WEAKNESSES IN THE PRESENT INTERNATIONAL MONETARY SYSTEM

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I. INTRODUCTION

In view of the persistent deficit in the U.S. balance of payments, the failure of new gold production to keep pace with the expansion of world trade, the recent worsening in the U.S. trade position and the rapid decrease official gold holdings, the frequent devaluation of British sterling, the two-price gold agreement of 1968, and the franc-mark crises of 1968, the agreement of the creation of SDR's, and the U.S. termination of convertibility of dollar claims into gold, it is not surprising that there has been much debate on major changes or reforms in the world monetary and payments system.

Central banks have been increasingly unwilling to accumulate dollar as

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an international reserve asset and people have lost faith in the convertibility of dollar into gold and frequent speculations on gold have been occurred. Finally in Sep., 1971, the U.S. declared the termination of dollar convertibility into gold. These recurring monetary crises described above express themselves evidently that the present international monetary system has been unstable and contained serious defects. Then, what are the defects and dangers of the present gold exchange standard?

This paper is designed to discuss the international financial developments and problems of the present system of gold exchange standard and to suggest some alternative solutions to them. Before discussing this, I am going to have a brief description of the history of the present gold exchange standard.

II. HISTORICAL BACKGROUND

In 1914, World War I ended the brilliant 40-year record of stable exchange rates under the aegis of an international gold standard, and the seeds of various trade and exchange controls began to appear. Many critics alleged that exchange-rate stability under the gold standard was achieved at the expense of a general deflation of prices, wages, employment and income in the gold-losing countries, while the reverse conditions were simultaneously developing in the gold-receiving country. In other words, international stability was achieved at the expense of the domestic instability. After the collapse of the gold standard, the gold exchange standard was adopted and believed to overcome the weaknesses of the gold standard. Under this system, international reserves are consisted of not only gold but one or more national currencies as well. Sterling was the largest component of the key-currency reserves, but the continuous increase in the British short-term monetary liabilities led to bring about a collapse of the system through the gradual weakening of foreigners' confidence in sterling. The collapse in 1931

was brought by large shifts of sterling balances into gold and dollars, leading to the devaluation of sterling. This led to the shrinkage of the international credit, competitive devaluation among countries, and temporary break-down of the international monetary system. After World War II, there was a revival of gold exchange standard; however, sterling by this time lost the status of major reserve currency and the U.S. dollar took its place and has since been playing the role of major key currency. The process of the present international monetary and payments system has been regulated by the IMF.

III. THE WORKING OF THE GOLD EXCHANGE STANDARD

Since the present international monetary system under the gold-exchange standard has worked under the aegis of the IMF, it might be helpful to have some acquaintance with the operations of the IMF. Under the gold-exchange standard, one or more currencies are fixed in terms of gold and become key currencies or reserve currencies to which other national currencies are tied and in terms of which international reserves are in part kept. Dollar shares with gold the status of a major international reserve.

The Principles of the Fund

(1) Stability of exchange rates: This principle is embodied in the obligation of each member of the IMF to declare a par value of its currency in terms of gold or dollar, and to refrain from changing the par value, except to correct a fundamental disequilibrium. Market rates of exchange are to be kept within 1% of the par value. A change of more than 10% in the par value of a currency has to be approved by the Fund. In general, the Fund will agree to a change in par value beyond the 10% limit only if the country's balance of payments is in a state of fundamental disequilibrium. The purpose of this rule is to prevent undue fluctuation and undue depreciation in exchange rates.

(2) Freedom of current-account transactions from quantitative controls: Regulation of exchange rate changes is supplemented by an additional function of the Fund; namely, elimination of foreign exchange restrictions. In essence, Article III urges a system of convertibility of each currency on current account transactions. However, controls over capital movements are permissible. The purpose of this regulation is the establishment of a multilateral system of payments in respect of current transactions between members and the elimination of foreign exchange restrictions which hamper the growth of world trade.

(3) Revolving pool of credit (drawing rights) available to members suffering temporary balance of payments deficit: The financial powers of the Fund are based on the substantial resources that it commands and that it uses to defend the par value system. Each Fund member has to contribute a quota that is paid upon admission with one-fourth of the quota paid in gold and the remainder in the member's own currency. Member countries can draw on gold tranche almost automatically, but the credit tranche position is conditional liquidity. In addition, the Fund can supplement its resources by borrowing. Under the General Agreements to Borrow, effective Oct., 1962, the Group of Ten agreed to provide the Fund with stand-by credits up to $6 billion in addition to their subscriptions to the Fund. The borrowed reserves are considered as temporary help and have to be paid within three or five years. Besides these resources, a mutual credit arrangement (or a currency swap system) has been worked out to help protect countries against speculative ruins on their currencies. Moreover, a new international reserve asset has been created in the form of Special Drawing Rights (SDR's) in the IMF to supplement international liquidity. The resources of the Fund are used to help members who experience temporary disequilibrium in their balance of payments. Each country has drawing rights on the resources of the Fund. The purpose for which the Fund's resources are to be made

available is to be that of providing members with an opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

IV. THE DEFECTS OF THE GOLD EXCHANGE STANDARD

In the following, I intend to discuss the weaknesses of the gold exchange standard in terms of adjustment problem, the liquidity problem, and the confidence problem.

