RECENT EVOLUTION AND PRESENT POSITION OF THE INTERNATIONAL MONETARY SYSTEM

(Remarks for delivery by the Governor of the Bank of Canada to the Second Reunion of Central Bank Governors of the American Continent, Punta Del Este, Uruguay, May 2nd to 5th, 1965).

LIBRARY FILE COPY
EXEMPLAIRE DE LA BIBLIOTHÈQUE

When I suggested that we should include on the agenda of this meeting some discussion of the recent evolution and present position of the international monetary system, I had in mind that though our main preoccupation at these meetings is to exchange views on our handling of our domestic problems and to consider the techniques of constructive regional co-operation, we all share a common interest in the proper functioning of the international monetary system. The developing countries of Latin America, no less than those of North America and indeed of the whole Free World, have a strong interest in international financial arrangements which will enable world trade to expand, which will encourage the international flow of funds to underdeveloped countries for productive investment, which will help the large industrial countries to maintain their balance of payments on a basis which does not inhibit the flow of imports or foreign aid. In addition, of course, the countries of Latin America have their own particular problems which must be taken into account in the further evolution of the international monetary system.

It may be appropriate to begin these remarks on the evolution of the international payments system by recalling the important developments which have occurred since our last meeting in Guatemala a year ago. Last summer you will recall that two important studies dealing with the international monetary system and the probable future need for liquidity appeared. One of these studies was prepared by the staff of the International Monetary Fund, the other by what is popularly known as the Group of Ten, that is the Ministers of Finance and central bank Governors of the ten countries, including Canada, participating in the Fund's general

Arrangements to Borrow. While these studies were not definitive in their conclusions regarding the future evolution of the world payments and reserve system, they provide a valuable appraisal of the system as it now exists and have helped to direct attention to the problems requiring additional study. In general, both studies conclude that the present international payments system, based on the price for gold and fixed exchange rates, provides a foundation on which to build and that the existing supply of international liquidity is adequate for the present. At the same time both studies note that in the longer run there is a possibility that the supply of gold and foreign exchange reserves may prove to be inadequate for the over-all reserve needs of the world economy.

The Fund study suggested various ways in which the Fund might enhance its contribution to the supply of international liquidity. The study prepared by the Group of Ten made two concrete proposals. The first involved giving support during the pending quinquennial review of International Monetary Fund quotas to a "moderate" general increase in member quotas and to a relative adjustment of those individual quotas which were "clearly out of line". The second involved strengthening the techniques of international monetary co-operation and consultation which have been developed in recent years, in particular by agreement among the ten participating countries to collaborate in "multilateral surveillance" of the ways and means of financing balance of payments disequilibria. In addition, the report of the Group of Ten suggested that certain special studies should be undertaken without delay - it recommended the establishment of a study group to examine various proposals regarding the creation of some new form of reserve asset, either through the International Monetary Fund or otherwise, and invited Working Party 3 of the O. E. C. D. to take charge of a study on the processes and procedures for maintaining balance of payments equilibrium.

What have been the concrete results of the various conclusions and proposals arising from these efforts? The first and most important of course was the decision of the Board of Governors of the Fund at the annual meeting in Tokyo last September to request the Executive Directors to undertake a review of the proposals to increase the general resources of the Fund. As you know the Executive Directors recently completed their discussions and recommended two proposals for adoption by the Governors - namely (1) a general increase of 25 per cent in members' quotas and (2) special additional increases for sixteen countries (including Mexico, Venezuela and Canada) whose quotas were clearly out of line in relation to their relative economic growth and their position in world trade. The Governors have now indicated their acceptance of these recommendations and all that is now required to make the proposal effective is the necessary legislative approval of member Governments. If all the proposed quota increases are taken up the total resources of the Fund will be increased from their current level of $16 billion to about $21 billion - an important and extremely helpful supplement to international liquidity.(1) This follows the important contribution of over $6 billion in supplementary resources made available to the Fund for a five year period by a number of industrial countries under the General Arrangements to Borrow, which became effective in October 1962.

