How Have Multiple Reserve Currencies Functioned in the Past?

Why were the Rules-Based Adjustment Indicator and the Substitution Account abandoned in the past?

Catherine R. Schenk
University of Glasgow
Catherine.schenk@glasgow.ac.uk

Prepared for 'The International Monetary System: old and new debates', sponsored by the Reinventing Bretton Woods Committee
Paris, December 2010

Summary

- Sterling operated as an important secondary reserve currency during the Bretton Woods period, comprising over half of the reserves of 35 economies as late as the 1970s. The competition between sterling, the US dollar and gold was considered destabilising, with portfolio shifts threatening exchange rate stability and international liquidity. This threat prompted collective action to support the role of both the dollar and sterling in the international monetary system while an alternative international reserve asset was debated from 1959-67.

- The effort to replace national currencies as international reserve assets was a failure. The SDR did not achieve this goal, nor did it prolong the pegged exchange rate system as it was intended to do. Instead, both gold and sterling gradually receded in importance as international reserve assets, leaving the dollar dominant by the early 1970s.

- The diversification of reserves by many countries from sterling to the US dollar did not take place naturally in response to market forces. The process was carefully managed by G10 central banks in cooperation with holders of sterling. **Three Group Arrangements were signed providing overlapping lines of credit amounting to the equivalent of c. £120 billion today.**

- The G10 Group Arrangements to manage the diversification of sterling reserves were agreed in 1966, 1968 and 1977 – they thus persisted despite the devaluation of sterling in 1967, the advent of a supposedly floating exchange rate regime in the early 1970s and a sharp fall in the share of global reserves denominated in sterling.

- During the end of the Bretton Woods period, from 1968-1974, currency competition was eliminated since the UK offered a US dollar value guarantee to countries holding sterling so long as they did not further diversify their reserves. Given high nominal interest rates in London, this guarantee allowed these economies to reap premium real returns on their sterling assets. The credibility of the guarantee was underpinned by the 2nd Group Arrangement from G10 central banks.

- The Group Arrangements provided the UK with a 'safety net' of credit from G10 central banks that could be activated if countries began to diversify their reserves away from sterling. They aimed to reduce first mover advantage for diversification and to delay a damaging run on the pound that would prompt a run on the dollar.

- The failure of the SDR to resolve apparent problems in the IMS led to consideration in the early 1970s by the C20 and IMF of a **Substitution Account** to promote the SDR as a replacement reserve asset for the US dollar. This plan was finally abandoned in 1981. Key obstacles were: burden of risk, use of IMF gold and governance.

- Rather than replacing the US dollar with the SDR, the US Fed and Treasury sought to improve the symmetry of the adjustment process through a **rules based system to force countries in persistent surplus to adjust through currency appreciation**. These plans were ultimately unsuccessful in the 1970s because of a lack of consensus over governance and implementation but they echo US proposals at the G20 Seoul Meeting in November 2010.

Multiple Reserve Currencies[1]

In the 1950s the sterling area (35 countries and colonies pegged to sterling and holding primarily sterling reserves) accounted for half of world trade and sterling accounted for over half of world foreign exchange reserves. In the early post-war years, this share was even higher – the IMF estimated that official sterling reserves, excluding those held by colonies, were four times the value of official USD reserves and that by 1947 sterling accounted for about 87% of global foreign exchange reserves.[2] It took ten years after the end of the war (and a 30% devaluation of the pound) before the share of USD reserves exceeded that of sterling. This rather contradicts Chinn and Frankel's assertion that 'by 1945 the dethroning [of sterling] was complete'. Figure 1 shows the changing composition of foreign exchange reserves from 1950 to 1982.

