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EUROPE'S ROLE IN A NEW INTERNATIONAL MONETARY SYSTEM

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I.

"No consensus, just expenses" is what most of the comments on the outcome of the last annual meeting of the IMF and the World Bank held in Nairobi seem to imply. However, as I see it, this assessment of the annual meeting is not quite borne out by the facts. The contrary is true, since a number of rather important decisions were taken — albeit outside the main assembly hall. The Finance Ministers of the Group of Twenty jointly agreed on a fixed deadline for the reform : they resolved to reach an understanding on the main principles of a new international monetary system not later than by 31 July 1974. The basis for such an understanding is the report of the Chairman of the Group of Twenty which sums up the results of the intensive work done by the experts during the last year. This report, which was published in Nairobi, is a remarkable document : it defines very clearly the problems concerned and shows that there already exists a rather high degree of consensus regarding them. *On* the other hand, this report does not conceal those points which need to be agreed upon at a high political level by the middle of next year.

General agreement upon the main principles, however, does not imply that the reform might in fact already take effect during the course of the coming year. A great number of technical questions still need to be solved -- questions which in practice may well be of some significance. Once arrived at the results of the experts' work will have to be translated into legal terms; in other words, they will have to be reflected in formal amendments to the Articles of Agreement of the IMF as well as in some by-laws affecting the so-called "rules of conduct". The third step then to be taken toward the reform will be ratification of the amended Articles by the legislative bodies of all the 125 IMF members, a process which will require at least another year or two : the new monetary system, therefore, will in fact not take effect before the end of 1976. However, I am sure that certain parts of the reform -- probably a new evaluation of the SDRs or a definition of the role of gold as a reserve asset -- will already become effective before the legislative process connected with the reform has been finalized.

This time-schedule does not seem to be very ambitious. Some may even feel that the studies calmness with which the Finance Ministers are treating the reform is out of place in view of the urgency of the problem. We must, however, be realistic : as long as the US -- for a long time to come the most powerful country in both political and economic terms -- continues to run up such a huge balance of payments deficit, no real monetary reform will be forthcoming. For example, we can hardly imagine the US accepting a rigid convertibility commitment -- an important element of a new monetary system -- before, at least, equilibrium of its balance of payments has been restored. I am inclined to be optimistic in thinking that this might happen next year and I also presume that there is some kind of relationship between the deadline set in Nairobi for the reform and the foreseeable development of the US balance of payments.

## II.

In the meantime we will have to live with the system as it is, and I think that we can live with it. However, before dealing briefly with various problems concerning the present system, I should like to comment on some features of the new one as it might be worked out. The new system will have to avoid the weaknesses of the old Bretton Woods System. There is general agreement on this point. However, what are the defects of the Bretton Woods System which caused its final downfall ?

The two main elements of the Bretton Woods System were :

- Fixed par values which could not be easily changed.
- The readiness of the US — originally not implied in the Bretton Woods Articles of Agreement — to convert into gold any dollars offered to it, which placed the dollar in the center of the monetary system.

As long as the US happened to be a surplus country and as long as the main intervention currency of the Western World was correspondingly scarce, this system functioned well. Under its regime, world trade experienced its most rapid expansion ever. But even then it could be foreseen that this system was doomed to collapse some time in the future on account of its inherent structural defects. In fact, from the very beginning there was a discrepancy between most countries' wish to pursue an independent economic policy — which in general terms means a policy of full employment — and their obligation to adhere to fixed par values. The fact that differences in prices, productivity and employment resulted in tensions, which — as we all have seen — more and more often sparked off world-wide currency crises, was, therefore, almost inevitable.

Another defect of the Bretton Woods System was the fact that since the dollar was as good as gold the US was actually not obliged to strive for long-term equilibrium of its balance of payments. However, already in the early sixties it became apparent that the US would no longer be able to convert its foreign obligations in the form of dollars into gold. Consequently, the US relied more and more on financing its balance of payments deficits by simply increasing its dollar obligations which in the course of the Vietnam war in the late sixties and early seventies ran into astronomical figures, At the end of 1972, the dollar reserves of all central banks amounted to more than 80 billion dollars. Alone in 1971 and 1972, these reserves increased by more than thirty billion and twenty billion, respectively.

This increase naturally resulted in a corresponding expansion of world liquidity. One does not have to be a monetarist to recognize that such an uncontrolled creation of money was a main source of world inflation. Nor do I have any doubts regarding the fact that the worrying acceleration of the inflationary process all over the world during recent years must be traced back to this exorbitant expansion of world-wide liquidity.

