Robert Triffin

THE INTERNATIONAL ROLE AND FATE OF THE DOLLAR

All Americans are alarmed at the shrinking value of the dollar in their neighborhood supermarkets—by close to one-half in the last ten years. With the President's announcement in early November ordering a series of dramatic actions to shore up the value of the dollar abroad, more and more Americans have also become conscious of the dollar's declining value in terms of major foreign currencies over the same period—by more than one-half against the West German mark and the Japanese yen, and by nearly two-thirds vis-à-vis the Swiss franc. But I suspect that no more than one American out of 10,000 realizes that these—and other—developments are rapidly undermining what President de Gaulle used to call our "exorbitant privilege" of being able to settle with our own dollar IOUs the growing excess of our expenditures abroad over our receipts from abroad (on capital as well as on current account). Such excess has been to the tune of $300 billion over the last ten years (see line I of Table I).

The Bremen summit meeting of July 6 and 7, 1978, of the West European heads of state and government should finally bring home to us the full dimensions of the international dollar crisis. It should awaken us both to the increased dangers of further procrastination in the shaping of sensible and comprehensive U.S. policy responses to this crisis, and to the new opportunities for *two-way* cooperation with the emerging "European Monetary System" outlined at Bremen. Such cooperation is essential in order to avoid a further disastrous collapse of the dollar, and of a world monetary system precariously anchored to it. The Bremen initiative to set up a European Monetary System reflects, at bottom, a desperate desire of the leaders of the Community to make their countries less dependent on the unpredictable vagaries of a shrinking U.S. dollar.

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II

The present dollar crisis and the foreign reactions to it cannot be understood without a brief reminder of at least its proximate origins, i.e., of the evolution of the international monetary system and of the role of the dollar in it over the last ten years.

Officials and public opinion in the United States are prone to ascribe most of the blame for the crisis of the dollar, and of the international monetary system built upon it, to the quintupling of oil prices at the end of 1973. In fact, the world inflation began well before then, and the abrupt rise of oil prices was, in part at least, prompted by it, although, of course, the oil price increase accentuated it in the following years.

World import and export prices, measured in dollars, rose by less than one percent a year in the 1960s, but by more than six percent a year from 1970 through 1972, and by as much as 30

TABLE I

THE INFLATIONARY EXPLOSION OF INTERNATIONAL LIQUIDITY
(in billions of U.S. dollars)

	End 1969	*End 1972*	*End 1977*	*Mid-1978*	*Mid-1978 % of 1969*
I. Foreign Dollar Claims	78	146	363	373	478
A. On U.S. Government and Banks	49	85	210	221	451
B. On Foreign Branches of U.S. Banks	29	61	153	152	524
II. International Monetary Reserves	79	159	319	330	418
A. Foreign Exchange	33	104	244	256	776
1. Dollars & Eurodollars	20	81	197		985
2. Other Currencies	7	15	27		386
3. Other	7	8	22		314
B. Other: World Monetary Gold, SDR Allocations and IMF Loans and Investments	46	55	75	75	163
III. Commercial Banks Foreign Liabilities in:	121	217	658	700	579
A. Dollars and Eurodollars	94	157	481		512
B. Other Currencies	27	60	177		656

SOURCES: These rough estimates are derived from various tables published by the International Monetary Fund in its *International Financial Statistics* and *Annual Reports*, by the *Federal Reserve Bulletin*, and by the Bank for International Settlements in its *Annual Reports* and quarterly releases on Eurocurrency and other international banking developments. They are not fully comparable, owing particularly to the different definition of "foreign" liabilities in U.S. and European reporting. Following usual practice, detailed figures are shown in rounded-off billions of dollars.

percent in the last 12 months *before* the explosion of oil prices in the fall of 1973. This was not unconnected, to say the least, with the enormous and mounting U.S. deficits abroad which flooded the world monetary system, doubling world reserves from the end of 1969 to the end of 1972 (see line II of Table I), i.e., increasing them by as much in this short span of three years as in all previous centuries in recorded history.

Under the Bretton Woods system set up in 1944, countries were committed to keeping exchange-rate fluctuations within very narrow limits: one percent at most above or below the par values declared to the International Monetary Fund (IMF); these values were changed only infrequently by the major countries. In order to maintain such narrow limits, each country's central bank or treasury undertook to "intervene" in the exchange market whenever an excess supply of its currency—arising from the country having spent, lent and invested more abroad than it earned—tended to depress its exchange rate; or whenever an excess demand for its currency—the country having earned more abroad than it spent, lent and invested—tended to raise its exchange rate. In the first instance, the country would redeem the overflow of its currency in the market to prevent its price from going down; and, in the second case, it would sell the amounts needed to prevent its price from going up.

