

# CEPAL

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## The revolt of the bankers in the international economy: a world without a monetary system<sup>1</sup>

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This article gives a brief overview of the post-war international monetary system and its main characteristics, with special emphasis on the aspects which subsequently created difficulties. It shows how the system developed and identifies the events which led to the international monetary crisis at the beginning of the 1970s. It describes the exchange arrangements which arose as a consequence of the crisis and analyses the conditions in which such arrangements can be effective, the developing countries' possibilities of using them, and the effects on those countries and on the demand for international liquidity by the public and private sectors. With regard to this latter aspect, it stresses the increase in the private sector's intervention role in the exchange markets and the influence of this increase on the international generation and transmission of disequilibria. It then goes on to the attempts to reform the monetary system and the amendments to the Articles of Agreement of the International Monetary Fund and their effects on the developing countries.

Finally, it offers some commentaries on the influence of the present international economic situation on the future development of the monetary system, contrasting the declared objectives with the present trends.

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## Introduction

The last ten years have witnessed profound and rapid changes in the field of international financial relations, extending from the attempt to regulate the growth of international liquidity in the second half of the 1960s to the official acceptance of freedom in exchange matters at the beginning of the second half of the 1970s. An important implication of these changes is that they have shifted the main responsibility as regards exchange regulation.

Thus, the system in force since the end of the Second World War placed the main responsibility for the functioning of the system in the hands of the monetary authorities, whereas in the present situation it is the private sector market and bodies, particularly the banks and the transnational enterprises, which play an accepted and decisive role in the short-term management of exchange rates and the accumulation and disposal of international means of payment.

### 1.

## The Bretton Woods system

The earliest sporadic efforts to organize some form of international monetary system to replace the gold standard date from the period of monetary disorder of the 1930s, but the first systematic proposals were made only in 1942, in government circles of the United Kingdom and the United States.

These proposals were aimed at finding a solution for the monetary problems which were expected after the Second World War. The studies and proposals were headed by Harry

<sup>1</sup>The theme of this article was presented at the CEPAL academic seminar of 4 May 1976. The author wishes to acknowledge the comments received, particularly those of Raúl Prebisch and Andrés Bianchi.

D. White of the Department of the Treasury of the United States and by John M. Keynes in England.

Less than three years had passed since the original proposal when the International Monetary and Financial Conference of the United Nations and their associates, meeting at Bretton Woods, New Hampshire, in the United States, gave its approval to the new system. This was reflected in the Articles of Agreement of the new International Monetary Fund, which were adopted at that conference on 22 July 1944, came into force on 27 December 1945, and continued without changes for almost 25 years.<sup>2</sup>

(a) *The problems to be solved*

This international agreement pursued two main objectives: the correction of balance-of-payments problems and the creation and regulation of international liquidity.

As regards the first point, the agreement laid down that a country could only vary the relationship of its currency with gold, i.e., its "parity", when there were fundamental imbalances which could not be solved by any other means, and it placed emphasis on monetary and fiscal policies. It was expected that, except in extreme cases, these would be successful in adjusting the balance of payments without any need to modify parity. In order to ensure stable parity, the countries undertook to maintain their currencies within maximum limits of variation of

one per cent above or below parity and to intervene in the market to maintain those limits. Thus, through this relationship with gold, a relationship of the various currencies among themselves was also established: the system of exchange rates.

Since the intervention was to be carried out with United States dollars, that country lost its freedom to determine its own exchange rate. Indeed, the dollar exchange rate was simply the result of the determination by the rest of the member countries of the system of their own exchange rates with respect to the dollar. If the United States had tried to establish a different exchange rate, this would have led to a situation of incompatibility of policies, so that country had to refrain from intervening in the market. It was, however, agreed to convert into gold, at the official price of 35 dollars per troy ounce of fine gold, all dollars presented for conversion by the monetary authorities of the member countries.

Thus, the dollar was the currency of intervention and current use in international payments, the exchange rates of the various currencies were established in relation to the dollar, and the dollar, in turn, anchored the system to gold. It was expected that the International Monetary Fund would recommend adjustment measures both for countries with deficits and those with surpluses in their international payments, and a system of medium-terms loans was set up for the countries which took adjustment measures, with the aim of covering the period needed until those measures took effect.

As regards the creation of liquidity, the Articles of Agreement of the International Monetary Fund provided that this should be regulated through "uniform changes in par values", which are no other but changes in the price of gold, expressed in all currencies in the same proportion. This is the same thing

<sup>2</sup> An excellent description of the various proposals made, the debates which took place and the negotiations which led to the Bretton Woods agreement may be found in Y. Keith Horsefield, *The International Monetary Fund 1945-1965*, International Monetary Fund, Washington, D.C., 1969.

as a change in the price of gold in all currencies: more currency units for the same quantity of gold, thus increasing international liquidity, although naturally only in terms of currencies and not of gold.

A second means of modifying international liquidity consisted of the possible accumulation of more gold in the vaults of the Central Banks. Thus, the creation of international liquidity was linked to the total existing reserves of gold, the annual production of that metal, and its price in terms of currency units.

(b) *The system in practice*

The economic conditions of the countries at the end of the Second World War were such that the dollar became the international means of payment and the most sought-after currency for accumulation. On the one hand the European countries needed to build up their reserves, while on the other, the rapid expansion of world trade after the war generated a growing need for means of payment. In order to accumulate these, the European countries maintained persistent surpluses on their international payments, which was only possible thanks to the persistent deficits of the United States, financed through the increase in the United States' short-term external liabilities.

The foregoing leads us up to one of the great problems raised by the scheme devised at Bretton Woods: the lack of incentives for making adjustments in countries with persistent surpluses or countries able to finance their deficits with their own currency which was accumulating abroad. Neither of these types of countries needed to have recourse to IMF financing, and they were therefore not subject to its

discipline,<sup>3</sup> which eventually applied in practice mainly to the countries with international payments deficits and without reserve currency.

Furthermore, the international liquidity requirements were being satisfied through the accumulation of dollars by the countries with surpluses, at the cost of transferring real resources to the country issuing the reserve currency.

The system therefore contained three main shortcomings: a shortcoming as regards the stimuli for making adjustments, which caused the burden of these adjustments to fall on the countries which had deficits and no reserve currency; a shortcoming as regards the obligation to intervene in currency markets which meant that the United States was exempted from this requirement in return for guaranteeing convertibility into gold, and a shortcoming as regards the generation of liquidity, the cost of which had to be paid by the rest of the world to the issuing country.

This last shortcoming calls for a special explanation. When a country accumulates means of payment from abroad it does so by refraining from using those means of payment to obtain real resources from other countries. For its part, the country which supplies the foreign currency thus accumulated does so in exchange for a good or service from the country receiving the currency. Thus, a country which finances its deficits with its own currency is really changing that currency for goods and services abroad. The country which accumulates such currency is supplying

<sup>3</sup> Except, in the case of the former, for the possibility that their currency might be declared a "scarce currency". This punishment was never applied, however.

goods and services in exchange for it, so that there is a net flow of real resources from the country which accumulates reserves towards the country which finances its deficits. The country issuing the currency is receiving seigniorage from those accumulating it.

