Cooper The International Monetary System

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Essays in World Economics

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The MIT Press
Cambridge, Massachusetts
London, England

This book was set in Palatino by Asco Trade Typesetting Ltd., Hong Kong, and printed and bound by Halliday Lithograph in the United States of America.

Library of Congress Cataloging-in-Publication Data

Cooper, Richard N.
The international monetary system.

Includes bibliographies and index.
1. International finance. I. Title.
HG3881.C6733 1987 332.4'5 86-7400
ISBN 0-262-03124-8

Introduction

I first became interested in the international monetary system as a graduate student at the London School of Economics in the late 1950s. A leading problem at that time was large foreign-held balances of sterling and whether Britain should "fund" them to reduce the possibility of raids on the Bank of England's limited reserves. I felt then that the issue as posed was badly oversimplified, that the main problem was private sterling balances that would be difficult to fund, and that the official balances which were the main focus of attention, far from being a major problem, had been largely stabilizing in their effect on the British currency. These views were developed, with supporting evidence, some years later during my participation in a Brookings Institution study of the British economy (R. E. Caves, ed., *Britain's Economic Prospects,* 1968).

This interest in international monetary questions was revived, reinforced, and extended during my stint as an economist on President Kennedy's Council of Economic Advisers (CEA). The new Council was concerned with the "gold problem," as John F. Kennedy called it—because there had recently been extensive foreign official conversions of dollars into gold—but the wide international role of the dollar made it difficult to consider the gold problem comprehensively without addressing the fundamental characteristics of the international monetary system itself. Under the direction of James Tobin, the council undertook a study of the international monetary system. Tobin's colleague at Yale, Robert Triffin, had just published his critique of the international monetary system and pointed to its fundamental long-run instability (*Gold and the Dollar Crisis,* 1960). But Kennedy's Secretary of Treasury, Douglas Dillon, and Under-Secretary for Monetary Affairs, Robert Roosa, were not interested in fundamental changes in the monetary system. They preferred to deal with the immediate pressures on the dollar through such measures as "operation twist" on the structure of interest rates to deter the outflow of US capital without discouraging domestic investment, the issuance of foreign currency–guaranteed Roosa bonds to foreign central banks, the promulgation of a "gold budget" to reduce U.S. government expenditures overseas, and in time the introduction of an interest equalization tax and other direct controls on outflows of capital from the United States.

Secretary Dillon was succeeded by Henry H. Fowler, who, with strong encouragement and assistance from Francis Bator on the staff of the National Security Council, took a more lively interest in the monetary system as a whole and urged a detailed examination of what might be done to solve Triffin's dilemma: The world economy could not thrive without a continuing increase in official dollar balances, but such an increase would gradually undermine the credibility of the gold convertibility, which foreign monetary authorities took for granted as they added to their dollar balances. The main technical discussions within the US government took place in an interagency group chaired by Under-Secretary of Treasury Fred Deming. The group included Francis Bator, Arthur Okun from CEA, and Dewey Daane and Robert Solomon from the Federal Reserve Board. Anthony Solomon and I represented the State Department. What finally emerged from these discussions and their international counterparts was the SDR, dubbed "paper gold" by financial journalists, which was negotiated in 1967, installed in 1968, and first issued as a genuine international fiat money in January 1970. (Robert Solomon has written an excellent history of the creation of the SDR in his *The International Monetary System: 1945–1981.*)

In the meantime, there had been a large increase in US government expenditures associated with the rapid buildup of US forces in Vietnam. Lyndon Johnson had delayed asking for and getting a tax increase to finance this buildup, and that in turn led, via domestic inflationary pressures, to an overvalued dollar. In some respects the situation in the late 1960s was similar to the situation in the early 1980s, with a rise in the real value of the US dollar financed by inflows of capital from the rest of the world. But the mechanisms differed sharply between the two periods; the appreciation of the dollar occurred in the late 1960s because of domestic inflation, whereas in the early 1980s the inflow of capital drawn by high US interest rates led to an appreciation of the dollar and downward pressure on domestic prices.

By the late 1960s there was much concern about how to introduce greater exchange rate flexibility into the monetary system. The growing international mobility of capital produced large-scale currency speculation in anticipation of the discrete changes in exchange rates that the Bretton

Woods system envisaged. Moreover, the US government was disturbed by the fact that the United States could not control its nominal exchange rate, because in practice other countries determined the rate between their currencies and the dollar. Both these considerations heightened interest in various forms of greater flexibility, with a number of academic economists recommending that exchange rates be allowed to float freely, determined by market forces without official intervention.

