The prospects for an international monetary system

The Henry Thornton lecture, given by the Governor at the City University, London on 14 June 1979.

Introduction

It is particularly appropriate that the lecture I am giving this evening is in honour of Henry Thornton. There are many useful perspectives from which to observe and analyse international monetary affairs, and Henry Thornton can be said to have personified many of them. He was an economist whose major work on monetary theory, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, went deeply into problems relating to foreign exchange. It was described at the time by Jeremy Bentham as 'a book of real merit [and] ...instruction'; by John Stuart Mill half a century later as 'the clearest exposition...in the English language of the modes in which credit is given and taken in a mercantile community'; and, after many decades of neglect, Professor Hayek drew our attention to Thornton's work as 'the beginning of a new epoch in the development of monetary theory'. But Henry Thornton was not only a theoretician. He, more than most, was able to bring to bear upon his understanding of the political economy his own personal experience of the worlds of politics—as MP and close friend of Pitt; of social needs—as Evangelical and friend of Wilberforce; of commercial banking—as a banker of whom Clapham writes that there was 'perhaps not one so able'; and more indirectly of central banking—several of his relatives were Directors, and his brother Samuel a Governor, of the Bank of England. I cannot hope to combine all these attributes and distinctions. My main aim tonight in providing some reflections on the world's monetary problems and prospects will be to draw upon my own experience as a practising central banker. I venture to hope that my approach will be consonant with the spirit of Henry Thornton's life and works.

You will note the central banker's caution at the outset—in the use of the indefinite article in the title: 'The prospects for an international monetary system'. I have remarked elsewhere that what we have at present is best described not as an international monetary system, but rather as a set of international arrangements. And I propose to offer as a focus for my thoughts the question of whether, or in what sense, the world can or should evolve towards something that could properly be described as an international monetary system.

It is a commonplace that the past decade has been characterised by economic and monetary disorder. Inflation and unemployment have both been, for most of the period and in most of the world, high and damaging. Very large payments imbalances have persisted. Protectionism has been creeping forwards. National policy actions have tended—although there have been notable exceptions—to be unilateral and *ad hoc* rather than co-ordinated. In these circumstances, it is perhaps natural to begin with the question 'why?' Why has there been such disorder, why such an absence of rules, why such a degree of tension and conflict in international economic relations?

But, placing the problem in a wider context, it is perhaps more natural to ask 'why not?' Why should we not expect the world to be characterised by international monetary and economic tensions? Tensions have, after all, been the norm in political relationships. Seldom in history have war or serious diplomatic conflicts been absent; and there have been long periods when economic relationships have been characterised by similar tension. In this longer perspective what was unusual and demanding of explanation was perhaps rather the brief appearance of the opposite: the quarter-century after 1945, when within the framework of a fully articulated international monetary system, the Free World achieved an unprecedented combination of growth, relative price stability, high employment and expansion of trade.

My subject this evening is so broad that it might help you if I give some indication, right at the outset, of the way in which I propose to lead you through it. I shall start with some discussion of the Bretton Woods system: its origins, its working, and its breakdown. My eye will not be that of the historian, but that of a practising central banker who believes that there are lessons to be learned which have a relevance today. Then I shall be attempting an assessment of the floating régime which followed Bretton Woods and in which we still live, and I shall seek to persuade you that it is as exaggerated to claim that floating offers all the answers as it is to claim that it offers none. Nevertheless, there are difficulties—dangers even—in the present régime; and in the final part of my lecture I shall offer some thoughts on how we might work towards a more effective and robust régime or set of arrangements.

Bretton Woods and its breakdown

Living in a period so inferior in performance, it is perhaps natural that we should look back to the Bretton Woods era as a golden age and be tempted to try to recreate some form of system which might provide similar benefits. Indeed the Committee of Twenty was set up, as the Bretton Woods system collapsed, to attempt just this. Despite valiant efforts and a great deal of work and thought, however, that effort proved unsuccessful. There were doubtless a number of proximate causes of this failure—notably the massive increase in oil prices in 1973—but I believe there were more fundamental difficulties.