1. Adjustment problem

Seasonal and minor cyclical balance of payments deficits may not require an adjustment if the country's international reserves are sufficient. Also the volume of such reserves affects the promptness and speed of the adjustment required in dealing with more serious deficit or sustained surplus positions. However, there can be no doubt that sometimes adjustments must be made and accordingly, that workable adjustment mechanisms should be available for use when required to restore the country's international equilibrium.

Under the present system, there are two generally recognized and accepted adjustment mechanisms: first, internal deflation for use in times of balance of payments deficit and internal inflation for use in times of surplus; and second, currency devaluation for times of deficit and revaluation upward for times of surplus.

The direct impact of inflation-deflation mechanism is on domestic economic activity, with repercussions on international transactions. The direct impact of devaluation-revaluation mechanism is on international transactions, with domestic repercussions. Both deflation-inflation and devaluation-revaluation mechanisms are intended to be neutral in their effects on different sectors of production, but some distortion is inevitable because of differences among industries in elasticities of demand and supply.

Many economists argue that an adjustment of monetary and fiscal policies cannot fully answer the disequilibrium problem. They contend that a decrease of spending by the deficit country and an increase by the surplus country will, of course, restore external balance, but will also aggravate each country's domestic problem and that an increase of spending by the deficit country and a decrease in spending by the surplus country will restore internal balance all around, but will work to aggravate the payments problem. Major industrial countries being well diversified, don't often display the rigid combinations of deflation-cum-deficit and inflation-cum-surplus since the many disturbances affecting their foreign trade tend to average out rather than accumulate. On the other hand, less-developed countries display these combinations frequently and painfully, because their economies are not well diversified; and there is insufficient averaging of trade-balance disturbances and when those disturbances appear, large changes in terms of trade are sometimes needed to re-establish external and internal balance.

Experience has shown that the deflation-inflation mechanism, although well adapted to cope with minor disequilibrium that arises out of unequal rates of growth and inflation among countries, is not likely to be used with sufficient strength in cases where the disequilibrium is substantial, or where there is a conflict with important objectives of domestic economic policy. Countries with balance of payments surpluses are reluctant to adjust by allowing the increased liquidity to raise the prices in their country and allow to accumulate reserves, largely because they are afraid that this would impair their export capacity. On the other hand, less-developed countries cannot or will not hold reserves but prefer to use international reserve assets to acquire goods and services. Thus when they incur balance of payments deficits, they must contract income sharply to reduce their deficit or they must incur more interest-bearing debt. Servicing this growing foreign indebtedness creates subsequent needs for foreign exchange which may cause

imports to be curtailed later. Alternatively, faced with a balance of payments deficit, they may devalue, thereby hoping to improve their export surplus. But repetitive devaluation further discourage private capital inflows. some people call this problem development problem.

One major exception permitted in the GATT rules as a method of overcoming serious balance of payments deficits is import quota. The import quota can indeed be made an effective instrument for temporary correction of a balance of payments deficit. However, quotas are almost always imposed for the benefit of specific industries so that whatever balance of payments benefits may be derived, they are accompanied by the damage done through the misallocation of resources.

Devaluation is not entirely ruled out when fundamental disequilibrium is present. What was sought by the IMF was a mechanism to avoid competitive devaluation as an alternative to domestic policies to eliminate short-term cyclical disequilibrium. There are some who argue that the gold exchange standard merely delays this form of adjustment and makes it bigger when it comes. The present arrangement removes the restraints of the gold standard, but does not remove the incentive to devaluation. Thus, it contains the rigidity of the gold standard as well as the uncertainty of the freely fluctuating rates.

Member countries peg their par value of the currencies when they join the IMF. Hence, the present international payments system, by providing for fixed exchange rates through the IMF, tends to obscure the supply and demand forces; and psychological barriers to taking actions of devaluation make countries reluctant to devalue. If the adjustment process delays too long, the prospective par changes cause massive speculation and where reserve currencies are concerned, also threaten to destroy international liquidity. This is a defect that arises out of the present payments system. Since par changes are so disruptive under the present system, there has

been a tendency to make sure that any devaluation that did occur was adequate, with the consequence that changes have gone farther than was necessary and so created subsequent problems for other countries.

Devaluation is a most serious matter that may impair credit position of the country and faith in its currency as in the case of pound sterling held as official reserves by other countries. These disruptive effects of devaluation on financial markets are too clear. It is in the retroactive impact side, that is, with respect to capital transactions in which destructive speculation is encouraged by continued deficits and surpluses. The revaluation of a national currency also disrupts financial markets and gives rise to speculation. It adversely affects domestic creditors holding foreign currency obligations. Moreover, repetitive devaluations further discourage private capital inflows and persistent disequilibrium leads to an acceleration of hot-money flows.

