

ESSAYS IN INTERNATIONAL FINANCE

No. 89, September 1971

THE REFORM OF THE
INTERNATIONAL PAYMENTS SYSTEM

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AND
HOSSEIN ASKARI



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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International Finance Section

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THE REFORM OF THE INTERNATIONAL PAYMENTS SYSTEM

The system of international settlement and liquidity presently in force and centering on the International Monetary Fund has served us, on the whole, rather well for a couple of decades. Under this system, there has been an unprecedented increase in international movement of goods and capital which has, by and large, benefited all participants. Unfortunately, with the passage of time, shortcomings have begun to be apparent in this system and they have become gradually more evident as economic and political crises have succeeded one another with increased frequency and severity. By now there is a general feeling that the system is no longer viable in its present form; yet no alternative design has been proposed that has sufficient economic cogency and political appeal to command the widespread support necessary for its implementation.

Our purpose here is to propose a set of reforms that would retain the major advantage of the present system, to wit the relative stability of exchange rates associated with a system of parities, while eliminating its major drawbacks, such as the need for occasional discontinuous large changes and attendant speculative upheavals, the severe constraint on the ability of countries to pursue independent domestic policies, the lack of an adequate mechanism for creating the "appropriate" amount of international liquidity or even of a criterion for judging what is "appropriate," and the uncertainty as to the desirability of the dollar as an international store of value. In addition, our reform would provide the world with a facility that has never existed before, namely, an international numéraire and store of value having a stable purchasing power. All this would be accomplished through a set of modifications of the present system which are institutionally and economically quite simple, although, no doubt, they presume a strong commitment to work for the common good, at the cost of some compromise.

In the conviction that our reforms are practical, we wish to address ourselves to a wide audience. Accordingly, before presenting our proposal, we devote respectively Sections I and II to a survey of the present system and to a review of its drawbacks and why these have become more acute with the passage of time. Then, in Section III we outline the basic ingredients of our reform, and, finally, in Section IV we analyze the properties and operating characteristics of the reformed system. The

expert, who is thoroughly familiar with the present system and its ills, may wish to proceed directly to Section III.

I. A SURVEY OF THE PRESENT SYSTEM

The present international payments system for countries that are members of the International Monetary Fund can be characterized by the following set of rules and institutions.

1. Reserve Assets and Factors Controlling their Quantities
 - (a) Monetized Gold: fixed in quantity, basically at the historical level determined by the gold reserves of member countries at the time of the adoption of the two-tier system. (That is, the understanding among the monetary authorities of major countries not to buy or sell gold except from one another.)
 - (b) Special Drawing Rights or SDRs ("paper gold"): an intangible asset issued through the International Monetary Fund, having a fixed parity to gold; quantity changeable by a rather complex procedure requiring the agreement of a qualified majority of members.
 - (c) Short-term Claims on the United States held by Foreign Official Holders (basically, Monetary Authorities): changed through payments deficits of the United States and redistribution of the outstanding stock of claims on the United States between official holders and other holders (commercial banks, nonbank public). Such redistribution results, in part, from foreign central-bank policy and, in part, from market forces. *De jure*, the rate of exchange between dollars and gold (and hence SDRs) is fixed by the United States and can be changed by the United States with the approval of the Fund; *de facto*, that parity is unshakable in that the United States is not, at present, willing to entertain the notion of changing it.

2. Permanently Fixed Parities

Each country fixes a "permanent" parity with SDR-gold which determines a permanently fixed parity with every other currency. The parities are subject only to discontinuous changes to a new "permanent" level. In practice, such changes have occurred only when the inappropriateness of the previous parity has become so glaring as to require a major change.

3. Narrow Allowable Bands of Fluctuation around Parity

Each participating country assumes the obligation to contain market fluctuations in exchange rates within a narrow band of parity. This obli-

gation is enforced through each central bank (other than that of the United States) intervening in its country's dollar market to maintain the market price within a band which is, *de jure*, one per cent on either side of parity (hence, of a total width of 2 per cent), but *de facto* has been mostly maintained within $\frac{3}{4}$ of 1 per cent on either side of parity (hence, of a total width of $1\frac{1}{2}$ per cent). The actual market rate of exchange with the dollar establishes all actual cross-rates.

4. *De Jure* Convertibility of Currencies into Gold and SDRs, and Conversely

Each monetary authority has the obligation to buy back its currency from, or to sell it to, other monetary authorities in exchange for gold and SDRs, with some special provisions with respect to the use of SDRs.

5. *De Facto* Semi-Inconvertibility of the Dollar

The United States has, for some time, been using its "power of persuasion" to discourage foreign monetary authorities from exchanging the dollars that they have acquired through interventions in the foreign-exchange market (3 above) for the other two reserve assets. Thus, *de facto, the convertibility of the dollar is limited and uncertain*. This is critical, because, with the obligation to remain within the band enforced by operation on the dollar market only, any country running a reserve surplus initially acquires just dollars. Thus, the United States is the only country that could be asked to exchange its currency for other reserve assets. Other central banks, as it were, are automatically re-acquiring any surplus of their currency flowing out when they support their exchange; and they are re-acquiring it for dollars. (If they run out of dollars, they can acquire more by selling other reserve assets for dollars to the United States or to some other official holder of dollars.)

6. Limitations on the Use of SDRs

When SDRs were introduced, some complex limitations were established on their use. In particular, the average SDR balance of a country over a five-year period may not be less than 30 per cent of its cumulative allotment. This restriction was a concession to the view, held by some countries, that the role of SDRs should be that of a transient reciprocal-credit arrangement.

II. DRAWBACKS OF THE PRESENT SYSTEM

The present system has at least four major drawbacks, which have become gradually more acute. These will be first listed and then examined in some detail.

1. As the underlying circumstances of various countries change in time, the initially fixed parities become inappropriate. As this happens, first tensions accumulate and, eventually, substantial discrete changes are forced on the system. The anticipation of these changes produces deeply disturbing speculative capital movements, and the execution is costly to the country making the adjustment. Thus, in the end, parities really do change, but in the worst possible way. Particularly disturbing (and still unresolved) problems arise when the country whose exchange rate has become inappropriate is the reserve-currency country (that is, at present, the United States).

2. Narrow bands have limited the ability of countries to carry out monetary policy suited for domestic stabilization; and, with increasing sensitivity of investors to intercountry differentials in short-term interest rates, this limitation has become gradually more stringent. Because of the size of the United States and its special role as provider of the reserve currency, this has meant, in practice, that other countries are increasingly forced to accept an interest policy imposed by American choice.

