SPECIAL DRAWING RIGHTS: BACKGROUND AND ANALYSIS

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Introduction

It is the purpose of this paper to look at the structure of the international monetary system - the system by which countries do business with each other and settle their transactions. The main objective is to provide a background for the development of Special Drawing Rights (S. D. R.'s), to analyse their significant aspects, and to review their possible consequences. This will be done with a heavy emphasis on the background of S. D. R.'s as it is felt that a relatively detailed analysis of such background is needed.

This study is being made for several reasons. First, there are still questions in the minds of many individuals as to how important the S. D. R.'s are. Second, in recent years, there has been some dissatisfaction with the traditional means of international settlement through gold, British gold, British pounds, U.S. dollars, etc. Third, the topic has economic, social, and political implications; only it's economic implications are of concern in this study.

A glance at the structure of the international monetary system

The present international monetary system is a set of written and unwritten rules by which countries do business with each other. Each country has a currency of its own, and since most countries want to have international trade, there

has to be some orderly system for converting currency of one country into another. This necessitates the establishment of a rate of exchange for each country's currency in terms of other currencies. The value of countries' currencies change over time; traditionally, however, their value has been stated in terms of gold which has had more price stability. After a country becomes a member of the International Monetary Fund, (I.M.F.) the par value of its currency is formally announced to the Fund, and for convenience each nation may establish the value of its currency in terms of U.S. dollars or British pounds. As a government announces a par value for its currency, it also agrees, according to the rules of the I. M. F., to maintain that value within prescribed limits by official engagement in the foreign exchange markets any time that private supply and demand tend to move the price outside the permitted limits. To defend the par value of their currency in terms of gold and/or dollars, governments may have to resort to their reserves of gold, foreign exchange, and even to their drawing rights at the I.M.F., and they may have to lose all or part of their reserves depending on the nature and magnitude of currency defence.

The loss of reserves may or may not be taken as a warning signal that a country must try to improve its balance of payments. Thus the present international monetary system is based on (1) the existence of domestic currencies, (2) the establishment of a par value in terms of gold for each currency, and (3) the establishment of a rate of exchange between different currencies. In this system, gold, U.S. dollars, British pounds, and drawing rights on the I.M.F. are normally referred to as international reserves.

The Special-Drawing Rights, a reality of the 1960's,are designed to supplement - and perhaps eventually substitute - international reserves.

Performance of the system

How well is the international monetary system functioning? This seems to be a controversial question to which different authors have given different answers and, in most cases, their answers are based on - or biased by - their value

judgments.

One group holds that the gold exchange standard is basically sound, and it can be improved either with the adoption of the additional key currencies or with continuing increase of dollar and sterling reserves. Advocates of this group have sometimes asserted that mutual co-operation and assistance among central banks, or reserves creation with overdraft facilities available to deficit countries, and reserve creation by the world central banks can also improve the system. Opponents of such views assert that a system based on a fixed price of gold is basically vulnerable because this fixed price has not facilitated increasing amounts of gold for the world trade, and dollar and pound availability depends upon U.S. and U.K. willingness to accept deficits. Some go as far as suggesting an abolition of the gold exchange standard. Upon exactly what type of a system should substitute a future gold-exchange standard, there is no agreement.

The range of agreement is so narrow that it is difficult to arrive at specific conclusions regarding the performance of the system. The key parameters, however,are the adequacy or inadequacy of the growth of monetary reserves, the change in the gold-holding position of different countries, the adjustability of the system, the concern of underdeveloped countries, and the vulnerability of the system. A discussion of all these parameters is beyond the scope of this paper. However, the first two factors will be briefly analyzed at a later point. In this system one can say that:

(a) Dollars and pounds would become available to the world, in the final analysis, only to the extent that the U.S. and U.K. stand ready to continue their deficits and/or other countries are ready to accept them.

(b) The supply of gold, at the current fixed official price, has not increased rapidly enough to keep pace with the growing needs of world trade, thus necessitating further reliance on key currencies.

(c) Because they possess key currencies, the U.S. and the U.K. have responsibilities to preserve the value of

their currency and act as world bankers.

(d) Some countries, such as France, do not feel easy - perhaps on grounds of envy - at allowing the U.S. or U.K. to decide the world's need for liquidity by themselves.

(e) Many less developed nations believe that international liquidity is far too small to permit adequate expansion of their flows of world trade and capital.

(f) On the other hand, some of the critics - who have been mainly from surplus countries undergoing inflationary pressure - have felt that a reserve currency system, such as the present international monetary system, by its nature necessarily generates too much liquidity.

(g) There are dangers of too much vulnerability in the system in the wake of currency depreciations, large-size defecits of individual countries, inadequacy of international reserves, and maintenance of long-term confidence in the system.

A glance at the preceding characteristics of the present international monetary system especially at points (e) and (f) shows that there are contradictory motives for reform in the system. The purpose of creating S.D.R.'s was not to solve all the illnesses of the present international monetary system. Rather, the present system - based on the established fixed official price of gold, international cooperation, and relatively fixed exchange rates - was accepted as a structure upon which to build future arrangements. It was also recognized that to create a continuously acceptable international money was a novel and, perhaps, very difficult task. In view of such recognition, the practical problem was not to arrive at a theoretically perfect solution, but rather to find workable schemes that governments might be willing to accept as a proper cure for the inadequacy of international reserves.

Adequacy of international reserves

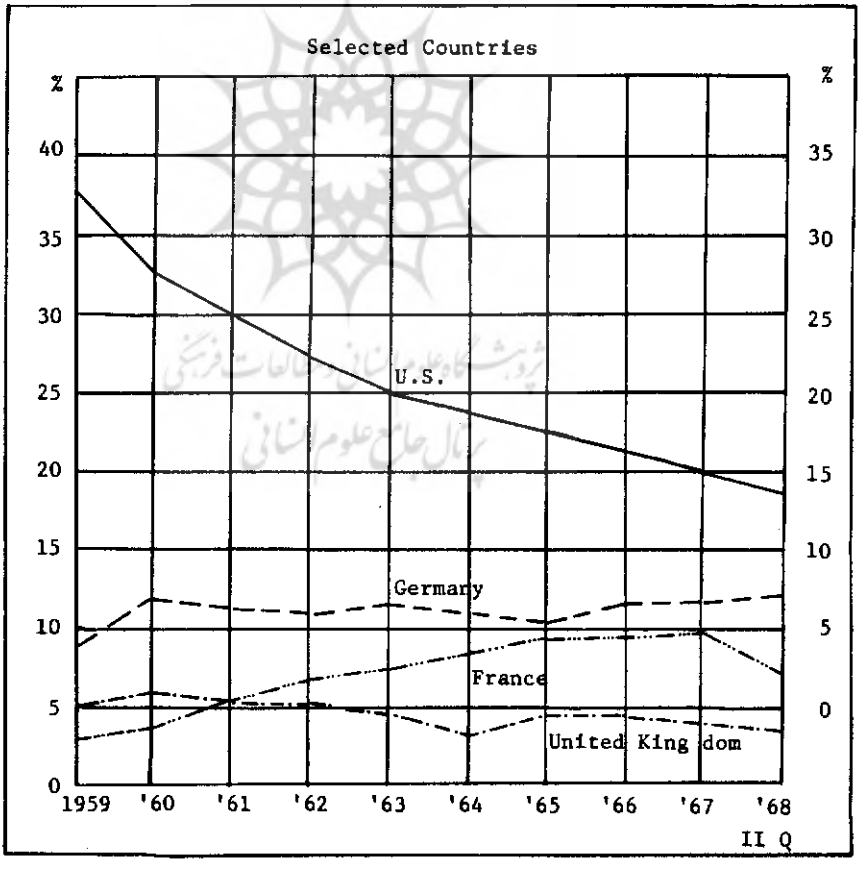
Statistical evidence of the volume of "international

reserves" and world trade testifies that the growth of reserves has not kept pace with the growing volume of international trade. As Table I shows, between 1950 and (the end of September) 1968, all international reserves increased by a little over $18.2 billion while the growth of the non-communist world trade, measured in terms of imports and on a C.I.F. basis, was $162.6 billion. A simple mathematical manipulation reveals that for the period of 1950-1968 the increase in international reserves was only 11.21 per cent of the growth of international trade. In addition, the percentage ratio of international reserves to world trade (figures in the last column of Table 1) has shown a general downward trend; evidence that every year the volume of international reserves formed a smaller proportion of world trade, and in the absence of S.D.R.'s could become as low as 22.3 per cent by 1976.[1]