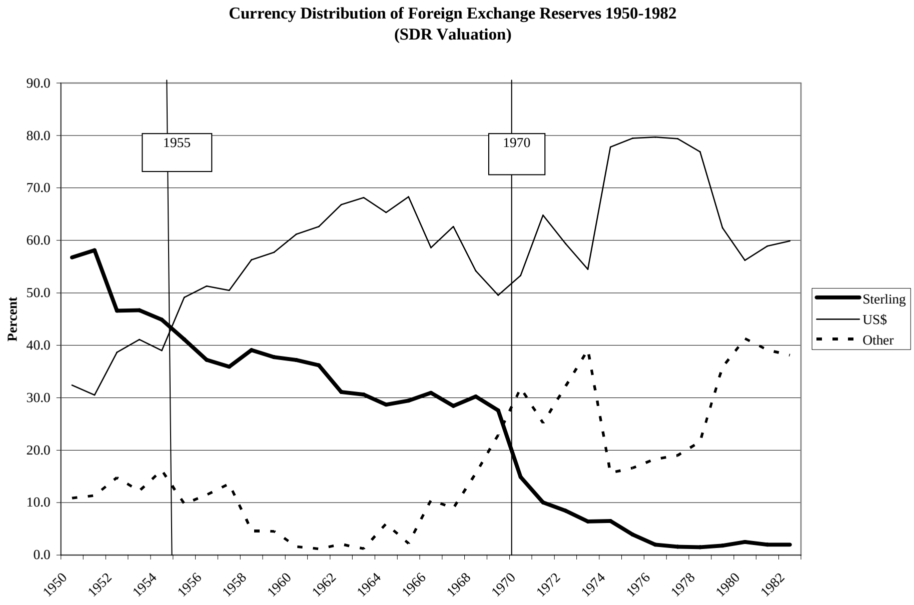
How do we explain the gradual nature of the decline of sterling, what Paul Krugman refers to as a 'surprising persistence'?[3] Was this due to British government efforts to prolong sterling's role because it increased the capacity to borrow, because it enhanced Britain's international prestige, or because it supported London as a centre for lucrative international finance? These are the traditional explanations in the literature, but archival evidence shows that from the 1950s many British ministers and officials believed that the burdens of sterling's role in terms of cost of borrowing and confidence in the exchange rate outweighed the benefits of issuing an international currency (greater demand for national debt).

[1] The first section of this paper is from C. R. Schenk, 'Lessons from History', in P. Subacchi and J. Driffill eds., *Beyond the Dollar; rethinking the international monetary system*, Chatham House, 2010. Further research supported by UK Economic and Social Research Council RES-062-23-2423.

[2] At this time foreign exchange was only about 30% of global reserves, but gold holdings were highly concentrated in the USA so that foreign exchange made up about half of global reserves excluding the USA.

[3] P. Krugman, 'The international role of the dollar; theory and prospect' in JFO Bilson and RC Marston, eds, *Exchange Rate Theory and Practice*, University of Chicago Press, 1984.

Figure 1 Currency Distribution of Global Foreign Exchange Reserves



Source: C. R. Schenk, *The Decline of Sterling; managing the retreat of an international currency 1945-1992*, Cambridge University Press, 2010.

Krugman asserted that 'the preeminence of sterling and its displacement by the dollar [after 1945] were largely the result of "invisible hand" processes, ratified more than guided by international agreements'. Closer examination, however, shows that sterling's role was prolonged both by the structure of the international monetary system and by collective global interest in its continuation. As the market network externalities for sterling reserves eroded, the retirement of sterling as a reserve currency was postponed through negotiated management among the developed and developing world, i.e. positive externalities in terms of global stability were identified and deliberately protected.

During the early 1950s the UK Treasury devised various plans to discourage the use of sterling as a reserve currency by increasing exchange rate volatility or unilaterally suspending convertibility, but these plans were abandoned because they threatened Britain's political as well as economic relations with creditors, and because the retaliation and disruption to the international monetary system that would ensue threatened domestic UK priorities of full employment and price stability. By the early 1960s, the future of sterling as a reserve currency became embroiled in global efforts to reform the international monetary system once the practice of using national currencies as international reserves in the pegged rate system was deemed to be flawed. The weakness in the system was the apparently precarious ratio of outstanding sterling securities held in the reserves of other countries relative to the slim volume of UK dollar and gold reserves (the ratio was 4:1 in the immediate postwar period). This exposed sterling to a collapse if there was a rapid switch to the USD. Competition between sterling, the dollar and gold was viewed as destabilising to the international monetary system. British governments and central bankers were successful in using the threat that the collapse of sterling as a reserve currency would lead to systemic crisis to gather extraordinary credit from the USA, IMF, BIS and the G10 while the world debated how to replace reserve currencies.

