Priorities for the International Monetary System

By PAUL A. VOLCKER
President, Federal Reserve Bank of New York

Remarks before the National Foreign Trade Council in New York City on Monday, November 17, 1975

It was three years ago when, in a different capacity, I last spoke before this forum. My purpose then was to explain and defend the official United States proposals for reform of the international monetary system that had been presented shortly before to the annual meeting of the International Monetary Fund.

The United States and other countries then looked toward an ambitious restructuring of the IMF articles, resolving in one set of comprehensive negotiations an outline for a monetary system suitable for today's world. Events have forced a different and less sweeping approach. Some major issues have been settled, at least temporarily, by markets and governments responding to the pressures of new events. Others have been left partly or wholly unresolved. Today, speaking not for the United States Government or for the Federal Reserve System as a whole, I would like to address a few of these problems again, in the light of what has happened in the intervening period.

In approaching the job of rebuilding the international monetary system, perhaps the first thing that strikes a "reformer" is the number, severity, and essential unpredictability of the shocks that have struck the world economy in these past four years. Since the Bretton Woods system broke down and the Committee of Twenty launched its efforts, there has been a worldwide boom, an outburst of two-digit inflation, enormous fluctuations in basic agricultural prices, the oil crisis, and then sharp recession. Meanwhile, the process of negotiation had clearly reflected marked differences in perspective among countries about the priorities for a new monetary system, and these differences could not be quickly resolved.

In the circumstances, it is not surprising—and perhaps more realistic—that we have adopted a more piecemeal approach toward change and reform. Notably, while specific exchange rate practices vary widely among countries, the floating of major currencies has become a dominant fact of life. Questions of international control of reserve creation and of reserve "consolidation", which had earlier been a preoccupation of many reformers, have been for the time put aside.

This is not a neat, intellectually satisfying picture. Many feared that resort to floating without clearly defined rules of behavior would undermine international economic integration and interfere with trade and investment. Some went further. They felt that what they saw as a total breakdown of the monetary order was responsible for much of the instability in the world economy and carried the seeds of political and economic chaos.

But the worst has plainly not happened. Flows of international trade and investment—while recently affected by recession—have been well maintained. Controls on trade and payments have not proliferated. Resort to "beggar my neighbor" policies—one source of concern to those pushing comprehensive reform—is so far notable mostly by its absence.

Have the fears been unjustified, or have we simply been lucky—at least in this area?

I don't want to discount entirely the possible role of good fortune in human affairs. But I suspect it has been three other, more identifiable, factors that have made the major contribution to the reasonably effective functioning of the system.

Private market mechanisms have proved to be much more resilient than the pessimists feared, or perhaps even than the optimists hoped. Both business firms and financial institutions have demonstrated remarkable ability to adapt to the new circumstances.

For their part, the national governments of the industrialized world, influenced by the habits of decades of successful international economic cooperation, have not retreated into overtly nationalistic and autarchic policies. To be sure, negotiations on trade, money, energy, and development have been proceeding at a frustratingly slow pace. But, the framework and platform for forward-looking negotiations have been maintained.

Not least, the new flexibility of exchange rates—introduced not by agreed design but under the force of events —has helped us cushion and absorb the successive blows to economic stability while facilitating some longer run balance-of-payments adjustments that had eluded us so long.

There is room for satisfaction in this experience. But it would, in my judgment, be a mistake to conclude all is well—that the essential job of reform has been done in, as it were, a fit of absentmindedness.

Exchange rates have at times been highly volatile. Practices with respect to reserve creation and composition have become more diverse and less predictable. More broadly, the international monetary system has been functioning with only rather vaguely understood "rules of good behavior" and guidelines of uncertain status.

In a period of radical change and transition, the absence of a well-defined structure and agreed rules has perhaps been inevitable and even useful in helping us to break out from outmoded patterns. Certainly, to accommodate to the turmoil surrounding us, a larger degree of flexibility has been essential.

Nevertheless, there are, in my view, dangers and difficulties in this situation—in continuing indefinitely without a greater sense of structure or an identifiable set of codes of conduct in international monetary affairs. Volatile exchange markets feed uncertainty. Diversity in management of official reserves, while undoubtedly welcome from the point of view of some individual countries, could degenerate into a lack of consistency and predictability contributing to further instability. A sense of drift, or worse, potential conflict, in the policies and purposes of major countries could arise, eroding instincts for cooperative policies and mutual confidence. All of this supports the thesis that monetary reform should remain high on the international agenda.

