NBER WORKING PAPER SERIES

RESERVES AND BASKETS

Michael D. Bordo
Harold James

Working Paper 17492
http://www.nber.org/papers/w17492

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
October 2011

Reserves and Baskets
Michael D. Bordo and Harold James
NBER Working Paper No. 17492
October 2011
JEL No. F02,F33,F55

ABSTRACT

We discuss three well known plans that were offered in the twentieth century to provide an artificial replacement for gold and key currencies as international reserves: Keynes' Bancor, the SDR and the Ecu(predecessor to the euro).The latter two of these reserve substitutes were institutionalized but neither replaced the dollar as the principal medium of international reserve.

Michael D. Bordo
Department of Economics
Rutgers University
New Jersey Hall
75 Hamilton Street
New Brunswick, NJ 08901
and NBER
bordo@econ.rutgers.edu

Harold James
History Department and Woodrow Wilson School
Princeton University
Princeton NJ 08544
hjames@princeton.edu

I. INTRODUCTION

There is currently a new interest in the question of reserve currencies. Reserves for the world as a whole have increased relative to GDP by a factor of three over ten years, although most major industrial countries no longer hold substantial foreign exchange reserves (IMF 2010). A substantial literature suggests that excessive reserve accumulation can be viewed as a symptom of imperfections in the international monetary system, and a threat to international monetary stability. It carries domestic costs - for reserve holders face opportunity costs in terms of foregone consumption and investment – as well as international costs - largely correlated to the problem of global imbalances. Is the accumulation unnecessary, costly, and politically destabilizing?

The concern about the danger posed by the growth of reserves is driven by a varied range of motives: first, the fear that any single reserve currency might be fundamentally unstable, because its price would be driven rapidly down if any large holder of reserves tried to use those reserves (China is often said to be trapped by its large dollar holdings). In order to be really useable, a reserve has to be liquid in a deep market. That is why even the currencies of small countries with excellent macro-economic records, such as Norway and Switzerland, are not suited to a reserve role. But even the euro and the dollar can be problematical, and over the past three years have been subject to dramatic exchange rate movements. Second, it is often argued that the push to build up reserves leads to the adoption of undervalued exchange rates that lead to a buildup of global imbalances and a distortion of world trade patterns, with worried countries stimulating their exports and exporting employment losses to competitors (although an alternative line of analysis suggests that it is not fundamentally the search for reserves that drives the policy as much as a mercantilist drive for export competitiveness that leads to the reserve

pile-up as a largely unintended and undesirable consequence). Third, there are deep-seated geo-political concerns about the role of particular reserve currencies, with the claim that the provider of the reserve asset has an unfair advantage. In this view, reserve assets are used to uphold a privileged position (or what French critics in the 1960s called the "exorbitant privilege" of the U.S. dollar).

The language of criticism often combines these points in a vigorous polemic. General de Gaulle claimed almost fifty years ago that: "The United States is not capable of balancing its budget. It allows itself to have enormous debts. Since the dollar is the reference currency everywhere, it can cause others to suffer the effects of its poor management. This is not acceptable. This cannot last." (Peyrefitte 2003: 664) The modern equivalent of Charles de Gaulle's influential adviser Jacques Rueff, the Director of the Institute of World Economics and Politics of the Chinese Academy of Social Sciences, Yu Yongding writes: "When helicopter-Ben drops tons and tons of dollar bills from the sky, what value does the dollars still have? When the balance sheet of the Fed is no better than a junk bond fund, it becomes a kind of junk bond fund." (Yongding 2009)

If conventional currency reserves are a problem, perhaps there is an alternative? Thinking of unconventional reserves (agricultural land in Africa or mines) is perhaps only for the very adventurous, because after all such assets are highly illiquid. Consequently, there has been a renewal of interest in synthetic or composite reserves, or in basket currencies; in the wake of the financial crisis, some influential figures have floated the idea of a new international currency which resonates with proposals from the past. The governor of the People's Bank of China, Zhou Xiaochuan, in March 2009 described John Maynard Keynes' "farsighted" bancor scheme as a basis for developing the IMF's SDRs into a global currency. A UN Panel chaired by Joseph

Stiglitz in 2009 recommended a generalized SDR reserve system as "feasible, non-inflationary, and could be easily implemented." (United Nations 2009) Robert Mundell argued that the financial crisis was caused by a global shortage of liquidity and called for the issue of a trillion SDRs, or a volume equivalent to some 8 percent of world merchandise trade (Mundell 2009). But as a longer term measure, he proposed a locking of the yen-dollar-euro rate and the creation of a new international currency, INTOR. Some proposals go further and call for a fully-fledged international money created on the basis of clearing arrangements in a payments union between the major central banks, on the analogy of European developments since 1950 (Alessandrini and Fratianni 2009).

