JACQUES J. POLAK

ECONOMIC THEORY AND FINANCIAL POLICY

SELECTED ESSAYS OF JACQUES J. POLAK 1994–2004

INTERNATIONAL MONETARY FUND

EDITED BY
JAMES M. BOUGHTON

Economic Theory
and
Financial Policy

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Selected Essays of Jacques J. Polak 1994–2004

Jacques J. Polak

Edited by James M. Boughton

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Contents

III. International Economic Policy: Theory and Practice

List of Boxes, Figures, and Tables

Boxes

Figures

Tables

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Introduction

James M. Boughton

As of 2004, Jacques Polak's career as an international economist spans sixty-seven years. It began at the age of twenty-three, in October 1937, when he accepted a position as assistant and office mate to Jan Tinbergen at the League of Nations in Geneva. In 1940, with the war closing in, he and several more senior colleagues accepted an invitation from the Institute for Advanced Study in Princeton, New Jersey, to continue the league's economics functions in the safer cloisters of an American university town (where, incidentally, they would share an office building with Albert Einstein, John von Neumann, and other scientific luminaries). Three years later, he moved to Washington, D.C., to take up a post at the Netherlands Embassy, where he immediately began studying the U.S. and British proposals for creating postwar international monetary institutions. That work led to his being appointed to the Netherlands delegation at the Bretton Woods monetary conference in July 1944: the seminal event in creating the institutions and the system of monetary cooperation in which he was to play such a major role and that would establish and define his professional legacy.

In the fall of 1944, Jacques Polak joined the staff of the United Nations Relief and Rehabilitation Administration (UNRRA), where he studied the economic recovery of countries assisted by the agency. When the war ended, however, the U.S. government lost interest in supporting UNRRA, and in 1947 Polak decided to move to the International Monetary Fund (IMF). For a young man who had now worked for two promising but now defunct international institutions and who had a growing family to support in a tight job market, the leap to the IMF was a major gamble. The Fund was far from being the preeminent institution that it would eventually become, and Polak would later admit that its early years were a "let-down from the high hopes held at Bretton Woods" (Polak, 1994a, p. xviii). This time, though, the gamble paid off.

In 1958, Polak succeeded Edward M. Bernstein to become the Fund's second Director of Research, and in 1966 he was awarded the additional title of Economic Counsellor.[1] In that capacity, among other achievements, he led the effort to create Special Drawing Rights (SDRs) as a new type of international reserve asset, and he helped direct the transformation of the IMF from the watchdog of the par-value exchange rate system to the overseer of exchange rate and macroeconomic policies throughout the world.

After reaching the IMF's mandatory retirement age of 65 in 1979, Polak took on new assignments that posed substantial challenges. First, as adviser to the managing director, he worked closely with Jacques de Larosière as they fought a determined but unsuccessful battle to establish a "substitution account" that would have partially replaced volatile U.S. dollars with more stable SDRs in official international reserve portfolios. He then served six years as the executive director in the IMF for a grab bag constituency of countries, two of which—the Socialist Republic of Romania and the Socialist Federal Republic of Yugoslavia—were in processes of economic and political disintegration that he and the Fund tried but ultimately were powerless to alleviate. (The others were Cyprus, Israel, and the Netherlands.) His final official appointment was as president of the Per Jacobsson Foundation (1987–1997), but since that time he has continued to serve as an informal adviser and mentor to a new generation of Fund staff, working out of an office on the top floor of the IMF headquarters in Washington.

This recounting of a lengthy and distinguished career is merely the backdrop for Jacques Polak's real vocation as a research economist. His main contributions—early econometric tests of macroeconomic regularities, in the late 1930s; a policy-oriented monetary model of the balance of payments, in the 1950s; analyses of the limits to international policy coordination, from the early 1960s on; and studies of the functioning of the international financial system, up to the present day—are well known and have been well surveyed before. Moreover, two collections of his papers have been published already, covering virtually all of his published work through the early 1990s—more than 100 papers in all.[2] But those collections are now incomplete. In the past

1. This title effectively acknowledged Polak as one of the top two staff members in the IMF, alongside Joseph (later Sir Joseph) Gold and above the other 11 department heads. Gold, the Fund's top lawyer, was given the title of General Counsel at the same time.

