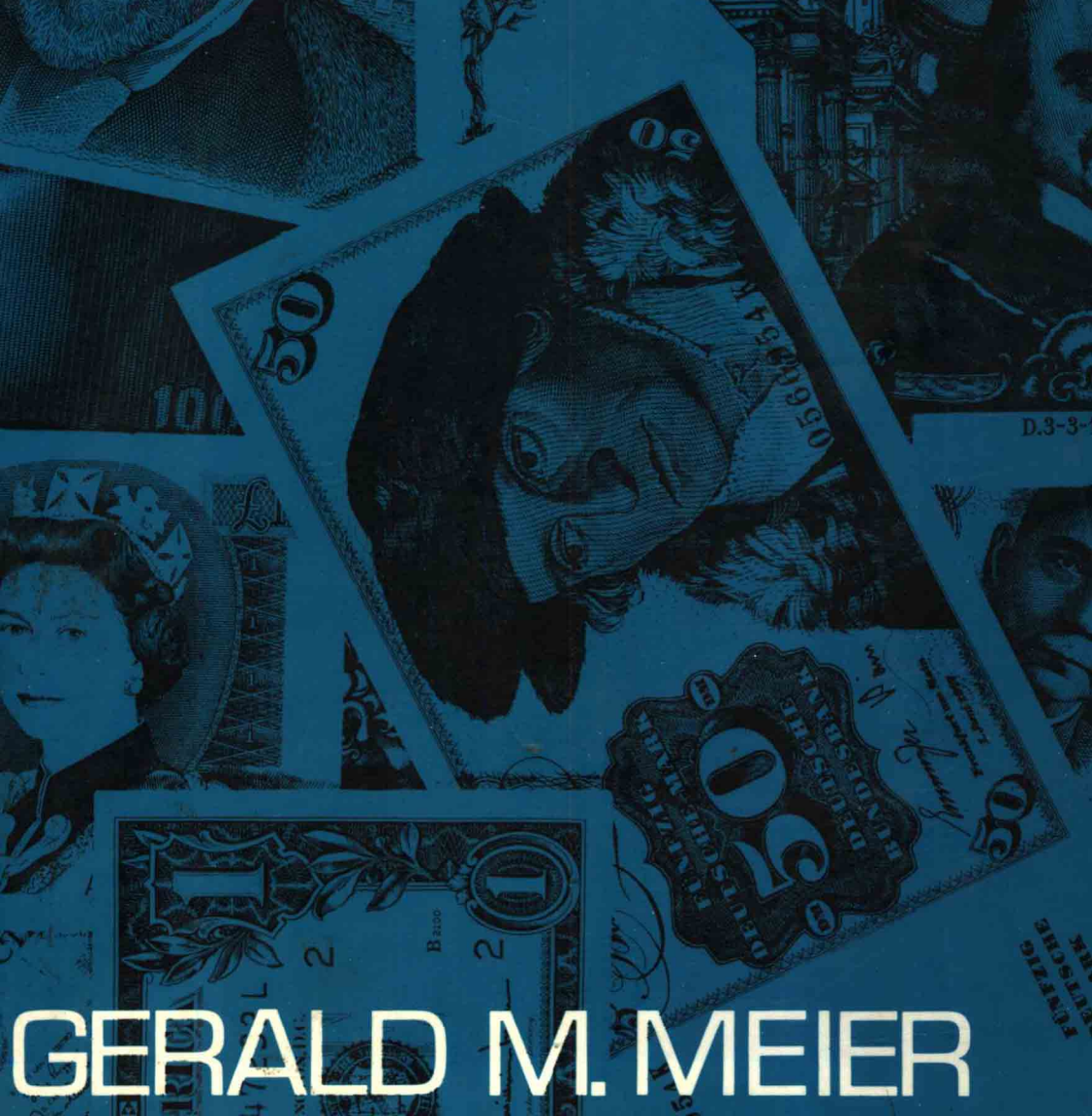


# PROBLEMS OF A WORLD MONETARY ORDER

SECOND EDITION



GERALD M. MEIER

# PROBLEMS OF A WORLD MONETARY ORDER

*Second Edition*

GERALD M. MEIER

*Professor of International Economics  
Stanford University*

New York                      Oxford  
OXFORD UNIVERSITY PRESS  
1982

Copyright © 1982 by Oxford University Press, Inc.

