COMMENT

Exchange Rate Alignment: Domestic and International Objectives

EXCHANGE RATE ALIGNMENT: DOMESTIC AND INTERNATIONAL OBJECTIVES

. . . if nations can learn to provide themselves with full employment by their policy . . . there need be no important economic forces calculated to set the interest of one country against that of its neighbours.

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I. INTRODUCTION

The regulation of international monetary affairs by international organizations is currently in a transitional stage. International monetary regulation, like most other forms of international regulation, is dependent primarily on cooperation and conciliation rather than enforcement of binding rules. The solution to international monetary problems thus lies in the development of "codes of conduct" necessary for governing nationalistic behavior in a multinational, interdependent world.[1]

The principal international monetary institution, the International Monetary Fund, was established after World War II during a period when prospects for cooperation among the major nations were high.[2] The major objectives of the International Monetary Fund (the Fund) were to promote "international monetary co-operation"[3] and "exchange stability"[4] and to "assist in the establishment of a multi-lateral system of payments."[5] The attainment of these objectives by the Fund is considered to be a means of helping its 126 members achieve economic growth, high levels of employment, and improved standards of living.[6]

The Board of Governors of the Fund[7] at its 1971 Annual Meeting requested the Executive Directors to study all aspects of the interna-

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1. *See Statement by the Honorable Paul A. Volcker, Under Secretary of the Treasury for Monetary Affairs before the Subcommittee on International Economics of the Joint Economic Committee, June 26, 1973,* DEPARTMENT OF TREASURY NEWS No. S-244. *See generally* Russell, *Transgovernmental Interaction in the International Monetary System, 1960-1972,* INT'L ORGANIZATION, Autumn, 1973, at 431.

2. The International Monetary Fund was created by a multilateral agreement. Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, 60 Stat. 1401 (1945), T.I.A.S. No. 1501, 2 U.N.T.S. 39, *as amended* effective July 28, 1969, 20 INT'L FINANCIAL NEWS SURVEY 985 (1969) [hereinafter cited as IMF Agreement].

3. IMF Agreement, *supra* note 2, art. I, § 1.

4. *Id.* art. I, § 3.

5. *Id.* art. I, § 4.

6. *Id.* art. I, § 2.

7. The Board of Governors of the Fund, on which each member country is represented by a Governor and an Alternate, is the highest authority of the Fund. IMF Agreement, *supra* note 2, art. XII, § 2(a). The Board may delegate many of its powers to the Executive Directors. *Id.* art. XII, § 2(b). Five of the twenty Executive Directors are elected by the

tional monetary system and report to the Governors on measures necessary for the improvement or reform of the international system.[8] The resulting report carried a resolution adopted by the Governors in July 1972, establishing an ad hoc Committee of the Board of Governors on Reform of the International Monetary System and Related Issues.[9] This committee, known as the Committee of Twenty, met for the first time in 1972 and recently held its last meeting on June 13, 1974. The result of the final meeting was an outline of proposals for the reform of the international monetary system.

This Comment will discuss the Outline of Reform[10] prepared by the Committee of Twenty at their final meeting in June 1974. A simplified model of international monetary relations will be presented in order to isolate the important problems which necessitate international agreement. The next section of this Comment analyzes the problems of international monetary relations in light of the conflicting interests of countries having a balance of payments deficit and those having a surplus. Part III of this Comment describes the specific proposals of the Outline of Reform prepared by the Committee of Twenty and discusses their impact on the working of the present Articles of Agreement. It describes the exchange rate adjustment problem confronting the Fund, which is attempting to establish a mechanism most consistent with its international economic goals.[11] Finally, in Part IV, the Comment discusses two impediments which are blocking overall reform of the monetary system: inflation and the build-up of foreign reserves by oil-exporting countries.

II. NATIONAL INTERESTS IN THE CHOICE OF ADJUSTMENT METHODS

A. Simplified Model

In order to illustrate the important role of international agreement in the adjustment of exchange rates, it will be useful to visualize international monetary relationships in the form of a simplified model. This simplified model parallels the international monetary system as it has

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five members with the largest quotas and the remaining fifteen are elected by groups of countries defined by the Articles of Agreement. *Id.* art. XII, § 3.

8. *See* INTERNATIONAL MONETARY FUND, SUMMARY PROCEEDINGS OF THE TWENTY-SIXTH ANNUAL MEETING OF THE BOARD OF GOVERNORS, 1971 (Resolution No. 26-9) 331-32; 23 INT'L FINANCIAL NEWS SURVEY (No. 39, 1971) at 322.

9. *See* SELECTED DECISIONS OF THE INTERNATIONAL MONETARY FUND (Resolution No. 27-10) 151 (6th issue 1972).

10. INTERNATIONAL MONETARY FUND, REPORT TO THE BOARD OF GOVERNORS OF THE INTERNATIONAL MONETARY FUND BY THE COMMITTEE ON REFORM OF THE INTERNATIONAL MONETARY SYSTEM AND RELATED ISSUES (June 14, 1974) [hereinafter cited as Committee of Twenty Outline of Reform] (Reprints are available from the Office of Public Relations of the International Monetary Fund).

11. See text accompanying notes 3-6 *supra*.

actually developed. In order to simplify the model, it will refer to only two countries, Country *A* and Country *B*.

Country *A*, having found exchange of goods and services on a strictly barter system unwieldy for international as well as intranational trade, issued white tokens as a legally acceptable means of payment for all traded commodities. When these tokens were originally issued, they could be exchanged for a certain quantity of gold which the government of Country *A* owned and held as a reserve fund. Although the tokens are no longer exchangeable for gold,[12] the people of Country *A* continue to recognize the tokens at a particular value specified by the government.

Country *B* has established a similar mode of intra-national exchange through the use of black tokens. These black tokens represent a certain quantity of goods or services within Country *B* which may be obtained by surrendering one's black tokens.