Given the difficulty to induce countries to limit their demand of reserves, a second-best alternative is thus to act on the supply side, by replacing national currencies with a supranational money. This solution meets the existing demand of reserves in a way more consistent with the goal of international monetary stability. But it does not tackle the issue of the potential instability deriving from excess reserve accumulation from the supply side.

Historically, composite currencies such as the SDR were carefully circumscribed so that in practice they could never become widely used as currencies, and consequently no deep markets developed. The bancor that Governor Xiaochuan referred to was designed by Keynes not to be used in commercial transactions; it was a sort of measuring stick and a disciplining rod for countries, but not a unit of account for individual transactions.

Moreover, previous synthetic reserve currencies needed to be accompanied by rules that would stop country holders moving out of them over a longer term: they were subject to what was called a reconstitution requirement.

As foreign exchange markets grew much larger in the second half of the twentieth century, it became increasingly clear that in order to be really useable, there would need to be a large private market: hence in the third case studied here, that of the European ECU, its designers turned to a deliberate encouragement of its private use.

	Bancor	SDR	ECU
Reserve function	Not to be used as permanent reserves but as a short term credit	Reserves with a reconstitution requirement	Reserves with a reconstitution requirement
Volume (criteria)	Equal to volume of world trade, with national quotas	To be decided by special majority of IMF to fill a need for additional liquidity: annual allocation	Initial supply created by 20 percent of gold and dollar reserves held by EC central banks
Initial volume as share of international trade	100	3.4 percent	3.9 percent
Private use	No	Discouraged	Encouraged

II. BANCOR

Keynes's scheme for a postwar monetary order proposed an international bank, which he initially called the Currency (and later the Clearing) Union, with a new unit of account that would be the basis for the issue of a new international currency. The proposed currency's name, bancor, indicates the way in which the new money was conceived as an artificially created replacement for gold, which should gradually be expelled from the civilized conduct of international economics. Keynes, incidentally, was never happy about the name and called bancor along with the U.S. alternative for a synthetic currency (unitas) “rotten bad names,” adding “but we racked our brains without success to find a better.” (Keynes 1980, Collected Works, XXV, 271) Gold might be sold by central banks to the new international bank for bancor, but would not be bought. Keynes called this “one way convertibility.” (Skidelsky 2000: 206) In practice, it would

thus be demonetized, and it would not circulate as a medium of exchange. A better way of thinking of bancor in the original Keynes draft is as a temporary and limited substitute for conventional foreign exchange reserves.

In practice, Keynes hoped that it would not be necessary (or desirable) to finance any long term imbalances at all – and he saw these imbalances as a cause of the malaise of the world economy. The object of the Union's activities would be to avoid balance of payments imbalances through the creation of a body of rules and practices relating to the overdrafts on the bank accumulated by debtors and the positive balances acquired by creditors. The quotas for each country in the Union were to be fixed as half of the average of imports and exports over the past five years. The overall stock of quotas thus amounted to the total of world trade. These quotas determined the limits up to which debtors could borrow (at interest rates that rose with the quantity of their debts). Creditors had to transfer to the Union surpluses above their quota, and pay charges to the Union if their balances rose above a quarter of their quota. Longer term surpluses (or deficits) would be dealt with by a requirement to revalue (or devalue) in 5 percent stages.

The Keynes scheme created a nearly perfect symmetry, both in the penalties for short term financing of deficits and surpluses, and in longer term adjustment: it was to be as unpleasant and as costly to hold credit balances as to be a debtor. The idea of symmetry became the basis for the scarce currency clause of the IMF's articles, but in practice though the possibility of a scarce currency determination was occasionally debated, the clause was never actually applied. The result would be the impossibility of policies such as those followed by the United States and France in the late 1920, as the rules of the Clearing Union would drive such creditor states to expand.

Behind these proposals lay very clear lessons from the Great Depression, at least as interpreted by the critics of the interwar policies of the United States and France. The chief British financial negotiator in wartime Washington, Sir Frederick Phillips, wrote about the new scheme: "Should a severe world depression threaten at some date subsequent to the conclusion of the war success in coping with it will, we think, largely turn on the adoption of a general expansionist policy. The efforts of individual countries to meet the evil may prove futile, as they have in the past, unless given the strong support of a common international currency policy." Keynes was very explicit about his wish to aim at “the substitution of an expansionist, in place of a contractionist, pressure on world trade.” (Keynes 1980, Collected Works, XXV, 74)

III: THE SDR

The background to the creation of the SDR was a debate about the adequacy of reserves that had been touched off by a series of articles by the Belgian-born economist Robert Triffin. The Triffin analysis laid out two threatening scenarios: one of an increasing shortage of world reserves; the other of the role of the dollar in filling the demand for reserves, but touching off fears of a possible inconvertibility of dollars into gold that might at some point set off a 1931-style panic.