2. For a survey, see "Major Themes in the Writings of Jacques J. Polak," by Jacob A. Frenkel, Morris Goldstein, and Mohsin S. Khan, in the Festschrift edited by Frenkel and Goldstein, cited in the annex to this introduction. The two previous collections, issued in 1979 and 1994, did not include eight books and monographs that Jacques Polak had written or edited. For a list, see Polak (1994a), Vol. 1, p. xxxi.

decade, Jacques Polak has contributed much to the debates on international financial policy, and the present volume brings together most of these recent papers to make them accessible to a broader audience.[3]

Part I. The Role of the International Monetary Fund

A hallmark of Polak's recent research has been his ability to draw on several decades of personal experience and reflection to comprehend and describe the context for current policy debates. Each of the six papers in Part I of this volume illustrates this quality well.

In "The Essence of Bretton Woods" (chapter 1), Polak debunks the notion that the Fund lost an essential function when the par value system of exchange rates collapsed in the early 1970s. The essential function, he argues, was not to maintain stable exchange rates but to establish "an institutionally organized cooperation" for countries to deal with monetary problems. The point of the chapter is not to defend the Bretton Woods agreements of 1944, but rather to stress the continuity of the IMF's mandate to promote monetary cooperation among countries.

"The International Monetary Issues" (chapter 2) draws lessons for the future from the work of the IMF in the 1960s and 1970s. The chapter recalls the international discussions of that era on five key topics: adjustment versus financing in response to reserve shocks, creation of SDRs, the SDR interest rate, the failed attempt to establish an SDR substitution account, and the use of objective indicators for assessing exchange rate pressures. Noting that these topics seemed outdated by the 1990s, Polak argues that important lessons can be drawn for contemporary problems: the need for consensus on adjustment policies, the appropriateness of SDR allocations for creating reserves for newly emerging countries, the need for a market interest rate on SDRs and on IMF operations, the value of a substitution mechanism for accommodating countries that would like to reduce dollar-denominated reserves without destabilizing currency markets, and the difficulty of establishing objective indicators of imbalances calling for exchange rate adjustment.

Chapter 3, "Fifty Years of Exchange Rate Research," surveys exchange rate research in the IMF. Here, Polak observes that such research has fallen into three distinct periods: a formative era in the 1940s and 1950s when research focused on understanding the role of exchange rates in economic

3. Papers that are subsequent to the Frenkel-Goldstein bibliography but omitted from the present volume are either short expository or topical pieces or those that overlap substantially with an included paper. For a complete list, see the annex.

adjustment; a middle period in the 1960s and 1970s when research focused on determining equilibrium rates for the United States, the United Kingdom, and France; and a mature period when research has focused on assessing different types of exchange rate policy regimes.

The fourth chapter, “The IMF and Its EMU Members,” deals with relations between the IMF and the countries in the euro zone. Written in 1997, before the introduction of the euro, the paper draws in part on the Fund’s experience with other currency unions, notably the CFA franc zone in Africa and the Belgo-Luxembourg economic union in Europe, albeit primarily to draw contrasts with the broader systemic issues associated with the new European currency. Polak focuses particularly on the implications for the IMF of a situation in which the exchange rate, monetary, fiscal, and reserve management policies of an important group of countries are to varying extents determined supranationally.

The longest chapter in this group, “The World Bank and the International Monetary Fund” (chapter 5), is a comprehensive historical review of how relations between the two Bretton Woods institutions evolved in their first half century. The paper notes that the overlap between the work of the two institutions grew substantially in importance in the 1980s and early 1990s, but that the basic functions remain (and should remain) distinct and separate.

“Liberalization of Capital Movements” (chapter 6) concludes this section on the role of the IMF by arguing against proposals to amend the Articles of Agreement so as to give the Fund jurisdiction over the regulation of international capital movements. Polak argues that such an amendment is not needed and could be counterproductive, since complete freedom of capital movements is not necessarily wise and since the Fund already can promote capital-account liberalization in a measured way.

Part II. New Thoughts on the SDR

Jacques Polak has long advocated streamlining the IMF’s financial structure by basing it entirely on the SDR rather than on a mixture of SDRs and national currencies. When the IMF was established in the 1940s, its financial structure was formally based on the principle that all currencies were created equal. The reality, however, was that the U.S. dollar was—and was expected to remain for some time—the dominant currency in the world economy. Moreover, the dollar provided an anchor for international payments by being linked firmly to gold. Member countries would contribute resources to the IMF, partly in the form of gold and partly in the form of securities or bookkeeping entries in their own currency. For the first decade of IMF operations, almost all lending was in U.S. dollars, but the institution eventually started lending other internationally accepted currencies. Sixty years later, the Fund uses the currencies of more than 40 countries in its lending operations (in addition to SDRs) and holds some 140 others that are not presently usable. The Fund's accounts have thus become increasingly complex and confusing.