3. There is no adequate way of regulating the aggregate supply of international reserves; their creation through American deficits, not settled through other reserve assets, is haphazard. At the moment, it is generally deemed excessive, but there is no satisfactory mechanism for reducing it. And the creation of reserves through SDRs is a cumbersome process, hampered by lack of objective criteria for determining the appropriate amount.

4. With the short-term dollar claims convertible *de jure* but almost inconvertible *de facto*, every significant addition to the reserves of a major third country sends waves of tremors through the international financial community, besides giving rise to a chorus of acrimonious rebukes to the United States for running an uncontrolled deficit. There is, in fact, a well-grounded fear that if large conversions were forced on the United States there would be, at the very least, the danger of an unwarranted contraction in world liquidity and, at worst, the possibility that the United States might become "bankrupt," in the sense of being unable to carry out its obligations. Furthermore, the occasion for such crisis is increased by the fact that the surplus of any one country bears but an indirect relation to the American deficit, certainly far less direct than the layman is led to believe. A third country could experience a large surplus even if the United States were not running a deficit, or, indeed, even if it were running a huge surplus. This is because, under

the arrangement described in 3, any country experiencing a surplus on an official-transaction basis will initially acquire dollars which may well come from the deficit of other countries than the United States. Furthermore, ever since foreign central banks have started investing their dollar reserves in the Eurodollar market, it is not even true that the sum of all surpluses on an official-reserve basis equals the American deficit on that basis.

Comment on Items 1 and 4

With parities fixed, there is, in principle, a unique relation of the domestic price level (and interest rates) to the price level (and interest rates) in the rest of the world that is consistent with basic-balance equilibrium. Since price levels do not automatically respond promptly to imbalance, and countries are understandably unwilling to undergo the painful process of raising unemployment to reduce relative prices or of fostering inflation to increase relative prices, the fixed parities are bound to drift out of equilibrium. This drift, helped by the increasing liberalization of capital movements, has gradually occurred. Thus, eventually, discontinuous changes in parity have been forced on the system; and, because changes have been long delayed, and hence are large in size, they have produced deeply disturbing speculative movements. They have also been costly to the countries concerned, as speculators have gained at the expense of the monetary authorities.

The problem takes on a special dimension in the case of the United States. Since its official liabilities are a component of reserves, strictly speaking the equilibrium level of relative prices for the United States is that level which generates a deficit, on an official basis, equal to the "appropriate" growth in world reserves, less the "appropriate" growth in other reserves. Since gold does not grow, by present rules of the system, the growth in other reserves means growth of SDRs. Unfortunately, there is, at present, no objectively accepted criterion for what is the "appropriate" growth of total reserves; and the growth of SDRs is a very cumbersome process requiring the political agreement of an appropriate majority of the Fund members.

We have already noted that, with fixed parities, there is no effective mechanism to insure promptly that the American price level relative to the rest of the world will be such as to generate the "appropriate" growth of dollar reserves. We now see that there is also no way of agreeing what the "appropriate" level is. Hence, there must be, unavoidably, a continuous wrangle as to whether the deficit of the United States is excessive, too little, or just right. This is indeed an issue which has divided deeply both economic experts and political leaders.

At the present time, there seems to be growing agreement that, at least in recent years, the rate of deficit has been excessive. It is, therefore, also fairly generally agreed that, at current parities, the American price level is out of line with the rest of the world, although there is far less agreement as to just how far out of line it is. There is indeed even a "minority" that believes that the gap is small enough to be safely disregarded. The "minority" view is held, in part, by American experts claiming that the deficit is not excessive or can be handled by means other than a realignment of American prices; and, in part, in certain European circles holding that the excessive deficit does not reflect too low a trade surplus but only excessive capital exports. Hence, the cure would lie not in reducing the relative American price level in order to increase its export surplus, but instead in the United States taking measures aimed at curbing capital exports through which it is "buying up" Europe.

Whatever one's view on the extent of overvaluation, it is apparent to all concerned that the United States is not willing—or even realistically able—to bring about a rapid downward adjustment of its price level relative to the rest of the world. Under these conditions what would be called for is a one-time reduction of its parity *vis-à-vis other major currencies*. There are obviously two possible ways this could be accomplished:

- (a) by devaluing the dollar relative to SDRs and monetized gold, while the other currencies retain the old parity, or
- (b) by revaluing the other currencies relative to SDRs and gold, while the United States retains the old parity.

A substantial body of American opinion holding that a change in parity is appropriate refuses to consider alternative (a) on the grounds that the major important effects are really the same for all concerned under either alternative, while many "minor" considerations point to alternative (b) as economically and technically preferable. These "minor" considerations include such propositions as

- (i) a revaluation of monetized gold relative to the dollar could threaten the continuation of the two-tier system;
- (ii) a devaluation of the dollar relative to SDRs and gold could shake confidence in the dollar as a reserve currency, causing a collapse of the present system;
- (iii) if the rest of the world feels that their currencies are undervalued relative to the dollar, why do not *they* raise their parity relative to the dollar? This, of course, would imply that their

currencies would be revalued relative to SDR and gold; but why should anyone care, since the only parity that affects the American deficit is that with the dollar.

- (iv) the present parity with the dollar is enforced by foreign central banks supporting their parities by operating on the dollar market; hence, it is only *they* that can change this support level. There is, indeed, under the present set-up, no operational way in which the United States could reduce the market rates of exchange of foreign currencies with the dollar.

We shall have occasion to deal with all these arguments at various points below, and will only note at this point that argument (iii) can be used quite symmetrically to support alternative (a) over (b). However, what needs to be examined first is the argument that, in terms of major substantive effects, alternatives (a) and (b) should be regarded as equivalent by all "rational men." This argument deserves close scrutiny, because it is widely held (at least in the United States), while, in our view, it is untenable in at least one major respect.

There is, first, one essentially institutional reason why foreign central banks prefer devaluation by the United States over revaluation by themselves. Central banks hate to appreciate, because they then have to write down a portion of their assets, which creates complications in their own accounting and/or that of the government. However, we suggest that there is a far more fundamental economic argument to justify their preference for option (a).

Suppose that, under option (b), the currencies of other countries appreciate relative to the complex dollar-gold-SDR; then the reserves held by the rest of the world retain an *unchanged* purchasing power in terms of dollars, and have a *reduced* purchasing power with respect to all other currencies. On balance, their purchasing power is *reduced*. If, on the other hand, under option (a), the dollar is devalued, that portion of reserves consisting of dollar claims fares exactly the same as under option (b). But that portion consisting of gold and net SDRs (that is, the excess of SDR holding over SDRs allotted) has a higher purchasing power with respect to dollars and an *unchanged* one with respect to all other currencies. On balance, the purchasing power of total reserves *rises*. Hence, option (a) is distinctly preferable for the rest of the world.

