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ARTICLES

Monetary Policy

The Recent International Crisis

by Professor W. M. Scammell, Vancouver

Since the efforts to save sterling in November 1967 through the post devaluation suspense to the speculative assault on the dollar which was finally repulsed in March, the future of international money has been in the melting pot. During that period it would be true to say that the international monetary system was never under control: rather that those who should have been controlling it were neither regulating its pace or direction of development but were reduced to the elemental position of preventing its disintegration. Control has now been regained but it is clearly a conditional control in which the recurrence of crisis can only be prevented by swift progress in solving the basic issues which remain unsolved.

The Creation of Two Gold Markets

In the broadest historical sense the crisis is of four years' standing. It began in 1964 when speculators decided that sterling at $ 2.80 would not survive under a Labour Government and when central bankers, and in particular the Federal Reserve central bankers, decided that the gold exchange system resting on dual key currencies, dollar and pound, would not easily survive a devaluation of either currency. The decision to defend sterling tenaciously was one which was consciously taken not only by the British government and the Bank of England but by the whole Basle group of central bankers. It is arguable that the distinctive British economic problem might have been more imaginatively met by an early and planned alteration of the sterling parity; but from the international standpoint and in particular from that of the United States it is clear that, in the sort of currency system we now have, the policies of the big currency countries must be international policies in which international stability must have primacy over unilateral advantage for either country.

The shaky nature of the arrangements made at Washington indicate the temporary character of the respite. The creation of two gold markets: one for monetary gold at a fixed price, confined to well-behaved central banks and one for commodity gold at a fluctuating price, probably above that ruling in the central bank market, is one which cannot endure for long. If the price disparity is wide and persistent it may prove impossible to seal off the markets from each other. Central banks of smaller countries which are in deficit with the United States may be tempted to flaunt the arrangement, sell such gold as they possess for dollars in the free market and with these settle their deficits with the United States. True, such countries have not as a rule large gold stocks for such operations, but to the extent that this took place the dollar would have two exchange rates, one corresponding to the $ 35 gold price and one at a depreciated level approximating to the dollar price of the gold sales in the free market. Any large-scale sales would probably depress the price in that market to the level of the official price. Another anomaly would arise if central banks were to commit the unforgivable act, precluded only by the sanction of displeasure of the Basle group, of buying gold in the official and selling it in the free market. This is, in the main, an unlikely event. But both of these possibilities might arise if the system in its present form came under pressure and was in process of deterioration. The best that can be hoped for from the Washington arrangement is a respite during which the United States may hope that enhanced stocks of international liquidity derived from the SDR scheme may save them from the *de jure* devaluation of a revised gold price on the one hand or the *de facto* devaluation of refusing to deal in gold on the other.

Probable Development of the Free Market

Indeed, it is an indication of the limited policy options open to the Washington central bankers that on the day of that Sunday meeting they had only a vague idea of what would happen under the new gold marketing arrangements. The plan (if it can be called a plan) came from the West German camp and found favour because it was a compromise between the two untenable alternatives of staying with $ 35 or of devaluing. But it was peppered with question marks. Some of these are now being answered, others will not be answered for some time.

Initially things have gone well. The Vietnam peace negotiations open up better prospects for the United States balance of payments. The Stockholm talks were

promising and French intransigence was contained. The London gold market reopened without incident and the free price drifted lower as short speculators took their non-too-fat profits. Just now, the future of the free market price is not too bright. Much buying during the crisis was done by international companies—that new breed of currency speculator whose accountants are alive to the consequences of sudden devaluation of assets—who are now caught between their uneasiness at key currency prospects on the one hand and their unwillingness in a world of high interest rates to hold a sterile asset like gold on the other. If prospects for the pound and dollar continue to improve such holders will progressively unload their gold on the free market as 1968 proceeds.

Another factor which weighs on the gold price prospect is France. As a result of past policies the Bank of France is over-stocked with gold but has a mere $ 500 million in dollars. If, as is widely forecast, the French balance of payments turns sour in late 1968 we may be treated to the unfamiliar spectacle of France selling gold presumably in the free market. If all these bearish features coalesce there may be little margin in the near future between the free price for gold and the official. If such is the case, the breathing space for repair and adjustment of the international mechanisms will be longer.

Finally, the position of South Africa is still unclear. In principle it seems prepared to sell on the free market but all that can now be said is that it is clearly waiting for conditions in the market to settle before deciding on a course of action.