Can this be taken as a sign of inadequacy of the growth of international reserves? No accurate answer can be given to this question. On the surface, the answer seems to be positive. But the actual level of a country's international reserves is no sure measure of their adequacy, because they are not used to settle day-to-day transactions which may be financed by private financial institutions and are normally cleared through the foreign exchange markets. The use of official reserves is limited to covering the differences that arise from time to time between a country's overall external payments and receipts. Furthermore, other factors, whose exact manner and degree of influence is not easily measureable, affect international liquidity. Among these are: capital movements, the degree of dependence on international trade, the efficiency of corrective adjustment policies, the amplitude and duration of imbalance in international payments, the size of national reserves, the psychological attitudes toward minimum or desired level of reserves, the level of reserves a country thinks it "ought to" hold under different policies, the actual significance attached to reserves, the use of available international credit facilities and the ability to borrow, the conventional forms of savings habits, the international banking habits of various countries, envisaged domestic and international policy aims, the use of appropriate exchange rates, the stage of development of the countries, the possible seasonal fluctuations of export proceeds, the state of fiscal and monetary objectives

and conditions in the world as a whole. The absence or presence of these conditions cannot be determined a priori.For example, reserves which seem adequate at one time, may be regarded as inadequate at another time. Below a minimum reserve balance, a country may want to undertake corrective measures, while above a maximum reserves may not be as important a policy issue. Reserves which are regarded as sufficient under one type of fiscal and monetary policy combination may be inadequate under different circumstances.[2] In this context, Figure I shows the changing position of the international reserves of the U.S., Germany, France,and the U.K. as a percent of world reserves.

Figure 1: Reserves as percent of world reserves



Source: IMF, various publications of *International Financial Statistics*.

Table 1: World total reserves, world imports, and the percentage ratio of reserves to imports 1950-68 (columns (2) and (3) in millions of U.S. dollars)[a]

Year	Total reserves	World trade: value of imports (cif)	%Ratio of reserves to world trade
(1)	(2)	(3)	(2)/(3)
1950	55000	59331	92.7
51	54400	81990	66.8
52	55050	80186	68.6
53	57100	76563	74.5
54	58750	79596	73.8
1955	59500	88968	66.8
56	60900	98122	62.0
57	66250	107010	58.1
58	57555	100800	57.0
59	57315	106700	53.7
1960	60215	119400	50.4
61	62205	124600	49.9
62	62885	142400	47.4
63	66200	143600	46.1
64	68410	160800	42.5
1965	70120	175000	40.0
66	71510	191700	37.3
67	73510	202400	36.3
68	73240[b]	221900[b]	33.0

Source: Data in column (2) are from: I.M.F., *International Financial Statistics*, Vol. II, No.8, Aug., 1958, p.14 for the years 1950 through 1957; for 1958 through 1966 from *I.F.S.*, Vol. XX, No.8, August 1967, p.16; data in column (3) from *I.F.S.*, Vol. II, No.5, p.23 for the years 1950-1957; Vol.18, No.5, for 1958, Vol. XX, No.8, August 1967, p.35 for 1959-1966; 1967 and 1968 data in both columns (2) and (3) are from *I.F.S.*, Vol. XXII, No.1, January 1969, p.16 for world reserves and p.35 for world trade.

a. excluding Communist bloc
b. ends of third quarter

Table 2: International reserves[a] of eleven selected countries, 1958-1966 (millions of U.S. dollars)

End of period	1958	1959	1960	1961	1962	1963	1964	1965	1966
U.S.	22540	21504	19359	18753	17220	16843	16672	15450	14881
U.K.	3105	3801	3719	3318	3308	3147	2316	3004	3100
Belgium	1553	1306	1506	1813	1753	1940	2192	2304	2320
France	1050	1736	2272	3365	4049	4908	5724	6343	6733
Germany	5879	4790	7032	7163	6956	7650	7882	7429	8028
Italy	2184	3056	3251	3799	4068	3619	3824	4800	4911
Netherlands	1539	1442	1863	1958	1946	2102	2349	2416	2448
Sweden	516	478	528	736	801	758	964	972	1027
Switzerland	2063	2063	2324	2758	2871	3074	3120	3244	3324
Canada	2038	2029	1989	2276	2547	2603	2881	3027	2693
Japan	1062	1447	1949	1666	2022	2058	2019	2152	2119
11 countries	43529	42652	46792	48605	48531	48702	51943	53141	51584
all others	14026	14663	13423	16300	14304	17498	16467	16979	19926
world total	57555	57315	60215	62205	62845	66200	68410	70120	71510
%, 11 countries	75.6	74.4	77.7	78.1	77.2	73.5	75.9	75.7	72.1

Source: IMF, *International Financial Statistics*, Vol. 20, No.8 (Washington, D.C. August, 1967), p.16.
a.International reserves are defined by the IMF as: Gold, Reserve Positions in the Fund, and Foreign Exchange.

Table 2 reveals that the eleven large industrial countries have held more than 72 per cent of total international reserves from 1958 to 1966. Moreover, the eleven countries held, in June 1967, a little over 90 per cent of $40,420 million of world gold outside the Communist bloc (Table 3).

Table 3: International reserves of eleven selected countries, June, 1967 (in millions of U.S. dollars)

	Total reserves	Gold	Foreign exchange	Gold as % of total reserves	Foreign exchange as % of total reserves
U.S.	14274	13169	739	92.2	5.17
U.K.	2834	1677[a]	1582[a]	59.1	55.82
Belgium	2457	1522	698	61.9	24.33
France	6688	5235	537	78.2	8.02
Germany	7794	4292	2411	55.0	30.93
Italy	4965	2412	1654	48.5	33.31
Netherlands	2471	1731	363	70.0	14.69
Sweden	1007	203	656	20.1	64.14
Switzerland	3239	2831	407	87.4	12.56
Canada	2630	1066	1112	40.5	42.28
Japan	2099	330[a]	1510[a]	15.7	71.93
11 countries	50458	36468	11568	72.2	22.92
all others	n.a.	3952	12042	n.a.	n.a.
world total	n.a.	40420[a]	23610[a]	n.a.	n.a.
%, 11 countries	n.a.	90.2	48.9	n.a.	n.a.

Source: IMF, *International Financial Statistics*, Vol.20, No.8 (Washington, D.C., August, 1967), pp. 15-17. All percentages are computed personally.

a.As of the end of the first quarter of the year; the world total of gold and foreign exchange is an approximation of the June, 1967 data.

Clear patterns can be seen in the holding of gold relative to foreign exchange among the eleven countries. Japan, Canada, and Sweden had 15 to 40 per cent of their reserves in gold. Italy, Germany and the U.K. had from 48 to 59 per cent of their reserves in gold. On the other hand, the U.S.