Much has been written about the Bretton Woods system and its breakdown and it is not my intention to go over familiar ground to provide either a history or an analysis of the period. I should like, however, to remind you very briefly of some factors that I believe were relevant to the way the system was set up, the way it operated and the way it broke down.

First then, Bretton Woods was devised during a world war, with the operation of international financial markets largely suppressed; and it was effectively a compromise agreed between two countries, the United States and the United Kingdom.

Secondly, although the system was symmetrical in form, with similar rights and obligations laid down for all countries, without reference to any differences between them, it was never so in practice. The United States was never under the same kind of constraint as others. Its overwhelming economic and financial dominance after the War meant that it provided the immediate reserve base and the economic underpinning of the whole system. Before 1914 the United Kingdom had exercised a similar dominance; but it is relevant to an understanding of our present situation that in the disturbed inter-war period no such dominance had existed, with the United Kingdom in decline and the United States not yet in full ascendancy.

The United States, as banker to the system, provided the private capital and the official reserves that other countries needed—directly in the form of dollars or indirectly, through the convertibility obligation assumed by the United States, in gold. This asymmetric situation produced, in principle and, at least for the earlier years of the system, in practice, a remarkably satisfactory means of reconciling the individual and potentially inconsistent balance of payments aims of different countries.

The reason for this is, I think, both interesting and important to understanding not only the success of Bretton Woods but also the difficulties in our present situation. In general, it seems to me that industrial countries will prefer, and therefore over the years aim, to avoid running a deficit on current account; while all countries will prefer, taking one year with another, to avoid a deficit on official settlements. Some economists may stigmatise these preferences as irrationally mercantilist. To my mind this is not so. An underlying stimulus to the economy from net exports is easier to live with and manage than an underlying reduction in demand from net imports. Borrowing is normally less agreeable than lending or building up reserves. A strong surplus country or one with large reserves is, in practice, able to play a politically more important rôle than its weaker neighbour. The normal exigencies of arithmetic under which it is impossible for all countries to be in surplus were eased by two elements in the Bretton Woods system. First, gold counted as an export for producing countries but as a reserve increase for those who bought it. Secondly, the reserve currency rôle of the United States, and the fact that the obligation it assumed for the maintainance of a par value did not involve an active exchange rate policy towards other countries, enabled the rest of the world to earn net reserves year after year.

The continued stability of the Bretton Woods system probably demanded a superior economic performance by the reserve centre: especially that it should, through non-inflationary policies, maintain the value of its currency. This condition was well met in the earlier years; but less convincingly later. Even with the best conceivable performance, however, it was long ago pointed out by Professor Triffin and others that a steady increase in the supply of dollars to the world would in due course create problems of portfolio dissatisfaction. The only way in which this could have been circumvented was by an appropriate adjustment in the price of gold.

For a number of reasons, the United States did not exercise its option to alter the exchange rate for the dollar against gold. With the inevitable relative decline in its economic performance, and indeed in its overall dominance, as Western Europe and Japan recovered—with much American help—from the ravages of war, the imbalances in the system became deeper and more persistent. The adjustment mechanism of the system had, however, become arthritic, partly through disuse. It became, perhaps predictably, impossible to engineer the requisite number of individual exchange rate adjustments of the right size and in the right direction in countries outside the United States.

These were, in my view, the main factors leading to the demise of Bretton Woods. They were exacerbated, of course, by an underlying acceleration of world-wide inflation and a steady growth in the size and volatility of capital flows. But we should perhaps consider these unwelcome developments to have been as much consequences as causes of the breakdown of the system. The evident failures of performance and adjustment stimulated massive outflows from the United States and hence produced a major increase in world liquidity which may have contributed to the really substantial acceleration in world inflation which came only after 1971.

Floating, the early experience

When Bretton Woods broke down, there was no ready-made alternative to replace it: floating was inevitable. The way in which one régime gave way to another, over broadly two years between 1971 and 1973, appears in retrospect, however, particularly unfortunate. First there were the legacies of the dying system: a massive monetary stimulus brought about by the outflows from the United States; the perhaps irreversible encouragement to large-scale speculative movements; a severe structural maladjustment between the major surplus and deficit economies; and an incoherence in the reserve base of the system which one might characterise by saying that the United States had adopted the same rules for the exchange rate game as the other players without giving up its rôle as the banker.

