the twin institutions viz. IMF and IBRD. The Fund (International Monetary Fund) which evolved out of the compromise formula between Keynes'³ Plan and White Plan, mainly represented the will of the United States. The White Plan formed the basis for the creation of the Fund.

2.2 This BWS (IMF) was mainly designed to incorporate the salient features of the Gold Exchange Standard which was in operation during the inter-war period and free itself from the drawbacks of that standard. The experiment with the Gold Standard mechanism clearly underlined the fact that it could not reconcile between domestic objectives (maintaining full employment and price stability) and Balance of Payments objectives (ensuring exchange rate stability). By attaching excessive importance to exchange rate stability it imposed real costs in the economies in the form of mass unemployment. It had an inherent tendency towards deflation. The framers of the BWS, set out to establish an orderly system of currency and exchange arrangements which would avoid the bitter lessons of 1930s.

2.3 Main Provisions/Salient Features of the BWS

(a) Gold occupied a 'pride of place' in the system.

It was the numeraire for the expression of par values of national currencies. By linking the value of their currencies to the Yellow metal which had no nationality, the respective member countries felt that their national sovereignties were not eroded. Gold served as the fundamental reserve asset and ultimate means of payment.

(b) The system was essentially based on 'stable and fixed par values'. This did not imply that the exchange rates were to be rigid for ever. In times of fundamental disequilibrium (a term which was not clearly spelled out in the Articles of the Fund), they could be altered after seeking permission from the Fund. Thus exchange rates were the matter of international concern and autonomy in exchange rate was surrendered to IMF. Member countries could express the par value of their currencies in terms of dollar (which was fixed at 35 dollars per one ounce of gold of .995 finess). Exchange rates were to be maintained within a narrow margin of one per cent on either side, thereby implying the need for market intervention.

(c) The Fund envisaged that the fixed exchange rates should not be fictitious ones and they should operate in an environment of freedom of capital and trade flows. But during the transitional period, the Fund allowed the member countries to practise discriminatory currency practices and restrictions on current payments. After this period was over the Fund was to take steps towards the non-residential convertibility of currencies so as to facilitate multilateral trade and payments.

(d) To accomplish this task and maintain fixed exchange rates within narrow margins a large amount of reserves was needed. By establishing a Common Reserve Pool (the quotas of member countries) the Fund stood ready to extend short term credit facilities to member countries so that they could tide over their temporary balance of payments (BOP) difficulties without resorting to restrictive trade practices.

Since the quota rights (into inconvertible currency) conferred on member countries were inadequate and the net addition to the monetary gold stock was negligible, the international liquidity structure was inelastic in relation to the requirements of the world economy. To ensure an adequate quantity of liquidity and impart an element of elasticity to the process of international money creation, the U.S. found itself in a situation where it could play the role of 'Reserve Centre'.

(e) Thus in the absence of any mechanism for the creation of genuine reserves the U.S. spontaneously emerged as the 'World Banker' by virtue of its dominant economic strength, huge amount of monetary gold stock (66 per cent of world monetary stock) and a strong BOP position at that time. Since the U.S. continued to honour her commitment* of converting dollars into gold at a fixed price of \$35 per ounce, it was as good as gold. Even it was more desirable than the latter, since it was a

* The U.S. fixed the dollar price of gold at 35 dollars per ounce in February 1934 and stood ready to buy and sell gold at that price.

readily usable, interest earning liquid asset. Thus the U.S. dollar - a national currency evolved as the principal vehicle currency for international trade and an intervention, Reserve medium for the Central Banking authorities.

The U.S. by performing the role of the World Banker and financial intermediary fulfilled a function left unspecified by the Bretton Woods Agreement. While the Fund Charter explicitly recognized the vital importance of the dollar, it was silent on the possible role the U.S. could play in shaping the international monetary system.

Thus the BWS began to heavily rely on the U.S. and the growth of international liquidity became dependent on the U.S. BOP deficit and the willingness of the Central Bankers not to convert the dollar balances into gold. In essence "the salient ingredients of the gold exchange standard were incorporated in the Fund's scheme".* The BWS projected itself to be the Gold Exchange Standard.

Before analysing the actual functioning of the BWS, during the post-war period, let us grasp some of the theoretical problems (concerning the international monetary system based on Gold Exchange Standard) which were extensively debated in the literature during the sixties. In the next chapter, we shall try to understand them.

* S.V. Bokil. The Mechanics of International Money. Macmillan (1971), p. 14.

CHAPTER 3

THEORETICAL PROBLEMS OF THE INTERNATIONAL MONETARY SYSTEM

3.1 During the 1960s, the experts on international monetary economics, analysed certain important theoretical problems confronting the post-war world monetary system (BWS) based on Gold Exchange Standard. Since these problems were clearly manifested in the course of its functioning, it is essential for us to grasp those theoretical issues for an in-depth understanding of the system. The problems involved were confidence problem, liquidity problem and adjustment problem. We shall also make a reference to the problems like Assignment, Redundancy and Seigniorage (problems) which were debated in the literature.

3.2 The confidence problem was mainly concerned with the use of dollar as international money, a substitute for gold. It had two aspects, short run and long run. Since international liquidity comprised not of homogeneous money units, but a number of alternative money forms like key currencies and gold, the holders might differ in their asset preferences. If the protracted BOP difficulties persisted in Reserve Currency countries like the U.S.A. and U.K., a run on these currencies would start, and the holders of these currencies would switch them into other strong currencies and gold. "The switchability as between international money forms hits at the heart of confidence

problem,"* and this would have a destabilizing effect both in exchange markets and private gold markets.

During the early 1960s, the monetary and fiscal policies combination of member countries were such that the outflow of reserves from the U.S. were larger than desired by West European Countries and that generated worldwide inflationary potential. The European Countries, by withdrawing gold from the U.S., tried to put pressures on the U.S. to desist from generating world inflation. The situation resulting from this conflict of objectives was termed as 'the short run confidence problem'.[@]

In the long run, the very inherent dynamics of Gold-Exchange standard would change the position of Reserve Centre and erode the foundation of the system. In the event of U.S. running into huge amount of BOP deficit, the ratio of U.S. gold reserves to foreign owned liquid dollar assets would decline, and induce a large scale conversion of dollars into gold. All these would shake confidence in dollar, extinguish liquidity and precipitate the monetary crisis causing disruption to international trade and payments.

3.3 The liquidity problem was that no adequate provision existed for expanding world reserves to meet the requirements

* Scammell, W.M. International Monetary Policy: Bretton Woods and After. Macmillan (1975), p. 33.

@ Johnson, H.G., "Theoretical Problems of the International Monetary System," The Pakistan Development Review, Vol. VII, No. 1 (Spring 1967); Reprinted in his Further Essays in Monetary Economics. George Allen & Unwin Ltd. (1972), p. 191.

of the world economy. In the absence of a sufficient increase in reserves, the U.S. BOP deficits served as the principal media for expanding international liquidity. Excess U.S. BOP deficits, resulted in the creation of more reserves, over and above the requirement of the world economy. This conferred an increasing advantage to the U.S. and generated inflationary forces abroad. By converting dollars into gold, the European powers tried to destroy the excess money creation. It was also feared that the growing U.S. deficit and her fast depleting gold stock, would lead to a crisis of confidence on dollar and cause a severe international liquidity crisis. To resolve this crisis and reduce the dependence on dollar and gold for reserve creation, an agreement was reached at IMF annual meeting in 1967 to create an international money (Special Drawing Rights).

3.4 The two problems discussed above viz. confidence and liquidity are closely related to the adjustment problem. The prompt adjustment in BOP would automatically restore confidence on the value of the currency and also reduce the need for liquidity for correcting transitional current account deficits. The adjustment problem was that during the 1960s, many industrial nations were reluctant to use Exchange rate as an instrument to correct BOP disequilibria. They could not also succeed in employing appropriate demand management policies. The unwillingness on the part of both Deficit and Surplus countries to alter the par values downwards and upwards respectively, ultimately made BWS as a 'Disequilibrium System'. Payments imbalances were becoming larger and more persistent, the

counterpart of the large deficits of the U.S. being the large surplus of other industrial countries, more particularly West Germany, and Japan.

3.5 In the actual process of the functioning of the BWS, exchange rates became rigid and hence the adjustment mechanism became inoperative. Then the problem was how to bring about both internal (full employment) and external (BOP equilibrium) balance or more particularly how to resolve the dilemma between BOP deficits and abnormal unemployment. It was suggested that even within the framework of Fixed Exchange Rate System, by adopting an appropriate policy-mix (Monetary and Fiscal policies), the dilemma could be resolved. This did not mean that the policy mix contained a mechanism of adjustment and indeed it would be the exact opposite of an adjustment mechanism. Suppose that a country persists in maintaining full employment, the wages and prices would increase at a faster rate and make the country's competitive power to fall out of line. Its current account would worsen further and this would again necessitate the countries to resort to policies of "mixing expansion and monetary contraction" and impose controls on capital outflow to keep the BOP account into equilibrium.

"In the actual working of the international monetary system however there is a mechanism of adjustment at work, of the classical gold standard kind involving deflation in the deficit countries and inflation in the surplus countries."^{*}

* Harry G. Johnson. Further Essays in Monetary Economics, op.cit., p. 173.

But the effective classical adjustment mechanism could not be at work because of the fact that the central bank tended to neutralise the liquidity effects of payments imbalances to avoid conflicts between domestic objectives and international ones. There would be always a constant tendency to resist deflation in deficit countries and inflation in surplus countries. As a result the "resulting system of reluctant adjustment" would have a tendency towards inflation.

Thus the inability of both surplus and deficit countries to employ appropriate policy mix effectively and the absence of the classical adjustment would slow down the adjustment mechanism.

3.6 Then the next problem would be how to bring about the best policy mix for reconciling between internal and external balance. This problem came to be known as Assignment problem in the literature (following the work of R.A.Mundel). This was derived from the observation that government assigned specific responsibilities to separate governmental institutions for fulfilling policy objectives (Central Bank controlling monetary policy is given responsibility for maintaining external balance and the treasury controlling fiscal policy is given responsibility for full employment). "The assignment problem is which objective should be assigned to which agency to assure the most efficient operation of policy" and a solution to this problem was provided by R.A. Mundel in the form of the 'Principle of effective market classification' - "that each agency should be

assigned the objective on which the policy instrument under its control has relatively the greatest influence, as contrasted with other objectives. In a fixed exchange rate system this means assigning external stability to monetary policy and internal stability to fiscal policy".*

3.7 In a single country model, it could be possible to achieve a just internal and external balance by an appropriate policy mix. But in the real World Economy, the situation would become complex and pose problems. (1) It would be no longer possible for a country to resort to the policy instruments and attain the necessary balance, for they would be thwarted or frustrated by inconsistent use of the policy instruments in other countries. (2) "Following Cournot's Law (Balance of Payments of all countries in the world economy must sum to zero), the external balance objective of all countries will be achieved if all but one of them achieve it." In a single country case discussed above (refer 3.5) there were two policy objectives requiring two policy instruments to implement them, in the n country case there will be $2n$ objectives requiring only $2n - 1$ policy instruments; in other words there will be one degree of freedom or one spare policy instrument in the system.® This implies that one country can alone enjoy this freedom for some third purpose and the basic problem is how this degree of freedom could be used for international purpose.