Library of Congress Cataloging in Publication Data

Meier, Gerald M.

Problems of a world monetary order.

Includes bibliographies.

1. International finance. 2. Foreign exchange problem. I. Title.

HG3881.M43 1982 332.4'5 81-9447

ISBN 0-19-503010-9 AACR2

Printing (last digit): 9 8 7 6 5 4 3 2 1

Printed in the United States of America

# *PREFACE*

“Mystery,” “maze,” and “muddle” are the words that most frequently follow “international monetary.” These words became current during the early 1970s when the Bretton Woods system was breaking down. They continue to describe the present regime of managed floating exchange rates. And they also apply to efforts for international monetary reform.

This book attempts to remove some of the mystery by involving the reader in three policy situations relating to the attainment of new international monetary arrangements. In an analytical narrative integrated with source materials, the policy problems carry the reader from the Bretton Woods system to an assessment of the recent experience with managed floating and on to an interpretation of prospects for reform—but one hopes, with an illumination of the maze and a removal of the muddle.

The policy problems unfolded here relate to the search for an international monetary order: the design of an international code of conduct at Bretton Woods and the eventual fall of the Bretton Woods system (Problem I), the management of the floating rate regime after Bretton Woods (Problem II), and the continued quest for monetary order through more formal proposals for a reformed international monetary system (Problem III).

These policy problems are not intended to be a record of events, but a means of highlighting fundamental issues that call for understanding through the application of basic principles of international monetary economics. The particular events are significant only as indicators of the wider and longer-term issues that dominate the shape of a world monetary order: the amount and distribution of international liquidity, the adjustment mechanism, confidence in different reserve assets, and the international harmonization of national policies.

This book, the second of three volumes on problems in international political economy, is designed as both a self-contained study of international monetary policy and a bridge connecting the first volume on trade policy with the third volume on development policy.<sup>1</sup> I have written this book with the same purposes in mind that I expressed in the first volume's introductory words to the student:

From a study of the policy problems in this book I want you to appreciate that economics is still concerned with social betterment; that economic problems cannot be solved in a political vacuum; that qualitative appraisals may be as important as quantitative calculations; and that in public policy formulation, the formal economic principle must usually give way at some point to a value judgment.

These problems do not allow a technocratic approach to policy-making. On the contrary, they emphasize that most policy problems have no natural boundaries and that decision-making is an art as well as a science. Long ago, Keynes observed that economics does not constitute a body of knowledge immediately applicable to policy. Notwithstanding all the advances in the "science" of decision-making, few—if any—economists would yet deny Keynes's dictum. And all who have experienced the complexities of actual decision-making in international economic affairs will appreciate that technical analysis must sooner or later yield to judgment—or to the qualities of imagination and intuition which Keynes believed to be as much a part of economics as logic and fact.

A word on organization. This book begins with a general expository introduction on international monetary affairs that recapitulates some basic principles and provides some perspective of the prob-

<sup>1</sup> Volume one is *Problems of Trade Policy* (1973); volume three is *Problems of Cooperation for Development* (1974).

lems that follow. The materials for each policy problem are then set forth in a way that I thought would best reveal the development of events and the execution of policy decisions. I have tried to unfold the “biography” of each policy situation by presenting an analytical narrative and a set of source materials so that you might gain a sense of the crucial issues in each situation, the types of international conflict involved, and the modes of resolution and cooperation effected.

To allow you to discover the major policy issues in the problem, I have tried to use to advantage, documents, reports, and other source materials—while providing continuity with a narrative. Some “seasoning” has been added by giving the observations of the actors, observers, or commentators of the time. Finally, I have provided questions designed to aid you in analyzing and evaluating the specific policy decisions.

