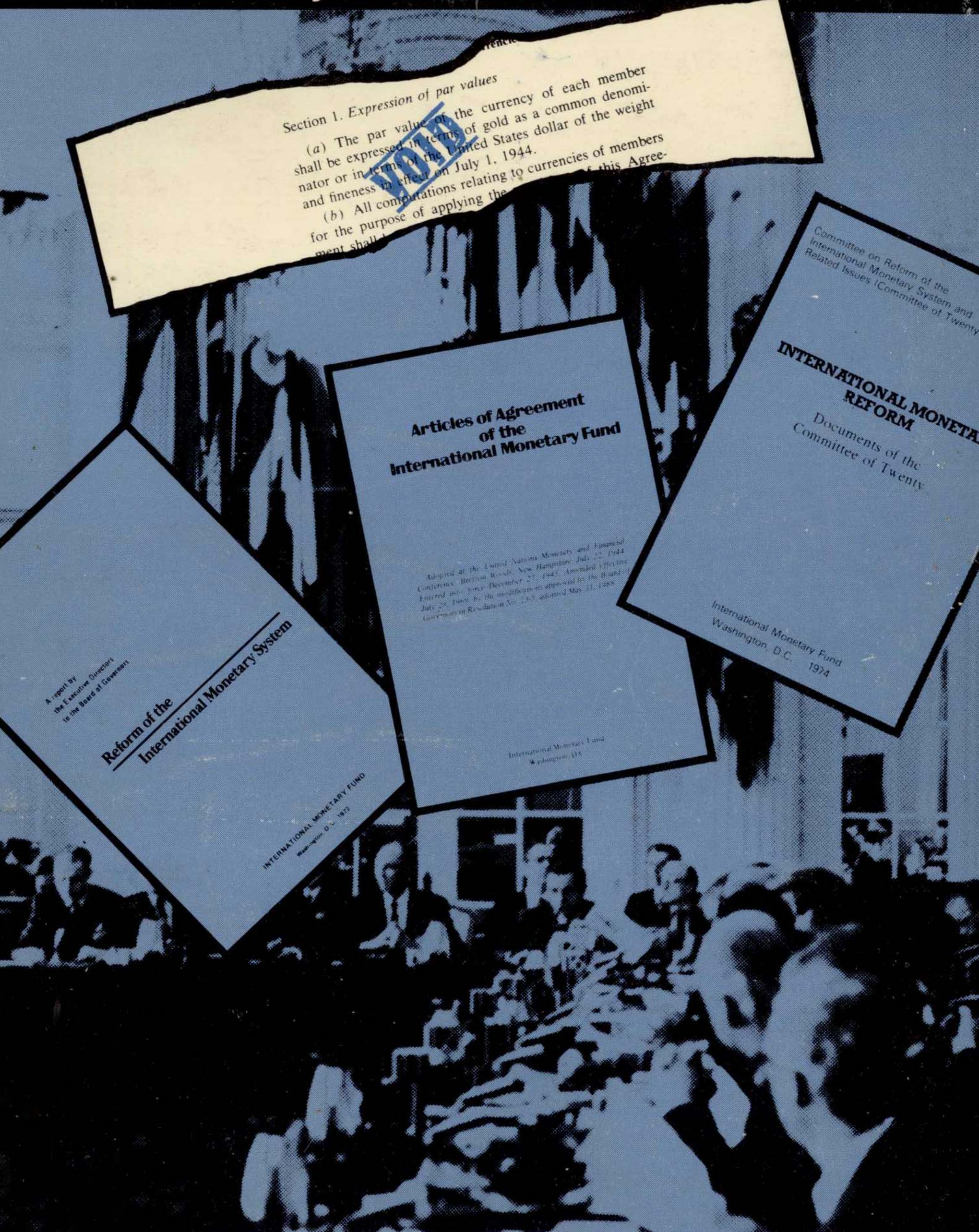
THE FAILURE OF WORLD MONETARY REFORM, 1971-74

