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The World Monetary Order

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THE WORLD MONETARY ORDER

The title of my speech this afternoon is taken from the title of a chapter in the Brandt Commission Report. It is Chapter 13, on "The World Monetary Order." I shall refrain from making many comments about this chapter because, just between you and me, it is not very good economics. But we don't have to tell that to anybody.

Order and Disorder, System and Nonsystem

What the writers of the Report had in mind when they wrote about the World Economic Order was really to say that it is not an order, but rather a disorder. This is a value judgment; what is "order" for one person is "disorder" for another, depending on whether he likes it or not. Some people try to escape this value judgment by speaking of a "system," in the present context, "the world monetary system." But then others come forward and deny that we have an international monetary system; instead, so they claim, we have a nonsystem. Yet, to discuss a nonsystem is sheer nonsense, for one cannot say anything about a nonsystem. If this sounds odd, let me explain. A system consists of a combination, or structure, of different elements, concepts, or variables. For example, we speak of national product, labour, productivity, employment, commodity prices, interest rates, exchange rates, exports, balance of trade and several other things, and assume that they are somehow interrelated. The notion of interrelatedness of different things is called "system." Whenever we talk about how one thing may affect another, we are talking about a system. To think about how a change in any one variable affects changes in some other variables implies thinking about a system.

Needless to say, one may assert that the system is good, or the system is bad, but in this case the person who says so should add **why**, in his opinion, it is good or bad for **what**, and good or bad for **whom**. What is good for one person or group of persons may be bad for another, and what is good for one purpose may be bad for another purpose. Thus, we are back at value judgments. Even if we agree on how the system behaves, that is, if we are in full agreement on how one thing affects another, we might still disagree on whether the outcome is good or bad for something and somebody.

Normally, when an economist speaks of a good system or a bad system, he has an objective in his mind. Now what kind of objective can someone have in mind when he speaks of a monetary system? For the **domestic** economy the answer is clear. A monetary system has the function to aid in the exchange of goods, services, and assets. A monetary system is good if it facilitates economic transactions. It should facilitate purchases and sales, lending and borrowing, and the exchange or transfer of assets of all kinds. And it should do so at the least cost and least inconvenience, with the greatest privacy, and without any obstacles and obstructions. Thus, an expert in economics will judge a monetary system as good if it facilitates transactions instead of making them more difficult.

This criterion can be applied also to the **international** monetary system. Thus, the international monetary system will be judged to be good if it facilitates international transactions, if there are no obstacles to purchasing and selling, to lending and borrowing, to the movements of goods, assets, people, and ideas from country to country. It will be judged as bad if it puts obstacles in the way of international transactions. Here, however, the agreement among observers ends, because many politicians and special interests are not in favour of easy and unrestricted international transactions. There are differences in objectives. Some

want their country to be isolated, or more insulated, to have more direct controls over its citizens or subjects, to allow them less privacy to exercise more regimentation, and so on. If so, they will not be in favour of an international monetary system that facilitates transactions. Controversy is inevitable if some people want freer international trade and capital movements while others want restrictions on trade and capital movements.

Besides the general objective of freer international trade and freer capital movements, economists entertain several other policy objectives. For example, many believe that monetary policy can contribute to stability of the price level or can guarantee stability of exchange rates, or can secure more employment of labour, or achieve faster economic growth, or help towards a more equal distribution of income, and so forth. Unfortunately, all or most of these objectives are mutually incompatible; and many politicians do not understand this incompatibility, or do not want to understand it. With some efforts, every intelligent person could learn to understand this sad or dismal side of economics, but a politician's life is easier if he remains innocent and uninformed. Many people are fond of all these objectives. They want them all, but it is practically impossible to have them all. Much conflict arises from this fact.

Objectives, Targets, Indicators, Instruments

There is more to say about the goals of monetary policy. We should distinguish between objectives, targets, indicators, and instruments of policy. Indicators are supposed to tell us how things are, how closely we have come to reaching a target or how far away we are from attaining an objective. Indicators are often used as guides to policy. Where economic and monetary policies are guided by such indicators, people often forget that indicators can be so used only if there are instruments available by which one can change the prevailing conditions in the

desired way. All too often the power of the instruments to work in the desired way is overestimated, and, when they are put into action, they do not perform to the expected extent or even in the expected direction. Ministers and politicians tell the central bank to achieve this or that, but the central bank has no instrument by which it can achieve it. Sometimes it is hoped that one and the same instrument can have two, or more, mutually inconsistent effects. Sometimes an instrument works "perversely", pushing things (and their indicators) in the opposite direction.