In addition, the machinery for the conduct of "multilateral surveillance" has been established through the facilities of the Bank for International Settlements and the O. E. C. D., and special study groups are undertaking the investigations proposed by the Group of Ten with regard to the

---

(1) The quotas of the 19 Latin American members will be increased by $450 million to $1,795 million as a result of these proposals.

possible creation of some form of supplementary reserve asset and the achievement of more effective adjustment of balance of payments disequilibria.

The underlying concern throughout these discussions of course has been whether or not present arrangements are likely to provide adequately for the world's rising needs of liquidity as world trade continues to grow. Is there a danger that inability to meet these growing needs will inhibit the expansion of world trade and hence of economic growth as well? Along the way, another question has frequently arisen - do present arrangements facilitate or impede the process of adjustment of the imbalances which arise from time to time in the payments position of individual countries - a process of adjustment which is continuously required if the international monetary system is to operate satisfactorily?

It may be useful at this point to refer briefly to the nature of present international monetary arrangements and how they evolved. The gold exchange standard as it developed in the period between the two world wars represented a substantial modification of the gold standard which had operated prior to 1914. Put in its simplest terms it was a system in which national currencies - notably, the pound sterling and the United States dollar - increasingly acted as supplements to and substitutes for gold. Such a system of course demands complete confidence in the national moneys which are held as an alternative to gold in international reserves. In this system gold remains the ultimate or basic form of international exchange. The possible vulnerability of a currency exchange standard in periods when a loss of confidence in the reserve currencies occurs was dramatically evident in the crisis of 1931 and the disorganization of the international monetary system which ensued.

Following the Second World War, important modifications were made to the system as it had existed during the inter-war period. By far the most important of these of course was the creation of the International Monetary Fund, about which I shall have more to say later. In addition, however, there was, with the weakening of the economic position of Britain (reflected in the long period of sterling inconvertibility), an increasing reliance upon the United States dollar as the principal supplement or substitute for gold. The relative ease with which this transition occurred in the early post-war period was due in considerable measure to the extremely generous grants and long-term loans which were given by the United States at the time to facilitate the rapid reconstruction of war-ravaged countries. Throughout the period in which the threat of a serious dollar shortage prevailed, this substantial outflow of aid to developed as well as to the less-developed countries prevented the emergence of a serious liquidity problem.

During the 1950's a gradual shift occurred in the balance of payments position between the United States and the countries of Western Europe. As the outflow of official aid payments by the United States to these countries dwindled, the outflow of private capital began to rise and accelerated sharply toward the end of the 1950's. As a result a sizeable net flow of capital from the United States to Western Europe continued even after Europe had completed its post-war reconstruction and was able to finance its imports from its greatly expanded export trade, i. e. without large net inflows of capital. In recent years, therefore, this large movement of private capital has contributed on the one hand to the substantial over-all deficit in the balance of payments of the United States and on the other hand to a steady build-up in the gold and foreign exchange holdings of the continental European countries.

Earlier I mentioned the great importance which I would attach to the role which has been played by the International Monetary Fund in the post-war period and the extent to which the existence of the Fund has improved and strengthened the functioning of the gold exchange standard compared to the years prior to World War 2. By making available substantial short-term credits to countries in balance of payments difficulties, it has provided borrowers with the time needed to make necessary adjustments and work out policies in ways that are much less disruptive than used to be the case. It has achieved - more effectively than all but the most optimistic would have expected at the time of its organization at Bretton Woods - the major objectives of exchange stability, convertibility and non-discrimination in transactions among the major trading nations of the world. Moreover, in contrast to the mechanistic workings of the gold standard in its classic form, these international objectives have been substantially achieved without the sacrifice of national economic objectives to sustain rapid economic growth and high levels of employment in the major industrial countries. When one looks back on the performance of the system since the organization of the International Monetary Fund, and especially if one contrasts this performance with that of the inter-war period, I think that one must recognize that it has worked remarkably well and that international and national economic objectives have been reconciled to a much greater extent than ever before.