John Williamson



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Nelson

Thomas Nelson and Sons Ltd
Lincoln Way Windmill Road
Sunbury-on-Thames Middlesex TW16 7HP
P.O. Box 73146 Nairobi Kenya

Thomas Nelson (Australia) Ltd
19–39 Jeffcott Street West Melbourne Victoria 3003

Thomas Nelson and Sons (Canada) Ltd
81 Curlew Drive Don Mills Ontario

Thomas Nelson (Nigeria) Ltd
8 Ilupeju Bypass PMB 1303 Ikeja Lagos

First published in Great Britain by
Thomas Nelson and Sons Ltd, 1977

ISBN 0 17 711208 5 (boards)
0 17 712208 0 (paper)

Typeset by Computacomp (UK) Ltd,
Fort William, Scotland

Printed in Great Britain by
The Camelot Press Ltd, Southampton

Preface

This book concerns the birth, life, death and possible after-life of the worthwhile, though unsuccessful, attempt to design an international monetary system to replace the one that collapsed in 1971. For the 2 years that the Committee of Twenty met in pursuit of this aim, I was privileged to watch its deliberations from the vantage point of the most junior IMF official whose duties involved regular participation in the work of the Committee. The issues that arose in those negotiations seem to me of sufficient importance to justify my drawing on the insights thus gained to present a reasonably comprehensive analytical account to the wider public that takes an interest in these questions but have, up to now, had to piece the story together from newspaper stories and official pronouncements. While I have used the experience gained from my temporary official position, I have endeavoured to avoid revealing what is not in the public domain: revelations, in so far as there is anything left to be revealed, come more appropriately from elder statesmen. Most of the facts in the book could, with sufficient diligence, be unearthed from published sources. I conceive my role as being that of exposing and clarifying analysis and where, for example, I describe national attitudes, this is motivated by the fact that one cannot hope to analyse international negotiations without probing into the positions adopted by governments and the national interests that motivate these postures.

I make no attempt to conceal the fact that I hold strong views on many of the subjects discussed in this book. I hope that this has not prevented my portraying contrary views as clearly and generously as I can, and explaining why they are held, as well as why I believe them to be mistaken, for there is nothing that I hold in greater intellectual contempt than the erection of straw men. But I do not pretend to be impartial, any more than I did before entering the Fund (as some of my writings make transparently clear) or, for that matter, during the time I was employed by the Fund. I hold the view, which is reflected in Chapter 7, that it is no part of the duty of an international civil servant to free himself of preferences between the alternative proposals under discussion; he needs a sympathy with the interests and hopes of the many countries he is charged with indirectly serving, but his usefulness depends on his willingness to work for particular proposals that have the potential of reconciling those interests, and not on a preparedness to give equal credence to all views, irrespective of their merit.

Chapter 7, which attempts to analyse why the reform negotiations failed, is the most speculative chapter in the book, although it is by no means the only chapter in which inherently speculative comments about motivations occur — generally with a word such as 'perhaps' to serve as a warning. The chapter was also the most difficult to write, for I am conscious that my professional expertise does not extend to some of the subjects that it is necessary to consider in this context. The viewpoint from which this chapter is written is less that of the expert academic observer than of the bemused participant who felt that mistakes were being made and has tried to analyse their nature, but who remains acutely aware that this analysis is offered without any background of study in the relevant discipline.

The remainder of the book is concerned with subjects that I have studied, with increasing concentration, for the past 10 or 15 years. It draws on a number of my previously-published papers, in particular: *The Choice of a Pivot for Parities*, Princeton Essays in International Finance No.90, Princeton, 1971; 'International Liquidity — A Survey', *Economic Journal*, September 1973; 'Payments Adjustment and Economic Welfare', IMF *Staff Papers*, November 1973; and 'The Future Exchange Rate Regime', Banca Nazionale del Lavoro *Quarterly Review,* June 1975. I am grateful to the editors of these journals for their consent to my free adaptation of the arguments first developed there. To a lesser extent I have also drawn on a number of my other papers, references to which are somewhat liberally scattered through the book.

