Miss Bourneuf
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Mr. Goldenweiser "Rules of the Game"

Mr. Haberler

Attached you will find some reflections on the "Rules of the Game". The memo is rather unsystematic and negative, I am afraid. But before putting more work into the matter, I should like to have some reactions on what can be considered acceptable for discussion. Not having participated in the discussions with the British, it is hard to judge. Many points not touched upon in the final draft agreement must have been discussed and eliminated.

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The Rules of the International Monetary Game

I.

I assume first that commercial policy and domestic monetary and fiscal policies are left out of the picture. It that is done, it seems to me that very few useful rules can be laid down apart from those which are already contained in the latest draft of the Keynes-White plan. (See Mr. Gardner's memo of November 2) But a few useful rules could be formulated which might be acceptable and would, if adhered to, improve the functioning of the international monetary mechanism.

The most important complex of such rules is connected with the introduction, operation and liquidation of a gold exchange standard.

It is conceivable that the introduction of gold (or dollar or sterling) exchange standards would facilitate the restoration of the international money mechanism. After the last war, gold exchange standards were introduced by a number of countries. Later the brusque liquidation of these standards, following the losses which the devaluation of the pound sterling inflicted on the countries that held balances in London, became a very disturbing factor.

It seems to me that the following rules might be acceptable and useful:

(1) No country (central bank, treasury, perhaps some provisions concerning commercial banks could be added) should operate an exchange standard without consultation and consent of the country in

which reserves are to be held. Such a rule would prevent the piling up of balances against the wish of the country where they are to be held. It is conceivable that the United States might find such a rule useful.

(2) A gold exchange standard should not suddenly be liquidated without the consent of the reserve country. Alternatively it may be stated that the latter should be given notice at an early date and that not all the gold should be withdrawn at once.

(3) After the bad experience of the early 'thirties, many countries will be reluctant to operate a gold exchange standard. But it would be very easy to provide machinery to remove the risk of losses through a sudden devaluation of the currency of the reserve country. The reserve country would have to guarantee the gold value (or conceivably the dollar value, if it was on another than the dollar standard) to the "member country". There is hardly an objection against such a provision, because in the absence of such a guarantee it would hardly receive the monetary reserves of other countries. Moreover in view of rule (1) it may decline the honor of functioning as the keeper of the monetary reserves of other countries.

Another set of rules, within the limits set by the principle that commercial policy and domestic monetary and fiscal policies should not be touched, concerns the principles of operation of exchange control. Exchange control for other purposes than the control of capital movements is ruled out by the plan for an international fund itself. But the control of capital movements is foreseen and it would perhaps be useful to lay down certain rules of management of such control.

Negative rule: No discrimination between countries.

Positive rule: Since it may not be feasible or desirable to exclude all capital movements a preference list of types of claims might be laid down, that is an order in which claims of different kind should be transferred. Such an order may look as follows:

(a) Interest and dividends

(b) Regular short-term commodity credit

(c) Repayment of long-term loans

(d) Stock exchange credit,

etc.

II.

The rules discussed under I may not be very important. They certainly would not prevent maladjustments in the current balance of international payments, although they may make it a little easier to deal with them. If we want to achieve more we must go beyond the limitations set by the postulated inviolability of commercial policy and domestic monetary and fiscal policies.

With respect to commercial policy, I wonder whether it might not be useful to lay down the rule that measures of commercial policy should not be used for monetary purposes. More specifically, new duties, increases in existing duties, quota restrictions and other impediments to imports should not be used for the purpose of making the balance of payment more favorable and obviating a depreciation or a loss of gold or foreign balances or a restrictive credit policy.

It is, of course, possible to object that such a rule would be (a) either too far-reaching and therefore inacceptable, or (b) too vague and hence useless:

(a) The introduction of new or higher duties and of new or tighter quotas has always a favorable influence on the balance of payments and would therefore be ruled out, if our rule were interpreted literally. That would be clearly inacceptable.

(b) If the intention were stressed rather than the actual effect, a country could always pretend that its intention was not an improvement of its balance of payment, but the protection of a particular industry or of particular producers.

I believe, however, that the objection goes a little too far. There have been in the past flagrant cases which would have been ruled out by the proposed rule. It would at least do no harm, if such a rule was stated.

If it is permitted to say something concerning domestic monetary and fiscal policies a much wider field for the formulation of useful rules is opened.

What we wish to achieve with these rules is to avoid chronic deficits in the current balance or even temporary deficits which are too large to be easily handled by the international fund with the resources at its disposal -- deficits which are not covered either by gold exports from current gold production or by capital imports for purposes of economic development of a country. (I realize that the formulation of the second qualification is not quite satisfactory. But if it is clear what is meant, it will be possible to find a better, unambiguous formulation).

It will be useful to give a fairly complete list of reasons that may cause a strain on the balance of international payments of a country and then investigate which disturbances could be avoided by the observance of some simple rules. A country may lose gold or foreign balances for the following reasons:

(1) Capital exports.

(a) Long-run capital outflows securing higher returns abroad.

(b) Short-run (A) higher return abroad

(B) greater securities abroad (capital flight)

(2) Domestic policy of expansion or inflation.

(a) Reemployment expansion with little or moderate price rise = "expansion".

(b) Expansion after substantial full employment has been reached = "price inflation"

It is usual now to make a sharp distinction between "inflation" and "expansion". But it should not be overlooked that it is not easy to make the distinction clear cut. There is always some unemployment and in the process of an expansion prices begin to rise long before unemployment has disappeared.

(3) Increase in import demand, due to crop failure, tariff reduction, accidental circumstances.

(4) Rise in imports and/or fall in exports due to long-run shifts in relative competitive situation, changes in relative efficiency.

(5) Fall in exports due to higher tariffs and other protectionist measures abroad.

