Robert Solomon

THE INTERNATIONAL MONETARY SYSTEM 1945-1981

An Updated and Expanded Edition of
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Preface to New Edition

The first edition of this book was completed in March 1976. This preface to the updated and expanded edition is being written in late January 1982. Much has happened in those six years. In particular, the world economy—as well as perceptions and expectations about it—has changed profoundly. It is these changes that justify a new edition.

The fact that the inelegant term "stagflation"—stagnation of the real economy combined with inflation—does not appear in the first edition is indicative of the alteration of fact and perception that has occurred. The first half of the 1970s had certainly been inflationary, but much of that inflation seemed to be explained by events—such as the synchronized boom in the industrial countries and poor harvests in 1972–73 and the first oil shock in late 1973—that need not recur. And in early 1976 inflation was subsiding in most industrial countries while their economies were expanding.

Furthermore, stagnation was not a conspicuous phenomenon in the early 1970s. The recession of 1974–75 was attributed to the oil price increase, and by the first half of 1976 real GNP in the seven largest economies was increasing at an annual rate of 6.5 percent. Yet over the next four years, GNP growth in Europe averaged only 2.5 percent per year and unemployment rose steadily. Meanwhile, inflation did not fall much after 1976 and in 1979–80 it jumped again under the impact of the second oil shock.

By 1981, inflation was no longer regarded as an aberration. It was expected to continue. One result of this change in expectations was that the very low and at times negative real interest rates (nominal interest rates adjusted for inflation) of the 1970s gave way in the early 1980s to strongly positive real rates.

At the same time, industrial countries were facing the prospect of slow growth without adopting policies to improve that prospect. Whereas in 1975 the governments and central banks of these countries had taken measures to counteract the recession, in 1981 they had not found the right policies to deal with the combination of inflation and stagnation—reviewed in Chapter XVI—that now afflicted most of them.

Another change concerns exchange rates. After two formal devaluations of the dollar and three cycles of depreciation and appreciation, it appeared, at least to me, that the system of floating rates had settled down by the spring of 1976. But in 1977–78 we experienced a sharp dollar depreciation, reflected in or reflecting—which form of the verb to use was a controversial matter—an upward movement mainly of the German mark, Japanese yen, and Swiss franc. Then in 1980–81 the dollar soared against the currencies of most industrial countries under the influence of steeply rising U.S. interest rates and a strong U.S. balance of payments. These substantial movements in exchange rates had significant economic effects, as is discussed in Chapter XVIII. They also stimulated a somewhat acrimonious debate across the Atlantic Ocean, as, once again, Europeans found it convenient to put the blame on the United States when their own economies were not performing well.

Still another change, which was well under way in 1976 but has become more visible and more widely recognized since then, is the emergence of about a dozen developing countries as industrial powers. The so-called newly industrialized nations, most of which were also heavy borrowers from the world's commercial banks in the 1970s and early 1980s, are in many ways more similar to the industrial countries than to the many developing countries that are mainly producers of food and raw materials. Although a North-South dialogue goes on, the "South" or "Third World" is a very diverse grouping indeed, including rich oil exporters as well as newly industrialized and poor countries.

Finally, a non-event should be taken note of. International monetary reform has not been an important feature of the years since 1976. Apart from inconclusive discussion of a possible substitution account for dollars in 1979–80 and the establishing of the European Monetary System in 1979, both covered in Chapter XV, governments and central banks have been preoccupied not with altering the international monetary system but with the problems of their own economies and their linkages with the rest of the world. Although voices are heard complaining about volatile movements in flexible exchange rates—and, as we bring out in Chapter XVIII, exchange rates have been overshooting—proposals for improving the exchange-rate regime have not had wide appeal. The analysis in this book points to the judgment that the ills of the world economy cannot be attributed, to any important degree, to the nature of the present international monetary system.

In this new edition, the last four chapters of the original book, dealing with economic and monetary developments in the first part of the 1970s, have been re-written and reorganized into five chapters and brought up to date. In addition, I have tried—with success, I hope—to make the treatment more analytical and less narrational. This shift in approach is partly the result of the passage of time: the dramatic events of the 1970s can be better understood in the longer perspective. Perhaps, also, the fact that I write now as a Guest Scholar at the Brookings Institution rather than as official at the Federal Reserve Board makes me more detached and more inclined to be analytical.