Some of the shortcomings mentioned above were solved more adequately in the plan put forward by Keynes during the discussion on monetary reform held in the last years of the Second World War. This plan provided for the establishment of a clearing house which would act as a kind of central bank of the central banks and keep accounts of international transactions, just as a central bank keeps accounts of the transactions between commercial banks. The plan provided for interest to be collected both on negative and positive balances with the system, thus creating an incentive for adjustments not only by the debtor countries but also by the creditor countries. It limited both the positive and the negative balances to a certain maximum and suggested the creation by multilateral decision of an international currency, "bancor", to provide the necessary

international liquidity. It laid down certain conditions under which debtor countries had to devalue their currencies or creditor countries had to revalue theirs, and it permitted much greater exchange flexibility than the agreement adopted at Bretton Woods, which was inspired by the ideas of Harry D. White. The Keynes plan also proposed the creation of an international investment organization to which automatic contributions would be made by countries with balance-of-payments surpluses, an organization responsible for regulating the cyclic variations in the prices of primary commodities, and an international economic organization for consultation and discussion on economic policy in the world.

Both plans—that of White and that of Keynes—assigned great importance to the action of the authorities in the functioning of the monetary system. This was clear both from the multilateral body which was supposed to be set up and from the policies whose application by governments was supposed to make exchange fluctuations unnecessary or at least minimal.

## 2.

### **The development and crisis of the international monetary system**

After the end of the Second World War, the economies of Europe and Japan began to recover from the effects of the world conflict, to grow more rapidly than the United States economy, and to increase their productivity at a rapid rate. International trade expanded, and the demands on official reserves increased. Private holdings of international liquidity were of no importance

whatever: the rigidity of exchange rates and the decreasing importance of exchange restrictions enabled the private sector to obtain the foreign exchange it needed from the monetary authorities at a given price. Since there was no serious uncertainty about exchange rates and the money markets were relatively limited, there were no abrupt short-term international movements of capital.

(a) *The development of the system*

A situation thus took shape in which the European countries and Japan registered continual balance-of-payments surpluses and thus accumulated the reserves which they needed. The United States balance of payments, for its part, registered a persistent deficit, financed by an increase in its external liabilities matching the accumulation of dollars by the countries which had a surplus.

Although the United States was not obliged to intervene in the markets to maintain the parity of the dollar, the system did provide for the convertibility into gold by the United States monetary authorities, on demand, of the dollar balances of official currency holders. It was assumed that this convertibility would induce the United States to apply adjustment measures to its balance of payments in view of the sustained deficits and the consequent accumulation of dollars abroad. These incentives proved ineffective, however, in view of the vigorous world demand for dollars with which to build up reserves. Already at the beginning of the 1960s official holdings of dollars abroad exceeded the gold reserves of the United States, and by the end of 1970 they came to 25 billion dollars<sup>4</sup> whereas in the same year the United States' holdings of gold amounted to only 13.8 billions dollars.<sup>5</sup>

As foreseen by Robert Triffin,<sup>6</sup> by the middle of the 1950s the massive

<sup>4</sup>Not counting official holdings of Euro-dollars. If these are taken into account, the figure rises to 34.2 billion dollars. See IMF, *Annual Report*, 1975, p. 39.

<sup>5</sup>Including 2.8 billion dollars in Special Drawing Rights and IMF loans.

<sup>6</sup>Robert Triffin, *Europe and the Money Muddle*, New Haven, Yale University Press, 1957: see especially pp. 296-299.

accumulation of dollars outside the United States created a risk of inconvertibility, since the monetary authorities of that country would not have been able to convert most of the official foreign holdings of dollars if these had been presented for that purpose.

(b) *The symptoms of the crisis*

The growing lack of confidence in the system led to the appearance of various crisis symptoms. When doubts arose regarding the capacity (or the willingness) of the United States to convert into gold the dollars accumulated abroad by official holders, this caused an unstable situation in which rumours were responsible for the movements of the market. As far back as 1960 the price of gold on the private market rose above 40 dollars per ounce, and this led Germany, Belgium, the United States, France, the Netherlands, Italy, the United Kingdom and Switzerland to enter into an agreement to pool their gold reserves in order to keep the market price at not more than 35.20 dollars per ounce. In December 1967 the United States lost almost a billion dollars—some 750 tons of fine gold at the official price of 35 dollars per ounce—when there was a wave of conversion of dollars into gold because of the fear that the United States exchange policy was likely to change. The losses continued in the early months of 1968, and in March the countries which had pooled their reserves declared that they would no longer support the price of gold on the free market and that the official price would be maintained only for transactions between central banks.<sup>7</sup>

<sup>7</sup>France left the group at the end of 1967.

The heavy conversions of dollars into gold in 1967, together with the growing accumulation of dollars abroad in contrast with the limited gold reserves of the United States, gave rise in the late 1960s to the generalized impression that the latter country would be obliged to apply adjustment measures to its economy in order to eliminate its balance-of-payments deficit. Such measures would bring about the closing down of the main source of new international liquidity, with the consequent danger that there would be a shortage of liquidity and a generalized tendency towards restrictions on foreign trade. In view of this prospect, the countries began to interest themselves in the possible creation of a substitute for the dollar as a means of international liquidity, the idea being to determine the value of that substitute by international agreement on the basis of some reasonable estimate of world liquidity requirements.

This is how Special Drawing Rights, which were linked to gold at the same parity as the dollar and which it was hoped would become the main form of international reserve assets, were born. Special Drawing Rights correspond to accounting entries between the IMF and the participating countries, and each country is assigned a certain amount of these rights, which it can use to obtain convertible currency. Special Drawing Rights have no physical existence and can only be held and used by institutions which carry out the functions of central banks. The amendment to the Articles of Agreement of the International Monetary Fund which set up Special Drawing Rights (SDRs) was adopted on 31 May 1968 and came into force on 28 July 1969. This was the first amendment to the Articles of Agreement of the Monetary Fund since these came into

force at the end of 1945, almost 25 years before.

The prophecies which had led to the establishment of Special Drawing Rights were not fulfilled. Not only did the United States balance-of-payments deficits continue, but there was also a big increase in the holdings of dollars and other currencies outside the issuing countries, thus giving a strong impulse to the Eurocurrency market.

Towards 1958 the Socialist countries, and especially the Soviet Union, began to deposit dollars in European banks to avoid possible action against them if they deposited the money in the United States, and these deposits gave rise to credits in the same currency. A little earlier the United Kingdom had introduced restrictions on the pound sterling for international trade purposes because of a heavy external deficit. These two facts gave rise to the Eurodollar market, made up of deposits in dollars outside the United States, both by central banks and governments and by commercial banks and other private bodies. Furthermore, as the international trade position of currencies other than the dollar was strengthened, deposits and credits in these currencies also began to be made outside their country of origin, thus diversifying and expanding the Eurocurrency market. These deposits and credits are not subject to the regulations and restrictions of the countries issuing the respective currencies, nor are they generally subject to regulation in the recipient country, so the Eurocurrency market is the freest and least regulated money market in the world.

The increase in the private holdings of foreign currencies, their diversification and the growing volume of official holdings brought still further instability



into the system. As soon as rumours of some change in the parity of a particular currency arose, this led to strong destabilizing movements of capital. Because of their magnitude, the monetary effects of such movements on the countries whose currencies were involved were impossible to compensate, even through non-traditional measures such as negative interest rates on deposits by aliens. Not even direct controls were sufficient to stop the short-term capital movements, since these were able to assume forms which were difficult or impossible to control, such as deferred or advance payments for imports and exports. By means such as those indicated, the capital movements sometimes took place through current transactions, which, according to the Bretton Woods agreement, could not or rather should not be regulated through direct controls.

(c) *Crisis and confusion*

As the accumulation of dollars in official and private circles outside the United States continued, this in turn generated lack of confidence in the convertibility of the dollar into gold and gave rise to strongly destabilizing capital movements. In these circumstances, on 15 August 1971 the United States Government officially suspended the convertibility of the dollar into gold, thus breaking the very basis of the monetary system set up at Bretton Woods. This date marks the final crisis of this system.