Permit me to give an example from the monetary policy of the United States. Many people believe that the central bank can control the rate of interest and push it to the level they like best. They are convinced that the central bank has the instruments to reduce the rate of interest. Low interest rates favour borrowers and investors, and more investment may raise employment. So the politicians, including those in the government, want the central bank—that is, the Federal Reserve system—to make the interest rate lower than where market forces put it at the given stock of money. They believe the central banks can get interest rates down, though it may take credit extension to get them down. Alas, the central bank may be unable to achieve this goal. It has no long-term control of the interest rate. Once I said to a group of central bankers who talked about interest-rate policy that the rate of interest is none of their business. They were horrified about what they thought was my "heresy". I made this provocative statement in order to make them aware of the fact that the old theory, or old rule, which they had learned was not valid, at least not under present circumstances. Once upon a time it was true that, if the central bank lent more money at a lower rate of interest, increasing its loans and its purchases of domestic securities, there was a tendency for the money market to become easier, and the money rate of interest to become lower for a time. These circumstances no longer exist. If the Federal Reserve system

in the United States were in the present situation to adopt a policy of extending more loans and purchasing more securities, the interest rate would rise almost immediately. On Friday evening, as soon as bankers and businessmen learn that the Federal Reserve has been doing this, the demand for loans would shoot up and the market rate would go higher. Why? Because the people in the money markets have become smarter. They have learned that all that the Federal Reserve can do is to create a larger monetary base for additional loans by commercial banks, and they have learned from recent experience that the anticipation of additional credit raises inflationary expectations. Inflationary expectations induce smart people to buy before prices rise and, in order to buy, they try to borrow. As a result of their demand for loanable funds, the rate of interest will immediately start going up instead of going down, as some had hoped.

This seemingly paradoxical phenomenon has been observed now for at least a year or two, though it will probably take several more years until conventional observers of the market begin to understand. We all have learned that some people persist in holding on to outdated theories and repeat their old arguments of faith for decades, if not generations. This "unshakable faith" is especially noticeable among members of legislatures.

It seems especially hard for people to understand that one and the same instrument may at one time work one way, but at other times in the opposite way. Even real experts may be quite uncertain about the direction, let alone the extent, a particular policy measure is going to work.

Central banks are often accused of pursuing a bad policy, harmful to the economy, when in fact they are doing the best that our present knowledge directs them to do. In some countries, central bankers are not only criticized but even harrassed, if not dismissed, when they pursue unpopular policies. In a good

many countries the minister of finance, or secretary of the treasury, may wield enough power or influence to tell the central banker what to do—even when expert opinion supports the more cautious view of the central banker and warns against the short-run policies often so dear to governments in power. In such instances of conflict the central banker has two choices: to obey or to resign. This may be a difficult choice to make. History has recorded some instances where central bankers have preferred to resign, or have threatened resignation, unless the inflationary pressures from political power and interest groups were stopped.

In discussing these conflicts of theoretical and political views and the inconsistencies among economic objectives, targets, indicators, and instruments, I was fully aware that these ideas are not easy to comprehend. My respect for my audience today has prevented me from omitting the discussion of issues that make high demands on the capacity to understand.

Liquidity, Adjustment, and Confidence

During the last twenty years or so it has become customary to distinguish three criteria by which the performance of an international monetary system can be judged. Early explanations of these criteria can be found in a brief publication entitled *International Monetary Arrangements: The Problem of Choice*. This was a report, published in 1964, summarizing the deliberations of an international group of 32 economists. We decided to discuss international monetary arrangements under three aspects: liquidity, adjustment and confidence. It is still convenient to use these three rubrics for a discussion of the international monetary system.

The concept of international **liquidity** is rather complex but can be made easier to understand by reducing it to some measurable aggregate, particularly the sum of international monetary

reserves held by international monetary authorities. The concept of **adjustment** refers to the mechanics and policies built into or associated with the national monetary systems that would allow the balance of foreign payments to adjust readily when it is disturbed by internal or external forces. If, for example, a deficit on a country's overall balance of payments arises, or is expected to arise, what kind of mechanism or what kind of policy can turn things around in such a way that the deficit is reduced, disappears, or gives way to a surplus. Such deficits and surpluses are usually measured by reductions or replenishments of the international reserves of national monetary authorities. Thus, it becomes clear that both, liquidity and adjustment, refer to monetary reserves; the first to the aggregate for all nations together, the second to the changes in the distribution of the aggregate among individual nations.