This method of presenting policy problems is intended to encourage your own thinking about these problems. Although materials are offered to illuminate the particular policy problem, it is up to you to identify and analyze the major issues. And you must be prepared to adopt and defend your own policy position with respect to the problem’s resolution. You need not worry about a “correct” answer to the problem, but you should be very much concerned about the quality of the reasoning behind your own answer—about the “why” of your conclusion. Your specific recommendations are not as important as your understanding of the complexity of the policy problem and your clarity on criteria for judging the merits of alternatives. Each problem has two objectives: to extend your capacity to evaluate the quality of public policy-making and to suggest ways of improving the process in international economic affairs.

In considering each problem, you will therefore have to exercise your own judgment on a set of questions: What were the crucial policy issues in the problem? How were they resolved? Would another course of action have been preferable? What do you now conclude about the desirable future course of action?

I am again indebted to my students at Stanford University for enduring early drafts of these problems; their receptivity was most encouraging. I especially appreciate the help from Margaret Garritsen de Vries, Historian of the IMF; Sir Joseph Gold, Senior Consultant and former General Counsel and Director of the Legal Depart-

ment of the IMF; Werner Dannemann of the IMF's Bureau of Statistics; and Sterie T. Beza of the IMF who have been generous in their answers to my many questions. I alone remain responsible for errors of omission and commission. The librarians at Her Majesty's Public Record Office and the World Bank-International Monetary Fund Joint Library have provided invaluable assistance. Special acknowledgment must be given for the exceptional services of Anne C. M. Salda and Yvonne G. B. Liem of the Joint Library. Their professionalism was exceeded only by their good cheer and encouragement in leading me through the Library's indispensable collection.

Joanne O'Donohue merits my admiration and gratitude for being all that an author could hope for in keeping track of innumerable revisions and in promptly and efficiently producing several typescripts.

Extracts from published works are reprinted by permission, and gratefully acknowledged.

G.M.M.

*Stanford*  
*March 1981*

# CONTENTS

## THE CONTEXT: INTERNATIONAL FINANCIAL CONDUCT, 3

1. Multiple Policy Objectives, 5
2. The Need for Remedial Policy, 8
3. Types of International Monetary Systems, 11
4. Political Economy of Monetary Reform, 15

## PROBLEM I. THE BRETTON WOODS SYSTEM: DESIGNING A CODE OF CONDUCT, 21

1. Interwar Monetary Disorder, 22
  - 1.1 The Decision to Return to Gold, 22
  - 1.2 Abandonment of the Gold Standard, 27
2. Negotiations at Bretton Woods, 32
  - 2.1 The Keynes Plan, 33
  - 2.2 The White Plan, 38
  - 2.3 Establishment of the IMF, 40
  - 2.4 The Gold-Exchange Standard, 52

3. Currency Crises of the 1960s, 57
  - 3.1 Financial Crisis Management, 57
  - 3.2 Anatomy of a Devaluation Crisis: Britain (1967), 60
  - 3.3 French Franc, Deutsche Mark, and Canadian Dollar, 68
4. The Dollar Problem, 74
  - 4.1 The Dollar as an International Currency, 77
  - 4.2 Analyzing the Deficit, 80
  - 4.3 Creation of SDRs, 89
5. Making of the Dollar Crisis, 96
  - 5.1 The “Eurodollar Slop,” 96
  - 5.2 Dollar Outflow, 98
  - 5.3 The Balance-of-Payments Mess, 100
  - 5.4 Other Disturbing Events, 107
  - 5.5 Action of August 15, 1971, 112
- Questions, 116
- Readings, 119

**PROBLEM II. FLOATING EXCHANGE RATES:  
ASSESSING THE NEW REGIME, 122**

1. Demise of Bretton Woods, 123
  - 1.1 Smithsonian Agreement, 127
  - 1.2 Role of IMF, 130
2. Managed Floating, 131
  - 2.1 Exchange Rate Movements, 134
  - 2.2 Managing the Rates, 137
3. International Reserves and Liquidity, 142
4. Use of the IMF’s Resources, 146
5. Conditionality: IMF versus Jamaica, 153