After this measure by the United States, there was great confusion in the markets and repeated attempts to find a new set of parities capable of being maintained. At the end of 1971, at a meeting held in the Smithsonian Institute, Washington, D.C., the highest

financial authorities of 11 industrial countries<sup>8</sup> agreed to vary the exchange rates of their currencies by devaluing some of them (mainly the dollar) and revaluing others, such as the Japanese yen and the German mark. In effect, the devaluation of the dollar represented an increase in the official price of gold from 35 to 38 dollars per ounce. At the same time, with the aim of trying to cushion short-term capital movements, it was decided to expand the permissible margin of fluctuation of the currencies each side of parity from 1 per cent to 2.25 per cent. When it ratified these agreements,<sup>9</sup> the IMF created a new concept, that of "central exchange rates". These, unlike the former "parities", do not necessarily assume a relationship with gold, but rather with another currency or with Special Drawing Rights.

The aim of the expansion of the permissible margins of fluctuation around parity or around the central rates was to establish an instrument which would cushion, through the functioning of the market forces, the short-term capital movements recorded in the recent past. It was hoped that, by increasing from 2 per cent to 4.5 per cent the width of the band within which the various currencies fluctuate without it being necessary for official intervention to take place to maintain the exchange rate, this would considerably weaken the incentive for short-term capital movements.

<sup>8</sup>West Germany, Belgium, Canada, the United States, France, Italy, Japan, the Netherlands, the United Kingdom, Sweden and Switzerland.

<sup>9</sup>The Smithsonian agreements are the first in which it was agreed to make generalized changes in exchange rates.

The new band was not sufficient to achieve its purpose either, however, and scarcely six months after the Smithsonian Agreement this had been completely smashed by events, while a very wide variety of exchange systems had sprung up in the various countries. For

reasons which will be analysed later, the majority of the developing countries had no alternative but to link their currencies to that of some industrial country with which they had important trade and capital transaction links.

### 3.

## The "snake", the "tunnel" and floating

The independent floating of the main currencies discourages economic integration to some extent, since it changes the degree of protection agreed in advance for each of the economies which form part of an integration scheme with regard to the others. Such changes tend to create friction between the countries and to weaken agreements which often reflect a delicate balance of interests.

Because of their awareness of this situation, and with the object of continuing to advance towards their aims of economic integration, a group of European countries, basically those of the European Economic Community, tried to find ways of limiting the relative fluctuations between their currencies and agreed to set up a system under which they undertook not to allow the exchange rates to diverge from each other by more than 2.25 per cent with respect to the central parities or exchange rates agreed upon. Consequently, the group of currencies was to move more or less in unison within maximum margins of fluctuation equal to half the total margin of 4.50 per cent permitted by the Smithsonian Agreement. Thus arose the "snake", made up of the group of European currencies which fluctuated less than the rest. The maximum margin of fluctuation of 4.50

per cent was called the "tunnel", so that a monetary system was set up for the major countries which consisted of a "snake in a tunnel".

In practice, the maximum margin of 4.50 per cent of fluctuation soon lost its validity, while some of the members of the "snake" abandoned and rejoined it according to circumstances.<sup>10</sup>

Some countries such as Canada, the United States, Italy, Japan and the United Kingdom decided to allow their currencies to float independently. This did not mean that their authorities gave up intervening in the market, but simply that they ceased to stick to any fixed or previously revealed rules in this respect. Other countries fixed their exchange rates with respect to a set of currencies or to Special Drawing Rights and

<sup>10</sup> West Germany, Belgium, France, Luxemburg and the Netherlands were the original members of this group, the formation of which was announced on 12 March 1972. On 16 March it was joined by Sweden, on 24 April by Italy, and on 1 May by the United Kingdom, Ireland and Denmark. These latter countries withdrew from the agreement on 23 June 1972, but Denmark re-entered it on 10 October. Italy left the group in February 1973. Finally, France left the group temporarily in January 1974, rejoined it in the last quarter of 1975, and left it once again at the end of the first quarter of 1976.

intervened in the market in order to maintain that rate, while others linked their currency to that of some other country. This latter category includes most of the developing countries.

Thus, the system of parities established at Bretton Woods, which had operated for 25 years, was replaced by a

variety of systems which reflected the diversity of interests and economic situations of the countries. For some of them, exchange rate floating has proved a relatively efficient solution, with relatively small alterations in exchange rates proving sufficient to bring about corrective movements, but for others floating may involve a high economic and social cost.

#### 4.

### To float or not to float

If small exchange rate changes are sufficient to bring about marked corrective movements in the balance of payments, then countries would be well advised to allow their currencies to float and the balance of international payments would be facilitated by only slight exchange rate modifications. In contrast, if severe exchange rate fluctuations are required in order to bring about a given corrective movement in the balance of payments, the countries probably would not be willing to allow their currencies to float freely or even with some degree of intervention. At the same time, while the existence of exchange markets—particularly for future transactions—enables exporters and importers to cover themselves against the risk of exchange rate changes, if such markets do not exist or if their scale is very limited this makes such coverage more difficult. Thus, a country where the existence of well-developed money markets is accompanied by a relatively high elasticity of response of the balance of payments to exchange rate movements will prefer the system of floating to other possible systems, whereas if such markets do not exist and there is poor elasticity of

adjustment to exchange rate movements this will act as a considerable deterrent to floating.

The responsiveness of the balance of payments to exchange rate movements will depend both on the price elasticities of the demand for imports and the supply of exports and on the probable magnitude of the changes in the conditions being faced by the country. This probable magnitude will influence the capital movements.

The smaller the proportion of imported products in the total and the more diversified are both imports and national production, the greater will be the price elasticity of the demand for imports. Thus, for example, a country which imports only a small proportion of the total domestic supply of particular products will find that the elasticity of demand for imports goes up in inverse proportion to the share of total demand, at each price, which is imported.

Furthermore, a country with diversified production which generally exports domestic production surpluses that are relatively small compared with total production will find that small exchange

rate movements will suffice to alter the price relationship between exported products and those consumed in the country; such alteration will be sufficient to cause the changes in demand thus generated to absorb an appreciable proportion of the exportable product or to increase considerably the balance available for export.

If these circumstances are present at the same time, then small variations in the exchange rate will produce substantial movements towards the adjustment of the balance-of-payments current account and, consequently, the probability that there will be very sharp changes in the exchange rate is only small. Moreover, if it is unlikely that the external or internal conditions faced by a country will change very substantially, then this set of circumstances will mean that the changes to be expected in the exchange rate will only be small. This will have an influence on capital movements, since limited movements in the domestic interest rates with respect to the external rates will be sufficient to compensate for possible gains through speculative transactions in connexion with exchange rate changes.<sup>11</sup>

Generally speaking, these conditions exist more markedly in the United States

<sup>11</sup>Let us assume, for example, that a 3 per cent devaluation in a country's currency is expected in the year. It will be sufficient for domestic interest rates to rise 3 per cent compared with external rates in order to eliminate any incentive to take capital out of the country. Similarly, however, if the expected devaluation is 15 per cent, then the domestic interest rates must rise by at least that figure with respect to external rates in order to achieve the same purpose. The necessary movements in interest rates would have to be even bigger if the devaluation was expected at a certain moment in time instead of taking place over a whole period.

than in any of the countries of the European Economic Community taken separately. The European integration efforts, however, together with the joint float of the European countries' currencies, mean that the comparison should not be with each country, but with the whole group of countries. Viewed in this way, the countries of the European Economic Community show conditions very similar to those of the United States, so that the system of floating seems suitable for both.