Nevertheless, in the last few years signs of strain have emerged. These have been due to the continuation of large deficits by reserve currency countries on the one hand and the concentration of the offsetting surpluses in the hands of Western European countries which, for one reason or another, have not developed compensating capital outflows. The result has been a growing concern on the part of the surplus countries of Europe regarding the possible inflationary dangers arising from the undesired accretions to their exchange reserves, at a time when their economies are already at full stretch. More seriously, this concern has been accompanied by some questioning of the basic functioning of the system which enables the reserve currency countries to continue to run large payments deficits without being forced to take adequate corrective action, and hence by a reduced willingness on the part of surplus countries to continue adding these currencies to their rising exchange reserves.

It is in the light of these evidences of strain in the system that the present balance of payments problems of the United States have come to assume a central position. As I have already mentioned, the deficit in that country's international balance of payments at the present time does not arise from any weakness in its current account balance. On the contrary, in 1964 the United States generated a commercial surplus on goods and services of close to $7 billion. Rather the deficit arises entirely from very large financial outflows. The United States has much the largest and most accessible capital market in the world, and private U. S. corporations have greatly increased their investment in other parts of the world. In addition to this, the United States has provided very large economic aid to other countries and, in pursuit of its world-wide responsibilities, has incurred heavy military expenditures abroad. More recently U. S. banking services to residents of other countries have been extended on an unprecedented scale. At the same time the United States Administration has been concerned with maintaining a domestic economic environment which would promote the highest rate of growth in national output consistent with internal stability and the reduction of unemployment below the relatively high rates which have persisted over recent years. Consequently the United States has been extremely reluctant to use the traditional weapon of high interest rates to restrain these very large outflows of private capital for fear that this might dampen the healthy and highly satisfactory rate of economic growth that has been sustained since the beginning of 1961.

On the other hand, European authorities have been faced with a dilemma which is almost the exact opposite of that confronting the authorities in the United States. In these countries, most of which have been operating at levels very close to the limit of their capacity for a number of years, the dangers of "over-heating" have been a persistent threat to internal stability, and increasing concern has been evident over the degree of inflation which has been experienced in the last few years. In these circumstances the sizeable net capital inflows which have been the counterpart of the deficit in the U. S. balance of payments are regarded as an unwelcome supplement to the inflationary pressures already threatening domestic economic stability. While a good argument can be made that the structure of European interest rates is inappropriately high, and that this reflects to some extent at least the inadequate development of capital markets in some of these countries, European authorities at the present time are understandably reluctant to have recourse to measures which, while deterring capital inflows, might increase the dangers of domestic inflation. In this connection I might say that Working Party 3 of the O. E. C. D. is providing an extremely valuable forum for frank and open discussion between the principals in this debate. Such mutual consultation is especially desirable at a time, such as the present, when as I have suggested there are genuine differences of view as to the precise mix of domestic policies that may be appropriate to the particular circumstances of individual member countries.

One consequence of the weakened position of the two main reserve currencies has been that the discussion of the further evolution of the international monetary system during the past year has not been as purposeful and concrete as one would have hoped. This stalemate has, moreover, opened the door to some disturbingly extreme views, exemplified by the proposals for a return to the gold standard which are currently being promulgated in certain quarters. To me the present impasse underlines the importance which must be attached to the efforts of the United States and British authorities to restore equilibrium to their balance of payments positions. Only when the efforts of these two countries have met with success will they be able to resume their proper and influential role in the discussions about the future evolution of the international payments system. At the same time, I think a strong possibility exists that, as these countries - and particularly the United States - approach their objectives of overall balance, further development and modification of the international system will be needed.

In the first place the annual increase in official gold holdings alone cannot be relied upon to provide sufficient liquidity to meet the needs of an expanding world economy. Nor can we expect the necessary supplement to liquidity to be dependent upon the resumption of large payments deficits by reserve currency countries. New solutions must be sought - solutions which ideally should make the creation of liquidity subject to more rational and more conscious control than was possible either under the original gold standard system or under the gold exchange standard system as it has operated to date. Such rational and conscious control must of course steer for the narrow course that lies between inadequate and unduly rapid expansion of liquidity. This expansion must be large enough to prevent sound economic growth from being inhibited by a scramble for reserves but not so large that the essential element of discipline in the international payments system is lost. Such an ideal course is not an easy one to achieve but, difficult as it may be, it is essentially the same goal which we central bankers must always strive to achieve in our domestic monetary management.