Table 4: Percentage ratio of foreign exchange to gold holding of selected countries (Foreign exchange and gold holdings in millions of U.S.dollars)

Country	1951			1953			1955			1957		
	F.E.[a]	G.H.[b]	% Ratio of F.E. to G.H.	F.E.	G.H.	% Ratio of F.E. to G.H.	F.E.	G.H.	% Ratio of F.E. to G.H.	F.E.	G.H.	% Ratio of F.E. to G.H.
(1) Greece	128	4	3200	180	11	1630	199	11	1809	183	13	1407
(2) Iceland	8	1	800	15	1	1500	13	1	1300	15	1	1500
(3) Ireland	188	18	1044	216	18	1200	225	18	1250	234	18	1300
(4) Portugal	291	265	109	255	361	70	244	428	57	226	461	49
(5) Turkey	66	151	43	69	143	48	67	144	46	172	144	119
(6) Argentina	253	267	94	160	372	43	85	372	22	185	126	146*
(7) Brazil	198	319	62	284	321	88	168	323	52	150	324	46
(8) Chile	10	45	22	26	42	61	38	44	86	6	40	15
(9) Colombia	77	48	160	104	86	120	50	86	58	83	62	133
(10) Mexico	46	208	22	61	158	38	276	142	194	272	180	151
(11) Uruguay	2	221	9	64	227	28	-	216	-		180	
(12) Venezuela	-	373	-	104	373	27	122	403	30	726	719	100
(13) Iran	58	138	42	48	137	35	67	138	48	107	138	77
(14) Iraq	114	-	-	181	-	-	286	-	-	242	-	-
(15) Israel	33	-	-	33	-	-	81	-	-	79	-	3950
(16) Kuwait	-	-	-	-	-	-	-	-	-	-	-	-
(17) Saudi Arabia	-	-	-	-	-	-	-	-	-	-	-	-
(18) Egypt	783	174	450	554	174	3100	467	174	268	277	188	140
(19) India	1698	247	687	615	247	2489	1619	247	655	695	247	281
(20) Pakistan	611	27		258	38	6789	322	48	670	242	49	483
(21) Philippines	240	7	2260	231	9	2566	140	16	875	65	6	1083
(22) Thailand	245	114	210	188	114	16	186	112	166	217	112	193

Source: International Monetary Fund, *International Financial Statistics*, Vol. 11, No. 12, December 1958, p.15 for gold holding and p. 16 for foreign exchange for 1951-1957; for 1959-1965 from IMF, *IFS*, Vol. 20, No.8, August 1967, p. 16 for gold holding and p. 17 for foreign exchange.

a F.E. = Foreign Exchange (elements of international reserves);

b G.H. = Gold Holdings.

Table 4 continued:

Country	1959			1961			1963			1965			1966		
	F.E.	G.H.	% Ratio of F.E. to G.H.	F.E.	G.H.	% Ratio of F.E. to G.H.	F.E.	G.H.	% Ratio of F.E. to G.H.	F.E.	G.H.	% Ratio of F.E. to G.H.	F.E.	G.H.	% Ratio of F.E. to G. (2)/(3)×100
(1)	185	26	711	164	87	188	200	77	259	158	78	202	128	45	106
(2)	10	1	1000	23	1	2300	31	1	3100	50	1	5000	53	120	5300
(3)	299	18	1661	317	18	1761	378	18	2105	378	21	1733	471	1	2147
(4)	260	548	47	249	443	562	330	497	66	418	576	72	460	23	71
(5)	11	133	8	62	133	46	63	115	54	25	116	15	29	643	28
(6)	220	56	392	196	190	103	192	78	246	170	66	257	132	102	157
(7)	40	327	12	185	285	64	66	150	44	442	63	701	352	84	782
(8)	86	42	204	26	48	54	34	43	79	94	44	213	126	45	280
(9)	141	71	198	61	88	69	44	62	70	95	35	271	97	45	373
(10)	271	142	190	259	112	231	354	139	261	325	158	205	369	26	338
(11)	12	180	6	25	180	13	23	174	13	35	155	22	50	104	34
(12)	65	655	9	141	401	35	306	401	76	404	401	10	313	146	78
(13)	73	140	52	79	130	60	87	142	61	87	146	59	108	401	83
(14)	212	84	252	130	84	154	194	98	197	109	109	100	195	130	185
(15)	116	2	5800	263	10	2630	449	60	748	575	56	1028	553	105	1202
(16)	-	-	-	40	43	93	50	48	104	60	52	115	-	-	-
(17)	156	18	866	159	65	244	422	78	541	635	73	869	656	67	950
(18)	131	174	75	29	174	166	42	174	24	54	139	38	63	69	67
(19)	567	247	229	418	247	169	360	247	145	319	281	113	364	93	149
(20)	248	50	496	221	53	416	239	53	450	168	53	316	146	243	275
(21)	81	9	900	17	27	62	82	28	282	147	53	316	122	53	277
(22)	204	104	196	339	104	325	461	104	443	624	96	650	808	44	870

Source for the year 1966: International Monetary Fund, *International Financial Statistics*, Vol. XX, No.7, August 1967, p.17 for Foreign Exchange column; and p.15 for Gold Holding column; % Ratio of Foreign Exchange to Gold $\frac{(2)}{(3)} \times 100$ column is based on personal calculations.

Switzerland, the Netherlands, and France held 70 to 90 per cent of their reserves in gold.

There are also great differences among these countries in their holdings of foreign exchange relative to total reserves. Japan, Sweden and the U.K. held 55 to 71 per cent of their reserves in foreign exchange; Canada, Italy and Germany had an intermediate range of 30 to 42 per cent; and finally, other countries such as the U.S., France, and Switzerland kept much lower percentages of foreign exchange relative to their total reserves. The range of variations in the foreign exchange holdings of the 11 countries (5 to 71 per cent) was less than the range of variations of their gold holdings (15 to 92 per cent).

What about the countries outside the Group of Eleven? To look at the behaviour of these countries from the standpoint of their holdings of foreign exchange and gold, twenty-two countries presented in Table 4 were chosen for which the data pertinent to these holdings were available in the *International Financial Statistics*. Their holdings of foreign exchange and gold for every other year starting from 1951 to 1965 were then recorded, and the 1966 data were also added. Upon computing the percentage ratio of foreign exchange to their gold holdings, three categories of countries were recognizable: First, countries whose percentage ratio of foreign exchange to gold holdings was generally more than 100 per cent (sometimes as high as 1800 per cent) such as Greece, Iceland, and Ireland. Second, countries in which this percentage was generally less than 100 per cent, such as Turkey, Irān, and Venezuela. Third, countries in which the percentage ratio of foreign exchange to gold holdings was less than 100 per cent at times, and more than that at other times, such as Argentina, Colombia, Mexico, and Egypt.

Although these data do not suggest too much in the way of a derivation of a pattern of behaviour, they are indicative that there are significant differences among these countries in this respect.

Table 5 shows significant changes which have taken place in the international position of the U.S., France, Germany, Italy, Switzerland and Japan. Most of the gold that

the U.S. lost went to the countries mentioned above.

Table 5: International gold and foreign exchange holdings of selected countries (end of period: millions of U.S. dollars)

	Gold		Foreign exchange	
	1953	1964	1953	1964
United States	22091	15471	—	432
United Kingdom	2263	2136	283	179
France	617	3729	212	1376
Belgium	776	1451	312	540
Netherlands	737	1688	426	496
Switzerland	1458	2725	310	398
Germany	325	4248	1411	2721
Italy	346	2107	422	1571
Sweden	219	189	315	688
Canada	986	1026	841	1658
Japan	18	290[a]	874	1496

Source: IMF, *International Financial Statistics*, Vol.18, No.5, (Washington, D.C. May, 1965), pp.16-17.

a.For the third quarter.

Proposals for reform

To cope with the problem of the inadequacy of international reserves a number of plans have been propounded. Each of these proposals is frequently associated with the name of one or more economists, e.g., The Bernstein Plan, The Keynes Plan, The Triffin Plan, The Posthuma Plan, The Zolotas Plan, etc. From the standpoint of substance one can classify these proposals into three broad groups: (i) raising the price of gold, (ii) accepting freely flexible exchange rates, (iii) increasing international understanding and co-operation either in the form of creating new powers for the I.M.F., or I.B.R.D., or in the form of creating other international agencies which could create international money. It is the purpose of this section to look into the substance of proposals for reform.

I. Change in the price of gold? Since 1933, the U.S. has announced the value of dollar in terms of gold to be

$35.00 = 1 oz. of gold; from that time on, it has kept this gold content fixed. If market forces were allowed to operate an ounce of gold would very likely be worth more than $35.00. Two summers ago after a short crisis of gold, this price rose as high as $49.00.[3] A number of economists, such as Sir Roy Harrod, hold that because the price of gold was fixed at $35.00 an oz. after 1934, and because of the increase in costs of gold production, it is not always profitable for gold miners to increase their production. At the same time they assert that the problem of inadequate liquidity cannot be solved by insisting on too low a level of gold production. The solution they have brought forward would be a revaluation of gold, thus making more gold production, more expansion of domestic money on its basis, and more international liquidity possible.