For most of the developing countries, in contrast, the situation is exactly the opposite. The price elasticity of the demand for imports is usually lower, since imported products normally represent a high proportion of the total consumption, or such goods simply may not be produced in the country at all. The exports of these countries, for their part, are highly concentrated in just a few goods, almost the entire production of which is sold abroad. Consequently, on both the export and the import side, the change in the relative prices between products traded with the exterior and products used inside the country must be large in order to bring about an adjustment of a given size. Thus, the probability of large fluctuations in the exchange rate is greater, since it is more difficult to compensate the incentives for capital movements through variations in interest rates.

Furthermore, the developing countries do not have substantial foreign exchange markets, and in most of them there are no future markets for their currencies, so that it is not possible for exporters and importers to cover themselves against foreign exchange risks in the domestic markets.

Moreover, in most of the developing countries revenue from taxes on export and import activities forms an appre-

cial part of fiscal income, so that changes in exchange rates are also transmitted to the rest of the economy through their repercussions on fiscal financing.

To sum up, then, while currency floating is a suitable possibility for the United States and Europe it is the least attractive or most costly option for most

of the developing countries. This is why the developing countries have not welcomed with any degree of enthusiasm the breakdown of the Bretton Woods agreement, and why in general they have linked their currencies with those of some industrial country with which they have substantial trade and financial links.

## 5.

### The effect of floating on the developing countries

As we have seen, the developing countries have generally been impelled to link their currencies to those of some industrial country with whom they trade. If there is a fluctuation in the mutual relationships of these currencies, then there will be changes in the effective exchange rate of the developing country in the same direction as the movement in the main currency. It is to be expected that the movements of the main currency will have a balancing effect for the country issuing that currency, but they will not necessarily have such an effect from the point of view of the developing country.

In practice, the exchange rate variations required in order to achieve a balancing influence on the balance of payments of a developing country are generally different from those which would make possible a correction of the international payments of the industrial country to whose currency the developing country's currency has been linked. This unbalancing bias does not disappear even when the currency of the developing country is linked to a group of currencies of industrial countries, since what interests every importer and exporter is the exchange rate of the

currency in which a transaction is being carried out, and not an average. The elimination of this problem involves relatively frequent adjustments to the exchange rate of the developing country with respect to the main currency. While such changes are made in some countries,<sup>12</sup> they are only possible in an inflationary environment in which advantage can be taken of the exchange rate movements made necessary by inflation in order to move the real exchange rate also in the desired direction. In countries where the rate of inflation has been low for a long period and where there is a tradition of exchange rate stability, these frequent adjustments are often politically impossible and may even be economically dangerous because of the expectations which they may generate.

Floating therefore introduces an additional element of risk into the external trade transactions of the developing countries and consequently tends to reduce the volume of resources devoted to the production of internatio-

<sup>12</sup> Such as Brazil, Chile and Colombia, for example.

nally saleable goods, since uncertainty is an additional cost in international transactions as compared with transactions on the domestic market.

Some countries have tried to tackle these problems by changing the currency

to which their own currency is linked. These changes cannot be made too frequently, however, since this would increase the risks involved in international transactions instead of reducing them.

## 6.

### **The role of private holdings of foreign currency in the generation and transmission of international imbalances**

While there is no clear proof of this, it might be expected that the floating of the main currencies would reduce the demand for reserves for the purpose of intervention by the authorities, as compared with the demand generated under a system of fixed parities. In this latter system, the private sector can minimize the balances which it maintains in foreign currencies, since it is possible to obtain such currencies at any moment from the monetary authorities. The latter bear the entire responsibility as regards intervention in the markets, particularly when only a small fluctuation is permissible around the established exchange rate. In a system of floating exchange rates, in contrast, the task of intervening in the market falls entirely or partially on the private sector. When a perfectly clean float is involved, i.e., when the official sector never intervenes in the market, the responsibility of the private sector is complete, whereas when the monetary authority aims to regulate exchange rate fluctuations in some manner through its own intervention the responsibility of the private sector is partial.

At all events, whether the monetary authorities do not intervene at all or intervene partially in the market, floating creates a stimulus for private intervention in the exchange markets

with a view to reducing variations in exchange rates or else spreading them over a period of time.

The private sector must accumulate stocks of the foreign exchange in which it is to intervene in order to play a part in the markets and thus try to reduce uncertainty about the exchange rates. Naturally, the bigger this accumulation of foreign exchange, the bigger will be the effect which the action of the private sector can have on the exchange markets, since when it has its own resources this sector is less vulnerable to control or regulatory measures that may be adopted by the authorities.

Consequently, it may be expected as a result of floating that there will be a reduction in the official demand for reserves and an increase in the private demand for these.

On the other hand, the greater the diversity of currencies which are of importance in the international market, the greater must be the diversity of the reserve holdings, both official and private, if there are changes in the exchange rates of these currencies. Such diversification may tend to make exchange rates more volatile by creating opportunities for speculative movements among the various currencies accepted in international payments. This is particularly so when a considerable part of the

accumulation of reserve currencies is concentrated in the private sector, since the official sector may be expected to be less sensitive to the possibility of speculative gains.

For the private sector this generates a problem of the composition of assets, which may be dealt with through the well-known models of the composition of these. If we follow the logic of these models, we may conclude that when the private sector accumulates foreign currency it does so by disposing of other forms of assets, including national currency. Thus, the private accumulation of foreign currency may generate pressures similar to those produced when the accumulation takes place in the official sector. Whereas in the latter case there would be an issue of money for the purchase of foreign currency, in the former case there would be a reduction in the demand for other assets, including money, matching the total demand for foreign currency.

Let us suppose, for example, that starting from a situation of equilibrium there is a deficit in the United States balance of payments, measured in terms of liquidity, although the equilibrium of the balance is maintained when measured in terms of official transactions.<sup>13</sup> This equilibrium will be maintained as long as there is no official intervention, but the absence of interven-

tion will not guarantee equilibrium in the balance of payments measured in terms of liquidity.

In the example described, additional balances of dollars in the hands of the private sector would be building up abroad, thus generating inflationary pressures towards the exterior. Through this mechanism, the disequilibrium in the United States balance of payments would be transmitted to the rest of the world, even if the exchange rates were floating.

Naturally, the process of transmission also functions through the exchange rates. A devaluation will produce an increase in the cost of imported products and will also apply upward pressure to the domestic prices of exported goods, thus causing an increase in the average domestic prices, whereas revaluation will not produce a similar reduction in these prices, because prices do not go down as easily as they go up. It will thus be observed that the system of exchange rate floating contains an inflationary element even when, over a long period of time, the average exchange rate remains constant. There are those who assert that this bias towards inflation is increased by the fact that exchange rate floating conceals behind the movements of the exchange rate the unbalancing effects of domestic policies, so that it reduces the incentive to apply anti-inflationary policies.

To sum up, there are various ways in which an imbalance can be transmitted internationally, even with completely floating exchange rates.

<sup>13</sup> This means that although the situation as regards the *official* external assets and liabilities of the United States does not change, the net liabilities to private creditors increase.

## 7.

## The reform of the system

The breakdown of the international monetary system in 1971 immediately generated greater interest in the discussions about its reform. Although some economists had long ago drawn attention to the need to make changes in the system, these proposals had taken shape only in the creation of Special Drawing Rights. The rest of the features of the system had remained completely untouched until their complete breakdown.