The U.S. dollar played the key role in these transactions. It had unwittingly acquired the poisoned "privilege" of being used overwhelmingly as the universally acceptable "parallel" currency against which every other country sold or redeemed its own national currency in the exchange markets. The dollar was also a major component of the "international reserves" accumulated in the process by national monetary authorities and, finally, of the "working balances" held by all private banks, firms, and individuals engaged in international trade, services and capital transactions. This universal acceptability derived from the fact that dollar holdings could be invested in a broad capital market at remunerative interest rates, while being legally convertible *at any time,* at a fixed price of $35 an ounce, into gold metal carrying no such interest earnings. The U.S. dollar was, therefore, as good as gold, and indeed better than gold as the liquid investment for other countries' surpluses and savings.

Nearly 20 years ago, I pointed out that such a world monetary system was not viable.[1] In what came to be known as the "Triffin

[1] Particularly in my October 28, 1959, testimony before the Joint Economic Committee of Congress, reprinted in Robert Triffin, *Gold and the Dollar Crisis,* New Haven: Yale University Press, 1961, pp. 3–14.

dilemma,"[2] I forecast that (a) if the United States corrected its persistent deficits, the growth of world reserves could not be fed adequately by gold production at $35 an ounce; but that (b) if our deficits continued, our foreign liabilities would far exceed our ability to convert them into gold upon demand, and bring about a gold and dollar crisis.[3]

The first term of this dilemma prompted, ten years later, the creation of Special Drawing Rights (SDRs), i.e., what are essentially reserve deposits in the IMF on which member countries could draw, under certain conditions, to obtain the foreign currencies needed to settle their payments deficits.[4] But SDRs were to serve as an addition to, rather than as a substitute for, reserve currency holdings (overwhelmingly U.S. liabilities) as international reserves. These reserves continued to pile up at an average yearly rate of about $600 million throughout the 1960s, but by nearly $8 billion in 1970 alone, and $13 billion in the first seven months of 1971. By August 1971, our shrinking gold reserves had dropped to less than one-third of our gold-convertible liabilities to foreign central banks, and less than one-fifth of our total liquid liabilities to foreigners, including those to commercial banks and other private holders. The "temporary" suspension of dollar convertibility by President Nixon, on August 15, confirmed—alas!—the second term of the 1959 "Triffin dilemma."

III

The end of dollar convertibility solved—after a fashion—the gold problem of the United States, but it did not arrest the inflationary proclivity of the dollar-exchange standard for America as well as for the rest of the world. United States government indebtedness (mostly Treasury securities) and banks' liabilities to foreigners (including those of branches abroad) nearly doubled in the years 1970–72, rising from $78 billion at the end of 1969 to $144 billion at the end of 1972, and increasing another two-and-a-half times in the following five years to $363 billion at the end of 1977. Their total increase of $285 billion over these eight years is exactly equal to the total increase of the federal debt over this period—

[2] See Oscar L. Altman's summary of my diagnosis in "Professor Triffin's Diagnosis of International Liquidity and Proposals for Expanding the Role of the IMF," *IMF Staff Papers*, April 1961.

[3] See Robert Triffin, *Gold and the Dollar Crisis, op. cit.*

[4] Beginning in July 1974, the value of the SDR was redefined as equivalent to a weighted basket of 16 major currencies valued at their market exchange rate for the dollar. The composition of this basket was modified in July 1978, the currencies of Iran and Saudi Arabia replacing those of Denmark and South Africa, and the weights of various currencies being also changed. The SDR fluctuates daily.

from $279 billion at the end of 1969 to $564 billion at the end of 1977—a bizarre coincidence undoubtedly but not an entirely fortuitous one. International monetary reserves doubled from 1969 ($79 billion) to 1972 ($159 billion); they doubled again in the following five years (to $319 billion at the end of 1977). Of this total increase of $240 billion, 88 percent ($211 billion) was in foreign exchange holdings,[5] overwhelmingly dollars and Eurodollars ($177 billion), most of which reflect the reported growth of U.S. government and bank (including branches) liabilities ($150 billion). This huge overflow of dollars into foreign countries' reserves slowed down inflationary developments at home in the United States by transmitting them in part to the rest of the world.