THE AMERICAN INTEREST IN REFORM

No reform effort will be successful that does not take into account some simple truths of international economic and political life. Among these is the fact that the United States is still by all counts the largest single economic force in the world. Foreign concern with, and sensitivity to, our economic health remains high. Our financial markets are unmatched in their breadth and strength. The dollar is still by far the world's leading currency.

However, the United States is not nearly so predominant in the world economy as it was in the heyday of Bretton Woods. The economic and political strength of our trading partners has grown, in relative as well as absolute terms. They are bound to look at some issues from a different perspective, and their differing views will need to be blended into a coherent whole.

It is not just that economic situations of individual countries differ—for instance, their relative dependence on external trade and capital markets and their degree of development. Intangible, but strongly felt, matters of national prestige sometimes develop, and there is a strong desire for the form and substance of symmetry and equality.

Faced with these complications and difficulties, the temptation can always arise for a large continental power like the United States to retreat from the process of negotiation and reform and to limit involvement in the world economy. But that is not today, if it ever was, a realistic course. The objective circumstances point in quite the other direction.

The growing strength of your organization reflects the fact that, even as the relative size and dominance of the United States in the world economy has been reduced, our economy has also become much more open. Our exports, in little more than a decade, have increased from 8 percent of the output of domestic mines and factories to 15½ percent. We are dependent on imported energy and other materials for a large fraction of our needs and on foreign markets for similarly large fractions of our agricultural output. Our major financial institutions have increasing proportions of their assets and liabilities overseas; some of our leading banks, generating half or more of their profits from international business, illustrate the point dramatically.

Inevitably, with few sectors of the United States economy insulated from external influence, our approach to monetary reform, as that of other countries, has to take account of our immediate economic interests. But the broader goals must remain as well, the larger vision of a developing world order, in which all countries—large and small, rich and poor—can prosper. The essential requirement is that we find ways to safeguard our legitimate interests in a framework that reconciles those interests with those of others.

The Committee of Twenty faced that issue on a large scale in attempting to deal with all aspects of the monetary system simultaneously. Perhaps it tried too much too soon. Now, we have a chance to proceed in a more evolutionary way, testing the results as we go and learning from the turbulent experience of recent years.

In this process, two priorities suggest themselves. For the longer run, we will need to take up again the old issue of how to achieve some control over international liquidity and to develop a stable and acceptable world reserve asset. More immediately, we need to see how, within the broad framework of the more flexible exchange rate practices achieved in recent years, we can achieve greater stability in market performance.

INTERNATIONAL LIQUIDITY

On the face of it, arrangements for international liquidity—its creation and composition—appear more haphazard today than ever. In the context of Bretton Woods, it was already complicated enough; the balance-of-payments positions of the reserve currency countries, the balance between the production of gold and private demands and official convertibility policies all played a part. Today, gold neither flows into nor out of reserves in substantial volume, but its price fluctuates widely in the market. Intervention practices, leading to the creation or destruction of reserves, vary greatly among countries, and there has been more desire for currency diversification in reserve holdings. The attraction of Euro-currency markets, whether for the placement of reserve assets or for official borrowings, has added to the avenues of reserve creation and opened new options for reserve holdings.

With other reserve components expanding so rapidly, the SDR—the chosen instrument for "rational" international reserve management—has understandably been held at a fixed and relatively small total. The revised valuation and interest rate formulas have made the SDR a usable asset once more in the context of a floating system, and it has received more attention as a unit of account. But, as matters stand, SDR creation is not a significant factor in determining the supply or composition of reserves. Gold is still important for some countries as a kind of residual national asset. But it stands, convicted by its own price instability, as an inactive component of international reserves.

All of this has raised two important questions. The first concerns the aggregate volume of reserves. The observable statistic is that a massive volume of new reserves has been generated by the present system—or more accurately out of the breakdown of the old. There is concern that this creation of international liquidity has contributed to strong inflationary forces in the past, and the process may be repeated.

The second question grows out of the possibility of sizable shifts in the composition of reserves among particular currencies. If such shifts developed on an important scale, they would add to exchange market instability in general and, in the view of some, to systematic undervaluation of the dollar should "diversification" out of dollars prove a lasting phenomenon.