The existing institutional machinery did not facilitate the study of a broad type of monetary reform in which the participants would be not only the most important industrial countries, but also the rest of the members of IMF, including the developing countries. The Board of Governors of the Fund, its highest authority, was not a suitable mechanism for the study and discussion of such a complex problem, as it was difficult both to arrange for relatively frequent meetings of over 120 Governors and to organize a fruitful discussion in such a large assembly. In view of this, the Executive Directors of the IMF proposed to the Board of Governors the establishment of a committee of 20 Governors representing the various countries or geographical areas of the world: with a small Executive Secretariat and through frequent technical-level meetings this could take upon itself the study of monetary reform. This Committee, which was set up with the name of the Committee of 20, worked in 1972 and 1973 to prepare the bases for the future monetary reform.

The Committee of 20 tried to conceive the basic characteristics of a

monetary system of the future which could solve in a suitable manner both the problems of adjusting the balance of payments and those of creating liquidity. The Committee agreed on the need to ensure greater similarity between the adjustment obligation of countries which had deficits and those which had surpluses and on the desirability of ensuring better control of the creation of liquidity. There was general agreement that the Special Drawing Rights should be the centre of the monetary system, thus replacing gold, and that it was desirable to set up a system of stable but adjustable parities.

The Committee of 20 was subsequently replaced by what was known as the Interim Committee,<sup>14</sup> which was the forerunner of another committee later set up as a permanent organ of IMF through an amendment to its Articles. This Interim Committee ratified the basic characteristics of the system as agreed in the Committee of 20, although it changed the approach of its work somewhat. It devoted itself essentially to determining what amendments should be made immediately to the Articles of Agreement of the Fund with a view to establishing some legal basis for the functioning of the international monetary system. At the Fifth Meeting of the Interim Committee of the Board of

<sup>14</sup>The Committee of 20 submitted its final report, with an outline of the reforms needed, on 14 June 1974. It was replaced on 2 October of the same year by the new Interim Committee of the Board of Governors of the International Monetary Fund.



Governors of IMF on the international monetary system, held in Jamaica in January 1976, it gave its final backing to a set of new measures which substantially modified the Articles of Agreement of the Fund.<sup>15</sup>

## 8.

### The developing countries, the amendments to the Articles of Agreement of the IMF, and the agreements of the Jamaica Meeting<sup>16</sup>

The amendments to the Articles of Agreement of IMF approved at the Jamaica Meeting refer to five basic aspects of the monetary system: the function of gold, the exchange system, Special Drawing Rights, the operations and transactions of the Fund, and its institutional structure.

#### (a) *Gold in the reformed monetary system*

The new measures mean the abolition of the official price of gold and of the set of rules designed to enforce that official price, including the end of the limitations of central banks or monetary authorities on free operations in the gold market. Without an official price, gold ceases to be the centre of the monetary system, since these measures eliminate all predetermined links between gold and currencies. Gold thus comes to play, within the monetary system, the same role as any other non-perishable product, the only difference being that this metal has a very generalized acceptance.

Generally speaking, the Fund is authorized to sell gold at a price linked to the market price in exchange for currencies, subject to certain limitations and after consultation with the country whose currency is being acquired in exchange for gold. The Fund is also authorized to sell gold to the countries

which were members on 31 August 1975, in proportion to their membership quotas at that date, in exchange for their own currencies and at the official price.

Every time that the Fund sells gold at the market price it must pay into its General Account the proportion corresponding to the official price, while the surplus must be paid into a Special Disbursement Account serving to pay both for ordinary operations and for financing special operations not considered in the Articles of Agreement, including possible direct distribution of the money to the developing countries in proportion to their quotas. When special operations are involved, these must be approved by the Board of Governors with a majority of 85 per cent of the voting power.

By eliminating the official price of gold, the system of parities based on gold disappears not only *de facto* but also

<sup>15</sup> In April 1976 the Board of Governors ratified what had been approved by the Interim Committee at the Jamaica Meeting. In order for the amendments to the Articles of Agreement to come into force, however, ratification by the legislature is needed in most of the Fund's member countries.

<sup>16</sup> A similar analysis of the subject dealt with in this section, made by the same author, previously appeared in *Temas del nuevo orden económico internacional*, Cuadernos de la CEPAL, N° 11, Santiago, Chile, 1976.

*de jure* so that the need arises for a new exchange system.

(b) *The exchange system*

The changes in the exchange system provide that every country can use the system of its choice: floating, frequent gradual adjustments, joint floats with other currencies, fixed exchange rates with respect to the intervention currency, Special Drawing Rights or a group of various currencies, or such other systems as may be adopted by the central banks. It is specified, however, that whatever the system used, the Fund shall exercise general supervision of the functioning of the systems in use, in order to ensure the collaboration of their members with a view to solving any problems which may arise.

In other words, the new articles of the Fund do not establish an exchange system but rather simply give their sanction to the existing situation,<sup>17</sup> although they do authorize the Fund to restore a system of parities whose basis is described only in general outline. Thus, the draft states that, with a majority of 85 per cent of the voting power, the Fund can decide that the international economic conditions permit the introduction of a general foreign exchange system based on "stable but adjustable" parities which may be established in terms of Special Drawing Rights or of some other common denominator which is neither gold nor national currencies. They also provide that the maximum

and minimum exchange rates for spot transactions between the currency of one country and those of others which maintain this system of parities may not differ by more than 4 per cent, although this margin can be changed by the Fund subject to an 85 per cent majority vote. Since these parities are not expressed on the basis of currencies, the margin is applied in the same way to all of them.<sup>18</sup>

In order to be able to restore the system of parities, in addition to the 85 per cent voting majority required, the Fund must take account of the situation of the world economy, particularly as regards the generation of liquidity and the process of adjustment. As regards the former, it was hoped that there would be good control of the growth of international liquidity, and as regards the latter it was hoped that arrangements would come into effect under which both members in surplus and members in deficit in their balances of payments would take "prompt, effective and symmetrical action" to achieve adjustment. The Fund must also make its determination on the basis of the underlying stability of the world economy, taking into account price movements and rates of expansion in the economies of its member countries.

(c) *Special Drawing Rights*

The amendments connected with the characteristics and use of Special Drawing Rights are designed to make these the main reserve asset of the international monetary system. They put

<sup>17</sup> It is proposed to change the title of Article IV of the Articles of Agreement of the International Monetary Fund, "Par values of currencies", to "Obligations regarding exchange arrangements".

<sup>18</sup> If the parities were expressed in terms of a currency, then the possible margin of variation of the latter would be half the margin of variation of the other currencies.

an end to the link between Special Drawing Rights and gold and authorize the Fund to determine the mode of valuing them and even make substantial changes in the systems of valuation. In general terms, they maintain the provisions which limit the use of Special Drawing Rights to situations of need rather than cases where there is simply a desire to change the structure of a country's reserves. The principle of "designation" is preserved, whereby the Fund can designate a country to provide currency in exchange for Special Drawing Rights, provided that the country's reserve position is sufficiently strong. In addition, the majority needed for modifying or eliminating the obligation to reconstitute funds is reduced.<sup>19</sup>

The limitations on the rate of interest payable on Special Drawing Rights are eliminated, and gold is eliminated as a means of payment for obtaining Special Drawing Rights in order to pay the charges applied. The countries participating in the Special Drawing Account undertake to collaborate to ensure that SDRs are converted into the principal asset of the international monetary system. In addition it is laid down that countries may pay the Fund in currencies of other member countries in exchange for

<sup>19</sup> The present provisions state that each participant shall so use and reconstitute its holdings of Special Drawing Rights that at the end of each calendar quarter the average of its total daily holdings of Special Drawing Rights over the most recent five-year period shall be not less than 30 per cent of the average of its daily net cumulative allocation of Special Drawing Rights over the same period. If the average is below the minimum, the participant is obliged to "reconstitute" its holdings, i.e., to acquire Special Drawing Rights in order to comply with this obligation.