In 1963 Edward Bernstein, the former Director of the IMF's Research Department, had proposed a more adequately balanced composite reserve unit (or CRU) constituted of the 11 currencies of the GAB countries (IMF 1964: 29). The IMF took up the debate and produced a study in 1964 that suggested that the need for international liquidity could not be met simply by adding more gold or foreign reserve assets." Since October 1963, a G-1O deputies' study group had been engaged in an analysis of "the functioning of the international monetary system and of

its probable future needs for liquidity." Its 1965 report argued that the world would shortly face a liquidity shortage: "from the considered expectation that the future flow of gold into reserves cannot be prudently relied upon to meet all needs for an expansion of reserves associated with a growing volume of world trade and payments and that the contribution of dollar holdings to the growth of reserves seems unlikely to continue as in the past." (G10 1965: 17)

The developing countries produced their own proposals in 1965, in a report of an Expert Group on International Monetary Issues, prepared for the newly launched UNCTAD. According to this statement, the provision of long-term aid, rather than the creation of additional liquidity, should be the main priority in reforming the international monetary system. Liquidity provision could only help to solve short-term problems and would not contribute to longer-term stable development. International liquidity creation should be linked to development finance; and developing countries should be represented in discussions of monetary reform. In a similar vein, in May 1966 the Group of Thirty-One Developing Countries insisted that "monetary management and co-operation should be truly international and ... all countries, which are prepared to share in both the benefits and obligations of such new monetary arrangements as may be devised, should be eligible to participate in the creation of new reserve assets." (de Vries 1976, I: 85)

In the IMF's Executive Board, the representatives of developing countries similarly insisted that "all countries, not only the economically big ones," should be involved in the discussion of reform." Schweitzer warned against the division of member countries into "the reliable few and the less responsible many." He was suspicious of proposals for a CRU composed of a few currencies and doubted whether they would work well in practice. By 1965, he was insisting that "international liquidity is the business of the Fund": that the IMF was

central to the operation and surveillance of the international monetary system. (de Vries 1976, I: 68, 90, 109)

Eventually the United States reacted to the flood of initiatives for international monetary reform, for its own reasons. As the use of the dollar as a reserve by other countries grew--in other words, as U.S. liabilities to the international system grew--the United States faced a reserve shortage. A new artificial reserve asset might be a way of providing much-needed additional liquidity for the United States. In July 1965, U.S. Treasury Secretary Henry H. Fowler indicated his partial conversion to Triffinism when, in a speech to the Virginia State Bar Association, he called for an international monetary conference to consider "what steps we might jointly take to secure substantial improvements in international monetary arrangements."

The IMF arranged joint meetings between the G-1O deputies and the Fund's Executive Board as a forum for the discussion of reserve creation in 1966. The large gathering that resulted--an assembly of 105 people--perhaps perversely appeared to make reaching agreement rather easier than if the same discussions had taken place in a more intimate setting with a more frank interchange of views. But it made the discussion of reform proposals very cumbersome and encouraged the use of deliberately obfuscating linguistic formulations in order to secure a basis for agreement. The most obvious of these concerned the name of the new international reserve: composite reserve unit suggested a clear challenge to the position of the U.S. dollar and might offend American sensibilities.

There existed a double problem regarding international reserves. The dollar in the 1960s had formed an increasing proportion of the world's reserves. But the growth of dollar holdings depended on U.S. actions. If the United States reduced its payments deficit, there would be a slowing in the growth of exchange holdings in other countries. In 1965, the U.S. balance of

payments deficit had been lower than in any year since the 1950s, and the U.S. administration also cut back the budget deficit quite effectively. It seemed that the confidence crises of the early 1960s had come to an end: but equally, that the long-awaited world reserve shortage would be realized. Other countries would begin to suffer from the consequences of an insufficiently large creation of dollars and would not be able to build reserves to finance their own potential deficits. At the same time, the pivotal position of the United States in reserve creation could seem like a use or abuse of power. Germany and particularly France produced a vigorous criticism of the U.S. position as being openly dominating. (Bordo, Simard and White 1995) French politicians focused on the reserve issue and insisted on the pre-eminent role of gold as a means of countering the American challenge. Metallic reserves, and an attack on the key currency concept, meant for them the assertion and preservation of national sovereignty in the face of the challenge of internationalization. But it also meant the rediscovery of the international financial system as a rules, based order that would prevent the hegemonic country drawing additional privileges from the pre-eminent position of its currency. Gold as the basis of the system would prevent the kind of manipulation that might be undertaken in a reserve currency system. In this way, it offered an escape from the conflation of economic and national security concerns that had, in the French interpretation, come to dominate and paralyze the international financial system. A popular way of putting this was to claim that the use of the dollar as an international reserve currency gave the United States illegitimate "seigniorage" advantages. It could finance its military expenditure overseas painlessly by simply applying green ink to paper. (In fact, since holdings of dollar reserves bore interest, the U.S. outflow could not truly be said to be a pure seigniorage gain for the United States.)