The SDR—defined initially as equal to a fixed quantity of gold that was then worth one U.S. dollar, and later redefined as a basket of currencies—was designed for an era when exchange rates were fixed and internationally accepted currencies might be in short supply for settling official payments balances. In 1996, the IMF held a seminar on the future of the SDR, at which experts from around the world addressed questions related to the function and importance of the SDR in a world of mixed exchange regimes and no obvious global shortage of reserve assets. Jacques Polak's contribution to that debate (chapter 7, "Should the SDR Become the Sole Financing Technique?") was to demonstrate the benefits of having the Fund lend only SDRs (i.e., lend by making bookkeeping entries rather than by conveying currencies contributed by members). To make the SDR into the sole financing vehicle for the Fund, however, would require allowing commercial banks to hold SDRs, in order to create a liquid market for the asset.

Polak elaborated on this theme in a subsequent paper, published as a Princeton Essay ("Streamlining the Financial Structure," chapter 8). That article explains the changes in the IMF's balance sheet and financial structure that would have to be made in order to have a Fund that was based entirely on the SDR rather than currencies. Those changes would require extensive amendments to the Articles of Agreement but would result in a greatly simplified charter and more transparent and readily understood financial practices.

The final chapter in this group (chapter 9), written jointly with Peter B. Clark, advocates resuming allocations of SDRs. Here, Polak acknowledges that the original argument for allocating SDRs—to overcome a general shortage of world liquidity—no longer has any real meaning and cannot be used to justify a new allocation. Nonetheless, official reserves are a valuable asset in the modern world economy, even for countries with floating exchange rates, and many newly emergent or less developed countries lack the resources to accumulate reserves by market means (i.e., by running surpluses in their balance of payments). That shortcoming is widespread enough to reasonably be called a "long-term global need . . . to supplement existing reserve assets," which is the prerequisite for an SDR allocation specified in the Articles of Agreement. To avoid any possibility of excess liquidity creation, Clark and Polak argue for a series of small annual allocations rather than occasional large jumps in the outstanding stock.

Part III. International Economic Policy: Theory and Practice

Jacques Polak's most enduring contribution to the economics literature was his exposition of the policy implications of the monetary approach to the balance of payments. In a 1957 article in *IMF Staff Papers*, he set out a simple four-equation model that required few data and fewer assumptions to estimate but that nonetheless was capable of determining a policy path that was likely to equilibrate a country's balance of payments. The theory underlying the model was similar to the monetary approach being developed by Harry Johnson around the same time at the University of Chicago. Polak's insight was that the monetary model could be interpreted as an open-economy model of a Keynesian one-period equilibrium, rather than as a model of steady-state monetary relationships as in Johnson's formulation. The Polak model thus could be used to estimate the degree of adjustment in monetary or fiscal policy that would be needed in real-world situations to equilibrate the balance of payments without a change in the exchange rate.

The first two chapters in the final section of this volume exposit the Polak model from the perspective of forty years of experience and evolution in macroeconomic theory and practice. "The IMF Monetary Model at 40" (chapter 10) recounts the origins of the model and the ways it has been used by the IMF staff over the years. Remarkably, a model that was developed for a world of fixed exchange rates, limited international capital mobility, and rudimentary domestic bond markets has proved adaptable to a wide variety of more complex circumstances through the simple expedient of introducing flexibility outside the model rather than by expanding the model itself. Chapter 11, "The *Two* Monetary Approaches" (the italics being Polak's own emphasis of the distinction between him and Johnson), shows how the Polak model differs in its analysis and policy implications from the superficially similar Chicago model.

Chapter 12 provides a fresh look at another type of model, the gravity model of international trade. Polak finds it implausible on a priori grounds to regard the Asia-Pacific region as a natural trading bloc, an argument that had been made by Jeffrey Frankel and co-authors. Frankel found support for this idea in estimates of a gravity model, and in response Polak shows that the usual specification of the model produces results that are biased in favor of finding significant regional effects for a geographically dispersed area such as the Asia-Pacific region.