Special Drawing Rights, provided that the countries issuing the currency in question are agreeable to the transaction.

(d) *The operations of the Fund and its institutional structure*

The new articles also provide for modernization of the operations and transactions of the Fund and expansion of the categories covered by them and facilitate the use of the Fund's resources to finance contributions to international buffer stocks of primary commodities; in addition, it is hoped that the IMF will use its holdings of all currencies in its operations, and not just its holdings of some of them, as occurs at present: the concept of "currency convertible in fact" is replaced by that of "freely usable currency".

As regards the institutional structure of the Fund, the new articles authorize the Board of Governors of the Fund to set up, as a new IMF body, a Council of Governors to serve as an organ of analysis and discussion of a political nature which will be more flexible and efficient than the Board itself. The Council will have as many members as there are Executive Directors of the Fund, and these members will be elected by the same countries or groups of countries which elect the Executive Directors.

(e) *Other decisions of the Interim Committee*

In addition to approving the amendments to the Articles of Agreement of the IMF, the Jamaica meeting of the Interim Committee ratified the decision to sell one-sixth (some 25 million ounces) of the Fund's gold holdings by public auction over a period of four years and to devote all the profits thus

produced to the developing countries both by directly supplying them with a proportion of the profits corresponding to their quotas and through the formation of a special aid fund for developing countries which are going through difficult conditions. In the latter case, the per capita income of the member country in question will be taken into account.<sup>20</sup>

The meeting also ratified the decision to provide each member country, in exchange for payment in its own currency, with a proportion corresponding to that country's quota of an additional amount of 25 million ounces of gold, valued at the official price of 0.888671 grams of fine gold per SDR unit.

At the Jamaica meeting, the Interim Committee endorsed the IMF Executive Directors' proposals for a global increase of 32.5 per cent in the quotas of member countries.<sup>21</sup> This increase would be so distributed that it would double the proportion of quotas accounted for by the oil-exporting countries (from 5 per cent to 10 per cent of the total), the proportion of the other developing countries would remain the same, while that of the industrial countries would be reduced. At the same time, the Committee decided to support the proposal for a 45 per cent increase in each of the credit tranches of the Fund

<sup>20</sup> This means that special preference will be given to countries with a per capita income of less than 300 SDR units (some 360 dollars), thus ruling out most of Latin America.

<sup>21</sup> The increase in the quotas has already been approved by a vote of the Governors, but it will not enter into force until the legal requirements are completed in each country and until the reforms to the Articles of Agreement of the Monetary Fund are approved. The whole process may last for another year or more.

as a temporary measure until the increase in the quotas came into effect.

In addition, the Committee noted with satisfaction the decision of the Executive Directors of the Fund to modify the arrangements for compensatory financing to make up for temporary shortfalls in export incomes. These modifications will liberalize the system and enable more account to be taken of the most recent developments, including the price increases recorded in international trade.

(f) *Effects on the developing countries*

Out of this set of decisions, the most noteworthy because of their effect on the developing countries in general and the Latin American countries in particular are those connected with the abolition of the official price of gold, the use of all currencies in operations and transactions, the acceptance of the existence of multiple foreign exchange systems, the changes made in the compensatory financing facility, the temporary increase in the credit tranches of the Fund, and the establishment of a Trust Fund.<sup>22</sup>

First of all, the abolition of the official price of gold means in practice—as long as its general acceptance lasts—an increase in that price. Market prices already influenced the decisions of the central banks in the past, but the freedom to carry out gold transactions at market prices gives official sanction to the consideration of gold at higher prices than the official rate of 1 SDR unit per 0.888671 grams of fine gold (equivalent

<sup>22</sup> The Trust Fund will be set up with part of the profits from the sale of the Fund's gold and will be designed to help the poorest member countries on highly concessional terms.

to about 42 dollars per ounce). In reality, the Fund had already agreed with at least one member country that the member could value its gold reserves, for domestic purposes, at a higher price than the official figure.

A higher price for gold means an increase in liquidity as expressed in terms of currency, in proportion to countries' gold holdings. Since there is uncertainty about the market price, however, it is probable that in measuring the liquidity created it will be necessary to reduce the apparent result by a certain amount in order to take this uncertainty into account.

If a difference in price of 60 dollars per ounce is assumed between the official price and the market price, the legitimation of the latter price for official operations will, if the proposed amendments to the Articles of Agreement are approved, affect the conduct of official holders of gold. If, in view of the uncertainty about the market price, the profit margin influencing the decisions of these official holders of gold is reduced to a figure of 50 dollars, the resultant increase in liquidity would be some 50 billion dollars. Out of this total, no more than 2.6 billion dollars would correspond to the non-oil-exporting developing countries.<sup>23</sup>

Moreover, the provisions concerning the Fund's use of all currencies in its operations mean that use will also be made of the currencies of the developing

<sup>23</sup> These estimates are based on the assumption that the total gold holdings of the member countries of IMF are 1 billion ounces, of which 5 per cent corresponds to holdings of the non-oil-exporting countries. It is assumed that the price of gold which influences the decisions of holders of this metal is below the market price, since the latter is subject to quite substantial fluctuations.

countries, which are not generally considered reserve currencies and will therefore be converted into such currencies. The reserves of the developing countries would thus be committed to some extent, although exactly how much is difficult to specify.<sup>24</sup>

The new agreements would probably also have other longer term but perhaps more important effects on the developing countries. The endorsement of floating as a system might oblige countries to diversify their reserve currency holdings, thus reducing instead of increasing the importance of Special Drawing Rights. For the developing countries, whose currencies will not generally be accumulated by other countries, these holdings could signify an extra cost in terms of resources delivered in exchange for the currencies of the other countries which are being accumulated. This cost is also difficult to estimate in advance, and its measurement will have to await the course of events.

Moreover, as already noted, floating does in itself impose an additional cost on most of the developing countries which, because of the lack of exchange markets for transactions in their currencies or because of the small size of such markets, are obliged to link their currencies to those of some other country or group of countries with which they trade. Naturally, if floating manages to minimize the fluctuations in the international trade of the developed countries it will in this way have a positive effect on the developing

<sup>24</sup> If a country, in drawing on the Fund, obtains currencies which are little used in international trade, it can approach the country issuing that currency to obtain reserve currencies in exchange for it.

countries, but what has been observed so far does not seem to point in this direction.

The changes made in the compensatory financing facility enable the developing countries to use it more easily,<sup>25</sup> and the estimates made by IMF seem to indicate that these countries would be able to draw on about 1 billion dollars in this way in 1976.<sup>26</sup> Assuming net increases of 1 billion dollars per year until the figure of an additional 5 billion dollars is reached, the current value of this greater access to credit, calculated at an actualization rate of 7 per cent per year, would be less than 4.4 billion dollars.

The temporary 45 per cent increase in the credit tranches of the Fund also represents an increase in the resources at the disposal of all member countries: in this way, the developing countries could obtain some 500 million dollars in 1976.<sup>27</sup> If it is assumed that these countries will be able to count on net increases of 500 million dollars per year under this heading until the figure of 2 billion dollars is reached, then the present value of such resources, also at an actualization rate of 7 per cent per year would be some 1.8 million dollars.

Finally, the Trust Fund could mean an additional contribution in favour of

the poorest developing countries of 400 to 500 million dollars.