Actually, the advantage of option (a) for the rest of the world (and its disadvantage for the United States) is, in reality, likely to be even greater. For, if the United States were to devalue, there would also be a "redistributional effect" among third countries. The gain to any country would be greater, the larger the share of their reserves held in gold

and SDRs, and the smaller the share in dollars. In short, there would be a relative loss for those countries which, in the past, have shown willingness to cooperate with the United States by holding their reserves in dollars instead of converting them into other reserve assets. It follows that under option (a) there would be an important loss of face and prestige on the part of the United States, to the advantage of countries and of political forces less sympathetic to the American position. Or, more likely, the United States would feel it necessary to show that it does not let its friends down by agreeing to compensate foreign countries for any loss on their net dollar-denominated claims on the United States (with proper allowance for the interest they have earned on their dollar reserves). This could be accomplished by issuing to them additional dollar claims as needed. With this further action, *all* the reserves of third countries would have increased purchasing power in terms of dollars, regardless of composition.

To summarize, the differences between the two options are not purely formal but, indeed, very substantial. The other countries are better off under option (a) than (b) (because their reserves are worth more), while the United States is either worse off in prestige, or worse off financially, or both. These considerations do not establish *per se* that one option is better than the other; but they do establish that the rest of the world is quite rational in preferring option (a) to (b), while the United States stands to gain financially, as well as politically, from option (b) versus (a).

There is, however, one further consideration which suggests that there is a case, on grounds of equity, in favor of option (a) over (b), particularly if we think of these options as relevant for the future. Assume that the overvaluation of the dollar relative to other currencies had resulted from American prices rising while other prices remained constant (or rose less rapidly), thus contributing to the rise in world prices. As long as all reserve assets bear a fixed parity to the dollar, this means that the American price behavior had caused a gradual erosion in the purchasing power of the rest of the world's reserves. A revaluation of other currencies is, in a way, a formal recognition of this relative loss of purchasing power. On the other hand, a devaluation of the dollar relative to other reserves would go in the direction of maintaining the purchasing power of reserves other than dollars. And, if accompanied by a compensation to the holders of dollar claims, it would maintain the purchasing power of all reserves and, in particular, the real value of dollar claims against the United States (that is, of the American debt). Since the assumption stated at the outset clearly has factual validity, we have established our equity case for option (a), accompanied by compen-

sation to the holders of dollar reserves for the net loss sustained, not covered by interest earned. More generally, thinking about the future rather than about the past, *if* the United States (the reserve-currency country) were to take the position that its parity with other reserve assets is *never* to be changed and, therefore, all reserves are, in fact, denominated in dollars, then all other countries have a very definite stake and vested interest in the maintenance of a stable American price level. A policy of "benign neglect" is thus not consistent with the United States retaining the role of reserve-currency country. There is, in this sense, a good deal of truth to a recent statement of French President Georges Pompidou that "We cannot keep a monetary standard which continuously loses value as a result of American Internal Policy." (As quoted by the Paris Edition of the *Herald Tribune* on May 26, 1971.)

Comment on Items 2 and 3

A country's ability to stimulate domestic activity by an expansionary monetary policy, and concomitant reduction of short-term interest rates, is constrained by the fact that the fall in interest rates creates an incentive for capital to flow out of the country, motivated by the favorable differential between domestic and foreign rates. It is well known that if the monetary authority has the obligation of preventing the market rate of exchange from falling outside some agreed band, then, as the differential gets large enough, the authority is forced to intervene in the exchange market and reserves begin to flow out of the country. This outflow, in turn, limits the achievable differential in two ways: (i) because it reduces the domestic money supply—that is, a portion of the intended expansion of the money supply "leaks out" in the form of reserve outflow; and (ii) because it drains the country's limited stock of reserves. Furthermore, the outflow of reserves tends to increase the money supply of the recipient countries, thus reducing their interest rates. While this helps the first country, by reducing the interest differential, it will tend to interfere with the desired monetary policy of the other countries.

It can be readily established that the maximum differential between the domestic rate of interest and the rate in other countries that can be achieved before reserves begin to flow out depends primarily on four factors:

- (a) the permissible band of fluctuations of the exchange rate;
- (b) the responsiveness of the basic balance to variations in the rate of exchange;
- (c) the responsiveness of the capital outflow to the so-called covered

differential spread; that is, the differential in the interest rates adjusted by the cost of hedging (by transactions in the forward market) against adverse movements in the rate of exchange at the time the lender wants to repatriate his capital;

- (d) the risk premium required by speculators in the forward market, who provide the cover.

Item (b) reflects certain basic characteristics of the economy, such as the elasticity of its exports and imports with respect to variations in the relation between domestic and foreign prices. For the present argument, this characteristic can be taken as given. It can then be shown that the maximum differential between domestic and foreign rates that can be maintained before reserves begin to flow can be expressed approximately as the sum of two components, as follows:

- (1) The first component can be written as B/t , where B is the total width of the band, and t is the maturity (measured in years) of the instrument whose yield we are comparing. (Thus, if the market rate of exchange is to be kept within $\frac{1}{2}$ per cent of parity, B is 1 per cent. Then, for the three-month rate, the term B/t equals $1/(\frac{1}{4}) = 4$ or 400 basis points. For the six-month rate, the term comes to 200 basis points, and so on.)
- (2) The second component of the maximum differential is more complex, but for present purposes, what matters is that it is positive; it grows large as the response coefficient under (c) above, call it R , gets low, and tends toward zero as that coefficient increases. It also tends to increase with the size of the risk premium.

We have seen under item 3, that, under present practice, B is somewhere between $1\frac{1}{2}$ and 2 per cent. However, in the early postwar period the responsiveness, R , tended to be small for many reasons. These include (i) outright restrictions on, and encumbrances to, capital movements; (ii) diffidence toward foreign investments, lack of familiarity with foreign instruments, and lack of information about their probable yields; and (iii) lack of an organizational network such as had existed in part in the predepression period but had died out during the 30's and the war years. In addition, the risk premium required by speculators was probably higher. As a result, in the early years of the system, central banks retained substantial freedom of domestic monetary policy. As the postwar period unfolded, each of the above factors gradually developed in the direction of increased responsiveness. In addition, a new important institution began to develop and flourish, namely

the multinational corporation. This new organization, because of its ubiquitous nature, and the resulting familiarity with institutions in different countries, and because of its concern with the efficient management of its liquid assets, has generated a very large pool of funds highly responsive to differential opportunities.