There are, however, a number of serious objections to raising the price of gold:

(a) Since gold is not divided fairly among different countries, those who have more of it may benefit more from its upward revaluation than those who do not. This may widen the already unequal distribution of gold possession in the world. Furthermore, certain areas such as South Africa and Russia which have richer natural reserves of gold may benefit more from its revaluation.

(b) A more serious objection may be read from the following lines:

> "nobody could ever have conceived of a more absurd waste of human resources than to dig gold in distant corners of the earth for the sole purpose of transporting it and reburying it immediately afterward in other deep holes especially excavated to receive it and heavily guarded to protect it.[4]

Miroslav A. Kriz states his opinion on the price of gold by saying that a gold appreciation:

> "would bring about a sudden surge in the purchasing power of current gold output and accumulated reserves... futhermore, a gold-price rise might mistakably be regarded as a substitute for the effective

> measures that nations will have to take to deal with the manifold issues of international trade and investment of the late 1960's... the world could deceive itself in thinking that a gold depreciation could, in some undefinable but automatic way, solve these fundamental problems (of economic growth,productivity and viability within a broad framework of economic and financial freedom.)"[5]

(c) The idea of raising the price of gold is also regarded by some experts to be a negation of what gold fundamentally stands for. a safe-guard against clearly excessive discretionary powers of governments.

> "In the international monetary system as it has evolved, gold has become a pillar of stability, while reserve currencies and credit facilities have been built around it to carry the bulk of the regular burdens of fulfiling the reserve needs of individual countries."[6]

(d) Assuming the desirability of raising the price of gold, the levels to which it should be raised cannot be left an open question. There must be econometric studies to see, among other things, exactly how much it should be raised and whether it should be a gradual increase or not.

(e) If the price of gold were raised, gold hoarders would be rewarded for their actions. This may, in turn, psychologically prepare them to expect further revaluation and engage in further hoardings which could very well be endangering the present international monetary system.

(f) If countries who benefit from an increase in the price of gold are going to compensate other countries who have suffered losses, there arises a complicated question of how much of the profit obtained by the sudden rise in gold's price ought to be given to countries adversely affected by the rising price.

(g) "At the fixed $35.00 price in terms of gold the dollar has itself become a tradition. Much of the confidence now gained by many other currencies throughout the world is in turn rooted in that tradition".[7]

(h) Any attempt on the part of the United States to devalue the dollar by writing up the price of gold "would assuredly be matched, within hours, by comparable and off setting action on the part of virtually every other country". And if this country finds itself unable to change it's parity against other countries, it would find that all that would remain from an increase in the price of gold would be the indicated profit from the mark-up on whatever was the stock of gold held by the United States at the time.

(i) Finally, allowing an increase in the price of gold is the same thing as a devaluation of the dollar in terms of gold. In this context it is interesting to note that in terms of equivalent gold content following the general wave of currencies adjustments in the 1930's, the deterioration in all currencies except the dollar has been striking.

> "On a percentage scale in relation to 1934, while the dollar remains at one-hundred, the French franc works out, for example, at 3 per cent, the German mark at 4 per cent, and the Belgium franc at 9 per cent; also the Dutch guilder and the Swiss franc have held close to 40 per cent and 70 per cent, respectively."[8]

according to Robert V. Roosa. Roosa has written this before the recent devaluation of the French franc on August 10, 1969. From 1900 to 1928, the par value of the franc was 5.183 francs to one U.S. dollar. Today, it stands at 555.-419/$.[9]

II. A flexible exchange rate? Advocates of a flexible exchange rate[10] including Milton Friedman maintain that if such a system were allowed, the need for international monetary reserves would be avoided. Because, when exchange rates are free to vary, this would mean that as one country's external performance slips behind that of most other countries its exchange rate also begins to slip. Plus the fact that the rates will remain at the true relationship determined by markets which, as the argument goes, are always wiser than bureaucrats. Furthermore, they say a flexible exchange rate is more consistent with the principle of market economy-that is the forces of supply and demand, and that adjustments in

rates of exchange can take place without forcing major internal price or income changes within the countries, which are not always acceptable measures.

> "It would keep the exchange rate continuously near the equilibrium level, would shoulder a substantial part of the adjustment burden, would make it unnecessary to manipulate interest rates predominantly on the basis of balance of payments considerations, would permit to insulate the economic policies in other countries, and would greatly reduce the need for reserves of international liquidity.[11]

Against these advantages, one can site the following disadvantages of a flexible exchange rate system:

(a) The system is criticized on the grounds that it inevitably leads to a competitive exchange depreciation and/or conflicting stabilization fund policy. Furthermore, it may create additional risks which tend to discourage international trade.

(b) Another weakness of a system of flexible exchange rates is that it can be misinterpreted as an invitation to the national economic authorities to disregard the foreign payments' implications of their domestic actions.

(c) A creditor would not want to lend to, or invest in, a country whose currency is depreciating, and if a loan is expressed at units of a creditors currency which is appreciating, the borrowing country would find it hard to meet its obligations. Therefore, as far as long term international capital movements are concerned, one can safely hold that they would be seriously impeded if exchange rates were permitted to fluctuate.

(d) Economic calculations of people and businessmen are often based on a seemingly firm degree of stability of money. The same might hold true in the international economy, and international money too should enjoy some degree of stability. John Meynard Keynes held that ". . . it is this distance (money stability) which protects the money market of one country from being upset by every puff of wind which blows in the money markets of other countries."[12]

(e) The arguments in favour of flexible exchange rates are partly based upon a reliance on "constructive speculation" and this is something of which one cannot always be sure. Depending on whether or not it is thought that exchange rates are short and temporary, the nature of speculation would vary, as expectations about future price movements would also vary.

(f) Apart from the basic economic disadvantages of a flexible exchange rate, there are a number of practical problems and operational complexities that are attached to its acceptability:

First, the implications of the acceptance of a flexible exchange rate is to allow different currencies to fluctuate vis-a-vis each other, theoretically, without limits. This would not only introduce elements of risk and uncertainty in some international transactions which might retard trade and capital movements but also would make the calculation of the cheapest way of making international payments a complicated or unacceptable procedure. Suppose, for example, that a flexible rate system is accepted for five countries: Japan, the United States, France, England, and Irān. If the currencies of each of these countries be designated by yen, dollar, franc, pound, and rial, as they are in practice, then there would be a $/pound, a$/franc, a $/yen, a$/rial rate in New York; a franc/pound, a franc/$, a franc/yen, a franc/rial in Paris; a pound/$, a pound/franc, a pound/yen, a pound/rial in London; a yen/$, a yen/pound, a yen/franc, a yen/rial in Tokyo; a rial/$, a rial/pound, a rial/franc, a rial/yen in Tehran with which to contend. In addition, since the system involves a flexible rate, a trader or a speculator in each of the above countries would have account for the fact that the prevailing rates in his home country money centres do not necessarily hold in the money centres of the other countries. Moreover, for each currency "spot" rate, there could, and probably would, be one or more "forward" rates which must be also taken into account. With a cross connection of the currencies like that of the above example, and with the possibility of each or all rates fluctuating against each other, the task of dealing in foreign exchange would become enormously complex and perhaps impractical especially when the assumption of five countries is relaxed and more countries be introduced, the complexity of calculations would

be magnified.

Second, should a system of flexible exchange rates be accepted and should the central bank officials engage in operations to smooth exchange rate movements, there is always a chance that the policies of two or more countries may cancel each other out, or compound the amount of intervention. If this becomes the case, the advantage of "free forces of the market" that a flexible exchange rate is to provide over the present system would be doubtful.

Third, the scope of a country's involvement in a flexible exchange rate system is not only a function of its relative magnitude in international transactions but also can be affected by non-economic factors. For instance, pride and prestige might dictate that the United Kingdom and the United States have moneys that would not depreciate vis-a- vis the currencies of others.