The subtitle of the original book, "An Insider's View," has been dropped, since I am no longer an insider. That was a great experience, but I am now reveling in the status of outsider. I do not believe that the reader is missing much as a result of the change of standpoint. This is so because international negotiations, which kept monetary officials so busy in the 1960s and early 1970s, were few and far between in the years after 1975. Less went on "inside" that was not widely reported. As noted earlier, officials have been primarily concerned with current economic and monetary developments, domestic and international, and little of their time and attention was focused on systemic problems or on matters that were not readily apparent to the observant outsider.

I happen to believe that they had their priorities right. What I regret is that, as of early 1982, they had not succeeded in coming up with a mix of policies that would end stagflation and encourage a better performance of the world economy.

It remains to express my thanks to the Brookings Institution, and its President Bruce MacLaury, for providing me with a congenial place to work and with the most stimulating and civilized colleagues anyone could wish for.

R. S.

Washington
January 1982

Preface to First Edition

This book offers an analytical interpretation of evolving international monetary relations since the end of World War II; its purpose is to improve the future by illuminating the past. Although the quest for an improved international monetary system is hardly a rallying cry for the ordinary citizen, the fact is that the structure and functioning of that system have an impact on all our lives. A better understanding of the history of that system is essential to the shaping of its future.

The international monetary arrangements agreed to in 1944 at Bretton Woods reflected U.S. dominance—political, industrial, and financial. As the economies of Europe and Japan recovered and went on to thrive, and as the developing countries threw off colonialism and began to act as independent economic entities, the deficiencies of the Bretton Woods system were gradually revealed in a series of monetary crises beginning in the mid-1960's. The efforts made to cope with these deficiencies were too little and too late.

Economic policies and practices that had been adopted both in the United States and abroad in the early postwar years to foster economic recovery and balance-of-payments strength in Europe and Japan persisted into the 1960's when they were no longer needed. Meanwhile, the United States took on a costly military burden in Vietnam but failed to adopt adequate domestic measures to prevent the inflationary consequences. For these reasons the Bretton Woods system broke down in 1971. A two-year exercise in reform was conducted by the Committee of Twenty in 1972–74. Although the Committee produced a broad vision of a reformed system, the sharp acceleration of inflation and the outbreak of the oil crisis in 1973–74 led to a decision to make reform an evolutionary process. In January 1976, agreement was reached on evolutionary steps regarding the role of gold; more important, a long-standing doctrinal dispute on the nature of the exchange rate regime was resolved.

This, then, in barest outline, is the history that is recounted in the pages that follow.* Although the viewpoint is international—I try to present the sometimes conflicting and often changing perceptions and objectives of policy-making officials concerned with international monetary questions in the United States and abroad—more emphasis is given to developments in the United States than in other countries. The largest entity and the central country in the system necessarily deserves the most detailed attention.

It is one of the themes of this book that there are no deep-seated national interests standing in the way of an improved international monetary system. The issues are technically complex, the forums for consultation and negotiation are unwieldy, and effective communication is exceedingly difficult. But these problems are surmountable, especially when the participants have a healthy dose of empathy.

A word is in order on the limits of this book. Although the Eurodollar market is mentioned often, the reader will find here no systematic analysis of the functioning of that market or other Euro-currency markets; that would require a separate book. Similarly, the problems of European integration are not dealt with in detail. Canada is mentioned from time to time, but its problems and various aspects of the U.S.-Canadian relationship are ignored. And little is said about the developing countries; their major problems lie outside the international monetary realm.

I should like to express my gratitude to the Board of Governors of the Federal Reserve System for encouraging me to write this book and for having given me, over the years, the responsibilities that made possible my participation in international monetary affairs. It was my friend Robert Holland, until recently a Governor of the Board, who first suggested that I write the book. The Board has not attempted to influence in any way what I have wished to say. By the same token, none of the analyses or judgments in this book should be attributed to the Board or its staff.