Readers whose primary interest is in the functioning of the international financial system should resist the temptation to skip over Polak's essay on historical relations between Belgium and the Netherlands (chapter 13). This anecdotal essay illustrates some broad principles for the conduct of monetary and commercial policy between close partner countries. Here Polak argues that fixing bilateral exchange rates, as these two countries did in 1943, can serve an important but transitory service, subservient to the broader objective of liberalizing and promoting international trade. This essay also includes the little-known story of how two small countries obtained and then held on to their own seats on the IMF Executive Board from 1946 to today.

The final chapter in this volume (chapter 14), though inspired by the specific circumstances of the 1992–93 crisis in the European Monetary System, examines international economic and financial integration in broad terms. The world has changed since Bretton Woods, and it continues to change in ways that complicate the making and the coordinating of economic policy. Polak focuses on two key developments: the rise of the private sector as a major actor in the international financial system and the increasing recognition of the limitations to macroeconomic stabilization policy. For both reasons, international policy coordination today is more difficult to implement effectively then it was in an earlier age (when it was already difficult enough).

The concluding paragraphs of this concluding chapter nicely sum up Jacques Polak's philosophy of political economy. He disdains the "droves of babes in Bretton Woods" who persist in believing in an optimum world economic order founded on fixed exchange rates or even a global currency union and buttressed by rational policy coordination. Such a result, he argues, is impossible to achieve unless one first somehow creates a single world "political area." As of this writing, this philosophy seems overly pessimistic, particularly since Polak uses it to express (writing in 1994) "grave doubts about the attainability of [European monetary union] without the prior achievement of a much greater degree of political integration than appears anywhere on the horizon." Will the euro succeed in the long run without a major tightening of European political integration? Time will reveal the answer, but that will have to await the next volume of Jacques Polak's collected papers.

Annex

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I

The Role of the International Monetary Fund

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The Essence of Bretton Woods

Monetary Cooperation

The Bretton Woods conference was one of a number of interallied conferences in the later part of World War II that led to the creation of a new international organization. Hot Springs produced the Food and Agriculture Organization (FAO), Atlantic City produced UNRRA, Dumbarton Oaks and San Francisco the United Nations. But only Bretton Woods entered the language as not just a geographical locale, but far beyond that, as a mystique about a world monetary system, and more specifically as a code word for stable exchange rates. One finds this mystique all over the world, but perhaps in its most pronounced form in France. There are even indications that the French at one time tried to steal Bretton Woods from the Americans. In one of his articles Giscard d'Estaing, then the French Minister of Finance and later the President of France, referred to the international monetary system as the system of Breton Woods. All it took him was to drop the second "t" in Bretton Woods and bingo, the origin of world monetary order was transplanted from New Hampshire to Brittany.

The Bretton Woods conference is known as the birthplace of the Bretton Woods twins, the International Monetary Fund and the World Bank. The Fund was very much the first order of business. The conference turned to the Bank only in its second week, but it did so with a bang. In the midst of an electrical storm, the chairman of Commission II, Lord Keynes, raced through the various draft provisions at a speed that few of the delegates could have kept up with even if they had been able to hear his voice over the thunder claps. Agreement on the Bank did not take much time because the Bank was essentially little more than a special kind of bank. The ideas

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Reprinted from *The Making and Remaking of the Bretton Woods System: A Fiftieth Anniversary Retrospective* (Professional Bankers Association, 1994).

underlying the Fund, on the other hand, were the force that drove the delegates to create a new and intellectually novel organization. The desire was, indeed, to create a new international monetary system. It may be hard to recall the intensity of the disgust that the delegates felt for the mess that governments had made of their financial and trading relations after World War I. In the opinion of many this situation had been responsible for the Great Depression and, indeed, for World War II. This desire to create a better international monetary system was what united the delegations, and what enabled them to find solutions to the many intellectually and politically difficult questions that arose in drafting the Fund's Articles of Agreement.

Par values agreed to with the Fund were a major component of this system, and this feature lasted for twenty-five years, from 1946 to 1971. These were years of unprecedented worldwide economic growth, in the developing countries even more strikingly than in the industrialized countries. Was this simply a case of cause and effect? Not necessarily. There were many other factors at work and a good deal of credit should go to another component of the Bretton Woods system, the high degree of international monetary cooperation.