The new Nixon administration was faced with these complex issues in 1969. Henry Kissinger, newly appointed as the Assistant to the President for National Security Affairs, had been told by a friend that the first foreign policy crisis he might face would be an international monetary crisis. I was asked to brief Kissinger on these questions in December 1968 and early January 1969, and agreed to monitor them for him on a part-time basis after the inauguration if he would agree to hire Fred Bergsten as a full-time assistant, which he did. Ernest Johnston, from the State Department, and Robert Hormats, fresh from the Fletcher School, rounded out the small economics group on the staff of the National Security Council. I was involved throughout 1969. Kissinger had a heavy agenda and by his own admission did not take great interest either in trade or in monetary issues; rather, he adopted a "watching brief," as he later put it in *The White House Years* (p. 950). It was not until the large oil price increases of 1973–74 that economic issues caught his eye as possibly being important components of foreign affairs.

But Paul Volcker as the new Under-Secretary of Treasury for Monetary Affairs could not ignore them. Tight money in the United States drew in funds from the rest of the world in 1969, thereby to some extent concealing the fundamental difficulties. When the American economy went into recession in 1970 and interest rates dropped sharply, that exposed a large payments deficit. In the meantime, John Connally had succeeded David Kennedy as Secretary of the Treasury, and his unsubtle technique for dealing with the problem was to urge President Nixon to impose an import surcharge and cease convertibility of the dollar into gold. Nixon acted in August 1971, in a program that also included price controls in the United States. After a turbulent autumn, the Smithsonian Agreement of December 1971 resulted in an agreed devaluation of the dollar against the major European currencies and the Japanese yen. But the international monetary system remained unsettled, and various countries abandoned fixed parities and allowed their currencies to float in the marketplace. In March 1973 floating became generalized, as all the major countries ceased to fix their currencies to the US dollar. In 1972 a formal exercise in international monetary reform was undertaken under the auspices of the International Monetary Fund (IMF) by the Committee of Twenty. The United States put forward a "reserve indicator" proposal for guiding exchange rate movements. This proposal bears some similarity to a proposal I put forward in 1969 (reprinted here as chapter 3). The US proposal was reported in the CEA's Economic Report for January 1973. But rapidly moving events overtook systematic deliberation, and each country was left to fend for itself. Belatedly, the Committee of Twenty recognized what was happening and in the spring of 1974 endorsed a high degree of national choice in determining exchange rate arrangements.

Agreement was reached in Jamaica in January 1976 to legitimize exchange rate flexibility by amending the IMF articles of agreement. The new Article 4 pays obeisance to exchange rate stability and even envisages a time when fixed parities might be reestablished "on the basis of the underlying stability of the world economy." But the language was chosen carefully. Countries pledge themselves "to promote a stable system of exchange rates," not a system of stable exchange rates. And they "seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not intend to produce erratic eruptions," thus implying that "unstable" exchange rates are a consequence of unstable underlying conditions rather than a failure to fix the rates. The new article in effect allows each country to have any regime of exchange rates that it wants, subject only to the two conditions that it notify the IMF of its arrangements and that it "avoid manipulating the exchange rates or the international monetary system in order to prevent effective balance-of- payments adjustment or to gain an unfair competitive advantage over other members." But this agreement left open all the difficult practical problems of actually managing a system of flexible exchange rates.

After 1974 the world's attention shifted from the international monetary system to the problems of adjusting to much higher oil prices and the deep recession associated with them. Reform of the monetary system dropped into the background, or rather became a secondary component of a North-South debate on reform of the world economic system as a whole, a component that was overshadowed by commodity policy, energy policy, trade issues, and foreign assistance, although the decision-making procedures of the International Monetary Fund came in for strong attack by some developing countries.

One component of the international monetary system that was actively discussed in the late 1970s concerned the role of the US dollar in official reserves and the possible need for a "substitution account" to absorb some of those dollars in exchange for some other asset that did not depend for its issuance on an individual country. As with sterling twenty years earlier, I was skeptical that the large officially held dollar balances were in fact a serious problem for the stability for the international monetary system. In my view, official dollar holdings were overwhelmed both in volume and in potentially destabilizing movement by large private dollar holdings, and I feared that a preoccupation with official balances and the creation of a substitution account would simply be a diversion of thought and official energy from more important issues. And indeed technical discussions among finance ministry officials and with the IMF quickly bogged down over the third-rate issue of who should bear the ultimate exchange risk of the substitution account in the event of certain contingencies.

