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AUTHORIZATION FOR TREASURY'S INTERNATIONAL AFFAIRS FUNCTIONS

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HEARING

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BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

S. 976

TO AUTHORIZE APPROPRIATIONS FOR THE INTERNATIONAL
AFFAIRS FUNCTIONS OF THE DEPARTMENT OF THE TREAS-
URY FOR FISCAL YEARS 1980 AND 1981

MAY 3, 1979

Printed for the use of the
Committee on Banking, Housing, and Urban Affairs



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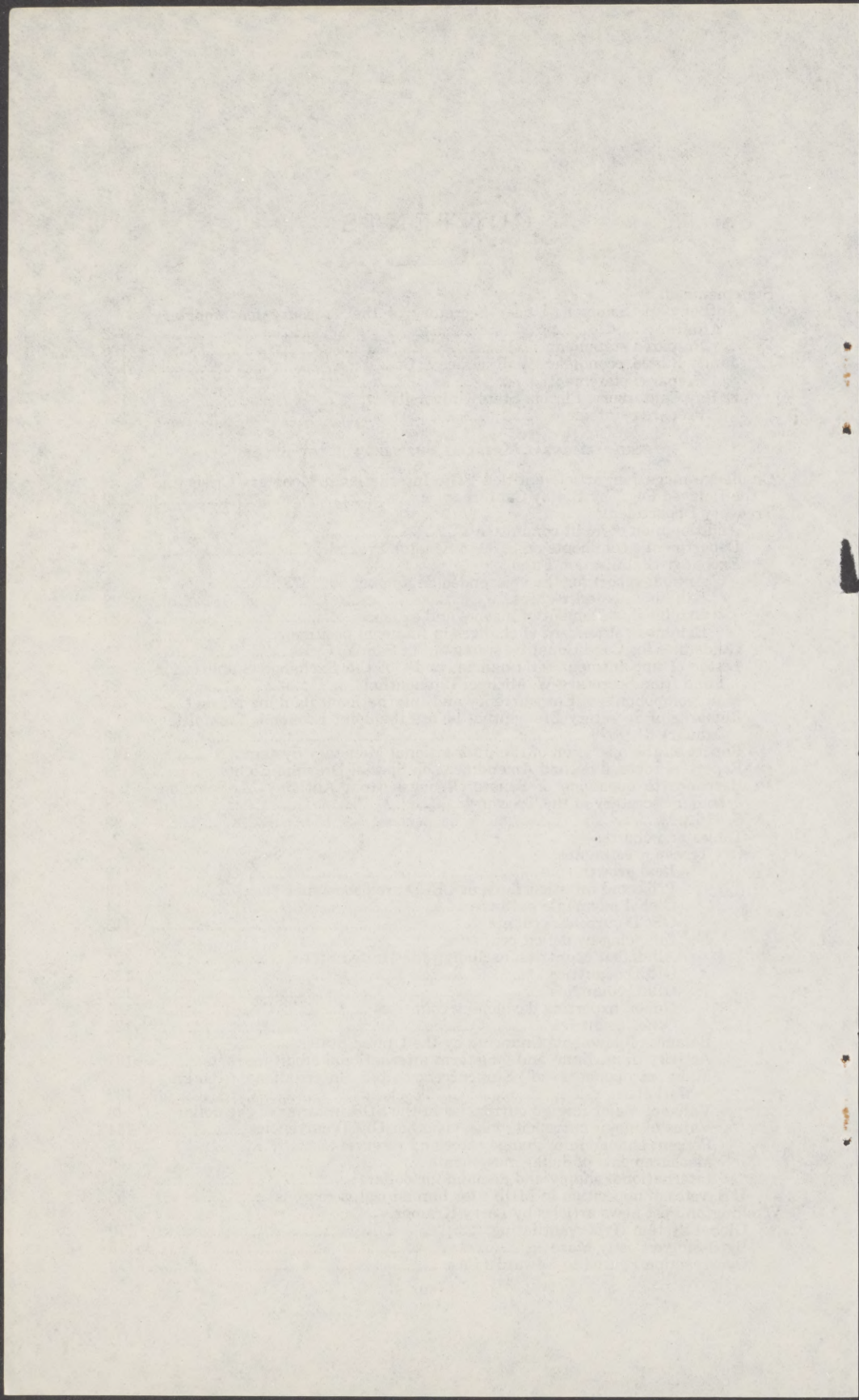
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AUTHORIZATION FOR TREASURY'S INTERNATIONAL AFFAIRS FUNCTIONS

THURSDAY, MAY 3, 1979

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON INTERNATIONAL FINANCE,
Washington, D.C.

The subcommittee met at 10 a.m. in room 5302, Dirksen Senate Office Building, Senator Paul E. Tsongas presiding.

OPENING STATEMENT OF SENATOR TSONGAS

Senator TSONGAS. Good morning.

I will open the hearing with an announcement that the chairman of the International Finance Subcommittee, Senator Stevenson, is unable to be present due to a meeting of another committee he chairs, the Senate Ethics Committee.

It is my pleasure to chair this morning's hearing.

The hearing has two purposes: The Banking Committee must report by May 15 a bill to authorize an appropriation to meet the Treasury Department's expenses in carrying out its international responsibilities during fiscal 1980. The subcommittee will hear testimony from the Treasury on S. 976, an administration bill to provide the necessary authorization.

The larger purpose of this session is to review the operation of the international monetary system. The subcommittee intends to conduct regular oversight hearings on international money matters. The subcommittee's most recent hearing for that purpose was held in October 1977, so today's review is overdue. I welcome this opportunity to explore with our witnesses questions about the stability of the dollar and its role in international finance.

People are confused and troubled by large and sudden shifts in the dollar's exchange value, by an unregulated Eurocurrency market which is approaching \$1 trillion, by the growing American debt to foreigners, by an International Monetary Fund which seems to create new liquidity when inflation is rampant, but imposes stringent conditions on emergency borrowings by poor countries, and by Treasury policies which appear to vacillate between talking the dollar down and pushing it up.

Such concerns may be misplaced or misinformed, but they account for much of the mistrust of economic policy and interest in gold medallions and other nonfinancial investments.

I hope our witnesses this morning will help dispel some of the uncertainty and confusion.

Our first witness this morning is Anthony M. Solomon, Under Secretary for Monetary Affairs in the Department of the Treasury.

Mr. Secretary, since your statement is reasonably short, why don't you go through it rather than summarize.

STATEMENT OF ANTHONY M. SOLOMON, UNDER SECRETARY
OF THE TREASURY FOR MONETARY AFFAIRS

Mr. SOLOMON. All right. Thank you.

Mr. Chairman, I am pleased to appear before your subcommittee to support S. 976, the proposed budget authorization for the Treasury's international affairs function, and to discuss recent international monetary developments. I have provided the subcommittee separately with a more extensive assessment of the operation of the international monetary system during the period July 1977 to March 1979, and have submitted written responses to the specific questions raised in your letter of April 20 to Secretary Blumenthal.

Mr. Chairman, this subcommittee acted favorably last year on legislation to bring the salaries and other administrative expenses of Treasury's international affairs functions under the appropriations process. In last year's hearings, I explained that pursuant to the Gold Reserve Act of 1934, salaries and other administrative expenses associated with the Treasury's international responsibilities had in the past been paid from the resources of the Exchange Stabilization Fund.

Shortly after taking office, Secretary Blumenthal and I ordered a review of this practice, and concluded that the former off budget and nonappropriated status of these expenditures could and should be terminated.

The legislation authorizing appropriations for these expenses was passed near the close of the last Congress and was signed as Public Law 95-612 by the President on November 8, 1978.

It authorized a sum not to exceed \$24 million to be appropriated for fiscal year 1979, and terminated the authority to use the ESF to meet administrative costs as soon as funds were made available by an appropriations act. We are at present seeking an appropriation to cover the last quarter of fiscal year 1979 pursuant to the fiscal year 1979 authorization.

Senator TSONGAS. Let me interrupt you there. I can read the next of it. Why don't you skip over the next paragraph.

Mr. SOLOMON. OK. The authorization we are requesting for fiscal year 1980 is approximately \$23 million which, despite inflation, is slightly below the amount authorized for fiscal year 1979. We are deeply concerned that our responsibilities be carried out efficiently, and we have made a deliberate and effective effort to control the costs of conducting Treasury's international activities. We have been less successful in some areas than in others, because of inflationary cost increases and international developments that have demanded more extensive international contact. But we are determined to limit costs and activities wherever possible and consistent with performance of our responsibilities.

Our draft bill also requests an authorization for appropriations for fiscal year 1981, consistent with section 607 of the Congressional Budget and Impoundment Control Act of 1974. We would prefer an authorization for both years, simply because it would permit a

more orderly budget process. The problem with seeking both authorization and appropriation in the same year is largely one of timing, and the result may frequently be hearings by the appropriations committees prior to action by the authorizing committees. A 2-year authorization this year would enable us to maintain an orderly sequence; and if approved, we would plan to submit a request for fiscal year 1982 next year.

This concludes this part of my statement, Mr. Chairman, and I urge the subcommittee to report the bill favorably both for fiscal year 1980 and fiscal year 1981.

If you like, I would summarize the rest, rather than reading it.

Senator TSONGAS. I prefer that you read it. It is not a 20-page statement.

Mr. SOLOMON. OK.

You have asked for an assessment of the international monetary system since the last oversight hearing.

For this purpose it is useful to examine separately two periods of heavy pressure on the exchange markets during which the dollar depreciated sharply against the deutsche mark and the yen, and to compare these episodes with the recent period of improved market conditions.

In the 6 months ending March 30, 1978, the trade-weighted value of the dollar against the currencies of all other members of the OECD depreciated by 7 percent. The deutsche mark rate rose about 16 percent, while that for the yen appreciated by approximately 20 percent. These movements occurred despite substantial intervention by a number of central banks.

When the market senses that there is a risk of fairly rapid appreciation or depreciation of a currency, traders and investors try to position themselves to avoid losses or make gains by accumulating assets denominated in currencies that are expected to rise, and liabilities in currencies that are expected to fall.

Thus, anticipatory moves tend to accelerate and amplify the pressures on the exchange market that may arise from other causes. The relative impacts of energy shortages on countries, relative rates of inflation, relative rates of economic growth and unused capacity, changing current account positions in deficit and surplus countries and differential interest rates are some of the more frequently cited specific causes of market pressures. Expectations as to shifts in government policy or governmental actions affecting basic conditions are particularly important.

The growing deterioration in the U.S. current account was probably the leading cause for dollar depreciation in the period of market stress which extended from October 1977 to March 1978.

In that 6-month period, the U.S. current account deficit exceeded \$27 billion at a seasonally adjusted annual rate, more than double the rate for the preceding 6 months. The U.S. economy was continuing to expand quite rapidly while growth was lagging in Germany and Japan.

Much public attention was being given to the debate over the need of policies to promote expansion in the surplus countries. There were widespread misperceptions as to U.S. policy toward the dollar.

During the second period of heavy market pressure extending from July through October of 1978, the deutsche mark, yen and Swiss franc again appreciated sharply against the dollar. In percentage terms, the rise was 18 percent for the deutsche mark, 14 percent for the yen, and 26 percent for the Swiss franc.

Once again there was heavy central bank intervention. In this second period of severe market disorder, the pressure developed in spite of the fact that the U.S. current account position had improved so that the annual rate was only about half as large as in the previous period of pressure—under \$14 billion at an annual rate.

In part, the development of market disorder in the face of this U.S. improvement can be attributed to the continuation of current account surpluses in the three major surplus countries in the range of about \$25 billion a year. The major factor, however, was the growing concern about rising rates of inflation in the United States, doubt as to the degree of restraint in domestic macroeconomic policies in the United States, and fears that the U.S. authorities were not concerned about the decline of the dollar.

These fears about the appropriateness and adequacy of U.S. policy, and thus the danger that the dollar exchange rate might decline rapidly, led to large sales of dollars against deutsche mark and yen, especially in October, associated with leads and lags in commercial transactions and other forms of precautionary shifts of asset and liability positions.

A few central banks, as well as some private entities, appear to have initiated policies leading to slight reductions in the proportion of their reserves held in dollars.

These shifts of funds took place despite the fact that short-term interest rates were substantially higher in the United States than in Germany, Japan, and Switzerland, implying expectations that the effect of continuing dollar decline on capital value of short-term investments would more than offset the effect of the interest rate differential.

As shifts occurred, they caused rate movements which simply reinforced the expectations of further declines.

Our November 1 program, details of which are described in our assessment, turned the market psychology. There were some events—the turmoil in Iran and the unexpectedly large increase in oil prices—which revived the pressure temporarily. When the market saw that the United States and its partners in this operation—the monetary authorities of Germany, Switzerland, and Japan—were firm, the expectations changed.

I believe the markets now accept the administration's assurances not only that intervention on a large scale will be carried out to deal with disorderly markets, but also that bringing inflation under control has become a dominant factor in U.S. domestic economic policy.

The disorder has now subsided. A good deal of the speculative movement has been reversed. The timing of payments for trade in relation to shipments seems to be returning to more normal patterns. Confidence has returned. Since November 1, the trade-weighted value of the dollar has risen against other OECD currencies by about 10 percent.

The two periods of stress that I have cited confirm that in a world of increasing interdependence in trade and great fluidity of capital movements across boundaries, divergent trends in competitive positions or in domestic macroeconomic policies are likely to be reflected quickly in the exchange markets for major currencies.

There are times when intervention on a forceful scale is needed and, in combination with sound basic policies, can be effective in combating disorder and restoring confidence. But market expectations as to future economic policies which will impact on the trade balance, future rates of inflation and prospective interest rate movements—in sum, market confidence in government policies and government determination to prevent disorder—are crucial.

A stable monetary system therefore is heavily dependent on sound domestic policies that restrain inflation in deficit countries and that promote noninflationary growth in surplus countries.

Let me turn to a brief look ahead. The recent increase in OPEC oil prices and the imposition of surcharges by most OPEC members have altered the general tone of the outlook for the global economy.

Most importantly, an already delicate inflationary situation has been exacerbated by higher oil prices. Our current projections suggest that inflation rates outside the United States will quicken this year, following 2 years of steady decline. Adding our own inflation rates means that inflation in the OECD area could be at least 1 percent faster in 1979 than in 1978.

The second troubling aspect of the recent OPEC price rise concerns external balances. For the last several years steady reductions in the OPEC surplus and redistributions of deficits among oil importing countries have significantly reduced the degree of external imbalance within the global economy. Much of this improvement will be erased this year as the OPEC surplus, which almost disappeared in the second half of last year, will rise to something like \$30 billion. The counterpart of this larger OPEC surplus will be a return to deficit of the developed countries of the OECD as a group and a somewhat larger deficit in the non-oil LDC's.

Actually, most of the OPEC members are recording deficits—the surplus is becoming increasingly concentrated in a few countries.

But the outlook is not all gloom and doom. During 1979 we should continue to see slow, steady progress in a number of important areas. We expect a substantial reduction in the disparities in economic performance among OECD countries. This is especially important in the larger countries. Somewhat faster foreign growth abroad, combined with slower U.S. growth, will add stability. Real growth outside the United States will exceed that of the United States for the first time since 1975.

This alteration in relative growth rates, coupled with the gains from past changes in competitive positions, will reduce external imbalances. We are already seeing very important changes in Japan and the United States and expect some reduction in the German surplus.

In closing, I am encouraged by developments in the exchange markets since November 1 of last year. Major countries have now put into place the framework of policies agreed upon at last year's

summit meeting—policies which seem appropriate to current circumstances.

While there remain very difficult elements in the outlook, these cooperative policies are reducing some of the more disruptive payments imbalances.

This will contribute to greater stability. Lasting monetary stability in our interdependent system will depend on sustained efforts to improve international cooperation, and on implementation of coordinated macroeconomic policy.

We must recognize that there will be periods of stress and instability so long as there are wide divergencies in national economic priorities and policies, and in relative competitive positions.

Our systems must accommodate those divergencies and facilitate the adjustments that will inevitably be needed. If the national priorities of the advancing nations come closer to a common scale, we can expect the international monetary system to operate more smoothly than has been the case in recent years.

Senator TSONGAS. Let me raise an issue with you which you have not mentioned in your testimony. One hears on the Hill and in the commentaries that one of the reasons beyond the actions in November that the dollar has gained is that the United States is less dependent upon imported crude—than, for example, Japan and Western European countries.

You don't mention that in your testimony. Is that a misconception? Is that an old wives' tale?

Mr. SOLOMON. I think that the markets are overreacting to that impression. I think it largely accounts for the very sharp weakening of the yen in recent weeks. And I feel that—in some cases I regret to say this—but I feel that Germany and Japan, even though they are somewhat more dependent on imported oil than us, have demonstrated their ability to cope with higher energy prices and to still continue in surplus on their external balances.

We have not.

It is true that mathematically Japan particularly is more dependent on imported energy. But I think that the markets are overreacting, and I do not see that the recent weakening of the yen has been justified—the degree of that weakening has been justified by the fundamental longer term factors.

Senator TSONGAS. Isn't there a difference between the capacity, for example, to engage in the aggressive export policy which both of these countries do and to overcome trade balance problems that they have, which reduces the sense of vulnerability but does not really provide the same kind of control over destiny the United States has, because of our capacity to produce some domestic crude.

Mr. SOLOMON. I'm not sure I understand your question, Senator.

Senator TSONGAS. Well, when you are talking about markets and the role of psychology in determining exchange rates, et cetera, the issue may be not whether both of those countries are capable, or not capable of aggressive export policies which balance off their need to import, but rather that both of those countries are in positions where, for example, in the time of an embargo they would be far more crippled than we would be.

And that vulnerability adds a certain psychological uncertainty as to what their long term prospects might be.

Do you see that as a possible rationale?

Mr. SOLOMON. I'm assuming that embargo is extremely unlikely. The real problem is that we are going to be living in a period of rapidly increasing energy prices.

I think that we still have yet to accommodate effectively to that type of financial pressure from rising energy prices, as Germany and Japan have accommodated. Both because of more conservation, as well as more vigorous and successful export drives.

So, therefore, I don't think of it in boycott terms. I think of it in financial pressure terms, because of the price aspect. And that is why I said that even though I think the United States will show improvement now that the President has embarked on a program of decontrol, I think that the temporary market, exchange market reactions, have been excessively influenced. But I do want to make one additional point which has not been reported in the press as much.

Even more important in the recent weakening of the yen, than the anticipation that Japan is more vulnerable to oil than we are, that is, oil developments, has been the very, very large outward capital flows from Japan.

Japan has liberalized its access to its capital market. There has been much foreign borrowing in those markets in recent months, very large movements by private Japanese capital outward. And this, coming on top of a fairly sharp decline in the current account surplus—last month, in fact, we reached a deficit, although only temporarily—these combined, put enormous pressure on the exchange markets. The President emphasized somewhat more the psychological factors to the OPEC price rise.

Senator TSONGAS. At this point let me insert in the record a list of questions submitted to you, together with your response.

[Questions and answers follow:]

QUESTION: What is United States policy at present with respect to intervention in foreign exchange markets? Is intervention limited to countering "disorderly market conditions?" Is it United States policy to intervene in exchange markets when rates fail to reflect fundamental factors in different economies?

ANSWER: The Administration believes that exchange rates must be allowed to reflect fundamental factors in different economies. It is prepared, however, to use intervention -- on a large scale, if necessary -- to prevent or counter the development of disorderly market conditions. In circumstances in which rate movements are clearly exceeding changes warranted by underlying factors, intervention -- undertaken within the context of appropriate basic policies and in cooperation with other countries -- will be used to restore market stability.

QUESTION:

Article IV of the Second Amendment to the Fund Articles of Agreement requires the Fund to exercise firm surveillance over the exchange rate policies of members. How is surveillance being conducted at present? What are the implications of surveillance for United States monetary policy and policy toward exchange market intervention? Please provide a copy of any IMF documents or comments pertaining to U.S. exchange rate policy arising from the Fund's exercise of surveillance pursuant to Article IV.

ANSWER:

With the entry into force of the amended IMF Articles of Agreement, the Fund has proceeded in a cautious and deliberate manner to implement its surveillance responsibilities. The guidelines on exchange rate policies have become effective and consultations have been initiated with members, including the United States and other major industrial countries.

The purpose of IMF surveillance is to ensure a member's policies are consistent with its international obligation to promote orderly underlying economic conditions and to avoid manipulating exchange rates to prevent balance of payments adjustment or gain an unfair competitive advantage. Although the guidelines list specific developments -- including large-scale intervention and monetary policies to inappropriately encourage capital flows -- which could trigger consultations, the Fund's evaluation is based on a comprehensive analysis

of the members' domestic economic and balance of payments situation and policies. Furthermore, while the IMF may make suggestions regarding a member's policies, it is the responsibility of the member to decide on the measures best suited to meet domestic and international requirements.

Attached are the documents relating to IMF surveillance of U.S. exchange rate policies.

QUESTION: To what extent should U.S. monetary policy be hinged upon international monetary developments, including exchange rate movements? What is the present United States policy with respect to interest rates and the international value of the dollar? Should U.S. interest rates be kept sufficiently above foreign interest rates to compensate dollar holders for higher inflation rates in the U.S.?

ANSWER: In recent times, domestic and international economic considerations have called for the same type of monetary response by U.S. authorities. U.S. monetary policy, which is aimed at fighting inflation in the U.S., without precipitating recession, also strengthens the dollar.

Typically, relatively higher inflation rates in the U.S. than in other major countries are associated with relatively higher U.S. interest rates. Our monetary policy should be aimed at reducing inflation in the U.S. and not, per se, at setting interest rates which compensate for the higher rate of inflation.

Question: What is the total loss to date on exchange-guaranteed instruments issued to foreign governments and central banks by the U.S. Treasury and Federal Reserve System in the period from 1960 through August 1971? What is the total loss on exchange market intervention by the Treasury and Federal Reserve System since August 1971?

Answer: Total net exchange losses on liquidation of obligations arising during 1960 - August 1971 amounted to \$2,461 million. All such obligations have now been met.

Total net exchange losses realized on operations from August 1971 through January 1979 amounted to \$50 million. As of January 31, 1979, there were unrealized net profits of \$36 million against outstanding assets and liabilities.

Attached are the detailed tables on profits and losses as published in reports on Treasury and Federal Reserve Foreign Exchange Operations.

Attachments

Question: Please report all exchange risk-guaranteed obligations currently outstanding or which are expected to be contracted during the next year.

Answer: Obligations currently outstanding include Treasury foreign currency denominated securities issued in December 1978, January 1979, and March 1979, and some remaining Federal Reserve swap indebtedness to the Deutsche Bundesbank. Obligations which might be incurred during the next year cannot be forecast.

Details on the security issues are as follows:

<u>Date of Issue</u>		<u>Dollar Equivalent at Issuance</u> (\$ millions)	<u>Maturity</u>	<u>Interest Rate</u> % p.a.
Dec. 15, 1978	DM 1,774	931	Dec. 15, 1981	5.95%
Dec. 15, 1978	DM 1,265	664	Dec. 14, 1982	6.20%
Jan. 26, 1979	SF 1,247	744	July 26, 1981	2.35%
Jan. 26, 1979	SF 768	459	Jan. 26, 1983	2.65%
March 1, 1979	DM 1,260	680	Sept. 1, 1981	6.30%
March 1, 1979	DM 1,243	671	Sept. 1, 1982	6.70%
		<u>4,150</u>		

As of the end of January 1979, the latest date for which data have been published, Federal Reserve swap drawings outstanding totalled \$4,615 million equivalent and those of the Treasury totalled \$613 million equivalent. Subsequently, the Treasury swap debt has been fully liquidated and that of the Federal Reserve sharply reduced.

Question: What is Treasury's current estimate of the effect of dollar depreciation on the Consumer Price Index, Wholesale Price Index, and U.S. export prices?

Answer: Between September, 1977 and December, 1978 the dollar depreciated roughly 10% on a trade-weighted basis. We estimated that this would add 1 to 1.5 percentage points to the CPI. Since then, the dollar has appreciated almost five percent. We believe this appreciation will -- over time -- work to cancel out about one-half of the inflationary impact of the earlier depreciation.

We have estimated that direct effect of exchange rate change on inflation is 0.04 per one percent exchange rate change and total effect -- direct plus indirect -- is 0.1 to 0.15 per one percent change.

If estimated inflation effect is symmetrical with respect to dollar appreciation and depreciation then recent dollar gain has wiped out part of past inflationary impact from dollar depreciation. The time lags involved in passing through the exchange rate change mean we are probably still receiving some of the remaining negative effect from earlier devaluation but over time positive impact from dollar appreciation will come into play.

Question: Please submit to the Subcommittee an audit and annual report for fiscal year 1978, and monthly financial statements as required by section 6 of P.L. 95-612.

The ESF Annual Report for fiscal year 1978, including the Audit Report is in final preparation and will be submitted as soon as possible. Attached are the ESF financial statements, as of December 31, 1978, as published in the April Treasury Bulletin.

Pursuant to P.L. 95-612, such financial statements are to be provided to the Committee on Banking, Finance, and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate on a more current basis -- within 30 days after the close of each calendar month. This reporting requirement is to become effective legally as of the date on which funds are made available pursuant to appropriations Acts authorized by P.L. 95-612. That is, at that time, the ESF financial statements will not contain items of administrative expense and will provide a complete statement solely of ESF financial and monetary operations. The absence of administrative expense items will substantially simplify the administrative tasks of preparing the ESF financial statements and so will make possible Treasury compliance with a 30-day reporting deadline.

To be published in April
Treasury Bulletin

ECONOMIC STABILIZATION FUND

Table ESF-1. - Balance as of September 30, 1978 and December 31, 1978

(In thousands of dollars)

Assets, Liabilities, and Equity	September 30, 1978	September 30, 1978 through December 31, 1978	December 31, 1978
<u>Assets</u>			
Current assets:			
Cash			
Account of U.S. Treasury (includes undeposited col- lections).....	\$ 654	\$ (546)	\$ 100
Federal Reserve Bank of New York, special account.....	<u>29,180</u>	<u>1</u>	<u>29,181</u>
Special drawing rights 2/.....	\$ 29,814	\$ (545)	\$ 29,269
Investments: U.S. Government securities.....	2,941,684	(1,382,194)	1,559,490
Foreign exchange and securities: 2/.....	1,783,009	1,627,091	3,410,100
Pounds sterling.....	4		
Deutsche marks.....	5,926	1,201,276	1,207,202
Japanese yen.....		1,558,202	1,558,202
Accounts receivable.....	56,861	43,430	100,291
Total current assets.....	<u>\$ 4,737,394</u>	<u>\$ 2,848,278</u>	<u>\$ 7,485,162</u>
Fixed assets:			
Land.....	\$ 100	\$	\$ 100
Buildings, less allowance for depreciation.....	24	(18)	6
Furniture and equipment (includes auto equipment and leasehold improvements), less allowance for depreciation.....	609	88	697
Total fixed assets.....	<u>\$ 733</u>	<u>\$ 80</u>	<u>\$ 703</u>
Total assets.....	<u>\$ 4,798,127</u>	<u>\$ 2,848,358</u>	<u>\$ 7,492,165</u>
<u>Liabilities and Equity</u>			
Current liabilities:			
Accounts payable.....	\$ 49,684	\$ 32,158	\$ 81,842
Exchange translation liability - Deutsche marks 2/.....	2,432	3,453	6,287
Exchange translation liability - Swiss franc notes 2/.....	746,726	(170,430)	576,296
Advance from U.S. Treasury (US drawing on IMF) 2/.....		3,000,000	3,000,000
Total current liabilities.....	<u>\$ 799,042</u>	<u>\$ 2,865,181</u>	<u>\$ 3,664,425</u>
Long term liabilities:			
Exchange translation liability - Swiss franc notes 2/.....	\$ 64,933	\$ (64,933)	\$
Other liabilities:			
Special drawing rights certificates.....	\$ 1,300,000	\$	\$ 1,300,000
Special drawing rights allocations.....	2,838,734	49,824	2,888,558
Total other liabilities.....	<u>\$ 4,138,734</u>	<u>\$ 49,824</u>	<u>\$ 4,188,382</u>
Equity:			
Capital account.....	\$ 200,000	\$	\$ 200,000
Net income (loss) (see Table ESF-2).....	(504,874)	(1,216)	(506,090)
Total equity.....	<u>\$ (304,874)</u>	<u>\$ (1,216)</u>	<u>\$ (306,090)</u>
Total liabilities and equity.....	<u>\$ 4,193,268</u>	<u>\$ 2,848,358</u>	<u>\$ 7,492,165</u>

See footnotes at end of Table ESF-2.

Classification	Current Quarter October 1, 1978 through December 31, 1978	Year To Date October 1, 1978 through December 31, 1978
Inc		
Profits on:		
Foreign exchange ^{4/}	\$ 18,224	\$ 18,224
Foreign Investment Valuation.....	(47,759)	(47,759)
Miscellaneous.....		
Interest on:		
U.S. Investments.....	45,723	45,723
Foreign Investments.....	14,705	14,705
Special drawing rights.....	(6,255)	(6,255)
Foreign balances.....	81	81
Adjustments for change for valuation of SDR ^{1/}	(21,315)	(21,315)
Total Income.....	\$ 3,404	\$ 3,404
Expense:		
Personnel compensation and benefits.....	\$ 3,721	\$ 3,721
Travel.....	384	384
Transportation of things.....	22	22
Rent, communications, and utilities.....	198	198
Supplies and materials.....	19	19
Other.....	373	373
Total Expense.....	\$ 4,717	\$ 4,717
Prior year expense.....	403	403
Net income (loss).....	\$ (1,716)	\$ (1,716)

Note: Annual balance sheets for fiscal years 1934 through 1940 appear in the 1940 Annual Report of the Secretary of the Treasury and those for succeeding years appear in subsequent reports. Quarterly balance sheets beginning with December 1938 have been published in the Treasury Bulletin. Data from inception to 9/30/78 may be found on the statements published in the January, 1979 Treasury Bulletin.

- 1/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of 16 member countries. The United States SDR holdings and allocations are valued on this basis beginning July 1974.
- 2/ Excludes foreign exchange transactions for future and spot delivery.
- 3/ The Exchange Stabilization Fund (ESF) entered into a bilateral currency agreement with the Deutsche Bundesbank on January 4, 1978. The exchange translation liability shown is the amount of loss the ESF would realize if redemption of outstanding swap debts under the agreement had taken place at the exchange rate on that date. As of January 31, 1979, there was an exchange translation receivable of \$5 million related to the agreement.
- 4/ The exchange translation liability shown is the amount of loss that the Exchange Stabilization Fund would sustain if redemption of the outstanding \$600 million Swiss franc-denominated U.S. Treasury notes had taken place at the exchange rate on that date. The exchange translation liability on the Swiss franc notes outstanding as of January 31, 1979 was \$458 million based on the exchange rate on that date.
- 5/ A non-interest bearing liability to the U.S. Treasury resulting from the transfer to ESF of foreign currencies drawn from IMF by the U.S.
- 6/ a. Deutsche Mark Transactions - During the period October 1, 1978 to December 31, 1978 cash losses of \$66 million were sustained. For the month of January, 1979 cash gains of \$1 million were realized.
b. Swiss Franc Note Redemption - During the period of October 1, 1978 to December 31, 1978 cash losses of \$157 million were sustained. For the month of January, 1979 cash losses of \$63 million were sustained.
c. Japanese Yen Transactions - During the period October 1, 1978 to December 31, 1978 cash losses of \$2 million were sustained. For the month of January, 1979 there were no cash gains or losses.

A N N U A L R E P O R T
(Including Audit Report of the Audit Committee)

FOR THE YEAR ENDED SEPTEMBER 30, 1978

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND

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Prepared for submission to the President and to the Congress pursuant to Section 10 of the Gold Reserve Act of 1934, as amended (31 U.S.C. 822a)

Exchange Stabilization Fund
Policy and Operations Statements
Fiscal Year 1978

1. Introduction

The Exchange Stabilization Fund (ESF) report and financial statements for fiscal year 1978 continued to reflect a number of important policy changes and financial developments which began in 1977. Exchange market developments led to the activation of the ESF for market operations on a significant scale for the first time since the early 1970's. The Congress enacted legislation terminating payment of administrative expenses from the ESF, and authorizing instead the appropriations of funds for that purpose. Significant exchange rate changes continued to result in large accrued and cash losses for the ESF in connection with pre-August 1971 Swiss franc debt issued by the Treasury. Following the statement period, these debts were redeemed in full on an accelerated basis.

This statement outlines the nature and functions of the ESF and describes the developments referred to above.

2. Nature and Functions of the ESF

The Gold Reserve Act of 1934 (31 U.S.C. 822a), established a fund to be operated by the Secretary of the Treasury, with the approval of the President, for the purpose of stabilizing the exchange value of the dollar. Section 10 of the Act provided that "The Secretary of the Treasury, with the approval of the President, directly or through such agencies as he may designate, is authorized, for the account of the fund established in this section, to deal in gold and foreign exchange and such other instruments of credit and securities as he may deem necessary to carry out the purpose of this section". Legislation approved in 1976 and in 1977 (P.L. 94-564 and P.L. 95-147) amended the purpose of the ESF to specify that the ESF is to be utilized as the Secretary may deem necessary, consistent with U.S. obligations in the International Monetary Fund (IMF) regarding orderly exchange arrangements and a stable system of exchange rates. This amendment to Section 10 of the Gold Reserve Act became effective on April 1, 1978, the date of entry into force of the Second Amendment of the IMF Articles of Agreement.

To enable the Secretary of the Treasury to carry out the provisions of Section 10, Congress appropriated in 1934 the sum of \$2 billion out of the increment resulting from the reduction in the weight of the gold dollar. This amount was deposited with the Treasurer of the United States, and the ESF began operations in April 1934. Operation of the ESF was authorized for a period of two years, and the President, by proclamation, extended the period for one additional year. Subsequently,

amendments to the Act continued the ESF in operation through June 30, 1945, and Section 7 of the Bretton Woods Agreements Act, approved July 31, 1945, continued its operations permanently. The Bretton Woods Agreements Act also directed the Secretary of the Treasury to pay \$1.8 billion from the ESF into the International Monetary Fund (IMF), for the U.S. quota subscription in the IMF, thereby reducing the ESF's appropriated capital to \$200 million.

Pursuant to the Special Drawing Rights Act of 1968, Special Drawing Rights allocated by the IMF or otherwise acquired by the United States are resources of the ESF. As of September 30, 1978, cumulative allocations (liabilities) ^{1/} to the United States totalled SDR 2,294 million (\$2,939 million), and U.S. holdings (assets) of SDR totalled SDR 2,296 million (\$2,942 million). ^{2/} Special Drawing Rights can be monetized through the issuance by the Secretary of the Treasury of Special Drawing Right certificates to the Federal Reserve banks; such certificates are a liability of the ESF which would become payable when the corresponding SDRs were used by the ESF. As of September 30, 1978, \$1.3 billion of these liabilities to the Federal Reserve were outstanding.

Pursuant to present exchange arrangements and U.S. law (P.L. 95-147), and consistent with the IMF Articles of Agreement, several broad criteria are presently utilized to govern use of the ESF, in keeping with the overall international monetary and financial policy of the United States. ESF operations are conducted in close consultation with the Federal Reserve System. Financing extended by the ESF to foreign monetary authorities generally must be short-term. No loan or credit to a foreign government or entity can be extended by the ESF for more than six months in any twelve-month period, unless the President provides a written determination to the Congress that unique or exigent circumstances make such a loan or credit necessary for a term greater than six months. ESF financing is designed to support the IMF and U.S. policy in that institution.

3. Exchange Market Developments in Fiscal Year 1978

At the beginning of the fiscal year, the dollar encountered generalized and continuing selling pressure in increasingly unsettled foreign exchange market conditions. These conditions reflected, in particular, the sharply rising U.S. trade deficit, the delays in completion of U.S. energy legislation, and concerns that growth rates among major industrialized nations would not

- ^{1/} These liabilities must be discharged only in the event of liquidation of or U.S. withdrawal from the SDR Department of the IMF or cancellation of SDR.
- ^{2/} The dollar value of the SDR changes daily with movements in exchange rates. These figures are calculated on the basis of the dollar/SDR rate as of September 30, 1978 (\$1.28107 per SDR).

soon converge. In December 1977, the President stressed the importance of reducing U.S. oil imports in urging Congressional approval of energy legislation, and reaffirmed the U.S. intention to intervene in the exchange markets to the extent necessary to counter disorderly conditions. From early October 1977, the Federal Reserve had been selling German marks in the market to implement this policy, and such sales had become larger and more frequent in November of that year. In January 1978, the Treasury began to use the Exchange Stabilization Fund (ESF) actively in foreign exchange market operations. Treasury operations were financed by drawings of German marks against a swap agreement concluded with the Bundesbank on January 3, 1978.

The adoption of more forceful joint intervention helped to improve foreign exchange market conditions early in the new year. However, the dollar remained on offer in the market from time to time, and there was insufficient improvement in narrowing global payments imbalances and the divergent trends in growth and price performances. In March, Secretary Blumenthal and German Finance Minister Matthofer reaffirmed that forceful action would be continued to counter disorderly market conditions. In this connection, in order to provide further foreign currency resources if needed, the Treasury announced that arrangements had been made for the sale of SDR 600 million to purchase German marks, that the Federal Reserve and Bundesbank had agreed to double the amount of their swap arrangement from \$2 billion to \$4 billion, and that the United States was prepared to draw against its reserve position in the International Monetary Fund.

In early April, selling pressure on the dollar intensified following the release of U.S. trade figures showing a record \$4.5 billion deficit in February. Later in April the Treasury announced that a series of monthly public auctions of gold would be initiated in May, amounting to 300,000 ounces at each of the first six auctions, which would reduce net imports of gold. The second quarter as a whole experienced more stable markets, and large reflows into dollars from commercial and banking sources occurred, enabling the U.S. authorities to make significant reductions in swap indebtedness. By the end of July, total U.S. swap indebtedness to the Bundesbank had been reduced by \$1,996 million from its early April peak to \$848 million.

Market tension resumed over the summer. Inflationary expectations and a renewed deterioration in the U.S. external accounts, following the second quarter improvement, were major influences. Dollar selling accelerated in disorderly trading. Over the third quarter, the dollar depreciated by a further 3.5 percent. Net currency sales by the U.S. authorities increased, raising outstanding indebtedness to \$1,031 with the Bundesbank and \$170 million with the Swiss National Bank by the end of September. In August, the President directed that measures be taken to deal specifically with the foreign exchange market

situation. Subsequently, Treasury announced that the amount of gold offered would be increased to 750,000 ounces beginning with the November auction. The Federal Reserve moved to increase U.S. interest rates further and reduced reserve requirements on Euro-dollar borrowings by U.S. banks. Also at that time, a Congressional compromise on the natural gas bill was achieved, paving the way for passage of energy legislation.

Toward the close of the fiscal year, signs were emerging that the U.S. deficit on current account would be likely to decline substantially in the next year. Progress was also being made in reducing the U.S. budget deficit. However, U.S. inflationary pressures continued strong, and foreign exchange market conditions continued to deteriorate. Discussions within Europe of a new European Monetary System (EMS) added to market uncertainties, and to pressure on the existing "Snake" arrangements.

Market disorder worsened in October. The market reacted unfavorably to the President's comprehensive anti-inflation program and failed to give adequate weight either to the fiscal and monetary policies being put in place or the improvements that were being made in the underlying conditions that determine the dollar's value. It became increasingly clear that the severe and persistent disorder and excessive decline in the dollar were undermining U.S. efforts to control inflation and adversely affecting the climate for continued investment and growth in the United States. On November 1, the President, the Secretary of the Treasury and the Chairman of the Federal Reserve announced a series of corrective actions. The Federal Reserve raised the discount rate from 8-1/2 to 9-1/2 percent and imposed a supplementary reserve requirement on large time deposits, substantially strengthening the monetary restraint on the domestic economy. The U.S. authorities joined German, Switzerland and Japan in closely coordinated exchange market intervention. To finance the U.S. contribution to the coordinated market intervention, the U.S. arranged facilities totalling up to \$30 billion in the currencies of these three countries. In addition, the Treasury increased its monthly sales of gold to at least 1-1/2 million ounces per month, starting with the December auction.

Announcement of the November 1 program was followed by a sharp appreciation of the dollar. Market conditions improved significantly thereafter, though economic statistics continued to be mixed. The Iranian situation, and the oil supply and price situation generally, were disturbing developments but their complexity tended to have diverse effects on the exchange markets, with implications not only for the U.S. economy but for all countries. Gradually, however, the underlying tone in the exchange markets improved significantly, encouraging more judicious assessments of new trading factors as they developed.

4. ESF Operations During the Fiscal Year

The ESF was used actively in U.S. foreign exchange market operations during the course of the year. Operations consisted of market sales of German marks financed by drawings under a swap facility with the Deutsche Bundesbank. Receipt of Special Drawing Rights in transactions with the IMF and other countries raised U.S. holdings to the level of allocations by the end of the year. Redemption of outstanding Treasury obligations denominated in Swiss francs and held by the Swiss National Bank continued on the regular schedule agreed in 1976. Monetary arrangements with the Bank of Mexico and facilities provided in the multilateral financing of reductions in certain official sterling balances were not activated during the year.

a) Swap activity in German marks. On January 3, 1978 the ESF entered into a one-year bilateral currency (swap) agreement with the Deutsche Bundesbank. The facility was used actively by the Treasury in financing market operations throughout the year, in coordination with Federal Reserve operations, as follows:

ESF Operations in German Marks in \$ millions equivalent

1978	Operations		Swap		Outstanding Drawings end-period	Peak Outstanding (date)
	Sales	Purchases	Drawings	Repayments		
Jan.-Mar.	1,226	261	965	-	965	
Apr.-June	42	626	35	534	466	1,000 (4/4/78)
July-Sept.	472	558	362	486	342	

During the fiscal year the ESF incurred net cash exchange losses of \$4.2 million associated with repayments under the swap facility. The ESF financial statement for September 30, 1978 also reflects a liability of \$2.6 million which represents the amount of loss the ESF would have sustained under the agreement if redemption of the outstanding \$342 million had taken place at the exchange rate on that date.

b) SDR operations. During the fiscal year holdings of Special Drawing Rights increased by SDR 157 million to SDR 2,296 million (\$2,942 million equivalent) at the end of September. This increase reflected: 1) SDR received as interest on financing provided to the IMF by the U.S. under the General Arrangements to Borrow; 2) remuneration received on the U.S. creditor position with the Fund, but less U.S. payments of interest and assessments to the IMF; and 3) purchases from other countries under designation by the IMF. During the fiscal year, the Secretary issued an additional \$100 million of Special Drawing Right certificates to the Federal Reserve, raising total outstanding certificates to \$1.3 billion.

c) Foreign currency securities. In November 1976, the ESF began to undertake foreign exchange operations in connection with the redemption of Swiss franc denominated U.S. Treasury securities held by the Swiss National Bank and outstanding since August 1971. Pursuant to an agreement reached with the Swiss authorities in October 1976 (which also covered outstanding Swiss franc drawings by the Federal Reserve under its swap lines with the Swiss National Bank), repayment by the Treasury was planned on a regular schedule over a three-year period, ending in October 1979. These arrangements were described in detail in the 1977 Annual Report.

During the fiscal year, the Treasury's outstanding Swiss franc securities were reduced from the equivalent of \$1,289 million to \$768 million as of September 30. Over this period, the ESF incurred cash exchange losses of \$335 million resulting from purchases for dollars at current market exchange rates of Swiss francs needed for the redemptions and transfer of the francs to the General Account of the Treasury for dollars at the exchange rate at which the securities are valued on the Treasury's books. The accrued exchange losses recorded as a liability in connection with the redemptions amounted to \$812 million as of the statement date, September 30, 1978.

d) Stabilization and Other ESF Agreements. The ESF entered into no other monetary arrangements during the fiscal year. ESF participation in multilateral, medium-term arrangements for financing certain reductions in official sterling balances continued. There were no transactions under this arrangement, which began in February 1977, and the facility expired on February 7, 1979. There were also no transactions under the \$300 million stabilization agreement with Mexico.

During the fiscal year, ESF investment earnings were exceeded by four operational items combined: exchange losses in connection with the redemption of Swiss franc-denominated Treasury securities; exchange losses associated with current operations in German marks; adjustments for changes in the valuation of SDR allocations and holdings; and interest payments on SDR allocations in excess of holdings. As a result the ESF registered net losses of \$641 million before administrative expenses which amounted to an additional charge of \$19 million.

After the close of Fiscal Year 1978 a number of developments occurred which will have a bearing on ESF financial statements for FY 1979. Following November 1 the ESF acquired balances in German marks and Japanese yen as an advance from the Treasury resulting from the \$3.0 billion U.S. drawing on its reserve position in the IMF. Additional amounts of these currencies totalling the equivalent of \$1.4 billion were acquired as proceeds from ESF sales of Special Drawing Rights to the German and Japanese authorities. The proceeds of the issuance of Treasury securities denominated in German marks and Swiss francs, totalling the equivalent of \$4.15 billion as of the date of this report, also are available for ESF operations.

The foreign currency proceeds are held by the General Account of the Treasury pending their use, if needed, for U.S. intervention operations. The General Account accordingly assumes the accounting effects of exchange gains or losses associated with the issuance of these public debt securities. In addition to these developments associated with the November 1 actions, during the early months of 1979 the ESF also received a new allocation of Special Drawing Rights from the IMF totalling SDR 874 million; purchased Swiss francs in sufficient quantity to enable the Treasury to redeem all outstanding Swiss franc securities held by the Swiss National Bank ahead of schedule sustaining cash exchange losses of \$687 million; and repaid the outstanding drawings (\$342 million) under the swap arrangement with the Bundesbank.

5. ESF Administrative Expenses

As indicated in last year's report, the Treasury on September 9, 1977, submitted a bill "To provide that the Exchange Stabilization Fund shall not be available for the payment of administrative expenses, and for other purposes". This bill provided that administrative expenses associated with the Treasury Department's international affairs functions will be funded by appropriations beginning in FY 1979. The bill was approved by the Congress in October 1978. When appropriations become available, these expenses will cease to be funded from the ESF. Requests for appropriation, for the last quarter of FY 1979 and for FY 1980, are under consideration by the Congress.

AUDIT OPINION OF AUDIT COMMITTEE

Washington, D.C.

APR 13 1979

Dear Mr. Secretary:

In accordance with your request of January 12, 1979, (copy attached), we have examined the balance sheets of the Exchange Stabilization Fund as of September 30, 1978 and 1977, Exhibit A, and the related statements of income and expense, Exhibit B, and changes in financial position, Exhibit C, for the years then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The total liabilities of the Exchange Stabilization Fund exceeded its total assets by \$305 million at September 30, 1978. The Exchange Stabilization Fund's continued ability to meet its obligations may depend both on utilizing and enhancing the Fund's resources to maintain adequate working capital.

In our opinion, subject to the effects, if any, on the financial statements of the matter discussed in the preceding paragraph, the financial statements referred to above present fairly the financial position of the Exchange Stabilization Fund at September 30, 1978 and 1977 and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Respectfully submitted,

The Audit Committee:

Eugene S. Sheskin
Eugene S. Sheskin, C.P.A.
Chairman

Richard J. McDonnell
Richard J. McDonnell, C.P.A.

Eugene L. Kales
Eugene L. Kales, C.P.A.

The Honorable

The Secretary of the Treasury



THE SECRETARY OF THE TREASURY
WASHINGTON 20220

January 12, 1979

Dear Sirs:

I am appointing you as a committee to conduct a financial audit of the Exchange Stabilization Fund for the fiscal year October 1, 1977 through September 30, 1978. The audit will be performed in accordance with generally accepted auditing standards. Mr. Eugene S. Sheskin will serve as the chairman of your audit committee.

As you may know, the Exchange Stabilization Fund was established pursuant to Section 10 of the Gold Reserve Act of 1934. Its operations are an important part of Treasury business and confidential by nature. Only well-qualified and highly professional employees are assigned to the committee and its staff. I appreciate your willingness to serve in this capacity and am confident that this audit will reflect the standards of excellence characteristic of your past performance.

The Bureau of Government Financial Operations will coordinate administrative requirements of the audit and will serve as the repository for the supporting records of the committee. To provide staff assistance for your committee three additional auditors have been recruited; one each from the Bureau of Alcohol, Tobacco and Firearms, the Bureau of Engraving and Printing, and the Bureau of the Public Debt.