This book has benefited, directly and indirectly, from help received from individuals ranging from my former teacher, Fritz Machlup, to those who offered valuable comments on part or all of the first draft of the manuscript: Benjamin J. Cohen, J. J. Polak, William Wallace, Denise Williamson, Geoffrey Wood and, most particularly, Fred Hirsch and Wolfgang Rieke. The responsibility for any remaining errors and for the opinions expressed remains, of course, exclusively mine. I also owe an immense debt to my former colleagues in the Fund, and in particular to J. J. Polak and the late J. Marcus Fleming, whose death was, sadly, announced shortly after the manuscript was completed. International monetary economics has suffered a profound loss in being deprived of

the always stimulating and often provocative views of one of its leading thinkers just before his retirement. It goes without saying that the views of my former colleagues cannot necessarily be inferred from the opinions that I express in this book, just as my former employer, the IMF, can in no way be implicated in my views. Mrs J. Gardner has earned my permanent gratitude for her typing of the manuscript. Finally, I wish to record my appreciation of the forbearance shown by my wife and family while the book was being written; but at least my wife, as an economist and former Fund employee, appreciated the cause more than most.

To Denise

Introduction

The Bretton Woods system is generally regarded as having come to an end when President Nixon announced his 'New Economic Policy' on 15 August 1971 and included in it a suspension of the right of foreign monetary authorities to convert their official dollar holdings into gold. Although this action terminated only one of a number of features that collectively constituted the Bretton Woods system, it was sufficient to render it emotionally impossible for the rest of the world to maintain its previous acquiescence in the slide towards a dollar standard. And since the United States' action was precipitated by a loss of patience with the passive or 'nth-currency' role assigned her by a dollar standard, there emerged a general desire to attempt the ambitious task of consciously redesigning the international monetary system on a new and more symmetrical basis. There followed a series of tortuous international negotiations, which culminated in the work of the Committee of Twenty (hereafter referred to as the C-20) from the autumn of 1972 to June 1974. During that period the international monetary system changed dramatically, but the changes owed little to the process of negotiation. The aims of this book are to provide an analytically-oriented history of these negotiations, to examine the economic issues with which the C-20 grappled, to offer an explanation of why the negotiations achieved so little and to extract such lessons as these events offer for the future.

By way of background, Chapter 1 is devoted to a short history of the Bretton Woods system. The chapter outlines the major issues that arose in designing the Bretton Woods system, the provisions that were incorporated in that system, its functioning and evolution over time, and the academic and official debate that developed on the problems of the Bretton Woods system and the means by which it might be reformed. In principle, this exposition is self-contained and assumes no prior knowledge of international monetary economics; in practice, however, the treatment is somewhat condensed and may in places prove obscure to those who lack a familiarity with international monetary economics equivalent to that normally reached in the later stages of a specialist undergraduate course in international economics.

Chapter 2 analyses the reasons for the breakdown of the Bretton Woods system. It considers separately the factors that led to the suspension of dollar convertibility in August 1971 and those that led to the abandonment of the Bretton Woods exchange rate regime, the adjustable peg, in March 1973. So far as the suspension of convertibility is concerned, it is argued that, while the timing of the crisis was a product of particular historical circumstances, notably the Vietnam War, the ambiguities of the Bretton Woods system as to the responsibility for initiating adjustment, and the absence of a viable is-proof method of effecting adjustment, would in any event have led to a similar dénouement at some time or other. The breakdown of the adjustable peg is interpreted as the inevitable consequence of the increase in capital mobility.