The third criterion, **confidence**, was often somewhat obscure, because it was not made explicit whose confidence in what was at stake. To make it clear, one should focus on confidence in various reserve assets in terms of the long-run expectations of their relative values. Thus, if official agencies and private agents hold among their reserves and cash balances large amounts of dollar holdings, it will be important that they do not entertain serious doubts about the dollar losing value in comparison with alternative assets suitable for reserve purposes and liquidity. When during the 1950s the dollar holdings of most countries had been increasing so much that they stopped complaining about "dollar shortage" and began to allude to an abundance of dollar holdings—so-called dollar glut—this change from too little to too much was interpreted by acute observers as a possible foreboding of a possible crisis of confidence. Such a crisis can destroy any existing international monetary system. If many countries were to become anxious to shift their reserve holdings from dollars to gold, or into other currencies, a system based on fixed rates of

exchange would collapse. The United States had lost approximately one half of its gold reserve in the eighteen years from 1949 to 1967 (holding only 12 billion dollars worth of gold at the end of 1967). During the same years, the United States had increased its liquid liabilities to official foreign holders of dollars from 3 billion to more than 18 billion dollars. Thus, it would have been impossible to convert all the dollar holdings into gold and, moreover, every amount of dollars actually converted into gold would be tantamount to a reduction of gross international monetary reserves by the same amount. The system could not survive such a crisis.

The End of Fixed Exchange Rates

The danger of mass conversions of dollar reserves into gold was averted when, faced with large demands for such conversions, the United States, in August 1971, cut the link between dollar and gold. The "gold window" was closed. If none of the countries can convert dollars into gold at a fixed price, one does not have to fear mass conversions.

The fear of a crisis of confidence had become quite obvious in the middle of the 1960s. In early 1968 a makeshift measure was adopted, creating a two-tier system of gold transactions and confining potential convertibility to official holders. When the danger of actual conversions by official holders of dollars became too obvious, and when the gold-holding countries were unwilling to accept an appreciation of their currencies relative to the dollar, the United States had no choice but to terminate all convertibility of dollars into gold.

One may interpret the problem of declining confidence during the 1960s as a consequence of the failure of the adjustment mechanisms. Beginning sometime around 1964, the U.S. dollar became overvalued at the fixed exchange rates. There could have

been two kinds of adjustment: either a drastic deflation of the money supply and aggregate demand in the United States, or an adequate devaluation of the dollar relative to the undervalued currencies of other industrial countries. Since neither of these two adjustment policies were accepted by the authorities of the time, the Bretton Woods system with fixed par values of exchange was doomed.

A few farsighted economists had predicted the collapse of the par value system as early as 1960; many others reached the same conclusion between 1965 and 1967. They knew that the attempts to prop up the system were in vain. The resistance of the central bankers and governments to abandoning fixed par values was futile and harmful. Even after August 1971, when the convertibility of the dollar into gold was terminated, most monetary authorities continued to purchase vast amounts of dollars, dumped on them by private holders. The central banks absorbed these dollars at a nonsustainable high price, chiefly in order to protect the industries of their countries against competition from "cheaper" American goods. In December 1971, they agreed to "realign" the par values, but what sense does a one-time realignment make in a world in which inflation rates are high and vary from country to country? Fixed par values simply make no sense in a world in which monetary means are used for purposes other than external stability of currencies. A few months after the realignment of presumably fixed exchange rates, the United Kingdom had to devalue the pound sterling, and early in 1973 the United States had to devalue the dollar a second time. By March 1973, the era of managed floating of foreign-exchange rates had begun.

In their attempts to avoid reductions in the exchange value of the U.S. dollar, many central banks had increased their dollar holdings by vast amounts. Their dollar holdings increased from 16 billion dollars in December 1969 to 76 billion dollars in

December 1974, an increase of 475 per cent. This brought with it the problem of excess liquidity and invited monetary expansion in virtually all countries of the world. It could have been avoided if the system of fixed exchange rates had been terminated in 1967 or 1968.

Supposedly Unnecessary Fluctuations

Many people have complained that the system of floating exchange rates has led to "unnecessary" fluctuations. They pointed to the fact that the dollar had fallen excessively, then recovered, then fallen again, and so forth. From this fact they concluded that such fluctuations were unnecessary, or at least exaggerated. Such a conclusion is unwarranted. If the price of a commodity moves up and down, this does not mean that the movements do not serve an important function. A larger demand may raise the price, and when this price induces increasing supplies the price may come down again. The demand that the price should be held fixed at some "average level" is understandable but unwise. This statement holds also for movements of exchange rates: such movements are usually warranted by perfectly reasonable expectations of future developments.

Private speculators are sometimes accused of causing "unwarranted" fluctuations in price. Yet, if these speculators make a profit, this can be taken as evidence that their activities have had a stabilizing effect. Their profits show that they purchased at relatively low prices and sold at higher prices. In buying at low prices, they prevented prices from being still lower; and in selling at high prices, they prevented prices from being even higher. Hence, profit-making speculators are unjustly charged with destabilizing activities.