Before approaching possible solutions to these problems, it is important to keep them in perspective. In the four and one-half years since the end of 1970, world reserves, as usually calculated keeping gold at the official price, have more than doubled in dollar terms, rising from $94 billion to over $225 billion this summer. The most rapid growth took place during the earlier part of the period, before floating exchange rates were generalized, and therefore should not be associated with that system. In fact, in 1971-72, the ratio of reserves to trade, one simple though incomplete measure of reserve adequacy, sharply reversed the long decline that had persisted over the postwar period. But the ratio of reserves to world imports then dropped again in the two years after 1972. For a sample of sixty countries, that ratio at the end of 1974 stood at 24 percent. That was the lowest point ever recorded since the series started in 1954, when the ratio stood at just over 70 percent.

The oil-related payments imbalances have, of course, affected the distribution of reserves. In fact, over the past two years, holdings of reserves by other than OPEC countries have experienced virtually no growth.

It is questionable in my mind whether the $40 billion of "reserves" accumulated by OPEC nations during that period should be considered, without qualification, as a part of the world total. Those OPEC reserves by and large are not considered by their holders as balances held against short- or medium-term contingencies—the usual function of reserves—but rather as an important element of longer term national savings, whatever the precise nature of the investment media used. Over a more distant time horizon, as their surplus oil income is curtailed, the funds may be spent. But it does not necessarily follow that reserves of other countries will then increase, since their surpluses might be used for the repayment of debt. To put the point another way, if the objective were to hold the recorded total of world reserves unchanged, the accumulation and subsequent liquidation of OPEC reserves would force sharp contraction and then rebuilding on other countries. For oil-importing countries, their willingness in many cases to engage in substantial official borrowing to maintain reserve holdings does not support the idea of an enormous surfeit of world reserves.

The parallel concern, about the possible instability of reserve currency holdings, seems to wax or wane with the performance of the exchange markets and particularly confidence in the dollar. While the statistics are not really adequate, the central banks of the leading industrial countries have not shifted any significant amounts of funds. Practices of countries that have been accumulating new reserves are more varied, however, and some have made placements in a number of different currencies.

Altogether, I do not see here cause for great immediate alarm. Nevertheless, the degree of remaining uncertainty about reserve creation and composition makes it appropriate to study techniques designed to deal with the problem. In particular, a number of proposals have been made for "consolidation" of holdings of dollars and other reserve currencies, a technique which contemplates individual countries depositing currencies with the IMF in return for an equivalent amount of SDRs. To achieve control over future reserve additions, further acquisitions of currency balances would presumably need to be limited.

In approaching these questions, I see no issue of national pride. Nor do I see any overwhelming national purpose or commercial advantage served by clinging to an exclusive reserve currency role for the dollar—a role that developed originally not out of deliberate national choice but out of a long evolution of market and reserve practices.

The real issue is whether so heavy a use of national currencies as at present contributes to the stability and adaptability of the monetary system as a whole. Consolidation of reserve currencies in concept would remove one source of instability in exchange rates and, if in fact the alternative would be some diversification out of dollars, the performance of the dollar in the exchange market might be strengthened. However, the case can easily be overstated in both respects.

Markets are affected by transactions at the margin. No consolidation plan in any relevant time horizon will dispense with a sizable volume of reserve currency holdings. Such holdings are necessary, apart from all other attractions, for intervention purposes and to provide some margin of elasticity for reserve creation or destruction. So long as a substantial volume of reserve currencies remains in the system, marginal shifts in these balances could still be a potential market factor. Moreover, continued use of the dollar as an intervention currency by others would mean that its value at times will be affected by changes in the payments position of other countries, just as at present.

More broadly, even complete elimination of reserve currencies would not insulate us or others from flows of funds in private markets inspired by swings in confidence, by differentials in interest rates, or by other factors. Private holdings of dollars—whether in the United States or abroad—are, after all, both larger in the aggregate and potentially more sensitive than official holdings.

Consolidation of reserve currencies can at best be only a step toward the further objective of regaining control over the growth of international liquidity. That objective could indeed be facilitated by wider use of a common international reserve asset on the SDR prototype. A few contingencies—such as a drain on world reserves from a persistent United States surplus sometime in the future—would then be dealt with directly. But consolidation would not by itself help with the larger problem of controlling future growth in reserves. Nor can it resolve the interesting question of just how many reserves we need or want in a new world monetary order.

Finally, a host of practical problems would need to be handled in any consolidation proposal, problems no less difficult because they are sometimes termed technical. For instance, what specific obligations would the United States or others assume if dollar balances were to be taken over by the IMF and SDRs emitted as a substitute? If SDRs are to become a much larger proportion of reserve assets, what new undertakings and obligations might be required to ensure their usability on a large scale on short notice?