French Finance Minister Valery Giscard d'Estaing announced at the Annual Meetings of the IMF and World Bank in 1964 that: 'The world monetary system must be set in concentric circles: the first one being gold, and then, the second, if necessary, recourse to deliberate and concerted creation of either reserve assets or credit facilities. The inner circle is gold. Experience in recent years has shown us that, aside from any theoretical preference, gold remains the essential basis of the world payments system." (de Vries 1976, I: 40) In a press conference on February 4, 1965, General de Gaulle attacked the U.S. abuse of its exorbitant privilege under the gold exchange standard. "The convention whereby the dollar is given a transcendent value as international currency no longer rests on its initial base, namely, the possession by America of most of the gold in the world." (Lacouture 1992: 381) A subsequent French dollar conversion campaign inevitably made the discussion of replacement of the reserve role of the dollar highly politically sensitive.

To the United States, the attraction of reform lay in taking the strain off the dollar, and avoiding new dollar crises, by the provision of additional liquidity. After a speech by Giscard d'Estaing at the IMF Annual Meeting in October 1963, in which he had criticized the composition of currency reserves, France set out in the meetings of the G-I0 deputies a proposal for a collective reserve unit (CRU). In June 1965, Giscard prepared a detailed program. The CRU would be linked to gold and be composed in fixed proportions of the currencies of the G-10 countries. Such a course, French policymakers now believed, offered the only way of raising the price of gold and thus restoring an international monetary order based· on the "inner circle" of value. General de Gaulle convinced himself that the planned reserve unit might constitute a defense "contre l'inflation americaine." It should be linked to a requirement that the United States reduce the volume of outstanding dollar liabilities.

The main purpose of the reform in French eyes would be to provide additional credit facilities, so that new reserves would not be needed. This would be conditional rather than unconditional liquidity. The credit facilities would require a tight institutional control. All these aspects of the French vision required a much more powerful role for the 1MF. In early 1967, France set about convincing the other members of the EEC of this position and also demanding that the voting system of the IMF should be reformed in order to give the Six a veto on important decisions. As a result of French demands, in July 1967, the word "reserve" was dropped from the discussion of the composite reserve unit and the concept was now rephrased as a "special drawing right" or SDR.

There needed to be an additional security against abuse of the SDR, the continental Europeans believed. De Gaulle believed that only a link with gold would give such security, but the United States resisted this precisely out of fear that it might lead to French pressure to change the gold parity of the dollar. The other Europeans followed de Gaulle in insisting that approval by the IMF's Board of Governors of the issue (and potentially the cancellation) of SDRs should require a majority of the Fund's voting power so large as to give Europe a veto.

The United States and the United Kingdom insisted that the new asset would constitute "frontline reserves." The United States urgently needed additional reserves in order to lessen the strain on the dollar. France asserted that it could not be a new currency designed to "replace gold" but merely represented "the possible extending of credit facilities," and eventually decided not to cast a vote for the SDR in the IMF's Board of Governors. The original French version of the plan had been undermined by the alternative American suggestion, and then defeated. Reform became more urgent in the late 1960s, because gold reserves were shrinking – by $2 bn. between 1965 and 1968 (de Vries 1976, I: 210). The IMF staff calculated a need for new

reserves of some $4-5 bn. annually, and this was the basis of the first three year plan for SDR allocation (3.5 bn. then 3 bn. and 3 bn.)

The SDR was approved by the Governors at the twenty-third Annual Meeting in 1968, and the amendment to the Articles of Agreement came into force on July 28, 1969. The purpose of SDRs (Article XXIV, Section 1(a)) was stated as follows: "In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world."

The intense and highly politicized debates that preceded the creation of the SDR ensured that the new instrument was surrounded by a protective web of regulations. It had no backing, and it did not represent a claim on any other asset. It could be regarded as the first international currency to be created in the manner of a national paper currency--purely through a series of legal obligations to accept it on the part of members of the system. As a result, it was widely suspected as "funny money." SDRs were administered as a separate account in the Fund. Each member was entitled but not required to participate in the scheme. The provisions creating the SDR made an allowance for the fact that SDRs would not be viewed as a desirable reserve. A limit was placed on the obligation to accept SDRs to meet the fear that with only a limited number of holders (participants in the SDR facility and other members and nonmembers approved by the Executive Board of the IMF), and no private holders, it could not be flexibly used in the way often required of reserves. The "designation" mechanism, by which the Fund staff would determine by means of a formula which creditor country was in the best position to provide its currency in return for SDRs, represented a further recognition of the probable

unpopularity of the new instrument. Each participant designated to do so was obliged to provide convertible currency in exchange for SDRs, but only up to three times its net cumulative allocation. A participant would be designated to supply currency if it had a strong balance of payments and reserve position; and a designation plan would be drawn up at quarterly intervals. Countries were expected to use SDRs only to meet balance of payments needs and not to change their reserve composition (for instance by removing the SDRs, or swapping SDRs for dollars). In accordance with the French preference, SDRs used in this way bore a resemblance to a credit, rather than to a reserve, in that they had to be partly repaid over a fixed time period (while if a country sells its gold reserves, or any other reserve asset, it is under no obligation to repurchase them). There was an obligation to make repayments-to "reconstitute" the SDR holding so as to maintain over a five-year period an average daily balance. The time horizon of five years for SDRs was in this way made compatible with the longest period permitted for the Fund's stand-by assistance. The word used in the new Article, "reconstitution," rather than repayment or repurchase, was chosen to make the reserve element as clear as possible and to camouflage the partial credit element implied in the instrument. The SDR was linked to gold, with a value identical to that of the U.S. dollar (until May 1972), and bore an interest rate of 1.5 percent (again emphasizing the partial credit element: this was lower than prevailing interest rates, while gold reserves obviously carried no interest).