For the U.S. to consider the use of devaluation has been more difficult. The U.S. is under great pressure not to change the gold content of dollar, even in the face of a prolonged deficit in its balance of payments. Were the dollar to be devalued, not only would foreign owners of dollars be subject to capital losses, but the dollar would probably lose its status as a reserve currency. This would be a heavy blow to the present international monetary system. Therefore, adjustment through repegging operations loses its applicability to the U.S.. In effect, this means that the U.S. is subject more to a gold standard type adjustment mechanism than to an adjustable peg adjustment mechanism. However, some observers argue against this position. They contend that the present system is deficient, because it unduly weakens normal balance of payments disciplines for the reserve currency countries, but rather harsh discipline on other countries. They charge that the system has given too much time for adjustment to the reserve countries and too little to the others.

We have seen how national authorities may be induced to deviate from

the rules of the game, not only by refraining from activation of policies impelling adjustments within a reasonable period of time, but also by actively intervening to delay the process. Many have criticized that the present international payments system, as a consequence of slow, or even worse, incomplete adjustment, allows the accumulation of international reserves in countries that do not need them, and the drain from countries that do need them. Our present payments system deteriorates because of the inability of the countries to reach an accord on the nature and scope of policy actions required both by countries in surplus and those in deficit. Under the present IMF system, there are no clearly accepted rules of the game as to which countries should make an adjustment to the balance of payments disequilibrium. Countries in balance of payments deficits cannot expect countries with surpluses to finance their deficits by granting them endless credits. Ever-increasing credits would contribute to world-wide inflation. Moreover, the longer the unbalancing factors are allowed to continue, the more the damage that might be done to the cost structure of deficit countries.

Some experts, like Prof. Friedman, allege that the solution to the dilemma of devaluation is to set up a freely fluctuating rate system. They maintain that the major advantage of a freely fluctuating rate system lies in the tendency of the balance of payments to "look after itself", that is, to evoke the appropriate corrective forces when it is in disequilibrium. They argue that under this system at no point is specific policy action required to balance international payments, thus freeing economic stabilization policy to seek to attain public ends for other economic objectives. A system of fully flexible exchange rates would make speedy changes in terms of trade, correcting trade balance disturbances whenever they arise.

Several uncertainties, however, are associated with the smooth functioning of floating rates. It is not clear what the elasticities of the demand and supply curves in the foreign exchange market are nor upon what they depend.

Thus, whether the change in exchange rate is caused by a shift in the supply of, or in the demand for, foreign exchange, one cannot be sure how much the exchange rate will actually move. If it does not move much, then the burden of adjustment will fall up on income and employment, exactly the situation the system was supposed to alleviate. Moreover, if small changes in the exchange rate lead to expectations of further changes in the same direction, speculators could hinder rather than help stability, adding to the amplitude of the fluctuations in exchange rates. The latter in turn might disrupt the trade account as well as retard the flow of nonspeculative capital across national boundaries.

Another criticism against the fluctuating exchange rates is the uncertainty with respect to the value of all international financial assets. International money market is unthinkable without any interference in respect to sufficient demand and supply volume. If a freely fluctuating exchange rate is established, it is unlikely that internal economic institutions would stand still. Opening up national economy by international mechanism would cause great resistance. In actual fact, it is technically impossible for all countries to have freely fluctuating exchange rates.

Then, how can we handle the problem of devaluation? It seems to me that a combination of flexible exchange rate and devaluation mechanism can be work out. In this regard, there is an interesting proposal on change in exchange rates, that is, sliding parity system (band proposal). The novelty of this system lies in the notion of retaining the official par value support as well as the band of permissible variation in about that par but making the former unilaterally adjustable both directions up to an agreed-upon maximum rate of change per unit of time. The proponents of the sliding parity system of exchange rates argue that it would substitute small but continuous variaiton around the permanently fixed parity for the present artificially delayed and abrupt changes in parity. It would, therefore, avoid the rigidity

of the present par system, while preventing undue fluctuations in exchange rates that would result from à system of freely fluctuating exchange rates. The present system allows 1% change around the par value. However, we can allow 2% or 3% change in exchange rate around the par value in the sliding parity system, thus giving more flexibility. By adopting the sliding parity system, we can find the signal about the need of devaluation and appropriate or inappropriate price of exchange rates if the exchange rate changes consistently with some range over considerable time. Thus we can expect the effect of devaluation and get the benefit of flexible exchange rate by the operation of this system. Next, let's turn to the liquidity problem.

2. Lqiuidity problem

The failure of gold production to keep pace with the expansion of world trade, the persistent balance of payments deficits of the U.S., the sharp increase in the U.S. short-term liabilities against foreigners, the substantial fall in the gold stock of the U.S., and consequently the increasing unwillingness of the monetary authorities to accumulate dollar as international reserve have given rise to debates on the adequacy of international liquidity and proposals of reframing the present system among monetary authorities. Under the gold-exchange standard, the gross total of international reserves increases not only with the official gold stock but also with the amounts of reserve currencies which the reserve-currency countries supply and which other central banks are willing to hold. In addition to gold and reserve currencies, certain drawing rights on the IMF, that is, gold tranche position, are sometimes counted among the foreign reserves of the national monetary authorities. Since the creation of the Special Drawing Rights by the IMF members, international liquidity is now composed of gold, foreign-exchange reserves, supplemented by the IMF reserve positions and SDR's.