* Ibid., p. 174.

® Ibid., pp. 182-183.

"The presence of the degree of freedom associated with Cournot's law give rise to what has been termed as the 'Redundancy Problem'."* One policy instrument becomes redundant. The question of who should enjoy this freedom ultimately culminated in the fundamental debate regarding the sharing of "the burden of long run adjustment to international disequilibrium the Europeans favouring a more deflationary system that would throw a larger share of the burden on the deficit countries and the Americans and British favouring a more inflationary international monetary system".@

3.8 An another important problem discussed during the sixties was the Seigniorage Problem. This was related to the special benefits which a reserve currency country could enjoy (having the first opportunity to pre-empt the real resources flowing from the rest of the world) by virtue of issuing the international money. During the late 1960s when reform proposals were under way for the creation of SDR (Special Drawing Rights), a new international money, again this problem cropped up. Since the creation of new money entails seigniorage benefit to the issuer, one of the main problems was how to distribute the gain among the member countries.

The substitution of non-interest bearing paper money (in the place of commodity money) entails negligible cost.

* Ibid., p. 184.

@ Ibid., p. 185.

"There would be a once over social saving equal to the real value of the existing stock of money, the resources embodied in which could be directed to more profitable uses and a continuing social saving equal to the resources formerly used to provide the additional money required by economic growth. The once over social saving could alternatively be presented by the flow of interest on the real resources initially embodied in the money stock."^{*}

The LDCs (Less Developed Countries) basing their arguments on the above line of reasoning demanded SDR-link with Development Finance as a potential vehicle for redistribution of newly created (reserves) resources towards them i.e. "creation of a new international asset involves the generation of the pool of real resources which pool constitutes benefit from international monetary reform that must be equitably shared".[@]

In the recent years much empirical work is going on regarding the measurement of Seigniorage benefits enjoyed by the Reserve Centre. In the light of the theoretical problems discussed above, we shall begin to analyse the functioning of the BWS in the next chapter.

* Ibid., p. 194.

@ Ibid., p. 195.

CHAPTER 4

A CRITICAL REVIEW OF THE FUNCTIONING OF THE SYSTEM

1946-1949: The Early Phase: Transitional Period

4.1 This was a period of suspended animation for the Fund. It played only a passive role. The economic conditions were grave; the volume of world trade had shrunk to a lower level, owing to paucity of international reserves. Since many currencies were not convertible, multilateral trade could not take place. The 'Bilateral Agreements' became the instrument for financing world trade. Various kinds of restrictions on the movement of goods and capital persisted. The liquidity problem was acute.

The U.S. after writing off the credit of 20 billion dollars, provided a new line of credit amounting to \$ 3.75 billion (1945) to Britain for correcting her transitional post-war current account deficit with the hope of facilitating Pound convertibility and thereby easing the international liquidity position. But Pound Sterling was in trouble. Britain's abortive attempt of Pound convertibility failed (1947). The U.S. dollar became the main focal point and as a key currency it enjoyed a 'monopoly' position.

The Resources of the Fund* (quotas in IMF) totalling \$ 8.8 billion were inadequate to meet the requirements of world

* This includes \$ 1.2 billion from the Soviet Union, which however never joined the Fund.

liquidity. The worldwide demand for goods resulted in a 'scramble for dollar'. The U.S. came forward to alleviate the dollar shortage, by extending a liberal economic assistance to Western Europe and Japan under Marshall Aid Programme.⁵

Second Phase: (1949-1958)

4.2 By 1949, the world buyers' market emerged and Camille Gutt describes this switchover as "the transition from an abnormal post-war market to a normal if not fully normal peace time market. It reflects itself in the increasing importance of price and demand factors"^{*} and in recognition of these changes a massive devaluation of major European currencies to the tune of 30.5 per cent in relation to the U.S. dollar took place. It tremendously improved the competitive power of these countries and helped them to capture a sizable segment of the world market.

Even after the termination of Marshall Aid, the U. S. continued to extend more military and economic assistance to her European allies. Her substantial current account surplus enabled her to play an active role. It should be here stressed that the U.S. was instrumental in cementing the foundation of the economic structure of West Europe and Japan. Since the U.S. allowed the European Countries and Japan to practise discrimination against the imports from here, there was no need

* Camille Gutt. Presentation of Annual Report, 1949, Summary Proceedings, IMF, Washington, p. 9. Quoted by S. V. Bokil, op.cit., p. 55.

for invoking the 'scarce currency clause' Article in the Fund. European countries were encouraged to build up dollar reserves and even convert a part of them into gold, since the distribution of the monetary gold stock was skewed. With the progressive increase in 'reserves' held by the European countries, the prospects of convertibility became bright. With the return of defacto convertibility of Sterling during mid 1950s, the substitution between the U.S. dollar and Pound could be possible in the composition of reserves and a duopolistic situation arose among the two currencies.

The BWS could function very smoothly during this period, mainly because, it was an era of dollar shortage. It was only the U.S. and not the Fund which played a leading role. The U.S. role as the Reserve Centre was unquestioningly accepted and the U.S. deficit led to an automatic increase in world liquidity.* "Over a period between 1950-57 the U.S. had to run an overall average deficit of \$ 1.3 billion." It amounted to \$ 2.9 billion in 1958. The U.S. deficit was termed as "net transfers of gold and dollar to the rest of the world". And this 'beneficial disequilibrium', facilitated the expansion of liquidity and paved the way for non-residential convertibility of European currencies at the end of 1958 (December). It did not give birth to 'Confidence problem'. The system was exposed

* "Out of the \$ 8.5 billion increase in world reserves in the years 1949-1959, the U.S. provided \$ 7 billion through the increase in its liabilities to foreign monetary authorities." Soloman, R. International Monetary System, 1945-1976: An Insider's View. Harper and Row (1977), p. 31.

to serve pressures only after 1958, when it began to operate in full swing.

1958-1971

4.3 The crucial test for judging the efficacy of the BWS came during this period. The realization of the non-residential convertibility of European currencies (1958), enabled the Fund to play an active role. By the time, the Fund started functioning effectively, the problems also cropped up. In this section we shall follow those momentous developments and analyse the tensions they have given rise to.

In the preceding chapter we have seen that in the absence of a mechanism for liquidity creation, the IMF system became heavily dependent on the U.S. deficit for 'reserve growth'. Moreover the system was built upon the illusion of the convertibility of dollars into gold. "The fixed par values and the established price of gold" became the basic underpinnings of the system.

Therefore for a clear-cut understanding of the actual functioning of the system and grasping various issues which cropped up in the course of its functioning, we must begin our analysis with the nature of the U.S. BOP deficit, the behaviour of the gold market and the functioning of the fixed exchange rates, in an era of the freedom of the mobility of capital.

4.4 Nature of the U.S. Balance Payments Deficit

At the very outset, it must be stressed that the nature

of the U.S. BOP deficit markedly differed from that of other countries. Though the U.S. deficits were very much influenced by her domestic policies and increasing external commitments, in the first instance, it served as a principal media for expanding international liquidity. During the 1950s the U.S. traditional trade surplus was substantial and the overall deficit was moderate. So the confidence problem did not arise. Indeed these payments deficits were welcomed because they enabled the European countries to build up their economies, strengthen the reserve position and thus augment their overall liquidity. But the U.S. deficits became a 'Problem' during the 1960s, when she indulged in excessive money creation to fulfil her external commitment.

The nature of the U.S. deficits differed on different occasions on different grounds. We shall not go into intricate details, but only point out the important highlights.*

The U.S. ran into increasing deficits from 1958 onwards. She could not sustain her massive traditional trade surplus. The formation of European Economic Community (EEC) and low wage cost conditions prevailing in Europe, conferred the distinct export advantages on European countries. During 1958-59, the U.S. deficits were mainly caused by a drastic decline in her export surplus. The deficit was around \$ 3 billion a year. (But it amounted to only less than half of one per cent of her

* "United States Balance of Payments, Selected Accounts, 1946-1973" are given in Table 1 in the Appendix.

GNP.) Foreign monetary authorities also purchased gold about \$ 2.3 billion from the U.S. (1958).

When the decade of 1960s started the first severe dollar crisis rocked the system, and Balance of Payments deficits were mainly due to short term capital flows from the U.S. (1960-61). Despite a massive export surplus to the tune of \$ 4.9 billion (1960), the overall deficit (on official reserve transaction basis) mounted to \$ 3.4 billion. During the next two years 1962-64, long term private capital outflow contributed to the deficit. The U.S. emerged as a potential European Investor to take advantage of an ideal investment climate created by the formation of EEC and low cost conditions in Europe. The interest rate differentials also caused much short term capital movements. Therefore during the period 1960-64, though the traditional trade surplus averaged \$ 5.4 billion, it was offset by both short and long term capital flows.

After 1957, the U.S. recorded the largest export surplus only in 1964. But during the mid-sixties, the U.S. experienced an expanding economic activity which necessitated a large volume of imports. The demand for imported capital goods, cars and other consumer goods shot up. "The ratio of growth rate of imports to growth rate of GNP was twice as high for 1965-1971 as it had been for 1950-1964."* At the same time her trade surplus was becoming thin (and during the early 1970s it became

* Yeager, L.B. International Monetary Relations. Allied Publishers Private Ltd. (1978), p. 572.

non-existent). The European countries and Japan which had absorbed new technology and emerged as a potential trade Bloc, posed a severe competition and as a result the U.S. dominance in world trade was considerably affected. There was a clear-cut shift of monetary power from the U.S. to Europe and Japan.

The escalation of Vietnam War in 1965 and the increasing involvement of the U.S. in the war and its evergrowing military commitments abroad once again made the U.S. BOP into red. No longer her current account surplus could be relied upon to finance her long term investment abroad. *plus military expenses*

During the late 1960s, the U.S. deficit was mounting (with the exception of the year 1968). A major monetary crisis was building up. During the final days of BWS (1970-71), the Basic Balance of the U.S. was very weak. In 1970 the U.S. experienced a record deficit of \$ 10.5 billion and in 1971 it increased to \$ 22.0 billion on net liquidity basis and \$ 29.8 billion on official Reserve Transaction Basis.

During this period (1970) there was a growing evidence of incompatibility between national domestic policies and exchange rate policies. The U.S. which was recovering from recession maintained a low rate of interest to revive the economy. This induced capital outflow from the U.S. to European countries more particularly to Germany where tight monetary conditions prevailed to combat the inflationary forces. Added to these interest rate differentials "exchange rate expectations" also played a crucial role in accentuating the flow of funds from

the U.S. into surplus countries.