International Monetary Cooperation

A second reflection on the crisis is unrelated to the problems themselves but is concerned with the way they have been dealt with. In the large technical literature of the later forties and early fifties dealing with international monetary problems there was frequent reference to what was usually called "the collapse of the international financial community". It was argued that two world wars and the turbulent years between them had demolished for ever the international fraternity of central bankers which had nourished and sustained the gold standard. In the absence of this fraternity international monetary cooperation was seen, in the future, as being best left in the keeping of international organisations. To this view in the early postwar period there were few dissentients. Keynes with his customary prescience and feel for events was one. His preference for a clearing union in the hands of monetary technicians rather than a currency authority in the hands of quasi-politicians was to be born out by the early

PUBLICATIONS FROM THE HAMBURG INSTITUTE FOR INTERNATIONAL ECONOMICS

In Preparation

FOREIGN AID IN THE ERA OF RISING EXPECTATIONS

by Karel Holbik

American and Soviet development aid gives decisive impulses to the policies of the remaining industrialised nations towards the developing countries. The author of this publication compares the economic foreign aid policy of the USA and the USSR, and makes the surprising assertion that the economic aid of the two great powers is approaching in many fields.

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record of the Fund, the success of the European Payments Union in the fifties and the yearning of Triffin and others for more ornate monetary arrangements than those provided by the IMF.

In the past decade central bank co-operation has seen a magnificent flowering. At least we may argue that the international financial fraternity has been rehabilitated. At the danger of exaggerating one might claim that central bank co-operation in the payments field now bids fair to usurp and supercede the influence of the IMF. The Basle Club, the series of lines of central bank credit, the network of currency swaps, the co-ordination of exchange market operations, the establishment, growth and operation of the Euro-Dollar market, — all these are manifestations of the web of personal relationships between top officials of the Federal Reserve, the Bank of England, the Deutsche Bundesbank and the other members of the Ten. The tremendous concerted effort by central bankers which, in one autumn day of 1964, produced a total credit line of $ 3,000 million to underpin sterling was a magnificent example of such co-operation.

The advantages of central bank co-operation are two. Firstly, the handling of currency problems in this milieu rather than in the political hothouse of the Fund, makes of them technical problems removing them from the public gaze, attention and comprehension. All that is to the good. The less that international finance is in the public eye, the better. It is to this degree of technical anonymity on a world scale that we should now aspire, and central bank co-operation leads us towards it. Secondly, central bank co-operation is far more flexible than the cut and dried arrangements of the Fund. It can give help precisely where and when it is needed, at the vital pressure points. It is not suggested that international monetary co-operation at Fund level should be allowed to languish. Clearly it is and has long been an enormous gain as compared to the maladroit "ad hocery" of the inter-war period; but it will be the greater gain now that it is supplemented and reinforced by the central bank co-operation which has flowered so richly in the past decade.

The Role of the Key Currencies

Perhaps the most interesting, but certainly the most fundamental question to be asked at the present stage of international monetary developments is: what new light, if any, does the recent crisis cast upon the role and future of the key currencies, dollar and pound, in international payments?

Under the modified gold exchange standard, which has existed since the war, international liquidity has consisted of gold, certain key international currencies, in practice the dollar and pound, and immediately usable drawing rights of countries on the IMF.[1] The key position of the key currencies as reserves and for settlement of residual transfers within the balance of payments is firmly based upon their position as great trading currencies, backed by banking systems and money and capital markets of skill and probity. The pound as a result of Britain's great mercantile dominance after 1870 was first in the field. The dollar, a powerful world currency since World War I, was slow to enter the field, but after World War II when Britain's foreign trade declined relatively, when its banking system was sealed off from the world behind the barrier of exchange control the dollar surged to the leading position as an international currency. Since 1959 when the pound became fully convertible, that currency has shared with the dollar, though in the minor position, the dual currency system which has been a feature of the modern period.

Key currencies must serve in the world both as transactions currencies and as reserve currencies. In the first role, as with domestic money, their supply is important; in the second stability in value is vital and confidence in their continuing value is a *sine qua non* of their efficiency.

Looking at the supply aspect we will waive the large and undecided question of how much international liquidity the world needs. Let us be content to say that it should be greater, the greater in the aggregate the unadjusted fluctuations in the balances of payments of trading countries are, and that most authorities agree that the present world supply is inadequate. Of course we could reduce the need for liquidity by adjusting balances of payments more quickly, say by a system of flexible exchange rates. But that is another question and by all appearances a question which the world is not yet ready to face. Suffice it to say that, with present conditions of balance of payments adjustment, the supply of international liquidity is inadequate. With world stocks of monetary gold fixed in price (at $ 35 per ounce) and with virtually all new gold going either to industrial use or into private hoards via the free market; with international trade expanding and world prices steadily rising, the main demand for international liquidity falls upon the key currencies. These must be available to the world in increasing, certainly not diminishing quantities.