Interest in the monetary system as a whole revived in the early 1980s, when several politically prominent Americans pressed for a revival of a monetary role for gold. The French and some other Europeans would have been delighted at this American initiative twenty years earlier but yawned in indifference in the 1980s. The interest in monetary gold was an American peculiarity that attracted some high-level attention for a variety of reasons, ranging from a search for effective discipline against inflation of the type that had plagued nations in the preceding decade to, it must be said, pure nostalgia. My view was that it would be impossible to revive gold in a monetary role that would provide effective discipline over national governments. The argument is developed in chapter 2 of this volume.

I thought that a constructive role for official IMF gold could be found by selling it into the private market at prices well above its book value, the capital gains to be used for agreed international purposes, such as foreign assistance to developing countries. These ideas were put forward in 1973 in *Toward A Renovated World Monetary System,* written with Motoo Kaji and Claudio Segre. I proposed this idea again to Henry Kissinger in 1974 to help deal with what was then called the "recycling" problem following the emergence of large balance-of-payments surpluses of oil-exporting countries. In addition to agreeing on amending the IMF articles of agreement, the 1976 Jamaica meeting also agreed that the IMF should sell one-sixth of its substantial gold holdings onto the private market and devote the capital gains from such sales to helping the poorest countries that had been hard hit by the increase in oil prices and the 1975 world recession.

Concern also arose in the early 1980s over the substantial misalignment among major currencies and what rules of the system might avoid such misalignments in future. It was in this period too that European monetary cooperation was revived, and the European monetary system was established, under which a number of European currencies established fixed parities among themselves and defined bands within which these currencies would be allowed to fluctuate against one another in the marketplace.

This, then, was the general background against which the essays in this volume were written. Something more can be said about the specific context of each essay here. With the exception of minor corrections they are published here as they were originally published or issued, so the context is important. They have been grouped in this volume under broad headings of common interest rather than in chronological order.

The first essay serves as an introduction to the volume as a whole. It attempts to lay out the major features of any international monetary system and the considerations that go into the choices among those features. It was written for a Brookings Institution conference of economists and political scientists, to bring the two disciplines into communication on matters of international economic policy. It adopts a much wider scope than the Committee of Twenty, which was just completing its deliberations. The key point of the article for political scientists and diplomats is that in designing the rules for a world economic system, political will alone is not sufficient to make the system work. Certain technical conditions of feasibility must also be met. The point is obvious to engineers. They cannot and do not try to build bridges in violation of the laws of physics. But the frequency of references to political will when it comes to international economic reform suggests that the point is not obvious to those preoccupied with the exercise of power, either as wielders or as students of those who are wielders, and demonstrates their great reluctance to consider the behavior of households and firms as a force that has to be reckoned with in considering the design of any economic system.

The next three articles discuss three different monetary systems: the gold standard, a system of exchange rate parities that are allowed and indeed encouraged to "glide" or crawl against one another, and experience under floating exchange rates.

The paper on the gold standard (chapter 2) was written in 1981, while the US Gold Commission was examining the possibilities for restoring some monetary role to gold. William Brainard and George Perry suggested that it would be useful to have a review of experience and issues for the Brookings Panel on Economic Activity. I felt that devoting time and space to the issue represented a misallocation of BPEA time, for there were more urgent issues of economic analysis and policy, but agreed to do it if they insisted on going ahead with this low priority project. In retrospect I believe they were right. The historical gold standard has been idealized out of recognition through years of teaching a highly stylized version of it in economics courses. Many of those who lived through it were dissatisfied with the performance of the gold standard in its brief heyday in the late nineteenth century, and today's publics would have found it intolerable. It is useful to set the historical record straight. The second half of the paper addresses several proposals for reviving a monetary role for gold in the late twentieth century and finds all of them flawed, basically for one fundamental reason. The dollar price of gold is no longer historically and immutably given, so it can be altered at will, and it very likely would be altered if conditions under a revived gold standard became too uncomfortable. That fact alters enormously the expectational environment of a gold standard and would weaken decisively any disciplinary role which gold could play.

Chapter 3 was written in 1969 in an attempt to suggest a method for introducing more flexibility into a system of fixed exchange rates while still retaining some of the advantages of fixed exchange rates. It is a variant of a proposal made a few years earlier by John Williamson, but with less emphasis on automaticity and greater linkage to reserve movements. As noted above, the US government later espoused a weaker reserve indicator proposal in 1972, but it was overtaken by the move to generalized floating in 1973.