Thus we can conclude from the above that the U.S. cumulative BOP deficit was caused by a variety of factors like declining traditional trade surplus, inflationary conditions at home, increasing imports from abroad, excessive economic and military assistance, massive direct investment in Europe and elsewhere, increasing involvement in the Vietnam war (and financing it not by taxes, but by the creation of new money) and above all keen competition from the potential trade bloc EEC and Japan.

4.5 We shall now briefly analyse the implications of the U.S. deficits. It would be recalled here that the BWS was designed to halt the bias towards deflation. But the system which became heavily dependent on the U.S. deficits degenerated into an 'inflation machine'. It is now increasingly admitted that the cumulative deficits of the U.S. were instrumental for excessive liquidity expansion and the resulting worldwide inflation. Indeed during the final days of the Bretton Woods System, as seen from above, there was a liquidity explosion. The massive influx of unwanted dollars into the surplus countries intensified the inflationary forces.*

While the European countries welcomed the U. S. BOP policy of 'Benign Neglect' during the 1950s they expressed their

* For example, in 1970, the flow of funds from the U.S. to West Germany nearly accounted for 23 per cent of total money supply. Between January-April 1971 West Germany's reserves went up by \$ 3 billion. On two days alone May 3 and May 5, 1971 reserves rose by \$ 2 billion.

resentment in the sixties by calling it a 'malign neglect'. There was a resistance to hold liquidity created by the U.S. deficit. Especially France was adamant in converting the dollar reserves into gold. All these imply that the U.S. should have taken necessary measures to correct her mounting payments imbalances and subjected herself to monetary discipline. But it should be remembered that as a 'Reserve Centre', the U.S. virtually enjoyed an unlimited credit card and therefore could merrily run into deficits (without tears). So it was a part of the system. Being handicapped by the lack of exchange rate autonomy, the U.S. was not prepared to surrender her Seigniorage benefit. As a true World Banker, the U.S. acted borrowing short and lending long. Any other country in that position would have also misused the position of Reserve Centre to fulfil the external ambitions.

Moreover the interlocking nature of the BOP position of the U.S. also made it impossible for her to have a soft option in the adjustment process. Her exports, imports, foreign aid and investment were interrelated with each other. It should be also stressed that her huge amount of military expenditure provided a sense of security for Europe. Therefore, for all these reasons it was suggested that other surplus countries could appreciate their currencies and relieve the pressure on dollar.

The European countries argued that the persistent U.S. BOP deficits was purely the sole concern of the U.S. It was not

their business to correct it. If they were to eliminate the U.S. deficits by revaluing their currencies, then the U.S. would never subject herself to discipline, since it would be always confident that other countries would make necessary adjustment in their exchange rates, whenever the imbalance in the U.S. BOP persisted.

Thus the U.S. chronic deficit resulted in a large overhang of America's liabilities and the U.S. has to be blamed for the crisis of confidence on the dollar and the system as such. But it is not just to blame the U.S. alone for the sickness of the system. Many European currencies (and also Japanese Yen) had been undervalued. If the European countries had wanted to reduce the accumulation of dollars, they could have imported more goods from the U.S. rather than what they exported to the U.S. They were reluctant to do this because it would have adversely affected their export sector. For the same reason they were not prepared to revalue their currencies. They were unhappy with the U.S. deficits and the resulting 'dollar overhang' in Europe and yet they were anaesthetized to live with it. They knew very well that any precipitate action on their part would have made the system to crumble like a pack of cards.

Thus the cumulative BOP deficit of the U.S. created an asymmetry in the adjustment process, a crisis of confidence on dollar and above all resulted in an explosive inflationary conditions throughout the world. Throughout the decade of 1960s and early 1970s, their impacts could be felt in the

movement of the open market price of gold and the exchange rates of major currencies.

4.6 Pressures in Private Gold Markets

Now we shall see how the BWS was exposed to severe pressures in both gold markets and foreign exchange markets. With the return of non-residential convertibility of currencies, the mobility of short term funds was made possible. The emergence of gold as a safe, fast appreciating asset (than dollar) widened the options of speculators.

The assumption that the dollar price of gold was immutable was falsified by the rise in the price of gold in the early 1960s. The weakness of the dollar was fully evident. Any rise in the price of gold resulted in a huge discount on dollar.* Holders of dollars (private individuals, speculators and other institutions) having a claim on the U.S. could not convert dollars into gold in the official market. Hence they entered into private gold market. In the early 1960s, the price of gold was ranging between \$ 38 and \$ 48 per ounce of gold. Holders of dollars started adjusting their portfolios of assets by constantly switching them into gold and other strong currencies which were likely to appreciate. This ultimately resulted in an increase in the dollar component of foreign

* In the 1960s on account of the dollar-gold link, the run on dollar started, whenever the price of gold shot up. Since the illusion of convertibility no longer exists now, the increase in the dollar price of gold does not lead to a flight from dollar. It is not taken care of, excepting by the rich people and big speculators who make large purchases of gold for 'windfall gains', in the future.

exchange reserves held by the Central Banks. Their portfolios got distorted and they tried to readjust it by converting part of dollar reserves into gold, which again in turn drained the official gold stock of the U.S.

With the support of the top industrial nations, the U.S. established Gold Pool Organization (1961) to control the market price of gold. During the first half of the decade of 1960s, owing to certain favourable factors, the upward trend in the price of gold was controlled and the Pool was a net buyer of gold. But the stoppage of selling gold by U.S.S.R. (1965), weakening position of British Pound (1964-67), withdrawal of France from the Pool (Summer of 1967),* devaluation of Pound (November 1967) and the speculation triggered by the Pound devaluation that the U.S. dollar would be the next target of attack were some of the factors which ultimately led to gold stampede of 1967-68.

"From the time Sterling was devalued in November 1967 until the gold market was closed on March 15, 1968, the gold Pool had sold \$ 3 billion of which sales of the U.S. share was \$ 2.2 billion."[©] The organisation felt that a huge amount of monetary gold stock had already percolated into private speculators' hands in quenching their thirst and it would be futile

* France discontinued active participation in the Pool, in the summer of 1967, but this became public knowledge only after Sterling devaluation - Quoted by R. Soloman. The International Monetary System, 1945-1976: An Insider's View. Harper and Row (1977), p. 114.

© Ibid., p. 119.

on their part to part away any official gold stock further.

Eventually the Pool had to be abandoned and a two-tier gold price system was introduced (Washington meeting of March 1968). We can say that in a sense, the world moved on to defacto Dollar Standard in 1968. The U.S. unofficially closed down the gold window and she did not lose much gold stock after this period.* The U.S. informally announced that it would be very difficult for her to maintain the convertibility of dollars into gold. Earlier (1967), West Germany had publicly announced its intention of not converting dollars into gold. France was the only country (which inherited the spirit of General De Gaulle Regime) which exerted pressures on the U.S. during the decade of sixties and tried to discipline her by demanding conversion of dollars into gold.

In the whole operation, the U.S. was the net loser. She heavily lost gold in her total reserves, while the other participants could get dollars in exchange for their contribution to the Pool and thus they only experienced a change in the composition of reserves.

4.7 Pressures in Foreign Exchange Market

The first major dollar crisis (1960) and the subsequent currency crises involving key currencies like Sterling (1964-67), Franc and Mark (1968-69), etc., imposed severe strains on the

* The U.S. monetary gold stock which stood at \$ 24.56 billion (1949), declined to \$ 10.89 billion in 1968. See Table 2 which shows U.S. gold reserves and official liabilities.

system. The vulnerability of the BWS was clearly evident. Exchange rate structure became rigid. Engendered by exchange rate expectations, hectic hot money movements took place. The gold rush of 1960 and the revaluation of Dutch guilder and D.Mark (1961) gave birth to fresh speculation that either they would be revalued further or some other strong currencies (which remained undervalued) would follow them. There was a flight from weak currencies (of deficit countries) towards gold and strong currencies. Pressures were strongly felt in spot and forward markets.

The speculative "pressures were manifested to a large extent in heavy forward selling of Sterling and dollar, causing a sharp discount on them in relation to European currencies. ... The buyers who bought continental currencies in the spot market and sold them for forward delivery at a premium were able to earn high returns."*

The Central Bankers of Western Europe intervened in the foreign exchange market and purchased dollars, when the exchange rate of their respective currencies crossed the upper supporting limit. This resulted in an increase in the dollar component of the foreign exchange reserves held by them. They were willing to add dollar reserves to their portfolios, because they could be eventually converted into gold at the U.S. treasury. The U.S. tried to check the discount on dollar and premium on European

* S.V. Bokil. *The Mechanics of International Money*. Macmillan (1971), p. 101.

currencies by intervening in the foreign exchange market and selling many foreign currencies forward. Indeed during the late fifties and early sixties this type of 'counter speculation' operation was prevailing. But ultimately some Central Banks lost heavily after the eventual devaluation of their currencies. Not

During the early 1960s, the U.S. tried to dampen the speculative attack on dollar and other key currencies, by establishing gold Pool Organisation (1961) (discussed in the previous section), entering into a network of 'Swap Transactions' (reciprocal credit facilities between the Federal Reserve System of the U.S. and other leading Central Banks of the world), issuing 'Roosa Bonds' (foreign currency denominated U.S. securities), requesting the advance repayment of long term debts to the U.S. by European countries and other adhoc measures. But all these measures could not provide any lasting solution.

4.8 Despite all these, speculative pressures persisted. The rigidity in exchange rates and a narrow one per cent fluctuation allowed on either side of the rate of exchange of the currency offered a golden opportunity for the speculators to switch from the weaker currency (of a country which has fallen into deficit) and move into the currency of a surplus country. Virtually it was a riskless speculation - one way option for the speculators. Even if the expected change in the rate of exchange did not materialize they did not lose much. The destabilizing, perverse capital flows were further intensified by

the spectacular expansion of Euro-currency markets and integration of various other international financial markets.

Thus, from the above, we conclude that basically "the adjustment mechanism" envisaged in the Charter of the BWS failed to function and "short run stability of the adjustable peg mechanism has turned into long run rigidity".* Between the period 1949 and 1967, only on two occasions, a major revision took place in the rate of exchange (a pair of devaluations of Franc in 1956 and 1958 and revaluation of German Mark and Dutch Guilder in 1961).

Though fundamental disequilibrium persisted in the BOP position of many countries, there was a resistance to exchange rate adjustment. Preponderant importance given to domestic price stability and full employment ruled out the operation of classical automatic mechanism. The successive waves of Sterling crisis (1964-67) and Franc crisis (1968-69) give ample evidence that devaluation became a prestigious political question and it was always denied and delayed. When it did take place at distant intervals (after much damage had been already done by the speculators), it was of a larger percentage which again implied that the economic ills were deep seated. As a result of all these the monetary effects of BOP deficits were not reflected in the economic situations.

The burden of adjustment was also not equitably distributed

* Mundel, R.A. Joint Economic Committee Hearing of November 1963, pp. 546-547.

among the surplus and deficit countries. The surplus countries were under less pressure. They were reluctant to inflate their economies and appreciate their currencies. "This competitive non-appreciation ... was very similar in its economic effects to the competitive depreciation specifically proscribed in the IMF Articles."^{*} IMF was virtually helpless. It had no power to impose its will on surplus countries. But IMF could exert pressures on developing countries which had to seek additional credit facilities for solving their payments problems. They had little control over the prices of their commodities, but had to yield to certain forced adjustments.