The result of these developments has been that, with the passage of time, the ability of each country to pursue an independent monetary policy has been gradually shrinking; and attempts at pursuing such a policy have frequently resulted in massive and disruptive flows of reserves. This has been especially true when the incentive to capital flows has been reinforced by processes generated by speculation on anticipated changes in parity, as witnessed in the recent experience of the German mark.

As is the case with other problems discussed earlier, the purely economic drawbacks of a narrow band have been reinforced and complicated by political considerations. It can be readily seen that the ability of a country to pursue an independent monetary policy depends on its relative size and on its ability to run a sustained loss of reserves. If a country is very large and is willing and able to stand a great deal of loss, then this country can pursue a policy of low interest rates and, as a result, spread this policy to other smaller countries. Now it happens that (i) the United States is the financial giant of the world, and (ii) it is able to disregard largely the loss of reserves. Indeed, in its case, the loss of reserves simply means an increase in the semi-inconvertible dollar claims held by the rest of the world. It is for this reason that the United States can blithely pursue a policy of "benign neglect" while other countries find themselves forced, in large measure, to dance to a tune called by the United States. The resulting and growing resentfulness and gripes of the rest of the world are then not so unjustified or hard to understand. Sacrificing independence to a common course of action is always irksome; but it is obviously more irksome when one feels that one has little to say about what that common policy shall be. And, for some at least, it is still more irksome if the party making unilateral decisions is called the United States and, further, influential voices in that country advocate a policy of "benign neglect" (or, in other words, a policy dictated entirely by domestic considerations).

These serious and growing shortcomings of the present system lead to the unavoidable, and generally accepted, conclusion that this system has but a short lease on life. However, no solution has yet been offered that appears economically and politically acceptable. In the next section we outline some proposed reforms, and in the concluding section we

indicate how these reforms would help to handle the shortcomings of the present system.

III. OUTLINE OF PROPOSED REFORMS

1. Broaden the Band of Permissible Fluctuations around Parity

The maximum permissible deviations of market exchange rates from parity before the central banks are required to intervene will be increased significantly above the present 1 per cent up and down of parity *de jure* and $\frac{3}{4}$ per cent *de facto*. The total width of the band—now 2 per cent *de jure* and $1\frac{1}{2}$ per cent *de facto*—should be increased to at least 4 per cent of parity, although a somewhat broader band deserves consideration.

2. Generalized Crawling Parities

(a) The official parity in terms of SDRs of each currency will be determined, indirectly, by the official parity of that currency with the dollar and the parity of the dollar with SDRs.

(b) The rate of exchange between the SDRs and monetized gold will remain fixed indefinitely (presumably, although not necessarily, at the current level).

(c) The official parity of each currency with the dollar will be an average of the market rates prevailing over a stated number of previous trading days; the specific number of days will be determined simultaneously with the permissible band in order to insure that the maximum annual rate of change of the parity to the dollar does not exceed x per cent per year. (The number x will have to be an object of negotiation, but we would favor a value of not less than 2 per cent—see below.)

(d) The parity of the dollar to the SDR (the price of SDRs in terms of dollars or dollars per SDR) will change if and when there is a change in an appropriately constructed index of the dollar price of internationally traded commodities. The dollar price of the SDR will increase continuously (daily) at an agreed maximum rate per year as long as it is less, relative to the price in the base period, than the current level of the price index relative to the same base period. The price will fall continuously as long as it is higher (relative to the base) than the price index (relative to the base).

3. Option of Foreign Official Holders to Denominate their Dollar Reserves in SDRs.

At the option of foreign official holders, the United States will have the obligation to denominate in SDRs any portion of the official reserves of a participating country having the form of short-term dollar claims.

Dollar reserves so denominated will take the form of a claim against the United States Treasury-Federal Reserve and will earn a rate of interest equal to that paid by the Fund on SDR balances. That portion of dollar reserves which is not so denominated will be managed, as under the present system, by the official holders and invested as they see fit, in earning assets in the United States, but *not* in Eurodollars or equivalent dollar-denominated assets.

4. *De Jure* Inconvertibility of the Dollar

The obligation of the United States to buy from, or sell to, foreign monetary authorities dollars in exchange for gold or SDRs shall be terminated *de jure*.

5. Use of "SDR Clause"

Participating countries will agree to make it legal, for their citizens entering into long-term international lending agreements, to denominate the loan in units of SDRs, no matter what currency may be elected for execution.

6. Acceptance by the United States of the Obligation to Reduce Its Deficit when "Excessive" and to Increase It when "Insufficient"

(a) A state of "excess American deficit" will be declared to exist if and when (i) the currencies of one or more countries remain at the upper limit of the permissible band for some stated interval of time; (ii) the aggregate increase in reserves of the countries whose currencies are at the upper limit, and which are gaining reserves, exceeds by some stated threshold value, the aggregate decrease experienced by countries whose currencies are at the lower limit, and which are losing reserves; and (iii) the United States is contemporaneously running a deficit on the official basis. While this state persists, the United States will have the obligation to take explicit measures to curb its deficit, through appropriate economic incentives.

(b) A state of "insufficient American deficit" will be declared to exist if and when (i) the currencies of one or more countries remain at the lower limit of the permissible band for some stated interval of time; (ii) the aggregate decrease of reserves of the countries whose currencies are at the lower limit, and which are losing reserves, exceeds, by some stated threshold value, the aggregate increase experienced by countries whose currencies are at the upper limit, and which are gaining reserves. While this state persists, the United States will have the obligation to take measures to increase its current deficit (or decrease its surplus) on an official-reserve basis.

7. Issuing SDRs

The issuance of SDRs will be regulated to achieve, on the average, a stipulated relation between the portion of reserves taking the form of SDRs and gold and the portion taking the form of claims on the United States. For example, suppose that at the end of a given "period" the stock of SDRs and gold represented a smaller proportion of total reserves than the agreed-upon target. Then, in the next "period" the issue of SDRs should be stepped up, and conversely.

8. Retention of Other Features of the Present System

Any feature of the present system that is not explicitly modified stays the same. In particular, this means the retention of the two-tier system. Possibly this system could be strengthened by eliminating *any* form of fresh gold purchase.