Sincerely,

W. Michael Blumenthal

Mr. Eugene S. Sheskin
U. S. Customs Service

Mr. Richard J. McDonnell
Bureau of Government
Financial Operations

Mr. Eugene Kales
Internal Revenue Service

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND

BALANCE SHEET

SEPTEMBER 30, 1978 AND SEPTEMBER 30, 1977

(In Thousands of Dollars)

<u>ASSETS</u>	<u>SEPTEMBER 30, 1978</u>	<u>SEPTEMBER 30, 1977</u>
Current Assets:		
Cash:		
Treasury of the United States - Checking Account	\$ 1,199	\$ 581
Secretary of the Treasury - Special Account #3 - Federal Reserve Bank of New York	29,161	22,947
Deposits in foreign banks <u>a/</u>	5,926	*
Special Drawing Rights <u>b/</u>	2,941,684	2,489,275
Gold <u>c/</u>	-0-	62,723
Investments in United States securities	1,763,009	2,049,565
Accounts receivable	433	441
Accrued interest receivable:		
Special Drawing Rights holdings <u>b/</u>	45,672	37,228
United States securities	10,311	9,032
Foreign bank deposits	137	-0-
Prepaid items	325	470
Total current assets	4,797,857	4,672,262
Fixed assets (at cost), net of allowance for depreciation and amortization:		
Furniture, equipment, automobile, and leasehold improvements	476	476
Land and structure	124	126
Total fixed assets	600	602
Total assets	\$4,798,457	\$4,672,864
<u>LIABILITIES AND EQUITY</u>		
Current liabilities:		
Accrued liabilities - Government	\$ 1,777	\$ 1,165
Accrued liabilities - other	16	489
Accrued payroll	797	733
Accrued annual leave	1,166	1,138
Accrued charges payable - Special Drawing Rights <u>b/</u>	46,313	40,394
Exchange translation liability - Swiss-franc denominated U.S. Treasury notes <u>d/</u>	746,726	162,366
Exchange translation liability - Deutsche marks <u>e/</u>	2,632	-0-
Total current liabilities	799,427	206,285
Long-term liabilities:		
Exchange translation liability - Swiss-franc denominated U.S. Treasury notes <u>d/</u>	64,933	241,939
Other liabilities:		
Special Drawing Rights allocations <u>b/</u>	2,938,755	2,669,132
Special Drawing Rights certificates <u>b/</u>	1,300,000	1,200,000
Total liabilities	5,103,115	4,317,356
Equity:		
Appropriated (January 30, 1934)	2,000,000	2,000,000
Less amount transferred to International Monetary Fund (July 31, 1945)	1,800,000	1,800,000
Net Appropriated Capital	200,000	200,000
Retained earnings:		
Balance beginning of period	155,508	153,473
Net income (loss) for the period ending September 30, 1978 and September 30, 1977	(660,166)	2,035
Balance end of period	(504,658)	155,508
Total equity	(304,658)	355,508
Total liabilities and equity	\$4,798,457	\$4,672,864

* Less than \$500.00

DEPARTMENT OF THE TREASURY

EXCHANGE STABILIZATION FUND

STATEMENT OF INCOME AND EXPENSE

FOR THE YEARS ENDED SEPTEMBER 30, 1978 and SEPTEMBER 30, 1977

(In Thousands of Dollars)

	FISCAL YEAR 1978	FISCAL YEAR 1977
INCOME:		
Investments:		
Interest earned on U.S. securities	\$ 120,120	\$ 91,137
Interest earned on foreign bank deposits	360	8,988
Net Investment income	<u>120,480</u>	<u>100,125</u>
Special Drawing Rights:		
Interest earned	98,170	91,982
Interest charges on SDR allocations	(101,897)	(101,413)
Gain (loss) on SDR revaluation	(9,369)	(1,345)
Assessments for administrative expense - International Monetary Fund	<u>(271)</u>	<u>(192)</u>
Net income (loss) on Special Drawing Rights	<u>(13,367)</u>	<u>(10,968)</u>
Foreign Currency Transactions		
Exchange (loss) on outstanding Swiss-franc denominated U.S. Treasury notes <u>e/</u>	(742,555)	(69,870)
Gain/loss on foreign deposits - Deutsche marks <u>a/</u>	165	-0-
Exchange gain (loss) on bilateral currency agreement - Deutsche marks <u>e/</u>	<u>(5,873)</u>	<u>-0-</u>
Net (loss) on foreign currency transactions	<u>(748,263)</u>	<u>(69,870)</u>
Gold transactions and charges <u>c/</u>	52	(8)
Miscellaneous income	<u>(2)</u>	<u>2</u>
Gross income (loss)	<u>(641,100)</u>	<u>19,281</u>
ADMINISTRATIVE EXPENSES:		
Personal services	13,016	12,807
Other services <u>f/</u>	2,860	1,861
Travel and transportation of persons	542	584
Rent, communications, and utilities	1,594	1,066
Reimbursement - Federal Reserve banks	468	336
Printing and reproduction	262	203
Transportation of things	82	56
Supplies and materials	139	193
Depreciation and amortization expense	93	92
Equipment not capitalized	9	49
Insurance claims	<u>*</u>	<u>(1)</u>
Total administrative expenses	<u>19,065</u>	<u>17,246</u>
Net income (loss)	<u>\$(660,165)</u>	<u>\$ 2,035</u>

* Less than \$500.00

The accompanying footnotes are an integral part of these financial statements.

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND
STATEMENT OF CHANGES IN FINANCIAL POSITION

FOR THE YEARS ENDED SEPTEMBER 30, 1978 and SEPTEMBER 30, 1977

(In Thousands of Dollars)

	FISCAL YEAR 1978	FISCAL YEAR 1977
Financial Resources Were Provided By:		
Operations - Net income (loss) for the period	\$(660,165)	\$ 2,035
Issuance of Special Drawing Rights Certificates	100,000	400,000
Losses/expenses not involving working capital in the current period:		
Exchange loss on outstanding Swiss-franc denominated U.S. Treasury notes <u>d/</u>	(177,007)	(88,314)
Loss from revaluation of Special Drawing Rights allocations	269,623	14,787
Net (increase) or decrease in fixed assets from interagency transfers	(2)	-0-
Depreciation	93	92
Total financial resources provided	\$(467,458)	\$ 328,600
Financial Resources Were Applied To:		
Acquisition of fixed assets	89	75
Increase (decrease) in working capital	<u>\$(467,547)</u>	<u>\$ 328,525</u>
Analysis of Changes in Working Capital:		
Increase (decrease) in current assets:		
Cash	\$ 12,758	\$(309,540)
Special Drawing Rights	452,409	132,642
Gold	(62,723)	62,723
Investments	(286,556)	520,228
Accrued interest receivable	9,860	4,296
Other	(153)	239
(Increase) decrease in current liabilities:		
Accrued liabilities	(231)	430
Accrued charges payable - Special Drawing Rights	(5,919)	435
Exchange Translation Liability - Swiss-franc denominated U.S. Treasury notes <u>d/</u>	(584,360)	(82,988)
Exchange translation liability - Deutsche marks <u>g/</u>	(2,632)	-0-
Increase (decrease) in working capital	\$(467,547)	\$ 328,525

The accompanying footnotes are an integral part of these financial statements.

DEPARTMENT OF THE TREASURYEXCHANGE STABILIZATION FUNDFOOTNOTES TO FINANCIAL STATEMENTS

- a/ Deutsche marks on deposit constitute all but \$117 of the amount shown at September 30, 1978 for deposits in foreign banks. The amount shown for gain/loss on foreign deposits consisted entirely of the revaluation gain on the Deutsche mark deposits.
- b/ Pursuant to the Special Drawing Rights Act of 1968, Special Drawing Rights (SDR) allocated to or otherwise acquired by the United States are resources of the Exchange Stabilization Fund (ESF). SDR, once allocated, are permanent resources unless cancelled (which requires an 85 percent majority decision of the total voting power of the Board of Governors of the International Monetary Fund), the Special Drawing Account is liquidated, the International Monetary Fund is liquidated, or the United States chooses to withdraw from the Fund or terminate its participation in the Special Drawing Account. Except for the payment of interest and charges on SDR allocations to the United States, the payment of the Exchange Stabilization Fund liability related to SDR allocations is conditional on events listed above, in which the United States has a substantial or controlling voice. The Special Drawing Rights Act also authorizes the Secretary of the Treasury to issue Special Drawing Rights certificates to the Federal Reserve Banks in return for dollar deposits in amounts equal to the value of the SDR held. The certificates may be issued to finance the acquisition of SDR from other countries or to provide resources for financing ESF operations. Allocations of SDR were made on January 1, 1970, 1971, 1972 and 1979. The 1979 allocation was for 874,120,000 SDR valued at \$1,138,796,897.27.
- c/ During the fiscal year ended September 30, 1978, ESF sold all of its gold (1,485,548.424 fine troy ounces) at the official price of \$42.2222 per fine troy ounce to the General Account of the U.S. Treasury.
- d/ Treasury practice prior to December 1978 has been for the Exchange Stabilization Fund to bear the exchange risk on foreign currency denominated securities issued by the Bureau of Public Debt. From October 1973 through November 1978, the outstanding balance of foreign currency denominated securities was comprised solely of Swiss francs.

In October 1976 the U.S. Treasury reached an agreement with the Swiss National Bank to repay over a three-year period the Swiss-franc

indebtedness. At September 30, 1978, the balance of the indebtedness--exclusive of the exchange translation liability--was \$768 million which are recorded in the accounts of the Bureau of the Public Debt.

The exchange translation liability on Swiss-franc notes was comprised of:

Exchange translation liability on Swiss-franc notes as of September 30, 1977	\$404,305,333
Liquidation of translation liability on Swiss-franc notes during fiscal year 1978 based on exchange rate in effect at time of transaction	(\$335,201,533)
Additional exchange losses on Swiss-franc notes as of September 30, 1978	<u>742,555,287</u>
Net increase in exchange translation liability	<u>407,353,754</u>
Exchange translation liability on Swiss-franc notes as of September 30, 1978	<u>\$811,659,087</u>

The exchange translation liability at September 30, 1978 amounted to \$746,726,360 which was to be repaid in fiscal year 1979; the remaining \$64,932,727 of the liability was to be repaid in fiscal year 1980. However, the Swiss-franc indebtedness covered by the October 1976 agreement between the U.S. Treasury and the Swiss National Bank has been repaid ahead of schedule. The exchange translation liability was entirely liquidated as of April 3, 1979. See footnote g.

- e/ The Exchange Stabilization Fund entered into a one-year bilateral currency agreement with the Deutsche Bundesbank on January 3, 1978. The exchange translation liability shown is the amount of loss that the ESF would sustain under the agreement if redemption had taken place at the applicable exchange rate on the balance sheet date. The revaluation loss shown consists of the accrued exchange translation liability at September 30, 1978 plus additional cash losses under the agreement on redemption during the fiscal year.
- f/ Includes ESF share of State Department direct and indirect administrative support and meeting expenses, professional service contracts, ADP programming and usage contracts, services performed by other Government agencies, and other miscellaneous services.

Subsequent Events

- g/ As part of the President's program announced November 1, 1978, foreign currency-denominated securities amounting to \$4,150 million were issued by the Bureau of Public Debt during the period December 1978 through March 1979. The exchange gains or losses with respect to these securities are to be borne by the General Account of the U.S. Treasury. This differs from Treasury practice in connection with securities issued to foreign monetary authorities in the 1960's and early 1970's, which was to have exchange risks on foreign denominated securities borne by the Exchange Stabilization Fund. The ESF has continued to bear the exchange risks on outstanding foreign currency denominated securities issued in previous years. The last of these previously issued securities were redeemed on April 3, 1979--see footnote d.
- h/ In November 1978, the U.S. Treasury Department drew the equivalent of \$3 billion in foreign currencies from the United States reserve position in the International Monetary Fund. Simultaneously, the U.S. Treasury General Account transferred the \$3 billion in foreign currencies to ESF and established a liability in an equal dollar amount in the form of a non-interest bearing advance. This transfer was made pursuant to the Bretton Woods Agreements Act.

The ESF utilizes the currencies advanced in its daily operating activities. It assumes the exchange gains and losses on the amounts advanced to the extent they are held in the form of foreign currencies.

Question: Under existing ESF arrangements and swap agreements via the Federal Reserve System does the United States bear the foreign exchange risk or do foreign countries?

Answer: Foreign countries bear the foreign exchange risk on drawings initiated by them. The foreign exchange risk is shared on drawings initiated by the United States.

Question: What changes have occurred during the past 12 months in the use of the U.S. dollar, Japanese yen, Swiss franc, German mark, pound sterling and other currencies to invoice international trade and denominate international credit?

Answer: Since data for the full year 1978 are not yet available, the following analysis is based on only the first nine months.

This evidence does suggest a decline in

the use of the dollar as a vehicle for

international credit in 1978. Since the stock of dollar assets is so large, changes

in the use of the dollar during one year

do not dramatically alter the outstanding

stock of dollar-denominated claims. Estimates

suggest that the proportions of total outstanding bank claims which were denominated

in dollars fell marginally from 70.6 percent

to 68 percent during the first nine months

of 1978. This decline was made up for by

an increase in outstanding claims denominated

in Swiss francs, German mark, and Japanese

yen.

Claims in Deutsche marks and Swiss francs, which constitute some 20 percent of total outstanding international bank credit, rose at a more rapid pace than dollar denominated claims, but much of this increase represented the valuation effects of appreciation of these two currencies against the dollar. Yen-denominated claims rose dramatically in relative terms, even after allowing for valuation effects, but the yen's share of total claims outstanding is still very small (about 1-1/2%). Claims in other currencies identifiable from data collected by the Bank for International Settlements registered a substantial increase but still accounted for less than 10 percent of total claims.

There were more striking shifts in the currency composition of new international bond issues. Dollar denominated issues fell from 55-60 percent of the total in previous years to about 40 percent in 1978. The share accounted for by the DM rose to over 25 percent, while yen-denominated issues jumped sharply to account for over 10 percent of the total in 1978. The Swiss franc continue to account for approximately 15 percent.

We do not have any information on changes in the denomination of international trade invoices during 1978. Market comments suggests that there was a tendency for exporters of manufactured goods in a number of major industrial countries to invoice in their national currencies.

April 25, 1979

Question: What changes have occurred in use of the dollar and other currencies as international reserve assets during the last twelve months?

Answer: See Treasury Report on the Operation of the International Monetary System.

Question: What steps has the Department of the Treasury taken to reach agreement with other countries on the future role of the dollar as a reserve asset?

Answer: The International Monetary Fund (IMF) is the principal forum for discussion and negotiation of questions related to the operation of the international monetary system, including issues relating to changes in the composition of reserve assets. The amended IMF Articles establish the long run objective of making the SDR the principal reserve asset in the international monetary system, and a number of actions have been taken recently to improve the quality and usefulness of the SDR in order to facilitate progress toward this objective. For example, new allocations of SDR totaling SDR 12 billion have been agreed upon for the three year period 1979-81; the formula for determining the rate of interest on the SDR has been modified to bring the rate more closely in line with market interest rates; the obligation of members to reconstitute their holdings of SDR has been reduced; and a number of steps are underway to reduce impediments to transactions in SDR among IMF member countries. In addition, the IMF Interim Committee has requested the Executive Board to give active consideration to the establishment of an account, to be administered by the Fund, that would accept deposits of foreign exchange from members on a voluntary basis in exchange for an equivalent amount of SDR denominated claims. Discussions are proceeding in the Executive Board with a view toward presenting conclusions on this question to the October meeting of the Interim Committee.

QUESTION: What is the estimated size of the Euro-currency market?

ANSWER: It is not possible to provide a single number measuring the size of the Euro-currency market, inter alia because the appropriate definition varies with the issue being considered. The attached table shows the calculation of two alternative measures of the "gross" Euro-currency market and its dollar component.

Measuring "size" by the total of assets or liabilities encounters the problem of significant "double counting" which arises from widespread redepositing of funds by Eurobanks with other banks participating in the market (interbank deposits are excluded from measures of the U.S. money stock). As a rough estimate, the net size of the Euro-currency market at the end of September 1978 could be put in the range of \$375 billion-\$425 billion and the Eurodollar market about \$300 billion - \$350 billion. However, the amount of bank liabilities to non-banks is much smaller - about one-third of these respective magnitudes.

TABLE
Main Components of Eurocurrency and International Banking Market

(Liabilities of U.S. and Euro-Banks) 1/

\$ billions

	Sept. 1978	INCREASE Jan.-Sept. 1978
<u>Liabilities To Non-Residents</u>		
1. Dollar Liabilities of Banks in Europe, Canada & Japan PLUS	342	24
2. Dollar Liabilities of U.S. Branches in Offshore Centers EQUALS	94	9
3. GROSS SIZE OF EURODOLLAR MARKET, FIRST DEFINITION PLUS	436	33
4. Other Foreign Currency Liabilities of U.S. and Euro-banks EQUALS	160	33
5. GROSS SIZE OF EUROCURRENCY MARKET, FIRST DEFINITION PLUS	597	67
6. Dollar Liabilities of Banks in U.S. PLUS	87	10
7. Domestic Currency Liabilities of Euro-banks EQUALS	80	16
8. GROSS SIZE OF INTERNATIONAL BANKING MARKET AS SHOWN BY BIS LESS	764	93
9. BIS Estimate of Double Counting due to Interbank Deposits Among Banks in BIS Reporting Area	264	23
10. NET SIZE OF INTERNATIONAL BANKING MARKET AS SHOWN BY BIS	500	70
<u>Foreign Currency Liabilities To All Customers</u>		
11. Liabilities to Residents	160	27
12. Of which: in dollars	119	17
13. GROSS SIZE OF EUROCURRENCY MARKET, SECOND DEFINITION (Lines 5 and 11)	757	94
14. GROSS SIZE OF EURODOLLAR MARKET, SECOND DEFINITION (Lines 3 and 12)	555	50
ESTIMATED NET SIZE OF EURODOLLAR MARKET	300 to 350	

1/ Consisting of banks in countries reporting to the Bank for International Settlements plus branches of U.S. banks located in the Bahamas, Cayman Islands, Hong Kong, Panama and Singapore.

Note: Partly Estimated

Treasury/OASIA
4-30-79

QUESTION: Does the Eurocurrency market contribute to U.S. inflation? hinder U.S. monetary policy?

ANSWER: Although it is sometimes suggested, in principle, that some Eurocurrency deposits and loans should be included with the domestic monetary and credit aggregates used as operating guides for monetary policy, in practice, the role of Eurocurrency transactions has been minor. U.S. resident holdings of Eurocurrency deposits are a small percentage of comparable domestic monetary aggregates - on the order of 1% - 2% - and net private capital flows between U.S. markets and Euromarkets normally are also small in relation to aggregate credit flows in the U.S. economy. In any event, the Fed is able to take Eurocurrency activity into account in framing monetary policy.

QUESTION: Does the Eurocurrency market contribute to instability in the foreign exchange market?

ANSWER: The growth in outstanding private credit and financial holdings - whether through the Euromarkets or domestic financial systems - obviously means that greater financial resources are available for foreign exchange transactions. In addition the existence of an efficient and highly integrated banking system makes it possible to mobilize large amounts of funds very quickly and thus may add to the potential for large scale foreign exchange transactions.

It remains axiomatic, however, that the strength of the dollar over time will be determined by the "fundamentals" - performance of and prospects for growth, inflation, trade and current account positions, terms and availability of credit in the U.S. money and capital markets. It will not be determined by the magnitude - or even the existence - of the Eurodollar market. Foreign held balances do not constitute an independent source of dollar stability or instability.

QUESTION:

If the Group of Ten nations agreed to place adjustable reserve requirements on all foreign currency holdings of all banks within their jurisdiction, including all foreign offices of their banks, would there be locations and institutions remaining to carry on significant Eurocurrency transactions free from such reserve requirements?

ANSWER:

This would depend on the extent of the jurisdiction exercised by authorities in G-10 countries. To be highly effective reserve requirements would have to apply to all banks wherever located which were controlled by residents of G-10 countries. It is highly unlikely that a substantial amount of foreign currency funds would be placed in banks based in other countries, or that these banks would have ample investment outlets for any significant increase in funds which might be available to them.

Question: What restrictions or disincentives are maintained by the following countries which discourage or limit external holdings and transactions in their currencies?

Answer:

Federal Republic of Germany: Prior approval is required for the acquisition by non-residents of German money market paper and fixed interest securities of German issuers with a remaining maturity of less than four years. At present such acquisitions are not permitted. Both domestic and foreign access to the capital market is controlled by a capital market committee that must authorize all issues.

Switzerland: External holdings of Swiss francs are discouraged by prohibiting banks from paying interest on Swiss franc deposits received from non-residents and by requiring the banks to charge a commission ("negative interest") of ten percent per calendar quarter on all net increases after 10/31/74 in non-resident-held Swiss franc deposits irrespective of maturity. As in Germany, access to the capital market is regulated for all issuers and the Swiss franc proceeds received by foreign issuers must be converted into another currency (50 percent through the central bank and 50 percent through market channels). In addition, there are numerous rules inhibiting capital transactions and prescribing foreign exchange trading procedures and reporting requirements that also serve to limit external holdings of and transactions in Swiss francs.

Japan: Japan has a very flexible capital control policy. The disincentives to short-term capital inflows in effect during 1978 (100 percent marginal reserve requirement on free yen deposits) were eliminated in 1979. Some important controls are informal (almost every large capital transaction requires some sort of official approval) and changes in these controls are not published. Major restrictions include the following:

- (1) Yen proceeds of yen bond issues by non-residents must be converted into foreign currencies within one week after payment.
- (2) The Japanese Ministry of Finance restricts issuers of Euroyen bonds to international financial institutions, foreign governments and some other international institutions.

France: Outward transfers of resident-owned capital generally are restricted. With minor exceptions, lending to non-residents in francs is prohibited. Franc-denominated foreign issues on the French capital market are quite limited in number and require prior authorization. Forward cover for purposes of trade and finance is allowed, but the timing of these transactions is strictly limited.

United Kingdom: Non-residents of the U.K. cannot borrow sterling or issue sterling-denominated securities if the transaction would be for capital account purposes;

that is, foreigners cannot float bond or stock issues in sterling, or obtain long-term sterling loans from banks. Foreigners can borrow sterling short-term to finance trade between their country and the U.K. Non-residents can buy sterling to make direct or portfolio investments in the U.K. All restrictions operate via a comprehensive system of controls operated by the Bank of England.

Saudi Arabia: No exchange controls are imposed on either current or capital receipts or payments by residents on non-residents, but payments must not be made to, or received from Israel, Rhodesia, or South Africa.

QUESTION: The IMF recently approved guidelines for "conditionality" to be applied to borrowings. How do the guidelines differ from previous IMF practice?

ANSWER: Attached is an IMF statement containing the new guidelines, and describing some of the differences between the previous guidelines and the new version. The guidelines have been modified:

1. To improve the adjustment process by encouraging members to adopt corrective measures at an early stage of their balance-of-payments difficulties with the IMF using the occasions of Article IV consultations to discuss such measures.
2. To moderate the impact of corrective measures by extending the period of stand-by arrangements from the normal one-year to up to three years in appropriate cases.
3. To further uniformity of performance criteria and minimize Fund involvement in the domestic social and political choices of members by: (a) limiting performance criteria, except in exceptional cases, to macroeconomic variables and those necessary to implement specific provisions of the Articles or policies adopted under them; and (b) emphasizing that, in helping members devise their adjustment programs, the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members.
4. To add flexibility in the terms of stand-by arrangements for stand-bys for more than one year, by allowing the criteria for drawings under the stand-by to be reviewed and developed over the period of the arrangement.
6. To provide for IMF assessment of the appropriateness of stand-by programs, effectiveness of the policy instruments, observance of the programs, and results achieved, with a view toward possible further evolution in the guidelines.

QUESTION: Do the Guidelines on conditionality conform to the intent of Congress as expressed in section 4 of P.L. 95-435, which states:

ANSWER: "The Secretary of the Treasury shall instruct the United States executive director on the Executive Board of the International Monetary Fund to initiate a wide consultation with the managing director of the Fund to formulate stabilization programs entered into pursuant to loans from the Supplementary Financing Facility which, to the maximum feasible extent, foster a broader base of productive investment and employment, especially in those productive activities which are designed to meet basic human needs."

ANSWER: Yes. During the IMF Board discussions of the new guidelines, the U.S. Executive Director made a statement (attached) that within the framework of those guidelines, "We feel that it is of great importance that member countries drawing from the Fund be encouraged to formulate the kinds of stabilization programs that will foster in the country concerned a broader base of productive investment and employment, especially in those productive activities that could lead to better allocation of resources and help meet basic human needs such as adequate food and shelter."

QUESTION: Why was the Witteveen Facility not activated until recently, although Congress was assured in the summer of 1978 that the Facility would be activated promptly once U.S. participation was authorized by Congress? How many IMF members have applied to use the Facility and in what amounts? Has any use of the Facility been made to date?

ANSWER: There were some delays in completing the legal and technical details of the arrangements between the IMF and some of the participations. In addition, the inability of three members -- Iran, Qatar, and Guatemala -- to participate initially reduced the total commitments below the minimum necessary for activation of the Facility, SDR 7.75 billion. Austrian participation in the amount of SDR 50 million increased the total participation above the minimum, enabling the Facility to enter into force on February 23, 1979.

There has been no use of the Facility to date, and no IMF members have formally applied for financing under the Facility. The IMF is, however, engaged in discussions with some members concerning the possibility of using the Facility.

QUESTION: If the reports required to be prepared and submitted to the Congress by section 2 and 4 of P.L. 95-435 are available in final or preliminary form, please provide copies to the Subcommittee for inclusion in the hearing record.

ANSWER: Enclosed is a copy of the report submitted to Congress pursuant to Section 2 of P.L. 95-435. Section 4 of P.L. 435 requires a report on the social, political, and economic impacts of IMF stabilization programs entered into pursuant to loans from the Supplementary Financing Facility during the previous calendar year. Because no drawings were made from the IMF under the Facility in calendar 1978, no report will be submitted this year pursuant to Section 4.

The U.S. Executive Director to the Fund is reported to have objected last year on human rights grounds to a credit to Nicaragua. Please provide for the Subcommittee's use a copy of statements by U.S. participants in IMF deliberations pertaining to Nicaragua during the past 12 months, and copies of all instructions or memoranda provided to U.S. participants in such deliberations by the International Monetary Fund, the Department of the Treasury, the Department of State, or any other agency or official of the U.S. Government during the same period.

A. On two occasions last fall, the U.S. Executive Director proposed in the IMF Board that a Nicaraguan request for a drawing under the IMF Compensatory Financing Facility be deferred, without prejudice, on grounds that extreme uncertainties in Nicaragua made it impossible to judge the validity of the technical data needed to assess the request.

On the second occasion, November 1, when the IMF Board agreed to the procedural proposal to defer, it was agreed there would be no further deferrals and the substance of the proposal would be considered in the week of November 15-22. However, Nicaragua withdrew the request before that date.

The U.S. Executive Director is instructed by the Secretary of Treasury or his delegate. Instructions are often given orally, and were given orally in this case. The decision to seek deferral of consideration of Nicaragua's request was made by Treasury after consulting with the State Department and other interested agencies, which is standard procedure.

In considering this matter prior to the November 1 meeting, our initial inclination was not to seek further deferral. Our decision in the end to propose a further deferral was made in the light of the following:

- a) We concluded that a legitimate basis remained for serious doubts about the reliability of the estimates on which the request was based.
- b) The State Department was concerned that IMF action either to approve or not approve Nicaragua's

request would be seen as a political move with major implications. They felt that IMF approval of the request at that point would have brought a major risk of renewed bloodshed and widespread violence.

Accordingly, the decision that the United States should seek deferral of IMF action on Nicaragua's request reflected the view that postponement both could be justified on economic grounds and was the wisest neutral political course.

More recently, Nicaragua has introduced new economic policy measures, and has submitted new requests for IMF financing, both under the Compensatory Financing Facility and the regular IMF credit facilities. These requests are expected to come to the IMF Board in 2-3 weeks' time. The United States has no intention of seeking further deferral at that time, and will consider the substantive proposals on their merits.

Attached is a letter from Under Secretary Solomon to Congressman Neal, dated March 16, giving further detail on the earlier Nicaraguan request and enclosing the November 1 statement of the U.S. Executive Director in the IMF Board. Also attached is the September 15 statement of the U.S. Alternate Executive Director.

Question: .Has the United States Government voted against international credit for Nicaragua through any international institution during the past twelve months? Please list all countries with respect to which the U.S. Government has abstained or cast a negative vote on credit applications in any international financial institutions during the past twelve months or denied bilateral financial assistance on human rights grounds.

Answer: No. The United States Government has not voted against international credit for Nicaragua.

In the International Monetary Fund, the United States proposed, on November 1, 1978, that consideration of a Nicaraguan request for drawing under the Compensatory Financing Facility be deferred, pending reassessment of the technical data. This request for a deferral was without prejudice to a subsequent decision on the merits of the case, and was made in light of the extreme uncertainties in Nicaragua which raised doubts about the validity of the technical data needed to determine Nicaragua's eligibility for financing, and our concern that action by the IMF either to approve or disapprove the request would be seen as a political move.

Attached is a list of the loans and recipient countries with respect to which the United States has abstained or cast a negative vote in the multilateral development banks in the twelve month period April 1978 through March 1979.

Bilateral economic assistance has been reduced, based in part on human rights considerations, to Afghanistan, Paraguay, the Central African Empire and Nicaragua. In light of human rights considerations, we have programmed less economic development assistance than we would have otherwise for Guinea, Chile and El Salvador. In some cases, notably Nicaragua and the Central African Empire, we have suspended new bilateral assistance with the exception of minor grants to private groups.

Attachment

U.S. Votes of Opposition in MEBs
for Human Rights Reasons
April 1978 through March 1979

<u>Country</u>	<u>Action</u>	<u>Date</u>	<u>Institution</u>	<u>Project</u>
Afghanistan	Abstention	3/27/79	IDA	Education III
Argentina	Abstention	4/25/78	IFC	Messuh, S.A.
Argentina	Abstention	5/09/78	IEFD	Agricultural Credit
Argentina	Abstention	5/30/78	IFC	IPAKO Polyethylene
Argentina	Abstention	12/14/78	IDE	Yacreta Hydroelectric
Argentina	Abstention	3/01/79	ILB	Science and Technology
Argentina	Abstention	3/27/79	IPRD	Railways II
Chile	"No" vote	11/09/76	IDB	Industrial/Tourism Credit
Chile	"No" vote	11/09/76	IDB	Agricultural Credit
El Salvador	Abstention	5/16/78	IBRD	Telecommunications
El Salvador	Abstention	3/01/79	IDE	Livestock Development and Animal Health
Ethiopia	Abstention	4/04/78	IDA	Grain Marketing and Storage
Laos	"No" vote	10/24/78	ADB	Forestry
Laos	Abstention	12/22/78	ADE	Rural Electrification
Paraguay	"No" vote	5/25/78	ILB	ANDE Electrical Transmission
Philippines	Abstention	4/25/78	IEED	PISO Development Bank
Philippines	Abstention	5/18/78	IEED	Industrial Credit II
Philippines	Abstention	6/27/78	IFC	Cebu Shipyard
Philippines	Abstention	10/26/78	ADE	Coal Mine Technical Assistance
Uruguay	Abstention	5/21/78	IFC	Acoñike
Vietnam	"No" vote	10/19/78	ADB	Go Cong Irrigation
Vietnam	"No" vote	10/19/78	ADB	Bin Dinh Irrigation
Vietnam	"No" vote	10/19/78	ADB	Tan An Irrigation
Vietnam	"No" vote	11/28/78	ADB	Water Supply
Yemen, PDR	Abstention	6/13/78	IDA	Power
Yemen, PDR	Abstention	6/28/78	IDA	Water Supply
Yemen, PDR	Abstention	12/12/78	IDA	Education II

4/26/79

QUESTION: In what specific accounting forms has the Department of Treasury made provision for U.S. participation in the Witteveen Facility? What fiscal and monetary effects upon the U.S. economy have these provisions had to date?

ANSWER: The United States has entered into an agreement with the International Monetary Fund, pursuant to P.L. 94-435 and 95-481, to provide financing to the Fund under the Supplementary Financing Facility in an amount not to exceed SDR 1,405 million, but no more than \$1,831,640,000. This amount is reflected as budget authority in the Budget of the U.S. Government prepared by the President. No calls have been made on the U.S. financing commitment to date. Should such calls be made, U.S. dollars would be provided to the IMF, for which the U.S. would obtain an increased reserve position in the Fund. Transfers of dollars to the IMF under calls on the U.S. would appear as a reduction in the Treasury's cash position, offset by an increase in U.S. international reserve assets.

QUESTION: When, and in what form, does the Administration intend to seek authority from Congress to increase the U.S. quota in the IMF?

ANSWER: The proposed increase in the U.S. quota, SDR 4,202.5 million or \$5.4 billion at current exchange rates, is to be subscribed not later than November 1, 1980, pursuant to the IMF Board of Governors resolution recommending a general increase in quotas. We are consulting with various interested committees on issues related to the budget and appropriations treatment of U.S. participation in the Fund, in an effort to arrive at a mutually satisfactory solution that will avoid the prolonged debate and disagreement that surrounded the legislation providing for U.S. participation in the IMF Supplementary Financing Facility. Transactions under the U.S. quota differ in a number of important respects from U.S. participation in the Supplementary Financing Facility, and these differences may call for somewhat different budget and appropriations treatment. We wish to initiate a formal legislative request as soon as possible and will transmit an appropriately worded draft bill as soon as our consultations can be completed.

February 28, 1979

Statement of Sam Y. Cross
on
Guidelines for Conditionality

The objective of programs supported by the Fund is economic stabilization and the restoration of conditions facilitating sound economic growth. Paragraph 7 of the proposed guidelines reiterates the existing guidance that performance clauses will include as performance criteria only those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives. This is an important protection for members proposing stabilization programs, and I understand from our earlier Board discussions that it is a provision which Directors strongly support. Two other important safeguards are the provision in Paragraph 7 that performance criteria will normally be confined to macroeconomic variables, and the provision in Paragraph 4 that the Fund will pay due regard to the member's circumstances and its domestic social and political objectives.

To me, these limitations taken together mean that the Board favors performance criteria being confined to matters that are clearly aimed at correction of an economy, normally avoiding criteria which deal with detailed allocative decisions or which challenge a country's choice of basic social and political objectives. None of this is new, although some of the words are more explicit. Many similar ideas were contained in the 1968 guidelines.

The United States Government supports these concepts. In addition, and within this framework, we feel that it is of great importance that member countries drawing from the Fund be encouraged to formulate the kinds of stabilization programs that will foster in the country concerned a broader base of productive investment and employment, especially in those productive activities that could lead to better allocation of resources and help meet basic human needs such as adequate food and shelter.

Let me emphasize that we would in no way want to dilute or subordinate the fundamental objective of stand-by programs, which is economic stabilization and balance of payments adjustment. Stabilization programs will of necessity include measures of short-run restraint in order to restore an environment within which longer-term investment and growth can take place. This is the main purpose of stabilization programs.

But within the formulation of such programs, we must not lose sight of the longer-term objective of strengthening the economy in such a way that it can better meet the basic needs of all segments of its population. Where there is a choice available to a member country in selecting

particular measures to meet a performance criterion, certainly everyone should favor stabilization measures which in the long run foster a broader base of productive investment and employment over those that do not. I believe that this approach is consistent with our guidelines and present practices, and that all countries drawing from the IMF should seek to formulate stabilization measures with this objective in mind.

The guidelines we adopt will apply to all IMF stand-bys. With respect to the Supplementary Financing Facility I am instructed to initiate a wide consultation with the Managing Director and other Executive Directors with regard to encouraging the staff to formulate stabilization programs entered into pursuant to the SFF which, to the maximum feasible extent, foster a broader base of productive investment and employment, especially in those productive activities designed to meet basic human needs. I plan to consult further with members of the Board about this at a later date.

QUESTION: The IMF has approved additional allocations of Special Drawing Rights (SDRs) even though the world is suffering from high inflation rates. What assurance is there that SDR allocations will not add to worldwide inflation? Will not many countries add SDRs to their reserves and borrow even more foreign currency on the Eurocurrency markets, using the SDRs as leverage?

ANSWER: The decision to allocate additional SDRs of approximately SDR billion during 1979-81 was based on a number of considerations, including the need to ensure that such allocations would not be inflationary. Substantial increases in international transactions can be expected in the future. A conservative estimate of the growth in the value of world trade over the next five years would be in the range of 10 percent a year. With such growth in the international economy there will be a need for growth in official reserves. An average increase in the range of SDR 20-25 billion a year over the next five years would appear to be a low estimate of the likely growth.

An SDR allocation will meet a part of this need for reserves and will promote the long-term evolution of the SDR as the principal reserve asset of the monetary system. There have been no allocations since 1972, with previous allocations totalling only SDR 9.3 billion. Since that time, SDRs as a percent of total reserves have decreased from 7% to roughly 4%.

In light of the expected growth in international trade and reserves during the years ahead, the amounts of SDRs to be allocated is very modest and is not expected to contribute to inflation.

Rather than lead to increased levels of borrowing in Eurocurrency markets, some part of the SDR allocations may, in fact, substitute for increases in official holdings of foreign exchange that would otherwise have taken place.

In determining the amount and timing of SDR allocations, account was also taken of the requirement that members pay in 25 percent of the quota increase agreed under the Seventh General Review of Quotas in SDRs. Under this provision, approximately SDR 4.9 billion are expected to be paid in to the Fund if all members consent to the full increase in their quotas.

group of members will be free to make his own arrangements to canvass the views of the group before any such voting.

8. The Council may adopt the regulations that it deems necessary or appropriate for the performance of its functions and may determine any aspect of its procedure. It must select a chairman, who must be a Councillor. He will not have a deciding vote in case of an equal division of votes, as has the Managing Director as chairman of the Executive Board (see Article XII, Section 4(a)).

Q. Special Drawing Rights (Articles XV, XVII, XIX, XX, XXI, and XXII)

1. In the amended Articles, the unit of value of the special drawing right is no longer defined in terms of gold. The Fund is empowered to determine the method of valuation. It may do so by the double majority of seventy percent of the total voting power of both members and participants, but a double eighty-five percent majority is required for a change in the principle of valuation or a fundamental change in the application of the principle in effect at the time of the change (Article XV, Section 2 and Article XXI(a)(iii)). A special majority is not prescribed for deciding whether a proposed change requires the lower or the higher majority, and therefore the decision can be taken by a majority of the votes cast. With this rule, there is virtual assurance that a decision on classification can always be taken. The method of valuation in effect at the date of the amendment will continue in effect unless it is decided at some time thereafter to change it (Schedule B, paragraph 6). The amended Articles require the value of the Fund's assets to be expressed (Article V, Section 10(a)), and the currency holdings in the General Resources Account to be maintained, in terms of the special drawing right (Article V, Section 11). Most computations involving currencies must be made at rates at which the Fund accounts for them in relation to the special drawing right (Article V, Section 10(b)).

2. The general obligation of participants to collaborate with the Fund and with each other to facilitate the operation of the Special Drawing Rights Department and the proper use of special drawing rights has been broadened by adding the objective of making the special drawing right the principal reserve asset of the international monetary

system (Article VIII, Section 7; Article XXII). The principles for the allocation and cancellation of special drawing rights remain unchanged, but a number of changes have been made in the characteristics and usability of special drawing rights:

- (i) The Fund is able under the amended Articles to engage in operations and transactions through the General Resources Account with prescribed other holders of special drawing rights, whereas under the present Articles it can do so only with participants (Article XVII, Section 2).
- (ii) The categories of possible other holders that the Fund can prescribe have been enlarged by the addition of the general class of official entities (Article XVII, Section 3(i)). A majority of eighty-five percent of the total voting power is still necessary for the prescription of other holders.
- (iii) The Fund may permit prescribed holders to enter into operations and transactions with other prescribed holders, as well as with participants, whereas under the present Articles other holders can be permitted to enter into operations and transactions only with participants (Article XVII, Section 3(ii) and (iii)).
- (iv) The majority for the prescription of terms and conditions on which prescribed holders may engage in operations and transactions in special drawing rights and on which the Fund and participants may enter into operations and transactions with them has been reduced from eighty-five percent of the total voting power to a majority of the votes cast (Article XVII, Section 3(ii) and (iii)).
- (v) Under the present Articles, a participant can enter into a transaction in special drawing rights by agreement with another participant, i.e., without designation, only if the transferor of special drawing rights is exchanging them for its own currency held by the transferee or if the Fund authorizes the transaction. The Fund can authorize other transactions by agreement by a majority of the votes cast if they fall into certain limited categories, and by an eighty-five percent majority of the total voting power if they fall outside these categories. One of the most important extensions in the use of special drawing rights under the amended Articles is the freedom of participants to enter into transactions by agreement in all circumstances without

the necessity for authorization by the Fund (Article XIX, Section 2(b)).

- (vi) The transactions referred to in (v) above must be conducted at rates of exchange compatible with the principle of equal value in Article XIX, Section 7(a). The Fund is authorized, however, to adopt policies, by a majority of eighty-five percent of the total voting power, under which in exceptional circumstances it can permit transactions by agreement at other exchange rates. The Fund can apply these policies to specific transactions by a majority of seventy percent of the total voting power (Article XIX, Section 7(b)).
- (vii) The Fund can decide by a majority of seventy percent of the total voting power to prescribe operations in special drawing rights entered into by agreement between participants that are not otherwise expressly authorized by the Articles. Only "operations" (i.e., dealings that do not involve the exchange of special drawing rights for currency) can be prescribed. "Transactions," which involve such an exchange (see Article XXX(i)), are not included because they may be entered into freely by agreement. Participants entering into these operations must observe any terms and conditions that the Fund adopts in prescribing the operations. The Fund may make representations to a participant that enters into any of these operations (or into the transactions by agreement referred to in (v) above) if the effect may be prejudicial to the process of designation or inconsistent with the effective functioning of the Special Drawing Rights Department. If the participant persists in entering into such operations (or transactions by agreement), the Fund may suspend the participant's right to use the special drawing rights that it acquires after the Fund's decision on suspension (Article XIX, Section 2(c) and (d); Article XXIII, Section 2(b)).
- (viii) A participant using special drawing rights in a transaction by agreement with another participant ((v) above) is not subject to the expectation that it will comply with the requirement of need in Article XIX, Section 3(a) when using its special drawing rights in these transactions. This provision considerably enhances the freedom of participants to engage in transactions by agreement, because they are sub-

- ject to neither the necessity for designation by the Fund nor the requirement of need. They remain subject, however, to the general obligations of collaboration under Article XXII.
- (ix) The formulation of the requirement of need in Article XIX, Section 3(a) has been simplified without changing its substance.
- (x) The provisions of the present Articles on the Fund's power to waive the requirement of need are substantially unchanged, but the limited scope of the power is less constricting because of the broad power of participants to enter into transactions by agreement without being subject to the requirement of need. In transactions in which the Fund designates the transferee of special drawing rights, the transferor is still expected to observe the requirement of need, but the Fund may waive the expectation that the requirement will be observed in a limited number of categories of transactions that contribute in a particular way to the more effective functioning of the Special Drawing Rights Department. In the light of experience, the amended Articles (Article XIX, Section 3(c)) do not refer to one category mentioned in the present Articles (Article XXV, Section 3(c)).
- (xi) Under the present Articles, in transactions involving designation, the designated transferee of special drawing rights is required to supply "currency convertible in fact," and the issuer of the currency supplied might be required in certain circumstances to convert the currency into another currency desired by the transferor of the special drawing rights. The definition of currency convertible in fact is complex. Moreover, the system of conversion contemplated by the Articles has not been operating in recent years. The provision with respect to the currency to be supplied (Article XIX, Section 4) has been simplified by the adoption of a new concept, "freely usable currency" (Article XXX(f)), in place of the present definition of currency convertible in fact. The new concept applies in both the General Department and the Special Drawing Rights Department, whereas under the present Articles "currency convertible in fact" applies only in the Special Drawing Rights Department. Article V, Section 3(e) and Section 7(j) deal with the exchange of freely usable currencies in connection with the transactions

of members with the Fund through the General Resources Account. It is hoped that participants in the Special Drawing Rights Department will collaborate regarding the exchange of freely usable currencies provided in transactions with designation, as would be normal practice pursuant to Article XXII.

- (xii) The Fund may review and change the rules for designation at any time, and not solely at the end of each basic period (Article XIX, Section 5(c)).
- (xiii) The Fund may review the rules for the reconstitution of participants' holdings of special drawing rights and may adopt, modify, or abrogate rules as a result of the review at any time, and not solely at the end of a basic period. Decisions with respect to the rules for reconstitution can be taken by a seventy percent, instead of an eighty-five percent, majority of the total voting power (Article XIX, Section 6(b)).
- (xiv) The rate of remuneration no longer limits the rate of interest and charges on special drawing rights, which the Fund may now determine by a majority of seventy percent of the total voting power (Article XX, Section 3), but the rate of interest now controls the rate of remuneration (Article V, Section 9).

3. Certain changes in the usability of special drawing rights in operations and transactions conducted through the General Resources Account have been mentioned in 2 above. In addition, certain changes, including the uses listed below, have been referred to elsewhere in this Report. Under the amendment, special drawing rights may be used:

- (a) by participants to pay part of the subscriptions payable upon increases in quota (Article III, Section 3(a));
- (b) by the Fund to make payments to participants on decreases in quotas (Article III, Section 3(c));
- (c) by the Fund in sales to participants for the currencies of other members (Article V, Section 6(b));
- (d) by participants in purchasing the currencies of other members from the Fund (Article V, Section 6(a));
- (e) by the Fund to replenish its holdings of needed currency, without any implication that other forms of replenishment under the

Articles should be canvassed first (Article VII, Section 1(ii)); and

- (f) by the Fund in distributions of net income or of the general reserve, even without the agreement of the recipient, unless the recipient decides that the payment to it shall be made in its own currency (Article XII, Section 6(e)).

Some of these uses are new; others involve modifications of uses that could be made under the present provisions.

R. Temporary Suspension of Operation of Provisions (Articles XXIII and XXVII)

1. Experience with the provisions on suspension of the operation of certain provisions has shown the possible usefulness of suspension but also the desirability of making it somewhat easier to bring about a suspension of one or more of the provisions subject to suspension if there is an emergency or the development of unforeseen circumstances threatening the activities of the Fund or of the Special Drawing Rights Department. Under the present Articles, a unanimous vote of the Executive Board is required for an initial decision to suspend. This requirement has been reduced to a majority of eighty-five percent of the total voting power in the amended Articles. A suspension by the Executive Board can be extended under the present Articles by a subsequent decision taken by the Board of Governors by an eighty percent majority of the total voting power. This majority has been increased to eighty-five percent in order to limit the number of different special majorities required for various decisions.

2. A possible purpose of the suspension of the operation of a provision is to give time to consider the desirability of the amendment of the provision. Therefore, the periods for suspension have been modified because experience has shown that the total period of three hundred and sixty days under the present Articles may be inadequate to enable agreement to be reached on an amendment of the Articles and to make it effective. The maximum period of one hundred and twenty days for which the Executive Board may suspend the operation of a provision has been extended to one year. The maximum period of prolongation by the Board of Governors has been extended from two hundred and forty days to two years.

Article XV

Special Drawing Rights

Section 1. *Authority to allocate special drawing rights*

To meet the need, as and when it arises, for a supplement to existing reserve assets, the Fund is authorized to allocate special drawing rights to members that are participants in the Special Drawing Rights Department.

Section 2. *Valuation of the special drawing right*

The method of valuation of the special drawing right shall be determined by the Fund by a seventy percent majority of the total voting power, provided, however, that an eighty-five percent majority of the total voting power shall be required for a change in the principle of valuation or a fundamental change in the application of the principle in effect.

Article XVI

General Department and Special Drawing Rights Department

Section 1. *Separation of operations and transactions*

All operations and transactions involving special drawing rights shall be conducted through the Special Drawing Rights Department. All other operations and transactions on the account of the Fund authorized by or under this Agreement shall be conducted through the General Department. Operations and transactions pursuant to Article XVII, Section 2 shall be conducted through the General Department as well as the Special Drawing Rights Department.