Thus during the decade of 1960s, especially in the first half, exchange rate question was hardly discussed. It was widely believed that given adequate liquidity, fixed par values could function very well. But the Fund did not envisage any rigid par values; it postulated an 'adjustable peg'. This concrete fact was totally forgotten. It was even thought that frequent changes in the rate of exchange would undermine the confidence in the Fixed Exchange Rate Mechanism. In this context it must be stressed that the inter-Central Bank cooperations and various other rescue operations to save some key currencies from the speculator's attack, helped very much to run the system smoothly. But the same measures, delayed the adjustment process, which in turn caused a perverse capital flows. One Central Banker called

* Andrew D. Crocket. International Money: Issues and Analysis. Nelson (1977), p. 81.

it as speculacratic standard. R.A. Mundel described it as the "Disequilibrium System".

Thus we find that the very inherent drawbacks associated with the Gold Exchange Standard Mechanism, generated tensions in the functioning of the system. As noted earlier, to resolve liquidity crisis and gradually reduce the dependence on "the U.S. BOP deficit and addition to monetary gold stock" for reserve creation an ingenious attempt was made, in the form of creation of SDRs. This (new credit) facility came too late, to save the system which had become sick and unable to cope up with the growing forces of internationalization of the world economy. By early 1970s, the system of fixed (and rigid) par values became inconsistent with the freedom of capital flows.

Towards the close of 1960s, the monetary crisis was building up. Franc had been devalued and Mark revalued (1969). British Pound had not fully recovered. German D.Mark continued to be the candidate for revaluation. Canadian dollar had been floating. On the eve of 1970s, the open market price of gold had been revolving around the official price. An uneasy calm prevailed in the foreign exchange market. This was the calm before the storm. The stage was well set for explosion.

It was thought that the Europeans and Japanese would be frustrated with the system and they would take defensive action, by floating or revaluing their currencies. But surprisingly the initiative came from the U.S. which lost its patience. The persistent deterioration in the U.S. BOP deficit, her fast

depleting official gold reserves, her inability to alter the exchange rate and the unwillingness on the part of European Powers and Japan to appreciate their currencies, ultimately forced the U.S. President to suspend officially the convertibility of dollars into gold on August 15, 1971. With this President Nixon's decision, the tension on the international monetary front culminated and the BWS came to an end. The system crumbled, but did not collapse completely because the fixed par values an another essential pillar of the IMF system was replaced by a floating regime only by March 1973.

Before concluding the historical review of the functioning of the BWS, it must be stressed that despite various shortcomings and contradictions in the system, this post-war world monetary system helped very much to facilitate multilateral trade and the flow of investment among the countries of the world and thereby contributing to an unprecedented increase in economic prosperity. If the rules of the BW game had been strictly adhered to and the official price of gold had been revised and kept in tune with market price of gold, the system would have lasted for some more years. But as long as the system was tied to gold, and exchange rates were within narrow margin, the system was prone to instability.

CHAPTER 5

BWS COLLAPSES: A NEW (OR NON) SYSTEM EMERGES

A. From Smithsonian Agreement to the Second Amendment

We have seen in the preceding chapter that the dramatic decision of Nixon in suspending the convertibility of dollars into gold precipitated the monetary crisis and the BWS got disintegrated. This was followed by many momentous developments in the international monetary and economic arena. In this section we shall make a brief reference to these significant developments and then try to analyse the tensions they have given rise to.

5.1 Nixon's shock was mainly intended "to generate a momentum towards the negotiation of new international monetary arrangements". For some months, there was a widespread floating of major currencies causing chaotic conditions in foreign exchange markets. The Smithsonian Agreement (December 1971) (which was hailed as "one of the significant monetary arrangements in history" by Nixon) established a "regime of central rates and wider margins" and brought about a major realignment in the exchange rates of major currencies; but it did not put an end to the monetary disorder and correct the underlying defects of the system. Both the Smithsonian Agreement and the Volcker Plan proposals were essentially the stop-gap arrangements to

rehabilitate the fixed parity within the framework of Dollar exchange standard and they did not take into account the realities of the situation.

A massive U.S. deficit of nearly \$ 30 billion in 1971 (in quite contrast to the average deficit of \$ 3 billion during the 1960s) became the immediate cause for the ultimate downfall of the system. The inevitable second devaluation of dollar came during February 1973, only after the outflow of hot money amounting to \$ 8 billion took place. The World Economy could not move towards fixed par values and a generalized system of floating regime (mixed exchange rate system) spontaneously evolved. By sheer evolutionary process certain changes took place automatically in the world monetary system.

At a time when the fixed par values system was passing into history, the EEC countries (foreign trade oriented economies) were moving towards a new European currency Arrangement under which the exchange rates of EEC currencies were to be maintained within a narrow band of 2-1/4 per cent (Smithsonian Tunnel) and they would have a joint float against the U.S. dollar. This system of cooperative exchange arrangement to reap the benefits of Fixed Par Values System came to be known as the 'Snake in the Tunnel'. When the currency crisis was rocking the world economy, the international oil crisis cropped up at the end of 1973 and aggravated the economic problems of the world and diverted the attention of the reformers towards immediate problems.

5.2 The Committee of Twenty (C-20)* which had been entrusted with the task of giving a comprehensive package of reforms had to confront itself with the new developments like the emergence of the floating regime and the escalation in the oil price (by OPEC). Under these fluid, and ever changing economic conditions, C-20 could not offer any blueprint solutions, but only give some outlines of reforms in 1974.⁶ Moreover it found it very difficult to reconcile the conflicting objectives of various countries' reform proposals. For example, European countries demanded an asset settlement (establishment of substitution account) for solving the problem of American dollar overhang. The U.S. demanded greater flexibility in the rate of exchange, legalisation of the floating regime and talked of reserve indicators for bringing about the prompt adjustment in the rate of exchange. LDCs fervently pleaded for SDR-link with Development finance. France resented the special position enjoyed by the U.S. and insisted on the restoration of fixed par values.

The Committee wisely, but realistically, remarked that "some aspects of the reform should be pushed forward and implemented early, while other aspects could be developed over time". International monetary reform became a sheer evolutionary process thereafter. Thus the 'reform exercise' which started with the appointment of C-20 (July 1972), culminated

* "The Committee on the Reform of International Monetary System and Other Related Issues" known as C-20, was appointed in July 1972. It comprised of Group 10 + 10 Developing Countries. It became a broader platform to reflect the composite view of the members.

itself at the Interim Committee Jamaica Conference (January 1976). During this period (1974-75) the industrial world experienced a deep recession partly due to escalation in the oil price and also the failure "on the part of fiscal and monetary policies in those countries to offset the depressing effect on total demand".

The Rambouillet Economic Summit* in France (November 1975) prepared the ground for Jamaica Conference. It was an important milestone in the sense that it produced a seminal diplomatic compromise between France and the U.S. especially with regard to exchange rate adjustment. However, a final accord on certain mild reforms was reached at the Interim Committee meeting at Jamaica and later they were incorporated into the Second Amendment of the Articles of the Fund.

5.3 Jamaica Package did not contain any radical reforms. It did no more than legalising the floating regime (which had spontaneously evolved since March 1973 and functioning without the approval of official stamp) and abolishing the official price of gold (which had become unrelated to the market price of gold for long time). As has been noted in the earlier chapters "the fixed par values and the established price of gold" were the two basic pillars of the BWS. It is only with regard to these two aspects only, fundamental changes were made.

* A Group of Six U.S.A., U.K., France, Italy, Germany and Japan - the top industrial nations discussed important monetary and financial questions. The meeting of this kind followed later.

In a sense Triffin observed that the Jamaica meeting "reformed the Bretton Woods System most radically by burying it". Nor did it spell out any clear-cut specific operational provisions regarding the important issues like management of global liquidity, convertibility (Substitution Account/Asset Settlement) symmetrical adjustment process, etc.

The Second Amendment of the Fund's Articles of Agreement (April 1978) sums up the important changes which have been introduced in the present international monetary framework.

(a) The system of par values has been abolished and the member countries are given freedom to have any exchange arrangements of their choice, except pegging to gold. Thus exchange rates have become the discretion of the national authorities and no longer come under the supervision and control of an international agency. Though provision has been made for the reintroduction of fixed par values with 85 per cent majority in IMF, in all likelihood, under the prevailing unstable economic conditions and huge inflation differentials, it would be hardly restored and we feel that the system of varied currency arrangement would be a permanent feature.

(b) The official price of gold has been abolished and gold ceases to be the denominator in exchange arrangement and there is no obligation on the part of the Fund and members to transfer or receive gold. How far the elimination of the monetary role of gold has actually phased out the yellow metal from the system is still a debatable point.

(c) Another important concomitant objective of the Amendment is to prepare the ground for elevating SDR to the status of the 'Principal Reserve Asset'. In the concluding chapter we shall see how SDR will hardly emerge as a principal reserve asset under the prevailing circumstances.

B. The Impact of Oil Crisis and Managed Floating

After having reviewed the significant developments that have taken place after the disintegration of the Par Value System, we shall now analyse the impact of these momentous developments on the World Economy.

5.4 The steep hike in oil price (by OPEC) at the end of 1973 aggravated the international currency crises and intensified the already complex economic problems. In the short run, it produced a depressing effect on Aggregate demand and introduced a serious distortion in the international payments pattern. Many industrial nations which were accustomed to running surpluses in their current account, suddenly ran into massive deficits. Again it resulted in differential impacts on the BOP position of many countries depending upon their requirements of oil and their capacity to tap domestic oil reserves (if there were any). The developing countries were hard hit by the OPEC measure. The OPEC Nations were baffled with the huge amount of surpluses (Petro-dollars). The BOP effects of the oil price rise can be fully understood by having a look at the Table overleaf.

So we find from the Table that OPEC countries enjoyed a current account surplus of \$ 66 billion in 1974 and OECD Bloc

Current Balances of Major Group of Countries*

	(Billions of Dollars)		
	1973	1974	1975
OECD	11	-22	7
OPEC	4	66	42
Non-oil Developing Countries	-9	-25	-35
Other ¹	-4	-10	-15
Discrepancy	2	9	-1

Note: Current balances are surpluses or deficits on goods services and private transfers.

Minus sign denotes deficits.

1 - Sino-Soviet area, South Africa, Israel, Cyprus, Malta and Yugoslavia.

Source: OECD.

moved into a deficit of \$ 22 billion. The deficits of non-oil developing countries mounted to \$ 25 billion. This oil price induced recession slowed down the rate of growth of OECD and restricted imports by OECD countries and they moved into a current account of surplus of \$ 7 billion in 1975, compared with a deficit of \$ 22 billion.