Chapter 3 describes the course of the negotiations that took place from August 1971 to the winding up of the C-20 in June 1974. It covers the negotiations on exchange rate realignment that culminated in the Smithsonian Agreement, the preparations for the C-20, and the work of the C-20 itself, including its failure to secure agreement on a comprehensive blueprint for a reformed system along the lines that were initially envisaged. The following chapter contains a survey of the attitudes and interests of the major groups of countries involved in the negotiations.

The heart of the book is the economic analysis of the issues that arose in the course of the C-20 negotiations. These are grouped under the headings of adjustment (Chapter 5) and reserve assets (Chapter 6). The chapter on adjustment deals with the questions of defining appropriate balance-of-payments objectives, of creating inducements for countries to pursue these appropriate objectives, and of selecting the techniques to be used to secure payments adjustment. An appendix deals with the related topic of the intervention system. The chapter on reserve assets covers the proposals for reform of the special drawing right (SDR) regarding its valuation, yield and use; for adoption of the link; for the future of gold; for reducing the role of reserve currencies through consolidation; and then discusses the problems of establishing, and exercising, control over the volume of global liquidity.

Chapter 7 considers five competing hypotheses about why the reform negotiations failed. It is argued that this failure was not the inevitable result of the disturbed state of the world economy or of the existence of irreconcilable national interests, but that it resulted from a combination of weak political will and technical inadequacy, reflected particularly in the decision to rename rather than to reform the exchange rate regime.

The final chapter turns to the future. It outlines the way in which a reformed system, satisfying the general aspirations that emerged in the C-20 as well as respecting the particular interests of individual countries, would fall into place once an appropriate proposal for the exchange rate regime were envisaged. It is argued that such a system would have significant advantages over the *ad hoc* non-system that emerged from the rubble of the C-20. Whether a reformed system is in fact likely to emerge in the future is another matter altogether.

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1

The Bretton Woods system

The Bretton Woods system was easily the nearest thing to a consciously designed international monetary system that the world has yet experienced. Without this example before them, the negotiators of the early 1970s might never have conceived the aim of 'writing a new monetary constitution for the world' (as Marina Whitman aptly described the task attempted by the C-20).

The Bretton Woods system was in large measure the product of ambitious Anglo-American planning during the Second World War. John Maynard Keynes in Britain and Harry Dexter White in the United States were the brains behind the attempt to design a new and liberal international economic order that would abolish the economic evils of the 1930s, which were generally held to have contributed to the outbreak of the war — depression, commercial warfare, bilateralism and competitive depreciation. The results of their deliberations in the monetary field were incorporated in the draft Articles of Agreement of the International Monetary Fund (IMF), which were, in due course, submitted to the historic conference convened at Bretton Woods, New Hampshire, in July 1944. The IMF Articles that were agreed at that conference did not merely create the legal framework for a new international institution, but also shaped the international monetary system that was aspired to for the next quarter of a century and that was, in substantial measure, actually achieved between 1959 and the mid-1960s.

An international monetary system can be characterized by the arrangements made in five areas: market convertibility, the exchange rate regime, balance-of-payments adjustment, the supply of reserve assets and the management of the system. The present chapter outlines the provisions and history of the Bretton Woods system and the main strands of academic and official discussion, grouped under these five headings. The Bretton Woods system contained explicit provisions on four of these subjects: the exception was the adjustment mechanism. The system broke down in two areas in the early 1970s: the adjustable peg exchange rate regime and the gold exchange standard, which governed the supply of reserves. It was the breakdown of the latter feature that precipitated the C-20. But two of its other key features — market convertibility and the arrangements for cooperative international management of the system — have endured. Perhaps the ultimate tribute to the architects of the Bretton Woods system is that these arrangements are now so taken for granted that people no longer associate them with Bretton Woods.