Fourth, it is argued that an inefficient and costly reallocation of resources will be induced if a flexible exchange rate exists. For example, over the course of a business cycle, should the domestic currencies depreciate in an expansion, the profitability of industries producing for the internal economy would be expected to change vis-a-vis import and export competing industries, and factors of production would have a tendency to move toward the profitable industries. A significant appreciation in a recession would reverse the process; hence, reallocation of resources may be subject to short term movements, and if the incentive for movement suddenly reverses itself, two or more costly movements may need to be made, thus making the resource allocations costlier than they would be had they not been subject to short term incentives.

Finally, in today's world, external and internal economic matters are so closely related and so intricately entwined that even the acceptance of a flexible exchange rate cannot insulate domestic economies from happenings abroad - exogenous factors over which no nation has control. Thus under any international financial arrangement international co-operation is needed, and the arguments for a flexible exchange rate system underscore this need.

Opponents of flexible exchange rate usually refer to one or more of the above arguments to show that the probability of success of this system is nil and that flexible exchange rates can be quite an unstable system.

One can go as far back as October 22, 1933 to President Roosevelt's announcement in a radio broadcast to see why a fixed price was set for U.S. dollars in terms of gold:

> "Our dollar is not altogether too greatly influenced by the accidents of international trade, by the internal policies of other nations and by political disturbances in other continents. *Therefore, the United States must take firmly in its own hands the control of gold value of our dollar* ..... as a further effective means to this end, I am going to establish a government market for gold in the United States." (emphasis mine)[13]

In the light of the above lines of reasoning, one tends to believe, despite what Professor Friedman believes, that benefits which might be derived from stable exchange rates - or from avoidance of competitive exchange depreciation, are more than the benefits to be derived from a flexible exchange rate, although there is no accurate way of measuring such benefits.

III. Increasing international understanding and co-operation. A third group of plans has been designated as international co-operation and can be broken down into mutual assistance among central banks, centralization of monetary reserves, strengthening the IMF, and creation of an international bank for the settlement and clearing of the international transactions. More hope can be placed on this category in terms of eventual agreement because the range of agreement among the supporters of this category of proposals is not very limited despite technical differences. Part of the reason for this assertion lies in the fact that many economists, for reasons discussed in the previous sections, are against either an upward valuation of the price of gold or the acceptance of flexible exchange rates. Therefore, they are automatically led to alternative types of suggestions which would bring about the desired reform. Sir Roy Harrod

is an example in this respect. His favourite plan, known as the Harrod Plan, is based on the idea of an upward valuation of the price of gold; he supports this with full conviction. Nevertheless, realizing the hesitation of practical men, he has proposed alternative plans called A, B, C, and D, all of which aim at providing countries so adequately with reserves that their permanent concern over restraints on the goals of the national economy and about the maintenance of equilibrium in their balance of payments would be relieved. As late as March 1967, in response to a question he had raised: "How quickly a nation that finds itself in deficit should feel obliged to cure that deficit," he answers:

> "If it is considered that immediate steps should be taken, then we could all get along with modest reserves. But if it is considered preferable to readjust at a more moderate pace, then larger reserves are needed..."[14]

Supporters of this category of proposals have enumerated the following advantages:

(a) There will be some arrangements to clear and settle international transactions and claims without resort to blocked balances, bilateral clearings, unilateral action and competitive exchange depreciation.

(b) As a result of these, there can be an orderly conduct of production, trade, and distribution on an international scale.

(c) There will be a means of reassurance to a troubled world whereby each country would be relieved of anxiety created by causes which are not of its own making. Furthermore, economic authorities of many countries would be able to focus their attention mostly on national economic objectives without undue worry about the adequacy of international reserves. If hot money movements are the cause of trouble for monetary authorities of a country, with international cooperation of central banks, "the outflow of speculative funds need not be associated with a reduction in effective demand for goods and services."[15] Acceptance of some international agreement on the world monetary system would also make unnecessary those methods of discrimination and/or

restrictions that some countries have adopted defensively.

(d) Defenders of this category of reform proposals have further held that countries - especially the ten industrialized ones - have had to resort, from time to time, to international co-operation and this has led at least to preventing crisis or chaos in the present international monetary system. One striking example is the General Arrangements to Borrow (GAB) which was concluded in Paris, in December 1961, between the ten leading industrial countries and the Fund, whereby participating countries stand ready to loan their currencies to the Fund whenever they and the Fund agree that additional reserves are needed for the support of the international monetary system. Needless to say, GAB was initiated, at least partially, because of serious deterioration in the U.K. balance of payments position which was caused by speculative movements induced by the prospects of possible further changes in the value of the Netherlands guilder and the German mark. Since such arrangements, by and large, have proved to be useful - at least in terms of preventing a serious monetary crisis - the question is raised: why not initiate a more ambitious plan of the central banks in order to accept arrangements whereby the international monetary problem is solved once and for all, at least for the foreseeable future?

(e) Supporters of international co-operation further assert that assistance by foreign or international institutions can eliminate the anxiety of losing gold and monetary reserves of the international prestige of key currencies. Furthermore, the system would be reinforced through international co-operation against the onslaught of hot-money movements. In addition to the above, pressures on monetary authorities of countries who suffer from capital outflows would be reduced. Needless to add, the pace of development and growth in underdeveloped countries could thus be made to be more smooth.

(f) In a domestic economy, a central bank can extend the volume of money and credits if and when it is needed. This potential advantage of a central bank can prevent money crisis which may occur in the absence of an effective central banking system.[16] Supporters of the establishment of a world central bank also claim - and rightly so - that it can

multiply the capacity of the world monetary system to create credits by temporarily transferring international reserves from one central bank to another and thus make individual central banks shock-proof. Moreover, arrangements can be made, so the argument goes, whereby assistance among central bankers or the supervision of an international institution, such as the World Bank or an expanded IMF, is not limited to emergency situations; thus the institution would function on a daily basis. Part of the trouble in the present international monetary system arising from the role of gold and its annual rate of growth can be coped with without exposing the system to the danger of collapse.

Obviously, this group of proposals varies in the degree of details, technicalities, accuracy, and even types of provisions made. Reference to the Triffin and Maxwell Stamp Plans which respectively call for the extension of the IMF into an international reserve bank and extending the IMF into an institution creating reserves internationally are sufficient to demonstrate this. More recent examples are the differences between the stand-by credits under the Bernstein Plan or under the Jacobson arrangements. "Among economists," says Machlup, "there are many who regard these proposals as premature but certain of eventual acceptance. A few economists go so far as to regard them as the only real solution."[17]

Against such advantages, of course, there have been a number of questions, objections, and/or criticisms to the centralization of world reserves, to the establishment of a world central bank, and to the types of arrangements necessary for the expansion of the IMF. These can be summarized as follows:

(a) A lending bank, or institution, may lend foreign exchange, possibly gold or its own currency. And what it receives for its portfolio may also vary since it may be in any of the following forms: medium or long term obligations of the borrowing country, payable in gold or currency of another country; currency of the country in need of help,etc.[18] These are, of course, open issues which have to be taken into account in the establishment of an international central bank. Needless to say, it is not easy for academic economists to agree on any practical solutions of the problems

under debate.[19]

(b) As far back as 1943, Keynes mentioned, in his proposal for an international clearing union,

> "It may be doubted whether a comprehensive scheme will ever in fact be worked out, unless it can come into existence through a single act of creation made possible by the unity of purpose and energy of hope for better things to come."[20]

(c) One can not ensure that drawing on the IMF - or the operation of any other international institution - would be of just the right magnitude to create the optimal supply of monetary reserves, to help troubled countries adjust their balance of payments disequilibrium, or to prevent inflationary or deflationary tendencies in the world economy.

(d) There are other problems and disagreements in regard to the type of guarantee to be given to participating countries, the manner in which they would be stimulated to participate, the pattern and the magnitude of change in the present international monetary system, the political and international implications of different proposals, the different responses and reactions of countries, their attitude as to how serious they think the problem at hand is, how urgently it should be attacked, how much hope can be placed on practical solution of the problem, who should initiate and/or lead international negotiations and how conditions of membership, provisions for the functioning of the international agency should be established. In short, a large group of other relevant factors would have to be taken into account.