Equally, or even more, alarming has been the fantastic increase in private banks' foreign lending and liabilities over this period. Incomplete reporting to the Bank for International Settlements (including, however, huge interbank operations) shows a total increase of these liabilities from about $120 billion in 1969 to about $700 billion in June 1978. About three-quarters of these liabilities are in dollars and Eurodollars, of which about 35 percent are debts of U.S. banks and their offshore branches in the Bahamas, the Cayman Islands, etc., another 15 percent in branches of U.S. banks in the United Kingdom, and an undetermined but undoubtedly substantial percentage are the liabilities of U.S. bank branches in other European countries.[6]

Taken together, official and private dollar and Eurodollar holdings are now well in excess of $700 billion, about half of which are U.S. government and banks' (including their branches abroad) liabilities, and the other half are liabilities of foreign commercial banks, built upon—and overlapping with—their claims on the United States.

This fantastic increase in international liquidity was well on its way before the suspension of the convertibility of the dollar in August 1971, the generalized adoption of floating rates in March 1973, and the fivefold increase in oil prices in the fall of that year. It has continued since then, however, at an unabated pace, and is undoubtedly the biggest factor in triggering the worst global inflation in history.

[5] The remaining 12 percent is accounted for by the 1970–72 allocations of Special Drawing Rights (4 percent), IMF lending (5 percent), and the impact of the dollar depreciation on the dollar valuation of Special Drawing Rights and of nearly unchanged world monetary gold stocks (3 percent).

[6] The term *Eurocurrency* is generally applied to bank assets or liabilities denominated in a currency other than that of the country in which the bank is located: *Eurodollar* for dollar transactions by a bank located outside the United States, *Euromark* for mark transactions by a bank located outside Germany, etc.

IV

The floating exchange-rate system that succeeded the Bretton Woods agreement has become more and more unacceptable to many countries.[7] Under the "floating exchange-rate" system, generalized in March 1973, central banks are no longer committed, as they were under the Bretton Woods system, to keeping exchange rate fluctuations within agreed margins through their own market interventions. Exchange rates may, therefore, fluctuate daily on the market in response to both private supply and demand and to central bank discretionary interventions—and other forms of management, such as interest-rate changes—aimed at slowing down, or accelerating, such fluctuations. They are rarely, if ever, left totally "free" to float without any intervention whatsoever by the official authorities.

Floating rates also became increasingly dangerous to the future of the dollar. The dollar's decline to one-half to one-third of its previous value vis-à-vis the major currencies in competition with it as a channel for the investment of international official reserves and private working balances has not succeeded—far from it!—in correcting huge and persistent deficits in our international transactions. The continued overflow of dollars abroad has piled up an enormous indebtedness (often called "overhang") of foreign dollar balances, rising from about $78 billion in 1969 to more than $370 billion in mid-1978, which private holders are more and more tempted to unload on the market, and which central banks are absorbing, more and more reluctantly, to slow down the depreciation of the dollar vis-à-vis their own currencies, and the consequent damaging impact on their own trade, production, and employment.

The international acceptance of the dollar by foreigners as the major world currency provided us with financing facilities rising from $10 billion a year in 1975 to $44 billion in 1977 (Table II, line III B). As a result, U.S. indebtedness or "overhang" rose to $221 billion by the middle of 1978 (Table I, line I A). While 44 percent of these dollar liabilities was absorbed by the private market in 1976, only 16 percent was absorbed by it in 1977, and only three percent in the first quarter of 1978.

The remaining overflow had to be bought by central banks and other official agencies and, contrary to a widespread assumption, only a minor portion of these purchases (18 percent in 1977 and 11

[7] See my paper on "The Future of Floating Exchange Rates: Free? or Mismanaged?" first presented on May 15, 1978 at a working conference sponsored jointly by *The International Herald Tribune* and *Forex Research Limited*, and updated in a forthcoming publication of *The Exchequer*.

percent in the first quarter of 1978) came from the OPEC countries. The largest bulk was bought by the United Kingdom and Italy in the first part of 1977, but later with growing alarm and protests by Germany, Switzerland, Japan and other industrial countries. This use of the dollar as the major means by which surplus countries accumulated official reserves and working balances imposed upon the United States the awesome responsibility of "recycling" these surpluses by lending to weaker countries that were also in balance-of-payment deficits. Our bank loans to foreigners thus rose in 1977 by $11 billion and by an annual rate of $25 billion in the first quarter of 1978, as against $1 billion in 1970, and even less in most of the 1960s (Table II, line III A-1).