The process of global reform was much more prolonged than expected and in the end the outcome (the SDR) was not radical enough to meet the task of retiring sterling. In the meantime, a multilateral support system was developed at the Bank for International Settlements that comprised three successive Group Arrangements in 1966, 1968 and 1977 whereby central banks pledged substantial lines of credit to minimize the impact of a tipping point away from sterling. These safety net schemes aimed to forestall a rush away from sterling as a reserve currency by retaining market confidence and reducing the first mover advantage from a flight from sterling. In 1968 (under pressure from G10 central banks) the UK also built a system of bilateral commitments with holders of sterling to limit diversification in return for a guarantee of the USD value of 90% their sterling reserves. These Sterling Agreements were renewed three times before finally being allowed to expire in December 1974. This forestalled some diversification, although the minimum ratios were set lower than the status quo ante in many cases and the thresholds were rarely binding. Although sterling's share of international reserves fell sharply in the early 1970s to below 10% of the total, accumulations by oil producers left Britain vulnerable to diversification in 1976. This provoked a final scheme to replace sterling reserves with UK-issued foreign currency bonds, again underpinned by a line of credit from G10 central banks, marking a final end to sterling's reserve role. Sterling now comprises only about 3% of global reserves.

The shift from sterling to the USD and the elimination of sterling as a major international currency did result in periodic crises, international tensions and conflict over British domestic economic policy. It was thus not a painless transformation, but it was tempered by the waning attractions of the USD as an alternative safe haven and by the international commitment to avoid a damaging tipping point for sterling that would undermine confidence in the reserve currency system as a whole. But the persistence of sterling's reserve role was not just an artificial one. Many developing countries were willing to accumulate sterling assets during the 1960s despite the pound's vulnerability because they denominated their trade and debt in sterling and because many currencies remained pegged to sterling. Starting in 1971, however, most sterling pegs were replaced by pegs to the USD or trade-weighted baskets, and sterling's commercial role declined rapidly relative to the USD during the oil crisis. The sharpest fall in sterling's share of reserve assets took place at a time of dramatic expansion in global reserves during a global commodity boom and inflation. These factors eased the pressure on Britain from this final transformation since inflation eroded the real value of liabilities and the fact that the nominal value of global sterling reserves was quite stable meant that the falling share of global reserves did not require the presentation in London of sterling assets for exchange to USD, gold or other currencies on a net basis. Rising international liquidity, inflation, geographical redistribution and international cooperation were the cornerstones that eased the retreat of sterling from global to national status.

The world is a different place now with private finance far outweighing central bank resources and more freely adjustable exchange rates. The problems of sterling were also not identical to those of the USD today. Nevertheless, the main lesson to be drawn from this case is that the decline of sterling was much more prolonged and less damaging than expected at the time, or portrayed in more recent analyses. From the early 1960s, competition between the two major reserve currencies was managed carefully through central bank cooperation. From 1968-74 competition was eliminated through the dollar value guarantee of sterling reserves, underpinned by G10 support. The shift from sterling to the dollar was achieved without major implications for global stability because it was a deliberately managed process involving the world's richest economies as well as the formal cooperation of holders of sterling assets. Without the Cold War context that encouraged cooperation in the 1960s, it seems less likely that heroic efforts to postpone a tipping point for the US dollar will be achievable. The scale of US liabilities also precludes an exchange rate guarantee. In this sense, the gradual decline in sterling's share of global reserves after 1945 should not give comfort to those who hope for a similarly unproblematic decline for the USD.