IV. PROPERTIES AND OPERATING CHARACTERISTICS OF THE PROPOSED REFORM

For the benefit of the expert who is interested in the "essence" and is used to technical jargon, the system resulting from our reforms can be characterized as follows:

1. Managed, limited float of the dollar with the power of management entrusted to foreign central banks.
2. Because the float is limited, all participating countries, including the United States, are committed to pursuing policies such that, in the long run, the equilibrium rate of exchange remains within the limit of the moving band. In the short run, however, the existence of reserves permits transient deviations from this requirement, and gives each country time to carry out the longer-run adjustment that may be required.
3. The management of exchange rates and the obligation to intervene at the limits of the band require, or make it desirable, to retain an international "money," for market intervention and settlement between monetary authorities. In the present system the dollar performs, *de facto* if not *de jure*, each of the three classical functions of money: numéraire, medium of exchange, and store of value, with the SDR and gold sharing in the role of store of value and, to a limited extent, in the role of medium of exchange. In the reformed system, the SDR and gold (though the latter could eventually be eliminated) become the numéraire, which is endowed with the valuable property of retaining a stable purchasing power. The dollar remains the principal medium of exchange, with the other two assets continuing to share this func-

tion to a limited extent, and the store-of-value function continues to be shared by the three reserve assets.

4. Through the management of exchange rates, the rest of the world is enabled to control the creation of reserves in the form of dollars and to provide an objective criterion for the creation of SDRs.
5. The availability of a numéraire with a stable purchasing power minimizes the possible unfavorable consequences of floating rates on the international movement of long-term debt capital.

Any *one* of the above features could probably be achieved by means other than our plan. But our plan achieves them all simultaneously, in the most convenient fashion. For instance, a stable purchasing power for the SDR could be insured through all member countries agreeing to change, simultaneously, the parity of their currencies with respect to SDRs in accordance with the price index of internationally traded commodities. Our proposal achieves this same end, far more conveniently, by changing explicitly only the parity of the dollar to the SDR, while tying the other currencies to the dollar.

We can now proceed to discuss in more detail, and in less technical language, what has been summarized above.

The key novel element of the plan is clause (2d). The purpose and effect of this clause is that the portion of reserves consisting of gold and SDRs will tend to have a stable purchasing power in terms of the broad collection of commodities that enter into international trade. Furthermore, when combined with clause (3), it gives to the rest of the world the option to hold the entirety of their reserves in a form which has constant purchasing power. Of course, a country opting not to denominate its dollar claims in SDRs will assume the risk of loss (or gain) of purchasing power if international prices rise and the dollar depreciates; but presumably, it will choose this option only when it expects that the yield obtainable in the American market is sufficiently high to exceed the expected depreciation plus the interest obtainable on reserves denominated in SDRs.

The other important effect of clause (2d) is that it eliminates the perpetual wrangling as to whether the dollar should be revalued with respect to SDR-gold, and by how much. This issue would be controlled by a mechanical rule, and one that makes sound economic sense.

Details as to the precise nature of the price index to be used need not detain us here, except for suggesting that it should be as broad as possible, preferably including major services as well as commodities. There are, no doubt, technical problems involved in the construction of the index, but they are not qualitatively different from those arising in

the widely used cost-of-living indices. Similarly, details as to how and when the option as to denomination of dollar claims can be exercised can be left for negotiation. For the sake of illustration, one might suggest that the price index be computed and published once a month on a stated date, at which date the dollar price of SDRs would change, and that the option for the next month be exercised within a few days of that publication. To minimize the incentive to massive shifts in the portion of reserves denominated in SDRs, we suggest that the index might well be a twelve-month moving average of monthly values and that the maximum change in the dollar price of SDRs in any one month be limited to a pre-established ceiling. It is relevant to point out in this connection that, according to the price index presently computed by the Fund, the change in the index from one year to the next has never been more than 3 per cent.

The other key clause, inseparable from (2d) and (3), is clause (4). By establishing *de jure* what is, at present, an uncertain *de facto* situation, this clause eliminates a major component of uncertainty and anxiety in the present system and bans forever the risk of a "run on the bank." Is there any reason why acceptance of this clause should be regarded as "onerous" to the rest of the world? We believe that, if we leave aside petty considerations of jealousy and prestige, the answer is clearly negative. First, accepting *de jure* what is nearly true *de facto*, cannot be very onerous, especially since the *de facto* situation arises, in part, from the fact that the United States could not, at present, convert all the dollar claims in official reserves into other reserve assets. But, in fact, the rest of the world would be better off, for, once the uncertainty about the status of the dollar is removed, it will be more freely accepted by all central banks in exchange for other reserves. Indeed, in view of the option of clause (3), dollar reserves should, rationally, be deemed at least as desirable and generally more desirable than other forms of reserves, as their expected return can be no lower than that of SDRs, and may be higher. (For this reason there may, at times, be a scramble to invest reserves in the form of dollars; and, since the supply is limited, some allocation rule may be needed. This point will be taken up again below.)

The purpose of clause (1), which simply incorporates in our reform earlier proposals of many other experts, is to increase the scope for an independent monetary policy. It is, by now, generally agreed that this increase in the ability of central banks to choose the monetary policy best suited for domestic stabilization is desirable; and that it can be achieved by broadening the band. Indeed, there are strong indications that many countries are already prepared to support this simple reform.

In terms of the analysis of Section III, a 2 per cent band would permit differences at least as large as 800 basis points in the three-month rate and 400 basis points in the six-month rate. Even though that analysis is not strictly valid once parities crawl, we believe that a band of the order of 2 per cent is adequate at least for a trial period, while still leaving the possible range of fluctuations sufficiently narrow to preserve much of the advantage of fixed parities—namely, to prevent expectations of large forthcoming changes in the market rate leading, through speculation, to large fluctuations in the actual market rate. Wider bands will tend to reduce the flow of short-term capital. But it is generally agreed that this is a desirable development, as short-term capital flows have primarily the disruptive effect of preventing countries from pursuing an appropriate domestic policy, while contributing little, if any, to the channeling of long-term capital to where it has larger social returns.

Proposal (2c) is also not original, although it is a good deal more controversial. All the relevant ideas in this regard are discussed in the *Bürgenstock Papers* (Princeton University Press, 1970). The purpose of (2c) is to allow parities to drift gradually in time, if, and as, differential developments in the economies of participating countries makes this desirable. With this proposal, over a period of years, parities would be allowed to change by very substantial amounts. At the same time, holding the maximum annual rate of change within modest limits provides little incentive to the massive flows that are generated by the expectation of a discontinuous, large change. In our proposed system, the maximum rate of change of the parity is controlled by the relation between the maximum allowable band and the length of the averaging period used in computing the current parity. Specifically, it can be readily established that the following formula holds:

The maximum per cent annual rate of change of parity equals the total width of the band, measured as a percentage of parity, divided by the length of the averaging period, measured in years.