Our net official reserves and bank assets (Table II, line III), which were still growing slightly in 1975 under the impact of an exceptionally large surplus on current account, declined by $8

TABLE II

THE U.S. BALANCE OF PAYMENTS
(in billions of U.S. dollars)

	1970	*1975*	*1976*	*1977*	*Yearly Rate* Sept.–Dec. 1977	*Yearly Rate* Jan.–March 1978
I. Current Account	2	18	4	−15	−28	−27
II. Net Capital Outflows (other than under III)	5	14	12	18	11	13
III. Official Reserves and Bank Assets (I–II)	−3	4	−8	−33	−39	−41
A. U. S. Assets	−2	14	24	12	35	24
1. Bank Loans	1	14	21	11	35	25
2. Official Reserves	−3	1	3	–	–	−1
B. U. S. Liabilities (−) to	−2	−10	−32	−44	−74	−65
1. Private Holders	6	−3	−14	−7	−11	−2
2. Official Holders:	−8	−7	−18	−37	−62	−63
OPEC	. . .	−7	−10	−7	−4	−7
Other	. . .	–	−8	−30	−58	−55
% Dollar Depreciation (−) since May 1970, vis-à-vis:						
10 major currencies	−1	−15	−13	−19	−19	−22
Swiss Franc	–	−39	−43	−54	−54	−57
Mark	−7	−28	−35	−42	−42	−44
Yen	–	−15	−18	−33	−33	−38
Pound	–	+19	+41	+26	+26	+29

SOURCE: *Survey of Current Business*, U.S. Department of Commerce, Washington, D.C.
NOTE: Contrary to the bookkeeping practice highly misleading to the layman, *minus* signs in this table indicate a decline of assets or an increase of liabilities. Capital outflows on line II exclude official and bank assets and liabilities recorded under III and reflecting the "recycling" use of the dollar as an international "parallel" currency.

billion in 1976, $33 billion in 1977, and at an annual rate of more than $40 billion during the first quarter of 1978. This growth of our net indebtedness was in part the result of our other capital exports (line II) but, increasingly, the result of our current account deficits of $15 billion in 1977 and $27 billion, at an annual rate, in the first quarter of this year (line I), reversing average surpluses of $9 billion a year in the previous three years, and a peak surplus of $18 billion in 1975.

It might be added that the deterioration of our current account balance would look far worse still if we excluded from it our net earnings on accumulated investments made in the past. These earnings have grown from $13 billion in 1975 to $16 billion in 1977, to an annual rate of $19 billion in the first quarter of 1978. Discounting them, our *current* absorption of real resources from the rest of the world reached $33 billion last year, and was running at an annual rate of $47 billion in the first quarter of this year.

Such a frightening deterioration of our balance of payments and accumulation of foreign indebtedness explains the gloomy view of foreigners—and of many Americans—about the future of our once mighty dollar. It explains also the desperate attempt of the Europeans to set up a new European Monetary System less overwhelmingly dependent on an inconvertible, fluctuating, and shrinking dollar for their own international settlements and accumulation of official reserves and private working balances.

V

The momentous decision reached last July at the Bremen meeting of the European Community heads of state and government to try to set up just such a European Monetary System deserves far more attention than it has received so far in this country. It is still dismissed by skeptics as a utopian dream, impossible to realize in the face of widely divergent rates of inflation among the member countries of the Community. What they do not understand is that the proposed European system does not entail, in the immediate future, any full, irrevocable, and undoubtedly premature, stability of exchange rates among the participating countries, and even less the replacement of national currencies by a single, common currency, though such a currency is hoped for as an eventual, but still distant, outcome of the institutional reforms now envisaged. What is planned for immediately is a vastly enlarged use of the present Unit of Account of the Community making it into a "parallel" currency usable as an alternative to dollars, Eurodollars and other Eurocurrencies already used to-

day in a wide variety of international accounts and transactions. This parallel currency, renamed ECU (European Currency Unit) in the Bremen proposals, will probably remain initially defined as a "weighted basket" of the member currencies.[8]

The ECU would be used as the main currency unit for all, or most, of the transactions of the European Communities and their agencies, for settlements among member countries' central banks, for mutual monetary support loans and their repayment (as an alternative preferable to the dollar denomination most frequently used today), and possibly for the flotation in the market of international bond issues.

Reserve accounts in ECUs would be opened for each member country in exchange for equivalent transfers or collateral deposits by them of gold and foreign exchange reserves (initially 20 percent of their global reserve holdings) and of matching amounts of their own currency. Valuing gold at prices related—but not fully equal—to current market prices would provide an initial pool equivalent to more than $60 billion, which member countries could draw on to finance their deficits and stabilize their exchange rates. Central banks could draw freely, of course, on that part of their ECU accounts which is fed by their gold and foreign exchange transfers. But their drawings on the accounts issued against their national currency would be conditional upon policy commitments aimed at avoiding inflationary abuses and at correcting persistent deficits in the country's external transactions.