There is a group of official speculators that does not usually profit from their transactions in the foreign-exchange markets. These official speculators are the central banks and other monetary

authorities that intervene in the markets, supposedly in the public interest. Several central banks have suffered considerable losses in their foreign-exchange business.

Unfortunately, we do not have any reliable statistics of official interventions in the foreign-exchange markets. I strongly suspect that the actual figures would show that these official sales and purchases have contributed much to destabilizing of exchange rates, probably more so than can be attributed to private transactions. For a few selected countries we have enough data to show that their monetary authorities hoarded dollars at one time and tried to dump them at other times, with results that cannot help being destabilizing. Aggregate statistics of foreign-exchange reserves cannot show the effects of official interventions. If some monetary authorities sell dollars while others buy dollars, the effects on exchange rates depend on who took the initiative: the price of the dollar will fall when some official holders attempt to diversify their holdings of foreign exchange and others are induced to absorb the weakening dollar; the price of the dollar will rise when some official holders attempt to build up their dollar reserves and others are induced to reduce their holdings as the dollar strengthens in the market. Empirical research on these matters would be possible only if all or most of the monetary authorities furnished weekly or monthly data of their holdings, broken down by denominations and by type, for example, dollars held in U.S. Treasury securities and dollars held in xenocurrency markets. I repeat that I suspect that many of the ups and downs of the dollar in recent years were caused or aggravated by official interventions. The irony of the situation is that the complaints about exchange-rate fluctuations are voiced chiefly by the official authorities, and they often blame private speculators for the "excessive" movements.

It may appear inconsistent if I speak of "warranted" fluctuations when they are caused by private speculation, and at the same

time speak disapprovingly of fluctuations caused by official interventions. Am I perhaps applying a double standard, favouring the private sector and disfavouring actions by public authorities? Perhaps I should admit such a prejudice, but in this case I may repeat the criterion of profits from stabilizing speculation and losses from destabilizing speculation. I think private speculation has, by and large, been profitable, whereas official interventions have often resulted in losses.

Xenocurrencies

I have used the word "xenocurrency" markets. Perhaps I should explain this technical term. Xeno is a Greek word and means "foreign." Xenocurrencies are claims against foreign banks located in countries other than those in whose currency the claims are denominated. Trade language uses the word Eurocurrencies, and especially Eurodollars, because originally these were claims against banks in Europe. Later, however, banks in Singapore, Hong Kong, the Bahamas, and many other non-European countries have become major markets for this sort of business. Since these places are not in Europe, it is silly to speak of Eurocurrency markets, Eurocurrency loans, and Eurocurrency deposits. The word "xenocurrencies" solves this terminological problem.

It is an interesting question whether the existence of xenocurrency markets has contributed to fluctuations of exchange rates. I believe, though one cannot be sure, that this question has to be answered affirmatively. There are two reasons why this should be so. For one, the possibility of xerobanks to denominate their loans and their deposit liabilities in currencies of other countries reduces the control of central banks over the total supply of their own currencies. For example, the U.S. Federal Reserve system has less control over the world supply of dollars if dollars can be created by banks in London or Singapore. Similarly, the German central bank has less control over the world supply of the German

mark if banks in Hong Kong or in the Bahamas can create deposits in German marks. The second reason is that foreign-exchange transactions are usually cheaper in the xenocurrency markets than in national markets. The lower the transactions costs, the more tempting will it be to use foreign-exchange operations in hedging and speculative activities.

The statistics of xenocurrency holdings are not very revealing, although we have received much valuable information thanks to the research activities of the Bank of England and the Bank for International Settlements in Basel. Their attempts to separate interbank deposits and nonbank deposits are highly significant, but the separation can be done only for banks located in Europe. For xenocurrency deposits held by residents of non-European countries, the separation is not possible, because of a lack of detailed reporting.

A good indication of the growth of xenocurrency creation is the difference between dollar holdings of monetary authorities and the American dollar liabilities to these authorities. These differences were minimal in the early 1960s but have grown from year to year. For example, as of December 1980 the total dollar holdings of official holders were approximately \$ 225 billion whereas the total dollar liabilities of the U.S. government and U.S. banks to these foreign official holders were only about \$ 157 billion. Most of the difference is accounted for by the fact that many central banks (though probably not those of members of the Group of Ten) hold xenodollars, that is, dollar claims against banks outside the United States. (The official holdings of xenodollars in December 1980 have been estimated to be \$ 68 billion, which tallies perfectly with the "difference" just mentioned.)

Gold Reserves

One may ask how much the official gold reserves have contributed to the increase in the world total of monetary reserves.