The rate of growth of the gold stock available for holding as monetary

reserves has in the postwar period fallen substantially short of the rate of growth of demand for international reserves by countries and these countries have made up the difference by accumulating dollars. These dollars, in turn, have been supplied through a sustained U.S. balance of payments deficit. As we can see from Table I, the relative position of gold among world reserves has decreased substantially from 68% in 1950 to 40% in 1970. The total stock of monetary gold has decreased since 1966, largely due to the private hoarding and speculation, and even the gold production itself has decreased since 1965, and increase in its production has been immaterial in recent years.

On the other hand, the reserve-currency position has increased from 29% in 1950 to 47% in 1970. It is noteworthy that the claims against the U.S. have actually increased since 1951 and most of the increase in foreign exchange has come from the increase in the U.S. balance of payments deficits—especially from the sharp increase in the U.S. short-term liabilities. The reserve position in the IMF has increased substantially by more than four times, from only 3% in 1950 to 14% in 1970, including SDR's.

〈Table 1〉 **World Reserve Composition and Growth** (in billions of dollars)

Year	Gold		Foreign Exchange				Position in IMF		Total	
	Amount	%	Total	%	U.S.	U.K.	Amount	%	Amount	%
1950	33.8	68	14.7	29	4.4	7.8	1.7	3	50.2	100
1955	35.4	64	18.8	33	7.9	8.1	1.9	3	56.1	
1960	38.0	60	21.7	34	10.5	7.6	3.6	6	63.3	
1965	41.8	59	23.4	33	13.7	7.5	5.4	8	70.6	
1966	40.9	57	24.9	34	16.0	6.9	6.3	9	72.1	
1967	39.0	53	28.6	39	21.8	6.8	5.7	8	73.3	
1968	38.9	51	31.3	41	23.8	7.1	6.5	8	76.7	
1970	37.2	40	44.0	47	36.8	7.2	7.3 SDR5.8	14	94.3	
1971May	36.9		48.7							

(Source: International Financial Statistics, IMF, Sep. 1967, Aug., '71)

At the end of World War II, Europe and its currencies were in a condition of collapse. Further, the U.S. had the productive capacity upon which Europe had to depend for reconstruction and the U.S. also held nearly two-thirds of the world gold stock. All of this argued that the dollar had to become the world trading currency and thus also its major reserve currency. The gold exchange standard built upon the dollar as a reserve currency was, in part, a contrivance to allow the U.S. to run deliberate balance of in payments deficits, in effect both supplying materials for reconstruction and also financing the transfer of the same. It is indeed the persistent decline in the U.S. reserve position which has been by far the major source of supply for the very satisfactory growth of the other countries' reserves since 1949. In the early postwar period, the deliberate deficits run by the U.S. were regarded as desirable since they enabled other countries to build up dollars as reserves and to use them to acquire goods to rebuild their economies. The deficits of the U.S. and the U.K. at first were not regarded as evidence of disequilibrium in the balance of payments of these reserve currency countries. However, in 1958 major industrial countries could make their currencies convertible, and since then they have been increasingly unwilling to accept unlimited amount of these dollar claims as reserves. More and more people began to doubt whether this steady excess supply of dollar liabilities could be absorbed without limit. With such doubts becoming more widespread, the willingness to accept further dollar claims has reduced, and

〈Table 2〉 U.S. Balance of Payments (on liquidity basis) & Gold Holdings

(in billions of dollars)

Year	1953	1957	1958	1960	1963	1965	1967	1969	1970
B/P	−2.18	0.6	−3.37	−3.90	−2.67	−1.34	−3.54	−7.06	−4.71
Gold	22.09	22.86	20.58	17.80	15.60	13.87	12.13	11.86	11.07

(Source : U.S. Department of Commerce, Office of Business Economics, and International Financial Statistics, IMF, Aug., 1971)

fears regarding the future value of dollar have become increasingly serious. Thus, people began to convert dollar claims into gold.

As can be seen from Table 2, U.S. gold stock has fallen substantially, its short-term liabilities (Table 1) have increased sharply, its balance of payments has shown a persistent deficit, and consequently, its net reserve position has deteriorated continually.

The U.S. gold losses of about $3 billion in 1958 were beginning to create some concern about the continued deterioration in the U.S. net reserve position. The U.S. has lost about $10 billion worth of gold while its short-term obligations to foreigners jumped by over $10 billion by the end of 1960. Beginning in 1960, steps were taken to reduce the U.S. balance of payments deficit; the deficit nevertheless has persisted, although at substantially reduced rates. These facts have led many observers to conclude that the world was witnessing a crisis in confidence about the ultimate ability of these reserve currencies to continue to serve as reserve assets. Moreover, even if they continue to so serve, other countries show a pronounced unwillingness to accumulate a additional reserves in this form. This would cause a liquidity problem.