The use of tokens representing a certain amount of purchasing power becomes more complicated on an international level because any trade between the two countries creates a problem of international exchange. For example, when a citizen in Country *A*, who uses white tokens as his national currency, wishes to trade with a citizen of Country *B*, who uses black tokens, the question arises as to what value the tokens of one country have when they are transferred and held by another country's citizens. As a result, it is necessary that in each country there be a means of exchanging one type of token for the other through a valuation of one currency vis-á-vis the other.

The most obvious means of assessing values in the exchange of one currency for another is to set the value of one currency vis-á-vis the other as the market price (*i.e.*, the price at which the currencies would be traded by a willing seller and a willing buyer). However, this system, called the "freely floating" exchange rate system, appears to have major drawbacks.[13] The "freely floating" system allows continuous adjustments of the price of a country's currency against the currencies of other countries. Because of this flexibility in exchange rates, the system does not necessarily require each country to alter its domestic economic poli-

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12. The world's major countries abandoned the gold standard in the 1930's. P. SAMUELSON, ECONOMICS 683 (8th ed. 1970) [hereinafter cited as SAMUELSON].

13. The Fund has defined a "floating" exchange rate as one which exists when a country's "currency is floating independently in the sense that it is not pegged, within relatively narrow margins, to any other currency or composite of currencies." International Monetary Fund, Press Release No. 74/30, at 4 (June 13, 1974). The drawbacks of "floating exchange rates" have repeatedly been pointed out by the Executive Directors of the Fund. *See, e.g.*, INTERNATIONAL MONETARY FUND, THE ROLE OF EXCHANGE RATES IN THE ADJUSTMENT OF INTERNATIONAL PAYMENTS 42, 67-78 (1970). *See also* R. WEISWEILLER, FOREIGN EXCHANGE 118 (1970).

cies when the country is facing a chronic deficit or surplus in its balance of payments.[14]

Because of the alleged disadvantages of "freely floating" exchange rates, Country *A* and Country *B* negotiated a fixed rate at which white tokens would be exchanged for black tokens.[15] This "fixed" exchange rate system requires each country to maintain the market price of its currency at the "fixed" exchange rate.[16]

However, the system of "fixed" exchange rates also became unmanageable. As the underlying economic conditions in Country *A* and Country *B* changed, the long-run market price of their currencies also changed.[17] In other words, supply and demand for the currencies dictated a long-run rate of exchange different from that set by the international agreement between Country *A* and Country *B*. As a result, Country *A*, which faced a chronic deficit, was no longer able to maintain the value of white tokens vis-á-vis black tokens at the value "fixed" by agreement with Country *B*. Since "fixed" exchange rate obligations could no longer be honored, currencies were subsequently valued by a "freely floating" exchange rate system.[18] Due to the disadvantages of the

14. In our simplified model, the problem may be illustrated as follows: The white tokens received by citizens of Country *B* in return for goods shipped to Country *A* may be held by citizens of Country *B* rather than being immediately exchanged for black tokens in the currency exchange market. Thus if Country *B* has a balance of trade surplus (*i.e.*, Country *B*'s commodity exports exceed its imports), the tokens of Country *A* will accumulate in Country *B*. However, Country *B*, acting in its own interest, should not allow this situation to continue to exist because it will desire to have goods or its own currency rather than the currency of Country *B*, which is of questionable value in terms of the commodities of other countries.

15. A system of "fixed" exchange rates was agreed to at the Bretton Woods Conference in 1944. IMF Agreement, *supra* note 2, art. IV.

16. A country can support the market price of its currency vis-á-vis other currencies by intervening in exchange markets and purchasing its own currency with reserves of gold or foreign currency. In our simplified model, if Country *B* wanted to prevent the value of black tokens from falling relative to white tokens, it could intervene on the exchange market and buy up black tokens by exchanging some of its reserve stock of gold or by exchanging white tokens held in its reserves. This action would have the effect of raising the price of black tokens relative to white tokens. *See* SAMUELSON, *supra* note 12, at 687-88.

17. Several examples of underlying economic conditions which may cause a shift in the long-run market price of a country's currency are: productivity, unemployment, consumer tastes, and foreign military spending. *See* SAMUELSON, *supra* note 12, at 697.

Another fundamental cause for the breakdown of the "fixed" exchange rate system was the tolerance of the system for substantial and persistent deficits or surpluses without an adjustment in the underlying exchange rate balance. R. WEISWEILLER, FOREIGN EXCHANGE 100-05 (1972).

18. The recent history of deviations from the Bretton Woods system of "fixed" exchange rates is as follows: On February 15, 1971, the United States suspended the convertibility of the dollar for gold reserve assets and, on August 17, 1971, took other actions to alleviate its chronic deficit. Proclamation No. 4074, 36 Fed. Reg. 15,724. (The actions were taken by President Nixon under the authority granted to him by the Trading with the Enemy Act of 1971, 40 Stat. 411 (1917), *as amended*, 50 U.S.C. App. § 5(b) (1964).)

"freely floating" system, discussed above, the countries are seeking to form a new agreement to stabilize the rate at which one currency will be exchanged for the other.

B. *Conflicting Viewpoints of Deficit and Surplus Countries*

The difficulties encountered in forming an international agreement in such a situation may be exacerbated by an apparent difference of interests between those countries experiencing a balance of payments deficit and those countries experiencing a surplus. This divergence is particularly apparent when attempts are made to establish duties to be carried out by both deficit and surplus countries.

1. Deficit Countries

A deficit in a country's balance of payments will occur when its imports (expenditures) exceed its exports (receipts). A country which has experienced a chronic deficit is under constant pressure from creditors in other nations to pay for its trade deficit by transfering funds from its stock of monetary reserves.[20] But there are absolute limitations on the ability of a deficit country to finance a trade deficit by such transfers of foreign exchange. A continuing balance of payments deficit may be financed only to the extent of the foreign reserves[21] held by the deficit country. Such an absolute restraint may place severe short-run pressure on a deficit country which has depleted its stock of foreign reserves.