The equivalence of the SDR to the dollar at the beginning created a notional value of 0.888671 grams of fine gold. In May 1972, the devaluation of the dollar created an exchange rate of $1.08571. With generalized floating after March 1973, the old valuation system looked inadequate, and in June 1974 the SDR was recalculated to be based on a standard basket of 16 currencies, selected because they had an average share of world trade in goods and services of

over 1 percent in the five year period between 1968 and 1972. In 1978, the Danish krone and the South African rand were eliminated from the basket, and replaced by the Saudi Arabian riyal and the Iranian rial. But since this move was quickly followed by the Iranian revolution, the whole process looked increasingly absurd and in January 1981 a new simplified basket was introduced with just the G-5 currencies. But the weight depended on current valuation, so as the dollar rose in the early 1980s on foreign exchange markets, the share of the dollar in the basket rose from 43 to 56 percent by February 1985. The new system provided for a five year review, and in 1986, the share of the dollar was reduced (Boughton 2001: 951-953).

In the long run, however, the disappointing history of the SDR, and its failure to emerge as a genuine major international reserve unit, was fundamentally not a consequence of the interest rate limitations or of the reconstitution requirement, which were respectively modified and dropped. The problem of the SDR was twofold: first, the issue of the international currency was controlled through the voting requirements that had been an essential part of the difficult compromise about the new reserve unit. As a result of the 85 percent stipulation, a relatively small number of countries could block new issues, and thus obstruct the emergence of the SDR as a reserve currency. As a result, the innovative proposals made several times during the 1970s that the SDR could come to replace national reserve currencies (and particularly the dollar) never materialized. It was the private capital markets that created increasing levels of dollar reserves, and at very much faster rates in the early 1970s. After 1971, it was in fact really hard to argue that there was anything like the shortage of reserves stipulated in the amended Articles of Agreement.

Secondly, a synthetic currency whose potential ownership was so excessively restricted could not really be expected to play a major role in the process of reserve-building through

private sector credit operations. Although it was possible to devise a private currency composed in exactly the same way as the SDR basket, the result was not an SDR; and the number of currencies in the basket after 1974 and the process of recalculation made the result unattractive. It was only after 1981 that the five currency basket offered a more attractive model for emulation; and the 1981 reform was indeed followed by a small surge in SDR-denominated private deposits and bonds.

IV. THE ECU

The problems of the gold market in the later 1960s drove the discussion of new types of artificial or synthetic currencies, and the debate over the role of the SDR in the international order spilled over into a consideration of a new European unit of account. The Europeans attempted to duplicate something in between the IMF and the Federal Reserve System on a European level.

Since 1950, when the European Payments Union was established, there had been a calculation of a European Unit of Account (EUA), originally defined as the equivalent of a dollar (Blondeel 1964). The calculation only became problematical after August 15, 1971, and the depreciation of the U.S. dollar against gold. The EUA was defined in terms of gold, at the old value of the dollar (0.088867088 gram of fine gold). But a debate inevitably started on whether this was the best way of basing the highly politically charged calculations about EEC financing, about the Common Agricultural Policy, or about exchange rate behavior.

The EUA was at the heart of the tenth report of the Théron group of European central banking experts in 1973, drawn up as the Committee of Governors of the Central Banks of the Member Countries of the EEC finalized their proposals for the creation of an international store or measure of value. (Théron Group 1973) It was intended not only to facilitate the initial tasks

of a financing mechanism for short term currency support in Europe, but also to "prefigure the future European money." But the experts could not decide on whether the unit of account should be fixed in terms of gold or reflect a composite currency based on EEC currencies. The Théron group laid out as alternative options, first, a gold based unit (so that it might be also used for the IMF's SDR), which would be only indirectly linked to the value of EEC currencies. This path was problematical since the role of gold in the international monetary system had not yet been defined. Secondly, Europe might adopt a basket currency, which would require potentially a cumbersome and continuous series of adjustments. Within the basket approach, there were several alternatives in terms of choices of weight, and the experts warned about the "complexity" of that approach. The question of a definition of money was debated in terms of principles: either "stability", which was supported by the Commission, and would correspond to a worldview in which there should be little movement of exchange rates; or "representativity", tracking the developments of the separate currencies.[1] At one point in the Governors' discussion, Sir Leslie O'Brien, Governor of the Bank of England, had argued (rather unrealistically) that the SDR would replace gold as the international standard, but he was promptly contradicted by Bundesbank President Karl Klasen, who pointed out that the SDR did not conform to an idea of stability, and that the intense debate about a "link" of the SDR with development showed that the synthetic international money would be very likely to become highly politicized.[2]