Valued according to the free-market price in London, the total gold holdings of monetary authorities in December 1980 were SDR 433.5 billion. This was the equivalent of U.S. \$ 553 billion. At the end of 1973 the value of these gold holdings had been only SDR 94.7 billion, which was equivalent to U.S. \$ 114 billion. It is important to bear in mind that in terms of physical quantity, the official gold holdings had not changed during these years, indeed they were slightly lower in 1980 (938 million ounces) than they had been in 1973 (1,018 million ounces). It was the enormous increase in the free-market price of gold that inflated the valuation of the physically unchanged gold reserves. The question arises whether the blowing up of these values of gold holdings has contributed to the inflation of the money supply in the world. I am inclined to answer this question in the negative. My reason for this is that the largest countries, say, the United States or Western Germany, have not been influenced at all by the valuation of their gold holdings. Indeed, the authorities of the United States carry their gold still at a book value of \$ 42.22 per ounce, virtually 1/10th of the present market price. Several other countries have chosen to revalue their gold holdings on their balance sheets. The Bank of France, for example, values its gold at the average market price of the preceding six months, so that they sometimes have to write it up and sometimes write it down on their books. It is quite possible that the feeling that its gold reserves have increased in value in the free-market may have reduced the monetary restraint of the Bank of France—if you can call it restraint when the money supply is increased by as much as 15% a year.

The gold holdings of the monetary authorities, no matter how high they value them in their balance sheets, are not really a liquidity reserve. A reserve is liquid only if the holder can use it freely with a feeling of confidence that he will not suffer a loss by doing so. Central banks will not easily use any part of their

gold to finance a deficit in the balance of payments when they must fear that the price of gold may rise during the next few weeks or months. No one wants to sell an assets when he thinks that it may soon appreciate. Thus, the continuous fluctuations in the price of gold have deprived gold of its quality as a "liquid" assets. Monetary authorities in need of reserves will at best use their gold as pledge or collateral for borrowing foreign currencies from other official agencies or in the market.

Special Drawing Rights

Of all types of monetary reserves special drawing rights represent the smallest portion of the total. At the end of 1980 the holdings of special drawing rights by national monetary authorities were only SDR 11.8 billion. At that time, total monetary reserves excluding gold were SDR 321.9 billion, and reserves including gold (with gold valued at the free-market price) were SDR 755.4 billion. The share of SDRs in total reserves was somewhat larger in 1981, partly because there was another allocation of special drawing rights in January 1981, and partly because the price of gold had declined in the markets. Still, SDRs are an almost negligible portion of total reserves, and this is in conspicuous contradiction to the official aim to make the special drawing right the most important reserve asset. It also shows that one of my Predictions was very wrong. Back in 1968, in a booklet titled *Remaking the International Monetary System: The Rio Agreement and Beyond*, I had written that special drawing rights could conceivably become the most important reserve asset. My mistake was that I did not believe that the monetary authorities would continue to purchase overvalued dollars. I rarely make predictions, and I always admit when I was wrong. I do this because I am firmly convinced that economists cannot predict with any reliability and should refrain from pretending that they can.

The idea of the creation of a new reserve assets was a good one. I was among the proponents as early as 1964|65. At that

time it looked as if monetary reserves might stop increasing. Gold reserves did not increase, because private hoarders brought all the gold that was newly produced, leaving no gold for monetary purposes. Dollar reserves would stop increasing, so I hoped, because the system of creating and financing continuous deficits of the United States was bad and should be terminated. I was pleased when the Governors of the International Monetary Fund agreed in the autumn of 1967, at their meeting in Rio de Janeiro, that a new reserve asset, called "special drawing rights", should be created. It took more than two years to get it legalized; in January 1970 the first allocation of special drawing rights took place.

Subsequent allocations were made in 1971 and 1972, and then again, after a lengthy pause, in the three years beginning 1979. No agreement has been reached on further allocations; thus, no allocation will be made in January 1982. This is significant because the Group of Seventy-Seven and the Group of Twenty-Four, both representing the developing countries, had proposed and emphatically requested that allocations be raised to SDR 12 billion annually. The Group of Ten, representing industrial countries, had argued against further allocations at this time. The only agreement the Governors of the IMF could reach was to ask the Executive Directors and the Interim Committee to engage in further studies of the problem.