Proposals for Reform

- Both a Rules-Based Adjustment Indicator Mechanism and a Stabilisation Account were discussed and dismissed in the 1970s

- The US proposed the Adjustment Indicator from 1969-1973 to correct the accumulating surplus of Japan – if reserves rose above a pre-determined 'normal' level, a country would be required to appreciate their currency. If this was not complied with, then sanctions could be imposed by other countries on their trade and payments relations with the surplus economy.

- From 1973-1980 the C-20 and IMF considered establishing a Substitution Account to absorb US dollar reserves and replace them with SDR denominated assets.

- Both initiatives foundered on a lack of consensus over governance and decision-making. The Rules were ultimately dismissed as unworkable and the burden of risk in the Stabilisation Account could not be agreed.

Reserves Indicator

With the Japanese economy in persistent surplus and a huge accumulation of US dollar reserves overseas from 1969-71, the need to enhance pressure on surplus countries to adjust attracted attention in both the Treasury and the Fed. In particular, **they sought ways to monitor incipient imbalances and to trigger currency appreciation by reluctant surplus countries** – a vital current policy issue. In 1969 a special policy group was established under the leadership of Paul Volcker, Treasury Under-Secretary of State for International Monetary Affairs.[4] The proposals developed in the Volcker Group including an international Ministerial Adjustment Committee [analogous to the Mutual Assessment Process of the G20] that would monitor imbalances and make recommendations for adjustment policies, applying sanctions where adjustment was not forthcoming.[5] By April 1972 the proposal included provision for

> A set of presumptive criteria to guide the committee in making judgments regarding the adjustment required in the balance of payments positions of individual members. Ideally, such criteria would also provide the basis for a scale of reference that could indicate the degree of disruptiveness of a given country's failure to adjust. One possibility would be to establish a set of bands based on reserve holdings of members.[6]

The Volcker Group's final recommendations in early June 1972 identified two objectives in forthcoming negotiations: greater exchange rate flexibility and a system of guidelines to promote prompt adjustment of imbalances.[7] This included

> 'agreement on procedures and guidelines for multilateral consultations and actions designed to stimulate corrective steps by governments pursuing seriously disruptive behaviour in the international economic area; possible actions should include withholding of access to international assistance funds and placing burdens on the international transactions of the offending

[4] Members included Fred Bergsten, Dewey Daane, Henrik Houthakker, and Nathaniel Samuels.
[5] Volcker Group Paper, 27 April 1972, FRUS, 1969-76 Vol III Doc 228.
[6] These institutional plans drew on a paper from early April by Geza Feketekuty, an early career economist with the Office of Management and Budget. He subsequently led the US team in the Tokyo Round of GATT. FRUS, 1969-76 Vol III Doc 228.
[7] Recommended Premises and Objectives of the U.S. in Forthcoming Reform Negotiations, 5 June 1972, FRUS 1969-76, Vol. III, Doc. 230.

nations.'

On 21 June 1972, sterling floated and the whole Smithsonian system and the future of pegged exchange rates was reassessed. In July, Federal Reserve Chairman Burns lured Kissinger into his reform agenda, promising that the USA had an opportunity 'to rebuild the world'. He proposed establishing 'the principle of symmetry between deficit and surplus nations...We should establish rules … that surplus countries have an obligation to reduce and eliminate surpluses and deficit countries have a similar obligation to reduce their deficits.' [8] In terms of sanctions on surplus countries, Burns suggested that 'In the first year, a warning. In the second year, if it continues, then withdraw convertibility. Previously convertibility has been taken for granted. It was felt there was a right to convertibility. No longer should it be an automatic right. The country would have to accumulate foreign currencies and could not necessarily convert them.' Given the loss of sovereignty required for such a scheme (for both deficit and surplus economies), both men recognized the difficulties of selling such a plan to Congress.