Since deficit countries face such serious economic constraints, they will be cautious in international negotiations not to agree to obligations which will worsen a chronic deficit position. For example, a country

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Following these actions by the United States, all monetary authorities allowed their currencies to float without the consultation steps and approval required by Article VIII, Section 6 of the IMF Agreement. However, on December 18, 1971, the major industrial countries reached an agreement, known as the "Smithsonian Agreement," which established a new exchange rate structure. The "Smithsonian Agreement" was followed until February 1973, when an exchange crisis broke the re-established "fixed" rates. On March 12, 1973, the Committee of Ten decided to cease transactions supporting the "fixed" rates of the "Smithsonian Agreement." Rueff, *Reflections on Currency and Credit*, 6 Int'l Currency Rev., March-April, 1974, at 9.

19. See text accompanying notes 12-13 *supra*.

20. The pressure to make transfers from reserves will not be present under a system of "freely floating" exchange rates because alignment may be achieved by making continuous price adjustments. See notes 12-13 *supra* and accompanying text.

21. A country's foreign reserves consist of its holdings of gold, special drawing rights (see note 48 *infra*), reserve positions in the Fund, and holdings of foreign exchange. Foreign exchange may be defined as "holdings . . . of claims on foreigners in the form of bank deposits, Treasury bills, short and long-term government securities, and other claims usable in the event of a balance of payments deficit . . . ." 27 Int'l Financial Statistics 17 (No. 7, July, 1974).

experiencing a chronic deficit should realize that in the long-term it is in its best interest to devaluate its currency.[22] Otherwise it will face severe contractionary pressures on incomes and employment. Thus, the deficit country should argue for a system which imposes a responsibility on all countries, deficit and surplus alike, to take appropriate action to adjust exchange rates before recessionary effects become intolerable for deficit countries.[23]

2. SURPLUS COUNTRIES

A surplus in a country's balance of payments will occur when its exports (receipts) exceed its imports (expenditures). This surplus will cause, in the long-run, a build-up in the foreign reserves of the surplus countries.[24] There is no necessary limit to the extent which the build-up of reserves by the surplus countries may continue. Thus the surplus country does not experience the same pressure to adjust exchange rates as does a deficit country whose reserves are nearing exhaustion.[25]

Because of the absence of this pressure on surplus countries, financial representatives in surplus countries are wont to take the position

22. *See* F. MACHLUP, THE ALIGNMENT OF FOREIGN EXCHANGE RATES 22 (1974) [hereinafter cited as MACHLUP]. However, the long-term interest of the country will not necessarily control the arguments of various interest groups within the economy. Importers and their immediate consumers may resist devaluation because the immediate effect will be a relative increase in the price of imports. *Cf.* Gerakis, *Budgetary Implications of a Devaluation*, FINANCE AND DEVELOPMENT, March, 1973, at 7.

23. MACHLUP, *supra* note 22, at 21-22.

Economic conditions in two of the world's major deficit countries are as follows:

The *United Kingdom* experienced a current account deficit of 243 million pounds in the fourth quarter of 1973. BANKERS TRUST EUROPE, BUSINESS OUTLOOK: UNITED KINGDOM, May 6, 1974. The rise in oil prices, a causative factor of this deficit, will ultimately add another 1 ½ billion pounds a year to the U.K. trade deficit if there is not a drop in oil prices before the end of 1974. THE ECONOMIST, March 2, 1974, at 69. An exacerbating factor has been the dilatory response of the government to the need for currency devaluation. THE ECONOMIST, June 15, 1974, at 11.

Italy, the most severe example of a deficit country, experienced a 490 billion lire deficit in January 1974. BANKERS TRUST EUROPE, BUSINESS OUTLOOK: ITALY, May 6, 1974. "Although Italy's problems are by no means confined to its balance of payments difficulties, it is accepted that to do nothing to alleviate them could spell disaster to Italian democracy." THE ECONOMIST, June 15, 1974, at 107. Italy, responding to conditions placed on its $1.2 billion borrowing from the Fund in June 1974, has imposed an emergency budget designed to cut demand by increasing taxes 2 billion lire a year and limiting credit to 14.5 billion lire. THE ECONOMIST, June 29, 1974, at 111.

24. MACHLUP, *supra* note 22, at 19-21. *See also* H. HELLER, INTERNATIONAL MONETARY ECONOMICS 206 (1974).

Germany, the major surplus country in Western Europe, had an 11.5 billion dollar surplus for the first seven months of 1974. THE ECONOMIST, Aug. 31, 1974, at 65.

25. "A continuing payments surplus can be financed indefinitely through endless accumulation of foreign assets and endless creation of domestic money issued in payment for the foreign currency acquired." MACHLUP, *supra* note 22, at 22.

that "it is unfair to ask their countries to bear the 'burden' of adjustment, since their surpluses are caused by the mistake of others and not by their own."[26] This position reflects a reliance on the mercantilist view of foreign exchange which maintains that the foreign trade objective of a country is to accumulate as much gold as possible by sustaining a surplus balance of trade.[27] However, the mercantilist theory of foreign exchange lost efficacy with the abandonment of the gold standard because, after that event, the size of a country's gold stock did not necessarily reflect its economic strength.[28]

The proper view of the interests of surplus countries reveals that the continued build-up of foreign reserves by a surplus country causes inflationary pressures.[29] These inflationary pressures, in turn, require "progressively more stringent fiscal and monetary policies to assure the steady contraction in domestic expenditures than would be required if the exchange rate remained unchanged."[30] Thus a country with a chronic surplus could not only improve the financial situation of deficit nations by revaluing its exchange rate,[31] but could also ameliorate its own financial situation by reducing inflation and allowing free growth in domestic expenditures.

III. RECENT EFFORTS TO REFORM EXCHANGE RATE ADJUSTMENT OBLIGATIONS

The coordination of exchange rate policies conducted by individual countries necessitates a mechanism of international coordination to ensure that the several policies are mutually compatible. One of the purposes of the International Monetary Fund is to "further the adjustment of international payments without resorting to measures destructive of national or international prosperity."[32] Given this purpose, the important question with respect to exchange rate policy is: what set of international rules should the Fund adopt so as to optimize the likelihood of achieving its objective?