All these caused a large financing problem and called for a network of institutions to recycle back the Petro-dollars into deficit countries. Many private international financial organizations and IMF played a commendable role in absorbing the surpluses of OPEC and establishing new credit facilities to resolve the BOP imbalances.

* Table reproduced by Soloman, R. International Monetary System, 1945-1976: An Insider's View. Harper and Row (1977), p. 296.

The need for recycling back the funds into deficit countries was greater for various reasons. If the OPEC countries had increased their imports from OECD corresponding to their surplus earnings, it would have solved payments problems at least for Developed Countries. It must be remembered that "the rise in oil price led to a jump in the oil revenues of OPEC countries of some \$ 75 billion from about \$ 33 billion in 1973 to about \$ 108 billion in 1974. Saudi Arabia's GNP per capita rose from \$ 540 in 1971 to an estimated \$ 3500 in 1974. For the United Arab Emirates, the rise of per capita income was from \$ 3150 to \$ 19,000."^{*}

When we analyse about the long run real income effect of the oil price rise, we can state that despite a steep rise in oil revenue of OPEC, they were not in a position to convert the paper claims into real resources, since the absorptive capacity of many OPEC countries was limited. Excepting the oil-rich countries like Iran and Venezuela (which had already embarked upon a massive development effort and hence in a better position to import more goods from the industrial nations), other OPEC countries could not import more. Hence "the actual increase in imports by OPEC countries in 1974 came to about \$ 12.3 billion or roughly 1/6 of the increase in OPEC revenues".[®] Moreover

* John Williamson. The International Financial System in Higher Oil Prices and the World Economy, p. 217. Quoted by R. Soloman, op.cit., p. 294.

® Edward R. Fried, and Charles L. Schultz, 'Overview' - Quoted by R. Soloman, op.cit., p. 294.

the oil revenues were deposited in more developed countries like the U.S. far excess of their BOP needs. In the whole economic turmoil, the LDCs were severely hard hit and IMF oil facility provided the much needed relief.*

The international oil crisis produced a paradoxical situation of coexistence of inflation with recession. Robert Solomon (Vice Chairman of the G-20) elegantly described a large increase in oil price as a large sales tax imposed on petroleum products which had a deflationary impact on demand. It is interesting to note that the very same oil crisis created recessionary conditions which in turn acted as a counter check in reducing the demand for oil. The recession did not develop into a deep depression, thanks to the advent of the floating regime.

5.5 This new system (or non-system as some people prefer to call it) was very much helpful in tackling the destabilizing capital flows, and accommodating the inflation differentials and thereby restoring the competitive position of many countries. Commenting on the performance of the Floating regime, IMF Report observed:

"On the whole exchange rate flexibility appears to have enabled the world economy to surmount a succession of disturbing events and to accommodate divergent trends in costs and prices in national economies with less disruption of trade and payments

* At the time of writing this paper, an another 30 per cent increase in the price of oil is forecasted. We feel that, the decision of OPEC will produce a deleterious effect on the World Economy.

than a system of par values would have been able to do.* We can rightly point out that in a sense the emergence of the floating regime helped very much to cope up with the new situation arising out of oil price explosion and double digit rates of inflation.

Yes
but
some

Though the floating regime had reasonably worked well and thus withstood the test of time, it also produced an erratic and excessive fluctuations in the value of major currencies, especially in the dollar rates vis-a-vis Snake currencies. A huge inflation differentials caused marked fluctuations in exchange rates. Moreover in the transitional period of floating, frequent shifts occurred from one type of floating or pegging to another. This was quite inevitable, because many countries were experimenting with different types, and by trial and error tried to choose an appropriate exchange arrangement suited to their own national interest.®

Especially those countries (particularly primary producing countries) which had linked their currencies to a single intervention currency realized that their effective exchange rates instead of reflecting their underlying economic conditions, became dependent on the BOP position of the major country. To help moderate the fluctuations in the rate of exchange they have chosen to peg their currencies to some composite of currencies of the important trading partners.

* IMF, Annual Report, 1975, p. 33.

® See, Tables 3.1 and 3.2 for different types of currency arrangements.

Even the EEC countries operating under the 'Snake arrangements' had to periodically alter their central rates among their currencies to reflect their inflation differentials. The monetary unrest in the Snake during 1976 clearly demonstrated that with official intervention weak currencies could be supported for short period only and ultimately they have to bow down to the underlying economic conditions. *and also Spain*

5.6 Thus as compared to BWS era, we find greater exchange rate flexibility since 1973. Yet, despite the active use of exchange rate as a policy instrument for correcting BOP disequilibrium, payments imbalances still persisted and the need for reserves continued in many industrial countries. The exchange rate movements have succeeded in eliminating BOP imbalances only when they have been supplemented or accompanied by appropriate demand management policies. Of the top 8 industrial nations, Japan, West Germany, U.S.A. and Switzerland could reduce the rate of inflation during 1973-74, because they adopted restrictive domestic policies.* Moreover, the volume of oil imports is not the same for all industrial countries and hence the differential impact of oil price rise on industrial countries also accounted for substantial differences in BOP imbalances among developed countries. Countries like France, Italy and the U.K. continued to experience inflationary pressures and payments imbalances. They had also resorted to

* These countries again moved into inflationary spiral when they started pursuing expansionary policies after this period.

intervention in foreign exchange market, imposition of controls and international borrowing.

The limited impact of exchange rate movements in correcting BOP imbalances, is increasingly evident in the recent years, by the operation of "J curve effect". Changes in relative prices caused by exchange rate changes do not immediately affect patterns of production and demand. Due to various structural factors, adjustment is very slow in the goods markets. "The trade balance may initially move in a perverse direction following an exchange rate change because the terms of trade effect may more than offset the slowly developing volume effect on the Balance Trade. This is often referred to as J curve effect."^{*}

An erratic and excessive change in the rate of exchange not only produces a perverse effect on current account, but also creates problems for small open economies which want to break the vicious circle of inflation and depreciation. The continuous exchange rate depreciation of the currency, makes the imported goods costlier in the local currency and even the prices of goods produced at home are marked up very high. As a result cost of living index shoots up. On account of the widespread indexation of money wages to the cost of living index, prices increase. Thus the feed back effect from exchange rate changes to wages and other domestic costs again start an inflationary spiral leading to a further depreciation of the

* IMF Report, 1977.

currency. Now many open economies "accept the 'vicious circle hypothesis' that exchange rate changes lead to offsetting price and cost movements and further exchange rate adjustments and they believe that the benefits from exchange rate adjustments are limited".*

5.7 The discussion pertaining to the efficacy of exchange rate adjustments and payments imbalances, underline the basic idea that many structural, non-price factors play a vital role in causing BOP imbalances and they cannot be simply eliminated by change in the rate of exchange. And also the erratic fluctuations in the rate of exchange must be judiciously controlled. Then the important question arises to what extent the managed floating system or mixed exchange rate system should be managed? Is it advisable to allow a free floating without large scale official intervention in the foreign exchange market[®] or should it be fully managed by effective direct intervention?

Countries like U.S.A. which are in favour of relatively free floating argue that large scale official intervention prevents exchange rate from playing their appropriate part, perpetuate the BOP imbalances and transmit inflation from weak currency to the strong.

On the other hand, the countries which favour considerable amount of official intervention argue that rate of exchange

* IMF Annual Report 1977.

® Even the countries which do not practise direct official intervention in foreign exchange market, can effectively control exchange rate by their operation in money markets.

is affected by a variety of factors. It is not only influenced by a country's foreign trade position, current account deficit or surplus or its structural position as a net importer or exporter of long term capital, but also by factors like changes in the preferences of both residents of a country and non-residents for holding assets in that country's currency as opposed to other currencies. Besides all these there are short term variations in the interest rates, changing political conditions and a continuous assessment of a country's economic and monetary policies.*

Considering the foreign exchange market as "an asset market and the exchange rate between two currencies as the relative asset price",[©] it must be stressed that in those countries where well developed foreign exchange markets exist and large movement of funds takes place, foreign exchange market is more important than the goods market. Changes in rate of exchange matter much.

Exchange rates are not like other commodity prices. R.A. Mundel once observed that "It is not a price like the price of a cabbage" which can be left to the market forces to be determined. Since the rate of exchange is one of the important crucial economic variables, which determines the whole pattern of resource allocation, and distribution of income, national governments cannot be indifferent to it. It is now fully agreed

* BIS Report 1977, p. 131.

© IMF Report 1978, p. 37.

that the exchange rates are still matters of international concern.

The experiment with the floating system clearly demonstrates that in the absence of timely intervention measures in the foreign exchange market, much overshooting (large exchange rate movement) will take place and "its price effects will typically be felt via changing cost of imports, more rapidly than its real effects on the BOP". It is now increasingly realized that intervention in foreign exchange rate to smooth out short term movements in the rates, can ensure exchange rate stability, only when it is supplemented by effective demand management policies.

5.8 Thus as compared to BWS (Disequilibrium System), we find that a hybrid variety of independent and Bloc floating of currencies (a Non System) has made the adjustment mechanism to operate effectively and enabled the monetary authorities to move towards correct exchange rates, without interfering with the medium and long term trend of the exchange rate. By halting destabilizing capital flows, it has averted many currency crises.

This system of managed floating has also enabled many European countries to regain their control over money supply and check inflation. There is no longer any obligation to support the U.S. dollar at a fixed price. No longer the U.S. could transmit inflation and internationalize it. It would be localized or bottled up in a country from which it originates.

As shown above, if the countries do not take appropriate demand management policies, continuous depreciation of the currency will result in vicious circle of inflationary spiral. So inflation ridden economies cannot escape adjustment. At the same time flexible exchange rate system cannot insulate the economy from outside pressures. For the time being it will allow the country to be free from BOP constraints. But ultimately, it should be remembered that it is not a magic wand to cure all the economic ills.

More particularly, the non-system (though it has enabled dollar to emerge once again in the present system) has put some additional check on the Reserve Centre U.S. As pointed out earlier, during the BWS era, the dollar value was maintained by the rest of the world by their intervention measures. But under the present system whenever dollar is depreciated in the market, the U.S. cannot escape its consequences impinging on it through international trade channels. Thus the system has made the U.S. to experience the real costs in the form of the increased prices of imports. To that extent, the U.S. will be constrained to take some measures for correcting the trade deficits, and adopt rational energy policies. (The U.S. has already started taking measures by imposing a higher excise duty on oil to curb its consumption.) Heavy import of oil alone constitutes the single element causing a huge deficit in her current account.

It should be here stressed that the functioning of private capital markets have also played their part in re-

cycling back the funds into deficit countries and meeting the BOP requirements of many countries. But it is also feared that the unrestricted expansion of these markets (which are not coming under any national check) would generate explosive inflationary conditions. "Enlargement of this role of private banks might well foster a climate of all too easy borrowing by deficit countries, thus facilitating inflationary financing and delaying the adoption of needed adjustment policies."* It can be also argued that the private capital markets will constantly assess the credit worthiness of the Deficit Countries and keep a vigilance over the economic situation in those countries. The deficit countries therefore cannot indulge in cumulative financing of their deficits. However, a control over these organizations is essential for averting any major crisis in the future.