Perhaps I should interject at this point an explanation of the term "special drawing rights." We must distinguish between two uses of this term, (1) as a right to draw funds, and (2) as a name for a monetary unit. In the negotiations for the creation of special drawing rights, a conceptual controversy had developed between one group that wanted to stress the creation of a new reserve asset and another group that wanted to stress the institution of a new credit facility. This quarrel was resolved by avoiding both these terms and coining a new one that would not include either

"asset" or "credit". "Special drawing rights" satisfied both parties. No agreement, however, could be reached on a name for the unit. The member countries were to get specified amounts allocated, and it was of the essence to find a name to express the amounts. No name used for any of the existing currencies could be acceptable, neither dollar, nor pound sterling, nor franc, nor mark, nor rupee. Should one call it "International Monetary Unit" (IMU) or "International Reserve Unit" (IRU) or "Composite Reserve Unit" (CRU)? Any such name would have been serviceable. When no consensus was achieved, the management of the Fund could do nothing else but use SDR not only as a generic term for the drawing rights but also for the units in which the drawable amount could be expressed. This makes as much sense as if people were writing a cheque and expressed the amounts also in "cheques," so that they would write a cheque for 2000 cheques and another cheque for 5000 cheques. Thus we must now live with this crazy scheme where the same name is given to the thing itself and to the quantity in which it is measured. The use of SDR as a unit in which some monetary values can be expressed has become general practice. We now speak of U.S. dollars in a value of this many SDRs, gold holdings in a value of that many SDRs, and special drawing rights in the value of so many SDRs.

Far more important than this question of nomenclature is the question of whether more special drawing rights should be created; if so, how much per year, and how should they be distributed among different countries? These are questions that are not matters of semantics and not even important questions for economic theorists, but they are of extreme importance for poor countries that need resources.

Transfer of Real Resources

The allocation of special drawing rights does not directly provide real resources for the recipients; indirectly, however, it

may. A country using some of its special drawing rights can obtain dollars or other currencies from countries that have large reserves and surpluses in their balances of payments. These dollars or other currencies can be used for paying for imports from any country. Net imports constitute a transfer of real resources. To be sure, these resources need not come from the country that has accepted the special drawing rights in exchange for some of their foreign-exchange reserves, but they come from any country that has the right kinds of goods to sell at the right prices. It should be clear therefore, that the use of special drawing rights constitutes drawing on some countries' real resources.

People who have learned their economics from teachers or books with mercantilist preconceptions believe that export surpluses are "good" for a country and that it is pleasant for a nation to give up real resources to other nations. Those holding such beliefs think that the allocation of special drawing rights to poor deficit countries and the use of these SDRs for paying for their imports will create additional income and employment in the surplus countries. This would be right only if these countries had no other use for their unemployed labour than to produce export goods. Yet the major cause of unemployment is lack of opportunities for employing labour profitably, and such lack exists when the prices of labour are too high relative to the prices of products. There are some exceptions, for example, in periods following a large-scale destruction of money, a condition that was present for several years after 1930, and that gave rise to the theory that employment can be created by creating and spending more money. Nowadays monetary expansion and increases in effective demand lead chiefly to inflation of prices, including wage rates, and not to a reduction in unemployment.

The fact that the transfer of real resources from more developed to less developed countries does not raise income and employment in the surplus countries, does not imply that such trans-

fers will necessarily cause a reduction in the wealth of the rich countries. For if exporters of capital can receive incomes from interest and dividends, and if the returns on the investment in developing countries exceed the returns achieved at home or in other developed countries, then the transfer of resources to developing countries will be advantageous also to the affluent nations.

It would be too narrow-minded to argue in favour of transfers of resources to developing countries only on grounds of material benefits accruing to the industrial countries. There are weightier arguments in support of development finance. The strongest argument, in my opinion, is humanitarian: the rich should help the poor even if the rich will be less rich as a result. But I have offered also another argument, one that was valid vis-a-vis the many persons in rich countries who propose a return to the gold standard. Let me demonstrate this argument, which I first presented in 1965 in an article with the title "The Cloakroom Rule of International Reserves: Reserve Creation and Resources Transfer."

Buying Gold or Earning SDRs

Industrial countries that are willing to restore a gold standard indicate thereby that they are willing to commit themselves to purchase at a fixed price all the gold that is offered to their monetary authorities. The producers of gold will be paid with the money of the countries that accumulate gold reserves, and this money will be used to buy the products of the gold-importing countries. In other words, any country that buys gold is giving up real resources in exchange for the gold that it puts into the vaults in the cellar of its central bank (or other monetary authority). The exports go to the gold-producing countries; about 80 per cent of the world's gold production comes from South Africa and the Soviet Union.