Indeed, the main purpose of the agreement is to promote domestic policies combating inflation as well as deflation, to achieve a better equilibrium in each country's balance of payments, and to reduce thereby exchange-rate instability among the member currencies. The so-called snake agreement would remain in force among its participating countries—West Germany, the Netherlands, Belgium, Luxembourg, and Denmark.[9] What the snake agreement does is to commit the participating countries' central banks to intervene in the exchange market to keep their bilateral exchange rates (between the mark and the guilder, for instance) within a margin of two-and-one-quarter percent of central parities expressed in each of the other participating countries' currencies. Such parities are revised only infrequently. These

[8] Composed of 0.828 German marks, 1.15 French francs, 0.0885 pounds sterling, etc., and giving in effect, as of June 1978, a weight of about 52 percent to the strong, appreciating currencies of Germany and the Benelux, 20 percent to the French franc, and 28 percent to the weaker currencies of Britain, Italy, Denmark, and Ireland.

[9] Besides the Community countries, Norway is also a participant, but the United Kingdom, France, Italy, Ireland and Sweden no longer participate in the snake arrangements.

interventions may be financed either through sales of dollars on the market from the weaker currency country's own reserves, or through short-term credits extended by the stronger currency country to the weaker and repaid by the latter, mostly in dollars, if the disequilibrium calling for such intervention is not reversed before these credits mature.

The aim, however, is to reach an overall agreement encompassing all member countries and committing them to observe broadly similar fluctuation margins, to consult with each other on desirable, or unavoidable, readjustments of their central parities, and to pursue policies deserving the broader financial support to be made available to them through this new agreement.

At this writing, a number of serious, highly technical problems must still be ironed out before concrete and operational reforms can be adopted at the December 1978 meeting of the European Council in Brussels. While it appears likely that agreement will be reached by then on most of these issues, the major hurdle to be overcome will be to reach full agreement with the two weaker countries of the group, i.e., Italy and particularly the United Kingdom, on acceptable and credible commitments by them. Although there is little doubt that Britain and Italy will be parties to an agreement signed in Brussels, some interim provisions may have to be included for either or both of them, postponing their full participation in the normal policy commitments and automatic credit facilities of the new European Monetary System.

This would inevitably entail special provisions regarding the definition of the ECU as a benchmark for compulsory stabilization interventions in the exchange market during an interim period. The temporary exclusion of sterling—and lira?—fluctuations from the calculation of the weighted ECU basket would complicate its definition. It would, on the other hand, make it more attractive to prospective holders by preventing exchange-rate fluctuations of the weakest currencies of the Community from affecting the value of the ECU.

The European Monetary System deriving from the Bremen agreement is also most likely to revolutionize the structure of private, as well as official, credit and financial transactions. Even before the Bremen meeting, a private group of influential business and banking leaders—the European League for Economic Cooperation (ELEC)—approved unanimously, in May 1978, a concrete proposal, which it had asked me to draft, for "A European Parallel Currency as a Shelter Against Exchange Rate Instability."

The League urged the adoption of a parallel European currency

as "an attractive alternative to the parallel currencies widely used already in *transnational* contracts which cannot, obviously, be denominated *simultaneously* in the national currencies of each of the contracting parties. . . . The exchange rate of an appropriately defined European parallel currency would be less volatile [than those of the Eurodollar, Euromark and other Eurocurrencies most in use today], its fluctuations remaining more moderate vis-à-vis the national currencies of member countries, as well as vis-à-vis other currencies."

The League further proposed as the parallel currency the same "European Unit of Account" basket defined in Bremen as the ECU, suggesting, however, that it be popularized under the name "Europa" that would both symbolize the ultimate aim of European Union and dispense with the need for multiple translations into the various languages of Europe and of the world. It pointed out the enormous and growing size of the Eurocurrency market open to the proposed Europa. For example, the foreign liabilities of the banks of the eight European countries reporting to the Bank for International Settlements and expressed in currencies *other* than the domestic currency of the debtor banks totaled, at the end of 1977, more than $383 billion, of which 71 percent was denominated in dollars, 17 percent in marks, and the remainder in Swiss francs, Belgian francs, pounds sterling, etc.