I wish to thank Roy Blough, Arthur Burns, Richard Cooper, Dewey Daane, Henry Fowler, Robert Roosa, James Tobin, Paul Volcker, and George Willis for providing me with recollections of events or developments of which

*An International Monetary Chronology will be found at the end of the book, beginning on page 383.

I had no direct knowledge. Needless to say, they bear no responsibility for what I have written.

For having read and provided helpful suggestions on all or most of an earlier draft, my sincere thanks to Ralph Bryant, Dewey Daane, Lewis Dembitz, Fern Solomon, Robert Triffin, and Edwin Truman. My former colleagues in the "Bureau" of the Committee of Twenty, Sir Jeremy Morse, Alexandre Kafka, and Edward George, provided helpful reactions to a first draft of Chapter XIV.

For her cheerful diligence and good nature, my secretary, Jan Anderson, has my lasting gratitude.

Finally, with love, I dedicate this book to my mother, Betty Solomon, who maintains a lively interest in world events though she has attained a certain maturity of years.

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I

The International Monetary System: What It Is and Why It Matters

Like the traffic lights in a city, the international monetary system is taken for granted until it begins to malfunction and to disrupt people's daily lives. During the first ten or fifteen years following World War II, while serious problems of postwar economic recovery were confronted and overcome, especially in Europe and Japan, the monetary aspects of international economic relations attracted little public attention. When monetary difficulties did arise, they were dealt with by specialized international institutions and by technicians in individual countries.

Not until the 1960's did acute problems emerge and come to the attention of the public at large. A series of events—annual crises culminating in a devaluation of the British pound in 1967, a crisis of weakness for the French franc and of strength for the German mark in 1968–69, the Nixon import surcharge and suspension of gold convertibility in August 1971, two formal devaluations of the dollar, the adoption of floating exchange rates in March 1973, and, finally, the quadrupling of the price of oil in late 1973—brought international monetary questions to newspaper headlines and into the conscious concern of the man and woman in the street. In recent years international monetary matters have even begun to show up as subjects of *New Yorker* cartoons—an infallible measure of public interest. Further evidence of such interest may be found in the Archbishop of Canterbury's plea to his flock to "pray earnestly" for the pound sterling as well as for the country.[1]

Because monetary developments affect the citizenry, the attention of high government officials became engaged. As Valéry Giscard d'Estaing, then Minister of Finance and later President of France,* said in 1973, "the problem of money had been treated as a matter for the experts and formed the subject of plans that were a delectable blend of sophistication and obscurity. Now it has become a problem for governments and is even being debated by statesmen. At stake is the expansion of international trade, that is to say, the growth of the world economy."[2] In France in November 1975, government leaders of the five largest industrial nations met at Rambouillet to discuss economic and financial matters, and the end result of the meeting was an agreement on the future exchange rate system—not the kind of issue that would have arrested the attention of such men a few years before.

The Impact of Monetary Events

International monetary developments affect individuals as workers, consumers, travelers, businessmen producing goods for domestic or foreign markets, and investors at home or abroad. The channels which transmit the impact of monetary events to people in their various roles in society are numerous.

Employment opportunities for some workers are improved when exports thrive and are weakened for other workers when foreign products compete effectively in price or quality with domestic output; exports and imports are influenced by what is happening to gross national product at home and abroad as well as by exchange rates, prices, and controls over international transactions.

A particular monetary change—for example, a movement in the exchange rate—may benefit an individual in one of his roles but leave him worse off in another. The individual as consumer may have a different view of, and a different interest in, what happens in the international monetary sphere from that of the individual as worker. One sees many foreign cars in the employee parking lots of automobile plants in Michigan and, no doubt, there are foreign-made television sets and numerous other imported products in the homes of American workers. Similarly, the son or daughter of a French worker wears American-made blue jeans and the Swiss worker may, these days, have an American or Japanese digital watch. A higher exchange rate for the dollar improves the welfare of the American consumer by making foreign products less expensive; at the same time it may weaken employment opportunities in

*It is no accident that finance ministers in recent years have succeeded to the post of head of government; in addition to Giscard d'Estaing in France, there have been Helmut Schmidt in Germany, James Callaghan in Great Britain, and José López Portillo in Mexico.