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26. R. HINSHAW, THE ECONOMICS OF INTERNATIONAL ADJUSTMENT 6 (1971) [hereinafter cited as HINSHAW].

27. *See* MACHLUP, *supra* note 22, at 56-7. *See also* SAMUELSON, *supra* note 12, at 625.

28. *See* FIRST NATIONAL CITY BANK, MONTHLY ECONOMIC LETTER 9 (Aug. 1974). *See also* HINSHAW, *supra* note 26, at 143-44.

29. *See* R. WEISWEILLER, FOREIGN EXCHANGE 106-07 (1972).

30. *See* HINSHAW, *supra* note 26, at 6. When a surplus country continues to build up foreign reserves, the country is not realizing, in the form of either profits or wages, the productive advantage which it has over other countries. Rather, the advantage is diverted into the accumulation of barren stocks of gold and foreign currency. *Cf.* note 14 *supra.*

31. When the price of a currency goes up relative to gold, it is said that the currency has been revalued. When a currency officially goes down in price relative to gold, it is said that the currency has been devalued.

32. IMF Agreement, *supra* note 2, art. I, § 5.

The Committee of Twenty, during the course of its negotiations, dealt with three aspects of the exchange rate adjustment problem which it felt that the present Articles of Agreement of the Fund do not adequately deal with.[33] First, the Committee made certain alterations in the par value system in order to increase the possibility that member nations would find it financially possible to comply with their par value obligations.[34] Second, the Committee of Twenty agreed upon a new role for "freely floating" exchange rates within the overall international monetary system.[35] And finally, the Committee discussed the need for new and more specific pressures which might be applied to a country which did not take appropriate action to comply with its obligations under the Fund's Articles of Agreement.[36]

A. *Altered Scheme of Par Values*

The Articles of Agreement of the Fund provide for the establishment of a "par value" for the currency of each member country to be expressed in terms of gold or the United States dollar of fixed gold weight.[37] Each member country has agreed to maintain spot exchange rates within a range of fluctuation above or below the par value.[38] The size of the range of fluctuation presently equals one percent of the par value.[39] The purpose of the par value obligation is to provide a stable pattern of exchange rates and to prevent members from manipulating

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33. The Committee of Twenty also discussed several issues other than those relating to exchange rate adjustment. The most important of these were:

a. The convertibility, consolidation, and management of capital flows.

b. The composition of primary reserve assets.

c. Credit facilities in favor of developing countries.

Committee of Twenty Outline of Reform, *supra* note 10, at 6-10.

34. See § III(A) *infra*.

35. See § III(B) *infra*.

36. See § III(C) *infra*.

37. IMF Agreement, *supra* note 2, art. IV, § 1(a).

38. The exact obligation in the Articles of Agreement reads:

> The maximum and minimum rates for exchange transactions between the currencies of members taking place within their territory shall not differ from parity
> (i) in the case of spot exchange transactions by more than one percent; and
> (ii) in the case of other exchange transactions by a margin which exceeds the margin for spot exchange transactions by more than the Fund considers reasonable.

IMF Agreement, *supra* note 2, art. IV, § 3.

39. The Executive Directors of the Fund, on December 18, 1971, adopted a "temporary regime" of wider margins. Executive Directors Decision No. 3463-(71/126), reprinted in INTERNATIONAL MONETARY FUND, SELECTED DECISIONS OF THE INTERNATIONAL MONETARY FUND 12-15 (1970). The Directors decided that they would, with certain restrictions, consider a country to be in compliance with Article 4(a) of the IMF Agreement even if it allowed its exchange rate to fluctuate as much as 2.25 percent on either side of parity. *Id.* paras. 1, 5, at 12, 14.

exchange rates for their own competitive purposes.

The Outline of Reform agreed upon by the Committee of Twenty reaffirms the Fund's belief in the need for a system of exchange rate par values. Paragraph Eleven of the Outline states that "the exchange rate mechanism will be based on *stable but adjustable* par values."[40] The Committee, by using the term "stable but adjustable" meant to imply that par value alterations are not to be considered an extraordinary circumstance.[41] Rather, "countries should, whether in surplus or deficit, make appropriate par value changes promptly."[42] The Outline suggests, furthermore, that the Fund adopt simplified procedures for approving small par value changes.[43] The implicit intent of these sections of the Outline of Reform is that par values be re-established, but that national financial conditions and policies should be more determinative than in the past of whether or not a par value change will be allowed.

A further alteration of the par value system proposed by the Outline of Reform, but as yet unagreed upon, is the widening of the range of values around parity within which the exchange rate may legally fluctuate. One value mentioned in the unagreed-upon appendix to the Outline of Reform is 2¼ percent of parity.[44] Significantly, the Outline of Reform points out that "the maximum margins . . . would need to be decided in the light of conditions prevailing at that time."[45] This phrase recognizes the fact that the margin of fluctuation is intended to allow for fluctuations in the spot exchange rate which are due to short-term forces and not due to long-term forces which require a change in the underlying par value itself. For this reason, the margin of fluctuation should ideally respond to the size of expected short-term pressures on the spot exchange rate.

A third alteration in the par value system proposed by the Outline of Reform is that "it would be desirable that the system of exchange margins and intervention should be more symmetrical than that which existed in practice under the Bretton Woods system."[46] This goal refers to the problem of the dichotomy of interests between those nations facing a balance of payments surplus and those facing a deficit.[47] The

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40. Committee of Twenty Outline of Reform, *supra* note 10, para. 11 (emphasis added).

41. C. Morse, Speech to the International Monetary Conference, Williamsburg, June 7, 1974, at 3. (On file at the office of the *Syracuse Journal of International Law and Commerce.*)

42. Committee of Twenty Outline of Reform, *supra* note 10, para. 11.

43. *Id.*

44. *Id.* Annex 3, at 3-1. Note that the 2.25% margin of fluctuation was also used in the temporary par value regime established by the Smithsonian Agreement. See notes 18 and 39 *supra*.