* Dr. H.J. Wilterun, Managing Director of the Fund in a Speech of April 29, 1976 "on the IMF and the International Banking Community" - IMF Survey, Vol. 5, No. 9 (May 10, 1976), p. 129.

CHAPTER 6

THE U.S. DOLLAR UNDER MANAGED FLOATING

After having reviewed the functioning of the BWS and the momentous developments that followed after its breakdown, we shall now try to assess the international monetary scene as it looks to us at present. The worldwide inflation generated by the pumping of dollars by the U.S. in the final phase of the BWS and the consequent two dollar devaluations, oil price hike, emergence of floating regime and the spectacular expansion of Euro-currency markets and multinational corporations, have dramatically changed the international economic and monetary environment during the 1970s.

6.1 We have today a mixed exchange rate system wherein a large majority of countries have either pegged their currencies to another currency or SDR or composite of some currencies or float jointly as a group with fixed but adjustable parities among themselves. Some of them float independently. In so far as exchange rate arrangements and adjustments are concerned, the new system has made a complete departure from the central features of the BWS.

Nevertheless, it is not a freely floating system. By considerable amount of official intervention, it is managed and need for more reserves still continues; controls over capital movements and other restrictions do exist. In a sense on

account of managed floating, in the short run exchange rates are more or less fixed (and thus the advantages of old pegged rate system is maintained), but in the long run the national monetary authorities allow the effective exchange rates of their currencies to reflect the underlying economic conditions. However nobody can accurately predict the nature and future of the system. It would be interesting to analyse how in the changed international monetary environment, the relative positions of SDR, gold and Dollar (and other reserve currencies) - the three major actors - have changed. We shall first examine the position of SDR.

6.2 SDR*

Rio de Janeiro annual meeting of IMF (1967) gave birth to SDR and the first amendment of the Articles of the Fund took effect in July 1969. The first allocation of SDRs was made on 1st January 1970 (amounting to \$ 9.5 billion to be distributed equally in three years Basic period). As noted earlier, the BWS did not envisage any mechanism for the creation of genuine reserves, and the creation of SDR was the first concrete attempt to fill this gap. In the first instance, it was mainly intended to supplement existing reserves like dollar and gold. At that time it was felt that with the subsequent allocations of SDRs at definite intervals (depending upon the requirements of world trade), the dependence on dollar and gold (for reserve growth) would progressively decline and SDR could ultimately emerge as

* The salient features of SDR are given in the Appendix.

the principal vehicle for future reserve growth. It was also hoped that by systematically projecting the estimated demand for reserves, the international liquidity could be regulated effectively.

But quite ironically, the issue of the first allocation of SDR coincided with an unprecedented liquidity explosion (1970-72). Triffin observes that during this period international liquidity doubled i.e. in those three years as much international reserves have been created as in "all previous years and centuries since Adam and Eve". With the emergence of a host of private capital markets, the international liquidity structure had become highly elastic. Now many member countries are accustomed to borrow foreign currencies from these private sources to finance their BOP deficits and increase their gross reserves. No longer the World Economy need to depend upon "the official sources and the U.S. deficit" for liquidity.

Moreover since 1970 many new credit facilities have been introduced under the auspices of IMF and existing facilities have been liberalized. The recent sixth revision of quota increase has also augmented the liquidity position. Thus we find that remarkable changes have taken place on the international liquidity front. In the light of these changes that have taken place, one should ponder over whether the pious wish of the framers of the Second Amendment to elevate SDR as the fundamental reserve asset could be realized or not.

As a first step towards collective control of international

reserves, this synthetic and artificial unit must have moved into centre of the system, after the suspension of convertibility of dollars into gold. But the unwillingness to establish a substitution account (for converting dollars and gold into SDR) under the auspices of IMF, has made all tall talks about assigning a central place to SDR in the system as a mere fancy.

As a result of all these, SDR has not made much strides. The holding of reserve currencies has gone up by leaps and bounds - at a much faster rate than expected and "the actual share of holdings of SDRs in reserves excluding gold has declined from about 10 per cent at the beginning of 1972 to about 4 per cent at present (1978)".* In the absence of fresh allocation, the SDR would continue its rapid decline as a proportion of reserves. In the early 1970s there was an academic debate as to what killed SDR? Dollar or gold? While the non-issue of SDRs (since 1972) is one of the important reasons for its low proportion of total reserves, it must be stressed that the very nature of the working of SDR facility has led to this sorry state of affairs.

"Central Banks with BOP problems use SDRs to acquire convertible currency. To the extent that the leading countries provide their own currency which would appear to be quite common, the foreign exchange component of global reserves rises immediately. The SDR content stays constant."@ Though the Second

* IMF Survey, November 6, 1978, p. 341.

@ Crystal, "The International Money and the Future of SDR," Essays in International Finance. Princeton University, 1978, p. 23.

Amendment has stipulated that SDRs should supplant other reserves and accordingly emerge as the Principal Reserve Asset, by making some changes in the use of SDRs, they can hardly emerge as Reserve Asset as long as they remain basically a credit instrument that allows the Central Bank to borrow real money.

"Unless SDR is transformed into potential real money and the IMF is restructured as a potential World Central Bank shaped on realistic lines, there is no hope for a symmetrical International monetary system. And there is little or no future for the SDR."^{*}

However SDR has been more popular as a unit of account (an average numeriare of all numeriares of member countries). To be an international money, it should effectively serve as a store of value and intervention currency. Otherwise it does not make much sense. As we shall see later, the U.S. dollar by virtue of its economic properties has made much strides in its role as a unit of account also as a result of many transactors preference to quote prices in terms of dollar. Again, if dollar maintains a smooth path and Sterling and D.Mark violently fluctuate, the dollar would be preferred to the SDR even as a numeriare. Since SDR is not available to trading sector it cannot also serve as a medium of exchange. Therefore SDR will remain only as a status symbol of the move toward international monetary integration which may turn out to be a day dream. For all practical purposes the U.S. dollar and other strong

* Ibid., pp. 28-29.

currencies like Mark, Yen, etc., perform the other functions of international money.

6.3 Gold

In this section we shall examine the position of gold. We have seen in the earlier chapters that gold occupied a central place in the Bretton Woods currency arrangement as a unit of account, means of payment and fundamental reserve asset, and how its price was artificially suppressed by official intervention (till 1968). Even after the suspension of official support, the open market price of gold was revolving around the official price (on the eve of 1970).

It was only from the beginning of the decade of 1970s the price of gold had been steadily sky-rocketing with occasional downswings.* The great surge in private demand, (in industry and fabrication of jewellery) widespread inflationary conditions, weakening dollar, the tension on the international monetary front and the psychological attachment toward the yellow metal (as a hedge against inflation) gave a boost to gold.

The role of gold as a monetary asset has changed markedly in the seventies. At the end of sixties when monetary crisis was actually rocking the system, some commentators proposed the solution of doubling the price of gold to tide over the crisis.

* The price of gold which stood at \$ 197.3 (nearly \$ 200) per ounce at the end of December 1974 dropped to \$ 126 on September 24, 1975. Again it shot up to \$ 140 (October 1975). Gold price hit a record level of \$ 256.6 (May 17, 1979) and again touched the dizzy height of \$ 280 around second week of June 1979.

Earlier France talking about the eternal qualities of gold insisted that world should go back to gold standard. The argument that the revaluation of gold would have benefited the gold producers and holders is untenable since in any event they stand to gain when open market price goes up.

Before introducing a two-tier gold price system, if gold price had been increased say to \$ 70 or \$ 80 per ounce, then the Monetary authorities could have taken over the lead in the gold market. The volume of international liquidity would also have gone up.

In the early 1970s, the U.S. which had lost a huge amount of gold stock (but still retains a substantial amount as compared to other countries) was no longer interested in restoring the position of gold and looked upon both gold and SDR as potential competitors to dollar. Robert Soloman observes that "there persists in some circles in Europe a desire to preserve a significant role for gold".

When gold market began to assume a highly speculative character and violent fluctuations in the price of gold became the order of the day gold lost the attribute of an impartial numeraire. When it was apparent that the ever increasing gap between the official and open market price of gold was a permanent phenomenon, authorities wanted to sever gold from the WMS. They felt that it was not fair on their part to prohibit the Central Banks to deal at the market price of gold.

But the main problem was how to ensure that the decision

to phase out gold would actually reduce its monetary role. We have hinted earlier that the Second Amendment set out to abolish the official price of gold and member countries have been given full freedom to engage in gold transactions at market price. The New Articles required the Fund to complete the disposal of 50 million ounces of its gold holdings with half of it to be restituted to members (in proportion to the quota of members) and the other half to be sold for the benefit of developing countries (i.e. the profits resulting from the sale have been routed through the Special 'Trust Fund' which has been created for this purpose. Group of 10 countries (the top 10 rich industrial nations) agreed among themselves outside the jurisdiction of the Fund in August 1975 that there should be no action to peg the price of gold and that the total stock held by monetary authorities and the IMF should not be increased.

The valuation of gold at current market price will inflate the value of the reserves of those countries which hold more gold stocks. Already the distribution of world liquidity is skewed towards the affluent industrial countries and OPEC. This would intensify the inequitable distribution of world reserves. We must note that this is the reality of the situation and bound to happen.

If gold continues to be a fast appreciating asset, (it will) the Central Banker's preference for gold would increase and they would be tempted to add to their portfolios. This is explained by Mrs. Machulp's Wardrobe Theory of Monetary Reserves:

"What she cares about is not so much how many dresses she has so long as she gets a few new dresses each year."* If they hold gold at the bottom of reserves without using it for payments purpose, they are acting no different from speculators who have now gained the lead in the gold market in dictating terms. Instead of checking speculators, they themselves have begun to act as speculators. This is an irony of the situation now. If the rate of appreciation of gold is higher than the rate of interest which they would have otherwise earned, Central Banks would hold gold and it will remain at the bottom of reserves. Once all the countries begin to operate freely in buying and selling gold, after many years, we may expect that there might be partial liquidation of official gold reserves into private markets. At present Central Banks of the world hold huge amount of monetary gold stock. If they take concerted action and unload the stock, the speculators can be beaten. But it is unlikely to happen. At least the Central Banks can refrain from rigging the price of gold. Nobody can accurately predict the future role of gold.

Keynes called gold as 'Barbarious relic of the past' and despite various trenchant remarks made by many writers against the use of metal in international currency circulation, for many centuries it has survived as the surest and safest metal against any calamity. Age has not withered its infinite variety and on

* Quoted by Bhagwan Bapat, "Gold and International Monetary System," Gokhale Institute Staff Seminar Paper, September 1978 (unpublished).

account of worldwide rampant inflationary conditions, the preference for this metal is steadily growing. As a fast appreciating commodity, it will continue to command more value. In the international monetary sphere, it won't be actively used for settling payments imbalances, but instead would be used as a collateral security for borrowing.