There was also, I am inclined to think, a more complex adverse force at work at this time. In the face of the manifest failings of the Bretton Woods system as it was operated in its last stages, it seemed clear that fixed rates could no longer be maintained. At the same time, academic opinion was rather positively in favour of floating. It was widely urged that the continuous, automatic adjustment possible under a system of flexible rates would avoid one of the problems attributed to the previous régime. Equilibrium would be maintained through frequent small changes rather than irregular and precipitate ones. More generally it was hoped perhaps that the adoption of floating rates would be a means of accommodating a greater diversity of domestic policy objectives by allowing more autonomy in economic management. No longer, it was hoped, would some countries find themselves unable to sustain a reasonable level of domestic demand because of a drain on their reserves, while others, soundly managed and with strong payments positions, were forced to import inflation.

Stated in this way, these arguments had a good deal of force. Unfortunately, there was a tendency for governments to embrace them in the distinctly over-simplified form that floating removed the external constraint on policy. This, it seems to me, may have been one of the factors contributing to the excessive and remarkably synchronised boom of 1971–73—a boom which produced a very sharp rise in primary prices, even before the massive increases in the oil price in 1973—for which of course there were additional, quite different causes. The inflation injected into the world at this time has proved a terrible legacy.

All this might be taken as giving some support to the well-known remark of Professor Friedman, a long-standing advocate of freely floating rates who, as long ago as 1967, pointed out that 'floating exchange rates have often been adopted as a last resort by countries experiencing grave financial crises when all other devices have failed. That is a major reason why they have such a bad reputation'.

An assessment of the present régime

Now, however—eight years since the United States severed the gold link and six since the onset of generalised floating—it is not unreasonable to attempt an assessment of the present régime. It would not be an exaggeration to say that there is now a fairly widespread disillusion with floating which cannot easily be dismissed.

First, it has not been possible—at least until the end of last year (and I shall come back to the measures of 1st November 1978 a little later on)—to see much sign of declining volatility in exchange rates. Destabilising capital flows continue to plague us. It has almost seemed at times that the fact that rates are free to move is sufficient guarantee that they will do so.

Sometimes the movements, even if perhaps excessive in the short run, have been in response to clearly demonstrable differences in monetary policy or inflation rates. But by no means always. Even two countries as closely harmonised as Western Germany and Switzerland, both having similar monetary policies, relatively low inflation rates and running sizable current account surpluses with a good deal of bilateral trade, have experienced fluctuations as great as 25%–30% between their currencies during the past couple of years.

It would be reasonable to put up with a continued volatility of exchange rates, even if it appeared superficially to be excessive, if one could see evidence that exchange rate movements were in general promoting greater adjustment and creating an environment in which appropriately designed national policies could be increasingly effective. Such evidence is not non-existent; but I think it fair to say that it is weak. The twin evils of inflation and unemployment flourish unabated; the menace of protectionism grows; and the polarisation of economies into strong and weak, surplus and deficit, appears if anything to have strengthened rather than weakened.

Recent experience has indeed suggested that there are more serious limitations to the rôle flexible exchange rates can play in promoting adjustment than was earlier believed. There are a number of possible reasons for this.

First, changes in costs arising from exchange rate movements appear nowadays to feed through into an economy more quickly and completely than used to be the case. An important cause of this unwelcome acceleration has undoubtedly been the development and persistence of high rates of inflation, the associated build-up of inflationary expectations and the defensive but inflationary response that these have stimulated among many businessmen and wage earners: whether formally or informally, most economies have become more highly indexed. At the same time, as world trade has consistently grown faster than world output, many economies have become significantly more open, more vulnerable to price and demand developments in their trading partners.

The result of these two developments appears to have been that adjustment in nominal exchange rates can no longer be relied upon to yield, for more than a relatively short period, as large an adjustment of real exchange rates as could once have been anticipated—in other words, exchange rate adjustment is, beyond the short term, now likely to be less effective as a means of changing international competitiveness. This phenomenon provides one of the most striking examples of the damage that inflation has wrought; in addition to the severe distortion of relationships within economies, it has probably significantly increased the difficulties of securing adjustment of imbalances among economies.