45. Committee of Twenty Outline of Reform, *supra* note 10, Annex 3, at 3-1.

46. *Id.* para. 12.

47. See § II(B) *supra*.

Outline of Reform does not specify how the obligations under the Fund might be made more symmetrical. However, there appear to be two methods for satisfying such an objective. One is to require a country to intervene in the exchange markets of several different currencies with respect to its own currency. This requirement would avoid the situation where a surplus country was not required to make purchases because the country issuing its intervention currency was in deficit. Another method for increasing the symmetry of the par value system would be to require a country to intervene to support the exchange rate of its currency by buying or selling SDR's.[48] This method makes it even more certain that a surplus country could not avoid its obligation to keep its currency aligned, for a surplus country would be required to sell SDR's which could be purchased by any country running a chronic deficit.

The three alterations in the par value system which have been proposed by the Outline of Reform and mentioned above would not accomplish the comprehensive reform of the international monetary system which was set as the goal of the Committee of Twenty. The Committee, in its attempt to provide a system flexible enough to be capable of implementation, has included in its Outline of Reform obligations which lack sufficient clarity to provide the predictability which the reformed system was intended to have. One example of the open-ended obligations in the Outline of Reform is that which forbids countries from making "*inappropriate* par value changes."[49] In order to determine what the Fund might deem to be "inappropriate," the only guidance given to a member country is the adjoining phrase of the Outline which declares that "the exchange rate mechanism will remain based on stable but adjustable par values."[50] Another example of the flexibility of the altered par value obligation is the exception to the par value obligations which is made by the provisions for "freely floating" exchange rates, which will be discussed in the next section.

Although the proposals of the Committee of Twenty for altering the par value system do not accomplish their goal of overall reform, they do serve as an important step in the envisioned evolution of the international monetary system. This step is the reinstitution of par values into a world economy which has made it impossible for the old obligations to be followed by member countries. The changes which will be made by the Outline of Reform will make it more feasible for a country to

48. SDR's (special drawing rights) are a numeraire for measuring the extent to which a member country may make withdrawals from the Fund's Special Drawing Account. SDR's came into existence on July 28, 1969 with the amendments to the IMF Agreement which now constitute articles 21-27. *See* 20 INT'L FINANCIAL NEWS SURVEY 985 (1969); W. HABERMEIER, OPERATIONS AND TRANSACTIONS IN SDR's, IMF Pamphlet Series No. 17 (1973).

49. Committee of Twenty Outline of Reform, *supra* note 10, para. 11.

50. *Id.*

comply with their par value obligations without unduly straining its financial resources and prejudicing its domestic economic objectives. The agreement to widen the margins of fluctuation is a prime example of the effort of the Committee to make the par value system viable under the present uncertain economic conditions.

B. Provision for Floating Exchange Rates

Presently the Fund cannot legally control whether or not a country has a floating exchange rate. The Fund can exercise surveillance over the manner in which members fulfill their undertaking under Article IV, Section 4(a), "to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations."[51]

The Committee of Twenty has proposed that since floating exchange rates are currently in widespread use, even by the major countries,[52] the Fund Articles of Agreement should deal specifically with this form of exchange rate adjustment by placing conditions and restrictions on their use. The Outline of Reform, recently adopted by the Committee, authorizes countries to adopt floating rates, subject to authorization, surveillance and review by the Fund.[53] This limited authorization of floating exchange rates is an explicit recognition by the Committee of the floating exchange rate system which has recently been adopted by many member countries due to the financial conditions in those countries.

The most important aspect of the reform proposals is the power given to the Fund to withdraw from a country its authority to float its currency. Paragraph Thirteen of the Outline of Reform states that:

> Authorization to float may be withdrawn if the country fails to conform with the guidelines for conduct, or if the Fund decides that continued authorization to float would be inconsistent with the international interest.[54]

As a result of this paragraph, the Fund would have a specific provision to apply in the event of the use of floating exchange rates and thus would not have to rely exclusively upon Article IV, Section 4(a), the section generally requiring members to collaborate with the Fund to promote exchange stability.[55]

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51. IMF Agreement, *supra* note 2, art. IV, § 4(a).

52. On March 12, 1973, the Group of Ten agreed that they would no longer attempt to maintain the par values of their currencies, as required by Article IV of the IMF Agreement. See note 18 *supra*.

53. Committee of Twenty Outline of Reform, *supra* note 10, para. 13.

54. *Id.*

55. See note 51 *supra* and accompanying text.

Now that the Committee of Twenty has recommended a qualified recognition of floating exchange rates, an important element of the reform may prove to be the Guidelines for Floating Exchange Rates, recently adopted by the Executive Directors of the Fund.[56] According to the Guidelines, members of the Fund having floating exchange rates would be under several obligations. In the short-run, a member with a floating exchange rate would be under an obligation to "intervene on the foreign exchange market as necessary to prevent or moderate sharp and disruptive fluctuations . . . in the exchange value of its currency."[57] Furthermore, if the country's exchange rate "moved outside of what the Fund considered to be a range of reasonable estimates of the medium-term norm for the exchange rate,"[58] the Fund could consult with the member and encourage it to take actions not inconsistent with allowing the exchange rate to move to its medium-term norm.

The action which the Committee of Twenty has taken with respect to floating exchange rates is appropriate in light of the current widespread use of floating exchange rates. It might be argued that the Committee has done nothing more than legislate reality (*i.e.*, form rules which merely reflect the status quo). However, a preferable view of the Outline of Reform reveals that the qualifications which the Guidelines have placed on the use of floating exchange rates are a needed force in the effort to stabilize the current widespread use of floating exchange rates, only some of which use can be justified by current economic conditions.

C. *Pressures*

One of the most important issues left unresolved by the Committee of Twenty at its final meeting was the form of pressures to be applied to a country which does not act in accordance with its obligations under the revised international monetary system. The Committee generally agreed that provision should be made for graduated pressures to be available to the Fund for application to both surplus and deficit countries in cases of large and persistent imbalances.[59] However, the Committee did not agree on what forms or methods of activation the pressures should have.