Since 1971 the par value system has become unraveled, and in the past twenty years countries have experimented with a bewildering variety of exchange rate arrangements. At the same time, the Fund's second quarter-century has seen far less sustained economic growth and far greater economic difficulties than the first one, including the debt crisis of the 1980s and the current levels of unemployment in most countries in Europe. Again the question of cause and effect presents itself—and I venture the opinion that the current lack of orderliness in the exchange rate system is not the root cause of disappointing economic performance in recent years. I think it deserves pointing out in this connection that international monetary cooperation over the past two decades has been strikingly less impressive than it was in the quarter-century before—despite the fact that the international machinery for cooperation has received a major addition in the form of periodic meetings of the Group of Seven major industrialized countries.

The collapse of the par value system in 1971–73 is often referred to as the end of the Bretton Woods system; indeed, quite a few observers at the time expected it to be the end of the Fund as well. In my opinion that is a myopic view of what Bretton Woods was all about. I was asked recently by Martin Wolf of the Financial Times whether the Bretton Woods conference would have been held if the organizers had known that the articles would be amended in the 1970s to include something like the permissive exchange rate regime. My answer to this hypothetical question was yes. It is true that the consensus view at Bretton Woods included a strong belief in the par value system. That view was most pronounced in the original White Plan, which asked for a US veto of par value changes. The Keynes Plan was more flexible on this point; it saw changes in par values in specific circumstances as an essential ingredient of the system's adjustment process.

In any event, the par value system was seen at Bretton Woods as a means, not an end in itself. In Article I, which lists the purposes of the Fund, the first priority was given to successive layers of more fundamental means: "international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems." It was this spirit of institutionally organized cooperation that had been notoriously absent in the interwar period, despite occasional international monetary conferences—some reasonably successful, such as that in Genoa in 1922; some disastrous, such as the London Monetary Conference of 1933.

The desiderata with respect to the exchange rate regime are not mentioned until the third purpose, and they are expressed in rather general terms: exchange stability, orderly exchange arrangements, and the avoidance of competitive exchange depreciation. The last two of these aims survived in a second amendment (I do not give any credit to the transparent pretense to preserve exchange stability by inserting the meaningless transposition of "a stable system of exchange rates" into the new Article IV.)

And, of course, the Bretton Woods system included another important instrument to promote its aims: the provision of balance of payments credit. The need for this was inspired by the experience of the 1930s, when the depression in the United States contaminated the economy of the entire world. (The scarce currency provisions were inspired by the same concern.)

Because the Bretton Woods system was so much more than the par value regime, it survived the demise of that regime. One of its aims, loosely described as currency convertibility, has taken off with a vengeance, applying these days to capital transactions as well as to carefully defined current transactions, as the Articles envisaged. The permanent institution has continued to serve as a vehicle for consultation and collaboration. It also has not lacked customers for its balance of payments credits, which it hands out more generously than its founders had anticipated. (The founders might not have pointed with pride—as the Managing Director's speeches tend to do—to the fact that some 40 percent of the membership is currently using Fund credit. As an indication of the health of the system, Horst Schulman had a point at a recent conference when he designated that percentage as a "misery index.")

The intense financial activity of the Fund in the 1970s, 1980s, and 1990s, as it dealt successively with the oil crisis, the debt crisis, and the transition problems of the formerly communist countries, does not mean that the events of the 1970s have left the Fund unscathed. It has lost most of its policy leverage over the industrialized countries (and it may have lost similar influence in the medium-income developing countries) as a result of two major changes in the system: the disappearance of par values and the emergence of wide-open capital markets. Despite the strenuous efforts of management and staff, the "firm surveillance over the exchange rate policies of members" that the amended Articles mandate has never been realized. The resulting disproportionate preoccupation of the Fund with developing countries—as the beneficiaries of its lending policies and the subject of its conditionality—has transformed the Fund in the eyes of many into a development institution and has led to calls for its merger with the Bank.