Since the WMS is no longer tied to gold, we need not bother about the increase in the price of gold. Indeed the speculative pressures would be bottled up in the gold market itself whenever bullish tendency prevails there. On the one hand it will relieve pressure on strong currencies and on the other, act as a check on the weaker currencies. In this sense exchange markets can be insulated. For all practical purposes, Gold has become a frozen asset in the Central Bank vaults. Just like gold has ultimately disappeared from the national monetary scene, it must also go in the international sphere. Let us hope that the dream would be at least realized in this century.

6.4 The U.S. Dollar

From the above we conclude that under the conditions of liquidity explosion and private capital markets providing a highly elastic liquidity structure, chances of fresh issues of SDRs are bleak. Even if they are issued to keep up its present percentage of total reserves, in the foreseeable future it would hardly emerge as reserve asset. With the position of gold uncertain and its price violently fluctuating, it is more likely to remain at the bottom of reserves. We feel that in the triangular

contest, dollar has once again re-emerged as the dominant currency, by virtue of its inherent strength backed by a strong economic base.

We have noted in the earlier chapters that the U.S. dollar played a prominent part in BWS and its position was challenged by emerging European Powers, especially by France during the mid-1960s. During BWS era, huge amount of deficits of the U.S. caused a crisis of confidence in dollar. This lack of confidence was not with regard to its purchasing power but its value in terms of gold. The gold-dollar link which was considered to be the cornerstone of the BWS, built up the speculative element and ultimately caused disaster.

When BWS got disintegrated, some commentators on the international monetary scene, expressed the opinion that the days of dollar were numbered and it could not recover from the onslaught. But events after 1973 conclusively prove that (freed from the clutches of gold), a U.S. dollar varying in its value is more stable and powerful than the dollar which was convertible into gold (during BWS era).

The significance of dollar can be very easily understood from the fact that it is more actively used in both private and official transactions. During the 1970s, there has been a dramatic shift in the level and composition of reserves and foreign exchange component of it has increased to a greater level.

"During the three years 1970-72, foreign exchange reserves nearly tripled. Two-thirds of the total increment of SDR 63

billion took the form of an increase in official claims on the U.S., while the larger part of the remainder was accounted for by the growth in identified official holdings of Euro-dollars."* Again, foreign exchange assets were the largest component of total reserves and "during 1977 they increased by SDR 40 billion to slightly more than SDR 200 billion at the end of the year ... and official claims on the U.S. increased in 1977 by \$ 34 billion (SDR 30.3 billion) and official Euro-currency holdings rose in the same period by SDR 19 billion".[©]

These clearly show that foreign exchange component of reserves according to IMF is mainly denominated in U.S. dollars. Moreover the volume of dollar denominated liabilities in the Euro-currency market is substantial. Percentagewise Dollar share has dropped. During 1964-69, dollar share of Euro currency market accounted for 82-84 per cent; it dropped to 80 per cent in 1970 and to a range nearer 70 per cent in 1973-74.[‡] Similar tendency was also witnessed in the dollar share of foreign exchange reserves. The net gainer in both cases was D.Mark. This was quite natural in an era of the transitional period of managed floating, where the fluctuations in the value of dollar and D.Mark were marked and with the oligopolistic type of situation prevailing among the currencies, Central Bankers would switch into stronger currencies and make adjustments in the

*H. Cenci
Banks
Source*

* IMF Annual Report 1977.

© IMF, Annual Report 1978, p. 46.

‡ Cohen, B.J. Organizing the International Money. Macmillan (1977), p. 236.

portfolio of their reserves.

Its popularity is also fully evident in private international transaction. "Because of the great volume of America's trade and Investment transactions with the rest of the world, the exchange market for the dollar is far and away the largest for any currency. This means that the dollar is the most exchange convenient of all currencies. That is to say it is both the most marketable in the sense that at any point of time there tends to be a very small difference between its buying and selling prices. At the same time, because of the great depth, breadth and resiliency of America's domestic financial markets, the dollar is also far and away the most 'capital certain' of all currencies. This means that it is the most liquid, in the sense that possible capital losses are minimized if dollar assets must be sold off at short notice."^{*}

We have hinted earlier that strong currencies like Mark and Yen have been preferred whenever dollar became weak. In the short run they would pose a competition to dollar, but in the long run on account of the comparative advantage of dollar many factors are tilted in U.S. favour. In this context the economists talk of 'Security area Properties'. One French writer observed:

"Of course, the Mark and the Yen can show greater stability than the dollar over the short run. ... How many countries can show greater stability than the U.S. in their currency (and

* Cohen. Organizing the World's Money. Macmillan (1977), p. 238.

in their political institutions) over a long period? One only has to ask this question to place in perspective the possibility of competition between the dollar on the one hand and the Mark or the Yen on the other."^{*}

Prof. Richard Cooper rightly sums up the reason for the predominance of dollar in the present international monetary framework as follows: "There is at present no clear, feasible alternative." No other currency can take this role at present. All these point out that perfect symmetry in IMS cannot be simply emphasized. At least till the emergence of a new monetary order, member countries would have to live with dollar reserves and reap the benefits flowing from this international money. The U.S. should also take a responsible role.

It would be recalled here that there was much uneasiness about the dollar overhang at the end of the 1960s and the early 1970s and this was clearly reflected in the plea of European countries to have a substitution account. But "the oil crisis and the emergence of the large OPEC surplus together with the corresponding deficits elsewhere have made countries more comfortable about their dollar holdings. This sense of comfort with official dollar holdings strengthened after the effective exchange rate for the dollar stabilized in the autumn of 1975".[©]

Therefore the U.S. dollar has once again become the focal

* Boyer de la Giroday. *Myths and Reality*, pp. 13-14. Reproduced by Cohen. *Ibid.*, p. 239.

© Soloman, R., *op.cit.*, p. 331.

point and re-emerged as a powerful key currency, enjoying more international confidence than ever before. The system of managed floating has rejuvenated dollar. Though the U.S. does not act as the creator of international liquidity, the floating liquidity that exists in the present financial markets enables the U.S. to meet its huge BOP deficits on account of imported oil. These credit flows in favour of the U.S. are a tribute to the New York Money Market. To this extent the U.S. continues to hold its key position. "Much of the emotion has gone out of the question of the special role of the dollar as a currency reserve."* The U.S. deficit is no longer a problem. Her trade deficits are financed by the private Banking Sector. We also feel that if the U.S. dollar maintains comparatively stable value, in many European countries, it would also supplement the national currencies of those countries, by virtue of its sheer economic properties. As things stand at present, we feel the 'floating world' is approaching towards Dollar Exchange Standard.

* Ibid., p. 332.

SUMMARY AND CONCLUSION

After having made a quick survey of the significant developments that have taken place in the international monetary arena during the 1960s and 1970, the following comments will be in order by way of conclusion.

The Post-war World monetary system (BWS) was essentially founded on the dominant economic strength of the U.S. This system was acceptable to Western Europe and Japan as long as they were dependent on the U.S. economically and politically. There is no wonder that the system came to a collapse, when its economic supremacy was challenged by these Powers during the 1960s. So we feel that the smooth functioning of the world monetary system is closely related to the political negotiations between big powers.

The system ran into increasing trouble during the 1960s (active phase of BWS), mainly due to the confidence problem and the adjustment problem. Excessive liquidity creation by the U.S. was firmly resisted by the European countries, by demanding conversion of dollars into gold. Indeed as R.A. Mundel rightly observed "the sole function of gold convertibility in the Bretton Woods arrangement was to discipline U.S.". But the U.S. persisted in overextending the gold exchange standard and consequently periodic currency crises began to rock the system.

The problems became more acute only after the U.S. took increasing part in the Vietnam War and financing it by creating new money. The failure to show realism on the exchange rate front and the unwillingness to revalue the official price of gold, inherently built up the 'speculative element' and exchange rate expectations gained more momentum.

The confidence on the reserve currency was shattered after British Sterling devaluation. The U.S. knew very well that in case Pound was devalued, a lot of pressure would fall on dollar and consequences would be highly unpredictable. Despite the major rescue operations undertaken by the U.S. and other international agencies, ailing Pound could not be saved. Throughout the decade of 1960s, the Pound failed to act as a catalyst to the U.S. dollar. The continued weakening of the British Pound and the emergence of D.Mark as a strong currency (with the Japanese Yen joining the battle during the early 1970s) made multilateral substitution between these currencies possible and confidence in dollar steadily began to wane.

If one single reason is to be given for the failure of the system, it can be stated that adjustment mechanism was not allowed to operate. As a result it became a disequilibrium system unable to cope up with the growing forces of internationalization of the world economy. In the early 1970s, it became irrelevant to the needs of the World Economy and had to be replaced.

The advent of the new managed floating regime has resolved

the problems of confidence and adjustment. In the early stages of dirty floating (transitional period, 1973-75), movements in exchange rates were excessive, and sometimes unrelated to the strength of the currency. In the recent years, the effective exchange rates of major currencies are comparatively stable. In a sense, this Non-System has averted many currency crises, as compared to the instability under the BWS. Moreover by putting some additional check on 'Reserve Centres' and strengthening their effective exchange rates, it has imparted some stability in an otherwise unstable world.

The problem of liquidity remains. During the final days of BWS, excessive liquidity was pumped into the system by the U.S. deficits. But since 1973, increase in liquidity has been not related to the U.S. deficits. The emergence of the oil crisis has added a new dimension to this problem. The increase in the price of an internationally traded commodity like oil, resulted in a huge amount of petro-dollars which were deposited in leading private capital markets. Many of these organisations have seized this opportunity of money making business and indulged in creating more credit. That is why we find an explosive international liquidity situation. Hence there is a need for checking the activities of these organisations.

Thus the concept of international liquidity has become highly elusive and lot of double counting takes place. In the present circumstances, control over global liquidity is impossible. Though there is surfeit of international liquidity, LDCs have

not been able to get rid of their payments problems and the problem of liquidity shortage. This type of unequal distribution of reserves is inevitable in a world where ^{here} is a hierarchical pattern of development. The payments problems of the Less Developed Countries arise out of their developmental efforts and hence can be tackled by means of long term transfer of capital thereby giving them more command over liquid reserves. One can easily see that developing countries for example India cannot quickly make use of their mounting exchange reserves and get into a paradoxical situation of having to invest these resources into more developed countries.

The changed international monetary environment means that though the U.S. dollar still retains its role as a medium, reserve and intervention currency and it still continues to enjoy some special benefits, the dominance of a single country over the system is over, ushering in an era of common sharing of the monetary powers by the leading countries. To a greater extent the new system is reconciling the growing internationalisation of the world economy with autonomous pursuit of domestic objectives. By explicitly stressing that domestic economic and monetary stability is more important than exchange rate stability, it demands a considerable amount of financial discipline from the member countries. That is what BWS implicitly expected from the member countries.