The gold in the vaults serves only psychological, emotional purposes whereas the real resources given up in exchange for it

are of material value to the workers and to the owners of the gold mines (that is, the government in the Soviet Union, the shareholders of the mining companies and the tax authorities in South Africa). In other words countries that build up their monetary gold reserves have to "earn" these reserves by sending goods to the gold producing countries. As long as these countries are willing to "earn" their monetary reserves through surrendering real resources, it would be much more helpful for the world if they were accepting SDRs from developing countries. The ink and paper needed to produce and allocate new SDRs cost almost nothing, whereas the digging of gold ores and the refining of gold costs a great deal of potentially productive resources. If the industrial nations are willing to earn their monetary reserves by exporting goods, these exports could go to the developing countries using the SDRs allocated to them. Instead of producing gold for filling vaults, the world would produce much needed things for the infrastructure of developing countries, such as irrigation projects, railroads, highways, schools, hospitals and other useful things. The resources-cost to the industrial countries "earning" the increases in their monetary reserves would be no greater for SDRs ("paper gold") than they would be for real gold. Moreover, SDRs would be "earning assets" in as much as they carry interest whereas gold is not an earning asset—it brings no return to the holder. To those who believe that real gold reserves may protect us from inflation we have to say that the expansion of SDRs is likely to be much more limited than the increase in gold reserves if gold is bought in unlimited quantities at fixed (or increased) prices by the monetary authorities. The inflationary potential of monetary gold is greater than that of SDRs.

The Case Against SDR Creation

The fact that an SDR system would be safer and more economical than the gold standard cannot reasonably be used in an argument in favour of SDRs as instruments in development finance.

Indeed, the most serious argument against SDR creation is the possible abuse of the system for purposes of promoting unilateral international transfers of real resources. We should not forget that special drawing rights were conceived as means to allow noninflationary increase in monetary reserves to finance temporary imbalances of international payments, not to finance long-lasting needs for long-term capital. Road building and hospitals are highly important projects, but they should not be linked with the operation of a sound international monetary system.

The principle that monetary reserves should not be used in lieu of long-term capital funds was quite clear to the founders of the Fund and the Bank. The Fund was not to have any business in procuring capital for investment purposes; this function was assigned to the World Bank and its affiliates. The purposes of monetary reserves were strictly confined to the short-term finance of deficits that were about to disappear. Fundamental disequilibrium, or imbalances that are not likely to disappear in the near future, should not be financed but should be cured by drastic adjustment (through demand management and/or changes of exchange-rates). Strictly interpreted, emergencies that are expected to last for several years ought not to be taken care of by the International Monetary Fund.

In my view, the extended facilities which the Fund has provided to relieve the nations' suffering from various kinds of shocks may be desirable on humanitarian as well as political and other pragmatic grounds, but they are in violation of the basic principles of monetary policy. Just as a central bank should not be misused to finance aid to poor orphans and widows or to finance investments for handicapped or disadvantaged persons, the International Monetary Fund should not be saddled with functions other than the ordinary alleviation of the adjustment of strictly temporary imbalances of payments. The use of any Fund facilities, just as the

use of other monetary reserves, should be only for strictly short-term purposes. (An easy way to define "short term" is to estimate the probability that a country in question will before long turn around its payments position from deficit to surplus and to demonstrate that the authorities have already taken the measures that are expected to accomplish this turn-around).

From the point of view of this hard-boiled orthodoxy, many things done by the Fund in recent years have to be condemned as being in violation of the spirit of the institution. The most recent news about the large loan to India is another case in point. No one can possibly deny that here the facilities of the Fund will help the financing of long-term investments.

Apply now my orthodox principles to the question of the creation of SDRs. It has been demanded that the scheme for creating a reserve asset that would circulate from country to country, and therefore would not promote unilateral transfers of resources, be linked with a scheme for the finance of development, that is, for a flow of resources from developed to developing countries. This link may or may not be acceptable on pragmatic grounds; but it is certainly inconsistent with sound principles of monetary management. Development finance is one thing, sound money is another. We should understand that many who are wholeheartedly in favour of more generous transfers to developing countries may vigorously oppose the link between reserve creation and resources transfer.

SDR Creation: The Total and Its Distribution

Before I leave the discussion of SDR problems, I should comment on a fallacy. It is sometimes believed that one can determine the "appropriate" amounts for new issues of SDRs—appropriate in the sense that the total increase in monetary reserves will be neither too little nor too large—and that, once this total

has been determined, one may distribute it among the nations in such a way that those in need get large allocations while those who do not need them be given little or none. This is a serious fallacy. The inflationary effect of a given amount of reserve creation will depend on its distribution. One and the same total will have no inflationary effect if the countries that receive allocations do not use them; it will have serious effects if the countries use much of what they are given.

This is easy to understand. If we print a billion dollars and give it only to rich people, they will not quickly spend the new cash received. If we give the billion dollars only to poor people, they will spend it immediately. The inflation of demand depends, not on the printing of money but on the spending of money. The larger the portion that is given to those who need it, the greater the inflationary effect. It follows that one cannot estimate the amount of SDRs that would be "noninflationary" before one knows to which countries it will be allocated.