It is also possible, though here I think the evidence is less firm, that the responsiveness of trade flows to such changes in price competitiveness as may occur has diminished significantly in recent years. Precisely because such changes in competitiveness are no longer generally expected to be of long duration, businessmen and others may be tending to adjust their behaviour less in the short term. It may further be the case that the extent and importance of product differentiation in international trade is steadily increasing; and that this trend diminishes the relative significance of price factors.

None of this, however, should be taken too far. There are certainly instances in the last few years where exchange rate changes do appear to have produced genuine balance of payments adjustment. Perhaps Japan on the one hand and the United States on the other hand provide examples; and it may be significant in relation to the point I have just made that in these two countries the foreign trade proportion of output is still relatively small. But, even among the very open and highly trade-integrated countries forming the so-called 'snake', exchange rate adjustments have been carried out from time to time with some evidence of success.

Indeed, few policy-makers would, I believe, be prepared to regard exchange rate movements either as simply damaging or as merely symptoms of more fundamental developments. Rather there is concern that the connexion between the exchange rate and genuine, lasting adjustment of the current balance has tended to become partial and unpredictable, and that the power of short-term market pressures over the exchange rate can be overwhelming. How can we improve on this patently unsatisfactory state of affairs?

Perfectly free floating?

When central bankers ask questions like this I find they are apt to be treated rather sternly by some of the economics profession, especially those who espouse the doctrines of international monetarism. It is urged upon us first that we have refused to give floating a proper trial, by our constant insistence on attempting to manage our exchange rates; and secondly, that if we did allow exchange rates to move perfectly freely and concentrated solely on carrying out appropriate domestic monetary policies, adjustment would in fact be brought about. This adjustment would not, however, necessarily take the form that policy-makers tend to seek. As I understand the argument, differing rates of monetary expansion in different countries may lead, if there is no official intervention, to exchange rate movements which will themselves in due course lead to new overall equilibrium positions in their balances of payments. It is, however,—so the argument goes—no use looking for adjustment in terms only of parts of the balance of payments such as, in particular, the current account. I want to return a little later to the question of the interaction between domestic and external monetary policy. In the meantime, I would simply make some rather practical observations.

I regret to say that I have little direct experience with economic equilibria—indeed, so far as I am aware, none at all. I sometimes see suggestions that we shall be moving towards equilibrium next year or perhaps the year after: but somehow this equilibrium remains firmly in the offing. In the meantime, governments and central banks are likely to be faced with a series of difficulties which have to be addressed. Their shoemakers or their steel makers, for example, may register impatience at the developments in the current account which bear particularly hard on them. We may regret such pressures and admonish governments to ignore them; but unfortunately these pressures do not in practice arise only from the inefficient; and in any case realism suggests that generalised admonition is a less than fully adequate response to the facts of the world. It is sometimes said that when there were no balance of payments statistics there were no balance of payments problems; and there is a sense in which this is an illuminating remark. But the more important point, perhaps, is that there were tariffs before there were trade statistics.

Or to take another point, the ability to attract stable and long-term capital inflows is likely to depend on maintaining some degree of creditworthiness, which in turn will depend on maintaining a current balance which appears in some sense reasonable. If such creditworthiness is lost, the subsequent collapse of confidence and of the exchange rate would no doubt produce an overall adjustment and new equilibrium eventually. But the industries in the countries concerned might have to face several painful changes of direction. The full adjustment may not be smooth, as the textbook picture tends to assume, and the road towards it may prove quite intolerably bumpy.

For all these reasons, I can see no prospect that national authorities will learn not to be concerned about the composition and structure of their balance of payments and the levels of their exchange rates. Even the United States and Canada, which were perhaps the countries which in the first years of floating came closest to allowing their rates to float freely, have now shown that, at least in certain circumstances, they are prepared to be distinctly vigorous managers of their floats.

An emerging desire for greater stability

At no time over the past six years has floating in fact been universally adopted. Smaller, and especially developing and primary producing, nations have on the whole shown a fairly consistent unwillingness to let their exchange rates float freely, choosing usually to peg either on the currency of a major customer, supplier or banker, or on a basket of a number of major currencies. A particularly successful example of this essentially regional approach to greater exchange rate stability was the so-called 'snake'.