As to the mechanism that should be adopted, I do not rule out the possibility that the solution we seek may be attainable by the appropriate enhancement and adjustment of the resources and machinery of the International Monetary Fund. But neither do I rule out the possibility that in addition we may have to adopt some more radical solution such as one of the various proposals to create a new composite currency for holding as an exchange reserve asset. The latter question of course is under active study at the present time by officials of the Group of Ten countries, and I do not propose to pre-judge the conclusions which may be reached in these discussions. Moreover, there are inevitably delicate questions relating to the control and management of such a system which may call for difficult compromises. I would hope that in the event that some new form of reserve asset is brought into being that it will not be necessary to adopt a system which places its operation and management wholly outside the aegis of the International Monetary Fund. It would be regrettable if a consequence of the creation of a new reserve asset were to be the establishment of a second, completely autonomous international monetary authority. In the search for the best solution to the problem of maintaining adequate international liquidity, the most important thing will be for all of us at this time to be receptive to new ideas and to be willing to examine closely all responsible suggestions that are offered by experts in the field.

So far in these remarks my comments have been directed toward the problem, as viewed by one of the active participants in the discussions which have been taking place over the last year or two. Before concluding I would like to say something about the significance of recent developments in the international monetary system for the countries of Latin America. There is one point in particular on which I can assure you that Canada's concern comes very close to those of Latin America - namely the vulnerability of our economies to major economic dislocations in the main industrial countries of the world. Canada, like many countries of Latin America, continues in its export trade to depend heavily on the sale of foodstuffs and industrial raw materials to the United States and other major industrial countries. We are most conscious of the importance to our own national well-being of a satisfactory evolution of the international monetary system. Recurring major balance of payments crises among the larger industrial nations or the retardation of growth in these countries as a result of a failure to make necessary improvements and modifications in the system poses as serious a threat to Canada's economic prospects as to any country in this hemisphere. It is, therefore, I think a matter to which we all need to give the highest priority at this time.

I realize that unlike Canada many of the countries of Latin America in common with most of the less-developed countries of Asia and Africa suffer from a persistent tendency toward inadequate levels of exchange reserves and that this shortage ranks very high among your problems. A good international monetary system must take account of this problem. However, in my opinion this problem of reserve shortage is not in essence a reflection of inadequacies in the international payments system. While these may tend to aggravate the shortage, the fundamental reason for the low level of reserves in many of these countries arises from their very high propensity to import and from the simple fact that most rapidly developing countries cannot afford to hold a significant proportion of their resources in the form of exchange reserves. Because this is so I think it is very important to make a clear distinction between proposals to reform the international monetary system and proposals to improve the allocation of international resources to meet the needs of developing countries. I do not feel that it is practical to attempt to blur this distinction by reforming the international monetary system in such a way as to try to settle both problems in one neat package. A resolution of present problems in the international monetary system is a necessary pre-condition to more vigorous efforts to confront the grave problems and difficulties associated with the economic development of the less-developed regions of the world.

It is probable that even when further progress has been made in our international payments arrangements the scarcity of resources available to hold in the form of international reserves will continue to confront many countries in Latin America and elsewhere. For this reason the careful examination to co-operative pooling arrangements such as we have been considering at this meeting represents, in my opinion, a constructive step. In addition the probability that the problem of reserve shortage will be a continuing one emphasizes the importance which must be attached to strengthening the invaluable role which the International Monetary Fund can play by providing a second line of defence when exchange reserves prove inadequate. Ultimately of course none of us can escape the fundamental concommitant that the proper management of our national economies remains of the first importance. However much further progress we may make in improving the machinery of the international monetary system, no arrangements can ever in themselves be a substitute for the application of sound policies at home.