- 5.1 New Guidelines, 158
- 5.2 IMF and Jamaica, 159
- 5.3 Breakdown of Negotiations, 163
- 6. The Eurodollar Market, 174
- 7. Recycling Needs and the Capital Markets, 177
- 8. Gold, 180
- 9. Assessment of Floating Rate Experience, 182
  - Questions, 207
  - Readings, 208

### PROBLEM III. INTERNATIONAL MONETARY REFORM: ORDERING THE FUTURE, 210

- 1. Bretton Woods Revisited, 210
- 2. Committee of Twenty's Agenda for Reform, 217
- 3. Jamaica Agreement, 227
- 4. Second Amendment, 236
- 5. Liquidity Problem, 239
  - 5.1 SDR as Chief Reserve Asset?, 239
  - 5.2 Substitution Account, 248
  - 5.3 Toward a Multi-Currency Reserve System?, 254
  - 5.4 The Future of Gold?, 258
  - 5.5 A World Central Bank?, 264
- 6. Adjustment Problem, 268
  - 6.1 Pressure and Reform, 268
  - 6.2 Fixed versus Flexible Rates—Once Again, 275
  - 6.3 Managing the Managed Float, 289
- 7. Developing Countries' Recommendations, 292
  - 7.1 Linking Reserve Creation and Development Assistance, 293
  - 7.2 General Aspects of Monetary Reform, 301

- 8. International Capital Movements, 314
- 9. European Monetary System, 319
- 10. Into the 1980s, 322
  - Questions, 334
  - Readings, 337

APPENDIX: INTERNATIONAL MONETARY  
CHRONOLOGY, 339

## PROBLEMS OF A WORLD MONETARY ORDER



# *THE CONTEXT*

## *International Financial Conduct*

Our subject is the continuing search for an organized world monetary order. How can the standards of international financial conduct be raised? How can international arrangements provide a more adequate system of monetary decision-making? In seeking answers to these questions, we shall encounter international monetary problems that are as fascinating as they are perplexing—combining as they do a rich mixture of technical economics, political repercussions, and even the psychology of symbols and beliefs.

We shall note how policy-making in international affairs proceeds beyond the narrow rigor of economic analysis or the quantification of econometric relationships. Beyond the teachings of technical economics, international currency experience is being continually shaped by the evolution of international institutional arrangements, by the extension of international law into national financial affairs, and by multinational negotiations as well as impersonal economic forces. The art of international financial diplomacy combines with economic analysis to shape the process of collective decision-making in international monetary affairs. As we review international monetary history and contemplate future international monetary reform, we shall attempt to discover ways for improving

the quality of this policy-making process—both in its policy objectives and its policy instruments.

We shall examine policy problems that span more than one-half century of international monetary change—from 1925 when Britain returned to the gold standard, through the par-value exchange rate system established in 1944 at the Conference at Bretton Woods, New Hampshire (Problem I), to the present managed floating system (Problem II), and proposals for international monetary reform (Problem III).

At the outset, we should draw a distinction between a monetary *system* and a monetary *order*. As expressed by Professor Robert Mundell, “An *order*, as distinct from a system, represents the framework and setting in which the system operates. It is a framework of laws, conventions, regulations, and mores that establish the setting of the system and the understanding of the environment by the participants in it. A monetary order is to a monetary system somewhat like a constitution is to a political or electoral system. We can think of the monetary system as the *modus operandi* of the monetary order.”<sup>1</sup>

Twice during the last one-half century, the passing of hegemony from a center-country and the decline in a key currency marked the culmination of a process of international monetary disintegration and a breakdown in world monetary order. In 1931, Britain abandoned the gold standard: overvaluation of the pound sterling coupled with a deep depression brought the downfall of the pound-centered standard. After years of international currency disintegration, nations finally agreed at Bretton Woods to establish the International Monetary Fund (IMF). The Bretton Woods system, together with the economic hegemony of the United States, provided a remarkable degree of monetary order for some 25 years. But 40 years after the fall of the pound, the dollar-centered standard also went into eclipse as the United States announced on August 15, 1971 the suspension of convertibility of the dollar into gold, and the dollar was devalued in 1971 and again in 1973. With the floating of the major currencies in 1973, the par-value system of exchange rates—the very essence of the Bretton Woods system—ended. The suspension of par-value

