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Sir Geoffrey Littler KCB
Second Permanent Secretary

24 February 1988

Dear Nigel,

SUMMIT PREPARATIONS

This is extra reading for the plane journey on Saturday - if you are not already overloaded!

It is a short letter from Balladur to the Chancellor, and it will have been sent in parallel to other G7 Finance Ministers, enclosing a rather well-written French paper arguing for moves towards a system of fixed exchange rates.

I doubt whether this will be brought on to the agenda for the Summit by the French, and I would think it best handled first among Finance Ministers in any case. But there could be some references to it, and I thought you and Rod Braithwaite would like the chance to see a sub rosa copy now.

Yours,

Geoffrey

Nigel Wicks Esq CBE
10 Downing Street.

Le Ministre d'Etat
Ministre de l'Economie, des Finances
et de la Privatisation

22 FEVR. 1988

Mister Chancellor and dear Nigel,

As you will remember, I had sent to you on October 23, 1987, some first thoughts on last year's financial crisis. I insisted, in particular, on the need for a concertation and an international coordination still stronger than had previously been the case.

Owing to the sense of responsibility and cooperation demonstrated by our countries, it has been possible to overcome the difficulties. This was a first result and certainly a very important one, if one considers that we were facing the most serious financial crisis since the second world war.

This success, which naturally has to be consolidated, should encourage us to go further.

In this respect, you will find hereafter a paper on the rebuilding of the international monetary system, which I intend to make public very shortly.

As you will observe, it was not my goal to outline a detailed draft of reform, but rather to suggest that we start now thinking about it, with no solution being excluded, in an open and pragmatic mind.

In this prospect, I propose that we agree on the constitution of a small group of eminent personalities, with undisputed moral authority and having demonstrated their capacities in the economic, monetary and financial fields.

In any event, I propose that we discuss this subject together, in Washington, during our next meeting of April 13, [illegible]

Please accept my best regards.

E. BALLADUR

22 février

REBUILDING AN INTERNATIONAL MONETARY SYSTEM

Since the 1960s, the world's industrialized countries have gradually abandoned the discipline of stable exchange rates based on the gold exchange standard in favor of floating exchange rates.

That system has been a failure. In the final analysis, proving devoid of discipline or constraints, much too tolerant of poorly managed economies, and ultimately harmful for the world economy. Floating exchange rates are probably one of the essential causes of the economic disorders of the past 15 years : variations in the price of oil and raw materials, trade imbalances, financial anarchy brought about by international speculative capital flows, indebtedness.

The merits attributed to floating exchange rates in the early 1970s have not been borne out :

- When they were introduced, it was said that balance of payments adjustments would be facilitated, but not only have imbalances not disappeared, they have become worse.

- It was thought that speculation would be curtailed. On the contrary, never has it assumed such proportions nor had such destabilizing effects.

- It was believed that market forces, at last left to their own devices, would determine the correct exchange rate balance. But never have imbalances been so great, nor fluctuations so wide and erratic and so little justified by economic fundamentals.

- It was hoped that autonomy in economic and monetary policy would be preserved, allowing each country free choice of its monetary policy and rate of inflation. Facts have cruelly belied this illusion.

Those countries with primary responsability for the world economy now recognize the need for international cooperation. Last year's Louvre Agreements marked the beginning of the end of the floating exchange rate system. Concluded a year ago this week, by the U.S. Japan, France, Britain, West Germany, Canada and Italy, they contain two complementary aspects : the coordination of economic policy, and more stable exchange rates.

The seven signatories have agreed to policies aimed at reducing their internal and external imbalances. Thus they are making a contribution to stabilizing their exchange relations, jeopardized by the highly excessive deficits and surpluses that have developed in recent years. Moreover they are ready, if need be, to intervene on exchange markets.