The Limits of Development Finance

Having made a few, possibly rather unpopular, comments on the finance of development, I might risk a few more observations on this subject, although they will go beyond the theme of my lecture, in that they no longer relate to the world monetary order but to the wider subject of the world economic order. The first observation will be on the question of the possible magnitude of development aid to be expected from democratic industrial countries.

Various rules or norms have been proposed for determining the minimum contributions by industrial countries. At one time the proposal was that they give 1 per cent of their gross national product, but it was not clear whether this amount should be net or gross, that is, whether payments of interest and principal on old

debts should be taken into account, and whether capital investments from private sources should be included in figuring the total aid provided. In recent pronouncements the rule was proposed that official aid, from government to government directly or through international agencies, be at least three-fourths of one per cent of the gross national product of the donor country. Very few countries have lived up to this expectation. If my memory is correct, the Scandinavian countries and also the Netherlands are among the most generous. The United States is below one-half of one per cent and many Americans are disappointed about the stinginess of their country.

I invite a realistic consideration of this problem. The gross national product of the United States is now approximately three trillion dollars. One per cent of this would be 30 billion dollars; three-fourths of one per cent would be 22.5 billion dollars. The Congress of the United States is just now debating the problem of its budget deficit and of the imminent deficit of the Social Security system. The senators, the representatives, and the administration are bickering about every million. No one wants to face the problem of cutting the benefits to old-age pensioners or to the unemployed. Cuts to all sorts of programmes, including grants for research, education, and health are being debated acrimoniously, and the latest proposal to cut another 3 billion dollars from the total budget is causing anguish to the legislative bodies. In these circumstances, is it realistic to expect the legislature to raise the foreign-aid contribution of the United States from 11 to 22.5 billion dollars? Can you imagine that elected members of the U.S. Congress will dare to propose that taxes be raised or domestic programmes be cut by another 11 billion in order to double the appropriations for foreign economic aid? I cannot imagine it.

The problem is how much generosity one may expect from the majority of voters in a democracy. Perhaps education, enlight-

ened propaganda, will eventually make people more generous. But until then, legislatures cannot, in the long run, be more generous than the people who vote for them.

I am not sure that even the fulfilment of the norm of "three-fourths of one per cent" would really change the pace of economic development. The world total of foreign aid would still be such a small fraction of what would be needed for speedier development in the Third World that I do not see a "solution" through this route. The needed formation of physical capital and human capital cannot be substantially aided by government-to-government aid. If we realize that the total foreign aid received by developing countries has been smaller than their expenditures for defence and the build-up of their military capacity, we cannot help concluding that optimism regarding economic development through foreign aid is not warranted.

The Gap Between the Rich and the Poor

According to the latest statistical data published by the World Bank, the annual national product per head was over \$ 5,000 in the richest countries and less than \$ 100 in the poorest. Using averages for larger groups of countries, the gap may not be that immense and, moreover, the statistical data are misleading in that they use foreign-exchange rates to convert national figures into dollar figures and thus disregard the purchasing power of different national moneys. Even so, the gap is terribly large and one understands that most people would prefer to see it getting smaller. But again, people are very naive about it and allow their rhetorics about the "gap" to become misleading and deceptive. I was shocked, a few weeks ago, to read news reports quoting President Ronald Reagan, speaking at the summit meeting at Cancun, Mexico, to the effect that he was hoping the gap would soon start declining. To say this is not only poor economics, but also poor arithmetic, and I feel obliged to make this clear.

For the sake of the argument assume two groups of countries, the rich group with an annual income per head of \$ 3,000 and the poor group with an income per head of \$ 300. The gap is \$ 2,700. Now make an assumption about their annual growth rates: say, that income per head in the rich countries grows by 3 per cent a year and in the poor countries by 6 per cent, that is, twice as fast. This assumption is completely unrealistic as far as the poor group is concerned. In actual fact, in many poor countries income per head has been declining, and on the average it has increased by only 1 per cent a year. To assume a growth rate of 6 per cent is a fantastic exaggeration—but I want to go through the argument on this overoptimistic assumption.

So, assuming 6 per cent growth for the poor and 3 per cent growth for the rich, how long would it take until the gap in annual income per head would start declining? The answer is: 57 years. The gap, \$ 2,700 at the beginning, would rise to \$ 3,494 in ten years, to \$ 4,456 in twenty years, to \$ 5,559 in thirty years, to \$ 6,700 in forty years, to \$ 7,626 in fifty years. It would reach a maximum of \$ 7,866 in the 57th year, and only afterwards would it start coming down. After eighty years the gap would disappear.

Now, I repeat, this is pure arithmetic. On economic grounds things look much worse, because the growth rate of the poor countries is far from the assumed 6 per cent. I have no prediction to offer, except to say that a gap will remain for hundreds of years—provided humanity will survive that long.