# The "System" in Disarray

## Efforts to achieve a new monetary order remain stalled on one key problem—how to correct imbalances in payments.

by Richard N. Cooper

International monetary affairs have been in disarray for six years, since the gold crisis of early 1968. The formal rules of the international monetary "system" are now in abeyance, and some observers contend that international monetary order has been completely shattered. The current circumstances are sharpened by the fact that the international monetary system apparently functioned marvelously throughout the 1950s and most of the 1960s.

How did we get into the present state? How bad is it? What is likely to emerge from the present disarray? Answering these questions requires an excursion into interpretive history.

Before we launch on this excursion, two common explanations should be set aside. The recent disarray cannot be attributed either to the presence or to the passing of any individual—President de Gaulle is often cast in that role. Nor is it due to the admittedly dramatic decline that has taken place during the past two decades in the relative position of the United States on the world economic scene. Its share of gross world output dropped from 39 percent in 1950 to "only" 29 percent in 1972, and its share of international reserves dropped from 50 percent to 8 percent during the same period. European nations and Japan grew rapidly following the devastation of war, and the former have coalesced into a community that now exceeds the United States in the relative importance of its trade.

These factors have played a contributing role in evolving monetary developments, but they have not been central. The main considerations, alas, have been more technical. But that is only superficially a cause for regret. While it makes the problem more difficult to explain, it also makes a solution easier to grasp—once nations recognize the technical nature of the problem. Disagreements on fundamentals may remain, but at least the non-solutions that have so far dominated discussions can be set to one side.

The key problem of financial relations among nations is how to keep countries from getting into a balance-of-payments deficit (or surplus) and how to eliminate an imbalance once it arises. There are two broad approaches to the task of correcting imbalances: Financial conservatives favor reducing total domestic demand, even if that causes higher unemployment. The other approach is to rely on measures acting directly on foreign trade and capital flows. Import taxes or quotas do that, and so do changes in the price of the country's currency with respect to foreign currencies—its exchange rate, in the language of financial markets.

The nineteenth-century gold standard had relied on the first approach; it was rejected by leading nations in the 1940s in favor of ultimate reliance on the exchange rate for balance-of-payments adjustment.

The Bretton Woods System—named after the New Hampshire village where the final conference was held in 1944—was bold in conception and ideal on paper. It was constructed on the ashes of the economic nationalism of the depression-ridden 1930s. The architects of this system laid down four points:

• First, international financial questions impinged on many nations, hence called for international accountability by nations to the community of nations.

• Second, it was thought that the best way to carry out this responsibility, yet still allow for the required adjustment, was for each nation to declare a *parity* for its currency, determining its exchange rate with respect to other currencies. That parity was to be changed when

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*Bretton Woods Reformers—Their four-point system "was actually tried for the first time in the late 1960s, and it collapsed in the process."*

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*In Search of a New Order—Treasury Secretary George Shultz with Kenya's Finance Minister Mwai Kibaki at last fall's annual IMF meeting in Nairobi.*

necessary to correct a "fundamental disequilibrium" in the country's balance of payments, but only with international approval. That approval was designed to prevent exchange rates from being changed in a predatory fashion, as they had been in the 1930s.

• Third, each country was to maintain convertibility of its currency into other currencies for all trade and service transactions. The use by the Nazi regime in Germany of restrictions on international trade and travel made these devices odious as a restraint on freedom. Each country was also to maintain the convertibility of its currency in quite a different sense—namely, convertibility into gold or into a currency convertible into gold for any foreign *official* balances of its currency acquired through trade.

• Fourth, a new institution, the International Monetary Fund (IMF), was created to police the new rules of behavior and to lend to nations in difficulty while they were still trying to determine whether or not they had a "fundamental disequilibrium" or to tide them over the period during which corrective steps were taking effect.

Most observers credit the Bretton Woods System with great work. World trade has grown at a truly fantastic rate—from $55 billion in 1950 to over $450 billion in 1973—nearly 10 percent a year over nearly a quarter-century, a record that must exceed all previous ones. Most of this growth was real; inflation accounted for a substantial part of it only in the last several years. World output has grown at a rate that looks small only by comparison with trade; and depressions have become "recessions," mild in comparison with pre-war strains of that malady.

But imputing this high performance to the Bretton Woods System has little validity. Indeed, the Bretton Woods System was actually tried for the first time in the late 1960s, and it collapsed in the process. It was out of tune from the start, for it neglected the important role of international capital movements and the difficulty—the virtual impossibility, without Draconian measures inconsistent with other dimensions of economic freedom—of controlling them. This iconoclastic assessment requires justification.

In 1947, when the IMF was created, the overwhelming dominance of the U.S. economy contrasted sharply with the juridical parity among countries called for in the Bretton Woods Agreement—and indeed in most international agreements. (The one concession to actual asymmetries was a system of weighted voting, with the United States having the largest vote.) The countries of Europe and Asia had been devastated by war, and their dependence on the United States for food, materials, and capital equipment was heavy. For most countries, the key financial problem was the "dollar problem"—how to earn enough dollars to pay for needed goods.