Section 2. *Separation of assets and property*

All assets and property of the Fund, except resources administered under Article V, Section 2(b), shall be held in the General Department, provided that assets and property acquired under Article XX, Section 2 and Articles XXIV and XXV and Schedules H and I shall be held in the Special Drawing Rights Department. Any assets or property held in one Department shall not be available to discharge or meet the liabilities, obligations, or losses of the Fund incurred in the conduct of the operations and transactions of the other Department, except that the

expenses of conducting the business of the Special Drawing Rights Department shall be paid by the Fund from the General Department which shall be reimbursed in special drawing rights from time to time by assessments under Article XX, Section 4 made on the basis of a reasonable estimate of such expenses.

Section 3. *Recording and information*

All changes in holdings of special drawing rights shall take effect only when recorded by the Fund in the Special Drawing Rights Department. Participants shall notify the Fund of the provisions of this Agreement under which special drawing rights are used. The Fund may require participants to furnish it with such other information as it deems necessary for its functions.

Article XVII

Participants and Other Holders of Special Drawing Rights

Section 1. *Participants*

Each member of the Fund that deposits with the Fund an instrument setting forth that it undertakes all the obligations of a participant in the Special Drawing Rights Department in accordance with its law and that it has taken all steps necessary to enable it to carry out all of these obligations shall become a participant in the Special Drawing Rights Department as of the date the instrument is deposited, except that no member shall become a participant before the provisions of this Agreement pertaining exclusively to the Special Drawing Rights Department have entered into force and instruments have been deposited under this Section by members that have at least seventy-five percent of the total of quotas.

Section 2. *Fund as a holder*

The Fund may hold special drawing rights in the General Resources Account and may accept and use them in operations and transactions conducted through the General Resources Account with participants in accordance with the provisions of this Agreement or with prescribed holders in accordance with the terms and conditions prescribed under Section 3 of this Article.

Section 3. *Other holders*

The Fund may prescribe:

- (i) as holders, non-members, members that are non-participants, institutions that perform functions of a central bank for more than one member, and other official entities;
- (ii) the terms and conditions on which prescribed holders may be permitted to hold special drawing rights and may accept and use them in operations and transactions with participants and other prescribed holders; and
- (iii) the terms and conditions on which participants and the Fund through the General Resources Account may enter into operations and transactions in special drawing rights with prescribed holders.

An eighty-five percent majority of the total voting power shall be required for prescriptions under (i) above. The terms and conditions prescribed by the Fund shall be consistent with the provisions of this Agreement and the effective functioning of the Special Drawing Rights Department.

Article XVIII

Allocation and Cancellation of Special Drawing Rights

Section 1. *Principles and considerations governing allocation and cancellation*

(a) In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.

(b) The first decision to allocate special drawing rights shall take into account, as special considerations, a collective judgment that there is a global need to supplement reserves, and the attainment of a better balance of payments equilibrium, as well as the likelihood of a better working of the adjustment process in the future.

Section 2. Allocation and cancellation

(a) Decisions of the Fund to allocate or cancel special drawing rights shall be made for basic periods which shall run consecutively and shall be five years in duration. The first basic period shall begin on the date of the first decision to allocate special drawing rights or such later date as may be specified in that decision. Any allocations or cancellations shall take place at yearly intervals.

(b) The rates at which allocations are to be made shall be expressed as percentages of quotas on the date of each decision to allocate. The rates at which special drawing rights are to be cancelled shall be expressed as percentages of net cumulative allocations of special drawing rights on the date of each decision to cancel. The percentages shall be the same for all participants.

(c) In its decision for any basic period the Fund may provide, notwithstanding (a) and (b) above, that:

- (i) the duration of the basic period shall be other than five years; or
- (ii) the allocations or cancellations shall take place at other than yearly intervals; or
- (iii) the basis for allocations or cancellations shall be the quotas or net cumulative allocations on dates other than the dates of decisions to allocate or cancel.

(d) A member that becomes a participant after a basic period starts shall receive allocations beginning with the next basic period in which allocations are made after it becomes a participant unless the Fund decides that the new participant shall start to receive allocations beginning with the next allocation after it becomes a participant. If the Fund decides that a member that becomes a participant during a basic period shall receive allocations during the remainder of that basic period and the participant was not a member on the dates established under (b) or (c) above, the Fund shall determine the basis on which these allocations to the participant shall be made.

(e) A participant shall receive allocations of special drawing rights made pursuant to any decision to allocate unless:

- (i) the Governor for the participant did not vote in favor of the decision; and
- (ii) the participant has notified the Fund in writing prior to the first allocation of special drawing rights under that decision that it does not wish special drawing rights to be allocated to it under the decision. On the request of a participant, the Fund may

decide to terminate the effect of the notice with respect to allocations of special drawing rights subsequent to the termination.

(f) If on the effective date of any cancellation the amount of special drawing rights held by a participant is less than its share of the special drawing rights that are to be cancelled, the participant shall eliminate its negative balance as promptly as its gross reserve position permits and shall remain in consultation with the Fund for this purpose. Special drawing rights acquired by the participant after the effective date of the cancellation shall be applied against its negative balance and cancelled.

Section 3. *Unexpected major developments*

The Fund may change the rates or intervals of allocation or cancellation during the rest of a basic period or change the length of a basic period or start a new basic period, if at any time the Fund finds it desirable to do so because of unexpected major developments.

Section 4. *Decisions on allocations and cancellations*

(a) Decisions under Section 2(a), (b), and (c) or Section 3 of this Article shall be made by the Board of Governors on the basis of proposals of the Managing Director concurred in by the Executive Board.

(b) Before making any proposal, the Managing Director, after having satisfied himself that it will be consistent with the provisions of Section 1(a) of this Article, shall conduct such consultations as will enable him to ascertain that there is broad support among participants for the proposal. In addition, before making a proposal for the first allocation, the Managing Director shall satisfy himself that the provisions of Section 1(b) of this Article have been met and that there is broad support among participants to begin allocations; he shall make a proposal for the first allocation as soon after the establishment of the Special Drawing Rights Department as he is so satisfied.

(c) The Managing Director shall make proposals:

- (i) not later than six months before the end of each basic period;
- (ii) if no decision has been taken with respect to allocation or cancellation for a basic period, whenever he is satisfied that the provisions of (b) above have been met;
- (iii) when, in accordance with Section 3 of this Article, he considers that it would be desirable to change the rate or intervals of

- allocation or cancellation or change the length of a basic period or start a new basic period; or
- (iv) within six months of a request by the Board of Governors or the Executive Board;

provided that, if under (i), (iii), or (iv) above the Managing Director ascertains that there is no proposal which he considers to be consistent with the provisions of Section 1 of this Article that has broad support among participants in accordance with (b) above, he shall report to the Board of Governors and to the Executive Board.

(d) An eighty-five percent majority of the total voting power shall be required for decisions under Section 2 (a), (b), and (c) or Section 3 of this Article except for decisions under Section 3 with respect to a decrease in the rates of allocation.

Article XIX

Operations and Transactions in Special Drawing Rights

Section 1. *Use of special drawing rights*

Special drawing rights may be used in the operations and transactions authorized by or under this Agreement.

Section 2. *Operations and transactions between participants*

(a) A participant designated by the Fund under Section 5 of this obtain an equivalent amount of currency from a participant designated under Section 5 of this Article.

(b) A participant, in agreement with another participant, may use its special drawing rights to obtain an equivalent amount of currency from the other participant.

(c) The Fund, by a seventy percent majority of the total voting power, may prescribe operations in which a participant is authorized to engage in agreement with another participant on such terms and conditions as the Fund deems appropriate. The terms and conditions shall be consistent with the effective functioning of the Special Drawing Rights Department and the proper use of special drawing rights in accordance with this Agreement.

(d) The Fund may make representations to a participant that enters into any operation or transaction under (b) or (c) above that in the judgment of the Fund may be prejudicial to the process of designation according to the principles of Section 5 of this Article or is otherwise inconsistent with Article XXII. A participant that persists in entering into such operations or transactions shall be subject to Article XXIII, Section 2(b).

Section 3. *Requirement of need*

(a) In transactions under Section 2(a) of this Article, except as otherwise provided in (c) below, a participant will be expected to use its special drawing rights only if it has a need because of its balance of payments or its reserve position or developments in its reserves, and not for the sole purpose of changing the composition of its reserves.

(b) The use of special drawing rights shall not be subject to challenge on the basis of the expectation in (a) above, but the Fund may make representations to a participant that fails to fulfill this expectation. A participant that persists in failing to fulfill this expectation shall be subject to Article XXIII, Section 2(b).

(c) The Fund may waive the expectation in (a) above in any transactions in which a participant uses special drawing rights to obtain an equivalent amount of currency from a participant designated under Section 5 of this Article that would promote reconstitution by the other participant under Section 6(a) of this Article; prevent or reduce a negative balance of the other participant; or offset the effect of a failure by the other participant to fulfill the expectation in (a) above.

Section 4. *Obligation to provide currency*

(a) A participant designated by the Fund under Section 5 of this Article shall provide on demand a freely usable currency to a participant using special drawing rights under Section 2(a) of this Article. A participant's obligation to provide currency shall not extend beyond the point at which its holdings of special drawing rights in excess of its net cumulative allocation are equal to twice its net cumulative allocation or such higher limit as may be agreed between a participant and the Fund.

(b) A participant may provide currency in excess of the obligatory limit or any agreed higher limit.

Section 5. *Designation of participants to provide currency*

(a) The Fund shall ensure that a participant will be able to use its special drawing rights by designating participants to provide currency for specified amounts of special drawing rights for the purposes of Sections 2(a) and 4 of this Article. Designations shall be made in accordance with the following general principles supplemented by such other principles as the Fund may adopt from time to time:

- (i) A participant shall be subject to designation if its balance of payments and gross reserve position is sufficiently strong, but this will not preclude the possibility that a participant with a strong reserve position will be designated even though it has a moderate balance of payments deficit. Participants shall be designated in such manner as will promote over time a balanced distribution of holdings of special drawing rights among them.
- (ii) Participants shall be subject to designation in order to promote reconstitution under Section 6(a) of this Article, to reduce negative balances in holdings of special drawing rights, or to offset the effect of failures to fulfill the expectation in Section 3(a) of this Article.
- (iii) In designating participants the Fund normally shall give priority to those that need to acquire special drawing rights to meet the objectives of designation under (ii) above.

(b) In order to promote over time a balanced distribution of holdings of special drawing rights under (a)(i) above, the Fund shall apply the rules for designation in Schedule F or such rules as may be adopted under (c) below.

(c) The rules for designation may be reviewed at any time and new rules shall be adopted if necessary. Unless new rules are adopted, the rules in force at the time of the review shall continue to apply.

Section 6. *Reconstitution*

(a) Participants that use their special drawing rights shall reconstitute their holdings of them in accordance with the rules for reconstitution in Schedule G or such rules as may be adopted under (b) below.

(b) The rules for reconstitution may be reviewed at any time and new rules shall be adopted if necessary. Unless new rules are adopted or a decision is made to abrogate rules for reconstitution, the rules in force at the time of review shall continue to apply. A seventy percent majority of the total voting power shall be required for decisions to adopt, modify, or abrogate the rules for reconstitution.

Section 7. *Exchange rates*

(a) Except as otherwise provided in (b) below, the exchange rates for transactions between participants under Section 2 (a) and (b) of this Article shall be such that participants using special drawing rights shall receive the same value whatever currencies might be provided and whichever participants provide those currencies, and the Fund shall adopt regulations to give effect to this principle.

(b) The Fund, by an eighty-five percent majority of the total voting power, may adopt policies under which in exceptional circumstances the Fund, by a seventy percent majority of the total voting power, may authorize participants entering into transactions under Section 2 (b) of this Article to agree on exchange rates other than those applicable under (a) above.

(c) The Fund shall consult a participant on the procedure for determining rates of exchange for its currency.

(d) For the purpose of this provision the term participant includes a terminating participant.

Article XX

Special Drawing Rights Department Interest and Charges

Section 1. *Interest*

Interest at the same rate for all holders shall be paid by the Fund to each holder on the amount of its holdings of special drawing rights. The Fund shall pay the amount due to each holder whether or not sufficient charges are received to meet the payment of interest.

Section 2. *Charges*

Charges at the same rate for all participants shall be paid to the Fund by each participant on the amount of its net cumulative allocation of special drawing rights plus any negative balance of the participant or unpaid charges.

Section 3. *Rate of interest and charges*

The Fund shall determine the rate of interest by a seventy percent majority of the total voting power. The rate of charges shall be equal to the rate of interest.

Section 4. Assessments

When it is decided under Article XVI, Section 2 that reimbursement shall be made, the Fund shall levy assessments for this purpose at the same rate for all participants on their net cumulative allocations.

Section 5. Payment of interest, charges, and assessments

Interest, charges, and assessments shall be paid in special drawing rights. A participant that needs special drawing rights to pay any charge or assessment shall be obligated and entitled to obtain them, for currency acceptable to the Fund, in a transaction with the Fund conducted through the General Resources Account. If sufficient special drawing rights cannot be obtained in this way, the participant shall be obligated and entitled to obtain them with a freely usable currency from a participant which the Fund shall specify. Special drawing rights acquired by a participant after the date for payment shall be applied against its unpaid charges and cancelled.

Article XXI**Administration of the General Department
and the Special Drawing Rights Department**

(a) The General Department and the Special Drawing Rights Department shall be administered in accordance with the provisions of Article XII, subject to the following provisions:

- (i) For meetings of or decisions by the Board of Governors on matters pertaining exclusively to the Special Drawing Rights Department only requests by, or the presence and the votes of, Governors appointed by members that are participants shall be counted for the purpose of calling meetings and determining whether a quorum exists or whether a decision is made by the required majority.
- (ii) For decisions by the Executive Board on matters pertaining exclusively to the Special Drawing Rights Department only Executive Directors appointed or elected by at least one member that is a participant shall be entitled to vote. Each of these Executive Directors shall be entitled to cast the number of votes allotted to the member which is a participant that appointed him or to the members that are participants whose votes counted towards his election. Only the presence of

Executive Directors appointed or elected by members that are participants and the votes allotted to members that are participants shall be counted for the purpose of determining whether a quorum exists or whether a decision is made by the required majority. For the purposes of this provision, an agreement under Article XII, Section 3 (i) (ii) by a member that is a participant shall entitle an appointed Executive Director to vote and cast the number of votes allotted to the member.

- (iii) Questions of the general administration of the Fund, including reimbursement under Article XVI, Section 2, and any question whether a matter pertains to both Departments or exclusively to the Special Drawing Rights Department shall be decided as if they pertained exclusively to the General Department. Decisions with respect to the method of valuation of the special drawing right, the acceptance and holding of special drawing rights in the General Resources Account of the General Department and the use of them, and other decisions affecting the operations and transactions conducted through both the General Resources Account of the General Department and the Special Drawing Rights Department shall be made by the majorities required for decisions on matters pertaining exclusively to each Department. A decision on a matter pertaining to the Special Drawing Rights Department shall so indicate.

(b) In addition to the privileges and immunities that are accorded under Article IX of this Agreement, no tax of any kind shall be levied on special drawing rights or on operations or transactions in special drawing rights.

(c) A question of interpretation of the provisions of this Agreement on matters pertaining exclusively to the Special Drawing Rights Department shall be submitted to the Executive Board pursuant to Article XXIX (a) only on the request of a participant. In any case where the Executive Board has given a decision on a question of interpretation pertaining exclusively to the Special Drawing Rights Department only a participant may require that the question be referred to the Board of Governors under Article XXIX (b). The Board of Governors shall decide whether a Governor appointed by a member that is not a participant shall be entitled to vote in the Committee on Interpretation on questions pertaining exclusively to the Special Drawing Rights Department.

(d) Whenever a disagreement arises between the Fund and a participant that has terminated its participation in the Special Drawing Rights

Department or between the Fund and any participant during the liquidation of the Special Drawing Rights Department with respect to any matter arising exclusively from participation in the Special Drawing Rights Department, the disagreement shall be submitted to arbitration in accordance with the procedures in Article XXIX (c).

Article XXII

General Obligations of Participants

In addition to the obligations assumed with respect to special drawing rights under other articles of this Agreement, each participant undertakes to collaborate with the Fund and with other participants in order to facilitate the effective functioning of the Special Drawing Rights Department and the proper use of special drawing rights in accordance with this Agreement and with the objective of making the special drawing right the principal reserve asset in the international monetary system.

Article XXIII

Suspension of Operations and Transactions in Special Drawing Rights

Section 1. *Emergency provisions*

In the event of an emergency or the development of unforeseen circumstances threatening the activities of the Fund with respect to the Special Drawing Rights Department, the Executive Board, by an eighty-five percent majority of the total voting power, may suspend for a period of not more than one year the operation of any of the provisions relating to operations and transactions in special drawing rights, and the provisions of Article XXVII, Section 1 (b), (c), and (d) shall then apply.

Section 2. *Failure to fulfill obligations*

(a) If the Fund finds that a participant has failed to fulfill its obligations under Article XIX, Section 4, the right of the participant to use its special drawing rights shall be suspended unless the Fund otherwise decides.

(b) If the Fund finds that a participant has failed to fulfill any other obligation with respect to special drawing rights, the Fund may suspend the right of the participant to use special drawing rights it acquires after the suspension.

(c) Regulations shall be adopted to ensure that before action is taken against any participant under (a) or (b) above, the participant shall be informed immediately of the complaint against it and given an adequate opportunity for stating its case, both orally and in writing. Whenever the participant is thus informed of a complaint relating to (a) above, it shall not use special drawing rights pending the disposition of the complaint.

(d) Suspension under (a) or (b) above or limitation under (c) above shall not affect a participant's obligation to provide currency in accordance with Article XIX, Section 4.

(e) The Fund may at any time terminate a suspension under (a) or (b) above, provided that a suspension imposed on a participant under (b) above for failure to fulfill the obligations under Article XIX, Section 6 (a) shall not be terminated until one hundred eighty days after the end of the first calendar quarter during which the participant complies with the rules for reconstitution.

(f) The right of a participant to use its special drawing rights shall not be suspended because it has become ineligible to use the Fund's general resources under Article V, Section 5, Article VI, Section 1, or Article XXVI, Section 2 (a). Article XXVI, Section 2 shall not apply because a participant has failed to fulfill any obligations with respect to special drawing rights.

Article XXIV

Termination of Participation

Section 1. *Right to terminate participation*

(a) Any participant may terminate its participation in the Special Drawing Rights Department at any time by transmitting a notice in writing to the Fund at its principal office. Termination shall become effective on the date the notice is received.

(b) A participant that withdraws from membership in the Fund shall be deemed to have simultaneously terminated its participation in the Special Drawing Rights Department.

Section 2. *Settlement on termination*

(a) When a participant terminates its participation in the Special Drawing Rights Department, all operations and transactions by the terminating participant in special drawing rights shall cease except as otherwise permitted under an agreement made pursuant to (c) below in order to facilitate a settlement or as provided in Sections 3, 5, and 6 of this Article or in Schedule H. Interest and charges that accrued to the date of termination and assessments levied before that date but not paid shall be paid in special drawing rights.

(b) The Fund shall be obligated to redeem all special drawing rights held by the terminating participant, and the terminating participant shall be obligated to pay to the Fund an amount equal to its net cumulative allocation and any other amounts that may be due and payable because of its participation in the Special Drawing Rights Department. These obligations shall be set off against each other and the amount of special drawing rights held by the terminating participant that is used in the setoff to extinguish its obligation to the Fund shall be cancelled.

(c) A settlement shall be made with reasonable despatch by agreement between the terminating participant and the Fund with respect to any obligation of the terminating participant or the Fund after the setoff in (b) above. If agreement on a settlement is not reached promptly the provisions of Schedule H shall apply.

Section 3. *Interest and charges*

After the date of termination the Fund shall pay interest on any outstanding balance of special drawing rights held by a terminating participant and the terminating participant shall pay charges on any outstanding obligation owed to the Fund at the times and rates prescribed under Article XX. Payment shall be made in special drawing rights. A terminating participant shall be entitled to obtain special drawing rights with a freely usable currency to pay charges or assessments in a transaction with a participant specified by the Fund or by agreement from any other holder, or to dispose of special drawing rights received as interest in a transaction with any participant designated under Article XIX, Section 5 or by agreement with any other holder.

Section 4. *Settlement of obligation to the Fund*

Currency received by the Fund from a terminating participant shall be used by the Fund to redeem special drawing rights held by participants in

proportion to the amount by which each participant's holdings of special drawing rights exceed its net cumulative allocation at the time the currency is received by the Fund. Special drawing rights so redeemed and special drawing rights obtained by a terminating participant under the provisions of this Agreement to meet any installment due under an agreement on settlement or under Schedule H and set off against that installment shall be cancelled.

Section 5. *Settlement of obligation to a terminating participant*

Whenever the Fund is required to redeem special drawing rights held by a terminating participant, redemption shall be made with currency provided by participants specified by the Fund. These participants shall be specified in accordance with the principles in Article XIX, Section 5. Each specified participant shall provide at its option the currency of the terminating participant or a freely usable currency to the Fund and shall receive an equivalent amount of special drawing rights. However, a terminating participant may use its special drawing rights to obtain its own currency, a freely usable currency, or any other asset from any holder, if the Fund so permits.

Section 6. *General Resources Account transactions*

In order to facilitate settlement with a terminating participant, the Fund may decide that a terminating participant shall:

- (i) use any special drawing rights held by it after the setoff in Section 2(b) of this Article, when they are to be redeemed, in a transaction with the Fund conducted through the General Resources Account to obtain its own currency or a freely usable currency at the option of the Fund; or
- (ii) obtain special drawing rights in a transaction with the Fund conducted through the General Resources Account for a currency acceptable to the Fund to meet any charges or installment due under an agreement or the provisions of Schedule H.

Article XXV

Liquidation of the Special Drawing Rights Department

(a) The Special Drawing Rights Department may not be liquidated except by decision of the Board of Governors. In an emergency, if the

Executive Board decides that liquidation of the Special Drawing Rights Department may be necessary, it may temporarily suspend allocations or cancellations and all operations and transactions in special drawing rights pending decision by the Board of Governors. A decision by the Board of Governors to liquidate the Fund shall be a decision to liquidate both the General Department and the Special Drawing Rights Department.

(b) If the Board of Governors decides to liquidate the Special Drawing Rights Department, all allocations or cancellations and all operations and transactions in special drawing rights and the activities of the Fund with respect to the Special Drawing Rights Department shall cease except those incidental to the orderly discharge of the obligations of participants and of the Fund with respect to special drawing rights, and all obligations of the Fund and of participants under this Agreement with respect to special drawing rights shall cease except those set out in this Article, Article XX, Article XXI(d), Article XXIV, Article XXIX(c), and Schedule H, or any agreement reached under Article XXIV subject to paragraph 4 of Schedule H, and Schedule I.

(c) Upon liquidation of the Special Drawing Rights Department, interest and charges that accrued to the date of liquidation and assessments levied before that date but not paid shall be paid in special drawing rights. The Fund shall be obligated to redeem all special drawing rights held by holders, and each participant shall be obligated to pay the Fund an amount equal to its net cumulative allocation of special drawing rights and such other amounts as may be due and payable because of its participation in the Special Drawing Rights Department.

(d) Liquidation of the Special Drawing Rights Department shall be administered in accordance with the provisions of Schedule I.

Article XXVI

Withdrawal from Membership

Section 1. *Right of members to withdraw*

Any member may withdraw from the Fund at any time by transmitting a notice in writing to the Fund at its principal office. Withdrawal shall become effective on the date such notice is received.

Section 2. *Compulsory withdrawal*

(a) If a member fails to fulfill any of its obligations under this Agreement, the Fund may declare the member ineligible to use the general resources of the Fund. Nothing in this Section shall be deemed to limit the provisions of Article V, Section 5 or Article VI, Section 1.

(b) If, after the expiration of a reasonable period the member persists in its failure to fulfill any of its obligations under this Agreement, that member may be required to withdraw from membership in the Fund by a decision of the Board of Governors carried by a majority of the Governors having eighty-five percent of the total voting power.

(c) Regulations shall be adopted to ensure that before action is taken against any member under (a) or (b) above, the member shall be informed in reasonable time of the complaint against it and given an adequate opportunity for stating its case, both orally and in writing.

Section 3. *Settlement of accounts with members withdrawing*

When a member withdraws from the Fund, normal operations and transactions of the Fund in its currency shall cease and settlement of all accounts between it and the Fund shall be made with reasonable despatch by agreement between it and the Fund. If agreement is not reached promptly, the provisions of Schedule J shall apply to the settlement of accounts.

Article XXVII

Emergency Provisions

Section 1. *Temporary suspension*

(a) In the event of an emergency or the development of unforeseen circumstances threatening the activities of the Fund, the Executive Board, by an eighty-five percent majority of the total voting power, may suspend for a period of not more than one year the operation of any of the following provisions:

- (i) Article V, Sections 2, 3, 7, 8(a)(i) and (e);
- (ii) Article VI, Section 2;
- (iii) Article XI, Section 1;
- (iv) Schedule C, paragraph 5.

(b) A suspension of the operation of a provision under (a) above may not be extended beyond one year except by the Board of Governors

QUESTION: Does the United States support creation of a so-called "substitution account" in the IMF to hold excess dollars and other convertible foreign currencies held by foreign central banks. Would the United States bear the foreign exchange risk under such an account? Please submit to the Subcommittee copies of any U.S. proposals presented to the IMF or other countries concerning a "substitution account" and copies of any comments made by U.S. representatives concerning proposals for a "substitution account".

ANSWER: The United States has not indicated support for creation of a substitution account, but has stated clearly its willingness to participate in international examination of the possibility of establishing such an account with the objective of promoting the role of the SDR in the international monetary system. This effort is just under way, and there are a large number of issues, including the question of foreign exchange risk, that remain to be discussed. The U.S. has not presented substitution account proposals to the IMF or other countries, nor has it commented formally on proposals advanced by others. Our general view of the substitution account idea is best explained in the attached remarks by Secretary Blumenthal.

from: Testimony of The Honorable W. Michael Blumenthal
Secretary of the Treasury, before the Joint
Economic Committee, January 31, 1979

First, while we do not believe the reserve role of the dollar is a major source of current exchange market difficulties, we are prepared to consider proposals for evolution of the international reserve system. We have no interest in preserving an artificial role for the dollar, and we are quite prepared to contemplate a reduction in its relative role in the international monetary system.

Second, substitution proposals are under discussion in the International Monetary Fund, and we are participating in those discussions. Our objective will not be to resist change, but to ensure that any change be an improvement from our own point of view and that of an open and stable system.

Third, while the substitution idea may look simple, appearances can deceive. There are serious questions about the costs of such a scheme and their distribution among countries; about the implications of a substitution account for the exchange rate system; about the contribution such an account could make to a better sharing of responsibilities for operation of the system; and about whether such an account would in fact contribute significantly to greater monetary stability.

In sum, the substitution approach involves questions that deserve careful evaluation -- and certainly closer examination than they are frequently given. We intend to give the idea full consideration, weighing both its potential contribution and its potential costs. While it may be that some form of substitution proposal will ultimately be found practical, useful, and agreeable to the international community, I would prefer that the U.S. suspend judgment on that matter pending careful study.

QUESTION: What effect will EMS have on the exchange rate for the dollar and on the role of the dollar in the international monetary system?

ANSWER: The EMS is intended to foster European unity by promoting the harmonization of economic conditions and policies in the participating countries. We believe that EMS will be implemented in a way which will contribute to an open growing world economy and a stable international monetary system. The achievement of this objective should benefit all countries, including the United States. In the final analysis, however, the impact of EMS on the dollar will depend on the performance of the U.S. economy relative to other major countries and the success of efforts by the U.S. and EC to reduce the present disparities in economic growth and inflation which have led to large payments imbalances and exchange rate changes.

The initial focus of EMS has been on the intervention and settlement arrangements associated with maintaining European currencies within the agreed margins of fluctuations. There is the possibility that in time a European currency unit may develop as a reserve instrument of broader use and interest. Such a development, and its implications for the relative role of the dollar, will depend on the future evolution of the world economy. We anticipate, however, that the dollar will remain the principal reserve currency for the international monetary system for the foreseeable future.

Question: Are the intervention practices of the EMS fully coordinated with those of the United States?

Answer: Intervention undertaken by EMS participants under EMS obligations is not coordinated with the United States. Full coordination continues on dollar intervention undertaken by Germany in whose currency the U.S. is also conducting operations. Frequent consultations are held with other EMS participants.

Question: What would be the consequences for the U.S. economy if the U.S. were to join the EMS, in effect, by agreeing to "divergence indicators" for the dollar vis-a-vis ECU?

Answer: The issue is hypothetical because the United States does not intend to adopt an ECU central rate or the use of a dollar-ECU divergence indicator.

It is our understanding that under the EMS the divergence indicator indicates how far a particular EMS currency has moved away from its central rate vis-a-vis the ECU. A maximum allowed divergence has been established for each currency. When a currency has moved more than 75% of the way towards its maximum allowed divergence, that currency is said to have crossed its divergence "threshold". Unless the "threshold" crossing proves temporary, consultations are held between the EMS countries and there is a "presumption" that the national authorities of the divergent currency country will act to correct the situation.

The choice of action is left to the divergent currency country and could include diversified market intervention, exchange rate adjustment, or other changes in economic policy.

Question: Why has the Treasury reduced the amount of gold offered at monthly auctions?

Answer: The amount of gold to be offered at monthly auctions beginning in May 1979 was reduced to 750,000 ounces in light of improved conditions in the foreign exchange markets and the fact that gold no longer appears to be a destabilizing factor in these markets. Sales in the magnitude maintained in recent months -- 1,500,000 ounces monthly -- do not appear to be needed under current circumstances.

Question: What effect have gold sales during the past year had on the price of gold and U.S. imports of gold?

Answer: The increased gold supply from Treasury sales has undoubtedly moderated the rise in the gold price since sales were initiated in May 1978. There is no basis on which to estimate the magnitude of this effect. However, the Administration has made it clear that it has no particular gold price objective for the gold sales program, and the continuation of the sales is in no way contingent upon the attainment of a particular price level.

Net imports of gold bullion in the ten months since the gold sales began in May 1978 were only 0.3 million ounces, a reduction of 3.4 million from the previous ten months. There is little doubt that the principal reason for the reduction in bullion imports, in the context of both a growing economy and rising inflationary expectations, was the 5.6 million ounces of gold delivered to the U.S. market from Treasury stocks.

Question: When will Treasury sales of U.S. gold medallions begin and how will sales be conducted?

Answer: Final planning for the production and sale of medallions will be completed and production begun only after Congress appropriates the necessary funds. Requests for appropriations are under consideration by the Office of Management and Budget. The Treasury expects to be able to initiate sales within nine months after funds become available for expenditure. The Treasury expects to use a direct mail order system to market the gold medallions as this system provides the best and least costly method of enabling individuals to obtain medallions at the market value of the gold content of the medallions plus production and distribution costs.

QUESTION: What is the position of the Department of the Treasury on S. 3624, a bill introduced by Senator Helms, which would repeal the authority of the Secretary of the Treasury to require U.S. persons to turn gold holdings over to the Government?

ANSWER: Attached is a copy of the Department's comments on S. 30, introduced by Senator Helms in the current session of Congress. S. 30 is identical to S. 3624, introduced in the 95th Congress. In essence, we believe that this authority has been implicitly repealed, and that no legislative action is necessary to achieve the purpose of the bill.

APR 5 1978

Dear Mr. Proxmire:

This is in response to your request for the views of the Department of the Treasury on S. 30, a bill "To repeal the authority of the Secretary of the Treasury to seize privately owned gold."

The purpose of the bill is to repeal section 11(n) of the Federal Reserve Act (12 U.S.C. 248(n)). Section 11(n), enacted on March 9, 1933, provides authority for the Secretary of the Treasury to require any or all persons to deliver to the Treasury any or all of the gold that they own when, in the judgment of the Secretary, this action is necessary to protect the currency system of the United States.

As a matter of statutory construction, the Department believes that section 2 of P.L. 93-373 (88 Stat. 445) implicitly repeals the provisions of section 11(n) of the Federal Reserve Act. P.L. 93-373 provides that "No provision of any law in effect on the date of enactment of this Act, . . . may be construed to prohibit any person from purchasing, holding, selling, or otherwise dealing with gold in the United States or abroad." Further, the congressional debates on this provision reveal the clear intent to permit private ownership of gold.

The language and legislative history of this law lead to the conclusion that it is not necessary to repeal expressly section 11(n) of the Federal Reserve Act. If Congress decides to repeal section 11(n), however, the Department would have no objection. It is the understanding of the Department that the proposed legislation would not affect the continued legal authority of the Department to seize gold acquired illegally prior to December 31, 1974 (see Exec. Order No. 11825 and 40 Fed. Reg. 16844 (1975)).

The Office of Management and Budget has advised that there is no objection from the standpoint of the Administration's program to the submission of this report to your Committee.

Sincerely yours,

(Signed) Henry C. Stockell, Jr.
Deputy General Counsel

The Honorable
William Proxmire, Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D. C. 20510

QUESTION:

The European Monetary System requires central banks of participating countries to deposit 20 percent of their gold reserves and 20 percent of their U.S. dollar reserves with the European Monetary Cooperation Fund. The gold deposits will be valued at near-current market rates, and the Fund may issue European Currency Units (ECUs) against these gold deposits and pay interest on the ECUs. The EMS provisions would seem to suggest an enhanced role for gold in the international monetary system, would they not?

ANSWER:

See the Treasury report assessing the operation of the international monetary system.

Question: If the U.S. were to value its gold reserves on the same basis as EMS does, what would the value of U.S. gold reserves have been as of April 1, expressed in ECU and in U.S. dollars?

Answer: For EMS purposes, gold is revalued every three months at either

- 1) the average of the two London gold market fixings (AM and PM) on the day preceding the "value date", or
- 2) the average of these two fixings during the six months preceding the "value date", whichever is lower.

On March 13, 1979, gold was valued for the first three months of EMS at ECU 164.926 per ounce. The U.S. gold stock totalled 271.9 million ounces on April 1, 1979. Valued on the same basis as EMS gold, the U.S. stock would have been worth ECU 44.8 billion or \$60.5 billion (1 ECU = \$1.35).

QUESTION: Why should the IMF continue to dispose of its gold holdings? Should the IMF not, on the contrary, set up a facility to encourage member countries to deposit gold in the IMF?

ANSWER: The IMF is in the process of disposing of 50 million ounces of its gold holdings pursuant to the 1975 agreement on steps to reduce the monetary role of gold. The amended IMF Articles of Agreement require the Fund to complete the disposal program and authorize the Fund to dispose of its other gold holdings.

During the monetary reform negotiations, consideration was given to the establishment of an account that would accept deposits of gold in exchange for SDRs. However, it was not possible to reach agreement and there is no provision in the amended Articles for such an account.

Senator TSONGAS. Let's project to the best of your ability inflation rates and growth rates into the future, recognizing as you say in your statement that such projections are indeterminant. How do you project the next 5 to 10 years, given the fact that both Germany and Japan are likely to have lower inflation rates than we do, and their growth rates at best may level out?

Certainly, I would think the United States being that far behind, in terms of potential relative growth rates over that period of time—would not give us hope that things will be getting any better.

Mr. SOLOMON. It may very well be that over that long a period of time, that the trade-weighted value of the dollar will strengthen at the same time that the trade-weighted value of the deutsche mark or the yen will strengthen more.

In other words, there may be, if we are unsuccessful in getting as low an inflation rate as Germany and Japan, it may be that the deutsche mark and the yen will gradually or slowly appreciate somewhat relative to the dollar.

But at the same time this does not mean a decline in the value of the dollar. There are 140 other countries in the world and the trade-weighted value of the dollar might very well be stable, or improve, notwithstanding if those assumptions prevail, some further appreciation in the bilateral relationship between those two countries.

The problem, Senator, was that there was not only the appreciation of the deutsche mark and franc and yen, but there was a decline generally in the trade-weighted value of the dollar, whereas I'm saying even based on those assumptions which you have made, which I hope will not materialize—but even based on those, you do not—one thing does not follow from it.

Senator TSONGAS. You seem to be suggesting a growing gap between those three countries and the rest of the world.

Mr. SOLOMON. No. Not necessarily. It's a pretty complicated phenomena, when one examines this.

So much of our trade is with Canada and with developing countries that it may very well be that it would be a continuation of present divergent trends in regard to prices—in that sense, I guess your statement is correct.

But in the larger sense, in terms of growth rates and other economic activity, there would not necessarily be a growing divergency. Only possibly in what we call real exchange rate relationships, which are the normal exchange rates as corrected by differences in the relative inflation rates.

Senator TSONGAS. The greater investment on the part of the countries involving deutsche mark and yen, as opposed to the dollar—those paths for those three countries—wouldn't they be in a better position to have yen or deutsche marks in their possession, rather than dollars?

Mr. SOLOMON. If I understand your question, certainly, there are some people looking at the long term who would like to, or have in recent months, increased their percentage of deutsche mark and yen holdings relative to the dollar. But the changes are still relatively small.

If you look at official foreign exchange assets held by all monetary authorities around the world, I think the decline in the percentage holding of dollars is something like from 86 percent to 84 percent during this period of great pressure on the dollar.

As for the deutsche mark reserves held by monetary authorities, we don't have the most recent data, but our guess is it might be somewhere around 10 percent. I think the percentage of official assets held in yen might be around 2 percent.

You are talking about fairly small changes, but it is true that there is some diversification from time to time.

Now, recently, there has been some evidence that this has been partially reversed as the dollar has been stronger.

I don't see diversification by official central banks as being very volatile in the future, notwithstanding judgment as to the relative exchange rate changes we were talking about.

Senator TSONGAS. The administration has talked about a much more aggressive export policy. Of course, the administration has been saying that for a long time now. But there seems to be some movement in that direction and there seems to be a growing awareness on the part of the U.S. business community that exporting is indeed a viable alternative and that the percentage of our products that are going into exports is increasing all the time.

If that trend continues, what impact do you think that is going to have on the dollar?

I suppose it could have an impact on the balance of trade problem, but what kinds of increases in exports over, let's say, 5 to 10 years, would be necessary to really have an impact on the value of the dollar?

Mr. SOLOMON. Well, we have averaged—we have swung back and forth in the last decade, roughly, between 19- and 21-percent share of world trade in industrial countries, I think. Maybe 19 to 21 percent of total trade—I will have to check those figures. But it is between 19 and 21 percent of world trade.

Now, more recently, partly as a result of our greater competitiveness due to exchange rate adjustments earlier, our share has increased again.

The sector analysis is the more volatile one than the overall one. In some sectors there has been fairly substantial decline in our share of world trade.

Your question was how much of an impact. The best way I think I can answer that, the most accurate way, would be this: If we could maintain a share of, say, 21 to 22 percent in developed country exports I think that we would be in current account equilibrium, which is the appropriate thing to look at since we have such a huge surplus on invisibles.

Now, that is doable. It takes an effort, but it is doable. It is just that—U.S. business has the biggest market in the world right here. It is not as consistently export oriented as the other countries in the world.

Our Government has not given a consistent priority to it.

Frequently we allow, in my personal view, regrettably, frequently we allow momentary foreign policy considerations to interfere with our appropriate priority for exports.

The Congress and executive branch have had difficulty ever since the Bank was put on budget in allocating large enough resources that I think are required given the very aggressive competitive situation in the world today.

There are things we can do, and U.S. business can do, which I think can give us that slightly higher share of world trade which would be required to, on average, put us in current account equilibrium.

Now, there are other ways of being in current account equilibrium as well, but they are much less attractive. Continued lower growth rates, et cetera, et cetera.

I would hope that we would promote exports, both the Congress and the executive branch, in a more consistent way. And I think it is doable.

Senator TSONGAS. I am always intrigued by the way we are going to do it because it is one of the few things that we can do that doesn't have a downside to the policy.

Mr. SOLOMON. I think, myself, to some degree there are two or three factors.

When market interest rates are not significantly higher than official rates, there is some justification in the view that direct official export credits by the Eximbank is not a necessary factor on a big scale.

But, of course, we are living in more inflationary times when the interest rates of our competitors on direct export credits, and our own direct credit export rates, are much lower than market rates.

There are some exceptions in the case of a couple of countries. But basically it is an important factor now, I think.

And yet there is a view among academicians and, to some degree, in the midseventies in the executive branch that it really didn't bring about that much true additionality in export.

I don't think that is a correct judgment under today's circumstances. So that is a factor.

Second, we have played the free world leadership role since World War II. We, therefore, think very much in foreign policy terms and we give economic considerations lower priority.

I think, myself, that's a mistake. Obviously I'm somewhat biased because I work with the international economic side and I think that a higher priority for exports in our foreign policy is appropriate given the relative situation of the U.S. economy today with the rest of the world.

Those are two factors to explain why we haven't done this. The third and possibly most important is that the private sector of the United States has the biggest market here. It pays secondary attention to markets abroad.

If they are running at full capacity here, they will not even accept export orders whereas in other countries the psychology always is that exports always take priority over the domestic market.

How one changes that without giving excessively inappropriate incentives, I don't know myself.

Senator TSONGAS. Let me suggest that my experience, not so much with the larger corporations but middle-size and smaller companies, is that for them it is really a question of bureaucracy.

It is a question of getting over the psychological barrier that exporting is indeed a viable alternative, not so much that they don't consider it to be an attractive possibility.

They are confused by exchange rates, all the processes that have to be gone through. And I think the Government does have a role to play in overcoming some of that institutional concern, as opposed to market forces.

Mr. SOLOMON. In that area I think some progress is being made. Commerce has embarked on a major program of education for somewhat smaller size business.

Senator TSONGAS. That's right.

The Eximbank has had a history of conflicting policy objectives. One is to encourage export. The other one is to not go into the red. It is like having your cake and eating it too.

Do you think the Eximbank needs more resources in hand to really be an effective competitor, given the aggressive policies that the French and others have engaged in?

Mr. SOLOMON. Yes, I do, very definitely. Particularly if we get into further trade relations with the People's Republic of China, if we want to be competitive in what is basically now, to some degree, a disguised credit race that is going on, competition, notwithstanding, there are some constraints on it from the OECD agreement.

I myself see no alternative but having as one component of our export policies enlarged resources for the Eximbank.

Senator TSONGAS. Is that in the works?

Mr. SOLOMON. The President did increase somewhat the resources for the Eximbank in his last budget proposal. Of course, we are under constraints since Congress put Eximbank on budget.

You may remember that during, part of the 1960's, the Eximbank was off budget.

Frequently the export credit agencies of our leading competitors are not on budget and the result is that they feel freer to be more aggressive.

Given our overall concern about the budget, the size of government expenditures, and the budgetary deficit, we have this problem as long as Eximbank is on budget.

Senator TSONGAS. You are not the only one that has the problem. We are pursuing a balanced budget. There are many problems along the way. This is an example.

There was a great deal of concern expressed when I was on the House side about what happens in countries that have to go to the IMF and what kinds of policies are imposed on Third World countries and whether, indeed, the poorest people in those countries are going to be the most affected by policies of restraint and contraction which are recommended to get ahold of the problem of inflation.

It has been suggested that there is a lack of sensitivity as to the alternatives that might be employed to have a lesser impact on the poorest element in these countries.

Has this issue come up in discussions? Has there been an attempt—

Mr. SOLOMON. There has been a good deal of discussion on this question of the forms of conditionality, the tightness of conditionality and IMF agreements, in the Board of Directors. And the Board

of Directors has recently adopted a set of criteria, in principle, which I would be pleased to send you. But they go in the direction of taking into greater recognition the political and social objectives of the country, not to give excessively detailed recommendations, to leave it up to the government itself as to how it intends to bring its accounts more into line, what forms it uses.

I, myself, would not call that weaker conditionality, but I would call it more sensitivity, and I think the IMF is making a very major effort today to recognize that this is an area of criticism.

To some degree, though, I must say, Senator, that the IMF serves a very useful whipping boy role. Governments have to undertake stabilization programs when their economies get overheated, inflation is running sky-high—

Senator TSONGAS. I don't think you have to convince us. We are politicians up here and we know the need for whipping boys.

I know of your time constraints and mine as well. Thank you very much.

[Copy of S. 976 and statement and additional material from the Treasury Department follows:]

96TH CONGRESS
1ST SESSION

S. 976

To authorize appropriations for the international affairs functions of the Department of the Treasury for fiscal years 1980 and 1981.

IN THE SENATE OF THE UNITED STATES

APRIL 23 (legislative day, APRIL 9), 1979

Mr. PROXMIRE (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

A BILL

To authorize appropriations for the international affairs functions of the Department of the Treasury for fiscal years 1980 and 1981.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 That section 5 of the Act of November 8, 1978 (92 Stat.
4 3092) is amended by—

5 (a) inserting “\$22,752,000 for fiscal year 1980,
6 and such sums as may be necessary for fiscal year
7 1981,” after “1979”, and designating the language in
8 that section as subsection “(a)”; and

1 (b) adding the following new subsection:

2 “(b) There are also authorized to be appropriated for
3 each fiscal year listed in subsection (a) such additional sums
4 as may be necessary for increases required by adjustments in
5 salaries, pay, retirement, and other employee benefits author-
6 ized by law and for other nondiscretionary costs.”.

FOR RELEASE ON DELIVERY

Remarks of the Honorable Anthony M. Solomon
Under Secretary of the Treasury for Monetary Affairs
before the
Subcommittee on International Finance
of the
Committee on Banking, Housing and Urban Affairs
United States Senate
May 3, 1979 10:00 A.M.

Mr. Chairman, I am pleased to appear before your Subcommittee to support S.976, the proposed budget authorization for the Treasury's international affairs function, and to discuss recent international monetary developments. I have provided the Subcommittee separately with a more extensive assessment of the operation of the international monetary system during the period July 1977 to March 1979, and have submitted written responses to the specific questions raised in your letter of April 20 to Secretary Blumenthal.

I.

BUDGET AUTHORIZATION FOR INTERNATIONAL AFFAIRS

Mr. Chairman, this Subcommittee acted favorably last year on legislation to bring the salaries and administrative expenses of Treasury's international affairs functions under the appropriations process. In last year's hearings, I explained that, pursuant to the Gold Reserve Act of 1934, salaries and other administrative expenses associated with the Treasury's international responsibilities had in the past been paid from the resources of the Exchange Stabilization Fund (ESF). Shortly after taking office, Secretary Blumenthal and I ordered a review of this practice, and concluded that the former "off-budget" and non-appropriated status of these expenditures could and should be terminated.

The legislation authorizing appropriations for these expenses was passed near the close of the last Congress and was signed, as P.L. 95-612, by the President on November 8, 1978. It authorized a sum not to exceed \$24 million to be appropriated for FY 1979, and

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terminated the authority to use the ESF to meet administrative costs as soon as funds were made available by an appropriations act. We are at present seeking an appropriation to cover the last quarter of FY 1979 pursuant to the FY 1979 authorization.

The Treasury's international affairs function embraces the wide range of issues involved in formulating policies and conducting negotiations with other governments and institutions on world economic, monetary and financial problems for which the Treasury has responsibilities. As chief financial officer of the United States, the Secretary of the Treasury has major international duties assigned by the President or directed by statute. He is Governor for the U.S. in the International Monetary Fund, the World Bank and the other multilateral development banks of which we are a member. He oversees U.S. international monetary policy and operations, including operations utilizing the resources of the Exchange Stabilization Fund. He is co-Chairman of the Saudi Arabian-United States Joint Commission on Economic Cooperation; Honorary Director of the U.S.-U.S.S.R. Trade and Economic Council; co-Chairman of the U.S.-U.S.S.R. Commercial Commission; and co-Chairman of the recently formed U.S.-China Joint Economic Committee, which will coordinate and oversee the development of U.S. economic relations with the People's Republic of China. He formulates and represents the Treasury's views on policy over the range of international trade, financing, development, energy and natural resource issues. He represents the United States in discussions and negotiations of bilateral and international monetary and financial issues with other nations and closely assists the President at economic summit meetings.