Over the past year, the Louvre Agreements have been reconfirmed and adjusted, as required by economic and market developments. On December 23, 1987, the seven countries published a joint declaration, and agreed upon secret exchange rate clauses. This declaration is really a second Louvre agreement, occurring after the Autumn financial upheavals and containing the measures adopted in response. Economic policy commitments have been adapted and strengthened, including those of central banks.

With Louvre Agreements 1 and 2, the seven major industrialized countries have shown that they agree on the collective management of exchange rates and coordination of their economic policies, in the absence of a true international monetary system. It is thanks to this spirit of responsability and cooperation that it was possible to overcome the recent financial crisis, the most serious since World War II. This represents major progress compared with the situation prevailing two years ago.

Thus a first milestone has been reached on the road to rebuilding an international monetary order, though it rests on the will and ability of governments to impose self-discipline. Beyond this stage, how might one envisage a true international monetary system with a standard unit of value, automatic mechanisms and sanctions that would be beyond the control of the countries involved ? The time is ripe for dispassionate consideration of this issue, since inflation has receded and the Louvre Agreements are working well.

There are three possible approaches. Each has advantages and disadvantages.

INTERNATIONAL COOPERATION

The first approach is a system based on international cooperation building on the spirit of the Louvre Agreements.

Their enforcement requires close surveillance of each of the major economies on the basis of such economic indicators as growth rates, inflation rates, fiscal balance, balance of payments, interest rates and exchange rates. This surveillance already is being established gradually .

It would be conceivable to perfect the Louvre Agreements by strengthening economic coordination, in budgetary matters for example, by strengthening cooperation among central banks, particularly on interest rates, and if need be by publicly announcing ranges for exchange rate fluctuations.I shall not dwell on the advisability of such measures.

A problem arises however in trying to perfect the decision-making mechanism.

The ultimate effectiveness of a system based on international cooperation such as the Louvre agreements rests on the willingness of the participating countries to agree. Would they be prepared to sacrifice some measure of national sovereignty ?

How can one build a system comprising automatic mechanisms and sanctions, the enforcement of which would be beyond the control of individual governments ? There is no doubt that while the Louvre system represents major progress over the anarchy of floating exchange rates, it does not constitute a true international monetary system.

A WORLD EMS

The second possible approach is to build an exchange mechanism similar to the Europeau Monetary System. The EMS, created in 1979, was Europe's response to international monetary disorders and was designed to provide protection for intra-European trade. It offers an illustration of automatic mechanisms and sanctions that could be restored at a world level.

The first feature of an EMS-style world monetary system is a monetary reference unit.

The monetary reference unit of the EMS is the ECU, a weighted average of european currencies, in relation to which all EMS currencies are defined. Similarly, a world EMS would need a basket of international currencies to serve as the standard for the new system. This is not a new idea. The Special Drawing Right or SDR, which was defined in 1974 as a "basket of international currencies", would work well as a world monetary reference unit. The SDR currently contains five currencies : the dollar, yen, pound , mark and franc.

(It should be pointed out that, as in the EMS, a world monetary reference unit would not be used as the main reserve and settlement instrument : national currencies would retain their international role in those respects).

The second feature of an EMS-style world monetary system is an automatic mechanism.

In the EMS, each country is required, to adhere to margins of fluctuation established around the "central" rates defined for each currency. The same would need to apply to a world EMS. Each central bank would have to be ready to intervene on exchange markets to ensure that its currency did not exceed its limits vis-à-vis another currency. This also is not a new idea. The Bretton Woods system included such intervention obligations. (In fact, the fluctuation margins within the EMS - 2.25 % - are the same as the ones authorized by the Bretton Woods system as of December 18, 1971).

The third feature of an EMS-style world monetary system is sanctions.

Each central bank, under the obligation to intervene to maintain the value of its currency, would thus be made to spend its reserve assets or to borrow from its partners predetermined amounts in their currencies if its own currency were subjected to downward pressure. The lowering of exchange reserves would in and of itself be a form of sanction.