The liberalization of the compensatory financing facility and the temporary increase in the credit tranches would thus mean some 5.2 million dollars more for the non-oil-exporting developing countries, measured in terms of the present value of the sums involved. The freeing of the price of gold and the establishment of the Trust Fund would represent about an extra 3 billion dollars.

At the same time, however, the termination of the Oil Facility would mean the loss of rights to draw resources amounting to some 2.8 billion dollars, which is the present value of the drawings by developing countries made or approved in 1974, 1975 and 1976.<sup>28</sup>

The developing countries are also affected by the greater need to adjust their economies to cope with the fluctuations of the main currencies and the need to accumulate additional currencies in their reserves. For the developed countries, in contrast, floating seems to solve some problems of capital movements which would be difficult to handle by other means, while the accumulation of currencies by these countries is compensated because each of them accumulates the currencies of the others. Thus, in net terms, the accumulation of currencies by the developing countries signifies the absorption by them of currencies issued by the developed countries.

Moreover, the developed countries and the oil-exporting countries will

<sup>25</sup> It is not yet possible to measure the greater ease of use of the compensatory financing facility in concrete terms, since this will depend not only on the new operating rules, but also on the specific policies which the Fund puts into practice.

<sup>26</sup> Statement by the Managing Director of IMF at press conference held on 8 January 1976, IMF Survey, 19 January 1976, pp. 24 and 25.

<sup>27</sup> *Ibid.*, pp. 24 and 25.

<sup>28</sup> The Oil Facility was set up by the Fund in 1974 with the aim of helping to avoid restrictive measures on international trade which might arise in oil-importing countries as a result of the sharp rise in the price of this fuel.

**MEASURABLE EFFECTS OF THE REFORM OF THE MONETARY SYSTEM AND  
OTHER AGREEMENTS BY THE FUND ON THE DEVELOPING  
COUNTRIES AND OTHER MEMBER COUNTRIES OF IMF**

*(Billions of dollars)*

	<i>Non-oil-exporting developing countries</i>	<i>Other IMF members</i>
Compensatory financing	4 387 <sup>a</sup>	-
Credit Tranches	1 812 <sup>b</sup>	5 616 <sup>c</sup>
Gold <sup>d</sup>	3 000	48 000
Oil <sup>e</sup>	- 2 757	+ 2 757
<b>TOTAL</b>	<b>6 442</b>	<b>56 373</b>

<sup>a</sup>Calculated on the assumption that only the non-oil-exporting developing countries make use of this facility. The calculations also assume that there will be a net increase in drawings of 1 billion dollars per year for five years and that from then on there will be no net increases. In order to work out the present value, an actualization rate of 7 per cent per year was used.

<sup>b</sup>Calculated on the assumption that there will be a net increase in drawings by the developing countries of 500 million dollars per year until a total of 2 billion dollars is reached.

<sup>c</sup>Calculated on the assumption that there will be a net increase in the drawings by the other member countries of 2 billion dollars per year until a total of 6 billion dollars is reached.

<sup>d</sup>Calculated on the assumption of a gain of 50 dollars per ounce in the price of gold kept as reserves.

<sup>e</sup>The effective data were actualized at the rate of 7 per cent per year.

receive an increase in their liquidity, measured in terms of currency, of some 48 billion dollars, while they will also have the possibility of using the expanded credit tranches of the Fund, which may signify a current value of some 5.6 billion dollars more, thus making a total of about 53.6 billion dollars. Furthermore, these countries will no longer have to contribute to the financing of the Oil Facility, which involved (after deduction of the drawings made by developed countries) the provision by them of financing with a current value of some 2.8 billion

dollars. Their total benefits thus rise to some 56.4 billion dollars.

As may be seen from the following table, the quantifiable effects of the Jamaica agreements and the other measures adopted by the Fund represent resources worth almost 64 billion dollars, of which only 10 per cent corresponds to the non-oil-exporting developing countries, although these countries contribute 22 per cent of the quotas of the Fund and generate at least 15 per cent of the total national product of the Fund members.

## 9.

## The effects of the present situation on the future system

The objective which should be achieved by a new international monetary system and which had been endorsed at various ministerial-level international meetings are those of reducing the role of gold in the system, making Special Drawing Rights the central element, achieving suitable control of the expansion of liquidity, and ensuring symmetrical incentives for adjustments by both deficit and surplus countries. Another objective which has been mentioned is that of achieving a system of stable but adjustable parities: more stable than the present exchange rates, but also more easily adjustable than the old parities. The strategy selected for achieving these objectives is that of gradual evolution in order thus to ensure that every further step is taken only when the general economic circumstances make this possible.

Today, however, the situation of the system seems to be pointing, as we shall see, in a different direction from that indicated. At present, a group of industrial countries has agreed on a joint float of their currencies, while those of other industrial countries float independently and the vast majority of the developing countries have linked their currencies to those of one or other of the industrial countries.

The joint floating of a group of currencies calls for official intervention in order to maintain each of them within the limits which have been accepted by the group. This intervention calls for the constant use of the various currencies which make up the group and for financing which is generally obtained

through some form of mutual credit support between the central banks. While the financing needs would be very small or zero in the long term if the system were stable, this stability is nevertheless not guaranteed, and at the same time there is a short-term need for financial resources in order to intervene. Naturally, this intervention is carried out with the use of currencies, and not of other international assets.

Moreover, the group of currencies which float together moves, with respect to the currencies which are floating independently, in a direction which is generally balanced for the group of countries involved, although not necessarily for each individual country. If this is a free or "clean" float, the authorities do not need to intervene in the markets. From this point of view, while the authorities need to possess resources in order to intervene in order to maintain the exchange rates within the limits agreed by the group of countries whose currencies are floating together, they do not need to intervene in respect of any currencies outside the group. In this case, however, as already stated, there will be incentives for the private sector to intervene in the markets of the currencies which are floating, and this sector will consequently have to accumulate currencies with which to intervene.

The developing countries, for their part, which are generally forced to link their currencies to those of some industrial countries, have to accept unlimited intervention by their central banks in order to maintain the exchange rate fixed in respect of the currency to



which they are linked. Since this link can produce destabilizing effects it may also increase the need for official reserves in order to intervene. Thus, considerations of uncertainty will assuredly lead the central banks of the developing countries, like other holders of foreign currencies, to diversify their holdings.

This situation has various effects on the demand for reserves. As already stated, the monetary authorities of the countries whose currencies are floating together cover their requirements for the intervention financing needed to maintain the exchange rates prevailing between them through a system of mutual credits, so that the net demand for additional reserves by the group for this purpose will be close to zero. Moreover, the floating with respect to the other main currencies will tend to diminish their demand for reserves and to change the composition of such reserves in favour of a larger accumulation of the currencies of the countries outside the group which are accepted as an international means of payment. The private sector, for its part, will display a bigger demand for currency with which to carry out the sector's expanded intervention in the currency markets.

It is difficult to gauge the relative effect of these influences in view of the limited number of observations available and the fact that the float has not been really clean. It is possible, however, to draw some tentative conclusions regarding the real transfers of resources implicit in the accumulation of reserves. The incentives which are inherent in the system seem to point towards a slight reduction in the official demand for reserves in those countries whose currencies are floating, as against an increase—sometimes considerable—in private demand. At all events, the countries whose currencies are used in inter-

national transactions will observe that the increase in holdings of the currencies of other countries is compensated, at least partly, by the increase in holdings of their own currency by other countries.