Chapter 4 reviews the experience of the first eight years of floating exchange rates. It was written for a Festschrift for Robert Triffin, one of the most persistent and perceptive analysts of the international monetary system over the years, and a most agreeable colleague during my fourteen years at Yale University. The timing of this article was magnificently bad. It was written in late 1980, and it argued that, while floating exchange rates did not satisfy all the claims of its advocates, on the whole the world under floating exchange rates had performed reasonably well and roughly according to expectations, given the severe shocks to which the world economy had been subjected during that period. Movements in effective exchange rates of the major countries were not great, and they behaved broadly as required to adjust for inflation differentials and to imbalances in the current account. This article did not foresee the huge increase in the value of the dollar that would occur in the period from 1981 to 1984 in response to the macroeconomic policy mix adopted by the United States and by other major countries. A combination of tight monetary policy and expansionary fiscal policy in the United States with contractionary fiscal policy in Britain, Germany, Japan, and (later) France resulted in high US interest rates relative to those abroad. That in turn resulted in huge flows of capital into the United States, which sharply bid up the value of the dollar, so that by late 1984 the dollar was over 30 percent stronger in real terms than it had been in 1980 with respect to other major currencies weighted by trade with the United States. This pattern of events had important consequences for the performance of the world economy as a whole and in particular for the level and distribution of investment. I would thus render a somewhat less generous view of experience under floating exchange rates today than I did in 1980. I return to this issue in the final chapter of this volume.

Chapter 5 was written for the Committee for Economic Development in 1972 as a background exposition of alternative mechanisms of adjustment to disturbances in international payments, a central feature of any international monetary system. It examines in general terms a number of proposals for introducing greater exchange rate flexibility into the monetary system, of the type that were then being urged on a reluctant Committee of Twenty. As noted, these issues were soon to be overtaken by generalized floating of exchange rates in March 1973. The article does not address what has since become standard fare in recent treatment of balance-of-payments questions, namely the difference between temporary and permanent disturbances. This question used to be taken up under the heading of the "liquidity" which was to be available to countries to cover temporary disturbances to the current account. Present practice is to derive results from a two or more period optimizing model, typically with well-defined utility functions, as though a country can be treated as an enlarged household that makes well-considered consumption choices over time. I am dubious about whether this fashionable approach adds substantially to our knowledge about how countries do or should behave. But certainly the decision of whether to adjust or finance a disturbance to the balance of payments is a crucial one for any country, and it has been so considered for many years. All too often, however, it is difficult to know at once whether a disturbance is temporary or permanent.

The issue of adjustment is treated again in chapter 6, which addresses the guidelines the IMF should establish in a world of floating rates for official intervention in exchange markets. The essay was written in 1976 following the Jamaica agreement to permit floating subject to the two general conditions noted earlier. I suggest here that the overall guiding principle should be that countries should not take actions that avoidably hurt other countries. The chapter discusses more specific application of this principle and the role IMF guidelines might play. It again mentions the desirability of reserve targets as discussed in chapter 2.

Chapters 7 through 9 were all written in the early 1970s, and all concern the role of national currencies, especially the US dollar, in the international monetary system. The dollar at that time was under a considerable cloud. There had been large capital outflows from the United States in 1970 and 1971, the dollar was devalued in December 1971 after a stormy autumn following the Nixon-Connally shock, and it was still greatly unsettled in 1972. Moreover, President De Gaulle had complained during the 1960s of the "exorbitant privilege" of the dollar, and the complaint gained both credence and support in European and even in American circles as the Vietnam War became increasingly unpopular. So a major question for those concerned with the international monetary system was, What should be done with the large outstanding dollar balances, and how can the role of the dollar be reduced and the dollar made more symmetric to other currencies? In this setting I suggested that many observers were substituting abstract wish for operational analysis, that careful thought would suggest how difficult it would be to make the system completely symmetric with respect to all currencies, and why, if there was to be an asymmetry among currencies, the US dollar was the logical choice for the central role. In chapter 7 I develop the analytical point, and in chapter 8, written for the more general readership of *Foreign Policy*, I draw the implication that, for all the alleged weaknesses and disadvantages of the dollar, it was likely to remain the key international currency for many years because of the difficulty of dislodging a well-established currency from its position of primacy in the absence of a clear alternative.

In chapter 9 I discuss a related issue, the creation of a common European currency within the European Community. The article was written in 1971, as the members of the EEC were making their first serious attempt at close monetary cooperation and shortly after Britain had applied for entry into the European Community. I was somewhat pessimistic about the impact of British entry on the British currency, but I also argued that, if this pessimism proved to be unwarranted, sterling would provide the most natural basis for a new European currency, for reasons similar to those that accounted for the entrenched position of the dollar on the world scene, namely a strong and efficient financial market.