Last year there were important signs of a strengthening desire among a wider range of central banks and governments to achieve more control over, and more stability in, their rates. The first of these was the conception of the European Monetary System (EMS): an idea that the kind of relative stability enjoyed by members of the 'snake' might, with some adaptation of conditions, be extended to the EEC as a whole—and perhaps, in a looser way to neighbouring countries as well. The second development was of its nature *ad hoc*, rather than formalised as in the EMS, but no less important because the task being attempted was inherently more difficult. I refer of course to the collaborative measures of 1st November and the months following to stabilise the dollar.

How are we to assess these two very different moves in the direction of attempting to impose more exchange rate stability on the world? There are perhaps two questions to be answered. What are the possibilities that central banks can, in today's circumstances, impose their will on the exchange markets? And how desirable is it, in terms of appropriate policies for combating inflation and promoting growth, that they should?

As to the first question, there is, as I have already indicated, much greater recognition now than perhaps there was some years ago of the severe limits to what a monetary authority can expect to achieve by exchange market intervention in a situation in which the exchange rate is believed to be materially out of line with the domestic policy stance. Probably the best prescription in such cases is that resistance should not even be tried. Certainly it is no part of the philosophy of EMS that in such circumstances exchange rates should be maintained *à outrance.* At least until we live in a more or less non-inflationary world, with broadly appropriate and harmonious domestic policies being followed by all major countries, it would be idle to look for any rigid grid of international exchange rates.

None of this, however, is to say that there can be no rôle for an official intervention stance. Indeed, in practice it is very difficult for a central bank to avoid having an intervention stance and thereby influencing market behaviour and expectations in one direction or another. Since all central banks have shown that under certain circumstances they are prepared to intervene —and indeed intervene heavily—their inaction at any particular time can be taken, almost as much as their action at other times, as an indication of official policy. Exchange market expectations are on occasions clearly extrapolative, feeding on themselves. At such times official intervention may be the only way of avoiding extreme and unnecessary instability. If the underlying circumstances of the countries concerned do not justify a particular pattern of exchange rates, then that pattern will not hold. But with any broadly consistent set of domestic policies, intervention operations that are co-ordinated, and presented as such, are much more likely to be effective in influencing exchange market expectations.

I turn now to the question of how far it is desirable that a group of countries should attempt to stabilise their mutual exchange rates. Underlying this question is the problem of the compatibility of any policy for the exchange rate with a desired domestic monetary policy. In now addressing this latter problem, I want to exclude from consideration situations in which objectives are plainly inconsistent. For although these litter recent financial history, the more serious policy interest is in less extreme cases where, at any rate at the time that targets are set, there may be no inherent reason to expect conflict between them. The academic answer—if I may so style it—is fairly clear-cut, along the lines that domestic and external monetary objectives cannot be independent and thus that, at any one time, priority has to be assigned to one or the other. Some support for this approach may be found in the experience of many countries, including the United Kingdom, in recent years, and there is now general acceptance of the view that different rates of money supply growth may have considerable relevance for exchange rate relationships, at any rate in the longer run.

But while there is a welcome realism in this view, it has a lack of time-scale that materially limits its relevance for policy purposes. In particular, it falls short of a conclusion that, having adopted a domestic monetary target, the only possible official attitude to the exchange rate is one of passivity. In common with, I think, most of my central bank colleagues, I would be reluctant to accept such a proposition in its most sweeping form.

I am not surprised that empirical work done in the Bank and elsewhere fails to find any clear, well-defined and close relationship between monetary growth and exchange rate developments in the short term. Not all external flows, in or out, have immediate implications for money supply. Moreover while, in my view, the influence of the authorities in stabilising expectations is likely to be greater if they are ready, and seen to be ready, to ride out, in the short term, conflicts between domestic and external objectives, a certain amount of elasticity in the pursuit of both may be the best way to permit temporary disturbance to wash through without serious prejudice to either.