(For instance, if the band had a width of 4 per cent and the averaging period were two years, the maximum rate of change of parity would be 2 per cent per year; if the averaging period were six quarters ($1\frac{1}{2}$ years), the maximum rate of change of parity would be $2\frac{2}{3}$ per cent per year.) Thus, once a decision has been reached on the allowable band, the maximum rate of change of parity can be limited by an appropriate choice of the length of the averaging period.

The considerations relevant in choosing the maximum rate of crawl are, essentially, that it should be as small as possible, but large enough to take care of the foreseeable maximum rate at which parities may drift

out of alignment. The postwar experience suggests that a maximum rate of change of 2-3 per cent would have been adequate to take care of all major needed adjustments. It should be stressed, however, that the rate at which parities may need to be changed is not an objective "economic fact"; it depends on the extent to which a country is prepared to rely on the whole set of tools of economic policy to control variations in its domestic price level. The smaller the maximum rate of crawl, the greater the chance for a country to have to take painful measures to keep price behavior under control for purely external reasons. But, at the same time, the smaller the maximum rate of crawl, the smaller the possible disturbances to the system from speculation. In a very real sense, in setting a limit to the maximum rate of crawl, countries are notifying the world—and hence speculators—that they intend to pursue policies which will not require rapid changes in parity. The more willing countries are to make this commitment, the less scope there will be for disturbing and, therefore, undesirable speculative fluctuations in the market rate.

The conclusion, then, is that the decision about the appropriate maximum rate of crawl is finally a "political" decision that involves trading between short-run fluctuations in the exchange rate and minimizing the need to implement unsavory domestic policies in order to adjust to the requirements of the foreign balance. Since this trade-off may well be different for different countries, we can see no reason why each country should not be free to choose a *different* averaging period and thus a *different maximum rate of crawl*. If no limitations were placed on this freedom, a country could, in practice, even opt for a freely floating rate, by making the averaging period short enough. Similarly, there is also no reason why a group of countries could not agree among themselves to limit the band of fluctuations relative to one another. This could be accomplished, for example, along the lines that the members of the European Economic Community are presently preparing to follow.

While the many advantages of crawling versus "permanently" fixed parities are increasingly being recognized, there continues to remain one very serious objection to moving parities, in terms of their unfavorable effect on the international movement of long-term capital. With respect to long-term capital flows, in fact, greater possible short-term movements of exchange rates resulting from a wider band are of little consequence; even a 4 per cent change in the market rate will have little effect on the yield of an investment whose length is measured in decades. But crawling parities pose a potentially serious threat: the parity might move continually in one direction at the maximum rate of crawl. If that rate were, for instance, as large as 3 per cent per year, a contract calling for,

say, a 5 per cent yield to the lender (and cost to the borrower) could end up yielding (and costing) as little as 2 or as much as 8 per cent. In other words, crawling parities tend to increase substantially the risk of long-term capital movement—at least for debt capital. (In the case of equity capital, on the other hand, the situation may well be reversed, since the relative movements of the exchange rates would presumably tend to offset corresponding movements in relative prices, and would tend to stabilize the real rate of return.) But this potential hindrance to long-term debt-capital movements is eliminated by our proposed reform, thanks to clause (5). This clause will make it possible for the contracting parties, if they wish to avoid the exchange risk, to denominate the contract in SDRs. Because clause (3) has the effect of tending to insure that SDRs will have a stable purchasing power, by contracting in SDRs, they will be able to insure for themselves a stable outcome in “real terms.” In this sense, SDR denomination bears close similarity to the traditional “gold clause”; but it clearly is potentially superior. Even under a pure gold-standard system there was nothing to insure a constant purchasing power for gold. In the present system, the purchasing power of gold is as uncertain and unstable as the purchasing power of the dollar—not terribly unstable but not notably stable!

The remaining major novel feature of the reform is that it provides an automatic mechanism for creating the “appropriate” amount of international liquidity. To lay bare the workings of this mechanism we must distinguish between normal and pathological conditions. We shall first discuss the normal working of the system and then the possible pathological cases which might arise if and when the American deficit were declared excessive or insufficient and clause (6) were to apply.

We first note that, as long as a central bank chooses to keep the rate of exchange of its currency within the maximum permissible band, one could justifiably infer that what was happening to the reserves of the country was considered desirable by its government, regardless of whether it was acquiring reserves, losing them, or neither. Suppose, for example, that the country’s reserves were rising. This would mean that it was intervening in the market, acquiring dollars, and selling its own currency, in order to prevent its currency from appreciating. If it did not want to accumulate dollars (possibly to be exchanged for other reserves), or at least not at the current rate, then all it would need to do would be to stop buying them, or reduce the rate of purchase. Similarly, if it were losing reserves at a rate that it did not deem appropriate, all it would need to do would be to stop, or reduce, its selling of dollars to support the exchange value of its currency. To be sure, the country might, in the first place, be buying dollars for fear that an appreciation

of its currency would hurt its exports and expose domestic producers to greater pressure of foreign competition. But, in that case, the acquisition of reserves must still be regarded as wanted, in the sense of being the means for securing the desired condition of maintaining, or increasing, the export surplus. Similar considerations apply in the case of a loss.

This inference, that whatever was happening to a country's reserves was operationally "wanted," would cease to hold only at the limit of the band. Thus, if the exchange rate had reached the upper limit and the country was still accumulating reserves, this behavior could not be interpreted as necessarily reflecting a desire to hold more reserves. In fact, the country would then have no choice but to acquire dollars to keep the exchange rate within the required limits. Similar considerations apply, *mutatis mutandis*, if the exchange rate of its currency had reached the lower limit and the country was still losing reserves.