The day on which the Bretton Woods System finally broke down was 15 August 1971 when the US Government officially revoked the convertibility into gold of the US dollar, A last attempt was made to salvage the old Bretton Woods System of fixed par values by means of the Smithsonian Agreement of 18 December 1971. As we know, however, this attempt failed just half a year later when the pound sterling began to float, followed only a little later by the split up of the Italian exchange rate and the floating of the Swiss franc. In February and March 1972, as you all know, the situation escalated to a point where the dollar had to devalue once more and the present system which we now usually refer to as a system of bloc-floating was created.

The new system which, as I said, must avoid the defects of the old one, should be based on the following four elements :

- It should be flexible enough to avoid, right from the beginning, a build-up of any material balance of payments disequilibria.
- It should enable every country, or — as I should like to say in respect of the EEC — every group of countries, to pursue in its domestic policy that course which it considers appropriate in view of its own situation.
- It should be so devised as not to hamper the liberal international flow of goods and capital, but — on the contrary — to foster this flow.
- It should make the creation of international liquidity independent of the vagaries of the balance of payments of one single country, in other words : additional liquidity should be created only on the basis of stringent and common criteria.

This having been said, the main objective of the reform discussion must be an improvement of the adjustment process and that means a restriction of the extent and persistence of balance of payments disequilibria. Of even greater importance is the fact that it has been agreed that the burden of the adjustment process should be distributed symmetrically between deficit and creditor countries : this means that if a country continues to pile up inordinately high balance of payments deficits or surpluses, it might be subjected to sanctions by the IMF — either in the form of barring this country from access to further credit facilities or — in the case of a surplus country — in the form of debiting the latter's excess reserves with negative interest.

The choice between internal or external policy measures for the purpose of accelerating the adjustment process should be left to the country concerned. However, one could easily imagine a situation where a country perseveres in a policy which may have a negative impact on other partners. In this case, the

**IMF** should, in the course of improved consultation procedures, have the right to scrutinize the various policy options available.

Of course, the exchange rate mechanism itself has an important part to play in this context. While on the one hand fixed but adjustable par values will continue to be the foundation on which the whole system is based, there is now broad understanding to the effect that minor and more frequent changes in exchange rates are a legitimate instrument of the adjustment process. What is more, even a temporary currency float **now** seems to have been accepted as an appropriate instrument for improving balance of payments disequilibria. Of course, certain rules of behaviour still have to be defined to prevent this instrument from being used for the purpose of competitive devaluation — although I find it somewhat difficult to understand why there are apprehensions in this connection if I consider the existing inflationary pressures.

The main point of the reform, though closely interrelated with the adjustment process, is how to restore convertibility. There is now general agreement that in future all countries without deficits with the aid of primary assets rather than by an unlimited expansion of their foreign liabilities. In practice, of course, this implies in the first place an abolition of the US dollar's previous central role as the main reserve and intervention currency — because hitherto it has been the exclusive privilege of the US to finance its balance of payments deficits by an uncontrolled expansion of its foreign liabilities. It is, therefore, obvious that this problem is the core of the whole reform scheme, because it does not only involve economic but also, perhaps even more important, political issues,

In other words, adjustment and convertibility are mutually interrelated problems : the more efficiently the adjustment process works the less important are the convertibility rules, This is the very reason why I think that it would

be useful to envisage a reform package providing as much flexibility as possible for the adjustment process to the convertibility rules. However, I do not need to stress that it is regarding the ultimate mixture of flexibility on the one hand and rigidity on the other that a wide variety of differing opinions still exists -- depending on a country's view of its future position within the international financial community. These different views, of course, are influencing the present discussion of techniques for achieving a certain degree of convertibility -- whether the asset settlement should be fulfilled on a voluntary or on a compulsory basis, whether there should be the possibility of a temporary suspension of the convertibility obligation or whether there should be defined rules for the freedom of choice in reserve composition.

The other hitherto unresolved reform issues -- as, for example, the future roles of SDRs and gold -- are of relatively minor importance. I, therefore, might be allowed to pass over these rather technical questions by sunning them up under the catchword "control of world liquidity". However, as far as this issue itself is concerned I do feel that it is necessary to include it as the third main pillar of the reform. Though a lot might be said about the necessary substitution of gold by SDRs, the main objective should always be : how can we bring the creation of world liquidity under better control ? What must be avoided is that the mechanism of inflation, which so far has been accelerated by an ever increasing amount of dollars outside the US, will in future be powered by an uncontrolled creation of SDRs. I, therefore, have some doubts whether the link between SDRs and development aid -- nowadays the ceterum censeo of the LDCs -- would not involve the risk of impairing the badly needed confidence in the stability of the new international monetary system.

### III.

However, a few more years will be needed before the new system can be put into effect. In the meantime we will have to live with the system as it is. As I already said : in my view, though, we can live with it.