The supply of the key currencies to the world at large must be through the balances of payments of the key currency countries. A key currency must be earnable through trade or alternatively the country concerned, if it is earning a surplus on current account, must lend abroad, so that it is freely available to other countries. To the extent that it becomes scarce it is ineffective as a key currency. Certain conditions are obviously advantageous. For example a key currency may run a large surplus but invest much of it abroad. Such was the case of nineteenth century Britain; or such a country, with large reserves of gold, may tolerate a balance of payments deficit which supplies the rest of the world with its currency. This until recently was the case of the United States. From the supply point of view both the key currencies have, in the sixties, been reasonably adequate. Sterling with either bare balance or deficit in its balance of pay-

[1] In practice the sum of the so-called "first tranches", i.e. the first 25 per cent of countries' quotas, upon which they may draw almost as of right.

ments has never been scarce. The United States with a deficit born of its great investment abroad, its aid programme and the cost of the Vietnam war has, at cost to its gold reserve, allowed great quantities of dollars to move into international monetary use. It is not the supply aspect which is defective, it is another element, the confidence element, which detracts from the efficiency of these currencies in the international field.

Less Confidence in the Key Currencies

In 1959 when convertibility of Western European currencies was established and the Bretton Woods system was belatedly brought into being the confidence problem was foreseen but its ultimate manifestation differs from the form which was anticipated. The original fear was that in a "dual-key-currency-world" holders of international balances would shift uneasily from one currency to the other as estimates of their individual strengths and prospects ebbed and flowed, — that there would be a "see-sawing" movement of confidence which would be particularly detrimental to sterling as the weaker of the two currencies. In practice this has been much less of a problem than was feared. Rather it is the weakness of both currencies which is now the problem. It was the devaluation of sterling in November which generalised lack of confidence in key currencies to include the dollar, caused the March crisis and even led to premature talk of a second sterling devaluation.

The fact is that any key currency has to walk a razor's edge. On the one hand it must never be a hard currency, that is difficult to earn by reason of a very favourable balance of payments; on the other it must never be so 'soft' that its balance of payments deficit gives rise to lack of confidence. In the case of the United States the deficit had to be large enough to supply the world with dollar balances, but not so large as to cause uneasiness about the strength of the dollar. At first sight it appeared in, say, 1960 that never in history was a country better qualified to walk such a razor's edge. With $ 14 billion in gold in the Federal Reserve the United States could tolerate moderate deficits in its balance of payments for many years. It could indeed regard its external deficit as a currency service supplying international liquidity to the world at large. Alas this comfortable view took no account of many factors: of French intransigence, of sterling's prolonged weakness, of the deep-rooted belief in the world that one day the United States would revalue gold, and of how social and political evaluations of a country's health can by some mysterious alchemy transmute themselves with disconcerting speed to views on its currency.

The United States might now inherit Britain's problem. To restore confidence and correct its balance of payments deficit it seems prepared to resort to domestic deflation which may inaugurate a stop-go sequence in a country whose steady expansion is necessary to the world economy. Such a step would be an unwelcome major policy revolution for a country whose economic policy has been hitherto decided by domestic considerations and whose balance of payments problems were regarded as residual. A United States economy which moved from boom to recession and back to boom in a three year cycle would be a cancer at the heart of the world economy.

In the light of recent events it is arguable that the key-currency approach to the international liquidity problem has failed. Key currencies, due to their value in use and the fact that they are main trading currencies, will always form part of the total stock of international liquidity. Because of the confidence and stability aspects of such currencies and the difficulty for the countries who operate them to reconcile their own domestic economic policies with those appropriate for maintaining confidence in the key currency, it is likely the effort to increase the stock of international liquidity should now be switched to the creation of a flexible form of international settlement unit. Such a unit is the proposed Special Drawing Right of the IMF.

SDR—A Legal International Money

The SDR scheme, mooted in London last August and approved in principle at the IMF Annual Meeting in Rio de Janerio in September has still far to go and it will be at least a year before beneficial effects are felt. France has already opted out of the scheme but may opt in again later if it wishes. With the SDR scheme goes a much less discussed proposal for reform of the power structure within the IMF. Hitherto only the United States had sufficient voting power to exercise a veto in the Fund. Now with changes in the Fund's voting rules a 15 per cent minority will be able to stop any major decision. Since the EEC countries will together command 17 per cent the Six will be in a strong position to influence such things as quota increases, changes in currency parities or changes in the role of gold.