NOTES

1. Seigniorage benefit: The term originates in the right of sovereign to place its stamp on precious metals. The sovereign rulers had the right to mint coins with a face value larger than the intrinsic metal value in the coin and cost of manufacturing, etc. In a monetary economy, where credit money is used, the issuance of money, confers this benefit on the government. On the international plane the seigniorage accrues to the World Banker (key currency country) because the only way the rest of the world can acquire Banker's national obligation is by running BOP surplus, thus transferring real resources or claims on assets to him.
2. For example, under the Bretton Woods System, the value of all n-1 currencies of the world was fixed in terms of gold and dollar. Other countries from time to time changed the par value of their currencies against dollar and gold. But the value of dollar was fixed in terms of gold. The dollar acted as the nth currency—as a numeraire in the BWS.
3. Lord John Maynard Keynes (representing Britain) was attempting to establish a thoroughly reformed system. He wanted the IMF to become a genuine World Central Bank, with the power to issue its own currency obligation and some power to encroach upon national sovereignty. On the other hand the U.S. representatives (Dr. Harry Dexter White was the key negotiator) rejected the Keynes' ambitious plan and were more cautious and conservative in their proposals of making IMF as a shareholders' institution.

For 'Keynes Plan' refer: "Proposals for an International Clearing Union" - reprinted in the IMF, 1945-1965 Volume III Documents (Washington: IMF, 1969), pp. 19-36.

Lord Keynes, "The International Clearing Union", Speech delivered before the House of Lords, May 18, 1943, reprinted in S.E. Harris (ed.). The New Economics. (New York : Knopf, 1947), p. 365.

4. Prof. Robert Triffin of Yale University was the first to diagnose the ills of the BWS and elegantly put forth his views in his celebrated book [Gold and the Dollar Crisis (1960) Yale University Press]. He warned that if the U.S. BOP deficits went on unabated without any corrective action, the U.S. external liabilities would grow at a faster rate than her gold reserves. This would undermine confidence on dollar and destabilizing speculation would take place. On the other hand if the U.S. deficits were eliminated,

the world would be deprived of its principal source of reserve growth, with depressing effects on world trade and payment patterns. Hence he called for the internationalization of foreign exchange reserves held by Central Banks and the reduction of the role of national currencies as reserve currencies.

5. Under Marshall-Aid Programme "between mid-1948 and mid-1952, the U.S. provided \$ 11.6 billion in the form of grants and \$ 1.8 billion in the form of loans to the countries of Europe. In the case of Japan grants amounted to \$ 950 million and loans to \$ 275 million." - (Agency for International Development, U.S. Overseas Loans and Grants. Washington, May 1974.) Quoted by Robert Solomon. *The International Monetary System, 1945-1976: An Insider's View* (1977), Harper and Row.

6. The 'Outline of Reforms' given by C-20 can be summed up as follows: (1) an effective and symmetrical adjustment process (2) an appropriate form of convertibility with symmetrical obligations on all countries (3) a better management of global liquidity, with the SDR becoming the Principal Reserve Asset (4) cooperation in dealing with disequilibrating capital flows and (5) promotion of the net flow of real resources to developing countries including possibly a link between Development Assistance and SDR allocation. When C-20 was wound up in 1974 (July) its place was taken over by Interim Committee.

Table 1 : United States Balance of Payments, Selected Accounts, 1946-1973

----- Mercandise Trade -----							Liquidity Balance -----			
Year	Exports as Percentage of Imports	Export minus Imports		Current account Balance		Basic Balance		ORT BALANCE		1946-1959 Gross (1960-1973 Net (\$ billions))
		\$ billions	% of GNP	\$ billions	% of GNP	\$ billions	% of GNP	\$ billions	% of GNP	

The current account covers trade in goods and services, investment income and transfers (including government non-military grants).
The basic balance covers the current and long term capital accounts.

Sources: "BIS, 42 Annual Report Basle 1972, Economic Report of the President together with the Annual Report of the Council of Economic Advisers, Washington 1973; Survey of Current Business, March 1973 and Federal Reserve Bank of St. Louis, U.S. Balance of Payment Trends April 1973" - Reproduced by Yeager. International Monetary Relations, Theory, History and Policy. Bombay : Allied Publishers, 1978.

Table 2 : United States Gold Reserves and Official Liabilities**(In billions of U.S. dollars)**

	Gold Reserves (1)	Official Liabilities (2)	Ratio (3)
1949	24.56	6.94	0.28
1950	22.82	8.89	0.39
1951	22.87	8.85	0.39
1952	23.25	10.43	0.45
1953	22.09	11.36	0.51
1954	21.79	12.45	0.57
1955	21.75	13.52	0.62
1956	22.06	14.90	0.68
1957	22.86	15.83	0.69
1958	20.58	16.85	0.82
1959	19.51	19.43	1.00
1960	17.80	21.03	1.18
1961	16.95	22.94	1.35
1962	16.06	24.27	1.51
1963	15.60	26.39	1.69
1964	15.47	29.36	1.90
1965	14.07	29.57	2.10
1966	13.24	31.02	2.34
1967	12.07	35.67	2.96
1968	10.89	38.47	3.53
1969	11.86	45.91	3.86
1970	11.07	46.96	4.24
1971	11.08	67.81	6.12
1972	10.49	82.88	7.90
1973	11.65	92.37	7.90
1974	11.83	119.10	10.07
1975	11.26	125.98	11.19

Source: International Financial Statistics. Reproduced by Andrew Crocket. International Money: Issues and Analysis. 1977.

Table 3.1 : Exchange Rate Practices of Fund Members, June 1975

	No. of Currencies	Percentage share of trade of Fund members
1) Currencies that float independently	11	46.4
ii) Currencies pegged to a single currency	81	14.4
Of which:		
a) Pegged to U.S. dollar	54	12.4
b) " French Franc	13	0.4
c) " Pound	10	1.6
d) " Spanish Peseta	1	-
e) " South African Rand	3	-
iii) Currencies pegged to composite of other currencies	19	12.4
Of which:		
a) SDR	5	5.0
b) Other	14	7.4
iv) Currencies pegged to others but that change the peg frequently in light of some formula	4	2.0
v) Currencies that are floating jointly	7	23.2
Total	122	98.4

Source: IMF Annual Report 1975, p. 24.

Table 3.2 : Exchange Arrangements as of December 31, 1978

I. Currency Pegged to:	
U.S. Dollar	42
Pound Sterling	4
French Franc	14
Other Currency	4
SDR	12
Other Currency Composite ¹	20
II. Exchange Rate adjusted according to a set of indicators²	
	5
III. Cooperate exchange arrangement (Belgium, Denmark, Germany, Luxemburg and Netherlands)³	
	5
IV. Others⁴	
	31

- Notes:**
1. Comprise currencies which are pegged to various baskets of currencies of the member's own choice, as distinct from SDR basket.
 2. Includes exchange arrangements under which the exchange rate is adjusted at relatively frequent intervals on the basis of indicators determined by the respective member countries.
 3. Refers to cooperative arrangement for multi-currency intervention (the Snake) maintained by a group of European countries.
 4. Covers a heterogeneous group of exchange arrangements including those of members whose currencies may be deemed to be floating independently and those which cannot be properly classified under other categories. [Currencies of Australia, Canada, France, Italy, Japan, U.S.A., U.K. are the important ones coming under this 4th category.]
[India - in other currency composite.]

Source: International Financial Statistics, Volume XXXII, No. 2, February 1979.

APPENDIX A

MEMBERS OF THE SNAKE COOPERATIVE CURRENCY ARRANGEMENT

The European currency arrangement called 'Snake in the Tunnel' came into operation from March 1972, with the original six members of EEC. New members U.K., Denmark and Eire joined in May 1972, but defected in June when British Pound started floating independently.

Denmark rejoined in October 1972, but the U.K. and Eire remained outside the Snake.

Between March 11, 1973 and January 1974 six members of EEC (Germany, France, Benelux Countries and Denmark) experimented the joint float of their currencies against the U.S. dollar. Italy left in February 1973 and France left in January 1974, rejoined in July 1975, but again left in March 1976.

On the other hand two non-EEC members—two Scandinavian Countries—joined the Snake. Norway in May 1972 and Sweden in March 1973.

However on December 31, 1978 only five countries (Belgium, Denmark, Germany, Luxembourg and Netherlands) have been operating in the 'Snake'. (As of October 31, 1978 Norway was in the Snake.)

APPENDIX B

SPECIAL DRAWING RIGHTS

SDRs (or technically called Paper gold at the time of its creation) simply represents the units of international money and basically a credit instrument created out of thin air. Number of these units known as allocations are issued to participants periodically in proportion to their IMF quotas and credited to their account. The Central Banks can alone use them through the IMF with the Fund designating a participant country with a strong payments position to receive them in exchange. *for its*

Its use is subject to 70 per cent rule i.e. the average net use of a participant's SDR holding shall not exceed 70 per cent of its average net cumulative allocation during this period. To that extent it constitutes an addition to its unconditional use of resources. If it maintains an average of 30 per cent of its past cumulative allotments over any five-year moving period, (Basic Period) it need not reconstitute (to repay the SDRs used in this manner). And the obligation by participants to accept SDRs "extends to the point where its holdings of SDRs equal the amount received as its net cumulative allocation plus twice this amount".

The participants can use SDR to acquire an equivalent amount of a currency convertible in fact only for meeting BOP needs and not to alter the composition of its reserves. SDR

derives its value not by gold backing or any other asset, but by the general acceptability of the participating countries. It is as if new gold had been mined and added to a country's reserves. It is essentially a created deposit in the Fund, conferring an unconditional right to borrow real convertible currency from another Central Bank at a stipulated rate of interest. Like gold SDRs are non-debt money. It was defined in terms of gold, but could not be convertible into gold. It carried a rate of interest of 1-1/2 per cent. It was raised to 5 per cent in 1975.

Initially 1 SDR = 1 U.S. dollar. The declining value of the floating dollar necessitated a change in the method of valuation. SDR was delinked from dollar and gold and defined in terms of the basket of 16 currencies of those countries which during the period 1968-72 had world trade at least equal to 1 per cent of world's total.

The Second Amendment of Article envisages that SDR should become Principal Reserve Asset and made some improvements in the use of SDRs. "Among other things the requirement of BOP need before SDRs may be sold will no longer apply to transactions by agreement and participants trading in SDRs by agreement can do so without the need for authorization by the Fund." Member countries can also discharge many obligations to the Fund in SDRs. Central Bankers are also permitted to make portfolio adjustments so long as another central Bank agrees to the exchange.

In the revised basket (effective July 1978 which will be

based on statistics for the period 1972-76) currencies of Iran and Saudi Arabia have replaced the currencies of Denmark and South Africa.

Currency	Weights	Currency	Weights
U.S. Dollar	33	Belgian Franc	4.0
German Mark	12.5	Saudi Arabian Riyal	3.0
Japanese Yen	7.5	Swedish Krone	2.0
French Franc	7.5	Iranian Rial	2.0
Pound Sterling	7.5	Australian Dollar	1.5
Italian Lira	5.0	Spanish Peseta	1.5
Netherlands Guilder	5.0	Norwegian Krone	1.5
Canadian Dollar	5.0	Austrian Schilling	1.5

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