To my mind, there is no justification for calling the present system chaotic -- as some people again did in Nairobi, I rather think that the floating of the US dollar in March was the only reasonable solution and that the floating system has stood its test quite well. It was thus possible to come to the long overdue new valuation of the dollar in a comparatively smooth manner. Maybe the market has overshot the mark a little, maybe today the US dollar is undervalued and the Deutschmark is overvalued. There is some truth in the argument that the exaggerated devaluation of the US dollar as well as the exaggerated revaluation of the Deutschmark may be corrected by operation of the market mechanism -- in other words : the dollar might well regain some strength during the course of the next year and that would, of course, mean a de facto devaluation of the Deutschmark. In any case, it should not be overlooked that such a massive correction of the exchange rate of the US dollar as it happened in the markets could never have been achieved by simple government action.

Another advantage of the floating system, as I see it, is illustrated by the fact that when, for political reasons, the dollar again came under pressure in early summer, this phenomenon was not accompanied by those exorbitant capital inflows into Germany which we are used to up to the beginning of this year. Under a floating system, so to speak, speculators speculate against speculators and no longer against central banks and governments.

By the way, a change-over to a floating system does not imply the introduction of completely flexible exchange rates; already in March there was complete



agreement that the central banks -- if necessary -- should well be prepared to intervene for the purpose of guaranteeing orderly markets. Actually, there have been such interventions from time to time -- but only in narrow confines and on a much lower scale than we were used to before the float.

Furthermore, as far as the Federal Republic is concerned, the floating of the Deutschmark enabled that country to pursue a quite effective anti-inflationary policy. You all know that both the Bundesbank and the Federal Government successfully made the most of the additional scope thus offered for the domestic policies,

In spite of these apparent advantages of the newly created system there is broad agreement that the floating period can be no more than a transitional one. Furthermore there are some apprehensions to the effect that the present currency blocs might some day turn into trade blocs or even into undesirable political blocs. However, there is no need to delay the re-introduction of fixed parities until the new monetary system has been fully put into effect. The *conditio sine qua non* for such a course, however, is an improvement of the US balance of payments. The prospects for this happening can be considered to be quite favourable. Not only in Nairobi but also during his recent visit to Bonn, the US Secretary of the Treasury, George Shultz, drew a fairly optimistic picture of the future development of the US balance of payments. In fact, for a couple of months, the trade balance of the US has been near to equilibrium. This trend will continue when, in the course of time, the effects of the devaluation of the dollar become more and more noticeable. As far as the Federal Republic of Germany is concerned, I have no doubts whatsoever that the drastic change in the dollar's various parities will in the long run result in a considerable change in competitive conditions. You will recall that since the end of 1969 the Deutschmark's value in relation to the dollar has increased by more than 50 per cent, in this year alone by more than 20 per cent. The Deutschmark's exchange rate vis-a-vis Britain, Canada and

Italy -- to name only a few of the major countries -- has undergone changes of similar magnitude.

The fact that there is an increasingly noticeable reversal of capital movements should also help to strengthen the dollar. I expect that European and Japanese investors will invest more and more of their money in the United States and that, above all, an increasing number of manufacturing plants will be set up in the United States, Canada and other countries by European and Japanese firms. In doing so, our industries will be reverting to a course which the US' industry has been pursuing since the forties, namely to concentrate on manufacturing in, instead of on exporting to, other countries.

For this and other reasons, I feel that I can be moderately optimistic in regard to the situation of the dollar in the years to come. Far greater problems, in my opinion, lie in the future of the "snake" -- that system under which six European currencies are linked to each other by fixed parities.

This brings me to the second aspect of the subject : the role of Europe in a new monetary system.

First of all, it is pleasing to note that in the reform discussion the European Community spoke largely with one voice and submitted joint proposals on the main issues. In addition, it may perhaps be said that certain elements of a new monetary system are already inherent in the "snake". This, for instance, applies to the so-called multi-currency intervention system operated by us in Europe. What it means is that: each country is itself responsible for hedging the exchange rate of its own currency against all other convertible currencies, and that implies the absence of a key currency. It also applies to the stringent rules on the settlement of balances, rules which exert a certain pressure towards balance of payments discipline and harmonization of economic policies -- in particular monetary and credit policies. No country party to the "snake" can

afford to adopt an attitude of "benign neglect", as pursued by the United States for many years, because every country, to put it simply, has to pay its debts at the end of the month. Thus, when faced with a considerable depletion of her monetary reserves it was, for instance, quite logical for France to raise her bank rate drastically, a reaction which actually brought speculation to a halt.