In chapter 10 I consider the future role of the SDR, which was by official agreement of the mid-1970s to become "the principal reserve asset" of the international monetary system. This article is a comment on a long, fine paper by Peter Kenen, of Princeton University, in which he argues the desirability and the technical feasibility of extending the use of the SDR to private markets. Kenen argued, and I agree fully, that this extension is necessary for moving the SDR into a central place as a reserve asset. Furthermore, success in that endeavor could ultimately permit some formal symmetry among currencies, with much less reliance on the US dollar or indeed any other national currency. I argue here that the original (1967) rationale for creation of the SDR remains valid in today's world, despite the presence of exchange rate flexibility among major currencies and despite the vast growth of international money and capital markets. I also argue that it is in the interest of the United States to keep the SDR alive, because in the course of time—two decades from now, say—Americans will find the international role of the dollar a more burdensome inhibition on the pursuit of domestic economic policy than they do now. If properly nurtured, the SDR could relieve the United States of that greater burden. But it will require active cultivation of a plant that will not grow from infancy by itself in the present inhospitable environment.

Chapter 11 is an expository article that attempts to cover briefly all aspects of the international monetary system for the benefit of nonspecialists. It was written in early 1982 for a conference at the Chinese Academy of Social Sciences to serve as a general introduction to the subject for the Chinese, who had begun to take a lively interest in how the international economic system functions.

Chapter 12 was written in the spring of 1983 for the British Commonwealth Conference on the possibilities for the evolution of the IMF into a world central bank. This paper points out that the evolution of national central banks was gradual: They did not always have the authorities and the responsibilities that they have today. It also points out that the IMF has already evolved part way toward a world central bank, but that it lacks some of the key powers of a central bank; in particular, it is not a true lender of last resort because it cannot create fiat money at its own volition.

The last chapter, after offering a brief survey of the evolution of the international monetary system since 1945, concludes that present arrangements are not sustainable indefinitely. Contrary to the implication of chapter 4, it argues that movements in real exchange rates are too great to be tolerable in conjunction with relatively free trade and capital movements and therefore foresees growing restrictions both on trade and on capital movements unless the world moves consciously toward a system that reduces real exchange rate uncertainty. In the article I then offer a bold—some would say utopian—proposal for eliminating exchange rate uncertainty by creating a common currency for the industrial democracies and a common system for management of that currency. Needless to say, this is not a politically feasible proposal in the near future. But it is not too early to begin thinking about where we ultimately want to end up if dissatisfaction with the present system remains as high as it has become in recent years.

The debt crisis and the exceedingly strong dollar in 1984 and early 1985 have drawn attention to the possibility of defects in the international monetary system. The recent official view, as expressed in a Group of Ten report in September 1985, is that the system itself is satisfactory and that the problems we observe arise mainly from poor national economic policies. Even if the official view is correct, it raises the question of whether a system of rules more sharply defined than those currently prevailing can impose some constructive discipline on national economic policies. That, after all, was the strong underlying assumption of the Bretton Woods system designed over forty years ago. That remains a central issue in thinking about the international monetary system of the future.

Contents

1 Prolegomena to the Choice of an International Monetary System

The international monetary system—the rules and conventions that govern financial relations between countries—is an important component of international relations. When monetary relations go well, other relations have a better chance of going well; when they go badly, other areas are likely to suffer too. Monetary relations have a pervasive influence on both domestic and international economic developments, and history is strewn with examples of monetary failure leading subsequently to economic and political upheaval. Recent years have seen considerable turmoil in international monetary relations, and a marked deterioration in relations between Europe, Japan, and America. Ideally, monetary relations should be inconspicuous, part of the background in a well-functioning system, taken for granted. Once they become visible and uncertain, something is wrong.

As a consequence of this recent turmoil, intense official discussions on the nature and the future of the monetary system were belatedly begun in late 1972, under the auspices of the International Monetary Fund (IMF). A year later, little real progress in these discussions could be recorded (official press releases to the contrary notwithstanding). De facto monetary relations between countries were on a radically different course from the official discussions.

Many intricate details attend consideration of alternative monetary arrangements, and the details are often vitally important. It is not possible, however, to discuss them all in an essay charged with covering a broad spectrum of possible monetary arrangements and the broad implications of alternative monetary arrangements for the world as a whole, for groups of particular countries, and for particular groups within countries.

This essay has a somewhat more limited purpose. It attempts to survey systematically various possible types of international monetary regime,

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