Such activities as these, on the part of the Secretary and other senior Treasury officials, require highly professional staff support. There is a continuing need for knowledge and analysis of economic conditions and policies abroad, for development and representation of U.S. positions at staff level with foreign representatives, and for relating U.S. foreign economic policy activities to the national interests of the United States.

The authorization we are requesting for FY 1980 is approximately \$23 million which -- despite inflation -- is slightly below the amount authorized for FY 1979. We are deeply concerned that our responsibilities be carried out efficiently, and we have made a deliberate and effective effort to control the costs of conducting Treasury's international activities. We have been less successful in some areas than in others, because of inflationary cost increases

and international developments that have demanded more extensive international contact. But we are determined to limit costs and activities wherever possible and consistent with performance of our responsibilities.

Our draft bill also requests an authorization for appropriations for FY 1981, consistent with Section 607 of the Congressional Budget and Impoundment Control Act of 1974. We would prefer an authorization for both years, simply because it would permit a more orderly budget process. The problem with seeking both authorization and appropriation in the same year is largely one of timing, and the result may frequently be hearings by the appropriations committees prior to action by the authorizing committees. A two year authorization this year would enable us to maintain an orderly sequence; and, if approved, we would plan to submit a request for FY 1982 next year.

This concludes this part of my statement, Mr. Chairman, and I urge the Subcommittee to report the bill favorably both for FY 1980 and FY 1981.

II.

INTERNATIONAL MONETARY DEVELOPMENTS

In the exercise of your oversight responsibilities, you have asked for an assessment of the operation of the international monetary system since the last oversight hearing in October 1977.

For this purpose, it is useful to examine separately two periods of heavy pressure on the exchange markets during which the dollar depreciated sharply against the Deutschemark and the yen, and to compare these episodes with the recent period of improved market conditions.

In the six months ending March 30, 1978, the trade-weighted value of the dollar against the currencies of all other members of the OECD depreciated by 7 percent. The Deutschemark rate rose about 16 percent, while that for the yen appreciated by approximately 20 percent. These movements occurred despite substantial intervention by a number of central banks.

When the market senses that there is a risk of fairly rapid appreciation or depreciation of a currency, traders and investors try to position themselves to avoid losses or make gains by accumulating assets denominated in currencies that are expected to rise, and liabilities in currencies that are expected to fall. Thus, anticipatory moves tend to accelerate and amplify the pressures on the exchange market that may arise from other causes. The relative impacts of energy shortages on countries, relative rates of inflation, relative rates of economic growth and unused capacity, changing current account positions in deficit and surplus countries and differential interest rates are some of the more frequently cited specific causes of market pressures. Expectations as to shifts in government policy or governmental actions affecting basic conditions are particularly important.

The growing deterioration in the United States current account was probably the leading cause for dollar depreciation in the period of market stress which extended from October 1977 to March 1978. In that six-month period, the United States' current account deficit exceeded \$27 billion at a seasonally adjusted annual rate, more than double the rate for the preceding six months. The U.S. economy was continuing to expand quite rapidly while growth was lagging in Germany and Japan. Much public attention was being given to the debate over the need of policies to promote expansion in the surplus countries. There were widespread misperceptions as to U.S. policy toward the dollar.

During the second period of heavy market pressure extending from July through October of 1978, the Deutschemark, yen and Swiss franc again appreciated sharply against the dollar. In percentage terms, the rise was 18 percent for the Deutschemark, 14 percent for the yen and 26 percent for the Swiss franc. Once again there was heavy central bank intervention. In this second period of severe market disorder, the pressure developed in spite of the fact that the U.S. current account position had improved so that the annual rate was only about half as large as in the previous period of pressure -- under \$14 billion at an annual rate. In part, the development of market disorder in the face of this U.S. improvement can be attributed to the continuation of current account surpluses in the three major surplus countries in the range of about \$25 billion a year. The major factor, however, was the growing concern about rising rates of inflation in the United States, doubts as to the degree of restraint in domestic macroeconomic policies in the United States, and fears that the U.S. authorities were not concerned about the decline of the dollar.

These fears about the appropriateness and adequacy of U.S. policy, and thus the danger that the dollar exchange rate might decline rapidly, led to large sales of dollars against DM and yen, especially in October, associated with leads and lags in commercial transactions and other forms of precautionary shifts of asset and liability positions. A few central banks, as well as some private entities, appear to have initiated policies leading to slight reductions in the proportion of their reserves held in dollars. These shifts of funds took place despite the fact that short-term interest rates were substantially higher in the U.S. than in Germany, Japan and Switzerland, implying expectations that the effect of continuing dollar decline on capital value of short-term investments would more than offset the effect of the interest rate differential. As shifts occurred, they caused rate movements which simply reinforced the expectations of further declines.

Our November 1 program -- details of which are described in our Assessment -- turned the market psychology. There were some events -- the turmoil in Iran and the unexpectedly large increase in oil prices -- which revived the pressure temporarily. When the market saw that the U.S. and its partners in this operation -- the monetary authorities of Germany, Switzerland and Japan -- were firm, the expectations changed.

I believe the markets now accept the Administration's assurances not only that intervention on a large scale will be carried out to deal with disorderly markets, but also that bringing inflation under control has become a dominant factor in United States' domestic economic policy.

The disorder has now subsided. A good deal of the speculative movement has been reversed. The timing of payments for trade in relation to shipments seems to be returning to more normal patterns. Confidence has returned. Since November 1, the trade-weighted value of the dollar has risen against other OECD currencies by about 10 percent.

The two periods of stress that I have cited confirm that in a world of increasing interdependence in trade and great fluidity of capital movements across boundaries, divergent trends in competitive positions or in domestic macroeconomic policies are likely to be reflected quickly in the exchange markets for major currencies.

There are times when intervention on a forceful scale is needed and, in combination with sound basic policies, can be effective in combating disorder and restoring confidence. But market expectations

as to future economic policies which will impact on the trade balance, future rates of inflation and prospective interest rate movements -- in sum, market confidence in government policies and government determination to prevent disorder -- are crucial.

A stable monetary system therefore is heavily dependent on sound domestic policies that restrain inflation in deficit countries and that promote noninflationary growth in surplus countries.

Let me turn to a brief look ahead. The recent increase in OPEC oil prices and the imposition of surcharges by most OPEC members have altered the general tone of the outlook for the global economy. Most importantly, an already delicate inflationary situation has been exacerbated by higher oil prices. Our current projections suggest that inflation rates outside the U.S. will quicken this year, following two years of steady decline. Adding our own inflation rates means that inflation in the OECD area could be at least one percent faster in 1979 than in 1978.

The second troubling aspect of the recent OPEC price rise concerns external balances. For the last several years steady reductions in the OPEC surplus and redistributions of deficits among oil importing countries have significantly reduced the degree of external imbalance within the global economy. Much of this improvement will be erased this year as the OPEC surplus -- which almost disappeared in the second half of last year -- will rise to something like \$30 billion. The counterpart of this larger OPEC surplus will be a return to deficit of the developed countries of the OECD as a group, and a somewhat larger deficit in the non-oil LDCs. Actually, most of the OPEC members are recording deficits -- the surplus is becoming increasingly concentrated in a few countries.

But the outlook is not all gloom and doom. During 1979 we should continue to see slow, steady progress in a number of important areas. We expect a substantial reduction in the disparities in economic performance among OECD countries. This is especially important in the larger countries. Somewhat faster foreign growth abroad combined with slower U.S. growth will add stability. Real growth outside the U.S. will exceed that of the U.S. for the first time since 1975.

This alteration in relative growth rates, coupled with the gains from past changes in competitive positions, will reduce external imbalances. We are already seeing very important changes in Japan and the U.S. and expect some reduction in the German surplus.

In closing, I am encouraged by developments in the exchange markets since November 1 of last year. Major countries have now put into place the framework of policies agreed upon at last year's Summit meeting -- policies which seem appropriate to current circumstances. While there remain very difficult elements in the outlook, these cooperative policies are reducing some of the more disruptive payments imbalances. This will contribute to greater stability. Lasting monetary stability in our interdependent system will depend on sustained efforts to improve international cooperation, and on implementation of coordinated macroeconomic policy. We must recognize that there will be periods of stress and instability so long as there are wide divergences in national economic priorities and policies, and in relative competitive positions. Our system must accommodate those divergences and facilitate the adjustments that will inevitably be needed. If the national priorities of the advancing nations come closer to a common scale, we can expect the international monetary system to operate more smoothly than has been the case in recent years.

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THE OPERATION OF THE
INTERNATIONAL MONETARY SYSTEM
JULY 1977 - MARCH 1979

A TREASURY ASSESSMENT

This report has been prepared by the staff of the Treasury Department for the Subcommittee on International Finance of the Senate Committee on Banking, Housing and Urban Affairs pursuant to the understanding contained in the letter of September 20, 1976 from the Secretary of the Treasury to the Chairmen of the Committee and the Subcommittee. It provides an assessment of the operation of the international monetary system from July 1977 - March 1979, including the following specific items referred to in the letter:

- a. The world balance of payments situation;
- b. Official balance of payments financing provided bilaterally by the U.S. and through multilateral channels by any government to the full extent that information is available to the United States;
- c. Exchange market intervention by the U.S.;
- d. Movements in exchange rates;
- e. Comparative rates of growth and inflation in the U.S. and foreign economies; and
- f. Changes in exchange controls and trade restrictions imposed by IMF member countries.

The report covers a period of major tensions and change in the international monetary system. The emergence of significant disparities in economic performance among the major industrial countries was accompanied by serious exchange market disturbances which ultimately required forceful and internationally coordinated countermeasures. The period also witnessed important modifications in the structure of the system with the implementation of the amended IMF Articles of Agreement and the adoption of the new monetary arrangements within the European Community.

A major objective of U.S. international economic policy since World War II has been the creation and maintenance of an open and liberal system of trade and payments. The progressive reduction of trade barriers and the development

of international capital markets has enabled the global economy to achieve rapid and sustained increases in the wealth and living standards of the industrialized countries and progress in the developing countries. The movement toward an open system of trade and capital has also resulted in a dramatic increase in the interdependence of the global economy.

The greater ease with which trade and capital can move across international boundaries has meant that differences among countries in growth and inflation now have a much larger and more immediate effect on the direction and magnitude of trade and financial flows, and, consequently, exchange rates. The experience of the past few years demonstrates that the future stability of the international monetary system will depend importantly on the ability of the major countries to pursue sound economic policies that will reduce the disparities in economic performance. A strengthening of the mechanisms for consultation and cooperation will be required to ensure that each country takes full account of the international ramifications of domestic policies and coordinates its policies with others so that all may benefit fully from an interdependent system.

The report is presented in eight sections as follows:

- A. Developments in world growth, inflation and payments balances.
- B. The financing of payments imbalances and activity in international credit markets
- C. Developments in the foreign exchange market
- D. Trade and exchange restrictions
- E. Role of the IMF
- F. Evolution of the role of gold
- G. Formation of the European monetary system

A. Developments in World Growth, Inflation
and Payments Balances

The Rambouillet Summit in 1975 and the Amended Articles of Agreement of the IMF explicitly recognized that developments in the international monetary system would parallel events in the global economy. Exchange rate relationships -- and implicitly the working of the monetary system -- have closely reflected changes in the underlying or fundamental economic conditions during the past two years. Any assessment of the operation of the international monetary system over the past 18 months should therefore start with a review of developments in the world economy.

During 1977, the global economy was characterized by sharply divergent growth trends among major groups of countries. The U.S. economy had already experienced a very strong recovery from the 1975 recession -- 1976 real growth was 6% -- while other developed countries have seen less robust growth (roughly 4-3/4 percent in 1976). By historical standards it is atypical for U.S. growth to exceed that of other OECD members for any extended period of time. During the 1960's growth averaged 4.2 percent in the U.S., while growth in other OECD countries of 6.2 percent prevailed.

This strong U.S. growth coupled with relatively slow foreign growth set the stage for a sharp swing in the U.S. trade and current account balances. During 1977, U.S. recovery fell back from the rapid 1976 pace but continued very strong at nearly 5%. Growth abroad fell back sharply from early recovery rates to about 2.7 percent. At the same time that the gap in growth rates was widening, the inflation differential also widened, as inflation began to quicken in the U.S. while price pressures abroad slackened.

Not surprisingly these sharp divergences in economic performance among the developed countries were soon reflected in external balances and the exchange markets. The U.S. current account shifted sharply into deficit in 1977 -- declining from a surplus of \$4.3 billion in 1976 to a deficit of \$15.2 billion in 1977. Other OECD countries experienced a substantial improvement in their combined deficits, which were roughly halved, from \$23 billion to \$11.5 billion in 1977.

These sharp disparities in economic performance among major countries continued into 1978. During the first quarter, the U.S. current account deficit skyrocketed to an annual rate of \$30 billion. Simultaneously the surpluses of Japan and Germany in particular began to balloon. In hindsight, this period appears to have been the peak of the sharp divergences in economic performances among the major countries. Forces were already at work to bring the basic underlying economic trends into closer balance among the major countries. Efforts at stimulating real growth by Japan and Germany were beginning to be reflected in rising domestic demand and import volumes. At the same time that growth abroad began to quicken, exchange rate changes of 1976/77 were beginning to exert their influences on U.S. trade flows volume flows. After four years of very sluggish export growth, the shift in foreign growth and the competitive gains of 1976/77 began to affect exports. For the last three quarters of 1978, the volume of U.S. exports rose at an annual rate of 22 percent. Over the same period, U.S. import volumes rose only 1 percent. These volume developments produced a substantial reduction in the U.S. trade deficit which fell from an annual rate of \$45 billion in the first quarter to \$29 billion in the fourth quarter.

For the year 1978 as a whole, OECD real growth averaged 3.6% -- roughly in line with the 1977 average rate of real growth. From a systemic point of view, it is important to recognize that real growth in the OECD area, excluding the U.S., increased by 1/2% in 1978, as growth rates in the U.S. and abroad were converging during the year. By year end growth abroad was expected to exceed U.S. growth for the first time since the 1975 U.S. recession.

In the aggregate, during 1978 non-oil LDCs continued along the solid 5% real growth path that had begun in 1976. This apparently steady growth rate was not reflected in more disaggregated regional growth rates however. Non-oil LDCs in Asia continued their impressively rapid 7% real growth, (and continued to lead the global economy in export growth); middle eastern non-oil LDCs increased their growth rates by 1 percentage point to nearly 6%; real growth in Latin American LDCs was unchanged at 4.3%; but African LDCs witnessed a slowing down of 1.3 percentage points to 2.8%.

Global inflation rates generally improved during 1978 although still remained for the vast majority of countries unacceptably high. OECD inflation slowed from 8.1% to 6.7% in 1978. Excluding the U.S. where inflation rose from 5.9 to 7.6% -- OECD inflation rates recorded an impressive decline -- from 9.6% to 6.2% in 1978. Non-oil LDCs were also

beginning to regain control of inflationary pressures during the year as average cost-of-living increases declined from 30% to 25%. Only the Middle East area witnessed rising inflation rates.

The distribution of world current account balances underwent the most important changes during 1978 since the 1973/74 oil crisis. Led by a substantial -- roughly two-thirds -- reduction in OPEC's current account surpluses -- the global distribution of external balances began to approximate a pattern thought to be sustainable over the longer term. The OPEC current account surplus fell to \$7-8 billion; for the year as a whole and during the second half the surplus was close to zero. The developed countries belonging to the OECD returned to an aggregate surplus current account position (about \$4 billion) for the first time since 1973, and the non-oil LDCs experienced a modest increase in their combined deficit position (reaching some \$18 billion).

Even with these important improvements in the distribution of external balances between the major groups of countries (OPEC, OECD, LDC) large and unsustainable imbalances within the groups remained. In the OECD area the combined surpluses of Japan, Germany, and Switzerland rose by \$12 1/2 billion to a disturbingly large \$30 billion total. At the other extreme the U.S. current account deficits soared to an annual rate of 27.5 billion in the last quarter of 1977 and the first quarter of 1978. These imbalances improved during the course of 1978. Both types of imbalances -- extreme deficits or surpluses -- strain in the monetary system. By year-end, evidence suggested that the Japanese and U.S. imbalances were undergoing significant reductions which would continue into 1979.

The oil price increases announced by OPEC in December, 1978, and March, 1979, will sharply alter the recent trends and will undoubtedly reverse the important movements towards a stable global pattern of payments balances. The effects of these increases were beginning to appear before the end of the first quarter.

Table 1

TREASURY ESTIMATES
Real Growth Rates
(% change, year on year)

	1959-60 to 1972-73 AVERAGE	1977	1978
North America*	4.3	4.7	3.8
U.S.	4.2	4.9	3.9
Canada	5.1	2.7	3.3
Japan	10.9	5.2	5.7
W. Europe	5.0	2.4	3.0
France	5.9	3.0	3.0
Germany	4.9	2.6	3.4
Italy	5.6	1.7	2.0
U.K.	3.3	1.8	3.1
Big 6 (excluding U.S.)	6.7	3.3	3.8
Big 7	5.5	4.0	3.9
Other OECD	5.5	1.7	2.4
Total OECD	5.5	3.7	3.6
OECD excluding US	6.4	2.9	3.4
Memorandum:			
U.S., Japan, Germany	5.7	4.6	4.2
Italy, U.K., France	5.1	2.3	2.8

*Geographic regions weighted by 1976 GNP shares.

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Table 2
 Treasury Estimates
 Projected Inflation Rates in OECD Area
 Consumer Prices
 (% change year on year)

	<u>1976</u>	<u>1977</u>	<u>1978</u>
U.S. <u>3/</u>	4.8	5.8	7.6
Canada <u>3/</u>	7.4	8.0	9.0
Japan <u>3/</u>	9.6	8.0	4.0
France <u>2/</u>	9.7	9.5	9.3
Germany <u>3/</u>	4.4	3.9	2.6
Italy <u>3/</u>	17.2	18.1	12.4
U.K. <u>4/</u>	16.5	15.8	8.3
Big Six (excludes U.S.)	9.6	9.1	6.3
Big Seven	7.4	7.6	6.9
Other OECD	10.5	11.2	6.0
OECD excluding U.S.	9.8	9.6	6.2
Total OECD	7.9	8.1	6.7

Aggregate estimates are weighted by 1976 GNP weights

2/ Implicit Consumer Price Deflator

3/ Cost-of-Living

4/ Retail Prices

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Table 3

		<u>Global Payments Patterns</u> ((\$billions))				
		<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>
<u>Balances on Goods, Services and Private Transfers</u>						
OPEC		+71	+35 1/2	+39	+35	+10
OECD	1/	-16 1/2	+13	-7	-12	+23 1/2
non-OPEC LDCs		-29	-34	-25	-20	-25
others	2/	-10	-16	-13	-11	-11
Unexplained Residual	3/	-15 1/2	+1 1/2	+6	+ 8	+ 5
<u>Official Transfers, Net</u>						
OPEC		-1 1/2	-1 1/2	-2	-2	- 3
OECD	1/	-11	-13	-13	-15	-19 1/2
non-OPEC LDCs		+5	+6	+6	+ 6	+ 7
others	2/	+1/2	+1	+2	+2	+ 2
Unexplained Residual	3/	+7	+7 1/2	+7	-9	-13 1/2
<u>Current Account Balance (including official transfers)</u>						
OPEC		+69 1/2	+34	+37	+33	+ 7 1/2
OECD		-27 1/2	0	-19	-27	+ 3
of which:						
(U.S.)		(+2)	(+18)	(+4)	(-15)	(-16 1/2)
(others)		(-29 1/2)	(-18)	(-23)	(-11 1/2)	(+20)
non-OPEC LDCs	1/	-24	-28	-19	-14	-18
others	2/	- 9 1/2	-15	-11	-9	-9
Unexplained Residual	3/	- 8 1/2	+ 8	+14	+17	+15 1/2

1/ Non-OPEC LDCs: 70 non-OPEC developing countries which are members of the IMF and which account for more than 90% of the trade of all countries not included in the other groups.

2/ Others: Israel, China, Cuba, S. Africa, Yugoslavia, and the centrally-planned economies of Eastern Europe.

3/ Unexplained residual includes among other things amounts for: (a) 27 small non-OPEC developing countries which are members of the IMF; (b) Malta which is a member of the IMF; and (c) 33 misc. countries and territories which are not members of the IMF but are treated separately in various trade and payments statistics.

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Table 4

Preliminary Treasury Staff Estimates
of OECD Current Accounts
(\$ billion)

NOTE: Countries are listed in order by projected 1978 balances.

	<u>1976</u>	<u>1977</u>	<u>1978</u>
<u>Surplus Countries</u>	<u>+17.3</u>	<u>+21.3</u>	<u>+41.9</u>
Japan	+ 3.7	+10.9	+16.6
Germany	+ 3.4	+ 3.7	+ 8.5
Italy	- 2.8	+ 2.3	+ 6.0
Switzerland	+ 3.5	- 3.4	+ 5.3
France	- 6.1	- 3.3	+ 4.1
Spain	- 4.3	- 2.5	+ 1.0
United Kingdom	- 2.1	+ 0.8	+ 0.2
Finland	- 1.2	- 0.2	+ 0.2
<u>Deficit Countries</u>	<u>-37.3</u>	<u>-48.2</u>	<u>-38.1</u>
Belgium-Luxembourg	- 0.1	- 0.7	- 0.2
Ireland	- 0.2	- 0.2	- 0.3
New Zealand	- 0.8	- 0.6	- 0.8
Sweden	- 2.4	- 3.4	- 0.9
Portugal	- 1.2	- 1.3	- 1.1
Denmark	- 1.9	- 1.6	- 1.4
Greece	- 1.1	- 1.3	- 1.5
Turkey	- 2.3	- 3.4	- 1.7
Austria	- 1.5	- 3.0	- 1.8
Netherlands	+ 2.4	+ 0.2	- 2.0
Norway	- 3.7	- 5.0	- 2.4
Australia	- 1.4	- 2.6	- 3.8
Canada	- 4.2	- 3.9	- 4.2
United States	+ 4.3	-15.2	-16.0
Total OECD	\$-20.0	\$-27.1	\$+ 3.8
Smaller OECD	-16.2	-22.3	-11.4
"Big Seven"	- 3.8	- 4.8	+15.2

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B. THE FINANCING OF PAYMENTS IMBALANCES AND ACTIVITY IN INTERNATIONAL CAPITAL MARKETS

INTRODUCTION

International money movements, if one includes all the short-term and foreign exchange transactions as well as medium and long term credit, are now in the range of tens of billions of dollars daily. These transactions occur for a variety of reasons and through a number of channels. There are no comprehensive reporting requirements which would provide data on the volume of transactions or their nature. The bulk of the transactions in terms of magnitude are very short term movements, and the flow is normally two-way. There is, in effect, an international money market. We do not have to add up all these transactions to reach conclusions about the way in which, on a net basis, they finance current account imbalances.

It is useful, however, to develop some estimates of the level of activity in medium and long term credit. There is a clear distinction between net balance of payments flows and a measure of activity. The net international capital inflow which "finances" the current account deficit of a country represents the balance of many transactions and is a much smaller magnitude than the volume of transactions. Moreover, the presentation of a balance of payments analysis cannot readily show such important questions as the extent of new borrowing which is necessary in order to repay maturing credits. A measure of activity of medium and long term flows can shed some light on this aspect and provide an indication of the institutional significance of credit markets--their strengths and potential weaknesses, and the impact of policy measures and supervisory practices--although it can be misinterpreted and lead to exaggerated views of the impact of international financial markets on real economic activity. This section looks at developments during the previous three years with a view toward assessing the relative role of the private credit markets and official credit flows in the functioning of the international financial system.

I. THE FINANCING OF PAYMENTS IMBALANCES

During the past three years countries with current account deficits have successfully sought to finance these deficits in large part from private sources, chiefly from

banks. Indeed, the role of private banks in intermediating large flows of funds from surplus to deficit countries is a hallmark of international monetary developments during the past five years. Funds provided by governments and by multilateral institutions, while increasing in 1978 in absolute terms, declined as a proportion of total financing extended during this period.

Nature of Capital Flows to Deficit Countries

Table 5 at the end of this section presents a very rough overview of the channels through which deficit countries as a group obtained the funds needed to finance their deficits. These financing patterns are shown separately in Tables 5-a through 5-d for four categories of countries: (a) OECD (i.e., largely the industrialized countries; (b) OPEC; (c) non-oil exporting developing countries; and (d) other deficit countries. The U.S. is not treated as a deficit country for the purpose of these tables.*

As can be seen from these tables, deficit countries as a group have continued to rely primarily on the private markets for their net annual financing needs, the total of which has fluctuated in the range of \$70-80 billion each year. Funds from official sources have been accounting for less than one-fourth of net financing required by all deficit countries. However, net official flows to developing countries have been proportionately much higher, ranging between 40% and 60% of their aggregate current account deficits. In 1978, there was a small increase in the amount of official flows to deficit countries as a group, accounted for entirely by flows to non-oil exporting developing countries.

In recent years, borrowing from banks has constituted the main channel of private finance to deficit countries although bond financing and other private investment flows have also been significant, particularly for OECD deficit countries. On average, the OECD deficit countries have been obtaining as much net financing through bond issues as from banks. Total liabilities of deficit countries to foreign banks have increased by considerably larger magnitudes, but claims of deficit countries on banks have also grown rapidly.

* Because of the extensive use of the U.S. money and capital markets and the international role of the dollar, inclusion of the U.S. would distort the presentation. A subsequent subsection discusses U.S. capital account transactions.

Part of this growth on both sides of the balance sheet reflects the inflating effects of banks' redepositing of funds with other banks (which is a characteristic of the "Euro-currency" market).

The growth in lending through the private markets also reflects the emergence of sizable imbalances in the payments positions of surplus and deficit countries in the wake of significant oil price increases. A significant portion of the surpluses has been placed with private institutions, especially banks, and has been recycled to countries in deficit. This recycling role has contributed to -- and partly results from -- the efficiency of the Euromarkets, which are uninhibited by capital controls common to the domestic markets in many countries and not subject to reserve requirements imposed by national authorities on lending by resident banks in domestic currencies.

Pattern of U.S. Capital Movements

As shown in Table 6, United States residents provided considerable amounts of private capital to other countries despite large deficits in the U.S. balance of payments on current account in 1977 and 1978. Net banking outflows were particularly large in 1978 -- about \$17 billion compared to \$10 billion and \$5 billion in 1976 and 1977 respectively. Gross outflows in 1978 reached \$34 billion. The concentration of bank lending in the fourth quarter last year, followed by a partial reversal in early 1979, suggests that some of the banking movements were associated with exchange market disturbances and other transitory factors. Direct investment outflows have been increasing at a moderate pace and last year, on a net basis, were almost two-thirds as large as net outflows from U.S. banks. (Of the \$15.4 billion in gross direct investment outflows, \$10.7 billion represented reinvested earnings and \$4.7 billion new funds from the U.S.) Compensating capital inflows to the U.S. largely took the form of increased official holdings of liquid dollar assets -- about \$34 billion. There was also, however, a significant "inflow" from unrecorded transactions which is usually assumed to be largely the result of capital transactions not captured by the reporting system. The increase in foreign official assets reflected in large part intervention by other major countries which purchased dollars in the foreign exchange markets to stem the appreciation of their currencies. A number of other countries, however, appear to have been motivated by a desire to increase reserves.

The exchange market developments which so greatly affected the U.S. capital account in 1978 were themselves heavily affected by developments and expectations concerning fundamental economic performance in the U.S. and abroad. At times these factors more than offset the effect of differentials between U.S. and foreign short-term interest rates. Of course, the sheer volume of liquid funds held in national as well as the Euromarkets and the volume of international trade for which payments have to be made provide considerable scope for very large swings, especially in banking flows, in response to a wide range of specific factors.

The United States is almost unique in its capacity to provide large volumes of external finance, directly or indirectly, irrespective of its own balance of payments position. These outflows are, however, a product of many individual transactions reflecting inter alia the inability or unwillingness of other countries to perform these functions.

Role of the IMF

As the central monetary institution, the IMF is the principal source of official multilateral balance of payments financing. In a very real sense the Fund acts as the financial back-stop for the system. It serves as the lender of last resort for countries experiencing financial difficulties. The Fund also promotes the corrective measures required to achieve effective balance of payments adjustment.

The pattern of IMF financing shifted sharply during 1976-78. In 1976, net drawings by deficit countries (i.e., gross drawings, including reserve tranche, less repayments) amounted to a record \$6.5 billion. The OECD countries accounted for about \$4.3 billion, or 66 percent, of the total, and developing countries \$2.2 billion (including \$128 million by deficit OPEC members), or 34 percent. Drawings were heavily concentrated in the relatively less conditional facilities: the temporary Oil Facility and the liberalized Compensatory Financing Facility.

In 1977 and 1978 the use of IMF resources by deficit countries (excluding the U.S.) slowed considerably. In part this reflected the successful stabilization efforts of some countries -- both developed and developing -- and the increased availability of financing from other sources. New drawings totalling about \$2.9 billion in the two years were offset by repayments of outstanding drawings of roughly the same magnitude. However the area pattern of use of IMF

resources shifted, with the developing countries having net drawings of \$440 million in 1977-78 while the OECD had net repayments of about \$460 million. In addition, drawings from the regular credit tranches were the predominant source of IMF financing.

II. ACTIVITY IN INTERNATIONAL CREDIT MARKETS

Amount and Types of Credit

Despite the relative stability in the size of aggregate current account deficits over the past three years, the volume of medium and long term credit raised in international markets during this period grew dramatically, as shown in Table 7. The increase in funds raised in these markets was especially large during 1978, particularly Eurocurrency credits.

A substantial portion of these loans did not create additional credit. The maturation of earlier debts contracted by borrowers required in many instances the seeking of new loans to "roll over" these debts. In addition, conditions in the private markets in the past year have been favorable to borrowers, leading to widespread refinancing of unmatured debt in order to reduce interest costs and to lengthen maturities. Such debt repayments in 1978 are estimated to have accounted for over 40% of medium and long term Eurocurrency loans and over 20% of international bonds issued. Accordingly, the amount of net medium and long term credit extended through the Eurocurrency markets and the international bond markets has been considerably lower than gross new credit extensions in these markets.

Not included in these totals are loans extended to non-residents by banks in "domestic currencies", e.g., dollar loans by U.S. banks, DM loans by German banks. Much of such foreign lending from national markets serves to fund Eurocurrency loans syndicated internationally, and its addition to these loans would introduce double counting.

A major development over the past year or so has been the sharp increase in foreign borrowing in the German, Swiss and especially the Japanese bond markets. In 1978, foreign issues in these three markets increased by about 55% to \$10.4 billion. Recourse to the Japanese market increased dramatically, as Japanese authorities adopted an increasingly liberal policy on foreign access to the Japanese capital market as a means of reducing pressure on the yen emanating from a strong current account position. In 1978, foreign bond issues in Japan more than tripled to \$3.9 billion compared to only \$1.2 billion the year before.

Size of the International Banking Market

Table 8 shows the main components of the liabilities of banks in major countries and "offshore" banking centers which serve to fund their net international lending of all types. The international banking market includes both transactions in the currency of the country in which the bank is located and transactions in other (i.e., foreign) currencies. The latter, e.g., borrowings and loans of dollars by banks in London, make up what is commonly known as the Eurocurrency market. The bulk of this market is denominated in dollars (Eurodollars), and since U.S. banks account for much of the transactions in domestic currencies, the predominant role of the dollar is evident. Indeed, almost all of the major form of Eurocurrency lending, the medium-term syndicated credit, takes place in dollars.

It is essential to recognize that measuring these markets by the gross amount of liabilities (or all external assets) is highly misleading. Almost half of the reported liabilities reflect the practice of redepositing of funds received with other banks in the reporting area, leading to "double counting" for which adjustments need to be made. These redeposits in turn reflect the high efficiency of the market in effecting rapid, extensive intermediation of funds between banks with excess supply of and demand for funds, and arbitrage activities which eliminate disparities in interest rates and exchange rates in the various markets of the world. Eurocurrency liabilities to non-banks as of end-September 1978 were on the order of \$150 billion.

Growth of International Banking Market in 1978

Growth of the international banking market in the first nine months of 1978 was quite rapid, and incomplete data suggest that it accelerated sharply during the fourth quarter to a record annual percentage increase. A substantial part of the rapid growth is attributable to a statistical phenomenon. Liabilities (and assets) denominated in other currencies are reported in dollar terms. When the value of a particular currency rises in terms of the dollar in a particular period, the dollar value of the entire stock of assets and liabilities denominated in such a currency rises. In 1978, there were significant increases in both the dollar and the non-dollar segment of the market, quite apart from valuation changes. The increase in the latter was proportionately greater. This development is further explored in a subsequent section discussing Currency Diversification.

The increase reflected a number of different factors, the relative importance of which varied during this period. In addition to the U.S. current account deficit, foreign lending by banks in the U.S. was large by historical comparison. Substantial liquidity in the economies of major countries made it possible for banks in those countries, as well, to place funds in the Eurocurrency market. Other factors were increased tension in the exchange markets, which increased non-bank demand for financing changes in their pattern of trade payments, and the placement of funds in the market by official institutions.

Concerns Over the Eurodollar Market

The large magnitudes of dollar-denominated assets and liabilities arising from transactions in the Eurodollar market have led to expressions of concern by some observers that this market: (a) results in the extension of international credit in excessive amounts; (b) exposes the banks involved to an inappropriate degree of risk; and (c) increases the potential for speculation in the foreign exchange markets and adds to instability in those markets.

The dangers tend to be exaggerated and distract attention from the efficient functioning of the market and its very important role in facilitating the international extension of credit which was critical to avoidance of world economic disaster in the aftermath of the oil price increase in 1974. Neither national governments nor international institutions are in a position to play the primary role which this market now performs in international credit extension. Nevertheless, developments in the market need to be carefully monitored, and steps are being taken to improve our knowledge of and influence on this market.

Concern that credit extension is excessive may stem in part from focusing on the size of the market rather than the flows that it generates. The magnitudes of the net flows shown in Table 5, which include but are not limited to Eurodollar lending, are a more meaningful indicator of the role of the market in financing payments imbalances. Moreover, it is erroneous to think that Eurodollar transactions are carried on outside the jurisdiction of any supervisory authorities and are insensitive to instruments of domestic monetary policy. U.S. regulatory authorities have for some time been examining the global operations of U.S. banks both through their examination procedures at the home offices and through on-site examinations of the branches. Demand and supply conditions in the market are influenced by interest rates which are linked to rates in the domestic market and thus to domestic monetary policy. With respect to international cooperation, steps taken by the governments and central banks of the major countries include expanding the collection of data on Eurocurrency transactions, limiting placement in the market by major countries of foreign exchange reserves, and increasing attention by bank regulators to the activities of foreign branches and subsidiaries of banks located in the major countries. While there may be room at the international level for improving regulatory techniques and strengthening the links to national credit markets -- the possibility of further improvements is under study -- international banking transactions can be said to be generally sound and to play a significant part in financing imbalances without undermining the adjustment process.

The Eurodollar market should not be viewed as being a unique causative factor in the weakness of the dollar last year, although the availability of dollar credit, whether from the Eurodollar or U.S. domestic market, provided one means of obtaining dollars to be sold for currencies that were expected to appreciate in the foreign exchange market.

TABLE 5
NET FINANCING BY DEFICIT COUNTRIES
\$ Billions

All Deficit Countries, Excluding United States

	1976	1977	1978
<u>FINANCING REQUIREMENTS</u>	<u>77</u>	<u>71</u>	<u>75</u>
-- Aggregate Current Account Deficits ^{1/}	72	65	68
-- Increase in Foreign Exchange Reserves ^{2/}	5	6	7

<u>SOURCES OF FINANCING</u>	<u>85</u>	<u>74</u>	<u>82</u>
<u>Official Flows, Total</u>	<u>19</u>	<u>13</u>	<u>15</u>
-- Multilateral Credits, Net	10	6	7
-- Net Use of IMF Credit	(6)	(0)	(3)
- Gross Drawings ^{6/}	(8)	(1)	(2)
- Repurchases ^{6/}	(1)	(1)	(2)
-- Net Flows from other Institutions	(5)	(6)	(7)
- Gross Credits	(6)	(7)	(8)
- Repayments	(1)	(1)	(1)
-- Bilateral Credits, Net of Repayments ^{7/}	9	8	8
<u>Private Flows, Total</u>	<u>66</u>	<u>61</u>	<u>67</u>
-- Increase in Net Indebtedness to Banks in other Countries ^{3/ 5/}	39	29	39
-- Increase in Gross Liabilities *	(82)	(75)	(92)
-- Increase in Gross Claims *	(42)	(46)	(53)
-- Bond Issues, Net	17	17	14
-- Gross Issues	(21)	(21)	(19)
-- Estimated Net Redemption	(4)	(4)	(5)
-- Net Direct and Non-Bank Portfolio Investments, and other flows ^{4/}	10	15	14

<u>RESIDUAL:</u>	<u>8</u>	<u>3</u>	<u>7</u>

* includes inter-bank depositing

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TABLE 5-a
NET FINANCING BY DEFICIT COUNTRIES
\$ Billions
OECD Countries, Excluding United States

	<u>1976</u>	<u>1977</u>	<u>1978</u>
<u>FINANCING REQUIREMENTS</u>	<u>33</u>	<u>35</u>	<u>28</u>
-- Aggregate Current Account Deficits ^{1/}	37	33	23
-- Increase in Foreign Exchange Reserves ^{2/}	- 4	2	5

<u>SOURCES OF FINANCING</u>	<u>33</u>	<u>41</u>	<u>28</u>
<u>Official Flows, Total</u>	<u>3</u>	<u>0</u>	<u>0</u>
-- Multilateral Credits, Net	3	0	0
-- Net Use of IMF Credit	(3)	(0)	(0)
- Gross Drawings ^{6/}	(5)	(0)	(0)
- Repurchases ^{6/}	(1)	(0)	(1)
-- Net Flows from other Institutions	(0)	(0)	(0)
- Gross Credits			
- Repayments			
-- Bilateral Credits, Net of Repayments	0	0	0
<u>Private Flows, Total</u>	<u>30</u>	<u>41</u>	<u>28</u>
-- Increase in Net Indebtedness to Banks in other Countries ^{3/}	7	20	10
-- Increase in Gross Liabilities *	(29)	(39)	(29)
-- Increase in Gross Claims *	(22)	(20)	(19)
-- Bond Issues, Net	15	14	10
-- Gross Issues	(19)	(17)	(14)
-- Estimated Net Redemption	(4)	(3)	(4)
-- Net Direct and Non-Bank Portfolio Investments, and other flows ^{4/}	8	7	8

<u>RESIDUAL:</u>	0	6	0

* includes inter-bank depositing

TABLE 5-b
NET FINANCING BY DEFICIT COUNTRIES
\$ Billions

OPEC Countries

	<u>1976</u>	<u>1977</u>	<u>1978</u>
<u>FINANCING REQUIREMENTS</u>	<u>2</u>	<u>4</u>	<u>9</u>
-- Aggregate Current Account Deficits ^{1/}	2	5	14
-- Increase in Foreign Exchange Reserves ^{2/}	0	- 1	- 5

<u>SOURCES OF FINANCING</u>	<u>2</u>	<u>2</u>	<u>6</u>
<u>Official Flows, Total</u>	<u>2</u>	<u>1</u>	<u>1</u>
-- Multilateral Credits, Net	1	0	0
-- Net Use of IMF Credit	(0)	(0)	(0)
- Gross Drawings ^{6/}	(0)	(0)	(0)
- Repurchases ^{6/}	(0)	(0)	(0)
-- Net Flows from other Institutions	(1)	(0)	(0)
- Gross Credits	(1)	(0)	(0)
- Repayments	(0)	(0)	(0)
-- Bilateral Credits, Net of Repayments	1	1	1
<u>Private Flows, Total</u>	<u>0</u>	<u>1</u>	<u>5</u>
-- Increase in Net Indebtedness to Banks in other Countries ^{3/ 5/}	1	1	3
-- Increase in Gross Liabilities *	(5)	(9)	(12)
-- Increase in Gross Claims *	(3)	(8)	(9)
-- Bond Issues, Net	0	0	2
-- Gross Issues	(0)	(0)	2
-- Estimated Net Redemption	(0)	(0)	(0)
-- Net Direct and Non-Bank Portfolio Investments, and other flows ^{4/}	-1	0	0

<u>RESIDUAL:</u>	0	-2	-3

* includes considerable inter-bank depositing

TABLE 5-c
NET FINANCING BY DEFICIT COUNTRIES
\$ Billions

Non-Oil Exporting Developing Countries

	1976	1977	1978
<u>FINANCING REQUIREMENTS</u>	<u>29</u>	<u>23</u>	<u>29</u>
-- Aggregate Current Account Deficits ^{1/}	22	18	22
-- Increase in Foreign Exchange Reserves ^{2/}	7	5	7

<u>SOURCES OF FINANCING</u>	<u>36</u>	<u>24</u>	<u>35</u>
<u>Official Flows, Total</u>	<u>13</u>	<u>11</u>	<u>13</u>
-- Multilateral Credits, Net	6	5	7
-- Net Use of IMF Credit	(2)	(0)	(0)
- Gross Drawings ^{6/}	(2)	(1)	(1)
- Repurchases ^{6/}	(0)	(0)	(1)
-- Net Flows from other Institutions	(4)	(5)	(7)
- Gross Credits	(5)	(6)	(7)
- Repayments	(1)	(1)	(1)
-- Bilateral Credits, Net of Repayments	7	6	6
<u>Private Flows, Total</u>	<u>23</u>	<u>13</u>	<u>22</u>
-- Increase in Net Indebtedness to Banks in other Countries ^{3/}	19	4	15
-- Increase in Gross Liabilities *	(40)	(23)	(38)
-- Increase in Gross Claims *	(21)	(19)	(23)
-- Bond Issues, Net	1	2	2
-- Gross Issues	(1)	(3)	(3)
-- Estimated Net Redemption	(0)	(1)	(1)
-- Net Direct and Non-Bank Portfolio Investments, and other flows ^{4/}	3	7	5

<u>RESIDUAL:</u>	7	1	6

* includes inter-bank depositing

TABLE 5-d
NET FINANCING BY DEFICIT COUNTRIES
\$ Billions

	1976	1977	1978
Other Countries			
<u>FINANCING REQUIREMENTS</u>	<u>13</u>	<u>9</u>	<u>10</u>
-- Aggregate Current Account Deficits ^{1/}	11	9	9
-- Increase in Foreign Exchange Reserves ^{2/}	2	0	1

<u>SOURCES OF FINANCING</u>	<u>13</u>	<u>6</u>	<u>12</u>
<u>Official Flows, Total</u>	<u>1</u>	<u>0</u>	<u>0</u>
-- Multilateral Credits, Net	1	0	0
-- Net Use of IMF Credit	(1)	(0)	(0)
- Gross Drawings ^{6/}	(0)	(0)	(0)
- Repurchases ^{6/}	(0)	(0)	(0)
-- Net Flows from other Institutions	(0)	(0)	(0)
- Gross Credits	(0)	(0)	(0)
- Repayments	(0)	(0)	(0)
-- Bilateral Credits, Net of Repayments	0	0	0
<u>Private Flows, Total</u>	<u>12</u>	<u>6</u>	<u>12</u>
-- Increase in Net Indebtedness to Banks in other Countries ^{3/}	12	4	11
-- Increase in Gross Liabilities *	(8)	(4)	(13)
-- Increase in Gross Claims *	(-4)	(-1)	(2)
-- Bond Issues, Net	0	1	1
-- Gross Issues	(1)	(1)	(1)
-- Estimated Net Redemption	(0)	(0)	(0)
-- Net Direct and Non-Bank Portfolio Investments, and other flows ^{4/}	0	1	0

<u>RESIDUAL:</u>	0	-3	2

* includes inter-bank depositing

1/ Balance of goods, services, and private and official transfers. Official transfers from OPEC countries are assumed to be entirely from surplus countries, and those to non-oil LDCs are assumed to be entirely to deficit countries. Non-oil LDCs may include some countries which, after receipt of official transfers, are in surplus on current account.

2/ As published in International Financial Statistics.

3/ Calculated from data reported to the Bank for International Settlements. Comprises increases in liabilities of residents of designated areas to reporting banks (i.e., increase in the banks' assets) less increases in their claims on those banks, excluding the estimated increase in that part of those claims representing foreign exchange reserves -- the latter are included in the "requirements" for funds. For 1978, data are available only through end-September and are extrapolated to obtain annual estimates.

4/ Very rough estimates based largely on direct investment transactions.

5/ Includes net borrowing by all Middle East oil exporters classified as "high absorbers", some of which are surplus countries (e.g., Iraq, Libya and, in 1976 and 1977, Iran).

6/ Not precisely comparable to IMF credit use/repayment. Drawings include Reserve tranche purchases, but repurchases exclude drawings of the respective member's currency by other countries.

7/ Includes the following balance of payments financing provided by the U.S. to several countries:

1976: Italy drew and repaid \$500 million under the swap facility with the Federal Reserve.

Mexico drew \$1,175 million under various Federal Reserve and ESF credit facilities of which \$300 million was outstanding at the end of the year.

United Kingdom drew and repaid \$600 million, split evenly between the ESF and Federal Reserve, under swap facilities.

1977: Mexico repaid \$300 million outstanding swap drawings to the ESF and Federal Reserve.

Portugal drew and repaid \$300 million under credit facilities provided by the ESF.

1978: Portugal received \$300 million in medium term balance of payments financing as part of a \$750 million multilateral credit arrangement.

NOTE: Components may not add to totals due to rounding.

TABLE 6

BALANCE OF PAYMENTS FINANCING BY UNITED STATES
\$ billions

	<u>1976</u>	<u>1977</u>	<u>1978</u>
<u>FINANCING REQUIREMENTS</u>	<u>46.8</u>	<u>49.6</u>	<u>73.2</u>
-- Current Account Deficit	- 4.3	15.3	16.0
-- Increase in U.S. Reserve Assets	2.5	0.2	- 0.9
-- Increase in Other U.S. Government Assets	4.2	3.7	4.7
-- Bank Lending to Non-residents	21.4	11.4	34.0
-- U.S. Direct Investment Abroad	11.6	12.2	15.4
-- Purchase of Foreign Securities	8.9	5.4	3.4
-- Other Capital Outflows	2.5	1.4	0.6

<u>SOURCES OF FINANCE</u>	<u>37.5</u>	<u>50.5</u>	<u>61.6</u>
-- Increase in Foreign Official Holdings of Assets in U.S.	18.1	37.1	34.0
-- Increase in Foreign Private Claims on U.S. Banks	11.0	6.7	16.9
-- Foreign Purchases of U.S. securities	4.1	3.4	5.1
-- Foreign Direct Investment in U.S.	4.3	3.3	5.6

<u>RESIDUAL</u>	- 9.3	0.9	- 11.4

Source: Survey of Current Business, March 1979

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Table 7

ACTIVITY IN MEDIUM AND LONG TERM INTERNATIONAL CREDIT MARKETS
\$ billions

	<u>1976</u>	<u>1977</u>	<u>1978</u>
New Medium and Long-term Eurocurrency Bank Credits	29	34	72
-- to Developed Countries	(8)	(11)	(30)
-- to Oil Exporting Countries	(0)	(2)	(1)
-- to Other Developing Countries ^{1/}	(20)	(21)	(40)
Less: Estimated Repayments and Refinancing	10	15	30
<u>Net New Medium and Long Term Eurocurrency Credits</u>	<u>19</u>	<u>19</u>	<u>42</u>
International Bond Issues	34	36	37
-- by Developed Countries	(23)	(23)	(23)
-- by Oil Exporting Countries	(0)	(0)	(0)
-- by Other Developing Countries ^{1/}	(11)	(13)	(14)
Less: Estimated Redemption	4	5	8
<u>Net International Bond Credit</u>	<u>30</u>	<u>31</u>	<u>29</u>

TOTAL LENDING ACTIVITY IN INTERNATIONAL MARKETS	63	70	108
Less: Estimated Repayment and Refinancing	14	20	38
NET NEW MEDIUM AND LONG TERM LENDING IN INTERNATIONAL MARKETS	49	50	70

^{1/} Includes Eastern Europe and International Institutions.

Source: World Bank and Morgan Guaranty Trust Company.