1 Robert Mundell, “The Future of the International Financial System” in A.L.K. Acheson et al., *Bretton Woods Revisited* (1972), p. 92.

obligations and the diffusion of economic and political power away from the United States toward the European Community, Japan, and the Organization of the Petroleum Exporting Countries (OPEC), raise questions about exchange-rate policy, as well as concern about more effective remedial policies for adjustment to balance-of-payments problems and attention to what should be the amount and distribution of international liquidity.

These issues run throughout our policy Problems. A similar set of issues concerned participants at Bretton Woods. Of the establishment of the IMF at Bretton Woods, it has been said that "it is difficult even for those familiar with the International Monetary Fund as a working organization to realize what a remarkable achievement its creation was. It came into being as a result of a supreme act of faith—the decision to surrender to an untried and imperfectly visualized international body the supervision of one of the most cherished attributes of national sovereignty, the right to change the rate of exchange. That this surrender was hedged round with safeguards is not surprising; that it was made at all and was accompanied by vesting in the same body an appreciable fraction of the member's international reserves, can be explained only by the coincidence of the hour and the men."<sup>2</sup>

If the task at Bretton Woods was to achieve world monetary order, so too is it now. The comparisons of "the hour and the men" within the institutional environment of recent years and against recent technical developments in analytical economics should be of interest in assessing the progress toward international monetary reform since the Bretton Woods system collapsed.

## 1. MULTIPLE POLICY OBJECTIVES

The reduction of trade barriers is a frequently avowed policy target for most countries; even more vigorously, national governments affirm their belief in economic expansion—a satisfactory rate of growth in rich countries and the acceleration of development in poor countries. Attainment of these objectives is, however, strongly conditioned by the type of international monetary system that exists. The design of the international monetary system is more than a matter

2 J. Keith Horsefield, *The International Money Fund 1945–1965*, Vol. I (1965), p. 3.

of instituting a technical mechanism: it necessarily involves policy choices that take international monetary affairs into the political arena, affecting the distribution of benefits and costs among nations and often requiring the resolution of conflicting interests.

Since the end of World War II, the overriding international economic policy question for most nations has been whether they can attain simultaneously the multiple objectives of high levels of employment, price stability, economic growth, trade liberalization, and balance-of-payments equilibrium. To the extent that these objectives may be incompatible, some policy trade-offs are necessary. In their efforts to achieve full employment, countries have often moved away from trade liberalization by resorting to import restrictions or to controls on capital movements. Even though international trade theory would label the advocacy of trade restrictions in order to promote full employment as a “nonargument” or as a “third, fourth, or *n*th best” policy measure,<sup>3</sup> governmental policies have in reality often had this neomercantilistic character. The pursuit of full employment also can entail balance-of-payments disequilibrium: as a country undertakes domestic expansion to achieve full employment, its imports may increase or its exports may fall so much that a deficit arises in the country’s international payments balance. Some trade-off must then occur between full employment and balance-of-payments equilibrium or between full employment and trade liberalization. Finally, if a balance-of-payments deficit arises, the country will likely attempt to remedy the situation either by undertaking measures that restrict employment and contract income, in order to reduce imports and stimulate exports, or by imposing trade restrictions or controls over capital movements.

When confronted by these policy conflicts, most governments have allowed the objective of full employment to dominate national economic policy even at the cost of a retreat from trade liberalization or pressure on the balance of payments. The central challenge to the operation of an international monetary system, therefore, is how to allow nations to pursue their domestic economic objectives with-

3 Economists refer to the theory of the “second best” as a guide to policy norms. See R. G. Lipsey and K. Lancaster, “The General Theory of Second Best,” *Review of Economic Studies*, Vol. 24 (1965), pp. 11 ff. The objective of the “second best” is to minimize costs of market intervention and to avoid an excess burden when the “first best” is unattainable (because it is impossible to have optimum conditions in every sector of the economy).