Suppose now that over some period of time we had observed that every currency had remained within the band. Suppose further that in the same period the total dollar reserves of the rest of the world had increased. This increase would be equal to the current American deficit on an official-reserve base. We would then be justified in inferring that the observed overall increase reflected a desire for larger reserves. Furthermore, the desired increase could be equated with the observed increase, that is, with the sum of the American deficit plus the period allotment of SDRs. This means, in the first place, that there could be no justifiable complaint about the American deficit, or the increase in world liquidity, being too large (or too small). At the same time, the experience of the period could be used to provide evidence about the adequacy of the allotment of SDRs. Specifically, suppose the agreed ratio of dollars to total reserves was 50 per cent, and this ratio had existed at the beginning of the period. If in the period, the allotment of SDRs had been, say, 3 per cent of the initial stock, while the growth of dollar reserves had been, say, 7 per cent, implying a growth of total reserves of 5 per cent, then we could infer that the SDR allotment had been insufficient. This information would provide the basis for the next "period" allotment. For instance, one might establish that SDRs should then grow by 7 per cent, in the expectation that, if the desired growth of total reserves remained 5 per cent, then the increase in dollars would tend to be around 3 per cent, reestablishing the desired ratio. Of course, the specific numbers used above are purely illustrative, and one could imagine more complex formulas taking into account circumstances other than the latest growth of total reserves and the initial composition. However, what has been said should be sufficient to indicate

how the plan would help provide the basis for a rational decision about the rate of growth of SDRs.

We may now proceed to possible pathological situations in which clause (6) might apply. We need to examine both what circumstances would justify invoking this clause and what measures might be appropriate while this clause was in operation.

With respect to the first issue, one can readily describe circumstances in which our plan would bring to light an excessive American deficit. Suppose that, over some period, no currency was at the lower limit of the band while all or most other countries' currencies were at the upper limit, and that those countries were none the less accumulating dollars. There would then be a *prima facie* case for holding that the accumulation of these countries was unwanted, and was forced on them by an excessive American deficit. Furthermore, to a first approximation, the size of the excess deficit could be identified with the accumulation of reserves of these countries (over and above any increase due to SDR allotment), or with the American deficit, whichever was smaller.

At the other extreme, suppose that no currency was at the upper limit, and the currencies of all, or most, other countries were at the lower limit, and the countries were still losing reserves. One could then say that the loss was unwanted and forced by an insufficient deficit of the United States (or an excessive surplus), and the insufficiency could be deemed to be at least as large as the loss by these countries. (Note the asymmetry in these two cases. The reason for this asymmetry will be discussed later.)

Generalizing from these limiting cases, one might say that a "probable excess deficit" existed when the aggregate accumulation by countries whose currencies were at the upper limit, and which were gaining reserves, exceeded the aggregate decumulation of countries whose currencies were at the lower limit, and losing reserves; and that a "probable insufficient deficit" existed when the aggregate accumulation of the first group was less than the aggregate decumulation of the second group. Furthermore, the size of the net difference could be used to provide an indication of the size of the excess or deficit.

The considerations above provide the basis for our specification of clauses (6a) and (6b), to which the reader may wish to refer. Note that clause (6b) omits the counterpart (iii) of clause (6a). This omission implies that clause (6b) would be invoked regardless of whether the United States were running a deficit or surplus. On the other hand, clause (6a) would not be invoked unless the United States was running a deficit, since we do not propose that, under any circumstances, the United States should be required to run a surplus or, even less, to increase it. But we suggest

that if condition (6a), (i) and (ii), were verified, but not (iii), the rate of issue of SDRs should become zero or even negative. Finally, while we suggest that clause (6a) should automatically apply when the stated conditions have been verified, one could allow for its suspension by agreement of all countries having currencies at the upper limit. Similar conditions apply to suspension of clause (6b).

Once clause (6a) has been invoked and while it remains in force, the United States would be obligated to embark on a set of policies designed to reduce its deficit. There is little point in detailing here what these measures should be, for clearly the appropriate measures would depend on the particular circumstances. To begin with, we believe that there would be really little likelihood that clause (6a) would have to be invoked, provided at the time our proposal was put into effect the rate of exchange between the dollar and other major currencies had already been adequately realigned. An adequate realignment would imply, to begin with, that there would be some movement before the American deficit could become excessive; and if a situation of incipient excess surplus was developing, with the currencies of major countries close to, or at, the upper limit, then their exchange would be appreciating relative to the dollar, tending to correct the situation. Indeed, much of our proposal is predicated on the notion that crawling parities, together with responsible domestic policies with respect to price developments, provide enough flexibility to prevent pathological situations from developing.

None the less, one cannot exclude the possibility of pathological situations developing, the most likely source of this being large variations in the relatively volatile component represented by capital movements. If this turned out to be, in fact, the source of an "excessive deficit," then the appropriate set of remedies would revolve around measures aimed at discouraging American investments abroad. This could presumably be accomplished by economic incentives such as interest-equalization taxes, taxes on the profits from foreign equity investments, shifts in the mix of monetary and fiscal policies, and generally by policies showing "benign concern," while avoiding direct regulations such as quotas and discriminatory measures. In particular, in some instances, it might be appropriate to strive for an explicit coordination of monetary policies. It would also seem appropriate to require of countries with currencies at the upper limit of the band, and gaining reserves, to contribute to the elimination of the surplus, by removing or reducing impediments to capital outflows as well as to imports. Finally, while clause (6a) was in force, and assuming that all parties were absolving

their duties, it would seem appropriate to reduce or suspend fresh allotments of SDRs.

In the light of recent experience, the likelihood of clause (6b), relating to an "insufficient American deficit," having to be invoked would seem even more remote, though we would hesitate to extrapolate that experience. In any event, the nature of measures that would be appropriate in this situation should be apparent enough from what has been said above. In particular, it would seem appropriate, while this clause was in force, to increase the allotment of SDRs.

Having raised the rather explosive issue of "excessive American capital exports," we should like to develop a few further considerations. These considerations are dictated, in part, by the awareness, kindled by exchanges with some European leaders, that this issue is paramount in the eyes of many influential Europeans and, therefore, any proposed reform has to face this issue squarely.

In the past, a substantial body of European public opinion has complained that (i) the United States, through its investments abroad, was acquiring valuable high-yielding assets as well as increasing economic dominance in their countries, and (ii) that it was paying with dollars which their central banks were forced to acquire, under the obligation to maintain their currencies at the fixed parity, and which could, at best, be invested in low-yielding, short-term American securities.

How does our proposed reform handle this problem? Under this system, if American investments were to continue more or less unabated, other countries would, of course, have the option of letting their currencies appreciate vis-à-vis the dollar, at least gradually, and this appreciation would increase the American net trade export and decrease theirs. In this way, American acquisitions would tend to be financed by a real transfer of resources, rather than by an increase in their dollar claims. But this solution might appear to them equally distasteful, if not more so. For, if there is one thing that they dislike even more than our continuing acquisition of assets and expansion of economic power in their country, it is to witness an increase in our net exports at the expense of theirs. This dislike, no doubt, reflects, in part, an inveterate mercantilistic tradition.