Such problems, however, should not discourage practical men. Academicians and practitioners should not despair even with the bombardment of suggestions developed. There is reason to believe, in the light of advances already made in the form of GAB and the like that,

> "the lines of development pursued in the postwar period offer the best chance for further progress. The international financial machinery has proved to

> be flexible and adaptable. Within its terms of reference or with relatively small changes in them... This machinery is capable of further growth and adjustment."[21]

It is only in this third category of proposals that one can place, in my opinion, the most hope for a practical solution of the problem of inadequacy of growth of the international reserves. The development of the SDR's demonstrates magnificent international co-operation, courage, patience, and willingness to be practical - without trying to stick too much to theoretical considerations.

Special drawing rights

I. Background and development. In a series of meetings growing out of recommendations made at the Annual Meetings of the International Monetary Fund in the 1960's there slowly evolved an outline for creating new international reserves.[22]

At the Annual Meeting of the Fund in 1961 the first official need for additional reserves to cope with unusually large movements of short term capital was recognized. As a result Belgium, France, Germany, Italy, the Netherlands, Sweden, Canada, Japan, the United Kingdom, and the United States, who became known as the Group of Ten - met in Paris to work out an agreement. This group of ten industrial nations became the nucleus of international monetary negotiations.

At the Annual Meeting in 1963 more serious problems were anticipated. As a result the Group of Ten and the International Monetary Fund were commissioned to make separate studies of future functions of the International Monetary Fund.

In 1964 reports of the two study groups were published. Both reports acknowledge that future international liquidity might demand sums greater than the supply of gold and foreign-exchange reserves. And a further study was set up to

examine proposals for the creation of reserve assets.

In 1965 the report describing several different means of providing new reserve assets other than gold and reserve currency was published. At the Annual Meeting of the Fund the Group of Ten instructed their deputies to report on what agreement could be reached to improve the international system, especially the future creation of reserve assets when they were needed.

In the 1966 report of the Group of Deputies the longest chapter was "Deliberate Reserve Creations". No one scheme was approved by the group but most of them favoured the creation of a new reserve unit by a limited group of responsible countries. France did not participate in most of the discussion.

The need for supplementing reserves, possibly by deliberate creation of additional reserve assets, was expressed by the Ministerial meeting of the Group of Ten, France again abstaining.

At the Annual Meeting of the Fund joint meetings of the Executive Directors of the Fund and the Deputies of the Ten were arranged. Four meetings were held; in November,1966 and January, April, and June, 1967. When everything seemed to point to disagreement between the two groups, sudden changes smoothed the way for an understanding. The Outline was written and approved. On September 29, 1967 the resolution to adopt the Outline was unanimously passed by the Board of Governors of the International Monetary Fund at the conclusion of the Annual Meeting held in Radio de Janerio. After the Outline is transferred into legal form it must be ratified by three-fifths of the governments of the member countries having among them four-fifths of the total voting power.

II. What are special drawing rights? Machlup defines special drawing rights as "... international money accepted by the participating monetary authorities in payment for various convertible national currencies."[23]

"The unit of value for expressing special drawing

rights will be equal to 0.888671 grams of fine gold. The rights and obligations of participants and of the Special Drawing Account will be subject to an absolute maintenance of gold value or to provisions similar to Article IV, Section 8, of the Fund's Articles" (vi, b). [24]

The above gold value of the SDR unit is equal to the gold value of the United States dollar. There was a thought that some countries might object to the expression of international monetary units in dollars; the dollar was, therefore, never mentioned in the Outline, although the similarity is sure to be recognized. Another reason for not mentioning the dollar could be to avoid confusion should the gold-par of exchange for the United States dollar ever change.

The SDR is defined above as international money but it does not exist except as a credit balance in the Special Drawing Account of the IMF. The total number of units of SDR's in the account book will always remain equal to the amount of SDR's the Board of Governors have created. SDR's will be transferred from one participant's account to another as transactions are approved in very much the same manner that a bank credits and debits the accounts of its customers. The country transferring or giving SDR's will receive money while the country receiving SDR's will be credited with an amount equivalent to the money they paid.

The SDR is similar to gold in many ways. Like gold it is an official reserve asset. Like gold SDR's are nondebt money. SDR's were created to supplement gold and other international reserves such as drawing rights on the IMF, U.S. dollars, British pounds, etc., in the monetary reserves of nations and may assume in the future a significant proportion in the total world reserve. Some journalists have referred to SDR's as paper-gold.

SDR's differ from gold, however, because gold is a heavy metal stored in bank vaults while SDR's are entries in the books of the Special Drawing Account of the IMF.Furthermore, SDR's differ from gold in that they derive their acceptability from an international agreement while gold

derives it's acceptability from long historical practice expressed in the laws of many lands and in myths.

This unit which has been defined in gold content and is referred to as a special drawing right has not been given an official name. Perhaps it is destined to be known by the initials SDR.

III. Distribution procedures among countries. The allocation of SDR's is a twofold problem. The first problem is the amount of SDR's to be created and when will they be created.

The Managing Director, with the approval of the Executive Directors of the IMF, will recommend how many new reserve assets are needed to keep international trade free from either deflation or inflation.

Acting on the recommendations of the Managing Director, the Board of Directors will then have to vote on a basic period for the creation of SDR's, e.g., three to five years. They will also decide the total amount of SDR's to be created and the intervals at which the SDR's will be distributed. The interval will very likely be a year.

This plan then has to be approved by 85 per cent of the participating members. To participate a country must be an IMF member and have filed a written agreement to participate in the Special Drawing Rights Account. All IMF members do not have to participate, as participation is optional.

The second problem concerns who will receive SDR's. Allowing all members to participate if they so choose was one of the most disputed parts of the Outline. There were many arguments for giving SDR's to a special group, e.g., to the poor countries because they needed them most, or to the industrial countries because of their significant role in international trade.

Those who favoured allowing everyone to share in the special drawing rights were definitely in the minority in the beginning. Their arguments about the resentment that discrimination would cause and the resulting harm to international co-operation reinforced by the point that all

countries, not just a few, needed amounts of monetary reserves finally won over the opposition.

All participating members will be credited with a per cent of the total amount of SDR's to be allocated at any given time. The per cent allocated to each member was finally based on their IMF quotas which seemed to be a fair basis for SDR's allocation. The fact that country quotas of the IMF were subject to periodic general review under IMF's Articles of Agreement facilitates an adjustment of the size of the Fund to the growth of the world economy and changes in their relative significance in international trade. Thus, allocation of SDR's, being based on the IMF quotas, can be said to be eventually adjustable too.

IV. Initial alloaction of special drawing rights. The International Monetary Fund reports that it has made an initial allocation of special drawing rights equivalent to $3,414 million, effective January 1, 1970, to 104 participants in the Fund's Special Drawing Account.

The allocation was made in accord with a Resolution adopted by the Fund's Board of Governors at its 1969 Annual Meeting. The Resolution approved a proposal of the Managing Director concurred in by the Executive Directors to allocate special drawing rights for a first basic period of three years, beginning January 1, 1970. The present allocation is made for the first year and will be followed by annual allocations on January 1, 1972. Allocations are made at a rate expressed as a percentage of the quotas of participants on the day before the allocation in question, the percentage being such as to yield allocations close to the equivalent of $3.5 billion in the first year, $3 billion in the second year, and $3 billion in the third year.

The rate of allocation for the first year of the basic period was computed at 16.8 per cent of the quota, as of December 31, 1969, of each participant receiving an allocation.

V. Specific purposes of special drawing rights. Since all SDR's are a credit balance in the Special Drawing Account book of the IMF they can only be transferred to another account. The participant receiving the SDR's will have to exchange an equal amount of money to the participant

transferring SDR's to it's account. Ordinarily, the money would be in the currency, of a third country although under certain circumstances when the United States is involved dollars may be exchanged.