Can this be remedied by a return to the spirit of Bretton Woods? Until about two years ago, advocates of this view would point to the success of the European exchange rate mechanism. If that system was possible for the European currencies, they argued, why not for all the currencies of the world, including the yen and the dollar? Or, if not in its original form, at least in its modified form of target zones? The fact is that the world is not that simple. The time has passed for a one-size-fits-all exchange rate system. For some countries or groups of countries fixed rates are indeed a rational and durable solution. But a proper understanding of what was agreed at Bretton Woods tells us why that kind of exchange rate regime is probably not now suitable for the major links in the international monetary system, above all the dollar–yen–deutsche mark triangle. As Professor Richard Cooper has pointed out, one of the main reasons why countries at Bretton Woods other than the United States were anxious to attach their currencies to the dollar at predominantly fixed exchange rates was that these countries considered the US economy and the US dollar to be anchors of stability. By committing themselves to maintain—if at all possible—a fixed rate on the dollar, they hoped to import America's stability into their war-torn economies. But that was fifty years ago. By now, the major industrialized countries (above all, Germany and Japan, which were not present at Bretton Woods) can take care of their own domestic stability. Moreover, their confidence in the determination of the United States to pursue stable financial policies has been badly shaken since President Johnson refused to increase taxes to pay for the Vietnam war. To pursue their own stability, these countries will want to remain masters of their own monetary policies, and so will the United States. For this reason, floating among the major currencies—though not necessarily wild floating—will be the chosen exchange rate system of the major countries for some time.

This conclusion does not in any way diminish the glory of what was done at Bretton Woods fifty years ago. It focuses on the need to cultivate the one achievement of the Bretton Woods conference that was even more fundamental than the par value system—the spirit of international monetary cooperation.

2

The International Monetary Issues of the Bretton Woods Era

Are They Still Relevant?[1]

1 Introduction

The key question addressed in this chapter can be formulated as follows: do we revisit the intellectual battlefields of the 1960s and 1970s, merely to reminisce about a *temps perdu*? Or do we find in this experience much that is of value to us in facing the problems of today's international monetary system?

There is no doubt, as Robert Solomon has pointed out recently, that there have been major shifts in the features of the international monetary system that preoccupy officials (Solomon 1991, pp. 67–77). We think differently about adjustment now than we did in the 1960s. We hardly think any more about international liquidity, which was our major preoccupation in the 1960s. Market fluctuations of 15 per cent in the exchange rates of the major currencies, though they make most of us feel somewhat uncomfortable, are pretty well tolerated by all concerned, in contrast to the four months of crisis it took in 1971 to reach agreement on more modest exchange rate changes. Of late, we have even developed an indifference to current account imbalances that would have given us apoplexy less than a decade ago.[2] Solomon attributes many of these changing perspectives on the international

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The author acknowledges valuable suggestions made by M. Goldstein and J. Williamson.

1. Editor's note: The subtitle "Are They Still Relevant?" was in the original paper presented at a conference in July 1992, but it was omitted in the published proceedings.

2. Compare Marris (1985) with Corden (1991, pp. 455–78).

monetary system to the enormous increase in the international mobility of capital. In a broad sense, that characterization is surely correct. But I would want to register two important reservations.

First, even though today's problems may look radically different from yesterday's, that does not make yesterday's solutions irrelevant to today's policymakers. Let me refer to some examples that relate to exchange rate regimes. At the end of the 'reform exercise' of 1972–4 most observers would probably have agreed with what Williamson wrote in 1977 'that the principal and crucial intellectual error of the Committee of Twenty (C-20) lay in the decision to opt for restoration of the adjustable peg at a time when this system had ceased to be viable because of the development of capital mobility' (Williamson 1977, p. 181). Yet, two years later most members of the European Community (EC) readopted the adjustable peg. By 1991, an enlarged European Monetary System (EMS), with freedom of capital movements for its members, is generally accepted as a striking success (I am not overlooking the special—and hence limiting—political factors that were necessary to this success). Not only the Bretton Woods experience, but also the gold standard experience, now seems quite relevant to the understanding and the design of the Economic and Monetary Union (EMU). To cite a quite different case, I find that what Nurkse wrote fifty years ago on the difficult exchange rate choices facing some sterling area countries is highly pertinent to the current problems of Australia and New Zealand (League of Nations 1944, pp. 134–6). The problems that populate the time-space universe in which economists roam belong to only a limited number of species. Old friends and enemies, or their close relatives, pop up all the time.