The Bretton Woods System was postponed from the start of the IMF in 1947 for a "transition" period that lasted nearly fifteen years. After extensive currency devaluations in 1949, only France among major countries changed the value of its currency in the 1950s (a fact that, in combination with the turbulence surrounding a modest revaluation of the German mark in 1961, led many financial pundits to the view that changes in exchange rates were neither necessary nor desirable). How then did countries correct payments imbalances? By deflation of domestic demand? Occasionally, but that was not the important method of adjustment. Rather, it was first the introduction, then the gradual and variable relaxation, of controls on transactions with the United States and other "strong currency" countries. The devaluations of 1949 gave many countries a competitive edge against American goods, and as their exports expanded, they gradually relaxed their restrictions on imports—a process that lasted until 1961.

By the 1960s that process of differential trade liberalization had virtually run out. The time to introduce the Bretton Woods System might seem to have come, and indeed it was formally accepted by many countries in 1961. But now a new factor emerged that prolonged its true introduction for another six years: the emergence, in 1958, of a large U.S. balance-of-payments deficit, which was to remain large throughout the 1960s. The causes of that deficit were varied, including a short burst of inflation in the United States from 1956 until 1958, the recovery of Europe and the formation of the European Common Market (which stimulated American investment there on a massive scale), and even the advent of intercontinental strategic missiles, which reduced the physical security of the United States relative to business locations overseas.

Because of the large U.S. deficit, virtually all other industrial countries ran balance-of-payments surpluses

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throughout the 1960s. They were thus spared the need for making hard decisions to correct payments imbalances. While they would have found it impossible to run deficits indefinitely, surpluses did not carry the same compulsion to take corrective action.

The United States was an apparent exception to the rule regarding deficits. During the dollar-shortage days of the 1950s, countries had formed the habit of building up their balances in dollars. Habits based on convenience are hard to break; so they continued in the 1960s. But so long as other countries willingly held dollars, there was no need for the United States to eliminate its deficit—it could simply issue more IOUs (in practice, the same Treasury bills that are issued in the domestic market—that was one of the sources of convenience). France made an abortive attempt to discipline the United States in the mid-1960s by cashing all its dollars into gold at the U.S. Treasury. But that move was correctly interpreted as a political act designed to humble the United States. Other countries did not share that purpose, and they perceived that large-scale encashment of dollars into gold would bring to an end the system they thought they were operating under; so they more or less voluntarily refrained.

The United States was of course concerned about its payments deficit, and the government took a number of foolish moves to correct it (such as imposing what amounted to a 50 percent tariff on all U.S. government purchases abroad, thus raising the tax burden), but it did not devalue the dollar, as a "fundamental disequilibrium" under the Bretton Woods System would have required.

The Vietnam war–induced inflation strained to the breaking point the willingness of other countries to accumulate dollars. First Germany (in 1969) and then Canada (in 1970) revalued their currencies upward to stem the inflationary impulses from the United States. The U.S. deficit grew enormously in 1971; and when the United Kingdom (a country that ironically had been in chronic deficit until 1969) allegedly raised the prospect of converting some of its dollars into gold, the result was necessarily a formal suspension of gold convertibility by President Nixon in his new economic policy of August 1971. But that suspension would have come sooner or later, for the sharp growth in foreign-held dollars relative to the U.S. gold stock was making convertibility increasingly hypothetical.

It has become fashionable to blame recent financial difficulties on "speculators," on the Eurodollar market, or on multinational corporations. These groups are blameworthy only in the sense that financial crises would be less dramatic without them. Speculators, which for these purposes include many of the multinational corporations, often acting through the Eurodollar market, anticipate changes that they believe more fundamental economic developments would require sooner or later in any case. Speculation is a symptom of difficulty, not the cause of it. Of course, speculators may be wrong in their judgment, and their fallibility creates a source of disturbance that otherwise might have been avoided. The dollar undoubtedly depreciated too much last year. But by and large, the "disequilibria" arise from underlying cost, income, and price trends, not from speculation.

Until the late 1960s, exchange-rate changes among major currencies were rare. Differential trade liberalization in the 1950s and large (but grudgingly acceptable) U.S. deficits in the early and mid-1960s had reduced the need for such changes. And even when the need arose, governments were reluctant to act because of the speculative turbulence, before and after, created by highly mobile capital, in effect nullifying the Bretton Woods stipulation for thorough international consultation and agreement on proposed exchange-rate changes.

It is thus not too much of an exaggeration to say that the Bretton Woods System broke down just when it was actually first put into operation, that is, in the late 1960s, when major countries began to use large changes in exchange rates to correct fundamental imbalances. The inflationary pressures of the late 1960s put exceptional strain on the system, but payments imbalances are *bound* to arise from time to time because of divergent economic developments among countries governed by democratic majorities. A large machine with parts changing speed at different rates requires clutches and gears to keep the parts in harmonious alignment. Completely fixed exchange rates require all the parts to move at the same speed all the time, accelerating or decelerating together; abrupt changes in exchange rates, à la Bretton Woods, run the risk of stripping the gears.