Allocation of Special Drawing Rights Received by Participants January 1, 1970 (in U.S. dollars)

Participant	SDR's	Participant	SDR's
Afghanistan	4,872,000	Equatorial Guinea	1,008,000
Algeria	12,600,000	Finland	21,000,000
Argentina	58,800,000	France	165,480,000
Australia	84,000,000	Gabon	1,596,000
Austria	29,400,000	Gambia, The	840,000
Belgium	70,896,000	Germany	201,600,000
Bolivia	4,872,000	Ghana	11,592,000
Botswana	504,000	Greece	16,800,000
Brazil	58,800,000	Guatemala	4,200,000
Burma	8,064,000	Guinea	3,192,000
Burundi	2,520,000	Guyana	2,520,000
Cambodia	3,192,000	Haiti	2,520,000
Cameroon	3,057,600	Honduras	3,192,000
Canada	124,320,000	Iceland	2,520,000
Central African Rep.	1,596,000	India	126,000,000
Ceylon	13,104,000	Indonesia	34,776,000
Chad	1,680,000	Iran	21,000,000
Chile	21,000,000	Ireland	13,440,000
Colombia	21,000,000	Israel	15,120,000
Congo (Brazzaville)	1,680,000	Italy	105,000,000
Congo, Dem. Rep. of	15,120,000	Ivory Coast	3,192,000
Costa Rica	4,200,000	Jamaica	6,384,000
Cyprus	3,360,000	Japan	121,800,000
Dahomey	1,680,000	Jordan	2,688,000
Denmark	27,384,000	Kenya	5,376,000
Dominican Rep.	5,376,000	Korea	8,400,000
Ecuador	4,200,000	Laos	1,680,000
El Salvador	4,200,000		

Participant	SDR's	Participant	SDR's
Lesotho	504,000	Southern Yemen	3,696,000
Liberia	3,360,000	Spain	42,000,000
Luxemborg	3,192,000	Sudan	9,576,000
Malagasy Rep.	3,192,000	Swaziland	1,008,000
Malawi	1,890,000	Sweden	37,800,000
Malaysia	21,000,000	Syrian Arab Rep.	6,384,000
Mali	2,856,000	Tanzania	5,376,000
Malta	1,680,000	Togo	1,890,000
Mauritania	1,680,000	Trinidad and Tobago	7,392,000
Mauritius	2,688,000	Tunisia	5,880,000
Mexico	45,360,000	Turkey	18,144,000
Morocco	15,120,000	Uganda	5,376,000
Netherlands	87,360,000	United Arab Rep.	25,200,000
New Zealand	26,376,000	United Kingdom	409,920,000
Nicaragua	3,192,000	United States	866,880,000
Niger	1,680,000	Upper Volta	1,680,000
Nigeria	16,800,000	Uruguay	9,240,000
Norway	25,200,000	Venezuela	42,000,000
Pakistan	31,584,000	Viet-Nam	6,552,000
Panama	4,704,000	Yugoslavia	25,200,000
Paraguay	2,520,000	Zambia	8,400,000
Peru	14,280,000		
Philippines	18,480,000		
Rwanda	2,520,000		
Senegal	4,200,000		
Sierra Leone	2,520,000		
Somalia	2,520,000		
South Africa	33,600,000		

*Source: International Monetary Fund, *International Financial News Survey*, Vol. XXII, No.1, January 9, 1970 (Washington, D.C.)

Participants are expected to use SDR's for only two legitimate purposes. First as a "balance-of-payments need",and second "in the light of developments of its total reserves".

In the first instance, if a country has a deficit disequilibrium in its balance of payments, it may exchange SDR's, provided it has them in its account at the IMF, with

another country for money to help balance its payments to other countries. In an ideal situation, the other country, the one providing currency for SDR's, would have a credit disequilibrium or a strong balance of payments. There is a long and rather complicated set of rules in the Outline directing countries in choosing who they should exchange SDR's with if there is no country that happens to fall in the first category.

The second legitimate drawing purpose, "in the light of developments of its total reserves" applies to a special circumstance of the United States. Since other countries may convert dollars to gold, the United States may purchase dollar holdings with its SDR's in order to prevent too much of a gold loss due to other countries' decisions for conversion, thus, eliminating or reducing undue pressure on U.S. dollars as a result of heavy conversion demands into gold.

Within certain limits transfers may be freely made but a country which fails to live up to expectations of appropriate use of SDR's may have drawings directed against it to correct the inappropriate use. An example of inappropriate use would, e.g., be exchanging SDR's for money to buy gold to hoard.

There are also rules for determining how much of its Special Drawing Rights Account a country may transfer. Under ordinary circumstances a country will be expected to retain at least 30 per cent of its total allocations in its account.

The director of the account would also keep an eye on the total amount of SDR's held by each country in order to make sure that they do not hold an excess of SDR's in proportion to their total reserves.

VI. Effect of special drawing rights on the balance of payments. The most immediate and direct effect of SDR's on a participating country's balance of payments will be that, like acquisitions by monetary authorities of new gold reserves, their allocation will make possible a net reduction in a balance of payments deficit or a net increase in a balance of payments surplus. Each country receiving an allocation of special drawing rights will enter the receipt as a credit in their balance of payments accounting, designating

the receipt as a unilateral transfer or a long-term capital import.

The allocation of SDR's to the participating countries will have the effect of reducing the combined payments deficit of the countries, increasing the combined surpluses of the countries or transforming a combined deficit into a combined surplus.

To the extent that allocation of SDR's to a particular country changes that country's payments position from a deficit to a surplus, such change could, at least theoretically, have the indirect effect of influencing the governmental authorities of that country to be more liberal in its domestic fiscal monetary policies or in its foreign policies.This, in turn, could cause changes in the balance of payments of that country, as well as the balance of payments of countries that trade with this particular country. To what extent this theoretical possibility can practically develop,no one knows now. Only time can tell. There is room to believe, however, that proper supervision of the IMF could check undue inflationary policies of irresponsible governments.

VII. Effect of special drawing rights on international trade. The primary effect of SDR's on international trade should be that their allocation to participating countries will have a liberalizing influence on the countries' foreign policies. Based on past history, increases in foreign reserves of a country typically result in an easing of credit, relaxation of fiscal and commercial policies, and additional foreign lending and investment. This usually leads to a relaxation of restraints on the demand for foreign goods and services. Thus, the allocation of special drawing rights should result in an overall increase in international trade.

Some business authorities fail to realize the relationship of a country's foreign reserve position to its foreign policies with respect to international trade. As a result, many contend that international transactions have not been prevented due to a lack of international liquidity. What they fail to realize is that restrictive foreign policies resulting from a weak international reserve position are the indirect cause of many international transactions never being initiated.

The recent Foreign Direct Investment Controls programme established by the United States is a good example of a restrictive foreign policy resulting from a relatively weaker international reserve position than in the past. The imposition of the controls by the United States, although necessary, certainly resulted in many international transactions not being realized.

If the allocation of SDR's to the United States results in a strengthening of its international reserve position, this hopefully would lead to a liberalization of its foreign policies with respect to international trade. The final result should be an increase in international trade. "Trade expansion" effects can also be expected as a result of SDR's for other countries.

VIII. Impact of special drawing rights on developing countries. It appears that the direct impact of special drawing rights upon developing countries will be rather negligible, at least initially. To illustrate this, total imports of the developing countries approximate 40,000 million dollars annually; their IMF quotas are approximately 6,000 million dollars. An annual allocation of special drawing rights of approximately 10 per cent of the IMF quotas, (this percentage appears to be reasonable based on preliminary discussions of the amount of special drawing rights to be allocated) would result in an increase in reserves of 600 million dollars. Under the proposed rules, participants must keep 30 per cent of their special drawing rights as a minimum balance; hence, 420 million dollars would be available with which to finance additional imports. As a result, total value of imports of the developing countries would be increased by only approximately one per cent. On the basis of initial allocation of SDR's as discussed above, the ten most industrialized countries (so-called Group of Ten) have been allocated a total of 2,191 million dollars of SDR's which is 64.17 per cent of total initial allocation.

The greatest impact of special drawing rights on developing countries appears to be the liberalizing influence which their allocation tend to have on the foreign policies of the developed nations. The allocation of special drawing rights to developed nations should allow them to relax at least parts of their restrictions on imports which will result in the developing countries exporting more goods and

services to the developed or "affluent" nations.

IX. Possibility of success for special drawing rights. In order for the allocation of SDR's to become a reality, a voting majority of eighty-five per cent of the participating members of the International Monetary Fund must concur on the timing, amount, and rate of allocation.