Opinions differ on the need for more liquidity. Some bankers, notably Europeans, argue that there would be plenty of liquidity and they suspect in the liquidity thesis a convenient cover for an attempt of the U.S. and the U.K. to elicit from surplus nations an advance underwriting of future deficits, relieving the deficit countries from harsh but healthy balance of payment disciplines. Thus they have put pressure on the U.S. and the U.K. by converting claims into gold. On the other hand, the key-currency countries emphasize the inadequacy of gold production to satisfy future liquidity requirement in an expanding world economy rather than the weakness of their own monetary positions. They would like this gap to be met through

agreed limitation on gold holdings and the continued use of their currencies as international reserves.

It is difficult to determine precisely what level of international reserves should be considered adequate. Many experts prefer to rely on the numerical ratio between aggregate reserves and imports. Any reduction in the ratio indicates to them that the growth of international reserves has been inadequate. This, however, presupposes that the ratio was just right at the outset.

〈Table 3〉 **World Trade and International Liquidity (in billions)**

Year	1950	1955	1957	1960	1962	1965	1968	1969	1970	1971(IQ)
Imports	59.7	89.3	108.2	118.6	131.5	175.2	225.1	255.8	292.7	306.7
Reserves	49.7	54.2	56.3	60.5	63.1	70.7	77.0	77.7	92.0	98.7
%	83	61	52	51	48	40	34	30	31	32

(Source: International Financial Statistics, IMF, Aug., 1971)

As can be seen from from Table 3, the ratio of the total reserves to imports has fallen substantially from 83% in 1950 to 31% in 1970. Thus it may be interpreted that international reserves has been insufficient. Nevertheless, if the ratio had been more than adequate in the beginning, a decline in this ration need not imply that the reserves have become inadequate. There seems to be agreement among observers on the adequacy of global reserves throughout the 1960's, since no persuasive evidence of either world inflation due to excess reserves or deflation due to reserve shortages exists. Moreover, it does not appear that growth in world trade has been held back in recent years by an insufficiency of world reserves.

The various proposals for reform of the international payments system arise from the concern that if dissatisfaction arises in official quarters about current or future failure of the international monetary system to provide increases in reserves, nations may adopt unnecessary restrictive policies on international trade and capital movements, leading to fall in world trade volume.

The fatal weakness of the gold exchange standard seems to be that world reserves can be increased to maintain an adequate growth only to the extent that the key-currency countries are willing to let their net reserve position, on which the system is primarily dependent for its continued operation, weaken through increases in their short-term monetary liabilities unmatched by corresponding increases in their own gross reserves. If they allow this to happen, however, and to continue indefinitely, they tend to bring about a collapse of the system itself through the gradual weakening of foreigners' confidence in the key currencies. Another absurdity of the gold exchange standard is that it makes the international monetary system highly dependent on individual countries' decisions about the continued use of one or a few national currencies as monetary reserves. The long-run problem surrounding the present system is how we can ensure a growth in world reserves since the world appears reluctant to accept additional dollars which come from continued balance of payments deficits on the part of the U.S.. If world reserves do not increase adequately, there would be a fear that countries will take restrictive actions on trade as well as capital movements to prevent a sitaution from arising in which they cannot pay for their deficits by draining down accumulated reserves.

To solve the problem of the impending shortage of international liquidity, international financial authorities agreed in 1967, after lengthy study and discussion, to establish a new international reserve asset in the form of Special Drawing Rights (SDR's) in the IMF and for the first time, SDR's was allocated to the member countries in 1970. The new SDR's which joined the ranks of international reserve assets at the beginning of 1970 operate in practice through a system of Special Drawing Accounts administered by the IMF. As in the case of official gold reserves, but unlike hold-

ings of reserve currencies, they do not represent liabilities of another country. The crucial fact is that they are accepted by all participating countries as owned reserves which may be used, under agreed rules, for official transfers among national monetary authorities (and the IMF itself). Countries which accumulate SDR's in excess of their allocations receive interest at one and a half percent per annum on these added balances. Thus it may be said that the SDR's are more attractive assets than gold which is non-interest bearing asset. On the other hand, for net spenders of SDR's there is one broad limitation to the effect that a country's average net use over the "basic period" (the first basic period for operation of the system was limited to 3 years) should not exceed 70% of its average allocation over the period. The unit of value for expressing SDR's is equal to 0.888671 gram of fine gold (that is, 1SDR=$1) and this means that SDR's have gold-value guarantees. A country may use its SDR's only to meet balance-of-payments needs or in the light of development in its total reserve holdings, and not for the sole purpose of changing the composition of its reserves.

The aggregate of the two allocations—3.41 billion in 1970 and 2.95 billion in 1971—at close to SDR 6.4 billions, represents roughly 8% of the present global reserves. As expected, SDR's have been used most extensively by the developing countries and because of the almost inevitable tendency of these countries to run their reserves down to a bare minimum, the SDR allocations represent in effect a form of aid to them. In fact, of the gross amount of SDR 875 millions used in 1970, about SDR 413 millions were used by participants in the less-developed areas, a total which represented about 50% of their initial allocation. By contrast, the SDR 444 millions used by the industrial and developed countries represented only about 17% of their initial allocation. Against a backdrop of growing difficulty in sustaining an adequate flow of aid to less-developed countries, the question of directing

a greater proportion of initial SDR allocations to them will almost certainly be kept in the forefront of its future operation. However, my position is that the new system (SDR's) of securing an adequate growth of reserves should not be designed to solve other international financial and monetary problem of equal, if not greater, importance. We cannot expect that the new system will solve the development problem. If we use the new system as a means of aid to less-developed countries, the credit on the new system will soon be undermined and the function of the new system to supplement the existing reserve assets would also be likely to fail.