One of the underlying reasons for the failure of the Committee to reach agreement on the forms and activation of pressures was the dichotomy of interests between deficit and surplus countries. Countries experiencing a chronic surplus often do not feel that it is in their best

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56. International Monetary Fund, Press Release No. 74/30 (June 13, 1974).
57. Committee of Twenty Outline of Reform, *supra* note 10, Annex 4, at 4-2.
58. *Id.* at 4-3.
59. Committee of Twenty Outline of Reform, *supra* note 10, para. 10.

interest to agree to stringent obligations to adjust their exchange rates; especially obligations which contain sanctions effective against surplus countries.[60]

Although the Committee failed to agree upon appropriate pressures, it did discuss, in an appendix to the Outline of Reform, several possible forms of pressures.[61] The first possible scheme of pressure would combine a charge on reserve accumulation above a certain norm[62] with a requirement to deposit reserves above a specified level with an Excess Reserves Account.[63] This scheme of pressures would most likely be strongly opposed by those countries which have chronically run a balance of payments surplus and are likely to acquire excess reserves thereby bringing them within the purview of the pressures. A second possible form of pressure which could be applied to a country which failed to meet its adjustment obligations would be to withhold for a specified or indefinite period all or part of future SDR allocations[64] of a country in surplus. A third form of pressure would be to publish a report on the external position and policies of a country in surplus.[65] Finally, the most severe form of pressure would be for the Fund to authorize other countries to apply discriminatory trade restrictions[66] against the surplus country.[67]

The Committee of Twenty did not agree on the form which pressures should take nor did they agree on the process by which pressures would be activated. The mechanisms which the Committee considered but did not agree upon fall into three general categories: discretionary, presumptive, and automatic.[68] A discretionary mechanism contem-

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60. Surplus countries often take the position that a revaluation of their currency would cause a reduction in their exports. Although this is likely to be true, the conclusion does not necessarily follow that it is against the overall interest of surplus countries to be required to revalue their currency when a serious imbalance exists. The benefits from reduced inflationary pressures which are likely to result from a reduced trade surplus may more than outweigh the detriment suffered from reduced exports. *See* MACHLUP, *supra* note 22, at 55-58. *Cf.* notes 14 and 16 *supra*.

61. Committee of Twenty Outline of Reform, *supra* note 10, Annex 2.

62. *Id.* Annex 2, § A(i), at 2-1.

63. *Id.* Annex 2, § A(ii), at 2-1.

64. *Id.* Annex 2, § A(iii), at 2-1.

65. *Id.* Annex 2, § A(iv), at 2-1.

66. Discriminatory trade measures which might be used to sanction a non-complying member include tariffs, embargoes, etc. However, the use of such measures is also controlled by the General Agreement on Tariffs and Trade (GATT). Thus modifications in GATT might be necessary before the pressures allowed by the IMF Articles of Agreement could be applied by members of the Fund who were also signatories of GATT. *See* GOLD, THE INTERNATIONAL MONETARY FUND AND INTERNATIONAL LAW: AN INTRODUCTION 23 (1965) for a discussion of the Fund's relationship to the contracting parties of GATT.

67. Committee of Twenty Outline of Reform, *supra* note 10, Annex 2, § A(v), at 2-1.

68. Committee of Twenty Outline of Reform, *supra* note 10, at 2-2—2-3.

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plates a grant of authority to the Executive Council of the Fund to assess a member country's actions and impose pressures if those actions do not comply with the obligations and principles of the Fund Articles of Agreement.[69] A presumptive mechanism is one in which precise and detailed rules for the imposition of pressures would apply but with a provision for overriding the rules in certain cases by means of the vote of an appropriate majority of the members.[70] An automatic mechanism is one in which precise rules necessarily determine when pressures will be activated against member countries.[71]

One of the principal difficulties with implementing a system of pressures is that, due to the absence of operational experience, it is difficult to judge how any particular arrangement involving the use of specific pressures would work in practice. Until recently, this difficulty alone would have been enough to prevent the implementation of such a mechanism. However, the very fact of instability may serve as an impetus for member countries to agree upon some forms of pressures, for all countries suffer a loss of trade when exchange rates become unpredictable. The implementation of pressures to comply with foreign exchange obligations (*e.g.*, those relating to the level of a member country's reserves), earlier thought to be politically infeasible, may become feasible in an economic climate where all countries have something to gain from increased stability of exchange rates.

IV. DETERRENTS FROM OVERALL REFORM

Although the Committee of Twenty has made several proposals to reduce the present uncertainty wrought by the use of freely floating exchange rates, it did not achieve the overall reform which was its objective when it began its discussions over two years ago. Several reasons have been given, both by representatives of the Fund and by commentators observing their progress, to explain why only limited reform proposals were achieved. One of the two foremost reasons given is the rampant inflation which has caused uncertainty about the short-term future of international monetary conditions. A second, related reason is the sudden growth of reserves by the oil-exporting countries following price rises

69. Morse, *supra* note 41, at 6.

70. *Id.* at 5. An example of the use of a presumptive mechanism by the present Articles of Agreement is the grant of power to the Executive Directors of the Fund to prevent the "automatic" application of the remedy of ineligibility of a member for making an unauthorized change of par values. IMF Agreement, *supra* note 2, art. IV, § 6 and art. XV, § 2(b).

71. Morse, *supra* note 41, at 5. Canada, France, Germany and Japan all object very strongly to the adoption of an "automatic" mechanism for determining when or by what means exchange rates should be changed. *See* Geiger, *The Issues in International Monetary Reform*, LOOKING AHEAD, Feb., 1973, at 7.

initiated by those countries. Both reasons will be discussed in this section in an attempt to explain the current difficulties experienced by reform efforts and to evaluate more fully the actual progress which has been made by such reform efforts.