The weakness of an international monetary system that relied for new reserves on the dollar—or on any other national currency—was recognized many years ago and has been potentially remedied through the creation of the new Special Drawing Rights at the IMF. Now the weakness in the adjustment process is perceived as well, but there is still a strong, if misguided, nostalgia—especially in Europe—for the Bretton Woods System. That system did serve the exceedingly useful purpose of establishing an international accountability for nations in the financial domain. But its basic *modus operandi* did not work and cannot work. Large-step changes in exchange rates are not compatible with the high mobility of funds prevalent today. We will not achieve a real reform of the international monetary system until this point is recognized by all the major parties.

The multinational Committee of Twenty, charged with laying down the principles of reform, is stalled on the key problem posed at the outset: how to correct imbalances in payments. Many participants would like to rely mainly on domestic economic adjustment. Indeed, they would like to see the new monetary rules impose much tighter discipline on domestic economic policies, especially in the present inflationary environment. Others, more realistically, perceive that the solution to inflation must be found domestically, not through international rules that cannot ultimately be enforced. Exchange rates must be changed more frequently and by smaller amounts (to discourage speculation) than in the past to provide the smooth adjustments among economies that are governed primarily by domestic concerns and considerations.

Since it takes twenty to agree, and the disagreements run deep, disagreement will prolong the status quo of floating exchange rates. This *ad hoc* system has weathered its difficulties far better than many had initially feared, and—who knows?—further favorable experience with it may provide the basis for agreement to institutionalize it. A worse fate could befall us. □

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A Glossary

# Out of the Woods Comes the Snake

Much of the trouble in understanding the world money muddle is a vocabulary problem. Memorize the following glossary, and you can astonish your friendly central banker or finance minister.

BRETTON WOODS—The town in New Hampshire where, in 1944 at the old Mount Washington Hotel, Harry Dexter White of the United States, Lord Keynes of Great Britain, and other delegates of the allied capitalist powers negotiated the postwar world monetary system. The delegates sat in rickety white chairs around a hollow square of dining-room tables covered with white tablecloths. Lord Keynes's friends called him "Maynard."

CONVERTIBILITY—The United States, the economic titan of the postwar world, stood ready to convert dollars held by foreign governments into gold on request. However, nations were glad to add not only gold but also dollars to their monetary reserves, because the dollar was considered as good as gold—even better, since dollars would earn interest if they were invested in U.S. securities. Thus the dollar became the sun of the world monetary system, and all other currencies its moons. But, alas, the dollar gradually weakened as the United States ran deficits year after year. Finally, on August 15, 1971, the Bretton Woods System collapsed when President Nixon said the United States would no longer convert dollars into gold or into . . .

SPECIAL DRAWING RIGHTS (SDRs)—International monetary reserves created by the IMF and nicknamed "paper gold." SDRs do not have the many uses of dollars—for foreign trade, investment, or dealing in foreign exchange markets; they are used only to settle payments deficits between nations. Yet the nations of the world have declared that SDRs—in altered form—should in time replace both dollars and gold as international money. Whether the nations really believe that is open to some doubt. The Europeans suspect the United States of wanting to

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preserve the "dollar standard." The United States suspects some European countries of wanting to restore the gold standard.

FIXED EXCHANGE RATES—The Bretton Woods Agreement—more the design of White than Keynes—required every country joining the International Monetary Fund (IMF) to pick a par value for its currency in terms of gold (whether it actually had any gold or not). The United States, which had most of the world's gold reserves, said it would keep the par value of the dollar at one thirty-fifth of an ounce of gold (where President Roosevelt had set it in 1933—before then it was worth one twenty-first of an ounce). So gold was officially priced at thirty-five dollars an ounce, and all other countries picked par values for their currencies in relation to gold and the dollar. The Bretton Woods System was one of fixed exchange rates, with only a little wobbling above and below par permitted.

FLOATING EXCHANGE RATES—As the Bretton Woods System fell apart, so did fixed exchange rates. Currencies floated

up or down, with supply and demand. The dollar, first cut in value by 8 percent and then 10 percent, subsequently floated still lower—until it began to climb again in the fall of 1973. The dollar has been coming on strong as the U.S. trade and payments position has improved—partly because dollar devaluation gave this country a trading advantage, partly because world food shortages increased demand for American farm products, and partly because, with the Arab oil embargo, the United States looks better off for energy resources than its chief competitors, Western Europe and Japan.

THE SNAKE—The Western European nations think stable exchange rates among them are essential to linking their economies closer together, so they are trying to hold their currencies inside a "snake"—really a water snake, which floats about in relation to the dollar.

WORLD MONETARY REFORM—Everybody has his own notion of what reform means. To the Europeans and Japanese, it chiefly means the end of the dollar's role as a reserve currency; the United States, they feel, should make good on its debts like any other country instead of having the power to print dollars to cover them. To the United States, the main object of reform is to improve "the adjustment process"—the way governments go about correcting their deficit or surplus positions. Countries can adjust, for instance, by changing their exchange rates, reducing trade barriers, increasing foreign aid, or controlling domestic inflation. Negotiating reform is proving unspeakably difficult. So everybody has begun to speak in favor of "monetary evolution"—his own kind.

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