The SDR's, if the new system is executed wisely, would certainly become net addition to the present international liquidity. Furthermore, the IMF, through the course of 1970, formally put into effect a further major enlargement of member country quotas, thereby raising the aggregate regular resources of the Fund by over 35%. These facilities, together with the formal agreement for the marketing of South Africa's gold would reduce, if not eliminate, the concerns about the possible shortage of international reserve assets and may solve the liquidity problem. Thus, it may be concluded that the liquidity problem is not so serious. So much for the liquidity problem.

3. Confidence problem (or so-called stability problem)

Confidence in a currency, or any liquid asset, is always relative, namely, compared with some relative alternative asset; the problem is the likelihood of massive switches between alternative assets held. Changes in expectations regarding the relative scarcity of the two assets lead to massive switches, which in turn may result in major disturbances of world monetary affairs. Switches from dollars to gold, if convertibility is maintained, destroy large amounts of monetary reserves and induce deflation and unemployment in

several countries. On the other hand, switches from gold into dollars would increase monetary reserves, as the disgorging of private gold hoardings creates additional reserves of commercial banks as well as additional cash balances of individuals and firms, which induces inflation of prices and incomes everywhere.

The problem of increased or reduced confidence in the dollar under the present system lies in its convertibility into gold. The greater the amount of claims is outstanding against the gold stock of the U.S., the greater is the probability that the country cannot meet its obligation to pay out gold. As can be seen from Table 2 and 4, the reserve positions of the U.S. and the U.K. have considerably deteriorated from 24.3 billion(49 % of the total reserves of the world) and 3.4 billion (7% of the total) in 1950 to 14.5 billion (16% of world reserves) and 2.8 billion(3.0% of the total) respectively in 1970, thus both countries having less than 20% of the aggregate world reserves in 1970, while reserve positions of the Western European countries and Japan has strengthened substantially. As the reserve positions of the U.S. and the U.K. have worsened, so were their gold holdings. In 1967, the U.S. had only $12.1 billion worth of gold and the U.K. only an estimated $1.8 billion of monetary gold. Thus it would obviously be impossible to convert all official holdings of dollars

〈Table 4〉 World Reserve (billions of dollars)

	1950	%	1970	%	1971 (June)
Total	49.7	100	92.0	100	98.7
U.S.	24.3	49	14.5	16	13.5
U.K.	3.4	7	2.8	3	3.6
Germany	0.2		13.6	15	16.7
Italy	0.6	1	5.3	6	6.1
France	0.8	2	5.0	5	5.6
Japan	0.1		4.8	5	7.8
LDC	10.7	22	18.2	20	18.9

(Source: International Financial Statistics, IMF, Aug., 1971)

and pounds into gold. Even an attempt at any large-scale conversion may have very serious consequences, particularly in view of the fact that the re exist also vast private holdings of these currencies. If fears arise that the reserve currency will depreciate in terms of gold or other monies, foreign holders of claims aganist it may exercise their right to demand gold, thereby causing sudden crises of confidence. The present system threatens those holding a particular currency with a substantial overnight capital loss in the event of devaluation, and it is not surprising to find that people attempt to protect themselves by moving out of a suspect currency. The magnitude of such speculative flows has been already large, as witnessed by the British crises of 1964-1965 and 1967, and the persistent loss of gold on the part of the U.S.. Thus, the whole present system of international payments is vulnerable when its foundation currencies become vulnerable to speculative attack resulting from a fear that these currencies will devalue. This is not a kind of system which can continue indefinitely, and sooner or later confidence is to break down. Perhaps the most telling criticism of the present system is that it is continually exposed to crisis due to the possible loss of confidence in the potential convertibility into gold of the the currency held as reserves.

The devaluation of the pound sterling in 1967 touched off a confidence crisis of alarming proportions. The rush for gold reduced official gold stocks by more than US $3 billions in the three-month period to the end of Feb., 1968, and in the wake of this crisis, the international financial authorities, in Mar., 1968, decided to establish a new set of rules for official gold transactions, as a means of discouraging this gold rush by speculators, thereby introducing the so-called two-tier system which separated the official fixed-price transactions from the private gold market in which prices could find their own level. However, this two-price system of gold could not eliminate

the speculation on gold and thus the confidence problem. As the U.S. liabilities rose rapidly from $16 billion in 1966 to $18 billion in 1970, its net reserve position also deteriorated from $16 billion in 1967 to the negative in 1970. In the light of this extremely worse position of its net reserve position, the U.S., finally in 1971, made the dramatic decision to terminate convertibility between dollar and gold to relieve her of the serious conversion pressure. All further decisions about the relations among currencies therefore, would be left to other countries. It would be for them, and not for the U.S. to decide the value of the dollar in their foreign exchange markets. One can imagine four types of decisions.