The ECU (or Europa) would, therefore, displace *foreign* currencies, rather than *domestic* currencies, in transactions for which the use of foreign currencies is legally authorized and already prevalent. Its use, however, could be gradually extended to various categories of domestic transactions, as each country succeeds in stabilizing its exchange rate vis-à-vis the ECU. If and when sufficient progress has been achieved to make the hoped-for European monetary union feasible, the already existing ECU would offer a more realistic transition than formerly envisaged (in the so-called Werner Plan) for the eventual merger of the national currencies.

VI

The first reactions of the Carter Administration to the Bremen proposals were ambivalent. The Administration reiterated both long-standing U.S. support for European monetary union, and U.S. skepticism over its feasibility. High-ranking Treasury officials also reiterated U.S. support for making SDRs the principal instrument for international settlements and reserve accumulation, "but, of course, without eroding the traditional role of the dollar." This is, of course, a contradiction in terms since the dollar has

been, since the war, and remains, by far the major instrument in both these respects. American officials also expressed some fears about the inflationary potential of ECU issues and accumulation—as though the use of the dollar had not proved wildly inflationary and was not one of the main arguments for an ECU alternative more controllable by the Europeans than the unlimited acceptance by their central banks of dollar overflows.

Finally, and most bizarrely, they voiced their concern about the fact that the new system might deter the strongest currencies from appreciating sufficiently against the dollar. While it is true that such appreciation might be slowed by being more evenly spread out from the present "refuge currencies"—primarily the mark and the Swiss franc—to a broader range of currencies, Washington's major worry should be exactly the opposite: an *excessive,* rather than inadequate, depreciation of the dollar vis-à-vis the ECU and the European currencies anchored to it. Possible switches in international demand from a weakening dollar to a stronger ECU would indeed threaten to accelerate dollar depreciation and so to make the dollar more and more undervalued. If this were to happen, the clamor for protection against U.S. "exchange-rate dumping" might become nearly irresistible abroad, and the depreciation of the dollar might also trigger a panicky reaction here at home toward protectionism and even some forms of exchange controls and restrictions. Americans and foreigners should accept a depreciation of the dollar sufficient to restore our price and cost competitiveness in world trade, but should not be expected to tolerate the much deeper depreciation that might be—and perhaps already is being—triggered in the exchange markets by the diversification of portfolio holdings from a near-monopoly of the dollar into a broader range of "parallel currency" alternatives. The Europeans are even more anxious than we are to avoid such a danger, and to participate with us in the joint defense and readjustments of the dollar rate vis-à-vis their currencies.

Such policies as may emerge, however, cannot be confined to official market interventions—by them or by us—if it means throwing good money after bad. An indispensable prerequisite for their success is a fundamental attack on the root causes of the dollar weakness, that is to say, our internal inflation and our external balance-of-payments deficits. The clear affirmation by the Congress as well as by the Administration of these two prior policy objectives, and their early implementation by concrete restraints on fiscal overspending, excessive money creation, and particularly on our profligate oil consumption and imports, should help

restore confidence in the dollar, and reverse bearish speculation against it, by Americans as well as by foreigners.

Incomplete and provisional balance-of-payments estimates for the second quarter of this year suggest that the tide may have turned already. Our current account deficit was halved from the first to the second quarter, and was exceeded, for the first time in many, many years, by net capital inflows (including an unprecedented $8 billion "statistical discrepancy"). Together with a contraction—for the first time also in many years—of foreign lending by our banks, and a further accumulation of dollar balances by private holders abroad, this permitted official holders to *reduce* their own dollar holdings—for the first time since 1969—by nearly $5 billion, as against quarterly *increases* of about $16 billion in each of the previous two quarters.

Yet a total and lasting correction of our deficits cannot be expected overnight. Corrective policies—including past readjustments of our exchange rates—produce their full effects only slowly. The avoidance of an excessive depreciation of the dollar is still most likely to require considerable financing of residual deficits that cannot be eliminated overnight.

The Bremen agreement opens up new possibilities in this respect, both for the absorption of residual dollar overflows and for the partial consolidation of the excessive dollar overhang piled up in the past.

G. William Miller, head of the Federal Reserve Board, has recently argued that we should no longer bar the possibility of denominating some of our foreign borrowings in the creditors' currencies rather than our own, in order to make them more attractive and acceptable to prospective buyers deterred by the risk of exchange losses on a depreciating dollar. This would seem even more necessary today than it was in the early 1960s when such bonds and notes were issued to official institutions of foreign countries (primarily Germany and Switzerland) at the initiative of the then Under Secretary of the Treasury, Robert V. Roosa. The adoption of the ECU as a European parallel currency should enable us, however, to denominate instead some of those foreign borrowings in ECUs. Financially, this would expose us to smaller risks of exchange losses than a denomination in marks or Swiss francs. Politically, it would express our concrete support for the new European Monetary System, and be far more acceptable than borrowings in any *national* currency other than the dollar.