Treasury/OASIA
4-30-79

TABLE 8

Main Components of Eurocurrency and International Banking Market(Liabilities of U.S. and Euro-Banks) 1/

\$ billions

<u>Liabilities To Non-Residents</u>		Sept. 1978	INCREASE Jan.-Sept. 1978
1.	Dollar Liabilities of Banks in Europe, Canada & Japan PLUS	342	24
2.	Dollar Liabilities of U.S. Branches in Offshore Centers EQUALS	94	9
3.	GROSS SIZE OF EURODOLLAR MARKET, FIRST DEFINITION PLUS	436	33
4.	Other Foreign Currency Liabilities of U.S. and Euro-banks EQUALS	160	33
5.	GROSS SIZE OF EUROCURRENCY MARKET, FIRST DEFINITION PLUS	597	67
6.	Dollar Liabilities of Banks in U.S. PLUS	87	10
7.	Domestic Currency Liabilities of Euro-banks EQUALS	80	16
8.	GROSS SIZE OF INTERNATIONAL BANKING MARKET AS SHOWN BY BIS LESS	764	93
9.	BIS Estimate of Double Counting due to Interbank Deposits Among Banks in BIS Reporting Area	264	23
10.	NET SIZE OF INTERNATIONAL BANKING MARKET AS SHOWN BY BIS	500	70

Foreign Currency Liabilities To All Customers

11.	Liabilities to Residents	160	27
12.	Of which: in dollars	119	17
13.	GROSS SIZE OF EUROCURRENCY MARKET, SECOND DEFINITION (Lines 5 and 11)	757	94
14.	GROSS SIZE OF EURODOLLAR MARKET, SECOND DEFINITION (Lines 3 and 12)	555	50

ESTIMATED NET SIZE OF EURODOLLAR MARKET

300 to 350

1/ Consisting of banks in countries reporting to the Bank for International Settlements plus branches of U.S. banks located in the Bahamas, Cayman Islands, Hong Kong, Panama and Singapore.

Note: Partly Estimated

Treasury/OASIA
4-27-79

C. Developments in the Foreign Exchange Market

I. Overview

From July 1977 to March 1979 the dollar depreciated by 10.5 percent on a trade-weighted basis. The movement would have been considerably greater, but the sharp appreciation of the dollar following the November 1 program reversed the 19.0 percent depreciation that had occurred up to end-October. In the second half of 1977 the dollar depreciated by an average, trade-weighted 4.8 percent as the divergence in growth and current account balances among the major industrialized countries became increasingly evident. Exchange market tensions continued into the first quarter of 1978. A further dollar depreciation was accompanied by large net outflows and increased official intervention. During the second quarter dollar selling abated and some reflow into dollars was evident, but the third quarter experienced a revival of market tensions. The dollar decline accelerated to a trade-weighted depreciation of 3.5 percent in the third quarter, while in terms of individual currencies the movement was even more pronounced; 7.6 percent against the German mark, 21.1 percent against the Japanese yen, and 21.9 percent against the Swiss franc. By the end of October exchange rate movements had become exaggerated, exceeding most expectations regarding international economic trends; in October alone the dollar depreciated by a further trade-weighted 8.2 percent, declining by 12, 7, and 6 percent respectively against the mark, yen and Swiss franc. The announcement of the November 1 program sparked a sharp turnaround in exchange rates, but underlying selling pressure remained intense in the last months of the year. Capital outflows and official intervention in the markets became extremely large. Nevertheless, a modicum of balance had been restored by year-end. Market stability has been evident thus far in 1979, though the dollar has appreciated steadily as the large adverse positions taken in the fourth quarter are unwound in response to interest rate differentials and expectations regarding international economic trends.

II. Developments in the Dollar

July 1977 - September 1978. The tensions in the exchange market which emerged in the second half of 1977 were based initially on the divergent trends in external balances and varying rates of domestic economic growth among the major industrialized nations. The U.S. trade deficit grew from \$9 billion in 1976 to a record \$31 billion in 1977 and the current account deficit shifted from a surplus of \$4 billion to a \$15 billion deficit. In contrast, the Japanese current account surplus almost tripled, the German and Swiss current account surpluses also increased, and there was evidence that the domestic programs undertaken

in other European countries were beginning to have a positive effect on their external accounts. Meetings of the OECD over the summer of 1977 and at the Annual IMF/IBRD meeting later in September highlighted these trends. At the same time private forecasts of future trends offered little hope of any convergence in the near future. Although tentative steps had been taken in Germany and Japan to stimulate domestic economic growth, there was little conviction that these actions would be sufficient to reduce their large current account surpluses and the mark, yen, and also the Swiss franc appreciated sharply against the dollar. As market tensions heightened, official intervention by the U.S. and major foreign countries became increasingly necessary. On December 21, President Carter announced several measures to reduce U.S. imports of oil and to stimulate exports, and stressed that the U.S. authorities would intervene to the extent necessary to counter disorderly conditions.

Exchange market tensions, however, continued into 1978. Large current account imbalances persisted, exerting pressure on the dollar, both through actual commercial transactions and through the buildup of commercial leads and lags. Although these commercial trends were significantly reversed in the second quarter, as were capital flows, the current account surpluses in Japan and Germany continued to grow, and by July the dollar was once again depreciating rapidly as major private forecasters projected further considerable widening in the imbalances between the United States, Japan and Germany to the end of the year.

Price trends, and especially market expectations regarding future trends, were another factor which increasingly influenced market behavior in 1978, and had become a predominant concern by the third quarter. In the third quarter, U.S. consumer prices stood 8 percent above the same period in the previous year, while comparable rates in Japan, Germany and Switzerland stood at 4 percent, 2.4 percent, and 1.2 percent respectively. More importantly from the market's perspective was the rapid acceleration that was taking place. U.S. prices, on a three-month annual rate basis, had risen to 9.3 percent in March and had accelerated further to 11.4 percent by June. Although short-term interest differentials were moving broadly in line with price levels, the rate of change in the differentials was not believed sufficient to offset the perceived rate of decline on real returns on dollar investments; the discount on forward dollars was tending to widen further as selling pressure moved in response to the more pessimistic expectations. Eventually, short-term interest rate differentials became less important in day-to-day trading as dealers found that the daily depreciation of the dollar more than offset the cost of borrowing to establish short positions.

Official action became increasingly necessary as market tensions mounted. During the second half of 1977 the Federal Reserve made net drawings of \$800 million equivalent in German marks under its swap facility with the Deutsche Bundesbank to finance market intervention. Following the President's statement in December, the Treasury announced a new swap arrangement with the Deutsche Bundesbank on January 4, 1978 to be used with the existing swap network of the Federal Reserve. On March 13, additional steps were taken to augment intervention resources, by doubling the Federal Reserve swap line with the Bundesbank to \$4 billion and arranging for the sale of SDR 600 million to purchase DM. The U.S. also announced it was prepared to draw upon its reserve position in the Fund. As a further measure to supplement the export effort, the Treasury began its monthly series of public gold auctions.

Using its augmented resources, the U.S. authorities financed market sales of German marks amounting to \$1,973 million in the first quarter of 1978, in addition to sales of \$69 million of Swiss francs financed by Federal Reserve swap drawings. Most of this intervention was carried out in February and March. During the second quarter, operations consisted of net foreign currency purchases of \$1.4 billion. These currency acquisitions were used to make substantial reductions in swap indebtedness. By the end of July, total U.S. swap indebtedness to the Bundesbank had been reduced by \$1,996 million from end-March to \$848 million. Federal Reserve drawings under the Swiss swap line had been repaid in May, but later sales of Swiss francs had increased commitments to \$23 million. During August and September, net currency sales were increased, raising outstanding indebtedness to \$1,031 million with the Bundesbank and \$170 million with the Swiss National Bank. Large intervention purchases of dollars were also conducted by major foreign countries.

The U.S. authorities took a series of actions directed toward the domestic economy which had international implications as well. After a series of delays which had adversely affected market sentiment, the U.S. made significant legislative progress on a domestic energy policy. The Federal Reserve increased the discount rate in several stages throughout the year, from 6 percent at the end of 1977 to 8-1/2 percent by October. President Carter had announced new measures to counter inflation in April, taken steps to reduce fiscal expenditures, and directed that action be taken to augment the U.S. export effort, of which the initiation of the Treasury gold auction program in May was a part. In August the President directed that further measures be taken to deal with the foreign exchange market situation. The Federal Reserve increased the discount rate and the Treasury increased the amounts offered in the monthly gold auctions.

November 1 Program. Though these actions had a temporary steadying effect on the market, dollar selling was renewed in October and daily exchange rate movements increased in intensity. By late October, with President Carter's new initiatives in the anti-inflation effort, a full range of U.S. policies had been set in place. Fiscal policy was reinforcing monetary restraint. Stricter wage-price standards were set forth. In addition to the steps taken on inflation, an export promotion program had been initiated, and important progress had been made in the formulation of U.S. energy policy. The divergence in growth rates among major industrial countries was narrowing, and there was evidence of declines in major foreign current account surpluses as well as significant reductions in U.S. deficits. Exchange rate movements had become exaggerated. The persistent depreciation of the dollar was threatening to nullify U.S. anti-inflation efforts. More explicit action in the foreign exchange market was needed to supplement the policies which were in place and to demonstrate our commitment to the successful implementation of those policies.

On November 1 the discount rate was raised by a full 1 percent and reserve requirements were increased; Treasury's monthly gold auction was raised to at least 1.5 million ounces per month commencing in December; and the governments and central banks of Germany, Switzerland, and Japan joined with us in a policy of strong and forceful action to correct the excessive decline of the dollar. The Treasury and Federal Reserve announced mobilization of \$30 billion of DM, Swiss francs, and yen to finance the U.S. portion of intervention, to be closely coordinated with the use of resources by the authorities in Germany, Switzerland and Japan. The U.S. financing involved an approximate doubling of Federal Reserve swap lines with these central banks, to a total of \$15 billion; U.S. drawings on the IMF of \$3 billion; U.S. sales of about \$2 billion of Special Drawing Rights; and issuance by the Treasury of foreign currency denominated securities in amounts up to \$10 billion.

The announcement of the November 1 program had an immediate impact and the dollar appreciated sharply. The cooperating authorities intervened heavily in German marks, Swiss francs, and Japanese yen, coordinating their operations closely. The exchange market gradually came into better balance at dollar levels well above the late-October lows, and the authorities were able to scale back their intervention. Despite the improved outlook, however, a period of tension continued in the market to the end of the year, requiring further heavy coordinated intervention to blunt periodic selling pressure on the dollar without holding rates at any particular level. The political upheaval in Iran, coupled with a stoppage of that country's production and export of oil, and the mid-December announcement by OPEC of a greater than expected rise in oil prices, prompted

periods of dollar selling, moving rates back some 2 to 5-1/2 percent from their early-December highs. For the fourth quarter as a whole, the U.S. authorities were net sellers of \$6.9 billion of German marks, Swiss francs and Japanese yen. Most of this activity occurred in November and December. Net of repayments, Federal Reserve commitments under the swap lines with the German Bundesbank, the Swiss National Bank, and the Bank of Japan rose to a peak of \$5,457 million in early January 1979. United States Treasury drawings under its swap arrangement with the Bundesbank stood at \$889 million equivalent, and the Treasury had used \$1,820 million of the \$4.4 billion equivalent of currencies obtained through IMF and SDR transactions in November and through the issuance of \$1.6 billion equivalent of mark-denominated securities in the German capital market in December.

First quarter, 1979. Thus far in 1979 the exchange markets have been better balanced. The dollar appreciated about 2 percent on a trade-weighted basis in the first quarter. The November 1 initiative and subsequent policy measures have demonstrated that the U.S. is strongly committed to reducing inflation and improving its balance of payments position, even if slower domestic growth is necessary, and that it is concerned about the exchange rate of the dollar. With more orderly conditions in the market and confidence in U.S. policies, capital flows again responded to real economic factors. U.S. interest rates, higher than those in most other major countries, attracted funds into dollar assets.

The amount of net U.S. foreign currency sales since November 1 has been significantly reduced. Federal Reserve swap drawings from the Japanese and Swiss central banks have been fully repaid. The Treasury has repaid its swap drawings from the Bundesbank and the Federal Reserve is continuing to reduce its commitments. In addition, the Treasury and Federal Reserve repaid pre-August 1971 debts held by the Swiss National Bank ahead of schedule.

III. Developments in Major Foreign Currencies and Intervention Policies

While developments in the exchange market were focused on general movements of the dollar against major foreign currencies, events varied according to individual circumstance. For purposes of classification, the currencies and policy actions of the major countries, excluding Canada, can be grouped into three broad and somewhat overlapping categories: surplus countries, those emerging from stabilization policies implemented in 1976, and countries associated with the joint float arrangement in the European Monetary System.

Surplus countries. Germany, Japan and Switzerland constitute the first grouping. Declining rates of inflation, slow growth, and external surpluses exerted pressures for appreciation on the currencies of these countries in 1977 and 1978. On a trade-weighted basis, these three currencies appreciated some 6-12 percent in each year from 1976 through 1978, but in terms of the dollar alone the movement was much larger in 1977-78 than in earlier periods, on the order of 12-22 percent in each year.

The response of the German, Japanese and Swiss central banks was generally similar; without defending any particular level of exchange rates the central banks purchased dollars when their currencies were appreciating rapidly and sold dollars when market demand recovered. The intensity and timing of their operations varied according to local market characteristics and policy objectives regarding domestic liquidity growth generated by intervention operations. The combined reserves of these three countries, including the effects of U.S. swap drawings, rose by around \$13 billion in the 4th quarter of 1977, rose by a further \$9 billion in the first quarter of 1978, declined by \$3 billion in the second and rose again by around \$7 billion in the third quarter. In addition, during the period these countries took actions in domestic monetary policy and imposed certain restrictions on capital inflows which, had some effect in slowing the appreciation of their currencies.

In November all three central banks agreed to coordinate closely with the U.S. authorities in a cooperative program of forceful intervention to correct the excessive exchange rate movements which had developed. As a result of these operations, as well as the effects of operations by the U.S., official reserve assets of these countries increased by \$17 billion in the 4th quarter.

During the first quarter of 1979, the improved exchange market conditions enabled the surplus countries to reduce reserve assets by around \$9 billion, primarily through dollar sales as their currencies depreciated. Again, the extent of their operations varied, according to official desires to absorb some of the domestic liquidity expansion caused by earlier local currency sales, or, as in the case of Japan, to moderate exchange market reactions to new developments in oil pricing and supply.

Stabilization Policy Countries. A more varied pattern of exchange rate movements and reserves movements is seen in the second grouping of countries, as shown in the attached table which provides an indication of direction and size of the changes. In 1977, the economies of Britain, France, and Italy had already begun to respond to the effects of stabilization policies implemented in 1976. As evidence of the positive results of the monetary and income restraints became apparent,

these countries also experienced large inflows from the reversal of leads and lags. Moreover, many investors, becoming more confident that risk of currency depreciation in these countries had diminished, were attracted by the comparatively high investment yields offered on instruments denominated in these currencies. Central bank intervention among this group therefore tended to consist of large dollar purchases to rebuild reserves and repay outstanding indebtedness incurred in 1976. The effect of these large intervention purchases of dollars was to minimize appreciation of their currencies against the dollar so that as other major currencies appreciated against the dollar the currencies of the stabilization group registered only small rates of appreciation on an average trade-weighted basis or depreciated further, improving their terms of trade against the major surplus countries.

Between the middle of 1977 and the first quarter of 1979, sterling appreciated by 20.3% against the dollar in moving from around \$1.72 to \$2.07, but appreciated by a much lesser extent (about 7% over the same period) in terms of the Bank of England's effective index.

During the second half of 1977 and in early 1978, the pound appreciated as the market responded to the turnabout in economic prospects and the success of the Labour Government in moderating wage demands. In the spring of 1978, however, sterling moved downward as tax cuts led to fears that public sector borrowing and monetary targets would be exceeded. Demand renewed over the summer as investors responded to actions to tighten control over monetary aggregates, and to the additional prospect of exchange rate stability combined with high U.K. interest rates in the event U.K. should decide to participate in the EMS. During the fall sterling continued to appreciate against the dollar as selling of the U.S. currency became generalized.

During the first quarter of 1979, despite a deterioration in the inflationary outlook in the face of widescale labor unrest, relatively high interest rates and the presence of domestically available energy resources attracted further inflows. Electoral considerations and capital gains opportunities attracted further short-term inflows. The British were able to add significantly to reserves during 1978 and 1979, and recently announced their intention to prepay \$1 billion remaining on IMF standby drawings in addition to \$2.2 billion of repayments of other external debt already planned.

An additional effect of the British intervention approach, however, has been to increase the rate of growth in domestic monetary aggregates. Finding that this trend was complicating efforts to reduce money supply growth, during the summer of 1978 the British shifted the focus of their intervention policy to a weighted-basket measure of sterling's movements and withdrew from the market, allowing sterling to appreciate more rapidly in the final quarter of the year.

Beginning in mid-1977 the Italian lira appreciated steadily against the dollar, moving from Lit 884-3/4 to Lit 830-1/2, while remaining relatively stable on a trade-weighted basis. In 1978, the Italian current account showed a strong surplus of over \$5 billion, which permitted the government to relax trade financing restrictions, repay substantial official indebtedness, and augment reserves. The lira has continued to be bolstered by a sustained current account surplus so far in 1979. Additionally, given strict lira lending ceilings, increasing domestic credit demands have been satisfied through Euro-currency borrowings. As a result, shortly after the commencement of the EMS, the lira moved to the top of the band and traded well above the 2.25% margin, though within the wider 6.0% band for which Italy had opted.

Over the mid-1977 to end-first quarter of 1979 period, the French franc appreciated by 14.6% against the dollar, moving from around FF 4.92 to FF 4.29 while depreciating by around 2% on a trade-weighted basis. The franc depreciated in late 1977 and in early 1978 as traders trimmed positions on electoral uncertainties. After victory by the Parliamentary majority, increased efforts by authorities to minimize public financing and channel savings into investments, and registering of surpluses on current account, and the franc appreciated to FF 4.35 in early July. Proposal of the EMS in July initially stimulated demand for francs, but as the market focused on the divergent French and German economic trends and the impact of industrial price deregulation on inflation, the franc tended to depreciate. Since the end of the summer, however, despite brief selling pressure on consideration of entry rates in the EMS, the franc has tended to move in line with other Continental European currencies.

European Monetary System. The distinguishing characteristic of the group associated with the European joint float and European Monetary System is the formal requirement to intervene in order to maintain explicit exchange rate relationships among member currencies. During 1977 and 1978 divergent trends in prices and external balances continued to cause periodic strains in the system requiring heavy intervention and, eventually, formal exchange rate changes. The central rates of the Snake currencies were realigned in April 1977, and in August Sweden withdrew from the arrangement and a new realignment was required.

In 1978, participation was limited to Belgium, Denmark, German, the Netherlands and Norway. At the beginning of 1978, the EC snake was extended to its limits, with the Norwegian crown at the floor and the mark at the top of the band. In February, the Norwegians realigned, depreciating the crown by 8%. Thereafter the snake was not stretched until June. Proposal of the EMS, in addition to the existing pressures on snake limits, tended to diminish demand for member currencies as participants considered the attractiveness of other EC currencies given the

prospect for earning higher yields with reduced exchange risks. In August and September, participants felt that a realignment of the existing snake and an appreciation of the mark relative to prospective EMS members was a necessary prelude to successful EMS commencement. Thus, speculative demand for DM developed which in turn placed severe pressures on margins. In mid-October, despite substantial intervention and efforts by EC snake members to defend their currencies by tightening credit, the Danish and Norwegian crowns were devalued by 4%, and the Belgian franc and the Dutch guilder by 2% against the mark. Thereafter the mark eased toward the middle of the band.

Under the new EMS arrangements similar commitment to exchange rate parities pertains though the terms and measurement of shifts have some additional implications. The startup of the EMS occurred formally on March 13, 1979. ^{1/} The 2.25% margin has been reached occasionally, with the Belgian franc at the bottom and the Danish crown at the top, though requiring only modest intervention to maintain margins. On March 30 the link between the Irish pound and sterling was broken, attributable to the sharp appreciation of sterling beyond the Irish pound's required 2.25% intervention margin within the EMS.

Canada. Between mid-1977 and February 1979, the Canadian dollar encountered steady selling pressure as it moved from the \$0.9450 to \$0.8325 level, and depreciated by 17.2% on a trade-weighted basis. The depreciation of the Canadian dollar reflected the large current account deficit, equal to \$4.2 billion in 1978, and an inflation rate running around 9.0%. Moreover, political developments in Quebec and the tendency for Canadian interest rate increases to lag behind those in the U.S. added to selling pressure despite substantial foreign borrowings by the Canadian government. During the first quarter of 1979, and into the second, however, the Canadian dollar appreciated above \$0.87. The presumption that domestically available energy resources would dampen the effect of global petroleum developments and improve performance on payments accounts combined with relatively favorable interest rate differentials to attract large flows.

Canadian intervention policy has been similar to the policies of Germany and Switzerland. The predominant stance taken has been one of U.S. dollar sales rather than purchases over the last two years to maintain orderly trading as the currency depreciated. Much of these intervention sales has been financed through foreign borrowing, thereby limiting the effect on Canadian reserves assets.

^{1/} Participating countries are Belgium, Luxembourg, France, Germany, Ireland, Italy and the Netherlands.

IV. Currency Diversification

In the face of pressure on the dollar in the exchange markets during various periods last year, foreign official institutions and the private sector in 1978 reduced the proportion of their external assets which they hold in dollars. Data (available only for the first three quarters of the year) indicate that the share of dollars in the portfolios of official holders declined from 86.2% to 83.8% from December 1977 to September 1978. This drop was equivalent to about \$6.0 billion. The proportion of external assets held in foreign private portfolios also fell -- from 70.6% to 68.0% over the same period.

Despite the drop in the proportion of foreign assets held in dollars, both private, and official institutions abroad sharply increased the total amount of dollars in their portfolios. Thus neither group was engaged in "active" currency diversification; i.e., in reducing the stock of dollars they held in absolute terms. Nonetheless, it is apparent that private and official desire to hold dollars waned somewhat. Neither group increased dollar holdings more rapidly than its foreign currency holdings as would be necessary to maintain a constant dollar share. In this sense, both groups were engaged in "passive" diversification of their assets away from dollars. For many institutions, the increase in the value of their foreign currency assets resulting mainly from exchange rate changes represented an easy way to reduce their relative exposure in dollars in the face of the declining dollar exchange rate. For others the need to draw down assets represented an opportunity to reduce their dollar holdings.

Had foreign holders maintained a constant proportion of dollars in their portfolios, their demand for dollars would have been about \$25 billion greater than it was in the first nine months of last year. This increase would have more than offset the \$15.5 billion absorbed by the Germans, Swiss and Japanese authorities during the same period, largely as a result of exchange market operations. On the other hand, other governments and foreign private holders clearly did not avoid the dollar. They increased their dollar denominated assets by \$57 billion. It simply wasn't sufficient to offset an even greater increase in supply, the bulk of which emanated not from the U.S. current account deficit or from lending from the U.S., but from the expansion of dollar credit abroad.

Chart 1
 PERCENTAGE INCREASE (OR DECREASE) IN THE VALUE OF
 THE SDR IN TERMS OF THE DOLLAR (ABOVE OR BELOW
 JUST AS OF MARCH 1973)

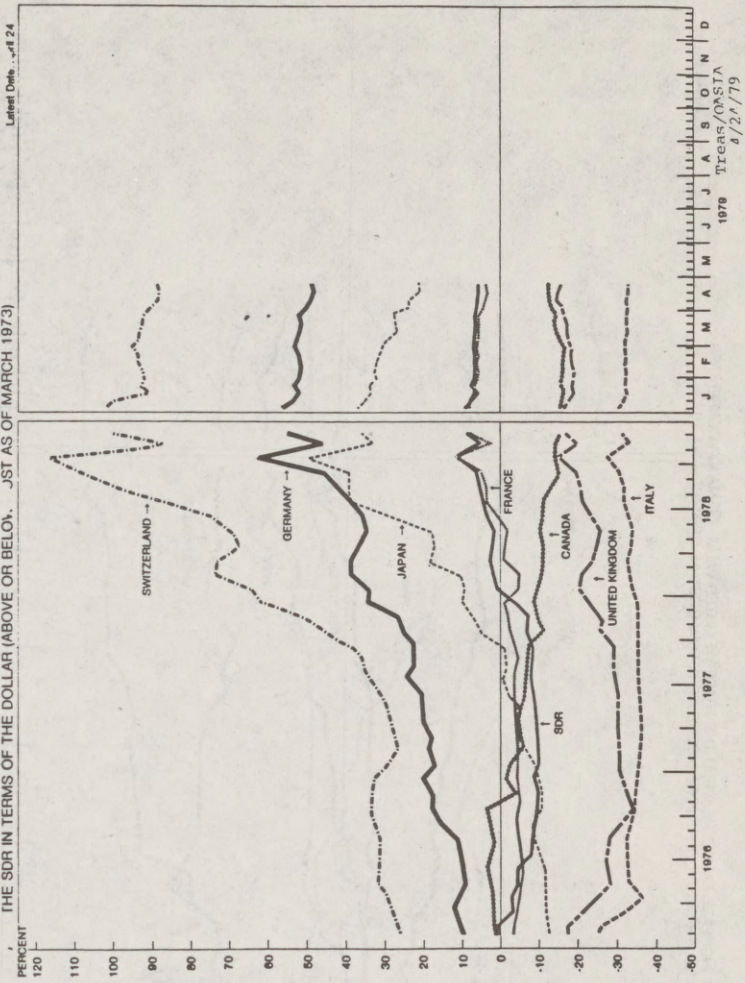


Chart 2

PERCENT INCREASE (OR DECREASE) IN THE TRADE-WEIGHTED VALUE OF MAJOR CURRENCIES
 VIS-A-VIS OTHER OECD CURRENCIES (ABOVE OR BELOW COST AS OF MARCH 20, 1973)

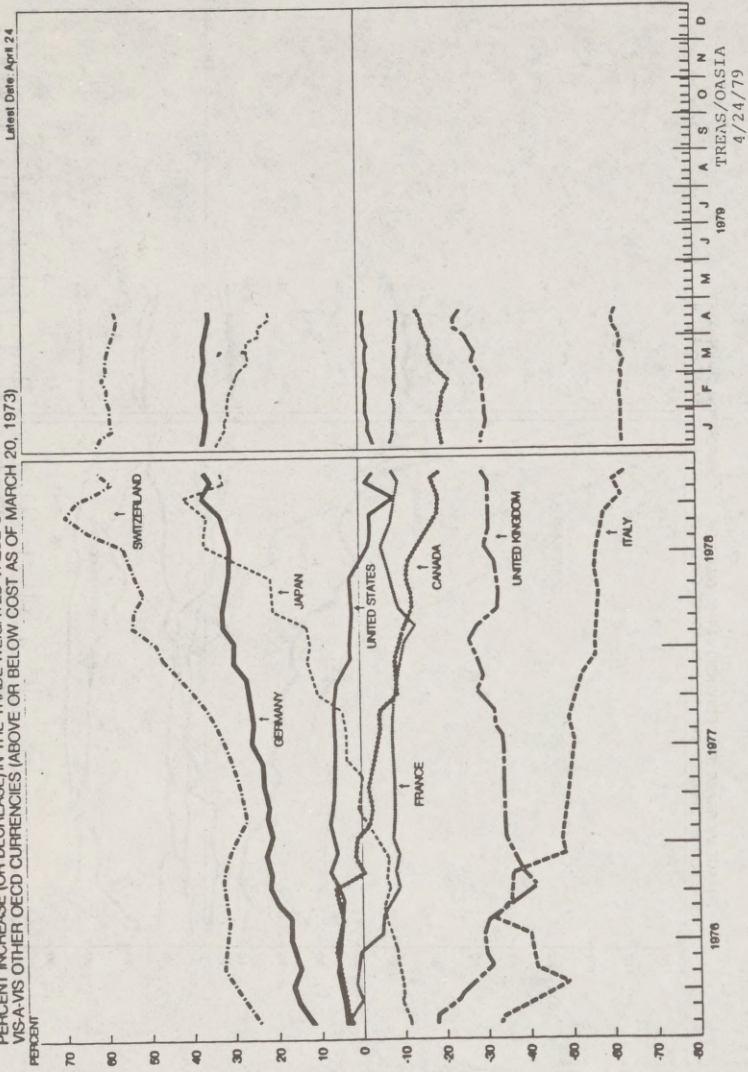


Table 9

Percent Change in Exchange Rates and Reserves ^{1/}, by Calendar Year

	<u>U.S.</u>	<u>Germany</u>	<u>Japan</u>	<u>Switzerland</u>	<u>U.K.</u>	<u>France</u>	<u>Italy</u>	<u>Canada</u>
<u>1975</u>								
vs. \$								
Trade-Weighted ^{2/}	+6	-8	-1	-3	-14	-1	-5	-3
Reserves		-3	+12	+2	-12	+7	+1	-1
		-5	-5	+16	-21	+42	-31	-9
<u>1976</u>								
vs. \$								
Trade-Weighted ^{2/}	+1	+11	+4	+7	-16	-10	-22	+1
Reserves		+12	+6	+7	-29	-10	-41	+2
		+12	+30	+25	-23	-24	+39	+10
<u>1977</u>								
vs. \$								
Trade-Weighted ^{2/}	-5	+12	+22	+22	+12	+6	+1	-8
Reserves		+6	+16	+12	+12	-1	-19	-10
		+14	+40	+6	+398	+6	+75	-21
<u>1978</u>								
vs. \$								
Trade-Weighted ^{2/}	-8	+16	+23	+24	+7	+12	+5	-6
Reserves		+5	+17	+10	-3	+2	-22	-12
		+36	+44	+56	-19	+37	+28	-1
<u>1979 QI</u>								
vs. \$								
Trade-Weighted ^{2/}	+2	-2	-7	-4	+2	-3	-1	+2
Reserves ^{3/}		-1/2	-6	-2	+7	-1	+4	+4
		-7**	-14	-27	+29	n.a.	n.a.	+19

^{1/} Percent change in total reserves as reported to the International Monetary Fund, converted into dollars from SDR equivalents.

^{2/} U.S. Treasury calculation using 1972 bilateral trade shares.

^{3/} Converted into dollars from published reports.

** Through March 23.

Table 10

Measurements of Dollar Movements
 % dollar depreciation (-) or dollar appreciation (+) during period
 March 30, 1979

Value of the Dollar in Terms of:	March 20, 1973 to Date	Within Calendar Years			Oct. 31, 1978 to Date	1979 to Date	March to Date	
	1974	1975	1976	1977	1978			
Swiss franc	-47.7	+3.5	-6.7	-18.0	-19.0	+13.8	+4.3	+1.5
German mark	-33.9	+8.8	-9.9	-10.7	-13.6	+7.6	+2.5	+0.9
Dutch guilder	-30.2	-11.3	+7.5	-8.5	-7.6	-13.2	+2.1	+0.7
Japanese yen	-20.5	+7.5	+1.4	-4.0	-18.2	-18.8	+7.9	+3.6
French franc	-4.9	-5.2	+0.9	+10.9	-5.4	-11.0	+2.8	+0.7
Canadian dollar	+16.3	-0.6	+2.6	-0.5	+8.3	+8.5	-2.3	-2.9
Sterling	+19.2	-1.1	+16.1	+18.8	-10.6	-6.4	-1.6	-2.2
Italian lira	+48.4	+6.9	+5.3	+28.1	-0.5	-4.6	+0.9	-0.2
U.S. dollar (trade-weighted vs. OECD)	-2.0	-1.6	+6.1	+0.7	-4.7	-8.1	+2.4	-0.1
Dollar in terms of SDR	-6.3	-1.5	+4.6	+0.8	-4.4	-6.8	+1.2	+0.2

Rate sources: London mid-day rates.

Table 11

International Supply of and Demand for Dollars
(\$ billions)

January - September 1978

I.	<u>Supply of Dollars</u>	<u>75.3</u>
	U.S. Current Account Deficit	15.3
	U.S. Bank Lending in Dollars	13.4
	Other U.S. Capital (net) and Errors and Omissions in U.S. B/P <u>1/</u>	- 3.3
	Dollar Lending of Banks in Other G-10 Countries and Offshore Centers	49.9
II.	<u>Demand for Dollars</u>	<u>71.8</u>
	Increase in Private Holdings in Banks in G-10 Countries and Caribbean	53.8
	Dollars Absorbed by German, Japanese, and Swiss Authorities	15.5
	Increase in Foreign Official Assets (excl. Germany, Japan, Switzerland)	2.5
III.	<u>Residual</u>	<u>3.5</u>

Memo: Currency Diversification:

Foreign Official Institutions	4.5
Private Holders	20.4

1/ Excludes increase in foreign official assets in U.S.
and private foreign holdings in U.S. banks.

D. Trade and Exchange Restrictions

The information available on changes in trade and exchange restrictions during 1978 is not complete. This report offers a general overview which will be supplemented by providing the Committee a copy of the IMF's "Annual Report on Exchange Restrictions" when it is issued, probably in June.

Protectionist pressures did not change significantly in the major trading nations during 1978. Continued slow recovery from the 1975 recession did permit some relaxation of broad-ranging restrictions adopted for balance-of-payments purposes. On the other hand, continued economic difficulties in such sectors as textiles and steel led to the initiation or maintenance of measures designed to protect those sectors, or to ease their paths of adjustment. But the major trade news of 1978 was the liberalization accomplished in the MTN.

* * * * *

There was a fairly heavy schedule of consultations in the GATT Balance-of-Payments Committee last year on restrictions maintained for balance-of-payments reasons. Most of these involved countries, such as Finland or Portugal, which had been experiencing difficulties for some time, or developing countries which maintain restrictive trade and payments systems as a normal element of their development strategies. A liberalizing trend was apparent in most of these cases, and two countries -- Argentina and Chile -- liberalized their trade and payments systems to the point where further consultations were not considered necessary.

Although the decision was not taken in the context of the GATT consultations, Brazil announced early in 1979 a decision to phase out by mid-1983 the 100% prior deposit required on a variety of imports.

The U.S. succeeded in negotiating an understanding in the Multilateral Trade Negotiations regarding use of trade restrictions for balance-of-payments reasons, thus fulfilling a mandate in the Trade Act of 1974. The understanding provides that developed countries will attempt to avoid such actions to the maximum extent possible, and that all signatories will give preference to the least trade-distorting kinds of measures (surcharges rather than quantitative restrictions) when they are unavoidable. The understanding also improves GATT procedures for dealing with such cases when they arise.

In the steel sector, the United States implemented its Trigger Price Mechanism early in 1978. The TPM was designed specifically to permit a rapid response to possible dumping in the U.S. market. Fairly priced imports are not inhibited. Thus far four investigations have been launched under the system. Two, involving carbon steel plates from Poland and Taiwan, resulted in positive determinations.

The European Community adopted, on January 1, 1978, a comprehensive plan to deal with a deteriorating situation in its iron and steel industry. The major objective of the plan is to restore the profitability and health of the industry and to restructure it through a process of rationalization involving the eventual closing of obsolete facilities. Key trade elements of the package include a system of basic import prices below which provisional antidumping duties may be levied, and a series of bilateral agreements embodying both quantity and price undertakings for iron and steel exports to the Community by its principal foreign suppliers.

A Steel Committee was established in the OECD in October 1978. Its purpose is to provide a multilateral forum in which countries consult on problems arising in the world steel industry. The United States views the Committee as a means of dealing with common problems which, were they left unattended, might eventually result in trade-restrictive actions.

With regard to textiles, the Multifiber Arrangement (MFA) was renewed for four years as of January 1, 1978. The protocol of renewal provided that "reasonable departures" from particular elements of the MFA could be "jointly agreed" in certain cases.

The United States in 1978 renewed existing bilateral restraint agreements under the MFA with 15 supplying countries accounting for 80 percent of our imports of cotton, wool or man-made fiber textiles and apparel. The U.S. also maintains consultation arrangements with 11 countries which provide no specific quantitative restrictions. These agreements generally provide for overall growth rates of 6 percent.

The European Community has concluded 23 bilateral agreements with textile exporting countries, regulating all but about 0.2 percent of the EC's textile and clothing imports from low-cost producers. The system distinguishes six main groups of sensitive products. For each product, exporting countries are allotted annual quotas which are subdivided among the nine EC member states. Early in 1978 the EC, justifying its action under the "reasonable departures" clause of the MFA, tightened the quotas established under these bilateral agreements.

Canada utilizes global import quotas, bilateral export restraint agreements, and import surveillance to regulate its textile trade. In June 1978 Canada announced that bilateral arrangements limiting the volume of exports to Canada by seven major suppliers would come into effect on January 1, 1979. Permissible growth rates will be about 2 percent in 1979. Other countries restricting textile imports to varying degrees in 1978 were Australia, Norway, Austria, and Finland.

Despite these restrictive policies, world textile trade continued to grow in 1978. Figures for other countries are not yet available, but overall U.S. textile imports -- including both those under quota and those which are not -- grew by about 15 percent.

The General Agreement on Tariffs and Trade requires import restrictions to be imposed in a fashion which does not discriminate among suppliers. Where restrictions depart from this norm they generally have been negotiated with the exporting countries, as is the case with U.S. Orderly Marketing Agreements on televisions and shoes. However, in 1978 the United Kingdom attempted unilaterally to impose severe, selective import restrictions on televisions from Korea. The case was appealed in the GATT, however, and an accommodation apparently was reached.

This case did underline the need to reach agreement on a new Safeguards Code as part of the MTN package. One of the objectives of a code would be to establish rules governing the use of selective safeguard actions, particularly unilateral ones. Efforts to reach agreement on such a code will continue after UNCTAD V in May.

On the liberalizing side of the ledger, the OECD Foreign Ministers at their annual meeting in June extended the Trade Pledge for the fourth time. Initiated after the 1974 oil crisis, the Pledge represents an undertaking by all parties to avoid imposing trade restrictions as a means of resolving balance of payments difficulties. The Pledge was important symbolically, as a sign of continued commitment to open trade policies, and practically, as a recognition that trade restrictions represent a self-defeating response to balance of payments deficits.

The trading nations of the world also made major progress in 1978 on the most important trade-liberalizing action since the postwar era -- the Multilateral Trade Negotiations. Carrying out the mandate given us by Congress in 1974, the United States threw its full weight behind the MTN, and that effort has now paid off:

- Industrial nations will make tariff cuts averaging more than 30 percent on over \$140 billion in trade in coming years.
- In civil aircraft alone, duties will be eliminated altogether on several billion dollars worth of world trade.
- Agricultural trade liberalization will benefit some \$4 billion in U.S. exports, to say nothing of benefits for other countries.
- We have a code setting substantial new rules on the use of subsidies, in the context of which the United States will adopt an injury test in our countervailing duty law.
- The new government procurement code will open up to foreign bidding some \$12 billion in U.S. federal purchasing, and some \$20 billion in foreign government purchasing, which had not previously been covered by the GATT at all.
- We have a new code governing valuation of imports for purposes of duty assessment; as Committee members well know, valuation can have as restrictive an effect on trade as the duties themselves.
- Other codes on standards, licensing, and Commercial Counterfeiting will address issues which have more or less openly restricted or distorted trade to an increasing degree.
- Finally, improvements in the GATT Framework will provide a better system for resolving disputes and a better international response to the particular trade problems of developing countries.

Despite restrictive actions in a few sectors, the world trading system clearly will register an enormous net gain on the side of fairer and more open trade as a result of negotiations in 1978.

E. Role of the IMF

The International Monetary Fund (IMF) is the central monetary institution for the world economy. The Fund's Articles of Agreement constitute the formal rules for the international monetary system, and the IMF provides a forum for cooperation and consultation on major international economic and financial issues. The IMF is also an important financial institution with substantial resources that are available to help assist member countries in dealing with temporary balance of payments difficulties in a manner compatible with the agreed rules and consistent with an open growing world economy.

During the period under review significant steps have been taken to enhance the IMF's ability to promote a smoothly functioning international monetary system. A general revision of the IMF Articles entered into force on April 1, 1978 providing a new legal framework for exchange rate arrangements, concrete action to formally remove gold from a central role in the system and steps to expand the IMF's authority to oversee the operation of the system. Moreover, the Fund's ability to provide balance of payments financing was expanded through increases in IMF quotas and the establishment of a Supplementary Financing Facility. Finally, actions have been taken to provide for the long-run development of the SDR as the principal reserve asset.

IMF Exchange Rate Surveillance

The amended IMF Articles of Agreement retain the basic purposes of the Bretton Woods system but modify significantly the techniques for achieving those objectives. In sharp contrast to the Bretton Woods system -- which sought stability by requiring adherence to fixed exchange rates -- the new provisions focus on achieving the underlying stability that is the prerequisite to currency stability. The amended Articles, therefore, give countries wide latitude in the choice of exchange rate arrangements, provided the member fulfills specific obligations to promote orderly underlying economic and financial conditions and avoid manipulation of exchange rates or the system to prevent effective balance of payments adjustment or to gain an unfair competitive advantage.

To ensure members' compliance with these obligations the IMF has been given enhanced authority to oversee the operation of the monetary system and was directed to exercise firm surveillance over members' exchange rate policies and practices. For this purpose, the Fund has adopted specific principles for the guidance of members with respect to exchange rates. The guidelines set forth general rules and procedures

for surveillance, including those developments which the IMF will examine in considering whether a member is fulfilling its obligations.

With implementation of the amended Articles, the Fund has initiated its surveillance activities. Strong and effective IMF surveillance can play an important role in the Fund's efforts to promote a stable international monetary system by encouraging both surplus and deficit countries to implement the economic policies required for a balanced international adjustment process. The United States has welcomed IMF examination of its policies, and cooperated fully with special consultations initiated by the IMF in conjunction with the November 1 measures to strengthen the dollar. Other members have also pledged to work closely with the IMF to ensure active and effective Fund surveillance.

IMF Financing Facilities

During the recent years of serious payments imbalances, the IMF has played an important role in the provision of balance of payments financing and the promotion of adjustment in member countries experiencing balance of payments difficulties. Major steps have been taken during the past eighteen months to strengthen the ability of the IMF to promote adjustment through the provision of balance of payments financing. These measures, which should contribute to a more effectively functioning international monetary system during the years ahead, include the entry into force of the Supplementary Financing Facility, the implementation of the increase in IMF quotas under the Sixth General Review, agreement on a further increase in IMF quotas and on new allocations of SDRs, and a revision of the IMF guidelines on conditionality.

1/ All conversions in this section are based on the \$/SDR exchange rate as of end-March 1979 of \$1.28682 per SDR.

Supplementary Financing Facility: This special temporary facility was described in detail in a Special Report transmitted to Congress in September, 1977. In addition, Under Secretary Solomon testified concerning the Facility before the Senate Committee on Banking, Housing and Urban Affairs on August 29, 1977. The Facility, which entered into force on February 23, 1979, is designed to reinforce the IMF's ability to meet world balance of payments financing needs and to promote economic stabilization by member countries experiencing particularly serious payments difficulties. Financing for the facility is being shared by the industrial and oil exporting countries and totals SDR 7,784 million (approximately \$10 billion). The U.S. has agreed to provide up to SDR 1,450 million ^{2/} under the Facility. Legislation authorizing U.S. participation in the Facility was passed by Congress and signed into law on October 10, 1978. (P.L.95-435). Appropriations were provided in P.L.95-481, signed October 18, 1978.

IMF Quotas: As part of the overall agreements on monetary reform reached at Jamaica in January 1976, it was agreed to increase IMF quotas -- the permanent base of IMF resources -- by approximately one-third under the Sixth General Review of Quotas. The details concerning and rationale for the quota increase were set forth in a Special Report to Congress dated April 9, 1976. This increase in quotas became effective on April 1, 1978, raising total Fund quotas from SDR 29.2 billion to SDR 39 billion (approximately \$50 billion). The U.S. quota was increased by SDR 1,705 million to SDR 8,405 million (approximately \$10.8 billion). Authorization for U.S. consent to this quota increase was contained in Public Law 94-564, signed on October 20, 1976.

A further review of IMF quotas -- the Seventh General Review -- was initiated in early 1977 and completed in December 1978. Under this review, agreement was reached on a further increase in IMF quotas of 50 percent, from SDR 39 billion to SDR 58.5 billion (approximately \$75 billion). This increase is designed to ensure that the permanent resources of the IMF are adequate to meet the needs of its members for official balance of payments financing over the medium-term.

The agreement was based on a number of factors, including the expectation that world trade will continue to expand significantly during the years ahead, and that IMF member countries will continue to experience relatively large payments imbalances and financing needs. The quota increase will help enable the Fund to continue to fulfill its responsibilities

^{2/} Subject to the dollar limitation placed by P.L.95-435 and P.L.95-481 on the amount of U.S. participation (\$1,831,640,000).

for promoting balance of payments adjustment through the provision of balance of payments financing to member countries in support of appropriate adjustment programs, thereby contributing to an open and growing world economy.

The proposed increase in the U.S. quota is SDR 4,202.5 million (approximately \$5408 million), from SDR 8,405 million to SDR 12,607.5 million. The Administration will be submitting legislation enabling the U.S. to accept its quota increase.

SDR Allocations: In a further step to help ensure the adequacy of official balance of payments financing during the years ahead, the IMF decided to resume allocations of Special Drawings Rights (SDR) by allocating approximately SDR 4 billion (approximately \$.1 billion) per year between 1979-81. The SDR is at present only a small fraction of total international reserves, with previous allocations during 1970-72 totalling only SDR 9.3 billion. With continued expansion of the international economy there will be a need for growth in official reserves. An SDR allocation will meet a part of this need for reserves, will help maintain the viability of the SDR as an important reserve asset, and will contribute to the long-term evolution of the SDR as the principal reserve asset of the international monetary system.

General Arrangements to Borrow: The General Arrangements to Borrow were activated in November 1978 to finance part of the reserve tranche drawing by the United States. The total drawings financed by the GAB equalled SDR 777 million. A number of technical changes in the GAB, which were necessary in order to conform with the second amendment of the IMF's Articles of Agreement, became effective on August, 11, 1978. In addition, the Group of Ten conducted an examination of the adequacy of the role of the GAB. This study concluded, *inter alia*, "that the GAB as an additional means of official financing will remain valuable in the future and should be maintained" and that "no further changes of the Arrangements are considered necessary by the Deputies at the present time." The Fourth Review of the arrangements is now underway, with a decision concerning renewal to be adopted by October 24, 1979.

IMF Conditionality: During the past year the IMF has conducted a review of the policies on conditionality pertaining to the use of its resources in the credit tranches. IMF conditionality consists, in the broadest sense, of the requirement that a member using Fund resources implement a program of balance of payments adjustment to correct its payments problems. It is essential to the IMF's performance of its vital role of promoting a stable and smoothly operating international monetary system. The basis for conditionality is the need

for the Fund to ensure that its resources are used in accordance with the purposes of the IMF and that the borrowing member is in a position to repurchase its drawing according to the prescribed terms and conditions.

The Fund's review of conditionality was completed in March 1979 with the adoption of a revised set of policy guidelines for the application of IMF conditionality. These revised guidelines reflect the changes which have taken place in the world economy and international monetary system during the 1970's. They are responsive to many of the concerns expressed by the IMF members while preserving the Fund's essential purposes. The main revisions in the guidelines are to:

- encourage countries to come to the Fund at an earlier stage in their difficulties;
- stress uniform application of conditionality to all members;
- provide for stand-bys extending beyond one year in appropriate cases;
- minimize IMF involvement in microeconomic choices and focus IMF conditions on broad macroeconomic aggregates;
- make clear that in helping a member devise an economic program the Fund will pay due regard to the member's economic circumstances and domestic, political and social objectives;
- establish a systematic procedure for reviewing reviewing the effectiveness of IMF programs.

A complete text of the revised guidelines is attached.

Role of the SDR

The Special Drawing Right (SDR) was created by the IMF in 1969 as a supplement to existing reserve assets and as a means of meeting future liquidity needs of the international monetary system independent of gold and reserve currencies. Initially the development of the SDR proceeded cautiously in order to encourage acceptance of the new asset. Thus, under original SDR provisions, participants could engage in SDR transactions only to meet a balance of payments need. In these cases, the IMF would designate a member in a strong balance of payments position to receive SDRs in exchange for currencies. In addition, to assure two-way adjustment, all members had an

obligation to reconstitute their holdings of SDRs so that net use would not exceed 70 percent of average net cumulative allocations over a given 5 year period.