(1) Some countries may decide to keep the present exchange rates between their currencies and the dollar unchanged; in this case, they would have to purchase all dollars offered in the market and to increase their dollar holdings if the dollar should continue to be in excess supply.

(2) Some countries may decide not to increase their holdings of dollars and, instead, to reduce the price they pay for dollars offered to them; in other words, they may decide to raise the dollar value of their own currencies.

(3) Some countries, unwilling to increase their dollar holdings and uncertain about the right price to pay for the dollar may decide to let their exchange rate float, against the dollar and other currencies that remain linked with the dollar; in other words, they may let exchange rates be determined by supply and demand in a free market.

(4) Some countries may be anxious not to allow the dollar to be devalued, because this would hurt some of their industries; they might therefore continue to purchase dollars at the present exchange rate whenever an excess supply arises from transations in goods and services, but they might refuse dollars that originate from imports of capital. This would amount to

multiple exchange rates, a system workable only in connection with foreign exchange controls.

The U.S. would gladly accept any of the first three possibilities. The first one would amount to the willingness of other countries to help finance its payments deficit. The second and third would greatly aid in the process of adjustment; indeed, it might be the only practicable approach to adjustment. Only the fourth possibility would be deplorable but not more so than the restrictions which the U.S. itself has been imposing. The termination of gold convertibility would not change the role of dollar as international transactions currency. The dollar may even continue as reserve currency, for while some monetary authorities may decide to sell their dollars, others may prefer to increase their dollar holdings. The present threat to stability, the possibility of massive switches at a fixed conversion rate, would no longer exist. But even the termination of dollar convertibility into gold could not eliminate the confidence problem since there would still exist the fear that the longer-term growth of international liquidity may prove to be inadequate due to the uneven, limited supply of gold and unwillingness of world monetary authorities to accept dollars without the elimination of the persistent balance of payments deficit on the part of the U.S.

Then, how can we solve the confidence problem of the present system? The traditional advice to the menetary authorities anxious to restore confidence in dollar is that they make the dollar scarce. However, when popular belief in a future scarcity of gold is widespread, it would take severe deflationary measures by the U.S to achieve a matching scarcity of the dollar. It is hard to expect that the U.S. would accept this action. Some experts strongly recommend to increase the official price of gold to take account of the expected relative scarcities. A sharp increase in the official price of gold could restore confidence in the devalued dollar for years, but only at a very high cost. One of the noneconomic cost facts would be the humiliation

of the nations who have believed the assurances and continued to hold dollars and reward those who have been uncooperative. The economic cost would mainly come from the world inflation induced by the monetization of gold profits.

Besides these two recipes—one to make dollar scarce by deflationary policies, the other to make gold more abundant by raising the price of gold—several other proposals have been made, mainly for schemes to prevent official switching from dollars into gold.

One is the "locking in" the dollars in the official reserves of the nations under so-called harmonization agreements to bind countries to hold a minimum ratio of their total reserves in the form of dollar assets. However, the defects of this scheme are that it would fail to guard against massive sales of dollars to central banks in the case of private asset switching and in the case of continuing deficits in the payments balance of the U.S.. Some suggest the proposal of removing reserve currencies from national reserves by having them turned into an international conversion account in exchange for deposits that are generally recognized as reserves. However, this scheme leaves gold problem unsettled. If the private price of gold differed substantially from the official price, leaks would be likely to develop from one circulation to the other. The ratio between exchange-pool deposits and gold in the monetary reserves would fiffer drom country to counry and the problems of differential confidence in these two reserve assets might arise.

Another proposal, which seems the most rational, is to have the same international agency corral all the monetary gold as well as all the existing reserve currency holdings, rather than setting up a separate gold pool. Since one of the predicaments in the present solution is the danger that dollars are converted into gold and thereby disappear as monetary reserves, this solution—that both the dollars and the gold are deposited in the same pool and that the deposit liabilities (or certificates) of the

pool become the major reserve asset of the national authorities—is very sensible. By pooling all official holdings of both types of reserve assets, the two problems—of safeguarding against official switches between dollars and gold and of providing for future developments in the supply and demand for gold could be solved. The U.S. could free itself of persistent conversion headaches by transferring its entire gold stock to the international agency and then using the resulting deposits as its major reserve. Germany, Italy and other countries holding both dollars and gold could avoid awkward external and internal political pressures regarding the most appropriate division of their reserves between non-interest-earning gold and non-value-guaranteed dollars by exchanging both for interest-bearing and exchange-value-guaranteed deposit claims against the agency. In the light of the past success of its operation and its ever-increasing role in the composition of world reserves, the IMF might take the role of the international agency. But in my opinion, there still remains one problem. Even this radical solution would fail to function well without the elimination of the balance of payments deficits of the U.S. due to the reasons explained earlier. Furthermore, this solution also fails to give adjustment mechanism—that is, devaluation—to the U.S. in case of balance of payments disequilibrium so long as the dollar remains as a reserve currency in the pool. It seems that no national currency can be an international reserve currency in the long run. Therefore, it may be said that the SDR's should replace the dollar gradually and thus the certificates of the deposits of the pool should be based on the gold and the SDR'S in the curse of its operation.