Another form of borrowings in foreign currencies is the "swap" or "reciprocal currency arrangements" under which the

Federal Reserve can theoretically draw up to more than $22 billion in foreign currencies, including nearly $18 billion in European currencies. Under these swap arrangements, the amount of any foreign currency bought "spot," i.e., for immediate delivery, is simultaneously sold "forward," i.e, for delivery on or before the maturity date.[10] If the present, still embryonic, European Fund for Monetary Cooperation (EFMC) is strengthened, as planned, to become the centerpiece of the new European Monetary System, these swaps might be denominated also in ECUs rather than in national foreign currencies.[11]

The ECU obligations accumulated abroad under these arrangements need not be bought and retained exclusively by national central banks and the EFMC. Arrangements should be made with central banks and the EFMC enabling them, under agreed conditions, to sell such obligations in the private market, in order to mop up some of the excessive inflationary levels of internal liquidity which their purchases of ECU obligations might create. The ECU exchange guarantee would make such U.S. obligations far more negotiable, at lower interest costs, than dollar obligations are today, and the placement of ECUs in the market would make the financing of our deficits far less inflationary than if ECUs were accumulated and retained solely by central banks and the EFMC.

The ECU denomination could facilitate not only the financing of current dollar *overflows*, but also the consolidation of part of the excessive dollar indebtedness or *overhang*, official and private, accumulated abroad as a result of our past deficits. Conversion of liquid foreign dollar claims—held more and more reluctantly by the creditors—into "substitution accounts" giving an exchange guarantee to the holders has long been suggested in various IMF reports. Too often this proposal has met with objections from the United States, a nation which should, instead, accelerate the negotiation of an arrangement of enormous potential benefit to its battered dollar.

The exchange denomination—and guarantee—proposed so far for these "substitution accounts" is an SDR denomination. But an ECU denomination would provide an alternative that might be deemed far more acceptable and attractive to some of the present dollar holders, especially in Europe, as well as to the EFMC to which some of these holdings might be transferred. The exchange risk that conversions of dollars into ECUs would entail for us

[10] Usually three months later, with the possibility of being rolled over for additional three-month periods by mutual agreement.

[11] The European Fund for Monetary Cooperation is an agency of the Community centralizing some of the operations and accounting of mutual monetary support arrangements among members.

would be more than compensated for by a lowering of interest rates on our obligations and by their consolidation into longer term maturities. Indeed, the most appropriate repayment provisions might even put aside any imperative repayment date. "Consol" bonds paying interest to their holders, but repayable only at the initiative of the debtor, were for many years a familiar feature of borrowings by the British government, and—under the name of *rentes perpétuelles*—by the French government. They could be made similarly familiar and attractive to some of our major creditors today, especially if coupled with a "contingent" repayment obligation in the event that present balance-of-payments disequilibria were reversed and our creditors were again to incur substantial deficits toward the United States.

The measures announced by the Administration on November 1st go exactly in the directions I have suggested earlier. The raising of the Federal Reserve discount rate and reserve requirements confirms the determination of the Administration to assign a high priority to the fight against inflation, which is one of the fundamental prerequisites, mentioned above, to the negotiability and effectiveness of the *joint* financing of agreed exchange rates.

More spectacular are the radical departures from past positions regarding the U.S. willingness to intervene in the exchange market. Huge resources will be mobilized to implement "a commitment to massive intervention, if necessary,"[12] not only to arrest, but even to correct, the excessive depreciation of dollar rates, without of course undertaking any premature commitment to full stabilization vis-à-vis other major currencies.

The United States plans to expand its monthly gold sales from 300,000 ounces to 750,000 ounces in November and at least 1.5 million ounces starting in December, sell $2 billion of our Special Drawing Rights, draw $3 billion from our $4.1 billion reserves in the IMF, increase our currency "swap" lines with Germany, Japan and Switzerland to $15 billion (more than doubling them) and issue up to $10 billion of Treasury securities denominated in foreign currencies.