This leads me to a more general point. I see no reason why the authorities of a country should not, at least for much of the time, be able to use exchange rate and domestic monetary policies in a complementary rather than a competitive manner. In attempting to reduce inflationary expectations and inflationary wage settlements, the declared constraints of an exchange rate and a monetary or credit target can often usefully reinforce each other. Incompatibilities which may emerge can, at least to a certain extent, be handled by the device used both in the EMS for the exchange rate and by most authorities for their monetary objectives: that is, a target range. Such a range can allow the authorities to exercise common sense in a world where the significance and the value of statistics are seldom clear, and permit a degree of reconciliation of exchange rate and domestic monetary objectives that is desirable and indeed necessary for those practising central banking. Certainly this is the approach that I normally find expressed in discussions with my colleagues in the European Community.

A rather different point is that in a formalised exchange rate agreement among a number of countries such as EMS, when it is appropriate that relative rates should change, it may be possible by agreement to achieve and maintain greater and more sustainable relative alterations than if all the countries concerned were freely floating. In particular, the relevant authorities may perhaps be in a stronger position to mount the appropriate flanking fiscal and monetary policies to help ensure that the desired adjustment comes about.

There may be further benefit from greater exchange rate stability, if it can be achieved, in the stimulus to what one might call benign rather than perverse capital flows. The experience of recent years indicates that substantial borrowing will be undertaken in the lower-interest-bearing currencies of the more price-stable surplus countries, only if markets are not dominated by expectations of early and substantial changes in the value of currencies.

I have been trying to indicate why I believe that governments and central banks have become dissatisfied with a régime of completely unsystematised floating; and, further, why the steps which are being taken, of an essentially pragmatic, but above all collaborative kind, seem to me to promise some degree of amelioration of our problems. I have already suggested that it may be illuminating to compare our present oligopolistic, systemless situation with the nearest parallel period—the years between the wars. Then, too, people were dominated by memories of a recent golden age—in this case one based literally on gold. Indeed, enormous efforts were made to adapt and prolong it. Then, too, the efforts proved vain, and the world experienced for a time highly volatile exchange rates. As dissatisfaction with this experience grew, attempts were made to reintroduce some degree of stability through agreements between the major centres—most notably in the Tripartite Agreement of 1936. There were, however, many differences—particularly the massive and damaging upsurges in both economic and political nationalism. We may perhaps comfort ourselves a little on our relative success in overcoming somewhat similar difficulties. Poor though the world's performance has been this decade, it would be wrong to exaggerate the lack of economic success. Despite the uncertainties created by floating exchange rates, world trade has continued to grow faster than world output. Businessmen may not thrive on uncertainties but they have learned to accommodate this particular difficulty. Protectionism creeps, but does not gallop. The variable and uncertain behaviour one would expect to characterise a world which has lost a standard of absolute value is everywhere evident; but we have not been engulfed by a collapse of confidence.

The reserve base

I turn now to a different, though linked, area in which we should also look for possibilities of pragmatic improvement, namely the world's reserve base. There is no question in my mind but that much of the instability which has characterised international monetary relationships in recent years has stemmed from the incoherence of the current arrangements for the provision of reserves.

If it were possible to have a world of totally free floating there would, of course, be no need for reserves at all, and the problem would not exist. I have already explained, however, why I believe that such a régime cannot be considered as a serious possibility either in the short or in the longer term. The evidence of the actual behaviour of countries since 1973 would indeed suggest that the desire for reserves to hold, and the acquisition and spending of them for the purposes of exchange rate management, are at least as great under the present régime as under a régime of nominally fixed exchange rates.

A particular factor here which now looks as if it may recur has been the phenomenon of the oil surpluses. The imbalances arising from large increases in the oil price are pre-eminently of a kind which it would be inappropriate to attempt to meet by exchange rate movements. As a result we have had, and are likely to continue to have, a situation in which some oil-producing countries build up large reserves and many consuming countries engage in major borrowings to prevent their reserves falling.