At the same time, there were obvious objections to the simplest option, of basing European currency developments around an existing currency. The French central bank governor Olivier Wormser in January 1973 as Chairman of the CCBG had laid down very clearly the principle that the numeraire of a new international monetary order should not be any

[1] CCBG Meeting 68, March 12, 1973, Basel, discussion of tenth Théron report.
[2] CCBG Meeting 64, November 11, 1972, Basel.

national money.[3] This was a comment directly aimed at the global position of the dollar, but it could be equally interpreted as a critique of any claims for a new anchor currency role for the Deutschemark. The discussion also foundered on the problem of how intervention obligations should be distributed between the countries and central banks.

The term European Currency Unit appears to have been first used by Commission President François-Xavier Ortoli, who told a New York audience in September 1974 that he wanted "a new monetary unit, which we could call ECU, as the Latin countries would quickly be familiar with this now defunct continental currency, while the Anglo-Saxons would be happy to see the English initials of the 'European Common Unit' for the common European currency." (Ortoli 1974) Also in September 1974, French Finance Minister Jean-Pierre Fourcade proposed a Community credit mechanism, a European unit of account, an exchange rate system with wider fluctuation margins, and coordinated action on the Euromarkets. The most innovative part of the proposal was that intra-Community fluctuations should be fixed relative to a new European Unit of Account, based on a basket of currencies. The EEC could then have its own collectively determined policy toward the U.S. dollar. (Mourlon-Druol 2010) At first, there seemed to be a political consensus about this new basket currency. On April 1975, there was an agreement at the European Council to establish the European Unit of Account, and Fourcade claimed that within five years the EUA would be, along with the SDR, the major means of international payments.

The new initiatives being discussed were aimed at making the EUA the major European reserve medium. This idea was consistently opposed by the Deutsche Bundesbank. In 1978, a Bundesbank paper argued that these suggestions were not "well thought out" as there were no existing attractive instruments for the holding of EUAs; but that an attractive ECU would

[3] CCBG Meeting 66, January 8, 1973, Basel.

provide competition for the dollar and might embarrass Europeans by producing a further decline in the dollar exchange rate; and, if another scenario should materialize, a weak EUA would necessarily focus even more unwelcome attention on the DMark as an investment currency. [4]

The European Council meeting at Bremen on July 6-7, 1978, spelled out a much more detailed version of proposals for a European Monetary System that would reach beyond the rather limited "Snake" of currencies closely aligned with the DMark that had first been adumbrated by French President Valéry Giscard d'Estaing and German Chancellor Helmut Schmidt. The central institution would be the new European Monetary Fund, which would be established within two years, though the Snake would continue to exist; and "concurrent studies" would examine ways of improving the situation of poorer member countries so as to make their membership in a coordinated monetary system an economic and political feasibility. The "Bremen Annex" which contained the detailed proposals specified that the ECU would be at "the centre of the system." It began with the observation that: "In terms of exchange rate management the European monetary system (EMS) will be at least as strict as the 'snake'." The Annex closed with an appeal for monetary stability: "A system of closer monetary cooperation will only be successful if participating countries pursue policies conducive to greater stability at home and abroad; this applies to deficit and surplus countries alike." An initial supply of ECUs would be created against deposits of gold and dollars, at a level corresponding to 20 percent of the existing stocks of member central banks.

Again this proposal attracted some hostility from the German central bank. Bundesbank technicians set to work in order to produce an alternative to ECU-based exchange rates, in which the key to the exchange rate system would be a parity grid. Many in the Bundesbank regarded

[4] Deutsche Bundesbank archive N2/K26 (13), April 14, 1978, Karl Otto Pöhl to members of Central Bank Council, with memorandum.

commitment to a parity grid as inflationary." By contrast, the Banque de France elaborated its proposals for an ECU base, with permitted margins of fluctuation suggested at 1 percent.

On July 18, 1978, there was a clash in the Monetary Committee, when the German representatives Manfred Lahnstein and Karl Otto Pöhl opposed the idea of expressing central rates in ECUs; and at the Finance Ministers' meeting of July 24, when Germany expressed its preference for a parity grid, and Britain and Italy wanted ECU-based central rates.

The reconciliation took place in both the EEC Monetary Committee and in the CCBG, with the presentation of what became known as the "Belgian compromise". The Monetary Committee discussed on August 11 and 12, and on August 21, the CCBG Heyvaert Group came up with a "compromise between the basket and grid variants."