Not counting our swap lines on other countries, nor gold sales that might bring us about $300 million a month if the gold price does not fall precipitously, this is an impressive package of $30 billion. It includes, notably, two of the major features suggested above: (1) borrowings in foreign currencies and (2) sales of Treasury securities to the private market rather than to central

[12] As announced by Treasury Under Secretary Anthony Solomon at a White House briefing, November 1, 1978.

banks only. I hope, of course, that the results of the December meeting of the European Council will make it possible to explore and implement my other suggestions, including an alternative ECU denomination for some of our foreign borrowings.

VII

The implementation of my proposals should, in time, restore confidence in the strength of the dollar, and even tempt many people—especially in this country—to retain it as the kingpin of a better managed "dollar-exchange standard." My advice would, of course, be exactly the opposite. We should be as averse as foreign countries—or more so—to incurring again the awesome political responsibilities and inflationary temptations inseparable from the exorbitant, but poisoned privilege of having our *national* currency used as the main international currency of the world. The same privilege proved fatal to the pound, leading to its overvaluation and to widespread deficits and unemployment after the First World War, and again in the last ten years, and to recurrent crises and depreciation of sterling. It proved equally fatal to the dollar after it replaced the pound as the keystone of the world monetary system.

These two experiences have persuaded Germany, Switzerland, and Japan to prevent, or discourage, private and official holders from switching from a weaker dollar into their own stronger currencies. They should also discourage the European Community from favoring similar switches into their proposed ECU and from allowing it to become a rival to the dollar as a parallel world currency. Particularly important in this respect would be a provision limiting or prohibiting official holdings of ECUs by countries that are not members of the Community.

But there is no doubt that in the absence of close cooperation between the United States and the European Community, the ECU might become a powerful rival to the dollar and aggravate further its already excessive depreciation in the exchange markets of the world. It is high time that U.S. officials—and their advisers—pay full attention not merely to the dangers but also to the opportunities flowing from a forthcoming European Monetary System. The early negotiation and implementation of the proposals summarized above—and of others—will be crucial to avoid a potential disaster and, instead, to make the European Monetary System highly beneficial to the United States and to the rest of the world as well as to its members.

The reconstruction of a viable world monetary order, acceptable

to Southern and Northern as well as to Eastern and Western countries, should prompt us to resume, with a new sense of urgency and determination to succeed, the negotiation of the basic reforms outlined by the IMF Executive Directors in their 1972 report on *Reform of the International Monetary System* and by the Committee of Twenty in 1974, after 20 years of continuous and searching debates and negotiations. An intellectual consensus had emerged at that time and could undoubtedly be revived and reflected in treaty form, if the United States now joined other countries in a political determination to implement, at long last, the reforms then deemed indispensable to the orderly functioning of any international monetary system.[13]

In brief, a new form of international reserve asset broadly similar to—but less absurdly baptized than—Special Drawing Rights should replace the dollar as well as gold in international settlements and reserve accumulation. It would be issued by the IMF in such amounts as to adjust the growth of world monetary reserves to the noninflationary requirements of feasible growth in world trade and production (rather than to the vagaries of the U.S. balance of payments and of the private gold market). The potential lending power transferred thereby to the IMF should be used for the financing of internationally agreed upon, top-priority objectives of the international community (rather than for the financing of U.S. deficits and gold sellers).

The explosion of private banks' foreign lending described above, and particularly the incredible mushrooming of "offshore" banking, should call, in addition, for some attempt to reach international agreement among the major countries involved in these operations. The foreign assets of U.S. banks alone—including those in the Bahamas and in the Cayman Islands!—have more than doubled since 1969 and are now more than double the foreign assets of their head offices. This can hardly be explained other than as an attempt to evade domestic taxes or regulations. But so far it has not prompted the governments of major financial countries to make any serious attempt to negotiate guidelines necessary to limit obvious abuses contrary to the public interest.

The forthcoming European Monetary System should be part and parcel of a more decentralized International Monetary Fund structure, leaving to regional groups of like-minded countries responsibilities for more intensive monetary cooperation and integration than is yet feasible, or even desirable, on a global scale.

[13] Latest summarized in the "Outline of Reform" on pp. 7–48, of *International Monetary Reform. Documents of the Committee of Twenty*, Washington, D. C.: International Monetary Fund, 1974.

The gradual stabilization of exchange rates, for instance, may still be for a considerable time a more feasible and desirable goal within each—or at least some—of these regional groups than it is as yet between all such groups and countries.

Thus, the most urgent task for the United States is to help the new European Monetary System to succeed, and to insert itself into a worldwide monetary order, rather than become at best a mere inward-looking oasis, or at worst a total failure, condemned by our lack of cooperation to live in a world of continuing monetary chaos.