V. CONCLUSION

In fact under a workable gold exchange standard, there are two essential rules of the game;

(1) Reserve currency countries must continue to run deficits as needed to supplement gold supplies, which has been limited and uneven and create adequate total reserves for continued growth of world trade.
(2) Other countries must deliberately refrain from absorbing the gold cover of the reserve currency countries which is required to make the system viable. If they are not willing to do either, the system cannot function well.

As I have discused so far, the system of the present gold exchange standard contains several defects mainly due to the unwillingness of abiding by the rules of the game by both reserve currency countries and the rest of the wold. These defects can bedistinguished in terms of the adjustment, the liquidity and the confidence problems. The liquidity problem refers to the failure to achieve an adequate gradual increase in the total reserves. The confidence problem refers to possible demands for changes in the composition of reserves and to the threatening destruction of reserves in the course of such changes. The adjustment problem refers to the failure of the system to stop or reverse changes in the international distribution of reserves arising from persistent deficits and surpluses in the payments positions of particular countries. Some people add one more problem—that is, development problem. The problem of involuntary development aid refers to the failure of some developing countries to hold on to funds allocated to them for reserve purpose to resist the temptation of using them for meeting shortage of long-term capital. In my opinion, the question of how to finance the developing countries cannot be answered by the system itself.

As to the liquidity problem, since the problem is not the inadequacy of total reserve supply, but the inflexibility in terms of supply in part due to preoccupation of gold, the new system(SDR's) would constitute an addition to international liquidity comparable in permanence to the additions to liquidity from increases in holdings of gold. The new system may, if operated wisely, solve the liquidity problem and thus it may be said that the liquidity

problem of the present system is not so serious.

However, in the operation of the newly created reserve assets, we must take careful attention. The reasons are as follows: To create additional liquidity is to allow some countries to postpone the adjustment or corrective measures that can eliminate payments deficits. If these countries are unwilling to tolerate real adjustment (devaluation or deflation) and would resort only to correctives of a restrictive character (imrport barrier, capital restraints, exchange controls), the use of new liquidity for the continued finance of payments deficits may spoil the purpose. The creation of the SDR's would give the U.S. more leeway in moves to protect its gold reserves and the position of the dollar. The U.S. responsibility for continuing to provide expanded world liquidity would be reduced along with diminution of dangers that world deflation and depression might follow the U.S. efforts to reach international equilibrium. It must be emphasized, however, that this would never free the U.S. from its principal concern in this matter: the elimination of balance of payments deficits or its reduction to more manageable proportion.

Another point is that to create additional liquidity is not to forestall crises of confidence in existing reserve assets. Attempts by large official holders of reserve currencies to have them converted into gold may destroy large amounts of monetary reserves, for which the new system cannot provide replacement. This threat to the international monetary stability must not be allowed to continue; international arrangements to avert the switches between reserve assets or to replace unwanted currency reserves with other reserve assets are urgently needed. Therefore the most urgent problems of international monetary affairs are those of adjustment to restore balance in international payments and of confidence to avoid destruction of existing currency reserves. These problems are both closely connected with the gnawing question of gold.

With respect to the adjustment problem, I suggest to adopt the sliding parity system. It seems to me that the technique of the movable band of exchange rates could furnish the international monetary system with the only reliable and economical adjustment mechanism for countries in which adjustments of incomes and prices are not tolerated. As compared with the presently permitted 1% range on either side of parity, a 2～3% range could offer a degree of added flexibility, getting the benefits of both the floating exchange rate system and the devaluation mechanism.

Another question is who should make the adjustment in case of disequilibrium. Does the sole obligation to make adjustment fall to the deficit country? In general, adjustment by the surplus country is conducive to the international expansion of trade and production while the adjustment by the deficit country has contractionary effect on the international trade and production. Therefore, I suggest the mutual adjustment, not suggesting to make adjustment by only one side, but it would be easy for the surplus country to make adjustment than for the deficit country to do so.

As to the confidence problem of the present system, I support the proposal of having the same international agency (IMF) pooling all the monetary gold as well as the existing reserve currency holdings in exchange for the certificates of the deposits issued by the IMF. But it seems more reasonable that the SDR's would gradually replace existing reserve currencies as an international reserve currency, thus giving the existing reserve-currency countries the adjustment mechanisms made by other countries.

Unless adequate progress is made in all of these directions, no system of international monetary arrangements is going to work well. The big task will now be to sustain the solid new achievement (SDR's) with the needed improvements of national economic policies, and with the essential further joint endeavours in the areas of trade and development. Any improvement in international cooperation would be a step forward, moving countries away

from the need to take defensive nationalistic measures that could reverse past trends and threaten the real gains in international trade, payments, and investment realized in the post-war period. This would provide a rational basis for effective further evolution of the international monetary system, which would provide the amounts and distribution of international liquidity adequate to satisfy the needs of a developing and expanding world economic system.

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