By the end of July the Treasury had devised Plan X which aimed to both mobilize the SDR as a primary reserve asset as well as promote a symmetrical rules based system of adjustment. Primary Reserves would consist of gold, SDRs and IMF gold tranches. Each country would have an identified level of 'normal reserves' calibrated against their IMF quota. The suggested threshold for 'normal' reserves was four times a country's IMF quota – in 1972 Japan's foreign exchange reserves not including gold were 13.7 times their IMF quota, Germany 10 times, USA 1.8 times. The plan clearly privileged the USA with its large quota. During a predetermined 'open season' countries could exchange their dollars and other foreign exchange to SDRs. Allocations of SDRs from the IMF would make up any shortfall to reach the predetermined level of 'normal reserves'. So long as they maintained central exchange rates, countries acquiring foreign exchange could present it to the issuing country for primary reserves. The system would not encourage or discourage the holding of foreign exchange in reserves, although the US 'would negotiate limits on foreign official holdings of dollars'. Countries where reserves fell below the 'normal' level would be permitted or required to devalue at a rate of 3-4% per year. When Primary Reserves hit 150% of 'normal', revaluation of at least 3% p.a. would be

[8] Memorandum of Conversation, Washington, July 25, 1972, 4:30 p.m., Henry A. Kissinger, Arthur F. Burns, Chairman, Federal Reserve System, Robert D. Hormats, NSC Staff Member. FRUS 1969-76, Vol. III, Doc. 236.

required. If reserves hit 175% of normal, then there would be no right to convert their foreign exchange reserves. Finally, if 'total reserves (primary plus forex) at 200 percent of normal level and maintained for period (e.g., 6 months) would indicate persistent surplus country, which would be expected, e.g., to increase aid, liberalize imports and unless corrected, subject to discriminatory restrictions (e.g., surcharge).'[9] This scheme sought a new and much broader international monetary agreement encompassing trade and monetary rules, so a parallel restructuring of GATT was required. Finally, the plan sought to 'politicize' the governance of the international monetary system by maintaining Executive Directors at Deputy Minister level and keeping the C-20 in existence. Those at the table had to be able to take policy decisions.

At the September 1972 meeting of the IMF and World Bank The Committee of Twenty was set up and tasked with developing proposals to reform the international monetary system including 'international trade, the flow of capital, investment and development assistance' under the chairmanship of Ali Wardhana, the Indonesian Finance Minister. At this same meeting Treasury Secretary Shultz launched the US proposal for resolving prolonged payments imbalances in the global system through a rules based system driven by 'indicators' to identify the need for internal and external adjustment by persistent surplus and deficit countries. Shultz noted that 'I believe disproportionate gains or losses in reserves may be the most equitable and effective single indicator we have to guide the adjustment process'.[10] The burden of adjustment was to be shared between surplus and deficit countries to introduce greater symmetry into the system, and greater flexibility in exchange rates was to be one route for adjustment. Deficit countries might be required to devalue while surplus countries could have convertibility suspended if they refused to revalue. Alternatively, a surplus country could increase aid expenditure, reduce trade barriers and remove outward capital controls. Ultimately, their trading partners could impose trade surcharges to force adjustment, which bore echoes of the Nixon Shock. The SDR 'would increase in importance and become the formal numeraire of the system' but foreign exchange reserves 'need be neither generally banned nor encouraged' since they offered monetary authorities greater flexibility in reserves management. Nevertheless, Shultz

---

[9] Paper Prepared in the Department of the Treasury, 31 July 1972. FRUS 1969-76, Vol III, Doc. 239.
[10] 'Needed: a new balance in international economic affairs', Speech by G. Shultz, to joint IMF-World Bank meeting 26 September 1972. The word 'balance' was used eight times in the first five sentences.

noted that 'careful study should be given to proposals for exchanging part of existing reserve currency holdings into a special issue of SDR, at the option of the holder'. In terms of governance the US proposal sought to vest the monetary rules with the IMF and to harmonize the IMF and GATT rules. Decisions on reform 'must be carried out by representative who clearly carry a high stature and influence in the councils of their own governments'; a hint at Plan X's politicization of the governance. After some undefined transitional period, Shultz claimed that 'the US would be prepared to undertake an obligation to convert official foreign dollar holdings into other reserve assets as part of a satisfactory system as I have suggested – a system assuring effective and equitable operation of the adjustment process' once the US had capacity so to do.