In the case of the countries whose currencies are floating jointly, it may be hoped that, if the system is stable, the purchases and sales of each particular currency will tend to cancel each other out in the long run. Consequently, for the countries whose currencies are used in international trade, any additional accumulation of reserves will take place without real transfers of resources or else with very small transfers. This contrasts with the situation before 1970, when the European group of countries accumulated the dollar without the United States having to accumulate European currencies. As a result of these influences, there will be a relative increase in the demand for currency compared with other reserve assets, and particularly compared with Special Drawing Rights.

In the developing countries, the demand for official reserves will tend to increase because of the additional requirements for adjustment created by the linking of their currencies to another floating currency. This accumulation will take place without compensation, since the other countries will not accumulate the currencies of the developing countries.<sup>29</sup> Consequently, these countries will accumulate reserves at the cost of transferring real resources to the countries whose currency they are accumulating. A link is thus established between the generation of liquidity and the transfer of real resources, but it is a link which operates in the opposite

<sup>29</sup> Except for the currencies of the oil-exporting countries.

direction to that which is desired: resources are transferred from the developing countries to those whose currency is accumulated.

This analysis enables us to conclude that the international monetary system does not help to strengthen the role of Special Drawing Rights. The requirements for reserves for the purpose of public or private intervention are concentrated essentially in the main currencies. If there is any increase in the demand for reserves, it will be an increase in the demand for currencies, and not for Special Drawing Rights. Although in the industrial countries there may be a reduction in the demand for reserves by the official sector, there can be no doubt that there will be an increase in the demand by the private sector, which requires currency for its action and cannot, by the very nature and characteristics of these instruments, use Special Drawing Rights for this purpose. Thus, in these countries the main effect will probably be that of a change in the composition of the overall reserves, both public and private, in favour of currencies and to the prejudice of Special Drawing Rights.

The same is not necessarily true of the developing countries, since the greater adjustment requirements created by the floating of the currencies to which the developing countries own currencies are linked will generate a bigger demand for official reserves. This bigger demand for reserves could also be reflected in an increase in the demand for Special Drawing Rights, but because of its small size this is not likely to increase the importance of the latter in the international monetary system. Thus, the role of Special Drawing Rights in the system may well be reduced instead of increased, even if these are maintained as a useful unit of account.

It should be stressed that the function of Special Drawing Rights as a unit of account, important though it may be, does not endow these instruments with a central role in the system, since the same unit of account could be constructed with a group of currencies, without any reference to Special Drawing Rights.

The greater the importance of currencies as a reserve instrument, and the greater the proportion of private holdings in the total, the more difficult it will be to achieve suitable regulation of the growth of international reserves. On the one hand, the accumulation of currencies will depend on the economic policy of each country, and not on a rational collective decision, and on the other hand, the action of the private sector may help to create or destroy international means of payment through the operation of the banking systems, thus introducing into the picture an additional element which is extremely difficult to manage.

In the Eurocurrency market, a banking multiplier is in operation which is similar to that which exists in any national banking system with fractional reserves.<sup>30</sup> In national banking systems, the decisions of the private sector—banks, enterprises and individuals—as regards the reserves to be maintained to cope with possible withdrawals of deposits and as regards the preferred composition of currency holdings will determine the capacity of the banking system to create more or less money. The same elements operate in the

<sup>30</sup> For a detailed explanation of the process of "creation" of money in the Eurodollar market, see M. Friedman, "The Eurodollar market: Some first principles", in *The Morgan Guaranty Survey*, October 1969.

Eurocurrency market, with the difference that generally there are no minimum legal cash requirements which tend to impose a relatively low limit on the banking multiplier. At all events, private decisions can reduce or increase the total volume of deposits of Eurocurrencies as well as cause changes in their composition. If private holdings grow sufficiently, then it will be the action of the private sector which predominates in matters of intervention, and there will be no guarantee whatever that this will take place with suitable attention to the international adjustment requirements.

At the same time, the private sector can now evade the monetary and credit policies of the national central banks more easily than ever by the simple expedient of operating through banks located outside the national frontiers. The veritable revolution which has taken place as regards private international financing means that it is now much more difficult for the monetary authorities of the countries to control the domestic monetary and credit situation. The private sector is therefore now at

the centre of the international monetary machinery.

Generally speaking, then, the countries which are of greatest importance in international trade feel quite comfortable about the floating of currencies, and their demand for Special Drawing Rights tends to go down, while the influence of the private sector tends to increase, thus solving the floating requirements.

For the developing countries, in contrast, floating is a costly business, and in order to obtain additional liquidity resources they are obliged to transfer real resources in exchange. As these countries are not sufficiently important in quantitative terms in international transactions and their power of decision at the international level is rather limited, it is unlikely that their interests will predominate over those of the industrial countries, so that it can hardly be expected that the stated objectives of monetary reform will be fulfilled. Furthermore, the influence of private decisions on exchange and credit matters has come to be decisive.

## 10.

### Conclusions

As will be gathered from the analysis made in the foregoing pages, the short-term situation is that the importance of Special Drawing Rights tends to go down, while that of currency floats tends to increase, as does the importance of certain individual currencies in international trade. At the same time, the authority of the body responsible for supervising the entire system diminishes, while the role of private decisions and

actions in the adjustment process is increased.

In this latter aspect, the private banks and bankers which operate in the international financial field have ever-increasing responsibilities. Their future expectations tend to make themselves come true, consequently provoking devaluations or revaluations if a devaluation or revaluation is what they expect. Thus, they have come to play a leading role in

exchange fluctuations and in the international adjustment process. The private sector is more sensitive than the official sector to variations in relative interest rates or expected exchange rates, so that the extraordinary volume now assumed by private holdings of foreign currencies introduces a dangerous element of instability into the picture. In addition, the changes in the desired composition of the assets and liabilities of the private sector may lead to important effects on global internal demand.

Because of this, the existing situation is not stable. It could lead to repeated crises and consequently bring about desirable modifications in the system, but such an effect would not be achieved through a peaceful evolution, but through the growing dissatisfaction caused by the crises.

As an illustration of this, the case of "snake" is particularly interesting. Because of the conditions in which the world economy is evolving, the continued existence of the "snake" is only possible as a result of frequent adjustments in the parities or central rates of the countries making up this system, or successive withdrawals and re-entries into the group, that is to say, frequent crises in the mechanism.

It would seem that only repeated crises in the international financial field could finally bring about the achieve-

ment of the objectives considered desirable. The highest authorities of the member countries of IMF have agreed that it is necessary to have stable but adjustable exchange rates, and to reduce the importance of currencies while increasing that of Special Drawing Rights in international payments. The present situation, however, is leading in exactly the opposite direction.

It is not even possible to achieve the objective of regulating the expansion of international liquidity in the present circumstances. The growing influence of private transactions in the international monetary markets<sup>31</sup> makes it practically impossible to exercise adequate control over international liquidity, yet this is necessary in order to guarantee the sustained development of international trade without inflationary or depressive pressures. Such control calls for greater influence by the official sector and by the international organizations, including suitable regulation of the Eurocurrency markets. In this aspect also, however, the tendency has been in the opposite direction.

In short, either the true objectives sought in the international financial field are not those which have so far been accepted internationally, or else the procedures adopted in order to try to achieve them are not the right ones.

<sup>31</sup> In 1964, the private holdings of international liquidity, which amounted to some 24 billion dollars, were one-third of the total official reserves. By 1973, however, they amounted to some 125 billion dollars, that is to say, over two-thirds, and far exceeded the

official reserves of the countries in whose currencies such holdings were maintained. See, for example, IMF, *Annual Report*, 1974, p. 44, which gives estimates of private holdings of international liquidity.