In raising these questions, I want only to emphasize that the problem of controlling the size and composition of reserves will not yield to quick and easy answers. I do not mean to suggest that these issues should be removed from the agenda for reform. Indeed, the incentive for giving more concentrated attention to the problem is not entirely economic. Suspicion and concern that the United States, despite a decline in its relative economic strength, wants to maintain special and inequitable advantages for itself through a dominant role for the dollar continue to lurk in the background of monetary negotiations. That suspicion will be removed only by dispassionate study of the real issues.

THE EXCHANGE RATE SYSTEM

There is one further, and fundamental, reason why the proper approach to the problem of international liquidity will take time to resolve: the answer, in important respects, will be dependent on the kind of exchange rate system we want. Exchange rate practices are much more directly relevant to the world's business—and in the past have been a matter of high controversy. Fortunately, there are signs that a broad consensus may be coming within reach.

I have already alluded to the constructive role of flexible exchange rates in dealing with some of the chronic payments imbalances of earlier years and in coping with other strains on the world economy. But along with the good, the degree of turbulence in exchange markets from time to time has been a cause for concern. A large measure of responsibility must be assigned to the violent shocks to the system, and to the weakening of confidence in currency values generally during a period of inflation. As economies stabilize, exchange rates may as well.

Nevertheless, there is room for questioning whether a system of completely free floating rates—*if* individual countries are led to believe such a system permits full autonomy in national policy—will continue to be prone to sizable fluctuations in currency values, with adverse consequences for trade and investment over time.

Analytically, floating rate theorists have typically emphasized the benign role that "stabilizing" speculators should play in maintaining the stability of floating exchange rates. As exchange rates begin for whatever reason to deviate substantially from some anticipated longer term equilibrium, theory suggests the speculator will step in and contain the movement.

But observation shows the opposite sometimes happens; a kind of bandwagon psychology can develop as an exchange rate begins to move, say, because of a change in relative interest rates or other factors. When there is considerable uncertainty in the market about what exchange rate *is* broadly appropriate in the future, market pressures can cumulate and for a time feed upon themselves. The friendly "stabilizing" speculator is reluctant to step in.

Looking back, we have avoided the atmosphere of crisis and the sharp discontinuities in exchange rates that characterized the later years of the Bretton Woods system. However, with floating rates, actual exchange rate swings among some leading currencies have been very sizable. The typical daily fluctuation is much larger than before and, more important, changes have cumulated to as much as 15 to 20 percent over a relatively short period of time only to be largely or entirely reversed in ensuing months.

The evidence is not yet all in as to the consequences. Banks and traders have by and large coped well—substantially better than if widespread controls had been introduced in a probably futile effort to promote greater stability. However, speculative excesses have also produced some strains, and surely swings so large as we have seen in key exchange rates can have little to do with comparative advantage and the efficient allocation of real resources. In the background, the larger danger remains that fear of overvalued or undervalued exchange rates, combined with the absence of more clearly defined rules of good behavior, may tempt one country or another to take refuge in trade and payments restrictions.

Different countries will naturally attach different weight to these problems, depending on their degree of dependence on foreign trade and the structure of their trade and other payments flows. The United States, which still has a relatively smaller foreign trade sector than most other industrialized countries, will naturally weigh the gains from domestic autonomy more heavily when a choice exists. But we have had ample reason to learn in recent years that exchange rate changes are not an insignificant matter to our own economy.

TOWARD GREATER STABILITY

The exchange rate issue has long been approached as a matter of doctrine. It is somehow more satisfying to argue for the extremes of fixed and freely floating rates—both have a long intellectual history and lend themselves to rather clear rules of conduct. The trouble is neither, pressed to an extreme, fits the reality of the world we have. Maintenance of fixed rates implies a degree of international economic integration we do not have and most governments do not want or, alternatively, heavy use of controls that would themselves damage trade and capital movements. Completely free floating by all important currencies, *when* combined with the exercise of complete autonomy in economic policymaking, could risk over time a degree of economic disintegration we cannot afford. The ground in between—while perhaps less satisfying intellectually—does not seem to me a vacuous compromise. It fits the world we have.

There is some evidence that is the way the debate is moving. Some countries—as in the Common Market—will seek a large degree of "fixity" among themselves but appear willing to float *vis-à-vis* others. Other important countries—including the United States—seem likely to retain floating rates for as long ahead as we can see. There is recognition, within the context of a system in which major currencies will remain floating, of the desirability of greater stability. But stability cannot be artificially imposed. The aim must be to achieve a stability consistent with market forces, not a rigidity imposed by official action.