The amended IMF Articles establish the objective of making the SDR the principal reserve asset in the system and make numerous changes in the SDR provisions in order to facilitate achievement of the goal by improving its quality. Thus under the amended Articles participants have freedom to enter into SDR transactions between one another on a voluntary basis without IMF authorization and without citing a balance of payments financing need. In addition, the possible uses of the SDR were expanded and the provisions for altering the operating rules made more flexible.

Pursuant to the authority provided by the amended Articles and with a view toward further promoting the role of the SDR, the IMF has taken a number of decisions early in 1979 to permit wider use of the SDR and increase its financial attractions. These actions include the following steps.

a) Wider use: The IMF has prescribed several categories of SDR operations which can be undertaken by participants without obtaining further IMF approval. These include the use of SDRs to settle financial obligations, to make or repay loans, and to provide security for the performance of financial obligations. The IMF Executive Board is considering authorizing other operations in SDRs such as swaps and forward operations as well as permitting the use of SDRs in donations and increasing the number of official institutions permitted to hold SDRs.

b) Reconstitution: The Fund has eased the reconstitution obligation by raising the permitted average net use from 70 to 85 percent of allocation. In effect this means that a participant will be able to use its SDR allocations more freely without incurring an obligation to spend other reserve assets to reacquire SDRs.

c) Interest rate: An SDR participant pays interest on its SDR allocations and receives interest on its SDR holdings. In effect, a participant with SDR holdings exceeding allocations receives net interest income and a country which uses its SDRs pays interest. To improve the financial incentives to acquire and hold SDRs, the interest rate has been raised to 80 percent (from 60 percent) of the weighted average of short term interest rates in the five members with the largest quotas (i.e., U.S., U.K., Germany, France, and Japan).

Discussions are proceeding in the IMF on further steps to enhance the role of the SDR. At its March 7, 1979 meeting, the Interim Committee requested the IMF Executive Board to

give active consideration to the establishment of an account, administered by the IMF that would accept deposits of foreign exchange from members on a voluntary basis in exchange for an equivalent amount of SDR-denominated claims. The Executive Board is to present its conclusions to the next meeting of the Interim Committee on October 1, 1979. The U.S. has indicated that it is prepared to consider such an account with an open mind and it is participating in the IMF discussions in a constructive manner.

INTERNATIONAL MONETARY FUND

Use of Fund's General Resources and Stand-By Arrangements

March 2, 1979

1. Members should be encouraged to adopt corrective measures, which could be supported by use of the Fund's general resources in accordance with the Fund's policies, at an early stage of their balance of payments difficulties or as a precaution against the emergence of such difficulties. The Article IV consultations are among the occasions on which the Fund would be able to discuss with members adjustment programs, including corrective measures, that would enable the Fund to approve a stand-by arrangement.

2. The normal period for a stand-by arrangement will be one year. If, however, a longer period is requested by a member and considered necessary by the Fund to enable the member to implement its adjustment program successfully, the stand-by arrangement may extend beyond the period of one year. This period in appropriate cases may extend up to but not beyond three years.

3. Stand-by arrangements are not international agreements and therefore language having a contractual connotation will be avoided in stand-by arrangements and letters of intent.

4. In helping members to devise adjustment programs, the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems.

5. Appropriate consultation clauses will be incorporated in all stand-by arrangements. Such clauses will include provision for consultation from time to time during the whole period in which the member has outstanding purchases in the upper credit tranches. This provision will apply whether the outstanding purchases were made under a stand-by arrangement or in other transactions in the upper credit tranches.

6. Phasing and performance clauses will be omitted in stand-by arrangements that do not go beyond the first credit tranche. They will be included in all other stand-by arrangements but these clauses will be applicable only to purchases beyond the first credit tranche.

7. The Managing Director will recommend that the Executive Board approve a member's request for the use of the Fund's general resources in the credit tranches when it is his judgment that the program is consistent with the Fund's provisions and policies and that it will be carried out. A member may be expected to adopt some corrective measures before a stand-by arrangement is approved by the Fund, but only if necessary to enable the member to adopt and carry out a program consistent

with the Fund's provisions and policies. In these cases the Managing Director will keep Executive Directors informed in an appropriate manner of the progress of discussions with the member.

8. The Managing Director will ensure adequate coordination in the application of policies relating to the use of the Fund's general resources with a view to maintaining the nondiscriminatory treatment of members.

9. The number and content of performance criteria may vary because of the diversity of problems and institutional arrangements of members. Performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives. Performance criteria will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them. Performance criteria may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macroeconomic impact.

10. In programs extending beyond one year, or in circumstances where a member is unable to establish in advance one or more performance criteria for all or part of the program period, provision will be made for a review in order to reach the necessary understandings with the member for the remaining period. In addition, in those exceptional cases in which an essential feature of a program cannot be formulated as a performance criterion at the beginning of a program year because of substantial uncertainties concerning major economic trends, provision will be made for a review by the Fund to evaluate the current macroeconomic policies of the member, and to reach new understandings if necessary. In these exceptional cases the Managing Director will inform Executive Directors in an appropriate manner of the subject matter of a review.

11. The staff will prepare an analysis and assessment of the performance under programs supported by use of the Fund's general resources in the credit tranches in connection with Article IV consultations and as appropriate in connection with further requests for use of the Fund's resources.

12. The staff will from time to time prepare, for review by the Executive Board, studies of programs supported by stand-by arrangements in order to evaluate and compare the appropriateness of the programs, the effectiveness of the policy instruments, the observance of the programs, and the results achieved. Such reviews will enable the Executive Board to determine when it may be appropriate to have the next comprehensive review of conditionality.

INTERNATIONAL MONETARY FUND

Surveillance over Exchange Rate PoliciesExecutive Board Decision - April 29, 1977

1. The Executive Board has discussed the implementation of Article IV of the proposed second amendment of the Articles of Agreement and has approved the attached document entitled Surveillance over Exchange Rate Policies. The Fund shall act in accordance with this document when the second amendment becomes effective. In the period before that date the Fund shall continue to conduct consultations in accordance with present procedures and decisions.

2. The Fund shall review the document entitled Surveillance over Exchange Rate Policies at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

Surveillance over Exchange Rate PoliciesGeneral Principles

Article IV, Section 3(a) provides that "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." Article IV, Section 3(b) provides that in order to fulfill its functions under 3(a), "the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." Article IV, Section 3(b) also provides that "The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." In addition, Article IV, Section 3(b) requires that "Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies."

The principles and procedures set out below, which apply to all members whatever their exchange arrangements and whatever their balance of payments position, are adopted by the Fund in order to perform its functions under Section 3(b). They are not necessarily comprehensive and are subject to reconsideration in the light of experience. They do not deal directly with the Fund's responsibilities referred to in Section 3(a), although it is recognized that there is a close relationship between domestic and international economic policies. This relationship is emphasized in Article IV which includes the following provision: "Recognizing ... that a principal objective (of the international monetary system) is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates."

Principles for the Guidance of Members' Exchange Rate Policies

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions which may be characterized *inter alia* by disruptive short-term movements in the exchange value of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

Principles of Fund Surveillance over Exchange Rate Policies

1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.

2. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among those which might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;

(ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and

(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements.

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.

Procedures for Surveillance

I. Each member shall notify the Fund in appropriate detail within thirty days after the Second Amendment becomes effective of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member shall also notify the Fund promptly of any changes in its exchange arrangements.

II. Members shall consult with the Fund regularly under Article IV. The consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV. In principle such consultations shall take place annually, and shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.

III. Broad developments in exchange rates will be reviewed periodically by the Executive Board, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct special consultations in preparing for these discussions.

IV. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and exchange policies, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its exchange rate policies.

V. If, in the interval between Article IV consultations, the Managing Director, taking into account any views that may have been expressed by other members, considers that a member's exchange rate policies may not be in accord with the exchange rate principles, he shall raise the matter informally and confidentially with the member, and shall conclude promptly whether there is a question of the observance of the principles. If he

concludes that there is such a question, he shall initiate and conduct on a confidential basis a discussion with the member under Article IV, Section 3(b). As soon as possible after the completion of such a discussion, and in any event not later than four months after its initiation, the Managing Director shall report to the Executive Board on the results of the discussion. If, however, the Managing Director is satisfied that the principles are being observed, he shall informally advise all Executive Directors, and the staff shall report on the discussion in the context of the next Article IV consultation; but the Managing Director shall not place the matter on the agenda of the Executive Board unless the member requests that this procedure be followed.

VI. The Executive Directors shall review annually the general implementation of the Fund's surveillance over members' exchange rate policies.

F. Evolution of the Role of Gold

The monetary role of gold has been declining for an extended period. This trend reflects broad recognition that gold, or any other commodity, is inherently ill-suited as a basis for a stable national or international monetary system. Natural forces limit new gold production at the same time that the expanding private uses appropriate a growing share of available supplies. Hence the residual supplies for monetary purposes are inadequate for, and unrelated to, the liquidity needs of an expanding national or world economy. Furthermore, the extreme price volatility of gold makes it a highly unstable standard. During the period under review, several developments have taken place which both reflect and foster the gradual demonetization of gold.

a) IMF action

The amended IMF Articles which entered into force on April 1, 1978, formally removed gold from a central role in the international monetary system. The official price of gold was abolished and the role of gold as the numeraire for the system was eliminated. The scope for transactions in gold between the IMF and members was also virtually eliminated. In view of the new IMF provisions, the major gold holding countries agreed that the transitional measures adopted in 1976 -- including a ceiling on the gold stocks held by the participants and the IMF and a prohibition against managing the private gold price -- were no longer necessary and were allowed to lapse in February 1978.

The IMF is continuing its program of disposing of one-third of Fund gold holdings by selling twenty-five million ounces of gold at public auction for the benefit of developing countries and distributing a further 25 million ounces to members in proportion to quota at the old official price (SDR \$35 per ounce). The IMF is in the third year of this four-year program and so far has sold 18.7 million ounces at public auction at a profit of \$2.4 billion, and distributed 18.3 million ounces to members.

b) U.S. gold sales

The United States presently has large gold stocks at a time of declining monetary uses of gold. Consequently, the U.S. initiated a program of sales of gold to the private market to help meet several important U.S. objectives:

- to reduce the U.S. trade deficit, which has been a major factor in the decline of the dollar;
- to respond directly to conditions in the gold market, which have contributed to the adverse psychological atmosphere in the foreign exchange market which has undermined international monetary stability; and
- to promote the internationally agreed effort to reduce gradually the monetary role of gold.

The U.S. gold sales program was initiated in 1975 and placed on a regular monthly basis in May 1978. The amount sold monthly has been changed on several occasions as conditions warranted. The amount offered was increased from 300,000 ounces at each of the first six auctions in 1978, to 750,000 ounces in November, and then to 1.5 million ounces in the December 1978-April 1979 auctions. It was reduced to 750,000 ounces a month beginning with the May 1979 sale because of improved conditions in the foreign exchange markets and the fact that gold no longer appeared to be a destabilizing factor in these markets.

The type of gold being sold reflects the general composition of U.S. stocks. Three hundred and four hundred ounce bars have been offered because they are the standard size in Treasury stocks. Only gold bars of high fineness containing at least 99.5 percent gold were sold in the monthly auctions in 1978. Sales of gold bars containing 90 percent fine gold were initiated in the January 1979 auction because 70 percent of the U.S. gold stock is in that form.

Since the minimum sale at the U.S. auction is a 300-ounce bar, only a handful of individuals have submitted bids. Although the opportunity to purchase gold in small quantities is readily available in the private market, Congress decided in 1978 that the small investor should be given the opportunity to buy gold from the United States gold stock. Consequently, legislation was enacted providing for the issuance over a five-year period of two types of American Arts Gold Medallions, containing one-half ounce and one ounce each of gold. At least one million ounces of gold in medallion form are required to be offered each year. Appropriations will be sought for the production and distribution of the medallions and, assuming the required funds are provided by Congress, the sales could take place in calendar 1980 as required by the legislation.

c) European monetary arrangements

Although the monetary role of gold is declining, gold remains an important reserve asset for some countries. The members of the European Monetary system (EMS) have decided to use a portion of their gold and other reserve assets as a basis for receiving the new European Currency Unit (ECU) that is being created. Each member has agreed to deposit 20 percent of its reserves, in exchange for European Currency Units (ECUs). For this purpose, the gold being deposited is valued at market-related prices.

The effect of this decision on the future role of gold is unclear and will depend on how the EMS operates. The European Community has stated that it is not their intention to revive the monetary role of gold and the provisions of EMS need not have that effect. Thus, there is no official price of gold being established and there is no requirement for official settlements in gold. The ECU will be used in financial operations but it will not be convertible into gold at a fixed price. In fact, participants will retain title to the deposited gold and must reacquire their gold periodically during an initial transitional phase. While it is envisaged that some gold might be transferred to EMS in a more permanent fashion at some future date, specific arrangements have not been agreed.

The EC arrangements reflect the fact that gold holdings are in fact not readily usable for official purposes. The arrangements may re-liquify them to at least a modest extent. The United States is confident that the EC will continue to consult closely with the IMF as EMS evolves to assure the consistency with the agreed international objectives concerning liquidity and gold.

G. Formation of the EMS

Another important step in the evolution of the international monetary system during the past year was establishment of the European Monetary System (EMS). All EC countries are members of EMS, although the United Kingdom does not participate in the exchange rate mechanism.

At the center of EMS is the new European Currency Unit (ECU), defined in terms of fixed amounts of the currencies of all nine EC countries. The ECU serves as the unit of account in the system's exchange rate and credit mechanisms, as the basis for the new divergence indicator, and as a means of settlement between EC monetary authorities.

Each EMS currency has an ECU-related central rate, based on which a grid of bilateral exchange rates has been established. As in the European currency "snake", currencies fluctuate within a band around their bilateral rates. For most currencies, the allowed fluctuation margin is $\pm 2.25\%$. Italy has opted for 6% margins. Exchange market interventions are, in principle, to be made using the participating currencies, rather than third currencies such as the dollar as was the case under the "snake". At bilateral margins, intervention is compulsory and must be done in participating currencies only.

To determine when EMS currencies have moved out of line with the new ECU, a divergence indicator has been established, with a divergence "threshold" being fixed at 75% of the maximum divergence allowed each currency. Crossing the divergence threshold results in a "presumption" that the authorities concerned will take adequate monetary or other economic policy actions to correct the situation. EC authorities hope use of the threshold warning and presumption to act will help avoid buildup of speculative pressures.

Credit mechanisms have been greatly expanded in EMS. For very short-term needs, swaps continue to be relied upon, but the repayment period for these swaps between central banks has been lengthened from 30 to 45 days and two 30-day extensions are now allowed. Countries needing credit for longer periods may borrow either short or medium-term, with the maximum effective credit now available in the two forms increased to 25 billion ECU (1 ECU equals about \$1.35).

The United States has welcomed this latest effort to achieve greater financial and economic cooperation in Europe. We support the objectives of EMS and appreciate European assurances that it will be implemented in a manner consistent with the stability of the international monetary system centered on the IMF.

Senator TSONGAS. Mr. Burtle and Professor Canterbury?

Do we have copies of your statements?

Professor CANTERBURY. Mine should be there.

Senator TSONGAS. I want to place in the record the articles that appeared recently in the Washington Post. They will be submitted at this point in the record.

[The documents follow:]

[From the Washington Post, Apr. 22, 1979]

GLOBAL SYSTEM HYPERVENTILATING

(By Larry Kramer)

PARIS.—The problem is not that there is so much money changing hands around the world these days, even though far more money is moving faster and farther than ever before.

The problem is that no one is watching.

The sense that bankers—and not governments—slowly but surely have taken hold of the future has begun to worry some people, particularly those elected to look after the interest of the general public.

But it is now clear that the world has grown to depend upon an extremely complex, yet at the same time delicate, 20-year-old financial system that is understood by few and—more importantly—that avoids regulation by any existing government body.

What is worrying those select few who are familiar with the ballooning business of foreign currency trading and is terrifying those unfamiliar with the complex system is the growing possibility that world monetary affairs have changed so dramatically and in such a short time that they may be out of control.

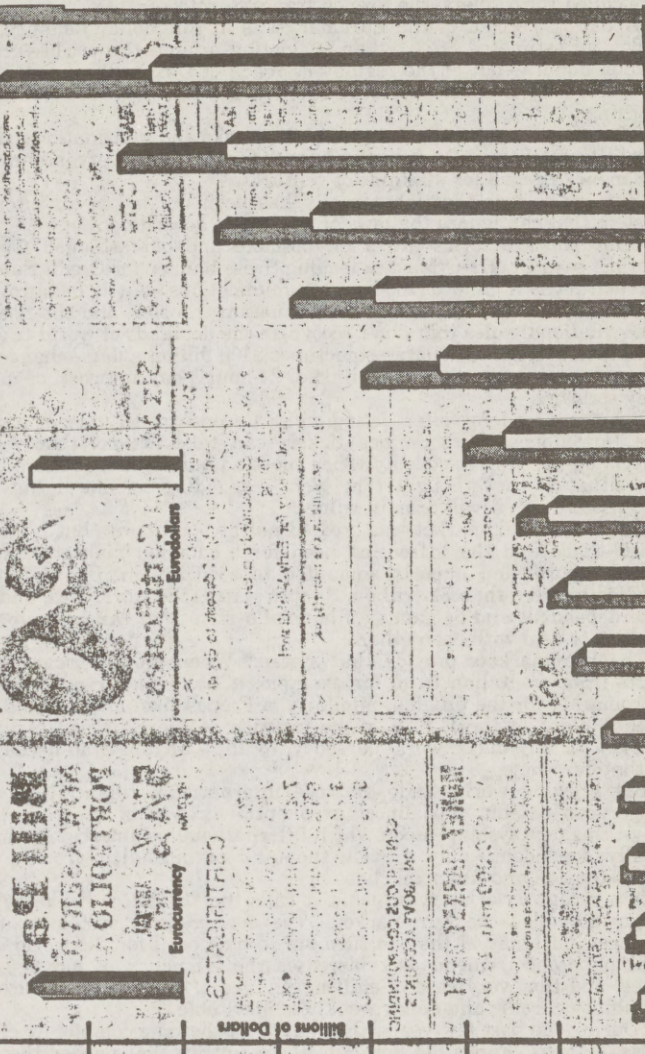
In fact, the new international monetary system has linked the economies of most major nations of the world inextricably. The same system that is designed to allow countries and their businesses such easy access to each others' funds has done so only at a high price: an almost helpless interdependence. No single country now has the power or the funding to stop the kind of rampant inflation that could occur because of the huge amount of money freely available around the globe.

The situation is similar to that encountered by consumers in the United States. Credit is so easy to come by in the form of credit cards and other charge accounts that the American consumer is now borrowed up to his or her neck. By the time many realize how much in debt they are, it's too late.

The amount of money that is held outside the country of issue—dollars outside the U.S., British pounds outside England, etc.—is 1,720 times what it was in 1959, having increased in 20 years from about \$500 million to about \$860 billion.

Eurocurrency Market

The estimated size of the gross Eurocurrency market and the Eurodollar market. Eurodollars are U.S. dollars held overseas and the Eurocurrency market is the total amount of all currencies held outside their country of issue.



1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977

Source: Morgan Guaranty, Inc.

That vast supply of money makes up what is called the Euromarket. The dollars are called Eurodollars, the French francs Eurofrancs, etc.

About 73 percent of the Euromarket is in Eurodollar holdings. That means that today an estimated \$627 billion is floating around the world—give or take several billion dollars—out of the regulatory reach of U.S. banking authorities. As recently as 1970, that number was only \$89 billion. Ten years before that, it was almost nothing.

That huge Euromarket is used by the banks and multinational corporations of the world to finance international transactions. It gives everyone an open marketplace for money needed for all kinds of ventures.

But critics fear that what really has been created is an international banking system that can ignore the laws of any single government.

"Our political forms are a bit obsolete and old-fashioned for today's financial world," says Dr. Hans Mast, a leading Swiss banker for Credit Suisse. "The Eurodollar market is a child of modern communications. But it has grown so fast for two reasons: the increasing speed of information transfer, and the need to work around many national rules that don't recognize the demands of world trade."

In fact, billions of dollars—sometimes \$100 billion a day—change hands in seconds through a vast, electronically linked, 24-hour-a-day network of money traders who defy scrutiny.

But those traders—often acting on an unconfirmed rumor or a three-line story on the Dow Jones News Service ticker—can take actions that will have profound effects on the world economy. They move so quickly that in some cases they create the situation they thought they were responding to, like a run to sell the dollar because of fears it will drop in value.

The Eurodollar market was created not by speculators but by the huge growth of world trade and the increasing need for a common marketplace. In 1965, overall world exports and imports amounted to \$350 billion. By 1977, that number had swelled to more than \$2 trillion. Simply stated, the world was, and is, growing more interdependent and demands a financial system that can keep up with the needs of nations to deal with each other.

The Euromarkets provide that system. When an American firm wants to buy parts from an Italian firm, for example, it has little or no trouble going into the Euromarket for the funding. Similarly, a French firm may need to borrow dollars to open a plant in the U.S. It is the function of the Euromarket to provide a ready market for any major world currency, to allow anyone who needs to have access to that currency.

But growing world trade and the international financial needs of nations no longer can explain the almost exponential growth of the Euromarkets. In many ways, this new system—upon which international commerce now has become almost totally dependent—may provide the kind of unbridled growth that can lead to overextension and financial chaos.

In a recent cover story on what it calls the "Stateless Economy", Business Week magazine called the Euromarkets "the new banking system that is a blessing to business [but] may in the end turn out to be a peril for the world at large. The new banking order tremendously increases the efficiency of moving cash around the globe, and that very ease of shifting billions at a moment's notice makes currency instability chronic and dollar weakness inevitable."

"During the past few years, the system has become completely crazy," adds Credit Suisse's Mast. "Funds did not go to the countries that needed them but to the ones that did not."

It is important to look back at the history of the foreign exchange market to understand its many reasons for being, and the factors that led to free-floating exchange rates.

At the end of World War II, major economic powers met at Bretton Woods, N.H., to set up a new monetary system that would help facilitate world trade, but insure stability in exchange rates, i.e., keep the relationships of currencies to each other the same.

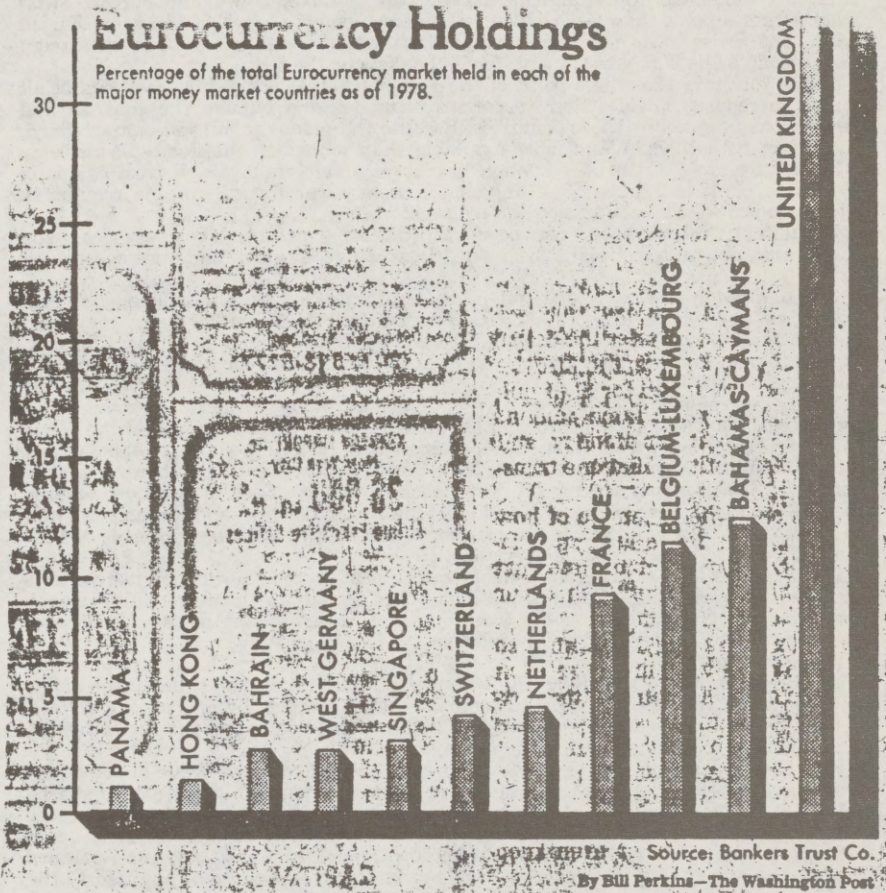
The Bretton Woods Conference established the International Monetary Fund to supervise exchange rates, and to approve any changes in the value of one currency with respect to another. The dollar was the cornerstone of the agreement because it alone always could be converted into gold at the fixed rate of \$35 an ounce, and gold was made the standard for international bartering.

But the Euromarket itself was born in the 1950s during the Cold War as a means for the Soviet Union and other Communist countries to protect their dollar holdings.

The Soviets began to worry that, in the event of heightened tensions, the U.S. could seize the Soviets' considerable deposits and loan holdings in U.S. banks. So the Communist countries asked certain European banks to take over their huge dollar deposits, and open their own corresponding accounts with U.S. banks. That way, the Soviets, for example, could keep their dollars, but at arms length and out of reach of U.S. authorities.

But in the early 1960s, as the Euromarket and world trade began to grow, the Bretton Woods system was threatened by significant changes in the world economic structure. The dollar was in danger.

Confidence in the dollar dropped as the U.S. built up bigger and bigger budget deficits and the dollar began to means less. Further, the U.S. began paying out more dollars around the world while taking back fewer and fewer. There were just too many dollars around the world.



And the ability of the U.S. to pay out—as promised—gold on demand to any foreign country offering dollars was in serious question as the size of the U.S. gold reserve began to shrink while the supply of dollars continued to grow.

Faced with worsening inflation and balance-of-payments problems, the U.S. ended convertibility of the dollar into gold in August 1971, wiping out a key support of the world monetary exchange system. Further attempts to maintain some form of fixed exchange rates between currencies failed, and slowly but surely the value of any one currency—including the dollar—began to float, that is, to rise and fall with the money traders' perceptions of the economic situation in that country.

If a country was financially sound, its money became more valuable because it was backed by a stable environment. Thus as U.S. fiscal problems intensified, the value of the dollar vs. other currencies dropped.

And there was a new development: Thanks to oil, the newly enriched Arabs began pumping billions of dollars into the Euromarkets—dollars that came, for a great part, directly from the U.S.

The attraction of dealing in the Euromarket grew as each nation took its own action to protect its domestic financial situation in the face of unstable world markets. Many countries, attempting to keep as much of their currency under their control as possible, set restrictions on the amount of money their banks could lend to nonresidents. While this served to limit the amount of local currency that would leave the country and its controls, it also often forced that non-resident to get that currency from somewhere else.

So if Switzerland did not let an American borrow too many Swiss francs from a bank in Zurich, all the American did was go to Luxembourg and borrow Swiss francs from a bank there—perhaps even a Luxembourg branch of the same Zurich bank. The Swiss have no control over branches that Swiss banks open on foreign soil. Nor does the U.S. government; for its banks; nor the British, etc.

There you have the whole point of the Euromarket. It is the huge deposits of all major currencies outside their respective countries and outside the controls and restrictions imposed by those countries. Because the money involved is unrestricted, it is often both cheaper and more available than money in the domestic markets.

So, for example, Citibank's London branch can help finance a British company opening a plant in France by selling that company Eurofrancs—and no regulatory agency in the world can question the transaction.

Regulatory "interference" can be devastating to a potential business deal, and bankers do not underestimate the value of avoiding annoying and time-consuming rules.

But something else is happening in the Euromarkets that is causing concern. Each time one nation imposes another form of controls on its currency, the world market finds a way to get around it. The system has become so efficient in fact, thanks to modern communications systems, that it may be hyperventilating—things may be going too fast.

Young, aggressive, but relatively unsophisticated money traders work out of an estimated 1,000 trading rooms for banks, multinationals or others around the world as part of a system that now never stops. They are linked by telephone and computer. When Europe closes down, New York is still operating. When New York winds up, Tokyo is just kicking off. Then back to Europe. Each of the 1,000 trading rooms—located in such places as London, Hong Kong, Bahrain and Panama, as well as New York, Tokyo and the major European money centers—does upwards of \$100 million worth of money trading every day.

Perhaps the most worrisome development is that trading no longer just reflects the needs of world trade. Rather than being used for buying or selling currencies to cover specific transactions in the world market, a significant number of foreign exchange trades now are purely speculative.

If money traders get a rumor, for example, that some national banks are planning to sell large quantities of dollars—an action that would cause the value of the dollar to drop—they frequently will try to jump on the bandwagon by also selling dollars. If they can sell fast enough, before the dollar is sold in large quantities by the central banks, the traders will make money.

How they make money is simple. As more dollars are sold, the value of the dollar drops because the supply is growing faster than the demand. So if a trader sells dollars at a higher value in the morning and buys them back at a lower value the next morning, then the difference in value is pure profit for the trader's bank.

In many cases, the trader even might borrow the dollars to sell, pay interest for a day on the money, buy it back the next day and pay off the loan. Frequently the profit on the exchange will more than offset the interest cost on the loan, and the trader has made money without using any of his company's cash.

It is not just that banks and firms want to speculate. In many cases, they now have to or risk huge losses.

As of 1975, U.S. companies must translate the value of their foreign assets, liabilities, revenues and expenses that are denominated in foreign currencies into dollars at current exchange rates every three months when they publish their income statements for stockholders. Consequently, the pressure is intense to stay in touch with the rise and fall of currencies.

Some multinationals learned that lesson the hard way, having to declare huge losses on quarterly statements merely because the value of the currency of a

country in which the firm has a subsidiary dropped significantly over a three-month period, sharply reducing the value of assets there.

So companies and banks are hedging their bets with increasing frequency, and trying to make quick gains by buying and selling huge amounts of currency over short periods of times.

And when the financial community blames "those speculators" for fluctuations in the money markets on a given day, the reference is not to wild-eyed high-rollers, but to the largest banks and multinational companies in the world, who are juggling the billion-dollar Euromarkets the way the average citizen shifts funds between his or her bank accounts.

"Corporate treasurers are hedging whenever and wherever possible," says Jonathan Aronson, international relations professor at the University of Southern California. But, he warns, "This has led to tremendous new activity in markets sensitive to rumors and short-term currency developments. In protecting their own positions, these corporations may actually turn spurious rumors into self-fulfilling prophecies."

Some economists blamed such speculation against the dollar for contributing to the drastic drop in the value of the dollar during 1977 and 1978, contending that the dollar dropped far lower than economic conditions would dictate because many traders were fueling the drop by "selling the dollar short"—selling it on one day for no reason except to speculate, and buying it back a short time later at a lower rate.

"Though our massive trade deficit and our inability to control inflation may be the primary reasons for the dollar's plight, it seems apparent that extreme volatility in exchange markets has resulted in exchange rates moving faster and farther—up or down—than can be justified by the underlying economic factors," says Sen. John Heinz (R-Pa), who is on the Senate Banking Committee.

Guido Carli, former governor of the Bank of Italy, agrees, warning that "more and more exchange rates in the market do not necessarily reflect the conditions—the fundamental conditions—of the various economies in real terms."

Carli adds, "I believe that we have reached a point which necessitates that a worldwide action be taken."

There is big money to be made—or lost—by speculators. If the dollar drops 1 percent in value over two days millions can be made.

A bank could sell \$1 million for French francs on Monday, for example, and, if two days later the dollar has dropped only 1 percent against the franc, the bank could sell for \$1.01 million on Wednesday the same amount of francs it bought on Monday and show a \$10,000 profit on that one transaction alone.

That is a simplified example of how money can be made through speculation, and it is important to note that the same kind of activity can occur with a steadily rising dollar.

With money trading happening so fast, and so often without any relation to trade or other economic factors, experts fear a liquidity crisis—where money becomes so easily available that it is borrowed and spent too freely, fueling worldwide inflation.

And there is no one international agency that can stop it, or even keep track of it.

[From the Washington Post, Apr. 29, 1979]

BYPASSING A COSTLY MAZE

A top official of the Bank of England is explaining to his foreign visitor how the bank would enforce new foreign exchange transactions.

"How many people will enforce the new rules?" the visitor asks.

"Five."

"That's fine," says the visitor. "We have 500 whose job it is to get around your regulations."

"There are no controls. You can't control the flow of international capital. There are no rules to the game. The only one really is profit, profit, profit."—a U.S. Treasury Department official.

(By Larry Kramer)

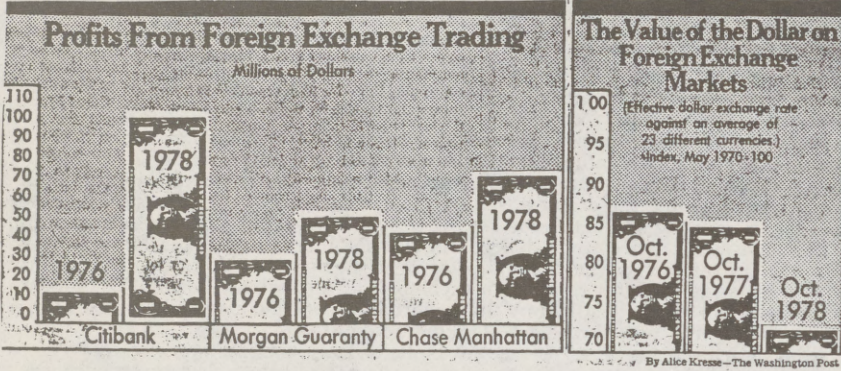
ZURICH.—For almost two years—from early 1976 through late 1978—the value of the dollar fell continually.

In a one-year period beginning in the summer of 1977, the dollar dropped 35 percent in value against the German mark, 55 percent against the Japanese yen and a whopping 67 percent against the Swiss franc.

That means that an American tourist or businessman going to Switzerland in the summer of 1978 had to spend three dollars for every one dollar spent the summer before—for the same goods and services.

But while the dollar was going down the drain, the largest U.S. banks were making big money speculating in the world money markets that the dollar would do just what it did.

The three largest New York banks saw their net profits from foreign exchange transactions soar 238 percent between 1976 and 1978.



For Citibank, the world's second largest commercial bank, foreign exchange profits jumped from \$28 million in 1976 to \$105 million in 1978—12.7 percent of all Citibank pretax earnings that year. Chase Manhattan's foreign exchange profits went from \$47.4 million to \$74.7 million (18.9 percent of total profits) during the same period, and Morgan Guaranty's leaped from \$33.8 million to \$56.4 million (15.2 percent of total profits).

Bankers properly argue that the huge growth in foreign exchange profits occurred because the markets were so active and the volume of trading grew exponentially, not because they deliberately were profiting on the slide of the dollar. And, in fact, they point out, it is highly likely that the banks would have made just as much money had the dollar's value increased by that same amount instead of decreasing. To be sure, much of the money traded by banks in foreign exchange markets belongs to individual companies, not the banks themselves. And, according to one French banker, "If the banks stopped doing the trading for the multinational companies, then those companies would just hire the people to do it for themselves."

But all the average citizens knows is that while the country was losing more and more buying power around the world, the banks were making more and more money. And the more unpredictable and volatile the markets became, the more money the banks seemed to make. There were also accusations that the banks were using the shroud of international transactions to shift profits improperly from countries where they would be subject to taxes to countries where there are little or no corporate income taxes.

The tax question is particularly annoying to federal governments. Citibank records filed in a private lawsuit against the bank show, for example, that Citibank structured several transactions between its branches overseas to shift profits out of certain countries. Certain currency trades conducted at suspiciously-pre-set exchange rates allowed the Paris office of Citibank—which is subjected to local income taxes—to declare a loss, and the Nassau office, where profits are not taxed, to show a profit, for tax purposes. But in a separate set of books kept for internal purposes, including the allocation of bonuses, the bank attributed those profits to Paris. Keeping two sets of books isn't illegal, the bank points out, but tax officials in several countries nevertheless are examining bank records to see if certain profits should be allocated the same way on both sets.

Because no international organization regularly monitors them, such transactions normally almost never would come to light, lost among the literally thousands of deals struck in every one of the 1,000 trading rooms around the world. But when they do, they raise serious questions about the seemingly unbridled ability of

multinational banks to get around whatever tax or currency control laws are set up by individual countries.

Prof. Charles Kindleberger of the Massachusetts Institute of Technology believes there is an "international good to be served" by the world money markets in general, and even by speculation. But he is "very uneasy" about the tax havens set up by most international banks in places such as Nassau, Singapore and the island of Jersey in the English Channel.

"Tax avoidance or evasion is a big problem," he said in an interview. "In the long run, maybe we will have to internationalize taxes."

And because of the events of the past two years, it is not only the experts who are asking questions. More and more people, and congressional committees, want to know: Why was the dollar dropping so much more than would seem to be justifiable under existing economic conditions? And why were the U.S. banks making so much at the same time?

The answers vary, but one word always found its way into every response: speculation.

There are two ways to profit on foreign exchange transactions. One is to charge customers for the service of buying and selling their various currencies, and the other is for bankers—or anyone who wants to—to buy and sell currencies on their own, and attempt to profit on the rise or fall of the currency. The latter method is known as speculation because it is an attempt to profit on the speculated rise or fall of a currency. If you sell dollars for francs, for example, and the dollar drops in value, you then can buy more dollars back for the same amount of francs.

The consumers on the street can profit in the same way. All they have to do is buy travelers checks in a foreign currency, like Swiss francs, and hold them for a period of time during which they think the dollar might fall in value compared to the Swiss franc. Then, when the dollar's value has dropped, the consumer can sell the Swiss-franc travelers checks for dollars at the new, lower rate, and, like the sophisticated banker, get more dollars for the same amount of francs.

Some economists charged that, although the dollar should have dropped during the 1976-1978 period—perhaps because it was overvalued—the drop that did occur was sharply accentuated by speculators gambling that just such a drop would happen, and positioning themselves to profit from that drop.

So as the dollar began to recover last fall, a new question popped up: What could be done to prevent the dollar from being victimized in such a manner again?

The answer was frighteningly simple: nothing.

"The Eurodollar market is essentially unregulated," says Sen. William Proxmire (D-Wisc.), chairman of the Senate Banking Committee. "Federal regulatory agencies don't even know what the daily volume is in foreign exchange trading in New York, let alone Europe. No one seems to know how large the Eurodollar market is or just what its effect on inflation and exchange rates might be."

And, Proxmire adds, "The banks do seem to enjoy handsome exchange profits, even when the markets are disorderly. Some banks are so huge that a few working together perhaps could * * * push the rates in a chosen direction, and, of course, profit a great deal from that."

Morgan Guaranty places the gross size of the Euromarket—the amount of money floating around the world out of the regulatory control of its country of issue—i.e., dollars outside the U.S., pounds outside of England, etc.—at about \$860 billion. Admittedly, that total includes a certain amount of duplication. Because banks conduct currency trades with each other, for example, some of that money is counted twice. Still, that \$860 billion market is 1,720 times larger than it was 20 years ago. And it continues to grow.

When asked by U.S. News and World Report, a few years ago how many dollars that are overseas, Citibank Chairman Walter Wriston said "nobody knows. It depends on how many times you count the dog when he runs by the door."

Late last year, Wriston's bank estimated that Euromarket business—the total volume of transactions in the worldwide markets, transactions out of control of any one country's regulations—totalled about \$50 trillion, a number significantly higher than the aggregate volume of all world trade.

But when a Federal Reserve Bank officer was asked about that figure, he gave an estimate of about \$40 trillion.

Asked to explain such a large discrepancy, the Fed official told the Wall Street Journal: "What's \$20 trillion among friends?"

It's not the \$20 trillion that worries the average citizen with little or no financial acumen—those kinds of numbers rarely mean anything real to the man or woman on the street—it's the friends."

In fact, bankers will be the first to say that few outsiders have any real understanding of world money markets, making regulation of that area by non-bankers almost impossible. Thus, international banking remains one of the most exclusive clubs. But the worrisome aspect of that club is that whenever its members get together, they can stop the world monetary system in its tracks if they want to, and no one really knows to keep them from doing just that.

"The world has dreamed up a new kind of money," says one of New York's most prominent international bankers. "It has done so because of the demands of world trade. We're not unduly worried about this International system. If the dollar goes down as far as it did, that's because the world was telling President Carter that the U.S. is not doing its job economically. And it is in everyone's interest to keep world markets stable."

Sitting back in the plush corporate dining room and pondering the bank's role in world affairs, this same banker acknowledges that there is virtually no regulation of international banking.

"It is right to worry about that," he said. "International banking is a continuing education process, and it is changing so rapidly [that] really only those who stay on top of it all the time really know what is going on—and even they don't know everything about it. No governments can control this market, but none of them would know how to even if they were able to."

He says he "can feel it in the air" when the Euromarket gets out of hand. He said he had such a feeling at the time of the famous Herstatt case, when a German bank finally went broke after recklessly overextending itself in the Euromarket: rolling the dice for big profits and losing.

Indeed, it is the opinion of most British bankers, and the Bank of England, that the central banks of every country should watch their own banks, and the activity of those banks around the world.

Central banks, while different in every country, essentially control the supply of money and credit as well as prevailing interest rates within their country. They are usually at least quasi-government organizations, and frequently intervene in a domestic economic crisis with actions designed to stabilize the economy. On the international front, these banks frequently also will buy or sell large amounts of money on world markets in an effort to stabilize the status of their respective currencies.

If there is a run to sell the dollar around the world, for example, the Federal Reserve here might buy a large amount of dollars to prevent the supply of dollars from so outweighing the demand as to dramatically decrease their value.

Central banks can work together to exert some influence in world money markets, as in the recent effort by the key European central banks to restrict the fluctuations of European currencies with respect to each other, eventually leading to a single European currency. But the plain fact is a central bank's real authority extends only to its own country's borders. And world bankers do not hide the fact that the world money markets actually were created to a great extent to avoid many of the domestic sanctions and restrictions created by the central banks in several countries.

"Money is rather like water," says a Bank of England official. "It flows everywhere, even under doors. There is no international regulatory agency that could watch the world money markets. They just flow too fast."

A French banker believes, however, that for the most part the foreign exchange laws of most countries are not being subverted, and the reasons for unstable currencies are unstable economies. "You can't be in favor of free trade and expect to have stable currencies," he said.

The Bank of England's Peter Cook heads up the only real international effort to monitor the money markets, known as the Cook Committee. Consisting of representatives for the 10 major international economic powers—known as the Group of 10—and Switzerland, the committee mostly watches for banks that might be overextending themselves, like Herstatt, or for unusual market circumstances.

They meet three times a year here in Switzerland under the auspices of the Bank for International Settlements, a bank for central banks of the countries involved, and one for the most part owned by those banks. The BIS manages funds for various central banks, and can buy or sell currencies for those banks without making public what country is behind the transaction.

Thus, the major international agency charged with watching the world money markets in any systematic way is actually owned by the central banks it is charged with watching.

"If every supervisory authority in all countries with major banks would look after their own banks around the world, then we would have a grip on the problem," says

the Bank of England's Cook. And in fact, the British banking authorities long have had the reputation of being the most diligent watchdogs. But in England, bankers still are treated with much the same respect that doctors meet with in the United States: the one person you can trust. It is not, needless to say, the same in the U.S. anymore.

An American banker in Paris disagrees with Cook over bank supervision. "It just doesn't work that way. You can really only watch the banks domiciled in your own country," the banker contends.

However, "the Federal Reserve Bank (in the U.S.) is now watching the Euromarkets much more closely," one banker for Morgan Guaranty says. "They are always asking us how we feel about the market that day, or if we see anything unusual going on. Any they are keeping much better numbers on the business done by American banks around the world."

But the main reason there likely never will be one international superagency to watch the foreign money markets is really quite easy to understand: Bankers don't trust governments to leave the international flow of money alone. "The growth of the Euromarkets is at least partly due to the need to free up capital not subject to ridiculous national laws in many countries," one British banker claims.

The International Monetary Fund, a club of 138 governments, was created at least partially to watch the world monetary system. It is charged with making sure, for example, that countries don't try to take unfair advantage of world money markets. The IMF watches for countries that try to keep the value of their currencies down even though they are strong because those countries want to keep their exports competitive around the world. If a currency rises in value, so does the cost of the goods made in that country but sold around the world.

But the IMF has no real weapons with which to force the economic powers to do anything. If a weaker country has to borrow money for the IMF for development, then the IMF has certain powers over that country. But the more powerful countries don't need the IMF's money, and thus don't owe any obligations to the world body. Still, it is not uncommon for the larger IMF members to pressure each other to make necessary changes. For example, there was widespread pressure from world economic powers on President Carter last November to take drastic actions to protect the dollar such as increasing interest rates sharply and amassing a \$30 billion pool of resources with which to defend the dollar if necessary.

Bankers in several countries acknowledge that the world system, whatever the good intentions were behind setting it up, is frequently abused. Besides the accusation that the various multinational companies and banks can play with their tax bills in each country, and cut back sharply on the taxes they should be paying by shifting profits around the world to places where there are little or no taxes, banks have been successful at circumventing virtually every national rule or regulation in the area of currency control merely by shifting to world markets.

"They may be right, the bankers, about the fact that no one understands the system" well enough to regulate it, say one congressional staffer. "But the plain fact is that people elect governments, not bankers. And a lot of people think that the answer for banks is to make their case to the government for better rules, not to just go out and break them. Who is supposed to be running the world, anyway?"

[From the Washington Post, May 6, 1979]

OVERREACTION FEARED TO EDWARDS' CASE

(By Larry Kramer)

PARIS.—For more than two years, Assistant Vice President David Edwards had been warning his superiors in Citibank's European money trading operation here that something was wrong.

There were things going on that were illegal, he kept saying. Certain employees were taking kickbacks, and some bank practices were in violation of tax and currency control laws in several European countries, he alleged in written verbal communications with other bank officers.

For a while, he was shuffled from one office to another to voice his concerns, often having to repeat the same tale over and over again, and present the same evidence he had gathered time and time again.

Finally, the bank got tired of hearing the story, and Edwards got tired of telling it to people he says were not listening.

On Dec. 14, 1977, Citibank asked for Edwards' resignation. He said no. Two months later, he was fired. It was only a few months after that that Edwards

responded, doing something that shocked the normally staid and secretive banking industry, and caused reverberations that have yet to subside.

Edwards went public. In doing so, he opened the door for one of the first public glimpses into the normally illusive world of international banking.

In a lawsuit filed July 24, 1978, Edwards charged the bank with "wrongful dismissal," claiming he had been fired merely for following the bank's own policy of reporting any suspected wrongdoing to bank superiors. He asked for \$14 million.

And he may not have been just whistling in the wind. Edwards had documents. When he left his job at the bank he took a significant number of papers in an attempt to support his allegations of illegality and his attempts to bring them to the attention of bank higherups.

In his now-famous 106-page "Blue Book (so-named for its blue cover), Edwards used Citibank's own internal memoranda to detail the bank's foreign exchange practices, which he said in many cases were designed to get around local laws in almost every European country in which Citibank operated. He claimed the bank was deliberately and illegally shifting profits out of European branch offices, at which such profits would be taxable, to tax havens like Nassau, the Bahamas, where the profits were not taxed. He also charged in his court filings that bank officials continually covered up his allegations.

What has occurred since that suit was filed has been what Business Week magazine called "Citibank's worst public relations problem in years."

Seven federal investigative agencies and two congressional committees are probing many of Edwards' allegations, made both in court and in an article he has written for a business magazine.

Bank regulators in several countries have begun investigating the bank's practices in their jurisdictions, with at least one, Switzerland, acknowledging a back-tax bill is likely.

But the most profound impact has been felt within the banking industry itself, an industry that is not used to having its dirty linen aired in public. And perhaps more importantly, an industry that has to rely on a great deal of public trust.

There is a fear among bankers that the Citibank "problem," as they prefer to call it, could cause an overreaction by the public, who the bankers are convinced understand little about the volatile and increasingly extensive world money markets.