But the compromise was heavily weighted in favor of the parity grid approach. The Heyvaert report emphasized the disadvantages of the basket, in particular that it "complicates the choice of intervention currency or currencies and raises controversial issues regarding the application of the rules for the settlement of debts arising out of interventions." The parity grid offered the advantage that it was "impossible for one currency to reach its upper or lower limit without simultaneously reaching its opposite limit." Parity changes in one currency vis-à-vis the numeraire did not require parity changes in other currencies. There would be none of the definitional questions associated with non-participation or opting out that the basket approach would pose. The compromise involved establishing a grid based on the ECU. As in the case of the Snake, the need for bilateral interventions could be derived from central rates. The ECU base, however, would allow the identification of a divergent currency by treating movement against the ECU as an objective indicator of divergence.

The core of the system became an "Agreement Between the Central Banks of the Member States of the European Economic Community Laying Down the Operating Procedures for the European Monetary System." On December 12, 1978, in Basel, the EEC Governors agreed to recommend to the Council of Ministers to use the existing central parities of the Snake, and to derive central rates for the new EMS members from the rates at 1430 on December 29. The ECU was to be the center of the system, as a numeraire, as a basis for calculating divergence, as the denomination of claims and liabilities arising from central bank interventions, and as the means of settlement between the EEC monetary authorities. It was to be re-examined every five years, or whenever there was a serious change (defined as more than 25 percent) in the weight of any currency. EMS central banks were limited in their reserve policy, and could only have "small working holdings" of other EMS currencies unless they had the approval of the issuing bank.

One large country, the United Kingdom, remained outside the EMS. Another, Italy, was now inside, but with a special regime of wider (six percent) fluctuation margins. But both currencies were part of the calculation of the ECU basket, which made the operation of the divergence indicator additionally complicated, requiring the periodic use of a "correction mechanism," and in practice brought its marginalization.

By the mid-1980s, many Europeans were congratulating themselves on the success of their system, and the development of a private market in ECUs. Bank credits in ECUs had risen by 80 percent from December 1983 to June 1984. (Lomax 1987; Wilson 2006).[5] The EEC, the European Investment Bank, Euratom and the ECSC all launched ECU bonds. The ECU clearly at this point overtook the other international artificial currency, the SDR, where the use was

[5] Bordo and Schwartz (1988) were sceptical of the ECU's long-run success. They referred to it as 'imaginary money' in analogy to the medieval "ghost monies'.

restricted through the absence of any official support. At the end of December 1981, there was an estimated 300 m. in ECU bank deposits, but by June 1985 there were 33,342 m.; by contrast, the volume of SDR bank deposits had contracted from an estimated 10-14,000 m. to 1,666 m. (Roushdy 1987: 39).

By the early 1990s, this sentiment was close to euphoria. One of the great successes of increased monetary cooperation in Europe was generally thought to be the increased private use of the ECU, which could be read as a measure of market acceptance of the idea of monetary union. Euro-notes and commercial paper denominated in ECU had been expanding steadily since the mid-1980s, with a 50 percent increase in the twelve months to September 1991.

But hubris was followed by nemesis. The EMS/ERM exchange rate crisis that broke out in September 1992 produced a contraction, with a 20 percent fall in these securities outstanding, to 8.6 bn. ECU in September 1992. In the intense period of the crisis, an interest rate premium developed in the short-term market, reaching 200 basis points on the worst days, as the idea of a synthetic currency came to be regarded as suspicious in the context of a market panic. In a moment of crisis, such as the speculative attacks of September 1992 to July 1993, market participants moved out of particular currencies, but also out of the basket currency (since it contained the currencies under attack). In any case, a currency with a clearly defined issuer – a sovereign state – seems to be a simpler and less vulnerable product, and hence is more attractive in times of financial stress.

V. Conclusion

The European solution could only offer the possibility of holding out a solution to the reserve dilemma when it became a real currency – in 1999 – as a consequence of monetary union. Even

after that, doubts about attempts to unmake the omelette and separate the component bits of the currency occasionally emerged.

There are, in the long run, only two answers that will make the world's currency difficulties and dilemmas disappear. One is that countries will gradually recognize that they need a lower stock of reserves**.** Freely floating exchange rates obviate the need to hold international reserves. The adoption of such an exchange rate policy however in turn requires deep and liquid financial markets, the absence of capital controls and exchange market intervention and the pursuit of stable and credible monetary and fiscal rules. These preconditions require the financial development that most emerging countries have not yet attained. The current pile up of reserves in many emerging countries was a result of the Asian crisis of 1997-8, in which apparently strong countries suddenly became vulnerable to reversals of market sentiment. As crises fade into a distant past, more countries might convince themselves that they do not need reserves. But that time is not now. The experience of the current turmoil shows precisely that they are still needed, and that countries cannot always have access to capital markets to finance themselves in an emergency.

The second possibility is equally remote at present: it is the application of the European answer of 1999, monetary union, on a world level (Bordo and James 2006)**.** This would instantly make the reserve issue completely irrelevant. But it would require the abandonment of a major component of sovereignty, the monetary policy tool, as well as a move towards global economic integration by every country – including the United States, which shows every sign of being resistant to such a move.