If then, we must take as given a continuing world-wide demand for reserves, we have also inherited from earlier developments a particular form of supply. First, gold. It has been unanimously agreed that gold should be phased out as an international reserve asset; the IMF Articles have been amended in this sense and the International Monetary Fund is in the continuing process of auctioning its existing gold holdings. Nevertheless, gold does in fact still represent a very significant proportion of total official reserve holdings—indeed at current price levels, industrial countries' holdings of gold exceed those of currencies. Moreover, the continual uncertainties and inflation that unfortunately characterise our present world have exerted an underlying upward pressure on the gold price—though the trend has been subject to very marked speculative fluctuations. Since even without any central bank agreement to buy or sell gold to each other at a given price, a central bank's borrowing power will be influenced to some degree by the market value of its gold holdings, there is an element of effective official liquidity here, subject to no control or agreement, but which can change in volatile and unpredictable ways.

The bulk of the rest of official reserves is constituted by holdings of currencies; and some 80% of these are held in dollars—a proportion which, taking the aggregate of all countries, has remained remarkably steady for a long time. Indeed, even during the later Bretton Woods days, the proportion was very similar. The main difference in the aggregate proportions in recent years is that sterling has nearly disappeared, its erstwhile proportion being taken by the deutschemark and to a lesser extent the yen.

It is, I think, difficult to believe that over the longer term so large a proportion of the world's currency reserves will be willingly held in one national currency. The relative decline in the absolute dominance of the United States, which I have stressed as a factor in many aspects of our current situation, is likely to remain. And already if one looks behind the aggregate figures—and especially if one abstracts from the total the holdings of the major Group of Ten countries whose dollar acquisitions in recent years have to a large degree arisen as a by-product of exchange market intervention—it can be seen that many countries have already substantially reduced the dollar proportion of their reserves in favour of other currencies. Moreover, the

US authorities themselves have on a number of occasions indicated, in what I believe to be a far-seeing and statesmanlike approach, that provided it can be accomplished in a collaborative manner and without harmful side-effects on international stability, they are prepared to see some secular decline in the dollar's preponderant rôle and to share some of the burdens and privileges of a reserve centre.

There are two possible ultimate destinations of such a development. Either we move to a world in which there is a single reserve asset, but in place of a national currency we have a man-made multinational 'outside asset'; or we move to a world in which there are several major reserve currencies, the dollar doubtless for the foreseeable future being the most important.

The first alternative is the more attractive in principle and I am sure we should try to avoid developments which seem likely to render the ultimate dominance of the special drawing right (SDR) more difficult of attainment, and look sympathetically on those which seem likely to promote it. In this latter connexion, it may be for example that the proposals currently under consideration in the IMF for an SDR substitution facility could make a modest contribution towards increasing the status of the SDR and reducing the portfolio instability of our present arrangements.

It would, however, be wrong to minimise the formidable obstacles to achieving an SDR-based system, even in the longer run. In its full sense, a world based on the SDR with no reserve currencies would involve convertibility and asset-settlement obligations on all countries alike. I find it difficult to see how an internationally-politically determined allocation and rate of growth of SDRs with subsequent mandatory convertibility obligations on all countries could produce and continue to produce allocations in such quantities and in such distributions as would keep the world on an appropriate path between deflationary and inflationary forces of unpredictable and unacceptable magnitudes. In particular, it is difficult to see how any currency could in such a régime continue to be used on any scale for intervention in the markets; and the replacement of all currency intervention by intervention in SDRs, while doubtless imaginable in principle, takes us into a very distant future indeed. It is important to remember how fundamentally different such a world would be from that of Bretton Woods. It would not simply be a matter of replacing the arbitrariness of gold creation by the politically-controlled creation of SDRs. There would be an absence of the important element of flexibility conferred by Bretton Woods where the creation of dollars over time was determined by political and market demand, with the ultimate constraint of gold convertibility not being fully and precisely enforced from day to day.

Be these doubts as they may, it will clearly be at the very least a long time before the SDR can assume a dominant rôle in international monetary affairs. In the meantime, there is evidently a good deal of pressure in the other evolutionary direction I mentioned earlier—towards a multi-reserve currency system. In a world of free markets, with public and private institutions alike throughout the world free to decide what assets they wish to hold, the pressures to hold more reserves in the form of claims on the world's higher performing economies are likely to grow. Understandably, the potential new reserve centres themselves, notably Western Germany and Japan, are reluctant to undertake the rôle, with the added complications it would be likely to involve for the operation of their domestic monetary policies and the history of the difficulties it has meant first for the United Kingdom and later for the United States.