A. Inflation

The par value system of exchange rates "depends on a reasonable degree of confidence, on the part of governments as well as the market, that rates will remain reasonably stable over a reasonable period."[72] The par values of the currencies of member nations are supposed to reflect long-term or at least medium-term trends in market exchange rates. However, when a high rate of inflation exists it is difficult to make appropriate par value adjustments because long-term exchange rates are highly unpredictable.

A United States Treasury spokesman, referring to the domestic economy, has stated that "in a world of accelerating inflation, financial stability can only be a dream."[73] A similar statement could be made about the international economy during a period of inflation because the financial stability of the world's nations is a necessary precursor to stability in an international monetary system.[74]

Although any international reform developed under conditions of widespread inflation is destined to be temporary and only partial in effect, this does not imply that immediate international cooperation is not necessary. Cooperation among countries is necessary in order to ensure that countries do not attempt to relieve these pressures through competitive devaluation or capital restrictions.[75]

The de-stabilizing effect of inflation upon exchange rates is exacerbated by the fact that the rates of inflation experienced by individual countries are unequal.[76] Given differing rates of inflation, it would be inappropriate for the Fund to merely freeze exchange rates at their present levels.[77] The prevailing view among members of the Fund is that more continuous movements of exchange rates over time might help to modify some of the disturbances felt by countries who have a rate of

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72. Morse, *supra* note 41, at 2.

73. *Statement of Paul A. Volcker, Under Secretary of the Treasury for Monetary Affairs on February 27, 1974*, DEPARTMENT OF THE TREASURY NEWS No. S-368, at 12.

74. *See* International Monetary Fund, IMF SURVEY, May 6, 1974, at 134.

75. *See Statement by the Honorable Paul A. Volcker, Under Secretary of the Treasury for Monetary Affairs Before the Subcommittee on International Economics of the Joint Economic Committee, June 26, 1973*, *supra* note 1 at 12. Morse, *supra* note 41, at 12.

76. *See generally Seeking Antedotes to a Global Plague*, TIME, April 18, 1974, at 72-76.

77. *See* H. HELLER, INTERNATIONAL MONETARY ECONOMICS 200-06 (1974).

inflation above or below the international average.[78] Reflecting this view, the Fund has provided that par value changes will be more readily available[79] and that floating exchange rates may be adopted under certain circumstances.[80] Although these provisions for more continuous movements of exchange rates may alleviate the short-term balance of payments pressures on those countries hardest hit by inflation, it is not the type of action which is likely to ensure longer-range stability in exchange rates.

The newly-proposed plan for more flexible exchange rates has no necessary restraining effect on the overall level of world inflation. Indeed, such flexibility has the potential disadvantage of allowing a country to continue lax domestic policies of dealing with inflation.[81] Longer-range stability may be achieved only if there are pressures upon individual countries to adopt policies which will restrain domestic inflation.

A fair assessment of the Outline of Reform requires some consideration of the alternatives which the Committee of Twenty had in forming a system that would be both feasible and politically acceptable and would deal effectively with world inflation. One alternative would be to condition flexibility of a country's exchange rates on the adoption of domestic policies appropriately dealing with domestic inflation. However, this method is not feasible because the appropriate domestic policies for dealing with inflation are not known with sufficient exactitude to make their adoption a condition precedent to the use of Fund provisions.[82] Most other alternatives, *e.g.*, the use of pressures for failure to comply with "reserve indicators," presently do not meet the test of political acceptability. Thus the ironic conclusion follows that the instability caused by rapid inflation is impeding efforts to achieve long-term stabilizing reform of the international scheme of exchange rate adjustment.

B. *Reserve Build-Up by Oil-Exporting Countries*

All countries which import oil have recently faced, in varying degrees, a sharply increased import bill for energy products.[83] The concur-

78. *Cf.* International Monetary Fund, Press Release No. 74/30 (June 13, 1974).

79. See § III(A) *supra*.

80. See § III(B) *supra*.

81. See text accompanying notes 13-14 *supra*.

82. An example of the widespread disagreement over the proper domestic policies to be used to combat inflation is the disagreement between American and British financial advisers over the appropriateness of the tight money policy pursued by Chairman Burns of the Federal Reserve Board. *Cf. An Expensive Gamble to Slow Inflation,* NEWSWEEK, June 15, 1974, at 76-78.

83. *See Statement by Paul A. Volcker Before a Joint Hearing of the Subcommittee on International Finance of the House Banking and Currency Committee and the Sub-*

rent transfer of purchasing power to oil-exporting countries has caused a marked shift in the pattern of world payments and a rapid build-up of foreign reserves by the oil-exporting countries. These occurrences have caused several serious problems for the establishment of a dependable mode of exchange rate alignment.

The build-up of reserves by oil-exporting countries stands as a serious obstacle to the adoption of mandatory standards of action based on the level of a country's reserves. The oil-exporting countries "are at a stage where their current use of resources cannot reasonably be expected to equal their output."[84] Thus, since the oil-exporting countries must necessarily be expected to continuously accumulate foreign reserves, these countries cannot be expected to accept any obligation to keep their foreign reserves below a specified maximum level.

Methods other than "reserve indicators" for dealing with the balance of payments problems caused by the surpluses of the oil-exporting countries appear similarly infeasible. An attempt to reduce the surpluses through sudden exchange rate alignments would be ineffective. Due to the suddeness of the build-up of the oil surpluses and their overwhelming size,[85] an exchange rate alignment alone could not be expected to cause a sufficiently large alteration in trade to counterbalance the huge surpluses of the oil-exporting countries. Rather, attempts by oil-importing countries to adjust their balance of payments deficits by depreciating their currency would merely shift the payments burden among themselves, with a net deficit still remaining on the oil-importing countries collectively.[86]

In addition to the problem of the build-up of reserves discussed above, there exists the problem of uncertainty about the pattern of reserve flows which will occur when the oil-exporting countries begin to choose investment outlets for their surpluses. There is uncertainty both about the type of investments these countries will make and about which countries those investments will be made in.[87] The question which this problem presents to the Fund is how can the Fund "ensure that the pattern of such flows helps rather than hinders the achievement of

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committee on International Economics of the Joint Economic Committee on November 13, 1973, DEPARTMENT OF THE TREASURY NEWS No. S-324, at 11.