As long as there is no obvious and catastrophic dollar crisis, the U.S. position will not change.[6] But a major dollar crisis is actually also difficult to imagine, even with the ballooning of the U.S. deficit, the possibility of a softer Federal Reserve policy, and the pile up of long-term debt as a result of an ageing population .[7] The world looks to the dollar because it is the largest and most liquid market of the world, and because of its political security. Almost everyone, including many Americans, agree that the international role of the dollar is a terrible solution to the world's currency problems. It is just that every alternative is even worse.

References:

Alessandrini, Pietro and Michele Fratianni (2009), "Resurrecting Keynes to Stabilize the International Monetary System", *Open Economies Review*, Volume 20, Number 3.

Blondeel, Jean L. (1964), "A New Form of International Financing: Loans in European Units of Account," *Columbia Law Review*, Vol. 64, No. 6, Jun.

Bordo, Michael D. and Harold James (2006), "One World Money, Then and Now", *International Economics and Economic Policy* 3, December, 395-407.

Bordo, Michael D. and Harold James (2010), "The Past and Future of IMF Reform," in Charles Wyplosz (ede), *The New International Monetary System: Essays in Honor of Alexander Swoboda*, Routledge International Studies in Money and Banking, London.

Bordo, Michael D., and Anna J. Schwartz (1988), "The Ecu—An Imaginary or Embryonic Form of Money: What can we learn from History?" in Paul DeGrauwe and Theo Peeters (eds.) *The Ecu and Monetary Integration*, MacMillan, London.

[6] Some interim solutions might include the development of the IMF as a manager of assets in lieu of conventional reserves (Bordo and James 2010).

[7] For a less optimistic view see Eichengreen 2011.

Bordo, Michael D., D. Simard and E.N. White,(1995), " France and the Bretton woods International Monetary System. 1960 to 1968" in Jaime Reis (ed.) *The History of International Monetary Arrangements***,** MacMillan, London.

Boughton (2001), James M., *Silent revolution : the International Monetary Fund, 1979-198* , Washington, DC : International Monetary Fund.

de Vries (1976), Margaret Garritsen, *The International Monetary Fund, 1966-1971 : the system under stress* , Washington, D.C. : IMF.

Eichengreen, Barry (2011) *Exorbitant Privilege, the rise and fall of the dollar and the future of the international monetary system*, Oxford University Press, New York.

G10 (1965), Group of Ten Study Group on the Creation of Reserve assets, May 31, 1965.

IMF (1964), Annual Report.

IMF (2010), Reserve Accumulation and International Monetary Stability, April 13, 2010.

James (1996), Harold, *International monetary cooperation since Bretton Woods*, Washington, D.C. : International Monetary Fund : New York : Oxford Univ. Press, 1996.

Lacouture (1992), Jean, *De Gaulle* Vol. II, New York: Norton.

Lomax (1987), David, "New Products and Instruments in Financial Services," in (eds.) Ugur Mildur, Olivier Pastré, *Europe and the Future of Financial Services*.

Mourlon-Druol (2010), Emmanuel, "The Emergence of a European Bloc? A Trans- and Supranational History of European Monetary Cooperation, from the Failure of the Werner Plan to the Creation of the European Monetary System, 1974-1979," EUI PhD thesis.

Mundell (2009), Robert, "Financial Crises and the International Monetary System."

Ortoli (1974), François-Xavier, Speech in New York, September 26, 1974: "The Personality of Europe and Economic and Monetary Union."

Peyrefitte (2003), Alain, *C'était de Gaulle*, Paris: Galliard .

Roushdy (1987), Juanita, *The Role of the SDR in the International Monetary System*, Washington D.C.: International Monetary Fund (Occasional Paper, No. 51).

Skidelsky (2000), Robert, *John Maynard Keynes : a biography*, Vol. III. London : Macmillan, 2000.

Théron (1973), Report No. X.

United Nations (2009), Report of the Commission of Experts and of the President of the United Nations General Assembly on Reforms of the International Monetary Financial System, September 21, 2009.

Wilson (2006), Jérôme, "De la creation d'un marché international des capitaux á l'unification monétaire de l'Europe: Une initiative belge et privée," in (eds.) Eric Bussière, Michel Dumoulin, Sylvain Schirmann, *Milieux économiques at intégration euopéenne au XXe siècle: La crise des années 1970*, Brussels: Peter Lang, pp. 69-85.

Xiaochuan (2009), Zhou Governor of the People's Bank of China, "Reform the international monetary system,**"** 23 March 2009, http://www.bis.org/review/r090402c.pdf.

Yongding (2009), Yu, "Some Thoughts on Current International Financial Crisis and EastAsia's Responses," IWEP, CASS, Jan.20, 2009), http://www.un.org/ga/president/63/commission/roadmap_yongding