It is by no means an exaggeration to allude to this European monetary bloc as being something of a nucleus of a European monetary union, seeing that the six EC countries and the other three who have joined in do in fact pursue a common external monetary policy by maintaining fixed exchange rates among themselves and by floating vis-a-vis the rest of the world. The fact, though, that because of their special domestic problems, three EC countries have abstained from joining any agreement whatsoever is more than a minor blemish. As long as this situation prevails, the development of the European Economic and Monetary Union will at least be considerably hampered. It would therefore certainly be desirable to see Britain, Italy and Ireland returning to the Common Market's monetary fold. However, things being as they are, such a return will not be feasible until the countries in question have removed the causes which originally induced them to turn their backs on the European monetary club, a step which, by the way, they did not take as late as March 1973 but much earlier : Britain during the summer of 1971 and Italy early in 1972. In other words : Britain, Ireland and Italy will not be able to return to the "snake" until their balance of payments troubles have been overcome,

These countries' position gives a particularly clear illustration of the cardinal problems surrounding a European Economic and Monetary Union. There is no denying the fact that such a monetary union, envisaging fixed exchange rates and narrow band margins, can in the long run function only if synchronized economic, financial and, in particular, monetary and credit policies are pursued by all participating countries. Any monetary union is bound to feel a constant strain, which may ultimately result in its destruction, if one country pursued an expan-

sionary policy at — virtually — no matter what cost whilst in another country price stability was given priority rating.

Theoretically, there is a way out of this dilemma : a device which, by the way, is also being contemplated in the approach to a new monetary system, namely frequent parity changes. And at least two such steps have in fact already been taken within the "snake" during the course of this year when the Deutschmark was successively revalued in its relation to the currencies of those countries among whom fixed parities had been agreed. The sole purpose of both these revaluations was to keep the "snake" together. However, we know full well that such a step is somewhat hazardous, and what I particularly fear is that the common agricultural market will in the long run hardly be able to survive constant changes within the European Community.

It may possibly be only a small step from frequent changes in parities to a "free for all" float. You may recall that in February heavy pressure was brought to bear on the Federal Government for a repetition of the 1971 "go it alone" float by the Federal Republic and that the argument advanced in favour of such a move was that this was the only way to pursue a truly effective anti-inflationary policy. At the time, the Federal Government did not fall prey to this temptation but rather endeavoured — with partial success — to attain a European solution. The primary motive for this endeavour was political : it was thought that a general float by all European countries would mean the end of a European Economic and Monetary Union for quite a time to come.

In no event can the problem of divergent objectives be solved by means of capital movement controls. It is true that the Federal Republic itself resorted to such controls when inflows of foreign exchange reached a frightening peak, and one strong argument in favour of doing so was the advice given by her European friends. However, it became clear that such controls offer no protection whatsoever

against speculative capital movements. In *my* view, capital movement controls may, perhaps, be unavoidable in certain emergency situations but they should certainly not be used on a permanent basis. They simply do not square with the objectives of an Economic and Monetary Union, namely the integration of European capital markets. I would, therefore, be in favour of abolishing these controls as soon as possible. Once introduced, official market controls, however, tend to die slowly, as experience has shown. Under no circumstances, though, will they be able to rectify undesirable trends towards structural discrepancies between different national economies.

Equally unsuitable for solving the problem of divergent objectives are those proposals which aim at pooling monetary union to provide for certain assistance machinery to adjust imbalances on a short term basis. Such assistance machinery does in fact already exist and it has proved its worth. It would, however, be fatal if the Fund for Monetary Co-operation were primarily turned into an instrument for medium or longer term financing of balance of payments deficits because it would then quite automatically become a kind of "inflation generating machine". During the discussions on the reform of the international monetary system, the European countries fortunately declared their faith in the principle of strict convertibility of currency. It would be utterly nonsensical if we of all people were to undermine this principle within the EC. We should be careful not to repeat the mistake of allowing an unlimited creation of liquidity to take place which, in the last resort, led to the collapse of the Bretton Woods System, and which is the main cause of world-wide inflation now being experienced by all countries,

What we need is not pooling of monetary reserves, but harmonization and co-ordination of our economic, financial and credit policies. Only then will it be possible to hold the "snake" together and to achieve genuine progress towards an Economic and Monetary Union. We are faced with important decisions this autumn : 1 January is the date set in the initial timetable for the Second Stage

of the Economic and Monetary Union to commence. In the light of the resolutions passed by the Summit Meeting at Paris last October, a breakthrough towards an effective harmonization of economic, financial and monetary policies might well be expected. But I know -- as all of you do -- that the actual situation leaves little scope for high hopes. But I should quite seriously like to say that if such decisions -- which would also involve the surrender of certain sovereign rights -- should fail to be taken, there would not only be a lack of progress from the European Community towards a European Economic and Monetary Union, but we would, moreover, have to fear for the continued existence of what has already been achieved. The "snake" as such is a tough creature, but it should not be driven to the point of collapse.

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