SDR's are intended to act as a supplement to existing gold reserves in that, like gold, they will represent a claim to resources without being anybody's legal liability. Thus, in order for special drawing rights to become an important part of total international reserves, participating countries will have to be convinced that the SDR's can in fact take on many of the characteristics that gold now "enjoys"; mainly acceptance by countries in exchange for their currencies which in turn is exchanged for their goods and services.

It appears that for the idea and actual allocation of SDR's to become a reality, each of the participating countries will have to follow the rules relating to SDR's as closely as possible. Some degree of effective supervision of the IMF is also required, especially at the initiation of SDR's. Adding domestic responsible monetary and fiscal policies, co-operation of governments on international financial affairs from which we have witnessed more in the past decade and their determination to make SDR's work, one can, indeed, foresee a day perhaps in just a couple of decades - in which SDR's, if properly managed, enjoy the present position of gold.

Summary and conclusions

This paper provided a glance at the present international monetary system and its components such as gold, U.S. dollars, British pounds, and drawing rights on the IMF. A statistical approach and a discussion of the adequacy of these international reserves was then followed. The performance of the system was not and still is not, quite satisfactory. With the hope of making the system perform more satisfactorily three broad categories of reform were discussed: a change in the price of gold, acceptance of a flexible

exchange rate, and increasing international understanding and co-operation. Each of these were discussed with the pros and cons, showing that raising the official price of gold would be undesirable and that the acceptance of a flexible exchange rate might run into practical difficulties. Thus more hope could be placed upon more international financial and monetary co-operation - a phenomenon from which the financial world has indeed seen relatively more in the last two decades. It was shown that SDR's offer a good chance of success. Practical attempts at the solution of the problem of inadequacy of international reserves thus led international financial authorities to many discussions which ended in the adoption of SDR's - often referred to as paper gold.

Notes

1. With the use of a "least-square method" of estimate.
2. There have been a number of innovations which have affected the supply side of international liquidity and have had the objective of strengthening the existing system. The innovations which are referred to here are typical but not inclusive. First, the I.M.F. instituted in 1952 what is usually referred to as "stand-by credits". This is an "advance" given by one country to another guaranteeing that a certain amount of foreign currency can be drawn by a member over a specified period subject to the limiting conditions of the I.M.F. The country receiving this advance can consider it a given factor in it's balance of payments. Second, there have also been increases in the I.M.F. quotas of member countries in line with Article III, Section 2, of the Articles of Agreement which reads: "The Fund shall at intervals of not more than five years conduct a general review and if it deems it appropriate, propose an adjustment, of the quotas of the members." Once by 50 per cent in 1959, by 25 per cent in 1964, and more recently in 1969 (as reported in the International Financial News Survey of January 9, 1970). *Third*, general arrangements to borrow (GAB) adopted in 1962 which was an arrangement between the so-called Paris Club or Group of Ten and the I.M.F. according to which the participating countries would stand ready to loan their currencies to the Fund when and if the countries and the Fund agree

that additional reserves and resources are needed to support the international monetary system. Massive "rescue operations" of the pound were accomplished in 1964 and again in 1965 under GAB. *Fourth*, since 1962, the U.S. has employed "currency swaps" which have taken the form of exchange of currency between the U.S. and another country whose currency is relatively stronger in the foreign exchange markets, the proceeds of these "swaps" are used by the U.S. to support the dollar with a major objective of combating temporary speculation against the dollar (such as what could have occurred at the time of Kennedy's assassination and short term capital outflows). *Fifth*, the U.S. in order to reduce the pressure on the dollar and finance the U.S. deficit without gold losses, has sold to other countries the so-called "Roosa bonds" which are intermediate term U.S. government securities. As an example, in 1963 such bond sales amounted to $702 million. *Sixth*, there was also a London gold pool formed in 1961 as a "gentleman's agreement" between some industrially advanced countries under which they agreed to pool gold sales and purchase on the London gold market with the aim of stabilizing the price of gold. The pool was cancelled in the late 1960's.

3. Before assuming office as President, the late John F. Kennedy made statements to the effect that "the dollar price of gold would in no event be changed." See Sir Roy Harrod, "World Reserves and International Liquidity", *The South African Journal of Economics*, Vol. 35, No. 2 (June, 1967), p. 94. Only in recent months the price of gold on the free market has gone down to below the official price of $35 an oz.
4. Robert Triffin, "Tommorow's Convertibility: Aims and Means of International Monetary Policy," in Banca Nazionale Del Lavoro, *Quarterly Review*, No.49 (June, 1959), p. 142.
5. Miroslav A. Kriz, "Gold: Barbarous Relic or Useful Instrument?" Princeton University - International Finance Section, *Essays in International Finance*, No.60(Princeton, N.J.: Princeton University Press, June, 1967), pp. 26-28.
6. Roosa, Robert. *Monetary Reform for the World Economy* (New York: Harper & Row, Publishers, 1965), p.10.
7. *Ibid.*, p.18. Countries used dollars for payments by more than 14.3 billion dollars worth of their

transactions as of May, 1967. See Board of Governors, Federal Reserve System, *Federal Reserve Bulletin*, Vol. 53. No.8, August, 1967 (Washington, D.C.), p. 1446.

8. Roosa, *op. cit.*, p. 84.
9. Federal Reserve Bank of Cleveland, *Economic Commentary*, Sept. 22, 1969.
10. See, e.g., Milton Friedman, "The Case for Flexible Exchange Rates, *Essays in Positive Economics* (Chicago University)and "Cure of Dollar Shortage", *Essays in International Finance*, Harberler, Currency Convertibility (Washington: American Enterprise Association, 1954); James E. Meade, *The Three Banks Review*, No. 50, June, (London: Macmillan & Co., Ltd., 1961); Egon Sohmen, "Flexible Exchange Rates, Theory and Controversy" (Chicago: University of Chicago Press, 1961); Charles R. Whittlesey, *International Monetary Issues*.
11. George Halm, "Fixed or Flexible Exchange Rates?"in U.S. Congress, Joint Economic Committee, *Factors Affecting the United States Balance of Payments*, 87th Congress, 2nd Session (Washington, D.C.: U.S. Government Printing Office, 1962), pp. 265-266.
12. John M. Keynes, *A Treatise on Money* (New York:Harcourt, Brace, and Co., 1930), p. 325.
13. Reprinted in Board of Governors of Federal Reserve System, *Federal Reserve Bulletin*, November, 1933, p. 699.
14. Sir Roy Harrod, "World Reserves and International Liquidity," in Council of the Economic Society of South Africa, *The South African Journal of Economics*, Vol.35, No.2 (June, 1967), p. 93.
15. Fritz Machlup, "Plans for Reform of the International Monetary System," in Princeton University,International Finance Section, *Special Papers in International Economics*, No.3, Revised (Princeton: Princeton University Press, March, 1964), p. 39.
16. Many crises can be found throughout the history of different industrialized countries, whose causes have been basically the lack of an effective monetary system. For example, in the U.S. the panics of 1873, 1884, 1893,... and 1907"... were accentuated by ... peculiarity of the national banking system." See Gilbert C. Fite and Jim E. Reese, *An Economic History of the United States*(Cambridge, Massachusetts: Houghton Mifflin Company, 1959), p. 474.
17. Machlup, "Plans for Reform of ...," *op.cit.*, p.40.
18. For further information see Machlup, *op. cit.*, p.31.

19. Robert Triffin, *The World Money Maze* (New Haven: Yale University Press, 1966), p. 317.
20. The Keynes Plan reprinted in George Halm, *International Monetary Co-operation* (Chapel Hill: The University of North Carolina Press, 1945), p. 228.
21. Oscar L. Altman, "Professor Triffin on International Liquidity and the Role of the Fund," *IMF Staff Papers*, Vol. 8, May, 1961, Washington, D.C. p. 188.
22. Material for this section is taken from a book by Fritz Machlup, *Remaking the International Monetary System, The Rio Agreement and Beyond* (Baltimore: The John Hopkins Press, 1968). Dr. Machlup is a professor of economics at Princeton University and is a leading authority on international monetary reform.
23. Machlup, *Ibid.*, p. 34.
24. *Ibid.*, p. 29.