Market convertibility

The question of 'market convertibility'[1] concerns the circumstances under which the holder of one currency can sell it in order to acquire another. A multilateral system, which the architects of Bretton Woods aspired to create, requires that someone who is paid in one currency be able to convert that currency into any other currency that they need to make payments, since in the absence of such a right they are under pressure to spend their earnings on goods from the country in which the currency is acquired. The IMF Articles therefore contained an obligation on member countries to make their currencies convertible (Article VIII, Sections 2-4). This obligation was, however, qualified in two important ways. First, countries were entitled (under Article XIV) to avail themselves of a transitional period of undefined length before accepting the obligation. Second, it was only currency balances acquired in the course of, or needed to make, current-account transactions that the issuing country was obligated to convert on request: in fact it was assumed that most countries would control capital transactions.

All members of the IMF, except for the United States, Mexico, and three of the Central American republics, initially availed themselves of the loophole provided by the transitional period allowed under Article XIV. The era of post-war reconstruction and recovery proved far longer than had been contemplated at the end of the war, and, although exchange controls were gradually liberalized during the 1950s, it was not until late 1958 that the principal European countries felt strong enough to accept non-resident convertibility. The assumption of Article

1. Gottfried Haberler invented the term 'market convertibility' to emphasize the distinction between the convertibility of one currency into another by private parties, as opposed to the right of a monetary authority to convert a reserve currency into other reserve assets ('official convertibility' or 'asset convertibility'). See G. Haberler, 'Prospects for the Dollar Standard', *Lloyd's Bank Review*, July 1972.

VIII status — i.e., the formal and irreversible convertibility obligations specified in the IMF Articles — was further delayed: until 1961 on the part of the Europeans and 1964 on the part of Japan. Most developing countries, except for some of the oil producers and some Latin American countries that had hard currencies in the early post-war period, still have inconvertible currencies. They show no signs of wishing to relinquish their Article XIV status, and the IMF exerts no pressure on them to do so.

Most countries maintained a system of exchange control after the adoption of convertibility. There was a general, though frequently interrupted, trend toward liberalization until the mid-1960s, which culminated in most other industrialized countries joining the United States in extending current account convertibility to residents, except for periods of acute payments deficits when some tended to restrict tourist expenditure abroad. Capital transactions, in contrast, remained restricted to some extent by most countries for most of the time: even the United States adopted a programme of controls over capital outflows in the mid- and late-1960s that amounted to *de facto* exchange control over large corporations and banks. Country after country found that these exchange controls were of limited effectiveness, especially as regards short-term capital flows: the opportunities for disguising capital movements through leading and lagging current payments and other devices are too great to make exchange control an effective weapon in an international economy with the degree of interdependence achieved by the 1960s. The United States abolished her capital controls in January 1974 in the wake of the oil crisis, and German controls (over capital inflows) have again been relaxed since the move to floating, but most other countries still maintain significant controls over capital movements.

The exchange rate regime

The exchange rate regime incorporated in the Bretton Woods system has become generally known as the 'adjustable peg'. The essential characteristics of this system are that at any time a country undertakes to maintain the value of its currency within a narrow margin of a par value, while the par value can be changed under certain circumstances. This arrangement was intended to provide a compromise between the desire to stabilize exchange rates in order to avoid the disorderly markets and competitive depreciations of the 1930s, and the desire to avoid forcing countries to revert to the gold standard 'rules of the game', under which defence of the exchange rate override the pursuit of domestic full employment policies.

The adjustable peg is one form of the par value system.[2] As the name implies, a par value system requires each currency to have a par value — i.e., a central value in terms of some numeraire. The numeraire of the Bretton Woods system was gold. This was to some extent obscured by the fact that many countries chose to express their par values in terms of the US dollar; but since the relevant IMF Article spoke of 'the United States dollar of the weight and fineness in effect on July 1, 1944' (Article IV. 1(a)), a dollar devaluation (*a*) was legally possible; (*b*) did *not* automatically change the par value of any other currency in terms of gold; and (*c*) *did* change the parities of other currencies in terms of the dollar. (The ratio of two par values is known as a parity: it describes the central value of one currency in terms of another.) All these points were suppressed — whether from ignorance or attempted wish-fulfilment — in much discussion by both academic economists and officials before the dollar devaluation of 1971.