84. Kafka, *The International Monetary System in Transition—Part II,* 13 VA. J. INT'L L. 539, 543 (1973).

85. Saudi Arabia, alone, has increased its international reserves from 1,930 million dollars in the first quarter of 1972 to 6,225 million dollars in May 1974. From March 1974 to May 1974, Saudi Arabia's foreign reserves rose 1,362 million dollars. 27 INT'L FINANCIAL STATISTICS 310-11 (No. 7, July, 1974).

86. IMF SURVEY, May 6, 1974, at 133.

87. *See* Tugendhat, *Oil—How to Avoid a Catastrophe?,* THE BANKER, Feb. 1974, at 101-03; IMF SURVEY, March 18, 1974, at 82.

monetary and economic stability."[88] While this question remains unanswered, attempts to provide a dependable exchange rate adjustment scheme can only be partially successful.

There are several possibilities for amelioration of the instability which has been fostered by the surpluses of the oil-exporting countries. The first possibility is a voluntary choice by the oil-exporting countries to abate price increases. Some of the oil countries already favor such action.[89] The voluntary abatement of oil price increases would have the effect of limiting the surpluses which the oil-exporting countries continuously experience. Even greater stability would occur if the oil-exporting nations were willing to put their decision to limit production in the form of a multilateral agreement. A second possible circumstance which would tend to slow down the accumulation of reserves by oil-exporting countries is a reduction in the demand for petroleum products. Although such a reduction is not likely in the short-term, a long-term reduction in demand is likely if the price remains at its current level vis-á-vis other commodities.[90] A third possibility is for the oil-importing countries to create alternate sources of oil supply. However, alternative supplies will not be significantly developed for several years.[91] A fourth possibility is for the oil-exporting countries to establish predictable patterns of medium and long-term investments in other countries.[92] Unless events, such as the four just mentioned, occur to abate the pace of foreign reserve build-up by oil-exporting countries, the build-up will continue to hinder efforts at overall international monetary reform.[93]

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88. International Monetary Fund, IMF SURVEY, May 6, 1974, at 134; *see also* Speech by H. Joannes Wittween at the Economic Club of Detroit, May 6, 1974, IMF Press Release.

89. *See* Demaree, *Arab Wealth, as Seen through Arab Eyes*, FORTUNE, April, 1974, at 108-09; *see also* Tugendhat, *Oil—How to Avoid a Catastrophe?*, THE BANKER, Feb., 1974, at 99.

90. *Cf.* Lomax, *Oil and International Debt,* THE BANKER, April, 1973, at 326.

91. Oil from the Alaskan North Slope will not become significant until 1977. THE ECONOMIST, July 6, 1974, at 99. Similarly, England's reserves in the North Seas will not begin to yield over 100 million tons a year until 1980. THE ECONOMIST, May 11, 1974. *But see* Rose, *Our Vast, Hidden Oil Resources*, FORTUNE, April, 1974, at 104. Mr. Rose argues that vast quantities of oil reserves have become profitable to extract since the rise in the price of oil. *Id.* at 105.

92. *See* IMF SURVEY, March 18, 1974, at 82; Mabro and Monroe, *Arab Wealth from Oil: Problems of its Investment*, INT'L AFF., Jan., 1974, at 15; THE ECONOMIST, Jan. 5, 1974, at 66-69.

93. The Fund has adopted several short-term devices to lessen the immediate fiscal impact of increased oil prices. The most important such device is the "oil facility," which allows countries facing serious balance of payments difficulties to borrow from a special fund supported by oil-exporting countries. IMF Press Release No. 74/31, June 13, 1974. However, such devices are directed toward short-term amelioration and not long-term stabilization. *Cf.* THE ECONOMIST, Oct. 5, 1974, at 84.

V. CONCLUSION

The Outline of Reform recently completed by the Committee of Twenty falls short of the comprehensive "code of conduct" which is necessary to control nationalistic monetary behavior.[94] One important aspect of comprehensive reform which was not included in the Outline of Reform is the imposition of enforceable obligations on surplus countries to prevent them from taking actions, such as the allowance of chronic reserve build-up, which unnecessarily prejudice the financial condition of deficit countries. Another necessary element of reform which was omitted from the Committee of Twenty's Outline of Reform was an adequate provision for influencing the domestic policies of deficit countries. For, in the absence of "fixed" exchange rates, there is an absence of inherent pressure in the international monetary system to prevent a deficit country from repeatedly devaluing its currency to finance a consistent deficit in its balance of payments.[95]

Notwithstanding the shortcomings of the Outline of Reform just mentioned, the Committee of Twenty has taken the first necessary step in re-asserting the Fund's role in the regulation of exchange adjustment. That step is the formalization of principles with which to deal with the existent "freely floating" exchange rates. These principles, although less desirable than predictable rules and obligations, do create an interim "code of conduct" to be followed by member nations. By taking this cautious, pragmatic step, the Committee of Twenty has attempted to re-establish a modicum of exchange stability within a world economy threatened by the dual problem of inflation and excessive accumulations of reserves by oil-exporting countries. The Committee has proposed obligations which would be both financially feasible for deficit countries and politically acceptable to the surplus countries.

When short-term stability has been restored to the adjustment of exchange rates, member countries, both deficit and surplus, will be able to more accurately assess their long-term interests. Only when exchange rates are reasonably predictable will a member country be able to adequately weigh the effects which an overall reform would have on their own national interests against the benefits to be derived from a well-defined, dependable international system of exchange rate adjustment. Such an assessment will be necessary before countries will be willing to surrender to the Fund the substantial amount of monetary sovereignty which will be necessary for the Fund to achieve an overall reform of the international mechanism for exchange rate adjustment.

Keith Leon Baker

94. See text accompanying note 1 *supra*.
95. See note 20 *supra* and accompanying text.