(6) Fall in exports due to depression abroad.

In theory the distinction of these cases would seem to be clear enough, but the diagnosis of concrete cases is apt to present difficulties. Different observers are likely to offer different interpretations of the same historical instances and mixed cases where several of the listed causes operate simultaneously may easily arise. This vagueness necessarily reduces the usefulness of rules formulated in terms of these causes. But if such rules are useful in dealing with extreme and sharply defined extreme cases, they will have achieved all we can reasonably expect.

It is difficult to think of rules with respect to the first case above. The plan for an international fund as it now stands envisages the utilization of exchange control to prevent undesirable capital movements. That seems to be a settled matter and hence no additional rules are called for. (But doubts must be raised concerning the wisdom of accepting or xxxx recommending exchange control for the purpose of controlling capital movements. Has sufficient consideration been given to the fact that censorship of the mails and many other supervisory measures are necessary to make such control effective? The outsider can only assume that all these things have been thoroughly discussed.)

It can be hardly assumed that any country would accept an obligation to refrain from expansionary policies if they endanger its balance of payments. Such an obligation or rule would reinstate an

old-fashioned gold standard from which everybody wants to get away.

What might be envisaged, however, is a rule, or rather the expression of a wish in the preamble, to the effect that countries should jointly plan expansionary policies so as to minimize the chance that some of them may get out of step with the others. If in the 'thirties expansionary reemployment policies had been started everywhere at the same time, instead of some countries moving ahead and others lagging behind, many disturbances in the international balance and restrictions on trade, etc., which those disturbances entailed would have been avoided. But I don't think that this subject can be dealt with in the form of "rules of the game". A programmatic statement in a preamble may be a more suitable method for influencing Governments in that direction. Even in case of a simultaneous expansion in many countries some may get out of line as far as their balance of payment is concerned, and lose gold. But in that case the gold loss would be temporary. It could be regarded with greater equanimity and more easily financed out of liquid reserves, making use of the resources of the international stabilization fund.

I doubt the usefulness of rules to the effect that outright price inflations (or government deficits or monetary [credit] policies producing or permitting such an inflation) which cannot be justified as an anti-depression measure, should be avoided.

Cases 3, 4 and 5 obviously cannot be dealt with by simple rules, except in so far as commercial policy is involved and rules concerning commercial policy are acceptable. Case 6 has been discussed above in connection with case 2 of which it is the obverse.

The results of this discussion are somewhat negative. It seems impossible to lay down simple rules the observance of which would prevent the rise of deficits in the balance of payments. It may be more useful to look into the question of how to deal with such deficits once they have arisen.

III.

We may distinguish four or five different ways of dealing with a balance of payments deficit:

(1) Cover the deficit with gold or foreign balances or credit. This requires the provision of large liquid reserves -- gold, foreign exchange or reciprocal credit arrangements.

(2) Price and income contraction in deficit country -- price and income expansion in surplus country. This is the orthodox gold standard method.

(3) Currency depreciation in deficit country and appreciation in surplus country.

(4) Measures of commercial policy -- increase in tariffs and tightening of quotas in deficit country and the opposite in surplus countries.

(5) Exchange control which is very similar to (4), but permits sharper discrimination.

Inasmuch as the chief purpose of the proposed monetary agreement is to outlaw some devices of exchange control or to make it unnecessary for countries to resort to (4) and (5), there is no use in introducing rules concerning these two methods of dealing with deficits in the balance of payment.

The first method mentioned above -- provision of large liquid reserves, is being utilized by the proposal for an international fund. Its most important function is to supplement the existing gold stock by international credit lines. But it might be asked whether rules could be formulated to encourage further credit arrangements between the central banks of different countries beyond and outside the resources of the international fund. I should like to refer to what was said in section I concerning the encouragement of the introduction or more extended application of a gold exchange standard.

Rules which recommend price and income contraction in the deficit countries are hardly acceptable. On the other hand rules urging the surplus countries -- "creditor countries" -- to play their part by expansionary policies, or, negatively formulated, to refrain from sterilising inflowing funds should be more acceptable. The original Keynes plan stressed that matter very strongly and tried to provide incentives for the surplus countries to take the necessary steps. The matter must have been discussed with the British experts and I should think that it would be in vain to try now to reopen the discussion by formulating rules on this subject. But a rule against sterilization policies pursued by surplus countries would be useful.

Currency depreciation, or more generally changes in the exchange rate, as a method for dealing with disequilibria in the balance of payment, is mentioned in the body of the draft agreement.

As the draft stands now the intention seems to be to leave the matter to the discretion of the board of directors of the international fund. Hence to draft rules concerning the matter would imply changing rather than supplementing the existing draft agreement. But I personally would recommend a more liberal use of depreciation in preference to methods (2), (4) and (5).

Appendix

As examples of rules concerning the operation of an exchange standard the monetary agreements entered into by Great Britain on the one hand and France, Belgium and the Netherlands on December 12, 1939, June 10 and 17, 1940 respectively, may be mentioned. Mr. Knapp drew attention to this precedent. (See his memo of April 20, 1942.) Being wartime agreements between allies they stipulate much closer collaboration than would be acceptable in peace time. But the guarantee against any loss arising out of changes in their exchange rates which they afford the party accumulating balances in the other party's currency seems worth consideration. The agreements provide that in case of a change in the relative value of the two currencies, each party must eventually redeem the balances in its currency accumulated by the other party at the rate prevailing when the balance was acquired. (See Mr. Knapp's memo. p. 4) Also the provision that balances exceeding a certain level can be converted into 3 per cent Treasury bills should receive attention.

Similar provisions have been inserted into the recent Dutch-

Belgian Monetary Agreement. (See text and Mr. Knapp's memo on the contents of the agreement -- General Files.)