If, however, as may be the case, it proves impossible fully to resist the pressures towards the emergence of a multi-currency reserve system, it may be the course of wisdom to explore ways in which such pressures can, at least to a certain degree, be accommodated with minimum disadvantage. In this context, it may be important to distinguish between the process of moving towards a multi-currency reserve system—a process which could potentially involve some instability—and the situation which might obtain if and when a fully established and mature multi-currency world were ever to become a reality. Once a well-balanced portfolio had been obtained—no doubt with different reserve holders satisfying different preferences—there might be less tendency for funds to move from one currency to another. Or, perhaps more realistically, it might be possible, on the basis of experience gained during the transition, to develop collaborative arrangements and agreements between the reserve centres themselves—and perhaps between them and many of the reserve holders—to minimise short-run instability.

The difficulties in such an evolution and the demands that would be made on the willingness of the major powers to collaborate are obvious. But are they in fact greater than in any other approach? Any other approach, that is, which is made in the present inflationary climate. For the current high levels of inflation throughout the world, including the major reserve centre, are surely at the heart of the instability that characterises the world's reserve base. If inflation could be conquered, the disturbing fluctuations in preference between various currencies and between all currencies and gold could probably be brought down to a level that was relatively easy to handle.

Conclusion

It is time to draw together the various thoughts I have tried to put to you on this complex topic. The first of these is perhaps that we should be continually aware of the intrinsic difficulty of the situation in which we are and will for the foreseeable future continue to be. We live in what I have called 'an oligopolistic world' dominated not by one super-power, but by a number of national economies, of unequal but formidable strength. Each individual nation will continually be attempting to carry out more or less specific monetary or exchange rate policies, and is likely to have, for most of the time and whether explicitly or implicitly, a specific balance of payments objective. These aims and policies will not automatically be mutually consistent. At the same time there exists neither the safety-valve of the asymmetric accommodation of the dominant single reserve centre; nor an agreed set of rules of the game; nor a general willingness to abandon one of the policy objectives, namely any management of the exchange rate. It does not require much imagination to see the dangers and potentialities for tension in so over-determined a situation. When it is subjected in addition to strains such as the massive increases in oil prices of recent years, with their consequence that the oil-consuming countries are competing to avoid their share in an overall deficit, the problems become all the more severe.

I emphasise what I see to be these formidable inherent difficulties in our situation not to instil gloom or in a spirit of alarm or despair. My point is rather first that we should not be bemused into thinking that systemic solutions could relatively painlessly be found if we simply had the will; secondly, that we should explore as fully as possible what degrees of freedom and possibilities of action we nevertheless possess despite the highly constrained world in which we live; thirdly, that we should see that our best hopes of success are to accept, indeed to develop, collaborative arrangements.

It is perhaps in this light that we should see a number of developments that have taken place in recent years. On the one hand there is the increasing degree of regional collaboration, most strikingly shown perhaps in the emergence of the EMS, an attempt both to achieve greater regional exchange rate stability and ultimately, it may prove, to make a regional contribution to the world's reserve asset problem. On the other hand, the increasing resort to 'summit-diplomacy' and the collaborative measures of 1st November 1978 may be seen as steps towards greater co-ordination and compatibility of individual economic management and exchange rate policies between regions or between major powers.

What then are the prospects for an international monetary system? If we think in terms of achieving a fully articulated system with a set of written rules, I believe that we are likely to be disappointed for a long time to come. But to put the question in this way conveys perhaps an unrealistic impression of possibilities and realities. The system we had, and have lost, arose from a deep and widespread revulsion against the economic failures and conflicts of the inter-war period; and was created during a war that those failures played at least some part in bringing about. Our task, in circumstances that are, like those of some half a century ago, intractable, is to avoid the errors of our predecessors and, to the extent we can, new errors of our own. To help us we have the lessons of their failures—and of their successes; and we have a network of information, consultation and collaboration on a scale far beyond anything that existed before the War. With these tools, we must set about, and I believe are setting about, steadily developing a set of arrangements and agreements which, though unformalised, may in fact comprise the most realistic framework in which the international economy and polity of the late twentieth century can survive—and perhaps ultimately again thrive.