Moreover, if a parity realignment were required, it could be made only by mutual consent, and after examining the economic policies followed by all. This could be done under the aegis of , for example, the IMF. Devaluation or revaluation of a currency could not be decided unilaterally. from a unilateral decision. Monetary and economic adjustments would go hand in hand.

Again, there is nothing new about such sanctions in the world monetary system. The Bretton Woods agreements restricted each country's leeway to modify its par value and required IMF authorization for realignments exceeding certain limits.

The advantages of an EMS-style world monetary system, in which a world currency made up of a basket of currencies would be the reference monetary unit instead of the dollar, would be substantial when compared with those of the Louvre system. A monetary unit with universal scope would give the system the beginnings of a standard, which does not exist in the Louvre framework. The automatic mechanisms and the sanctions would be both known to all, and institutionalized, whereas the Louvre Agreements rest on constant appraisal of the "meeting of the wills" of the major countries.

Such a system would not however be flawless.

First of all, it would not provide built-in guarantees against an inflationary drift of all the currencies. Second it probably would contain certain asymmetries similar to those of the Bretton Woods system since a national currency could continue to play a dominant role both as a reserve and a settlement instrument.

In all, while a world EMS would represent major progress over the Louvre system, is it possible to go still further, in the direction of an even more objective system including automatic mechanisms and sanctions beyond the control of governments ?

A MONETARY STANDARD

The third approach is that of a system organized around a standard that would play the role of main world reserve asset.

The historical model for such a system is the 19th century gold standard, under which all currencies were defined on the basis of their gold content. All currencies in the system were freely convertible into gold.

Under a pure gold standard , the first automatic mechanism is that parity fluctuations are maintained naturally, without central bank intervention on exchange markets, within narrow bands defined by the "gold points". International settlements can be made at any time either by purchasing foreign exchange on the exchange markets, or by physically transferring gold. The band within which par values may fluctuate on exchange markets is limited by the two extremes defined by the central rate (the gold content ratio between two currencies), to which is added and subtracted the cost of physically transferring gold.

In the same fashion, the second automatic mechanism is that monetary inflation in each country is a direct function of gold transfers. A country with a large deficit has an unbalanced exchange market ; its gold is gradually transferred to surplus countries. The contraction of a nation's money supply - directly linked to the stock of gold at its central bank - leads to recession and lower prices. The counterpart to this contraction in surplus partner countries is credit expansion due to the inflow of gold which leads to a higher level of activity and prices. Thus the competitiveness of the deficit country rapidly improves and its foreign trade balances out.

If such a system were applied today, countries with large deficits would be driven to important changes in their monetary policies and therefore in the level of their economic activity, surplus countries would be led to reverse changes. The gold standard -along with its automatic mechanisms and sanctions would be objective and beyond the control of governments and monetary authorities, who would be obliged to adapt their policies, on the basis of the results of their balance of payments.

Let us be realistic. The actual operation of the gold standard was in fact far more complex than the short summary just presented - in particular each country could always try to circumvent the discipline of the system by modifying the gold content of its own currency. This model of the gold standard would today give rise to very serious problems of enforcement. First the amount of gold available today depends on the gold producing countries, which are in a position to determine quantities and prices, and which do not necessarily share the values of the Western world. Second although the gold standard, in its purest sense, implies free convertibility into gold, internally as well as externally, no central bank today would be ready to restore the internal convertibility of its currency, a policy that was abandoned beginning with the 1930's. Finally, in every country today there is a consensus to limit inflation as much as possible. It would be difficult to implement a system that uses price increases in countries with surpluses as the major factor in restoring external equilibrium.

Once again, let us be realistic : no Central Bank is willing to relinquish its gold reserves. That proves how important holding gold still is to governments. Furthermore, gold is still valued by the market. In spite of the difficulties mentionned above , is it possible to rebuild a true system without allowing gold to play a role ? I for one do not believe so.

Could we today establish a monetary standard, automatic mechanisms and sanctions that would be just as objective and independent of governments ?