The Euromarkets, as they are called, represent a huge pool of currency out of the regulatory reach of any single country. An estimated \$860 billion worth of currency is floating around the world outside the country of its issue, i.e., dollars outside the U.S., francs outside of France. In the past 20 years, the size of the Euromarket has increased 1,720 times, reflecting both the growing demands of world trade—which, in turn, needs easy access to huge amounts of all major currencies—as well as the banks' perceived need to avoid costly and bothersome local restrictions in many countries that they say thwart the free flow of money around the world.

Because the attraction of the Euromarket is its freedom from regulation, bankers become understandably nervous when there are attempts to apply some kind of controls that would end such freedom. And, they feel, if people begin to distrust bankers, they will begin to seek such controls.

Citibank also has been criticized in news accounts for changing its publicly stated reasons for firing Edwards on two different occasions.

In a Dec. 14, 1977, letter from Citibank Executive Vice President Thomas Theobald, Edwards was told he was being fired because "your continued allegations were detrimental to the best interests of the bank."

But in the Aug. 24, 1978, Citibank News—an internal employee publication—the bank stated that Edwards was fired "not because he raised questions about bank practices, but because of circumstances surrounding his refusal to accept reassignment."

Then, in the March 1979 issue of Executive, the Cornell University Graduate School of Business magazine, Citicorp Chairman Walter Wriston said Edwards was fired because he was "totally incompetent." Wriston further claimed that the sacked banker's "famous accusations didn't arrive until after he was dismissed."

"In our country, we call that being badly briefed," one British banker said, commenting on Wriston's statements.

But the implications of the Edwards case, and the bank's reaction to it, are far more serious than just one banker being "badly briefed."

"You're damn right we're upset," said an international banker at Morgan Guaranty in New York. "People see a bank stonewall like that, and they think we all have something to hide. Then, they see that we are regulating ourselves for the

most part—which is the way it has to be for this market to work—and they begin to wonder if we are hiding a lot more.

"Well, we aren't hiding a lot more, but I have no idea how we are going to convince people of that when they see this kind of stuff" (pointing to a news account of the Edwards case.)

"I'm shocked by the behavior of this fellow Edwards," says Dr. Hans Mast, a widely respected banker for Credit Suisse in Zurich. But Mast comes from a country where banking secrecy has been a way of life for decades. And Mast would not discuss the merits of Edwards' allegations, except to say that it is both legal and legitimate for a bank to seek to reduce its tax bite—to "avoid taxes"—around the world.

Other bankers point out, however, that there is a fine line between "tax avoidance," which is the legal avoidance of taxes, and "tax evasion," which is illegal. Many countries, for example, have explicit laws forbidding the establishment of transactions that are designed solely to cut down taxes. The bank defends many of the transactions in question by claiming they were designed not to avoid taxes but to keep money flowing around the world and available to its worldwide network. That taxes also were reduced is merely a side effect, the bank says.

"What Edwards says Citibank was doing is abusive, and (if what he says is true) it is morally wrong," says an international banker for Chase Manhattan. "We are hoping that most of the foreign governments looking into this case don't come to the conclusion that we all can't be trusted, because that could have a disastrous effect on the entire worldwide market.

Because the attraction of the Euromarket is its freedom from regulation, bankers become understandably nervous when there are attempts to apply some kind of controls that would end such freedom. And, they feel, if people begin to distrust bankers, they will begin to seek such controls.

There are indications that such concern may be justified. Only last week, Rep. Jim Leach (R-Iowa), ranking minority member of the International Trade Subcommittee of the House Banking Committee, cited the Edwards case when he introduced legislation aimed at putting new controls on the Euromarkets.

Leach called on the Federal Reserve to place reserve restrictions on the dollar and for the U.S. to pressure foreign governments to do the same on their currencies in an effort to stabilize the Euromarkets and slow their growth.

"The existence of a large Eurocurrency market acts as a driving stimulant to currency speculation," Leach said. "Unfortunately, potential conflicts of interest develop between banks and their customers when banks trade on their own account, and between banks and the goals of a stable dollar and international monetary system when profiteering in currency exchange transactions is so alluring."

"Speculation is the major new business of international banks, with a number reporting 12 percent to 19 percent of their last-quarter profits coming from currency transactions," he said. "Unfortunately, the very profitability of this activity gives international banks a vested interest in increasing currency instability since currency profits are most apt to be made in a fluctuating market."

Leach also warned that the large Eurocurrency market "increases the temptation to seek profits in currency transactions and to move monies to appropriate tax shelters. The possibilities for tax evasion are significant."

"A lot of money is created in the international markets outside the control of any central bank," Federal Reserve Board Chairman G. William Miller said to the National Press Club last year, calling the Eurodollar situation "one of the greatest worries" he has.

"And this Edwards case can do nothing but make people more suspicious about what we are trying to do," adds a Chemical Bank official in Europe.

A large part of the problem in the Citibank case is due to the bank's own handling of the matter since the suit was filed. There has been a virtual stonewall on information from the bank, except for the release of an exhaustive, yet inconclusive, eight-month study,

"What Edwards says Citibank was doing is abusive, and (if what he says is true) it is morally wrong," says an international banker for Chase Manhattan. "We are hoping that most of the foreign governments looking into this case don't come to the conclusion that we all can't be trusted, because that could have a disastrous effect on the entire worldwide market. There are already too many domestic controls in each country that don't recognize the needs of the international market."

Even Citibank's own Theobald—the man who fired Edwards—acknowledges that international banking is virtually unregulated.

"As a matter of economic policy, it is absolutely correct to say that attempts to stop, in one location, a global market are futile," he said in an interview. Asked if

people and companies are flouting the law, he said, "Yes. But you don't have to flout the law. All a country can do is pass laws relating to that country, and if the person, company or anything else does business in more than one place, then automatically (they) are under two jurisdictions or more (and out of the control of any one of them)."

But Citibank appears from its internal documents to be aware of the fact that it probably crossed that fine line from legal avoidance to illegal evasion of both tax and currency laws in several of the countries in which it operates. In a 21-page internal memo in 1976, Citibank's then assistant vice president, Paolo Cugnasa, warned that the bank's system of "parking" various foreign exchange holdings in tax havens like Nassau should "be kept as inconspicuous as possible."

There is concern that the problems faced by Citibank were due to overzealous employees driven by the bank's profit incentive system, which is tied to performance. "Young guys get greedy," said a former Citibank official, "especially overseas where so much money moves around so fast. It's hard to keep track or even notice something is wrong until it reaches epidemic proportions."

"The problem isn't Citibank," says one Frankfurt-based American banker. "Everyone works essentially the same way. Oh, Citibank may be a bit more aggressive than anyone else, and maybe that rubs off on their people. But on the whole, they're an honest and hard-working lot. The real problem is the perception the public has of bankers, and what we are trying to do. When they read a book like the 'Crash of '79' or they read in the papers about this Edwards case, it looks like the industry has something to hide. Actually we don't, but we are so sure that no one will understand us that we don't talk to anyone. So, naturally, no one will trust us."

Senator TSONGAS. Are you familiar with those articles that appeared in the Post?

Mr. BURTLE. No.

Senator TSONGAS. Mr. Burtle, why don't you start off?

STATEMENTS OF JAMES BURTLE, VICE PRESIDENT IN THE ECONOMICS GROUP, W. R. GRACE & CO., NEW YORK, AND PROF. E. RAY CANTERBERY, FLORIDA STATE UNIVERSITY

Mr. BURTLE. Mr. Chairman, I very much appreciate the opportunity to be here. Of course, the viewpoints expressed by me are my own personal viewpoints and do not necessarily represent positions of W. R. Grace & Co. or any of my colleagues.

I have been asked to comment on the international reserve role of the dollar, U.S. exchange rate policy, gold, SDR's, the substitution account proposal and Eurocurrency markets. This apparently disparate group of subjects can be brought into focus by first considering the international reserve role of the dollar.

The basic trouble with the United States in the international monetary system is that we are like a general store that opens a bank on the side.

The commingling of banking and trading means that the store can lose money for an extended period but, nevertheless, can be kept afloat by bank deposits.

On the other hand, when there is a run on the bank, the store must have a fire sale in order to keep the bank liquid. Just as the store is obliged to cut prices, we had to let the dollar depreciate.

Senator TSONGAS. Is that an original analogy?

Mr. BURTLE. You mean the comparison? I suppose it is. I didn't get it directly from anyone else, but I'm not sure.

It's not an analysis. It's an analogy. A very rough comparison, that's all.

Senator TSONGAS. When we try to explain these to people, specially Senators, analogies have a certain appeal.

I assume it's correct; however, having appeal and being correct may be two different things.

Mr. BURTLE. Thank you.

Against this background, the system of managed floating has been subjected to criticism because of the wide swings in exchange rates. I believe, however, that exchange rate changes can usually adjust trade and long term capital disequilibria, but they cannot equilibrate violent changes in the composition of reserve assets.

If a bank and a general store are run as one business and there is a run on the bank, cutting prices in the general store is an ineffective way of protecting the bank.

But the problem is not really with the price system implicit in floating exchange rates.

The problem is with the world monetary system that uses the debt instruments of one country, namely, the United States, as the reserve assets of other countries.

When these debt instruments, mainly, U.S. Treasury bills and claims on U.S. banks, become suspect, there is a scramble to convert out of dollars into other currencies or gold.

This tendency was strong last year and could have been a disaster if the Treasury in November had not acted decisively to defend the dollar.

Since November 1 the dollar has strengthened against most currencies.

There could be a further improvement this year if the economy slows thus restraining imports, and if the depreciation of the dollar that has already taken place is a stimulus to U.S. exports. But it would be pollyannish to imagine that this improvement in the dollar will lead us to a new era of no more international monetary difficulties.

Instead, the old saying that Europe has pneumonia when the United States sneezes may be reversed with the United States in trouble whenever Europe and Japan sneeze.

We have this vulnerability not primarily because of any perverse trade or structural relations with Europe or Japan. Suppose that no one bought or sold dollars except for goods and services.

Under these conditions I believe deficits in the U.S. current account could be handled easily by the foreign exchange market. But any serious disequilibrium in the U.S. role as a trader now has an immediate impact on its role as a banker.

This greater vulnerability of the United States in its banker role to a run on the bank is central and critical. It arises not just from the rise in dollar liabilities abroad.

It arises from institutional changes. The management of central banks in less developed countries is no longer less developed in financial sophistication.

No longer will they sit and take losses on dollars with equanimity.

Moreover, the emphasis on portfolio management as taught in every business school is beginning to affect the policies of most central bankers.

They are asking themselves why most of their reserves are in dollars when a balanced currency portfolio would be less vulnerable to losses.

Against this background of shortrun improvement but longer run vulnerability for the dollar, the U.S. Treasury should act from

a position of greater strength to reduce the U.S. role as a world banker.

U.S. liabilities abroad should be reduced and funded to the point where they are sought after rather than merely tolerated.

The measures that should be taken to achieve this goal involve a wide range of technical questions.

But the broad outlines of policy are clear. We should continue selling gold in order to mop up additional dollars.

I do not understand why the Treasury reduced its gold sales last month. We should back proposals for a substitution account in which SDRs would be exchanged for short term dollar obligations for which the United States might trade long term bonds to the IMF.

We should work for an international agreement imposing reserve requirements on Eurodollar banks, so that dollar deposits abroad do not become a pyramid often built on redepositing by central banks.

It should be emphasized that all of these institutional changes are not going to stabilize the dollar, if the United States is following a policy that is excessively reflationary or if Europe and Japan are following policies that are excessively deflationary.

In response to such policies, exchange rate adjustments will be required.

But under the present system everyone is punished too severely whenever there is a disequilibrium in world payments.

Because dollars held abroad in reserves are unloaded often with dramatic suddenness, fluctuations in the dollar are much more volatile than what would be required if the United States did not have the role of world banker, a role that is becoming unnecessary and unwanted in a world that will no longer tolerate the United States paying its way by simply issuing more liabilities.

If one accepts the premise that the United States should not be a world banker, the question then arises as to how to mop up the excess dollars that have been accumulated abroad (1) partly because U.S. balance-of-payments deficits have been too much and too often and (2) partly because the Eurodollar market has permitted the further multiplication of claims on the United States. For the broom closet of international finance, a number of mops have been proposed.

One mop is to permit the dollar to devalue so much that the U.S. current account balance would improve sufficiently to repatriate excessive dollars abroad.

This would be a burlesque of the basically sound idea of floating exchange rates; such an extreme drop in the dollar would disrupt business planning, would be a disaster for companies and individuals with debts in strong currencies and, via steep rises in import prices, could set off a vicious circle of inflation and more devaluation.

Another mop is the proposal, usually associated with Jacques Rueff, to raise the price of gold sufficiently to buy up dollar reserves abroad. The world would move back to some approximation of the gold standard. My own view is that the gold standard cannot work in the 20th century, but that gold sales at market prices, as is

now being done by the U.S. Treasury, can contribute significantly to the mopping up process.

Another mop is the sale of long term bonds abroad denominated in dollars.

However, in the highly unified world money market today, such action would be nearly equivalent to selling long term bonds in the United States.

As more bonds are sold and the price of long term bonds falls, U.S. long-term interest rates might be pushed higher than would be consistent with reasonable levels of investment, income, and employment.

It might be possible, however, to issue nonmarketable long-term dollar bonds to central banks, but it is doubtful that they would accept the exchange risks of such a transaction.

It is interesting that the issue of foreign currency bonds, as announced in the Carter program of November 1, is the opposite of a mopup operation, since the amount of dollars abroad was not changed, while other currencies abroad are made scarcer.

In this case, however, the buildup of a kitty to defend the dollar had a strong prodollar effect because of the threat that it would be used massively for dollar defense.

The more rapid expansion of Eurodollars compared with short term dollar assets in the U.S. money market seems to indicate that Eurodollars have a greater multiplier, because they have no reserve requirements.

Insofar as Eurodollar deposits are in affiliates of U.S. banks, the straightforward answer is that they should be subject to the same reserve requirements as U.S. domiciled banks.

However, the United States has no authority to impose reserve requirements on Eurodollar deposits in foreign banks.

In order to apply reserve requirements to these deposits, an international agreement may be required. In any event, a high-level committee should be appointed by leading governments to consider measures to restrain Eurodollar expansion.

Finally, we come to the possibility of mopping up of excess dollars by means of an SDR substitution account. This is, in my view, the most effective action that could be taken to get the dollar away from its reserve currency role, that is, to get the United States away from its role as banker of the world.

The substitution account might involve the IMF exchanging SDRs for dollars.

Dollars taken by the IMF could be funded by the IMF purchasing long-term bonds from the United States.

While SDR's are sometimes called paper gold, this term has suffered from connotations of alchemy. It is better to think of SDRs as simply a mutual agreement among participating countries that they will, in effect, make specific values of goods or services or capital assets available to each other on demand.

These values are stated in SDR's which are calculated as a weighted average of different currencies.

SDR's can thus serve as a substitute for the dollar, other currencies or gold in a country's reserve position.

When SDRs were first issued, it was expected that world reserves would be inadequate as the U.S. balance of payments improved.

This expectation went wrong: The U.S. balance of payments deteriorated and dollars flooded the world.

Thus the SDR should now be viewed not as an addition to world liquidity, but as a substitution for dollars in world reserves. Once SDR's are substituted for dollars in reserves, there should not be a problem of central banks diversifying reserves when a particular currency becomes prone to devaluation.

Since the SDR is a basket of currencies, there is a strong tendency for its value to remain relatively steady because a decline in one exchange rate will be offset approximately by a rise in other exchange rates.

The above appraisal of methods for mopping up excess dollars abroad is, of course, tentative and subject to modification on the basis of further study and experience.

What is crucial is that the U.S. Treasury should recognize that attempts of the United States to continue the role of banker of the world are becoming increasingly prejudicial to world monetary stability.

Senator TSONGAS. Thank you.

Just one question, then Professor Canterbury may proceed.

Would you feel the same way if the United States did not have its current problems of inflation and balance-of-payments difficulties?

Mr. BURTLE. I didn't quite understand you.

Senator TSONGAS. Does your argument obtain even if the United States would get hold of its inflation problem and bring its balance-of-payments situation into equilibrium?

Mr. BURTLE. I think that is almost impossible. If you could say for sure in the future that our inflation rate would never get out of line with the inflation rate of other countries, then we probably could get along with the present situation.

I think, though, at this time we are excessively vulnerable to a real run on the currency whenever we, in effect, make a relatively small mistake in monetary policy.

I think if we had tried to get along without any inflation, in order to preserve our world banking role, we would have ended up being a highly deflated economy with a slow growth rate and with a high level of unemployment.

Professor CANTERBURY. Mr. Chairman and members of the committee, I thank you for the invitation to testify. My gratitude would run even more deeply if I had more than 2 days to prepare my statement. But I understand how Congress works.

Senator TSONGAS. If you do you could be very dangerous.

Professor CANTERBURY. What?

Senator TSONGAS. If you do understand how Congress works, you could be very dangerous.

Professor CANTERBURY. To Congress or——

Senator TSONGAS. To the Congress.

Professor CANTERBURY. I see.

Senator TSONGAS. Let me interrupt you. The issue of Rhodesia is expected to come on the Senate floor today. Since I am the one that is most involved with that issue, when you finish your testimony, we will submit questions to you to be responded to for the record.

I don't want to be caught if it comes up on the floor. That's why I explain to you what the constraints are.

Professor CANTERBURY. Thank you, Mr. Chairman.

International monetary reform is opposed by central banks and governments during two kinds of periods. One is when a crisis in international finance exists. Then it is argued that you cannot have monetary reform because the long drawn-out negotiations will only deepen the crises.

The second period in which it is argued that you cannot have monetary reform is when there is no crisis. Then it is agreed that the system is working perfectly and no reform is needed.

Today we are between those two positions. We do not have an ongoing crisis, though one could begin at any moment, but the system only appears to be stable. It only appears to be working well. Thus, now would be the ideal time for considering international monetary reform.

An ideal monetary system is one in which nations can pursue their own domestic economic goals without continuously on a day-to-day, week-to-week, month-to-month basis being concerned with foreign exchange rates and the international value of its currency.

In an interdependent world, however, no international monetary system can survive greatly divergent economic growth and inflation rates among its dominant members. A congenial and viable international system, therefore, requires that necessarily interdependent nations relinquish some political sovereignty. Whereas domestic political reality requires that the sovereignty lost not be too much.

In the industrialized nations this delicate balancing act can be achieved. One rarely encounters a modern leader who does not express an interest in stable prices, low unemployment rates, and stable economic growth.

The main problem of the national leaders is achievement of these goals. Particularly in an environment of highly concentrated industry and associated labor union power, the task of designing policies is extremely difficult.

The main advantage claimed for a floating exchange rate regime is that it frees governments to pursue their domestic policies without any balance-of-payments constraint. If you take that advantage away from flexible or floating rates, you might as well not have them.

Why, then, have we acted as if we are still on a fixed exchange rate system?

Well, like the original Bretton Woods system, the present one has not behaved as intended. Under Bretton Woods the so-called adjustable pegs were never adjusted. Under floating rates, the rates do not float. The rates are managed in two ways. One, by continuous intervention by various monetary authorities in the exchange markets and two, by assigning commercial, fiscal and monetary policies the role of pushing domestic economies in directions favorable for an exchange rate target.

Unfortunately, the use of domestic policy to meet exchange rate goals eliminates the singular advantage of flexible exchange rates.

Why has this condition developed? I think Mr. Burtle went a long way toward explaining it.

The answer is found in the continued, persistent, and determined multiple use of the dollar as a unit of account, trading vehicle, and reserve currency. Also, the current conditions are in part caused by some defects of floating exchange rates which even many academic economists were unaware.

The way the dollar's price falls does not matter as much to foreign governments as the fact that it falls at all. Ultimately the outcome for traders and bankers is the same, whether you have depreciation or devaluation.

Exporters do not want to sell less to the U.S., foreign bankers do not want their dollar assets to depreciate in value. Therefore they attempt to interfere or change domestic policies to conform with the required exchange rate.

Despite this intention to modify the exchange rate, neither the U.S. Government nor the foreign central banks have much of a chance of controlling the dollar's exchange rate through foreign exchange market intervention. There are simply too many dollars outstanding held in foreign balances. The dollar overhang is too great. And so we need the mopup operation.

Within the new system, the Carter administration has turned to the same policies that were followed in prior administrations when we had fixed exchange rates.

Therefore, the theoretical attractiveness of floating or flexible exchange rates is tempered by: One, the historical circumstance of the dollar overhang leading to great instability; two, uncontrollable forces such as OPEC, strikes, riots, wars, threatened wars, famines, Watergates and so on; three, flexible exchange rates at the option of national governments offering the irresistible temptation to intervene and set exchange rates which accommodate national economic and political demands.

Now, there is a domestic policy connection. The U.S. domestic conditions relative to the domestic policy alternatives only makes matters even worse.

First, we have the energy crisis—about which I do not have time to go into detail. Second, we have American stagnation, the simultaneous existence of inflation, unemployment, and slow production growth.

This condition stems in great part from highly concentrated corporations controlling industrial markets and from powerful labor unions.

The Fortune 500 accounts for about 65 percent of U.S. industrial sales and 75 percent of total industrial employment. Even within the 500, the largest 50 corporations account for more than one-half of the group's manufacturing sales.

One to four corporations in most major industries—telephone equipment, motor vehicles, computers, petroleum, refining, drugs, soaps, industrial chemicals, aircraft, aluminum, copper, tires and tubes, photocopying, beer, cereals, appliances and so on—control the relevant market.

Such corporations use full-cost pricing. That is, they have a fixed or variable markup over prime costs—wages and raw materials. An increase in the price of a raw material such as oil—whether it comes from at home or abroad—can be passed on to the consumer. So too, wage increases can be passed on as higher prices.

Senator TSONGAS. Let me inquire why are we any different from Japan in that situation?

Professor CANTERBERY. I am sorry, I didn't quite—

Senator TSONGAS. The situation you described is not unique to the United States.

Professor CANTERBERY. No, it is not. The social and policy reactions have been different in different industrialized countries. The response in Sweden has been much more effective than here. They have more informal, semiplanned relationships between large corporations and government.

In the United States the Carter administration has chosen voluntary wage and price guidelines. Voluntary guidelines simply do not work because each corporation is waiting for the other one to drop the same shoe. The same is true with the labor union. With this policy failure, we have attempted to substitute traditional Keynesian demand management supplemented by traditional monetary policy, to raise interest rates and slow down the growth of the money supply during periods of rising prices, even though the unemployment rate can be, is often quite high.

This kind of policy approach, demand management, does not work when rising costs or profits produce inflation.

Thus, the defects in the American scene come from the kinds of policy reactions that we have had in relation to the condition of a highly concentrated industrial sector confronting monopoly-type union power.

Senator TSONGAS. I hesitate to ask you what policies you recommend.

Professor CANTERBERY. Well, if you did, I could not resist replying.

I would simply say that it is a very difficult situation. We have to reorient our thinking about the American enterprise system. That is, we have been thinking of it traditionally as little shopkeepers and small manufacturers competing intensively in the marketplace and then the consumer benefiting from the low prices that emerge from such competition. During the period we had such competitive enterprise we gave the corporation a lot of special privileges. Then as a result it grew very large. These are privileges that ordinary individuals could not have, such as immortality.

Then, because the corporation became so powerful against labor we, through Congress, allowed unions to be effectively organized through union shop arrangements in order to confront the large corporations.

Now corporations and unions have grown to the point where they have immense power without the attendant responsibilities. Therefore, we have to reassess our social contract with them. We have to reconsider whether we want to leave the statutes intact to protect the corporation, protect the union—and both. Consumer sovereignty that went the way of competitive markets can be restored only through the political process.

First, I would empower the President, with the advice and consent of the Congress, to appoint public representatives to the executive decisionmaking group, the management group of each of the 1,000 largest corporations, These public representatives would be

actively involved in the major price, investment, and product innovation decisions, all the major decisions of those corporations.

Second, I would recommend an investment planning council or board that would oversee the entire industry in each case. This would not involve many firms in each industry. This investment council would plan the longer run policies of the industrial group, the group that controls that particular manufacturing process, such as the production of automobiles, steel, or petroleum.

This may sound like an extreme proposal, though when I think of the alternatives I only come up with more extreme suggestions such as mandatory, very harsh price and wage controls, which would be very disruptive to the equitable allocation of resources and incomes.

Senator TSONGAS. Of course from a purely practical point of view, the question would also involve who gets appointed by whom and what their philosophies might be. Could you imagine Ronald Reagan as President of the United States appointing someone to sit in one of these positions? I suspect you would not see major change.

Professor CANTERBURY. Then it would be a determination of the democratically controlled Senate as to whether they would approve such an appointment.

Senator TSONGAS. Democratically controlled Senate?

Professor CANTERBURY. Well, I have been under that illusion.

Senator TSONGAS. Conservatively controlled coalition, as you must realize.

Professor Canterbury. The selection of a person for such a task, and the selection of any Cabinet officer or Supreme Court member carries the same risks. If the President and Congress cannot make reasonable appointments, then all hope is lost in any case.

Senator TSONGAS. In that case why not continue with the testimony.

Professor CANTERBURY. OK. This covers, by the way, a good part of my planned testimony.

In any case, within this structure of highly concentrated power groups and failed traditional demand management policies, the industrialized economies have developed a new policy tool—incomes policy. As I just articulated, the particular U.S. version of this policy, voluntary wage and price guidelines, also has failed. So it seems a paradox that the United States has opposed any fundamental ongoing international monetary reform because it feared giving up some of its sovereignty. Yet we have given up considerable sovereignty over domestic economic policy by making monetary policy do precisely what we want it to do to control exchange rates but not to stabilize the domestic economy. In particular higher interest rates have been used for this purpose.

At the present, interest rates are more than twice that of most of the leading European countries.

How can the current situation be improved? International monetary reform must go beyond the vague IMF amendments of 1976. Reform must extend to the exchange rate mechanism as well as to the liquidity mechanism; the two, of course, are interrelated.

International monetary reform requires leading ourselves away from the dollar and toward a faceless world currency. A feature of

my own plan is the worldwide extension of the concept of new European monetary unit. The European initiative should provide excellent incentive. True reform, however, requires a rejection of all proposals to return to a narrow band exchange rate system and rather adoption of a new type of limited exchange rate flexibility that has the advantages of fixed and floating rates without the most injurious disadvantages.

With a born-again narrow band we would be stuck with the same monetary policy considerations that we had under that system and, for that matter, under the current floating arrangements. Thus, an adjustable peg system requires some politically safe mechanism for causing enabling nations to adjust whenever international conditions warrant.

Successful limited exchange rate flexibility involves the following items. One, short-run exchange rate variations sufficient to create uncertainty among speculators. Two, long-run par value changes sufficient to alter effective international prices significantly and thus tend to reduce trade deficits, but administered in a way to minimize speculative capital flows.

Three, assured international reserve growth rate adequate to defend par values. Four, a strengthened role for the International Monetary Fund in order to wrest the political responsibilities and also political repercussions of par value adjustments from the exclusive hands of national leaders. A wide SDR band would meet these requirements.

However, the SDR has to be made more of a truly international money for an adjustable peg geared to the SDR. One task of monetary reform, therefore, would be to enhance the prestige of the SDR. This could be done in four ways. One, the complicated circular calculation of the value of SDR in terms of the market basket of currencies, heavily weighted in favor of the U.S. dollar, should be discontinued. In fact, I never understood why it was done in the first place.

Par values should be expressed in terms of the SDR in the same way we once expressed exchange rates in terms of gold. Such an SDR valuation would facilitate its widespread use for accounting purposes and the familiarity should enhance its stature.

Two, the interest rate on SDR's should be made competitive with American Treasury bill rates. Three, the IMF and U.S. Treasury should cease selling gold. Four, the IMF should exchange SDR's for official gold holdings at a substantial discount in order to reflect the interest-earning features of the SDR and the IMF's view that gold is overpriced.

The universal use of the SDR-denominator would allow increased control of the U.S. dollar exchange rate as a means to influence capital flows, allow a wider permissible band of fluctuations to exchange rates and enhance the prestige of SDR's as an international unit of account which in turn would encourage the use of other currencies besides the dollar for intervention purposes. Central banks could draw dollars or whatever through their SDR balances at the IMF.

Once we have the enhanced SDR stature, we would move to a wide SDR band. Par values would be reinstated and expressed directly in SDR's. Then a wide band of variability of exchange

rates, I would say 3 percent either side of par, would be imposed. With a sufficiently wide SDR band, investors still would be encouraged to protect themselves, and so would importers and exporters, from exchange rate risks by entering the foreign exchange rate market. This feature of a floating system would be retained. The actions of such risk avoiders, of course, has the effect of limiting capital flows.

A wide SDR band, therefore, would diminish the narrow band disadvantages. Beyond such benefits there would be a bonus to the widened band. The exchange rate movement should be sufficient to alter the effective price of competitive commodities such as wheat, so that some reductions in any deficits or surpluses would accompany exchange-rate variations within the band. Again, this advantage claimed for floating rates would be retained.

We still have a problem when the upper or lower limit to the wider band is reached. We would have to have an IMF amendment which would be workable, in the sense of causing par values to actually be altered. I have suggested the idea of the delayed peg. The delayed peg would be triggered to change par values when the upper or lower end of the band is violated for a certain period. This band violation could be defined in terms of reserve losses by deficit notions or accumulations by surplus nations. The exact indicator used for a change in par values would be subject to negotiation. I have simply suggested that reserve changes per unit of time would be an appropriate objective indicator.

When the band is moved, the violated limit would become the new par value. This new par value would be supported for an indefinite period in order to fool speculators. Then it would be unclear to speculators—when the rate is left free again within the new band—whether the exchange rate would go up or down.

It may be necessary to change the band a number of times in a short period because of the degree of pressure on the dollar, or on any particular currency.

An important feature of such a delayed peg would be the specification of mandatory or semi-mandatory changes. In other words, the IMF articles of agreement would be amended to include a general procedure and specific objective indicator for par value changes.

There could be various bands within this time span in which negotiations between the affected government and the International Monetary Fund could take place prior to the change in par value. Generally, however, there would be some kind of objective indicator which would be mandatory in the sense that once a certain amount of reserve attrition or gain had been reached, the band would then have to be changed even though the precise timing or definition of the trigger would be negotiable between the International Monetary Fund and the effected country after each par value alterations.

The importance, from the standpoint of domestic policy, of the delayed peg is that it would allow some time for adjustment in domestic economic policies by the affected nation. We simply cannot change productivity, alter wage rates, and dampen or inspire consumer demand fast enough under floating rates. The delayed peg would give some breathing space to the affected govern-

ments and they would have a greater discretion regarding how much dampening or stimulation of the domestic economy they would want to undergo over what length period in order to avoid the par value change, or further reserve attrition or gain.

Now we return to the issue of sovereignty. Current IMF surveillance is meaningless because the IMF has no specific corrective powers. This is why the IMF amendments resulted in no significant change in the policy practices of members. In fact, the amendments told the members they can do whatever they want. In order to fill this power vacuum we would have this mandatory arrangement under a semi-automatic market rule for changing the par values. Sanctions beyond this, such as freezing SDR assets or IMF credits would be required.

Senator TSONGAS. Let me inquire at that point, the system strikes me as being quite complicated is it not?

But, second, on what you said on page 1 about the psychology of people willing to make changes, why would any country submit itself to this kind of system at this point in time?

Professor CANTERBERY. Well, I would think that a country would prefer to have more autonomy in terms of its domestic economic policies.

In other words, I would think that this nation would prefer that interest rate change be used for domestic stabilization purposes. For example, a few days ago the Federal Reserve indicated the desire to get interest rates even higher, because of international considerations.

I would think that this country would want to regain control over its domestic policy instruments, particularly monetary policy. As I have suggested, we have given up sovereignty in the monetary policy area, and it is shortsighted of us not to see that the only way we can regain that sovereignty is give up a modicum of it in the area of exchange rates which indeed should be less important to us—much less important to us than domestic economic stabilization.

In fact, if the United States and each of the major nations in Europe and Japan follow appropriate economic policies, design them appropriately, and use all the instruments accurately, then you do not have to worry about exchange rates anymore.

So the delayed peg system would provide an extra incentive to each of the countries to perform more effectively and efficiently in terms of domestic economic stabilization.

Senator TSONGAS. Isn't it a kind of—

Professor CANTERBERY. Utopian—

Senator TSONGAS. No, a kind of tail-wagging-the-dog phenomenon? I think in the United States, assuming that our policies domestically are determined by international obligations in reality, rather than balance-of-payments problems, it's a domestic-oriented economy, as opposed to European-oriented economies.

Professor CANTERBERY. Certainly, in the United States, we pay far too much attention to international monetary affairs relative to what movements in Europe, particularly in regard to exchange rates, can do to our economy.

But the reason for that is because of our role as international banker, because of the role of the dollar as international reserve currency.

We feel somehow the stature of the country will be diminished if the dollar declines. We associate the strength of the country with the international value of the dollar which, in fact, is exactly backwards. The value of the dollar is strengthened by the country being strong, not the other way around.

Maybe we are a little more sensitive about that, because of our relative economic decline, vis-a-vis Japan and Europe.

I don't know.

Britain behaved the same way with the pound over a long period. It was willing to do almost anything to pump up the value of the pound in international financial markets long after it made any sense to, in terms of Britain's domestic economic goals. This is so, even though the external value of the pound was far more important to England than the dollar is to the United States.

Senator TSONGAS. That's right. I mean I don't think it's fair to suggest the United States has the same kind of emotional commitment to the dollar that the British had to the pound.

Professor CANTERBERY. Well, I have been reading speeches from the Treasury and the Federal Reserve. I often have the impression that they feel that a strong dollar is necessary to the continuation of the present system.

I realize that there was great forbearance on the part of the Carter administration during the—I'll call it the meltdown of the dollar, that ended in late October, 1978.

Obviously, the Administration intentionally abstained from supporting the dollar. But it was under so much pressure from European and Japanese leaders that the administration then massively intervened, using \$15 billion of funds and credits over a 2-month period to stabilize the dollar under a "floating" exchange rate system. So we yielded sovereignty under duress in a crisis, and now we are back with the dollar-as-a-reserve-currency mentality again. Having once saved the dollar by clever financial manipulation, the Treasury and Federal Reserve feel that they can save it every time.

I seriously doubt that they can.

They went through 50 percent of their emergency package of credits and funds in only 2 months and, therefore, they could do the same thing, over a similar 2-month period, if they tried to support the dollar, if it began to fall in a reaction to the current domestic inflation rate and foreign oil dependence.

Senator TSONGAS. Why don't you run through the rest of this, since I may have to leave.

Professor CANTERBERY. There are just a couple other points I wanted to make. The others were in response to your questions.

The volume required of official international monetary reserves to finance trade growth under the delayed peg would be smaller than under the old Bretton Woods system and, indeed, would be much smaller than under the current managed floating exchange rate system, despite the fact that the floating exchange rate system supposedly requires zero foreign exchange reserves.

We still, therefore, need some provision for added growth in official reserves. I suggest that the growth in the role of the SDR,

would be appropriate, because an international currency is the best reserve asset and the money's growth is not dictated by pure national interest or by the vagaries of mining technology and the fixed endowment of raw gold.

Therefore, in addition to gold conversions to SDR's, which I would recommend, the current excess of official holdings of dollars also should be convertible to SDR's, through a substitution account to reduce the dollar overhang which from time to time has threatened to destroy the system.

The reform initiative has now passed to other governments, as most of the members of the Common Market are moving into a plan very similar to the delayed peg to stabilize currencies of nations and hence trade among them.

The effect of this new arrangement is likely to be even slower economic growth for Europe, in what Germany considers to be a fair trade-off for greater economic stability. From the point of view of the United States, this is unfortunate, because it will worsen our trade balance. Moreover, the existence of a new reserve substitute invites the dumping of dollars.

Senator TSONGAS. Isn't Europe more sensitive to instability and inflation than we are, just because of their history of violent swings in inflation rates?

Professor CANTERBERY. I think Germany is. The natural German tendency is toward conservative fiscal and monetary behavior and policy. This is not so much the case for Great Britain, nor for France.

But we are coming to a point in this country where we are getting to be very sensitive to inflation, because inflation is becoming such a problem, particularly in terms of the inflation of necessities.

Inflation in prices of food, clothing, shelter, medical care, and also fuel which we all need to get to work.

That is, if inflation continues at the present rate—I am talking about 10 to 15 percent a year it could wipe out most of the middle class in this country. The middle class is losing its discretionary spending power, having to divert what would ordinarily be discretionary spending into necessities. What is worse, many of those items once thought discretionary are viewed now as necessities. Thus, the powerful labor unions demand wages to avoid a decline in members' minimal and customary standard of living. As such demands are met, it only heightens the inflation rate.

The political sensitivity to inflation is mounting with each report about the Consumer and Wholesale Price Indices. In the first quarter of 1979, according to the National Center for Economic Alternatives, the price of necessities rose twice the rate of nonnecessities'.

I realize that popular wisdom seems to favor a do-nothing Congress these days, and some would say, "Well, Congress should do what it does best: that is, nothing."

In times of crisis, however, the most distinguished Members of Congress tend to rise above the public pessimism of the crowd. Such leaders make the transition by showing how significant problems can indeed be solved with fresh approaches.

Problems, therefore, become opportunities.

There have been a few times, both in terms of domestic policy and international monetary policy when we have had such abundant opportunities.

Senator TSONGAS. Well, let me just respond as one Member, I share your view that even though the country is demanding the Congress do nothing, that's probably no answer to long term problems. As one who was interested in this field when I was on the House side, in the year and a half before I sought to get over here, I do intend to be involved and will be more so as time goes on. I appreciate your being willing to come here today. I apologize for the lack of attendance on the part of the other members but the Senate is in session and arguing over the military budget, which clearly in their minds has a greater priority.

The questions will be submitted to you but I would also ask whether Mr. Burtle could respond to the specifics of what we have just heard. Not only the grand design but also the details that have been outlined. Would that be possible?

Mr. BURTLE. You mean Professor Canterbury's?

Senator TSONGAS. Yes.

Mr. BURTLE. I agree with much that Professor Canterbury has said, particularly with respect to international monetary reform. Let me just comment briefly. My own feeling is that, insofar as the structure of the U.S. economy is concerned, it really is not different enough from other countries to account for the international monetary problems that we have been having. I would think if we got away from trying to be the world banker, that, while most of those problems would remain, they would not make it impossible for the world monetary system to function.

Now on the question of having controls over the extent to which exchange rates should fluctuate, I myself tend to be skeptical about these. Whenever a hedger sees—and I use the term "hedger" advisedly because I think many people called speculators in the foreign exchange market are really trying to protect themselves from loss—they see some kind of a rule that says if the exchange rate moves so far then the peg has to change or the changes in the exchange rate will be suspended for so long, it seems to me all those rules tend to undermine a particular parity rather than to really support it.

I would say that even for the European Monetary System. It is rather vulnerable to falling apart unless the monetary policies of the countries become the same. Of course, if they start behaving as one country with essentially one monetary system, then they can have one exchange rate. But already we have had two developments that would seem to point in the other direction: First, they have what they call in the system a divergence indicator, that's supposed to show when the currency has gone too far in relation to the others. And already that indicator, after being spelled out in a great amount of detail, has had to be changed temporarily in order to avoid activating the system because one of currencies, the Belgian franc, depreciated too much. But they decided that this was a special situation.

The other development has been the statement that the German Central Bank has been making to almost everyone that they certainly are not going to support other currencies in the system. And

if a currency in the German central bank view becomes basically weak, it will simply have to change its parity.

So I feel that any system of floating according to some kind of a rule will be subject to all kinds of loopholes being found out almost immediately and the rule will break down.

I think insofar as you are going to try to control the possibility of exchange rates being too volatile, that is best done by central bank intervention and perhaps there is some possibility of also having IMF intervention. I don't exclude the possibility that if a certain currency is suddenly in great demand for what seems to be a rather temporary reason then central banks or the IMF might put more of that currency on the market. Or if on the other hand a country's currency—as, for example is unloaded too much, perhaps because of some temporary difficulty as was true with Japan in the '20s, when the yen devalued because of an earthquake—then there is an argument for some authority buying up that particular currency temporarily.

I have commented on only a few of the points raised here, but these are the ones where my emphasis would be different from Dr. Canterbury's.

Senator TSONGAS. Well, I think no matter what scheme we have seen, whether it's the fixed rates or exchange rates or floating rates or whatever, that none of the systems have worked out in practice as they have in theory because of national self-interest concerns and so forth. There is no reason to expect that's not going to continue in the future.

Professor CANTERBERY. Could I just add one thing? Mr. Burtle's criticism really applies to what is called the crawling peg where it is known in advance how much the par value would change and usually over what period. The delayed peg does not have that characteristic because the exact trigger for the movement would be kept secret by the International Monetary Fund and the affected government. Speculators would have no way of knowing for certain how much of a change in international monetary reserves could occur before the par value would be altered.

Even if they knew that, they would not know precisely when the change to the new band would occur. There would be the delayed action between the time that a decision to change the band is made and the time that the exchange rate is freed within the new band again.

So I have taken into account in the delayed peg, these criticisms which I myself and John Boorman directed in publication many years ago—The Canadian Economic Journal, May-June 1971—in fact, to the crawling peg.

Senator TSONGAS. You really think in practice you could devise a system that complex and have it still work?

Professor Canterbury. I think that it requires not only good faith on the part of governments but a close negotiating relationship between the national governmental authorities and the executive board, or whatever committee makes the decisions, in the International Monetary Fund. The exact timing of par value changes—would be on a managed administrative basis so that adjustments can be made to take into account counterspeculation. It would be the kind of relationship that we probably have not had between

national governments and the International Monetary Fund but one which should be developed.

Senator TSONGAS. Had those relationships been there, of course, we might not have the problems we have today.

Professor CANTERBERY. Precisely. I think the IMF-centered delayed peg system is a way of spurring nations to move national behavior closer to the ideal. Once they adopt the habit, perhaps we will not need the semiautomatic rules any more. In fact we could promptly move to the SDR, as the international currency for transactions in international trade—have a world economy.

Senator TSONGAS. One of the questions that we are going to submit, and I do have to get over to the other committee, is what the response would be to this kind of notion by the other major industrialized countries.

Professor CANTERBERY. The European nations have already responded. They have done pretty much what I have suggested.

Senator TSONGAS. I mean to go beyond that to a worldwide system.

Professor CANTERBERY. To a worldwide? Well, I think the United States would be very persuasive in any serious reform movement because we do have such a large quota in the International Monetary Fund, so many votes. And I think we would be critical in gaining the allegiance of so many allies in Europe. I would think if the United States set out a position statement on international monetary reform, it would be very influential with these nations and with the International Monetary Fund. In fact, I am puzzled that we have held back so long.

Senator TSONGAS. So your answer is that it would be acceptable to them only if the United States exerted leadership and persuasiveness. Not inherently in their own interests to do so?

Professor CANTERBERY. It is in the interests of Europe and Japan to maintain stable economic relations and to grow apace. Some nation has to take the leadership just as with the establishment of the European monetary system it was the German and the French governments who exercised the required leadership. It would not have been established without that kind of leadership, particularly from Germany, which is going to be the focal point or the center around which the system revolves. I have difficulty in envisaging an international monetary system in which the United States is not a major factor both in its establishment and in its operation.

Senator TSONGAS. I think on that, we'll recess. We appreciate your coming. Thank you.

The committee will be in recess.

[Whereupon, the committee adjourned at 11:45 a.m. subject to the call of the Chair.]

[Complete statements of Mr. Burtle and Professor Canterbury and additional documents follow:]

STATEMENT OF JAMES BURTLE
VICE PRESIDENT IN THE ECONOMICS GROUP,
W. R. GRACE & CO.

Mr. Chairman:

I very much appreciate the opportunity to be here. Of course, the viewpoints expressed by me are my own personal viewpoints and do not necessarily represent positions of W. R. Grace & Co. or any of my colleagues.

I have been asked to comment on the international reserve role of the dollar, U.S. exchange rate policy, gold, SDR's, the substitution account proposal and Eurocurrency markets. This apparently disparate group of subjects can be brought into focus by first considering the international reserve role of the dollar. The basic trouble with the U.S. in the international monetary system is that we are like a general store that opens a bank on the side. The commingling of banking and trading means that the store can lose money for an extended period but, nevertheless, can be kept afloat by bank deposits. On the other hand, when there is a run on the bank, the store must have a fire sale in order to keep the bank liquid. Just as the store is obliged to cut prices, we had to let the dollar depreciate.

Against this background, the system of managed floating has been subjected to criticism because of the wide swings in exchange rates. I believe, however, that exchange rate changes can usually adjust trade and long term capital disequilibria, but they cannot

equilibrate violent changes in the composition of reserve assets. If a bank and a general store are run as one business and there is a run on the bank, cutting prices in the general store is an ineffective way of protecting the bank. But the problem is not really with the price system implicit in floating exchange rates. The problem is with the world monetary system that uses the debt instruments of one country, namely the United States, as the reserve assets of other countries. When these debt instruments, mainly U.S. Treasury bills and claims on U.S. banks, become suspect, there is a scramble to convert out of dollars into other currencies or gold. This tendency was strong last year and could have been a disaster if the Treasury in November had not acted decisively to defend the dollar.

Since November 1 the dollar has strengthened against most currencies. There could be a further improvement this year if the economy slows thus restraining imports, and if the depreciation of the dollar that has already taken place is a stimulus to U.S. exports. But it would be pollyannish to imagine that this improvement in the dollar will lead us to a new era of no more international monetary difficulties. Instead the old saying that Europe is in bad trouble whenever the U.S. sneezes may be reversed with the U.S. in trouble whenever Europe and Japan

sneeze. We have this vulnerability not primarily because of any perverse trade or structural relations with Europe or Japan. Suppose that no one bought or sold dollars except for goods and services. Under these conditions I believe deficits in the U.S. current account balance could be handled easily by the foreign exchange market. But any serious disequilibrium in the U.S. role as a trader now has an immediate impact on its role as a banker.

This greater vulnerability of the U.S. in its banker role to a run on the bank is central and critical. It arises not just from the rise in dollar liabilities abroad. It arises from institutional changes. The management of central banks in less developed countries is no longer less developed in financial sophistication. No longer will they sit and take losses on dollars with equanimity. Moreover, the emphasis on portfolio management as taught in every business school is beginning to effect the policies of most central bankers. They are asking themselves why most of their reserves are in dollars when a balanced currency portfolio would be less vulnerable to losses.

Against this background of short run improvement but longer run vulnerability for the dollar the U.S. Treasury should act from a position of greater strength to reduce the U.S. role as a world banker. U.S. liabilities

abroad should be reduced and funded to the point where they are sought after rather than merely tolerated. The measures that should be taken to achieve this goal involve a wide range of technical questions. But the broad outlines of policy are clear. We should continue selling gold in order to mop up additional dollars. I do not understand why the Treasury reduced its gold sales last month. We should back proposals for a substitution account in which SDR's would be exchanged for short term dollar obligations for which the U.S. might trade long term bonds to the IMF. We should work for an international agreement imposing reserve requirements on Eurodollar banks so that dollar deposits abroad do not become a pyramid often built on redepositing by central banks.

It should be emphasized that all of these institutional changes are not going to stabilize the dollar if the U.S. is following a policy that is excessively reflationary or if Europe and Japan are following policies that are excessively deflationary. In response to such policies exchange rate adjustments will be required. But under the present system everyone is punished too severely whenever there is a disequilibrium in world payments. Because dollars held abroad in reserves are unloaded often with dramatic suddenness, fluctuations

in the dollar are much more volatile than what would be required if the U.S. did not have the role of world banker, a role that is becoming unnecessary and unwanted in a world that will no longer tolerate the U.S. paying its way by simply issuing more liabilities.

If one accepts the premise that the U.S. should not be a world banker, the question then arises as to how to mop up the excess dollars that have been accumulated abroad (1) partly because U.S. balance of payments deficits have been too much and too often and (2) partly because the Eurodollar market has permitted the further multiplication of claims on the U.S. For the broom closet of international finance a number of mops have been proposed.

One mop is to permit the dollar to devalue so much that the U.S. current account balance would improve sufficiently to repatriate excessive dollars abroad. This would be a burlesque of the basically sound idea of floating exchange rates; such an extreme drop in the dollar would disrupt business planning, would be a disaster for companies and individuals with debts in strong currencies and, via steep rises in import prices, could set off a vicious circle of inflation and more devaluation.