We have, in this paper, taken great pains in pointing out, and developing as forcefully as we could, the valid rationale of many European positions. Let us then take a look at what, if any, is sound and deserving in this position.

We submit that there are basically two grounds on which a country could, reasonably, object to American foreign investments. First, if it does not wish the United States to acquire assets and influence inside it.

And, second, if it does not wish to acquire additional reserves, least of all additional dollar balances.

The first objection is understandable, as a nationalistic sentiment, whether or not it is economically rational. But the answer to this problem very clearly lies in the country's using the power it generally already has (or can easily secure) explicitly to limit, discipline or prohibit American expansion—by way of acquisition, mergers, or direct investment in new productive facilities—within its borders. To some extent, this prohibition will make its balance of payments less favorable, thereby reducing either the acquisition of reserves or the need to let its exchange appreciate to avoid an increase in reserves.

Is there then any "rational" ground for a country to complain about American investments in other countries? Only if these investments were to cause that country to accumulate unwanted reserves. This could happen if the third countries, receiving American investments, were to utilize the resulting inflows of funds to increase, directly, or through triangular relations, their imports from the country in question. Such a development, however, should be regarded as favorable to a "mercantilist" mind; and if the country did not welcome an increase in its reserves, it could always let its currency appreciate. The outcome would then be a smaller increase in exports matched by some increase in imports, which could hardly be objectionable, especially since, presumably, it would be accompanied by an improvement in the terms of trade.

A problem could arise *only* if the required appreciation of the currency were larger than consistent with the obligation to maintain its exchange rate within the upper limit. For, once it had hit the upper limit, the country would be forced to let its reserves increase. The unwanted increase in reserves could then be traced to the American "excess" investment, and the country might even hold, with some reason, that through this increase it was helping to finance American expansionism. At this point, however, our clause (6a) becomes relevant. For if the country was acquiring reserves while some other countries were losing reserves even faster with the exchange rates of their currencies already at their lower limits, then the problem could not be reasonably laid at the American doorstep. While, if other countries were not losing sufficiently large amounts, then we would be in the circumstance in which the American deficit was indeed excessive and clause (6a) would apply. The invoking of this clause would then require the United States to take steps to curb its capital movements.

We, therefore, submit that our plan does protect the legitimate interest that any country might have in limiting American investment abroad.

Another point warrants brief consideration, though it borders on the kind of detail that is best settled at the level of concrete negotiations. If our reform is applied and is successful, one can anticipate that a sort of pecking order will tend to prevail between the three alternative forms of reserves. We would anticipate that, eventually, gold would be regarded as the least desirable of the three, because it yields no return. We would further anticipate that dollars would, at least some of the time, be preferred to SDRs, because they might yield a higher return, even after account is taken of the risk of devaluation. Any difficulties arising from this preference ordering could be resolved by the very simple principle that no country would have the right to hold SDRs and dollars in proportions significantly different from the composition of total reserves of the rest of the world. Thus, a country holding less than the average share of these two instruments would be entitled to acquire SDRs and dollars for gold, or dollars for SDRs, from a country having significantly more than the average share. In the longer run, if countries manifested a clear preference for SDRs over gold, one could conceive of a simple arrangement to change the overall composition, by allowing countries to sell some or part of their gold to the Fund against credit to its SDR account. The Fund could then sell this gold to the private market and use the proceeds to acquire earning assets whose return would be used to cover the interest payable on SDR balances. This arrangement would, however, run into difficulties if the free-market price of gold were to be significantly smaller than the monetized value of gold.

Another interesting issue for negotiation relates to the target composition of reserves between gold and SDRs, on the one hand, and dollars, on the other. We shall merely note in this connection that it is entirely conceivable that, at least at some later date, the target amount of dollars could be an absolute constant instead of a constant *proportion* of reserves; or it might be a proportion, or amount, decreasing in time, though, in our view, there are good reasons for keeping dollars as a substantial component of total reserves.

One could also readily amplify the scope of our reform by requiring countries to accept explicitly certain further obligations intended to insure a smoother working of the system. To illustrate, a country whose reserve had dipped below some stated level in relation to its Fund quota, could be required not to intervene in the market to support its currency, unless its exchange rate had actually reached the lower limit of the band. This would prevent a country from dissipating its reserves in an effort to manipulate its exchange market, at the risk of not having enough reserves left to perform its obligation. On the other hand, a country that

was supporting its exchange rate at the lower limit, could be transiently accommodated with additional reserves if it had abided by the rules of the game and was enforcing a set of policies deemed adequate to restore equilibrium. Similarly, a country whose reserves exceeded some stated level in relation to its quota could be required not to intervene to hold down its exchange rate, unless it had reached the upper limit; and if it had reached the upper limit it could be required to embark on policies aimed at reducing the surplus. These rules, by curbing accumulation of reserves by countries already having a strong reserve position, would help other countries running a deficit. While we feel that there is much to be said for such rules, they clearly go well beyond the general framework that has existed heretofore, and, in view of the resistance they can evoke, we do not intend to propose them as an integral and necessary part of our reform.

One more question that cannot fail to be asked is: how much does the United States stand to gain from the proposed arrangement? We do not propose to go deep into this question but would like to offer two considerations. From a strictly economic point of view, we regard this reform as less advantageous—or more onerous—for the United States than the current system, in view of clauses (3) and (6). But, this is, in our view, a small price for the United States to pay to have the moral right to a greater independence in monetary policy and the management of the price level, and to have the advantage of a stable, livable system that minimizes the scope for political conflicts. As for the balance of absolute advantages and disadvantages (in contrast with a comparison with the past) we can see some advantages in being in part the “banker of the world,” entitled to create a portion of the world’s “money supply”—but it should be recognized that this banker pays interest on his “deposit liabilities” at the rate equal to the going market rate, and also that he gives his depositors the option of denominating their deposit claims in real terms. On the other hand, there are significant costs. In particular, the exchange rate of the dollar with the currencies of the rest of the world is now largely in the hands of these countries, which can manipulate it to serve their interests. Thus, the fortunes of American exports and imports are somewhat at the mercy of the rest of the world. However, the United States is in a uniquely good position to bear this cost, because it is so large, because it can count on some randomness and cancellation on the behavior of the countries that constitute the rest of the world, and, finally, because its foreign trade, though a very large share of the world’s total, is but a small fraction of its Gross National Product. It is, therefore, doubtful that one could, at present, find any other country, or consortium of countries, that could substitute for the United States in the role of reserve-currency country.

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