There are also signs, as yet inconclusive, that the markets themselves are moving toward more stability. After all, exchange rate flexibility is a very new element in post-World War II monetary arrangements, and the market and the authorities have benefited from a learning period. I am optimistic that the extreme instability of recent years will prove to have been—in retrospect—just a historical episode.

But I don't want to sit back and rely on hope alone. The chances for stability will improve as market expectations about an appropriate range of equilibrium exchange rates are more firmly established. And I believe the authorities have a role to play in the process.

Questions of confidence are paramount. Confidence in currency values is inexorably linked to confidence in the soundness of our economies, our institutions, and in the policies followed by governments to assure domestic stability.

At a much more technical level, official intervention is sometimes useful in smoothing disturbed markets. Indeed we have seen periods when the mere knowledge that the authorities were ready to move in steadied the market. When markets move to extremes clearly out of keeping with more fundamental factors, more forceful approaches have at times been helpful.

Conversely, any favorable effects will soon be dissipated if there is disarray in tactics or purposes among the principal trading nations. Moreover, no amount of intervention will be useful if it runs against fundamental market forces or if it is viewed as a substitute for other action to bring monetary and other economic conditions into closer alignment.

In other words, intervention is a tactic—sometimes useful, sometimes not. By itself, it will accomplish little if not accompanied by appropriate domestic policies, by internal stability, and by some willingness to take account of international considerations in policymaking. Floating rates are attractive precisely because they give us a beneficial new degree of freedom in reconciling our domestic policies with open international markets. But to act as though nations can have complete independence in national policy in an interdependent world would be to abuse the system. The result would be to diminish the chances for greater stability in exchange markets.

These are obvious points, and so are the difficulties in approaching better coordination of policies. All those old dilemmas and conflicts in domestic and external policy rear their heads. The United States and other nations will often find it difficult to give international considerations heavy weight. And because the exchange market is multisided, the difficulties are increased when several countries are involved.

Nevertheless, there is ground on which to build. The central problem primarily concerns a small number of major countries—if their currencies are reasonably stable, the rest can fall in place. Indeed, there is room in practice for a considerable variety of specific exchange rate practices; these can be managed without great difficulty so long as the exchange rate relationships between the United States, its European Common Market trading partners, and Japan provide a reasonably stable focus.

We have already gone a long way in developing informal consultative arrangements among these countries, and I hope an atmosphere of mutual trust and respect. Gradually, at least around the edges of economic policy, decisions can take into account the mutual desirability of relatively stable exchange markets. This seems to me possible, for instance, in shaping the precise mix of fiscal and monetary policies and their timing. Eventually, a common view can emerge as to an acceptable broad range of exchange rates—possibly deliberately fuzzy around the edges—consistent with mutual balance-of-payments equilibrium and adjustment.

That view cannot be static and rigid if we are to retain the flexibility afforded by floating rates. Over time, it is the market that has to tell us what is realistic and what is not. But we also have seen the market move to extremes, and it is those extremes that could usefully be dampened.

That will happen when expectations in the marketplace about an appropriate range of exchange rates become firmer. In the end, those expectations will need to find support and justification in the stability and predictibility of our economic policies.

CONCLUSION

We have come through these turbulent years, not unscathed, but with our monetary system operating and trade strongly flowing. In the process, we have all learned a good deal about markets, about the limits on official action, and about ourselves.

We have learned again that no international system will work well except on the bedrock of strong internal economic policies and domestic stability.

We have learned, too, that policies that may be fully responsible and adequate in a purely domestic context are not enough. We need to see how those policies fit and mesh with those abroad to assure the stability of any monetary system.

We have learned that large elements of flexibility in the international system are essential in today's world.

We have developed new habits and machinery for consultation, building on the old.

What remains is to distill from this experience the new codes of conduct necessary to strengthen the system and to assure its durability, to fill in the obvious gaps, and to bring the whole more clearly within the orbit of the International Monetary Fund.

By definition the international monetary system has to serve the needs of all nations. Success is dependent on the reconciliation of national views and mutual adjustment.

In the end, those qualities can only be maintained by understanding and impetus from the highest levels of government. That is one reason—without personally having been engaged in the planning or privy to its results—why I can see an extremely useful purpose in the Summit Conference now ending. Perhaps my view is parochial, but it seems to me a good thing for heads of government of the principal trading nations to get together and discuss economic issues, and to understand each other's problems in a way that only face-to-face discussion can achieve. Economics after all is going to have a lot to do with how well we get along on this increasingly small planet.