Another mop is the proposal, usually associated with Jacques Rueff, to raise the price of gold sufficiently

to buy up dollar reserves abroad. The world would move back to some approximation of the gold standard. My own view is that the gold standard cannot work in the 20th century but that gold sales at market prices, as is now being done by the U.S. Treasury, can contribute significantly to the mopping up process.

Another mop is the sale of long term bonds abroad denominated in dollars. However, in the highly unified world money market today such action would be nearly equivalent to selling long term bonds in the U.S. As more bonds are sold and the price of long term bonds falls, U.S. long term interest rates might be pushed higher than would be consistent with reasonable levels of investment, income and employment. It might be possible, however, to issue non-marketable long term dollar bonds to central banks, but it is doubtful that they would accept the exchange risks of such a transaction. It is interesting that the issue of foreign currency bonds, as announced in the Carter program of November 1, is the opposite of a mop up operation since the amount of dollars abroad is not changed while other currencies abroad are made scarcer. In this case, however, the build-up of a kitty to defend the dollar had a strong pro-dollar effect because of the threat that it would be used massively for dollar defense.

The more rapid expansion of Eurodollars compared with short term dollar assets in the U.S. money market

seems to indicate that Eurodollars have a greater multiplier because they have no reserve requirements. Insofar as Eurodollar deposits are in affiliates of U.S. banks the straightforward answer is that they should be subject to the same reserve requirements as U.S. domiciled banks. However, the U.S. has no authority to impose reserve requirements on Eurodollar deposits in foreign banks. In order to apply reserve requirements to these deposits an international agreement may be required. In any event, a high level committee should be appointed by leading governments to consider measures to restrain Eurodollar expansion.

Finally we come to the possibility of mopping up of excess dollars by means of an SDR substitution account. This is, in my view, the most effective action that could be taken to get the dollar away from its reserve currency role, i.e., to get the U.S. away from its role as banker of the world. The substitution account might involve the IMF exchanging SDR's for dollars. Dollars taken by the IMF could be funded by the IMF purchasing long term bonds from the U.S. While SDR's are some times called "paper gold" this term has suffered from connotations of alchemy. It is better to think of SDR's as simply a mutual agreement among participating countries that they will in effect make specific values of goods or services or capital assets

available to each other on demand. These values are stated in SDR's which are calculated as a weighted average of different currencies. SDR's can thus serve as a substitute for the dollar, other currencies or gold in a country's reserve position. When SDR's were first issued it was expected that world reserves would be inadequate as the U.S. balance of payments improved. This expectation went wrong: the U.S. balance of payments deteriorated and dollars flooded the world. Thus the SDR should now be viewed not as an addition to world liquidity but as a substitution for dollars in world reserves. Once SDR's are substituted for dollars in reserves there should not be a problem of central banks diversifying reserves when a particular currency becomes prone to devaluation. Since the SDR is a basket of currencies, there is a strong tendency for its value to remain relatively steady because a decline in one exchange rate will be offset approximately by a rise in other exchange rates.

The above appraisal of methods for mopping up excess dollars abroad is, of course, tentative and subject to modification on the basis of further study and experience. What is crucial is that the U.S. Treasury should recognize that attempts of the U.S. to continue the role of banker of the world are becoming increasingly prejudicial to world monetary stability.

PREPARED STATEMENT OF E. RAY CANTERBERY,
PROFESSOR OF ECONOMICS, FLORIDA STATE UNIVERSITY :

MAY 3, 1979

Mr. Chairman and Members of the Committee, I thank you for the invitation to testify.

International monetary reform is opposed by central banks and governments during two conditions. (1) During an international financial crisis, it is argued that long drawn-out negotiations will deepen the crisis. (2) When there is no crisis, it is agreed that the system is working perfectly and reform is unnecessary. Today, we are between these two conditions. There is no financial crisis--though one could emerge any day--but the system only appears to be working well. Federal Reserve preoccupation with higher interest rates, concern with a balanced Federal Budget by the President and the Congress, and the U.S. Treasury's intensive trading in the Exchange Stabilization Account belie stability. Thus, it appears a good time to consider further reforms.

An ideal international monetary system is one in which nations individually can pursue their own domestic economic social goals without continuous concern with what the required policies do to the short-term international value of these currencies. In an interdependent world, however, no international monetary system can survive greatly divergent economic growth or inflation rates among its dominant members. A congenial and viable international system, therefore, requires that necessarily interdependent

nations relinquish some sovereignty whereas domestic political reality requires that it not be "too much." In the sophisticated industrialized nations, this delicate balancing act can be achieved if indeed each nation's goals be realized. One rarely encounters a modern leader who does not express an interest in stable prices, low unemployment rates and stable economic growth. The main problem is--given the highly concentrated industrial structure and the associated labor union power--the design of policies to achieve these objectives.

The main advantage claimed for floating exchange rates is that it frees government authorities from the balance-of-payments constraint on domestic policies. A country then can undertake whatever measures necessary to accomplish domestic goods without worrying about international consequences and the recessionary or inflationary policies of its trading partners need not upset the domestic apple cart. Why, then, has the U.S. deficit persisted under floating rates? Why, then, does virtually every policy pronouncement from the U.S. Treasury, the White House and the Federal Reserve express a concern about international money markets? The reasons, in our interdependent world, are in part domestic. However, they also relate to the failures inherent in the present international monetary system.

Defects of the Current Managed Flexibility

Like the original Bretton Woods system, the present system has not behaved as intended or hoped. Under Bretton Woods, the so-called adjustable pegs were never adjusted. Under floating rates, the rates do not float. They are managed in two ways: (a) by continuous intervention on stabilization

accounts in the United States, Europe and Japan and (b) by assigning to commercial, fiscal and monetary policies the role of pushing domestic economies in directions favorable for a desired exchange rate level. Unfortunately, the use of domestic policy to meet exchange rate goals eliminates the main advantage claimed for flexible exchange rates. The United States was pressured into this dilemma by the European and Japanese authorities who do not want further depreciation of their huge dollar reserves.

The first major test of the floating regime came with the tripling of the price of oil during 1973. Bankers began to call for "corrective strategies" by the United States, such as tighter fiscal and monetary policies and a slowdown of energy imports. The responsibility for guaranteeing that the dollar would not depreciate was again thrust upon the United States.

Why has a condition developed under "floating" exchange rates that is identical to that under the felled fixed-exchange-rate regime? The answer is found in the continued multiple role of the dollar as a unit of account, trading vehicle, and reserve currency, as well as in some overlooked defects in a flexible-exchange-rate system.

The way the dollar's price falls does not matter as much to foreign governments as does the fact that it falls at all. A dollar which is devalued under fixed exchange rates depreciates under floating rates. Ultimately the outcome for traders and bankers is the same.

With about \$500 billion held in banking balances outside the United States, neither the U.S. authorities nor the foreign central banks have much chance of controlling the dollar's value through foreign exchange market intervention. (The United States has only \$7 billion in liquid international reserves augmented by a \$30 billion emergency fund.) Within this system the Carter administration must turn to the same policies followed by prior administrations under fixed exchange rates.

Therefore, the theoretical attractiveness of floating exchange rates is tempered by the facts that: (a) the historical circumstance of huge dollar reserves introduces an uncommon element of instability; (b) uncontrollable forces (OPEC, strikes, riots, wars, famines, Watergates, and so on) cause sharp and unpredictable movements in exchange rates and; (c) flexible exchange rates at the option of national governments offer the irresistible temptation to intervene and set exchange rates which would accommodate national economic and political demands.

The Domestic Policy Connection

United States domestic economic conditions relative to the domestic economic policy instruments applied only makes matters even worse. American stagflation--simultaneous inflation, unemployment and low real production levels--stems in great part from industrial concentration and union power in such industries. The Fortune 500 accounts for about 65 percent of industrial sales and 75 percent of total industrial employment. Even with the 500, the largest 50 corporations account for more than one-half of the total sales revenue of the group. One to four corporations in most major industries--

telephone equipment, motor vehicles, computers, petroleum refining, drugs, soaps, industrial chemicals, aircraft, aluminum, copper, tires and tubes, photocopying, beer, cereals, appliances and so on--controls the relevant market.

Such corporations use full-cost pricing. That is, they have a fixed or variable mark-up over prime costs (wages and raw materials). An increase in the price of a raw material such as oil--whether it comes from at home or abroad--can be passed on to the consumer because of the corporation's market power. Their management can acquiesce in wage demands from powerful unions with the prospect of passing the wage cost along to the consumer. A falling price for the dollar to foreigners allows American producers in concentrated industries to raise their prices, which has the effect of modifying or reversing the otherwise favorable impact of a declining dollar on the U.S. balance of payments.

Within this framework, in which the traditional market mechanism fails, orthodox tight fiscal and monetary policies cannot slow the tide of inflation unless the authorities are willing to inflict a deep depression (such as the Great Recession of 1974-75) upon the American society. The reasons are simple. (a) Giant corporations can rely on profits growth for investment funds and can forego borrowing when interest rates are high. (b) Even as demand slackens and sales revenue begins to decline, the firm with market power can make up the revenue loss by raising prices. (c) The main impact of tight money and higher interest rates is to simultaneously depress the construction industry, raise construction prices, and therefore

reduce that part of output while raising the wholesale and consumer price indices (the latter weighted heavily by housing). (d) If fiscal spending cutbacks become so large that the direct sales of large corporations drop sharply, the corporations adjust, not by lowering prices, but by reducing production and employment. (e) If the slump in employment is sufficiently deep, consumer sales declines will eventually lead to no further price increases because unemployed workers have little income.

It is this structure of the industrialized economies that has led to the development of a third domestic policy tool, incomes policy. In an economy geared to a wage-price spiral, only an incomes policy can slow inflation. President Jimmy Carter's version of such a policy, voluntary wage and price guidelines, is failing. (In the first quarter of 1979 the average wage settlement increase for large unions was 9.3 percent in contrast to the 7 percent guide.)

High interest rates in particular have been used to attract short-term capital and improve the exchange value of the dollar. It is a paradox that the American authorities insist that the level of outstanding dollar balances be maintained or increased to sustain U.S. sovereignty even though the requisite actions diminish U.S. sovereignty.

How can the current situation be improved? First, international monetary reform must go beyond the vague IMF amendments of 1976. Reform must extend to the exchange-rate mechanism as well as to the liquidity mechanism. (The two, of course, are related).

International Monetary Reform

International monetary reform must lead away from the dollar and toward a faceless world currency. A feature of my own reform plan is the worldwide extension of the concept of a "European" currency. The European initiative should provide extra incentive for such an extension. True reform, however, requires rejection of all proposals to return to a narrow-band exchange rate system and rather to adopt a new type of limited exchange rate flexibility that has the advantages of fixed and floating rates without the most injurious disadvantages.

Under a born-again narrow band, any disequilibria in the American balance of payments would still have to be corrected either by an up-valuing (against the dollar) on the part of trade surplus nations, or by a government-created economic recession in the United States. An "adjustable" system simply cannot be expected to work unless some "politically safe" mechanism exists for causing and enabling nations to adjust whenever conditions warrant.

Successful limited exchange rate flexibility involves: (1) short-run exchange rate variation sufficient to create uncertainty among speculators and therefore slow speculative money (capital) flows; (2) long-run par value changes sufficient to alter effective international prices significantly and hence reduce trade deficits, but administered in a way that minimizes speculative capital flows; (3) assurance of an international reserve growth rate adequate for stabilizing par values; and (4) a strengthened role for the IMF in order to wrest the political responsibility (and repercussions) of par value adjustments from the exclusive hands of national governments. A wide SDR band would meet these requirements.

SDRs as International Money

Thus far, however, the role of SDR's has been minor. SDRs can be exchanged (under certain conditions) by central banks for other foreign exchange reserve currencies. One task of monetary reform would be to enhance SDRs as a truly international money.

The complicated circular calculation of the value of an SDR in terms of a market-basket of 16 currencies, heavily weighted in favor of the U.S. dollar, should be discontinued. Par values should be expressed directly in terms of SDRs in the same way in which the dollar was once linked to gold. Businessmen understandably tend to fear what they do not understand, and they presently continue to use the dollar as a unit of account, as do most central banks. The simple SDR valuation would facilitate its widespread use for accounting purposes. Such familiarity should enhance the SDR's stature. Two further steps would encourage central banks to hold SDRs instead of dollars and gold. First, the interest rate on SDRs would be made competitive with American and European Treasury bill rates. Second, the IMF and U.S. Treasury would cease selling gold. Third, the IMF would agree to exchange SDRs for official gold holdings at a substantial discount from recent free market prices in order to reflect the interest earning characteristics of SDRs and the IMF's view that gold is over-priced.

The universal use of the SDR-denominator would: (1) allow increased direct U.S. control of the dollar exchange rate as a means to influence trade and capital flows; (2) allow a wider permissible band of fluctuations in exchange rates; and (3) enhance the prestige of SDRs as an international unit

of account. The use of other national currencies for pegging operations would be further encouraged because the central banks could draw dollars, marks, or whatever through their SDR balances at the IMF.

A Wide SDR Band

The first step toward limited exchange-rate flexibility would be to reinstate par values, expressed directly in SDRs. The second step would be to establish a wide band of variability of exchange rates, 3 percent either side of par, slightly wider than under the Smithsonian Agreement. The old narrow gold band led to highly volatile capital movements and therefore to hikes in interest rates by the Federal Reserve. Higher interest rates abroad usually are attractive only if investors consider the investment to be relatively free of risk. However, with a sufficiently wide SDR band, investors would be encouraged to protect themselves from this risk through arrangements (which offset risk) in the forward exchange market. The actions of such risk-avoiders will increase the cost of offsetting their risks and diminish the incentive to continue investing abroad even though interest rates are higher than at home. Short-term investment or capital flows tend to be self-limiting when the forward market is engaged.

Under the Bretton Woods narrow-band system, capital flows were not self-limiting. The risk from losses through foreign exchange rate variations was limited by the narrowness of the band. Therefore, the protective actions in the forward market were not taken and the self-stopping mechanism failed. The same considerations also reduced the necessity for importers and ex-

porters to use the forward market. One-way speculation--attempts to gain profits solely from variations in the exchange rate--also was encouraged by this system.

A wide SDR band would diminish these disadvantages. Purchasers of foreign securities would be virtually compelled to enter forward exchange markets to protect their exchange position so that such capital flows would tend to be self-limiting. Within most of the band, speculators would be uncertain, for example, whether the yen would next move up or down, and such uncertainty would exert a sobering influence in the market. The moderate nature of short-term capital flows would eliminate one excuse for higher interest rates geared to "international considerations."

Beyond such benefits, there is a bonus to the widened band. The exchange rate movement should be sufficient to alter the effective price of competitive commodities such as wheat, so that some reductions in any trade deficits or surpluses would accompany exchange-rate variations within the band. Thus, two of the advantages of floating rates would be retained.

The Delayed Peg

However, the upper or lower limit of currency will eventually be reached because of economic forces pushing the exchange rate in one direction. At and near the limits difficulties would arise because speculators would foresee an impending alteration in par values and behave accordingly. What could be done at the limits to avoid the speculative crises of the old adjustable-peg system?

I have suggested the "delayed peg." According to this system, the wide SDR band would be lowered (raised) with the old lower (upper) limit as the new par value. The announcement of the new band would come several weeks after its adoption, deterring speculation. This par (or new mid-band) rate would be precisely supported to give those traders not protected against exchange risk an opportunity to protect their commitments (this action could be completed within hours or days). The maintenance of the new mid-band level for an indefinite period plus an initially controlled rate of depreciation (if the rate does indeed fall) would further discourage speculation in the appreciating currency.

Speculators could be neither sure of the time required to hold purchased currencies for profits nor certain whether trade balance changes (which necessarily lag behind exchange-rate movements) would cause the exchange rate to reverse its direction. By the time the rate was set free within its band again, the exchange rate would have given domestic policymakers the opportunity to make changes in domestic policies favorable to the balance of payments.

This time lapse is crucial, especially for domestic adjustments in a stagflation-prone economy. The floating rate system does not provide enough time for domestic policies to change productivity, alter wages, or dampen consumer demand. The wide band of the dollar could, if required, be pegged and repegged over a period of one or two years.

Now we return to the issue of sovereignty. Current IMF "Surveillance" is meaningless because the IMF has no specific corrective powers. This is

why the IMF Amendments resulted in no significant change in the policy practices of Fund members. In order to prevent the lower limit from becoming a rate which is "fixed for all times," parity adjustments should be mandatory. The IMF should be empowered to alter currency par values (when necessary) under a semi-automatic market rule. Some formal or informal indicator or array of indicators would have to be recognized explicitly in the IMF articles of agreement as a trigger for par value changes. Although the market exchange rate would be its own indicator under the delayed peg, IMF machinery to prevent competitive depreciation, such as the Japanese pushing the yen price downward despite a huge trade surplus, still would be needed. Sanctions, such as freezing SDR assets, or IMF loans, would be required.

Several possible semi-automatic market rules, objective indicators, could be used to determine the "fundamental disequilibrium" that would require a change in par values. I have suggested that a monetary reserve base coefficient could be calculated by the IMF, so that the weekly value of reserves lost (or gained) as a share of this base could be determined. The reserve rule would be decided in consultation between the national governments and the IMF, differing for each nation, would be altered from time to time on an unannounced basis, and would be secret until the IMF advised the national government that a basic problem existed according to the semi-automatic market rule, calling for a movement of the band. The intervention responsibilities would rest equally with the deficit and surplus nations, a symmetry which would be in American interests.

Further Reforms

Although the volume of required official international monetary reserves to finance trade growth under the delayed peg would be smaller than that under the old Bretton Woods system (and indeed smaller than under the current managed floating exchange rate system), we need a provision for adequate growth in official reserves. A truly international money is potentially the best reserve asset, and one whose growth is not dictated by pure national interest or by the vagaries of mining technology and the fixed natural endowment of world gold. Therefore, in addition to gold conversions to SDRs, excess official holdings of dollars also should be made convertible to SDRs to reduce the dollar overhang which from time to time has threatened to destroy the system.

The reform initiative has now passed to other governments, as most of the full members of the Common Market are moving toward a plan to stabilize currencies of member nations and enhance trade among them. At the core of the new system would be the European Currency Unit or ECU, whose value would be based upon a weighted average (market basket) of the prices of European currencies. Within this proposed currency union, payments between nations would be made in ECUs rather than in dollars and member nations would intervene in foreign exchange markets with their own currencies in order to isolate Europe as much as possible from the deleterious effect of the unstable dollar. The European currencies would fluctuate in a wide band around the ECU and the ECU would float more or less freely against the dollar. The effect of this new arrangement is likely to be even slower economic growth in Europe, in what they consider to be a fair trade-off for greater economic stability.

This "slowth," however, will worsen the trade balance for the United States. Moreover, the existence of reserve substitutes for the dollar invites current dollar holders to dump them.

Domestic Policy Considerations

As suggested earlier, no international monetary system can survive extreme domestic economic instability among its member nations for long. The delayed peg is designed to give nations experiencing temporary or even long-standing disruptions sufficient time to design new policies and stabilize their economies. If such policies fail, the onus of devaluation or up-valuation no longer falls upon the heads of governments, but rather upon the semi-automatic exchange-rate adjustments mandated by an international organization. Such forces would not mean that all discipline for adjustment by individual governments would end. Domestic stabilization is consistent with international stability in an interdependent trading world. National leadership which fails to maintain relatively stable prices, high employment and steady economic growth will be defeated at the polls.

The issue of domestic economic stability brings us full circle to the problem of stagflation. The giant corporation and the powerful union alone cannot be expected to make fair decisions regarding the consumer if the consumer is not a party to the decision-making process. As the corporation and the union have taken away the clout of the individual, this strength can only be restored through the political mechanism. Elsewhere (The Making of Economics, 2nd Edition, Wadsworth Publishing Company, Inc., 1980), I have suggested the consideration of a new social contract. This new contract would require that the major price, investment and wage decisions of the

1000 largest corporations be made with viable public representation in the decision-making process. Public representatives would comprise the membership (along with corporate and union members) of quasi-public investment planning panels for each concentrated industry. Each panel would deal with a limited number of firms.

I realize that popular wisdom seems to favor a "do-nothing" Congress these days. In times of crisis, however, the distinguished members of Congress tend to rise above the temporary public pessimism of the crowd. Such leaders make the transition by showing how significant problems can indeed be solved with fresh approaches. Problems become opportunities. There have been few times of such abundant opportunities.

E. RAY CANTERBERY

The International Monetary Crisis and the Delayed Peg

Traditional "floating" or "fixed" exchange rates can no longer solve the problem of international monetary instability. Fundamental reform is needed, in the shape of a workable compromise between those two extremes.

Floating foreign exchange rates, in which the price of the dollar to foreigners is more or less determined by supply and demand in the market, functioned well for a few years, but now the international monetary system is in disarray. The United States dollar has not been floating: it has been sinking. American tourists in Germany or Japan do not know from one hour to the next how much less their dollars will buy. Banks holding dollar-denominated accounts and U.S. Treasury securities cannot predict what foreign currency value these items will have when bank doors open. The main U.S. response has been higher interest rates and a tighter federal budget even when key domestic economic

indicators have pointed downward. The troubled international monetary system is now endangering the health of the American economy.

The uncertainty shrouding the price of the dollar also is threatening the relatively liberal trading system of the "free world." Britain has been discussing quota schemes, Italy has imposed a tax on foreign exchange purchases, and France has moved toward stricter currency and import controls—trade restrictions aimed at the common goal of limiting the influx of goods from other nations, including such commodities as machine tools and Marlboro cigarettes from the United States. This economic warfare is ultimately counterproductive,

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for nations will sell less to each other, retarding world economic growth. Remedial measures notwithstanding, the fundamental forces still point downward—toward the bottom of a sea of international dollar balances.

The most recent causes of the sliding dollar have been a trade deficit (about \$20 billion yearly) with the oil-producing countries and the slow growth in U.S. exports to Germany and Japan due, at least partly, to their weak economic growth. The total resultant U.S. trade deficit approaches \$30 billion annually. The surge in demand by Americans for the foreign currency (exchange) to pay for these imports relative to the weaker demand by foreigners for our dollars has led to a decline in the dollar's value, a trend accentuated by the gnomes of Zürich and speculators elsewhere.

According to the theory of floating or flexible exchange rates, the plunge of the dollar in the face of a large U.S. trade deficit is precisely what is supposed to happen. The U.S. foreign exchange rate is the price an American importer pays for the currency used to purchase foreign goods: an increase in the foreign exchange rate is the equivalent of a rise in the price of Toyotas, Beebeater gin, or Italian silk. A lower price for dollars (the foreigner's foreign exchange rate) gives foreign buyers bargain rates for U.S. exports of Ford Mustangs, Jack Daniels bourbon, and Brooks Brothers suits, and makes foreign goods expensive to Americans. In due course the trade deficit should right itself as Americans buy fewer Toyotas and Japanese buy more Mustangs. Why, then, has the U.S. deficit persisted under floating exchange rates?

The adjustable parity exchange rate system of the post-World War II era did not function according to theory either. This earlier system was one in which exchange rates were fixed (pegged) by the buying and selling of foreign currencies (exchange) within narrow intervention limits (pegs) by foreign central banks. In a classic case of history repeating itself, the reasons are the same for the failures of two apparently opposite systems; the policies fostered under each as well as the institutions and special interests which decided how each should function are also alike. The United States dollar has played a central role in the difficulties, and the history of the dollar illustrates the story of either system equally well.

Bretton Woods and the dollar heritage

The Bretton Woods Agreement, ratified by the United States and most of its allies in 1944, provided for fixed exchange parities (or par values) which member nations of the International Monetary Fund (IMF), the "custodian" of the system, were obligated to defend. Exchange rates were allowed to fluctuate within a narrow band of about one percent on either side of the parity, or official rates of exchange. Member nations could alter these official rates only in the face of chronic deficits or surpluses in nations' balances of payments called "fundamental disequilibria." Less serious imbalances were to be dealt with by temporary financing based partly on newly created IMF lending facilities, as well as by appropriate national economic policies.

Although the prices of foreign currencies were expressed by the IMF in terms of ounces of gold, in practice currencies were fixed in terms of the price of a dollar. In turn, foreign currencies were only convertible into gold by their convertibility into dollars. For example, in 1968 the U.S. gold price was \$1.00 = 13.7 grains of gold and the British gold price was £1 = 32.9 grains of gold. The par value of the dollar was 32.9/13.7, about \$2.40 per £1. However, the Bank of England agreed to buy an unlimited number of pounds with dollars at \$2.38 and to sell unlimited pounds for dollars at \$2.42 to establish the lower and upper pegs. In practice, the Bretton Woods system became a rigid dollar standard.

Over the years the American economy came to lead and then to dominate trade expansion in the West. Through the fortunes of finance, the dollar, a national currency, began to serve a dual purpose as the international currency. In recent decades it has been the main unit of account for valuing trade, the key currency for trade payments and—most important in connection with its difficulties—a store of wealth in the form of reserve currency. The German mark was considered to be "worth" about 25 cents, the price of a Mercedes Benz was quoted in dollars, and the German central bank willingly accumulated dollars in order to maintain the mark at a level roughly equivalent to an American quarter-dollar. No economist, government or international agency consciously designed the dol-

lar's multi-faceted role.

By the late 'fifties, the United States experienced large balance of payments deficits while continental European countries (and later Japan) registered huge surpluses. To maintain the par values of exchange rates the European central banks had to intervene and buy more and more of these "excess" dollars. These, as well as private dollar balances, became so large that the dollar emerged as the main vehicle for reserve storage and maintenance of par values.

The dollar utilized as international money and as a store of wealth is a contradiction: a national currency used to finance expanding trade cannot forever be a reliable reserve currency. With the dollar as the main reservoir of wealth, total trade financing potential (international liquidity) could be expanded only through still larger U.S. payments deficits. As such deficits led to larger dollar reserves, however, confidence that the dollar parity in terms of gold could be maintained was eroded. A small crack in confidence widened, threatening to engulf the system as central banks began to demand gold from Fort Knox in exchange for dollars.

With the bulk of the world's monetary gold locked up in the Kentucky citadel, the unabated accumulation of dollar reserves abroad presented a very awkward problem. If the United States devalued its currency (possible only in terms of a higher dollar price for gold), foreign central banks holding dollars as reserves would find their assets shrunken in value. Equally important was the fact that official and private foreign dollar balances in New York banks would be worth less, and foreigners might convert such balances into other currencies or assets, creating a "run" on the dollar and on gold simultaneously. The holdings of official and private dollar accounts were and still are sources of enormous profits to the largest New York banks. Under the pressure of foreign central bankers and private commercial and investment bankers, the Eisenhower, Kennedy, and Johnson administrations rejected devaluation or par value changes. Although traders and bankers often feared it, "devaluation" under "fundamental disequilibria" was almost as empty a threat as the cry that "the Russians are coming."

Par values really were fixed. The United States was left with the alternative of restrictive economic policies. Higher interest rates could be used to re-

duce the level of aggregate demand, thus reducing imports. It was also hoped the higher interest rates would attract foreign capital. Direct controls on trade and capital flows could be tried: taxes and quotas on imports, tourism, and the export of U.S. capital. All these policies were imposed at one time or another.

Despite such measures, the troublesome payments deficit persisted and dollars continued to finance trade growth. Traders and speculators finally came to believe that a realignment of exchange rates—so long rejected—was now inevitable, and speculative crises emerged. Massive private selling of British pound sterling forced its devaluation in 1967. There was a rush to buy gold from the United States: by 1971 it was widely agreed that the U.S. dollar had to be "devalued."

The American authorities again were in awkward straits. As other currency prices were now in dollars, the U.S. dollar could be devalued in terms of foreign currencies only at the option of other countries. Other nations finally allowed their exchange rates to float upward freely against the dollar in mid-1971. The arrangement whereby dollars could be exchanged for gold officially ended. Without the float toward lower dollar prices, foreign central banks would have been flooded with dollars and, had the gold window stayed open, Fort Knox would have become a vacant warehouse.

The major trading nations signed the Smithsonian Agreement at the end of 1971, resolving to return in the near future to a pattern of fixed exchange rates, with somewhat wider bands than had characterized the previous system of fixed rates. Unfortunately, the balance of payments continued to run red, accompanied in January 1973 by massive speculation and in February by a proposed further 10 percent "devaluation." By the end of March, several European Economic Community (EEC) member nations decided to stabilize their currencies against each other but to let them float against the dollar, an arrangement called the "snake." This action dealt a final blow to the Bretton Woods system.

The shape of the present crisis

The first major test of the floating regime came with the tripling of the price of oil during 1973.

Dollar reserves shifted *en masse* into nations in the Organization of Petroleum-Exporting Countries (OPEC), and the central banks intervened sharply—buying dollars again—to influence the market price of currencies. Bankers began to call for “corrective strategies” by the United States, such as tighter fiscal and monetary policies and a slowdown of energy imports. The responsibility for guaranteeing that the dollar would not depreciate was again thrust upon the United States.

Why has a condition developed under ostensibly “floating” exchange rates that is identical to that under the felled fixed-exchange-rate regime? The answer is found in the continued multiple role of the dollar as a unit of account, trading vehicle, and reserve currency, as well as in some overlooked defects in a flexible-exchange-rate system.

The way the dollar's price falls does not matter as much to foreign governments as does the fact that it falls at all. A dollar which is devalued under fixed exchange rates depreciates under floating rates. Ultimately the outcome for traders and bankers is the same.

A cheaper dollar means a more expensive German mark; the United States can now undersell Germany in world markets. Likewise, a higher British pound undercuts the competitiveness of Britain's exports and worsens its rate of unemployment. Japan, France, and Italy, with no oil reserves, have deliberately undervalued their currencies in order to encourage trade surpluses and to export—among other things—their unemployment. Moreover, foreign central banks still hold in reserve accumulating dollar assets that decline in value with each drop in the dollar's exchange price, and private New York banks and investment houses still worry about the decline in the value of their clients' dollar-denominated assets which might spur them to move their accounts elsewhere, into gold or other currencies. Furthermore, the Carter administration must contemplate the consequent dollar outflows which would worsen the payments deficit and accelerate the dollar's descent.

With about \$500 billion held in banking balances outside the U.S., neither the U.S. authorities nor the foreign central banks have much chance of stopping the dollar slide. (The United States has only \$7 billion in liquid international reserves.) At best, the foreign central banks can only temporarily control swings of the exchange rate under this managed or

“dirty” float—and then only at enormous costs in terms of official reserves expended. Within this system the Carter administration must turn to the same policies followed by prior administrations under fixed exchange rates.

Therefore, the theoretical attractiveness of floating exchange rates is tempered by the facts that: (1) the historical circumstance of huge dollar reserves introduces an uncommon element of instability; (2) uncontrollable forces (OPEC, coal strikes, riots, wars, famines, Watergates, and so on) cause sharp and unpredictable movements in exchange rates and; (3) flexible exchange rates at the option of national governments offer the delightful temptation to intervene and set exchange rates which would accommodate national economic and political demands.

The worst may be yet to come. OPEC is concerned about the dollar slump because the lower-valued dollars it receives impair its members' ability to buy non-American goods. OPEC has expressed an intent to raise the price of oil to compensate, should the decline continue.

Stagflation, old pleas, and tired policies

American stagflation—simultaneous inflation and unemployment—makes matters even worse. The rising price of oil worsens the balance of payments problem, which in turn causes the fall of the price of the dollar. OPEC retaliates. Another round of balance of payments deficits brings another round of dollar declines. The falling price for the dollar to foreigners allows American producers in concentrated industries to raise their prices. (Automobile and steel producers were quick to raise prices as the U.S. foreign exchange rate rose.)

A flexible exchange-rate system is not supposed to work in this way. The prices of American exports are supposed to remain low, but the contributors to stagflation—giant corporations and powerful unions—are also obstacles to cost and price movements favorable to the balance of payments.

Even though the present exchange rate regime is alleged to be the “flip side” of the Bretton Woods system, rhetoric from the 1960s echoes through the canyons of Wall Street today. Henry Kaufman, chief economist at the securities firm of Salomon

Brothers, is quoted by the *Wall Street Journal* (August 18, 1978): "With the dollar going down, you have an international monetary system without a rudder." Willard C. Butcher, president of Chase Manhattan, expresses (in the same *Journal*) the sentiments of David Rockefeller during the 'sixties, when he called for swift action to restore "confidence in the U.S. dollar." "We think the Fed ought to raise the discount rate," said Mr. Butcher.

Three days later the Federal Reserve raised its discount rate, an interest rate closely tied to the interest charged prime business borrowers by private banks, from 7.25 percent to 7.75 percent, citing the dollar as the Fed's main concern. Although this action came upon the heels of indications of an economic slowdown, Chase Manhattan was not entirely satisfied. Mr. Butcher urged "a significant cut (\$25 to \$40 billion) in government spending to reduce our massive budget deficit" (*Wall Street Journal*, August 21, 1978).

It is even more hopeless in the 'seventies than it was in the 'sixties to use tighter fiscal and monetary policies at home in an effort to maintain product prices which are more attractive to foreign buyers. Stagflation is a common affliction of the industrialized nations; to slow inflation, these monetary-fiscal policies must squeeze the domestic economies until a substantial fall in output and employment

occurs. The problem is that wages and prices are not very flexible downward. Despite this fact, U.S. Treasury officials at times have seemed even rhapsodic about the current prospect for a slowdown in the U.S. rate of economic growth and hence in the dollar outflow.

Fundamental reform

The profit concerns of a small number of powerful New York bankers cannot be ignored, but dollar chauvinism has been costly to the general public in terms of production shortfalls, fewer jobs, and less housing construction. The United States controls the greatest number of votes in the IMF and has had many opportunities to lead the Western world into planned international monetary reform. Each time, apprehensions about a sovereignty that is ephemeral in an interdependent world and the elusive prestige of a self-tamishing dollar have caused government officials to limit themselves to shouting slogans that are the envy of private bankers in their vain attempt to bolster the dollar. However, we have played out our string of dollars: they are going to start coming home whether we push or pull the string.

The reform initiative has now passed to other governments. Spurred by West German Chancellor

Culver Pictures



Helmut Schmidt and French President Valéry Giscard d'Estaing, the Common Market is moving toward a new plan to stabilize currencies of the nine member nations and enhance trade among them. At the core of the new system would be the European Currency Unit or ECU, whose value would be based upon a weighted average (market basket) of the prices of European currencies. Within this proposed currency union, payments between nations would be made in ECUs rather than in dollars and member nations would intervene in foreign exchange markets with their own currencies in order to isolate Europe as much as possible from the deleterious effect of the unstable dollar. The European currencies would fluctuate in a wide band around the ECU and the ECU would float more or less freely against the dollar. The effect of this new arrangement is likely to be even slower economic growth in Europe, in what they consider to be a fair trade-off for greater economic stability. This "slowness," however, will worsen the trade balance for the United States. Moreover, the existence of reserve substitutes for the dollar invites current dollar holders to dump them.

The embarrassing truth is that the "free world" has never really had a formal, comprehensive "monetary constitution." Although U.S. oil dependence is the most recent "excuse" for the international crisis, the roots of the problem lie in the special role of the dollar. International monetary reform must lead away from the dollar and toward a faceless world currency. A feature of my own reform plan is the worldwide extension of the concept of a "European" currency. The European initiative should provide extra incentive for such an extension. True reform, however, requires rejection of all proposals—and they come most frequently from private bankers—to return to a narrow-band exchange rate system and rather to adopt a new type of limited exchange rate flexibility that has the advantages of fixed and floating rates without the most injurious disadvantages.

Under a born-again narrow band, any disequilibria in the American balance of payments would still have to be corrected either by an up-valuing (against the dollar) on the part of trade surplus-nations, or by a government-created economic recession in the United States. In the former case, surplus nations must consider the domestic political repercussions of up-valuation, which is viewed by producers as a

penalty for their efficiency and by governments for their financial discipline. In the latter case, the U.S. President would have to consider the political risk of rising unemployment. An "adjustable" system simply cannot be expected to work unless some "politically safe" mechanism exists for causing and enabling nations to adjust whenever conditions warrant.

Successful limited exchange rate flexibility involves: (1) short-run exchange rate variation sufficient to create uncertainty among speculators and therefore slow speculative money (capital) flows; (2) long-run par value changes sufficient to alter effective international prices significantly and hence reduce trade deficits, but administered in a way that minimizes speculative capital flows; (3) assurance of an international reserve growth rate adequate for stabilizing par values; and (4) a strengthened role for the IMF in order to wrest the political responsibility (and repercussions) of par value adjustments from the exclusive hands of national governments. A wide SDR band would meet these requirements.

A wide SDR band

Because gold reserves were inadequate and further dollar amassments precarious, a new type of international monetary device, Special Drawing Rights (SDRs), was established in 1968 to add to world liquid reserves. Thus far, however, the role of SDRs has been minor. SDRs, often called "paper gold," are bookkeeping entries at the IMF in the names of member nations. SDRs can be exchanged (under certain conditions) by central banks for other foreign exchange reserve currencies. The SDR unit, originally expressed in terms of gold (at about \$1 = 1/35 ounce of gold), has been calculated since 1974 in terms of a complicated weighted average of the prices of sixteen major currencies. Although the current trend is toward expanded dependence on SDRs, the dollar remains the main reserve currency for use in moderating exchange-rate movements. (Any SDR rate can be calculated in terms of dollars.) One task of monetary reform would be to establish conditions that would enhance SDRs as a truly international money.

The first step toward limited exchange-rate flexibility would be to reinstate par values. However, all par values should be expressed in terms of SDRs

rather than the dollar, in the same way in which the dollar was once linked to gold. If, for example, $\$1 = 1 \text{ SDR}$ and if $\pounds 1 = .25 \text{ SDR}$, then $\$1 = \pounds 4$ would be the par value.

The universal use of the SDR-denominator would: (1) allow increased U.S. control of the dollar exchange rate as a means to influence trade and capital flows; (2) allow a wider permissible band of fluctuations in exchange rates; and (3) enhance the prestige of SDRs as an international unit of account. The use of other national currencies for pegging operations would be further encouraged because the central banks could draw dollars, marks, or whatever through their SDR balances at the IMF. With the dollar as the denominator currency, the pound sterling price of German marks, for example, could vary as much as twice the difference in the rates between the dollar and each country individually. Bankers and traders cannot fathom, much less predict, the present SDR market basket valuation. Businessmen understandably tend to fear what they do not understand, and they presently continue to use the dollar as a unit of account, as do most central banks. The simple SDR valuation would facilitate its widespread use for accounting purposes. Such familiarity should breed content and enhance the SDR's stature.

The second step of our proposed course of action would be to establish a wide band of variability of exchange rates, 3 percent either side of par. The old narrow gold band led to highly volatile capital movements and therefore to hikes in interest rates by the Federal Reserve that tended to dampen further an often sluggish domestic economy. Higher interest rates abroad usually are attractive only if investors consider the investment to be relatively free of risk. Movements in the exchange rates in which securities are valued could erase the expected gain from investment in the higher-yielding foreign securities. For example, a Japanese businessman holding a \$10,000 one-year U.S. Treasury bond yielding 8 percent at the beginning of 1978 would have experienced a net loss of about 14 percent by mid-year (upon conversion to the fewer yen that the dollar bought). Investors can protect themselves from this risk through arrangements (which offset risk) in the forward exchange market, a market in which currencies can be sold or bought for future delivery.

Investors tend to think alike. If all investors are

engaged in the forward market, their actions will increase the cost of offsetting their risks and diminish the incentive to continue investing abroad even though interest rates are higher than at home. The details of this process need not concern us here. Suffice it to say that short-term investment or capital flows tend to be self-limiting when the forward market is engaged.

Under the Bretton Woods narrow-band system, capital flows were not self-limiting. The risk from losses through foreign exchange rate variations was limited by the narrowness of the band. Therefore, the protective actions in the forward market were not taken and the self-stopping mechanism failed.

The narrow distance between pegs (the upper and lower limits to the exchange rates) under the Bretton Woods system also reduced the necessity for importers and exporters to use the forward market. One-way speculation—attempts to gain profits solely from variations in the exchange rate—also was encouraged by this system. Speculators knew that their maximum losses were restricted by the narrow limits to exchange rates while their potential for gains was virtually unlimited if in fact any devaluations occurred. Speculation was rampant. Therefore, in the waning days of the system, when par value alterations became unavoidable, such changes were hastened in a climate of crisis by massive speculative currency flows.

A wide SDR band would diminish these disadvantages. Purchasers of foreign securities would be virtually compelled to enter forward exchange markets to protect their exchange position so that such capital flows would tend to be self-limiting. Within most of the band, speculators would be uncertain, for example, whether the yen would next move up or down, and such uncertainty would exert a sobering influence in the market. The moderate nature of short-term capital flows would eliminate one excuse for higher interest rates geared to "international considerations," a policy that might conflict with a domestic goal of economic expansion.

Beyond such benefits, there is a bonus to the widened band. The exchange rate movement should be sufficient to alter the effective price of competitive commodities such as wheat, so that some reductions in any trade deficits or surpluses would accompany exchange-rate variations within the band. This advantage of floating rates would be retained.

The delayed peg

The wide SDR band works well—up to the limits of allowed variation in the exchange rate. However, the upper or lower limit of currency will eventually be reached because of economic forces pushing the exchange rate in one direction. At and near the limits difficulties would arise because speculators would foresee an impending alteration in par values and behave accordingly. What could be done at the limits to avoid the speculative crises of the old adjustable-peg system?

We need a wide SDR band that moves. In 1968 (in *Economics on a New Frontier*) and again in 1971 (in the May/June *Journal of Political Economy*) I suggested the "delayed peg." According to this system, the wide SDR band would be lowered (raised) with the old lower (upper) limit as the new par value. The announcement of the new band would come several weeks after its adoption, deterring speculation. This par (or new mid-band) rate would be precisely supported to give those traders not protected against exchange risk an opportunity to protect their commitments (this action could be completed within hours or days). The maintenance of the new mid-band level for an indefinite period plus an initially controlled rate of depreciation (if the rate does indeed fall) would further discourage speculation in the appreciating currency. As the effective price of such commodities as corn and cotton fell with the foreign exchange rate, exports would tend to grow, which would favor a higher exchange rate even before the par value change.

Speculators could be neither sure of the time required to hold purchased currencies for profits nor certain whether trade balance changes (which necessarily lag behind exchange-rate movements) would cause the exchange rate to reverse its direction. By the time the rate was set free within its band again, the exchange rate would have given domestic policy-makers the opportunity to make changes in domestic policies favorable to the balance of payments.

This time lapse is crucial, especially for domestic adjustments in a stagflation-prone economy. The floating rate system does not provide enough time for domestic policies to change productivity, alter wages, or dampen consumer demand. The wide band of the dollar could, if required, be pegged and repegged over a period of one or two years.

In order to prevent the lower limit from becoming a rate which is "fixed for all times," parity adjustments should be *mandatory*, once the international rules for such adjustments are formulated. The IMF should be empowered to alter currency par values (when necessary) under a semi-automatic market rule. Some formal or informal indicator would have to be recognized explicitly in the IMF articles of agreement as a trigger for par value changes in the various currencies. Otherwise, some nations might reject changes in currency values. Although the market exchange rate would be its own indicator under the delayed peg, IMF machinery to prevent competitive depreciation, such as the Japanese pushing the yen price downward despite a huge trade surplus, still would be needed.

Several possible semi-automatic market rules could be used to determine the "fundamental disequilibrium" that would require a change in par values. A monetary reserve base coefficient could be calculated by the IMF. With some base reserve value, the weekly value of reserves lost (or gained) as a share of this base could be determined. Hence, both the speed and the volume of reserve attrition (or accumulation) would be considered. (A 10 percent weekly reserve loss or gain for three weeks would be viewed with as much concern as a 5 percent coefficient during a six-week span.) The permissible losses (or gains) and the reserve rule would be decided in consultation between the national governments and the IMF. The critical range of coefficients for each nation as well as the reserve base period would differ, would be altered from time to time on an unannounced basis, and would be secret until the IMF advised the national government that a basic problem existed according to the semi-automatic market rule, calling for a movement of the band. The intervention responsibilities would rest equally with the deficit and surplus nations. The use of non-dollar intervention currencies would now be possible with the expansion of German mark, Swiss franc, French franc, and Japanese yen holdings.

Further reforms

Although the volume of required official international monetary reserves to finance trade growth under the delayed peg would be smaller than that under the old Bretton Woods system (and indeed

smaller than under the current managed floating exchange rate system), we need a provision for adequate growth in official reserves. A truly international money is potentially the best reserve asset, and one whose growth is not dictated by pure national interest or by the vagaries of mining technology and the fixed natural endowment of world gold. Therefore, further measures should be taken to replace gold and a large share of dollar reserves with SDRs. This move would require some additional changes and technical arrangements, including the payment of a still higher interest rate to central bank holders of SDRs. The strongest national currencies would be used as the intervention currencies during the foreseeable future. As SDRs became more acceptable as reserve assets, their use would extend to private transactions; eventually the SDR unit would be the international unit of account and currency for trade.

Is the delayed peg reform idea politically palatable? In 1972 the U.S. Treasury proposed a similar

plan, but was defeated by special interest pleas that were only drowned by the inescapable float in rates. In June 1974, the IMF Committee of Twenty completed an *Outline of Reform*, proposing the establishment in principle of many of the features of the delayed peg, such as the use of "objective indicators" to obligate a country to make politically risk-free parity changes, a band of ± 2.25 percent for any new par value system, more par flexibility, and the use of an international unit of account. The Committee for Economic Development (CED), a private research organization that avoids special interest entanglements, had endorsed an almost identical plan the preceding year.

With the exception of the private banking choir singing the praises of the dollar, widespread agreement has emerged regarding the specific features for international monetary reform. Further delay in implementing such reform will surely prove hazardous to the common interest of Europe, Japan, and the United States.

GLOSSARY OF FOREIGN EXCHANGE TERMS

Par value or parity—An official exchange rate used as a reference point in pegging currencies. Under the Bretton Woods system currencies were pegged at points about 1 percent either side of parity.

Devaluation—A reduction in the par or "official" value of a currency under adjustable parities. The British pound, for example, was devalued in November, 1967 when the U.S. foreign exchange rate was reduced from \$2.80 = £1 to \$2.40 = £1.

Undervalued exchange rate—An exchange rate at which a country's balance of trade is chronically in surplus.

Overvalued exchange rate—An exchange rate at which a country's balance of trade is chronically in deficit.

"The Snake"—The system by which EEC nations have agreed to fix par values against each other within a ± 2.25 percent band but to let them float against the dollar. The "snake" breaks apart from time to time. Its current membership includes Belgium, Denmark, the Federal Republic of Germany, Luxembourg, the Netherlands, and Norway.

Special Drawing Rights (SDRs)—A unit of account entered as a reserve asset in a member nation's IMF balance. The IMF issues SDRs to each member nation according to the country's quota size (based upon trade volume) with the IMF. The SDRs can be used to settle accounts between nations. The SDR unit was originally expressed in terms of gold and the dollar with 1 oz. of gold = \$35 and \$1 = 1 SDR.

U.S. foreign exchange rate—The number of dollars it takes to buy one unit of a foreign currency (e.g., 40 U.S. cents = 1 D-Mark).

Forward foreign exchange rate—The number of dollars it takes to buy one unit of a foreign currency for future delivery.

Peg—The term which denotes the intervention rate, that is, the exchange rate at which the monetary authorities of a country intervene in the foreign exchange market in order to keep a currency from falling or rising. There are two pegs: an official selling price, and a buying price for the currency.

Adjustable parities—Parities that are adjusted at once by more than one-half of the band width at a time. The original Bretton Woods intent was to adjust parities in this way when "fundamental disequilibrium" existed.

Wide Gold Band—A system in which the total distance between pegs is more than four percent. The band need not be centered on parity.

Narrow Gold Band—A system in which the exchange rate pegs are four percent or less in total width. The band need not be centered on parity.

Mandatory parity adjustment—A parity adjustment to which the country in question is firmly committed under international rules and which is enforceable by an international agency.

Flexible or floating exchange rates—Exchange rates which neither of two countries in question undertakes to keep invariant within narrow limits.

Managed float—An exchange rate system similar to the floating one, except that national monetary authorities intervene in the foreign exchange market either to moderate the speed of exchange rate movements or to push them intentionally one way or another.