Apart from these political constraints the SDR scheme is still only in its nascent stage. All that can be said is that, with the French out of the way and the major participants, in particular the United States and Britain, anxious for progress, the scheme may be in operation in 1969. What has been proposed is in effect a supplementation of IMF drawing rights by the creation of a new international settlement unit to be allocated to all IMF members in amounts proportional to their Fund quotas. Such amounts will be accounting units only and will be transferred by debiting the user country and crediting the recipient country. SDRs will have no monetary use outside the Fund and will be only for settlement of residual balance of payments transfers between central banks.

All this is hopeful. It means at last the purposive creation of a legal international money with no commodity basis. It lifts international finance to a higher level of sophistication, albeit one which is still far behind that of the best domestic national banking systems. For the "alleviation" of present problems,

however, much depends upon how much in SDRs is to be created, — a matter on which there has been great reservation. It may be as low as $ 1 billion or $ 2 billion a year. This would be meagre and would only give progressive assistance in a quite long term. On the whole question of the size of the SDR creation it is well to be prepared for trouble. The wrangles at and before Bretton Woods on the size and distribution of quotas were loud and prolonged. Nevertheless, once established, SDRs and the whole SDR scheme might grow progressively and with far less publicity and international friction than the periodic revision of Fund quotas which at this stage seems the only alternative.

Common Market

Britain and EEC — The Problem of Agriculture

by Dr Michael Schulz-Trieglaff, Hamburg

The attitudes of the EEC Member States as well as of the Commission show that Britain will have to accept the Common Agricultural Policy (CAP) as it stands, when joining the Common Market.[1] There is little doubt that serious problems will stem from adapting the principles of the CAP as evolved by the Six — a farm policy, which is entirely different from the current British agricultural policy.

EEC Farm Policy

The two key elements of the Common Agricultural Policy are uniform price levels for agricultural commodities and the Community financing of support measures, for which the European Agricultural Guidance and Guarantee Fund (EAGGF) was set up by the Six. Uniform price levels are already established for cereals and will come into force for milk and milk products, beef and veal, rice, sugar, oilseeds and olive oil.

Trade in agricultural products between the Six is virtually free of any duties and quantitative restrictions, whereas a variable import levy is charged on imports from countries outside the EEC. The purpose of the variable levies is to neutralise effects of the difference in prices between the Community and the world market; the latter being on the whole lower than the common prices. The amount of the levy is adjusted to the world market price every day in the case of grains, fortnightly for dairy products and quarterly in the case of pork. Refunds on exports of farm products into third countries are the counterpart of levies on imports. They are paid at a rate at least equal to the levies imposed on similar products when imported.

Price-support arrangements for Community producers are dominated by target prices and intervention prices. Target prices are fixed for the marketing centre of the region with the least adequate domestic supplies for the wholesale stage (i.e. Duisburg, Germany). They are not guaranteed prices. In order to keep the actual market price close to the target price, intervention prices are established, at which the Guarantee Section of the Fund will buy from producers without any restrictions. The intervention price (which is about 5—10 per cent below the target price) thus constitutes a guaranteed minimum selling price for producers. The producers receive the intervention price minus transportation costs to the intervention agencies.

The EAGGF is divided into two sections. The Guarantee Section is responsible for the cost of price-support on internal markets. It also covers refunding for exports to non-member countries. The Guidance Section contributes to expenditure on structural improvements. A third of the money for market operations is allocated to this section.

Contributions by the Six to the Fund's financial resources comprise a variable component, which amounts to 90 per cent of the levies on farm products imported from third countries and a fixed key scale as shown below:

Belgium	8.1 per cent	Italy	20.3 per cent
Germany	31.2 per cent	Luxemburg	0.2 per cent
France	32.0 per cent	Netherlands	8.2 per cent[2]

The Member States themselves are responsible for structural adaptation in agriculture. The Community only provides an active lead by co-ordinating the structure policies of the Six and by contributing to schemes for adaptation whenever they further the aims of the CAP.

British Agricultural Policy

The basic principles of British agricultural policy are a virtually free entry of imports of most agricultural commodities (the only exception being horticultural produce) and the use of the deficiency payment system to support domestic producers. Guaranteed prices exist for the main agricultural products as wheat, barley, milk, sugar-beet, fat, cattle, eggs, and

[1] EWG-Kommission, Stellungnahme der Kommission an den Rat, betreffend die Beitrittsgesuche des Vereinigten Königreichs, Irlands, Dänemarks und Norwegens gemäß Art. 237 des EWG-Vertrages, 205 des EWG-Vertrages und 98 des EGKS-Vertrages, Brüssel, 29. Sept. 1967, Kom. (67) 750, p. 30.

[2] VO/130 EWG des Rates über die Finanzierung der gemeinsamen Agrarpolitik, Amtsblatt der Europäischen Gemeinschaften, Nr. 165, 21. 9. 1966.