The other side of the relevancy question is that one should not assume that, at any time, officials are focusing their attention on issues that are relevant *even at that time*. As seen from a safe distance, the 1960s and 1970s—and I am sure many other decades as well—reveal a considerable amount of lost motion, pursuit of solutions to phantom problems, or of ill-considered solutions to real problems. I shall come to some interesting instances in the course of my chapter. Here, I shall just briefly recall a single major misdirected effort of the 1970s. In 1974–5, the Organization for Economic Cooperation and Development (OECD) and the Group of Ten (G-10) spent an intense six months in working out an SDR 20 billion 'Financial Support Fund' proposed by the US authorities and the Secretary General of the OECD. This facility, to be attached to the OECD, was designed 'to back up private capital markets and other financing mechanisms'.[3] The developed

3. OECD 1976, pp. 17–19. At the time this was known as the *Kissinger Plan*. The total of quotas at SDR 20 billion about equalled the sum of the quotas of the OECD members in the IMF.

countries did not need this third line of defense; in fact, since 1977, they have not used the second line, the International Monetary Fund (IMF). When the US Congress refused to put up the US share of the money, the plan collapsed without a trace and with hardly a tear.[4]

On the question of relevancy I would put my intermediate conclusions as follows:

1. Even though the system has changed, much of the experience of the 1960s and 1970s remains relevant. Many of the outlines of that experience have become blurred by the events of the past quarter century. They deserve to be brought back to light.
2. The same period also saw some major preventable misdirections of international efforts. They too deserve our attention—first, as a general matter, to maintain a healthy skepticism with respect to the collective wisdom of officials, and second, more specifically, because in economics bad ideas seem to have almost as many lives as cats. (My favourite example of this proposition is the topic of 'commodity currency'.)

Guided by these two thoughts, I have selected five topics for discussion, all of them very much in the area in which Ossola played a leading role. Each contains some elements of theory that deserve to be brought out, some aspects of history that need straightening out and perhaps even some modest lessons to be learnt. The topics relate to the adjustment process, liquidity creation, the interest rate on the Special Drawing Rights (SDR), a substitution account, and objective indicators for exchange rate adjustment. I will not reveal in advance which of these belongs in category one (the past unjustly forgotten) and which in category two (if only we had been brighter). And, as will become clear, where I criticize 'officials', I do not exclude those in international organizations.

I realize that my selection of topics leaves out what some might regard as the most significant failure of financial officials in the period: the long and agonizing death of the par value system, lasting (at least) from the November 1968 Bonn Conference to the second devaluation of the dollar in February 1973. That topic deserves a full-scale study of its own. I shall leave it here with a question. Can one fault the official family (ministers, central bank governors, senior officials) for their unwillingness to administer euthanasia to a beloved system while there was still a glimmer of hope that it might survive?

4. No reference to the plan can be found in Solomon (1982).

2 Adjustment

There is a widespread impression that, in the period we are here considering, there was too much emphasis on financing payments disequilibria and too little on adjustment. Up to a point, this impression is correct: note, for example, the fact that the two industrial countries that used the Fund's oil facility, the United Kingdom and Italy, soon thereafter had to come to the Fund for standby credits. But it would be quite wrong to say that the need for adjustment was neglected.

The first G-10 Deputies Report (1964) on 'the monetary system and its probable future needs for liquidity' started out with a long chapter on the importance of adjustment and suggested that Working Party 3 (WP-3) of the OECD prepare a special study on this. It did not take too many meetings of the WP-3 to prepare this study, which was published in 1966 (OECD 1966). The members of the committee knew their Tinbergen and Meade, and they could readily agree that 'the adjustment process is therefore essentially a question for governments as to how to achieve a wide range of aims of an economic, political, and social nature with the limited number of policy instruments actually or potentially available to them' (para. 16). The report notes wide agreement on the policies appropriate in 'pure demand cases' (para. 45). It is recognized that it is more difficult to deal with cases of 'imperfectly adjusted competitive positions': surplus countries don't want to inflate and deficit countries don't want to accept prolonged periods of stagnant demand. Exchange rate changes are mentioned (for deficit countries only!), but with considerable reservation. It should be remembered that in the mid 1960s, exchange rate changes were a near taboo subject among the G-10 countries, especially for the United States and the United Kingdom.[5]

Looking at this 1966 OECD report from today's perspective, there are at least two interesting and I would say endearing characteristics that have tended to get lost in the succeeding period. They are:

1. Countries are, on the whole, responsible for their own payments imbalances. This presupposes, of course, that aggregate demand in the world is

5. The first G-10 Deputies Report (chaired by Robert Roosa) had managed only barely, in a backhanded way, to recognize the exchange rate as an instrument of adjustment. The report did not include it in its listing of six instruments of economic policy, but then added: 'Such instruments must be employed with proper regard for obligations in the field of international trade and for the IMF obligation to maintain stable exchange parities which are subject to change only in cases of fundamental disequilibrium' (G-10 1964, para. 6).