There are two possibilities : an objective standard, comprising gold and if it is possible commodities (a suggestion made last year by the U.S Treasury Secretary, James Baker) or a world currency based possibly on a basket of currencies to which gold might be added. Studies by the Committee of Twenty at the beginning of the 1970s could serve as inspiration. The Committee considered how to devise a reserve instrument with constant real value, in other words an instrument that would be revalued every year on the basis of world inflation.

What about automatic mechanisms ? One possibility would be to let the standard to act as the main world reserve asset. For that to be possible, it would be necessary for each national currency to be convertible into the world currency at a fixed exchange rate. Settlements among central banks would be made by transferring the world currency, the reserve asset held by each national central bank and the central reserve asset of the system.

What sanctions would apply ? The automatic mechanism would include its own sanction, as the system based on the gold standard. No country could remove itself from the external constraint, since all countries would have to maintain their solvency in the world currency.

If such a system was already in existence countries with external deficits would have lost their reserves of world currency. They would have to replenish their reserves to become solvent again and thus would be forced to adjust their economic policy, or failing that, their exchange rate in agreement with their partners. The latter should of course be exceptional. Technical modalities could make it possible to have a symmetrical constraint on surplus as well as on deficit countries.

Such a system - with a stable world currency as the main instrument of reserve and settlement - would have three advantages over a world EMS : it would be more objective, more automatic and more symmetrical.

Its disadvantages would be related to the difficulties of implementation - the technical difficulty of defining a world currency and its rules of issuance and convertibility, and the very serious political difficulty of making it acceptable to all participating countries. The system would imply that the new standard of reference and value would gradually be recognized and accepted by all, so that governments and monetary authorities could not depart from it without being called to order, not only by an international body, but also by their own economic agents.This raises the whole problem of internal convertibility.

When all is said and done, will not the choice among these three approaches, which introduce an increasing degree of constraint into national economies, depend above all on the degree to which each country will be willing to join in international cooperation and relinquish national egotism ?

None of these three approaches is intended as a definite plan for reforming the international monetary system. But I think that the leaders of the major economies now have the duty to ponder the system best adapted to today's world. In this area as in others, it is the duty of decision-makers to prepare for the future, by studying all possible solutions in an unbiased manner.

Money is at the heart of all the political and social problems. It must not be handled solely by specialists. It is also a matter of policy.

How is it possible not to see the extent to which the Western World has been weakened over the past 15 years, by the monetary and economic disorders caused by the refusal to accept a common discipline ? How is it possible not to see that the economic crises we have suffered, inflation, indebtedness, fluctuations in the price of oil and raw materials, are bound up with monetary disorders ? How is it possible not to fear that these disorders may lead to political and social turmoil in all countries, be they industrialized or developing, turmoil that could alter the balance of the world ?

Inflation has been largely brought under control in the main industrialized countries. Thus, for the first time in fifteen years, this prerequisite for the restoration of an international monetary system has been fulfilled.

I would like the governments to work together to find answers to the questions I have put forward here. I would like us to do so with the greatest of caution and realism but also, with imagination and boldness. That is why I propose that the international community entrust a small group of distinguished people of unquestionable moral authority who have proven their economic, monetary and financial competence with the task of lighting our way.

The point is not to resuscitate an ideal state that has never existed. Order and freedom go together. Economic freedom will have little hope for the future unless it is based on a world order accepted by all and binding for all.

Handed round at Sherpa's meeting on 29 Feb.

NEXT MILESTONES

March 9-10	EPC WP III
March 18-20	Lake Konstanz Trade Mins.
March 21-25	Paris Club
March 22-23	EPC WP I
April 6-7	OECD S-T Forecasters
April 7-8	OECD Trade Committee
April 14-15	IMF-IBRD Meetings
April 15-17	Trade Mins Quadrilateral
April 24	French Elections - 1st round
April 28-29	OECD EPC
May 2-3	OECD ECSS
May 8	French Election - 2nd round
May 18-19	OECD Ministerial
May 19-21	3rd Sherpa meeting (Paris)