There are two aspects of the operation of a par value system: the provisions for the defence of a par value and those for selecting and changing par values. The Bretton Woods system contained two methods by which a country might defend its par value. One method, which was written for and used by the United States, was to buy and sell gold in exchange for its currency at rates close to par. The other technique, which was adopted by all other countries, was to prevent the market exchange rate deviating from its parity against an intervention currency by more than 1 per cent. This was accomplished by buying (or selling) unlimited quantities of the intervention currency at a rate no more than 1 per cent above (below) parity. Most countries chose to intervene in terms of the US dollar: thus the dollar was pegged to gold and other currencies were pegged to the dollar, so that all were pegged with narrow margins of ± 1 per cent to the numeraire.[3] The dollar was therefore the dominant intervention currency in the Bretton Woods system. A consequence of this was that the intra-margin flexibility of the dollar was only half that of any other

2. The par value system is sometimes treated as synonymous with the adjustable peg. In my view this is wrong: the crawling peg is also a par value system, but it is sufficiently distinct to merit classification as a separate exchange rate regime. The essential difference is that a crawling peg includes a limitation on the size of permitted par value changes, so that a necessary change is effected gradually in a number of small steps.

3. The sterling area and franc zone countries pegged respectively to the pound sterling and French franc, which meant that the values of their currencies could deviate by up to 2 per cent from par. The cross rate between two currencies which both pegged to the dollar could, of course, deviate from parity by ± 2 per cent, which was contrary to the requirement of Article IV.3(i) that spot rates should be kept within 1 per cent of parity. The Fund exercised its considerable legal ingenuity to find a way of condoning these practices.

currency in the sense that the maximum possible exchange rate change between the dollar and any other currency was 2 per cent, while between any other pair of currencies it was 4 per cent (which occurred if one currency appreciated 2 per cent in terms of the dollar while the other depreciated 2 per cent in terms of the dollar).

There was considerable controversy between Britain and the United States regarding the provisions for selecting and changing par values in the discussions leading up to Bretton Woods. The White Plan had originally envisaged par values being determined by the IMF. This was vigorously resisted by the British and was eventually replaced by a provision that countries should propose their initial par values and any changes therein, and that the IMF should have no right to take an initiative with regard to par value changes, but that IMF consent to the country's proposals would be required. Countries were forbidden to propose a change in par value except to correct — famous phrase — a 'fundamental disequilibrium'' (Article IV.5(a)), and the Fund was required to concur in the proposal provided that it was satisfied that the change was indeed necessary for that purpose. It was specifically precluded from objecting because of 'the domestic social or political policies of the member proposing the change'. (Article IV.5(f)). This provision was occasioned by the British (and very Keynesian) preoccupation that countries should not be forced into the abandonment of full employment policies by an obligation to defend an over-valued exchange rate. It is ironical that in the 1960s Britain did voluntarily what she had gone to such lengths to avoid being forced to do. In fact the Fund has not objected to a proposed par value change since 1948,[4] although it is possible that the knowledge that its approval was required has deterred countries from seeking changes that would otherwise have been made.

The adjustable peg operated until March 1973. In the initial post-war period most currencies were overvalued relative to those of the dollar bloc, but this was corrected — indeed, with the aid of hindsight, overcorrected — by the substantial devaluation of most non-dollar currencies in 1949. The par values of all major currencies except the French franc, which was devalued twice, remained stable throughout the 1950s, despite periodic intense speculation — particularly on a revaluation of the Deutschmark (DM) and a devaluation of the pound sterling. Canada, however, adopted a floating exchange rate in 1950 because of her concern over the inflationary consequences of a large

4. In 1948 the Fund objected to a proposed par value change by France largely on the ground that it considered some proposed associated multiple-currency practices unacceptable. See J. K. Horsefield, *The International Monetary Fund 1945-65*, IMF, Washington, DC, 1969, Vol.I, p.202.