This scheme has similarities to that attributed to the US Treasury Secretary Tim Geithner at the G20 Summit in November 2010, although rather than focusing on reserves, he suggested quantitative indicators for current account balances that would require adjustment.[11] In the end the G20 landed on a compromise that tasked Finance Ministers to develop 'indicative guidelines composed of a range of indicators would serve as a mechanism to facilitate timely identification of large imbalances that require preventive and corrective actions to be taken.'[12]

In the 1970s, the indicator proposal did not find many supporters outside the USA. Giscard d'Estaing's expressed his misgivings at the Rejkiavik summit in 1973.[13] The French priority remained a return to pegged exchange rates and he worried that a set of weak 'indicators' would leave states free to embark on competitive devaluation. Neither Giscard d'Estaing nor Mr. Pierre-Brossolette, believed that the proposal could be realistically implemented, partly because 'There was always room for discussion as to whether a country should act when the indicators so suggested. Also, the indicators did not work the same for a large country and for a small country—they allowed greater freedom for the large country.' **These criticisms must also be overcome for the proposed indicator of current account imbalance as a % of GDP.** Volcker defended the scheme as a negotiating platform or 'skeleton' that

[11] Tim Geithner letter, extracted in *Financial Times,* 22 October 2010. http://www.ft.com/cms/s/0/651377aa-ddc4-11df-8354-00144feabdc0.html#axzz1DfLI6xwl

[12] Text of G20 Communique, Seoul, November 11 2010.

[13]Memorandum of Conversation Reykjavik, May 31, 1973. Participants France, Minister Giscard d'Estaing, Mr. Claude Pierre-Brossolette, Mr. Jean-Pierre Brunet, U.S. Secretary George P. Shultz, Under Secretary Paul A. Volcker. Memorandum of Conversation, Reykjavik, June 1, 1973. Participants, President Pompidou, Foreign Minister Michel Jobert Finance Minister Giscard d'Estaing President Nixon Secretary of State William P. Rogers, Secretary of Treasury George Shultz, Dr. Henry A. Kissinger, Assistant to the President for National Security Affairs, FRUS 1969-76, Vol XXXI

required flesh to be attached through international negotiation but that no progress was likely without a firm ‘backbone’ proposal to discuss and he tried to convince Giscard that ‘if the French would agree, we could get the rest of the world to agree. Some of the LDC’s had begun to see some of the advantages of the U.S. system to them, in that it did not leave them at the mercy of IMF control.’ The French were key to an effective compromise but they rejected the American scheme. In any case both sides agreed that no new system would be agreed before the Nairobi C-20 meeting in September and that public expectations should be dampened by announcing that there would be no communiqué from that meeting.

Rather than following the indicator proposals, the C20 planning focussed on the substitution of existing and future dollar reserves with SDR assets. The US was thus invited to adhere to the substitution element of their proposed reform without the benefit of the rules to ensure symmetry of adjustment that underpinned their own plans.

Substitution Account

By February 1973, on the eve of the end of the pegged rate system, three proposals for substituting US dollars for SDR as reserve assets were under consideration in the C20 and were brought to the IMF Executive Board for discussion.[14] The Italians proposed a substitution facility that would stand ready to exchange USD reserves for SDR. In addition, the US would have to settle any fresh deficits in primary reserve assets (gold, SDR or IMF position) rather than by selling USD debt. To make this work, the SDR would have to be more attractive in terms of interest and the ‘reconstitution’ element would need to be revoked ‘thus eliminating the present connotation of credit from the SDR’. The British proposal was to put a ceiling on foreign exchange reserves beyond which all would have to be held as SDR or gold. As countries in deficit ran down their foreign exchange reserves, the ceiling would fall so that a ratchet effect would gradually eliminate reserve currencies and replace them with SDRs. The British also included provision for holders of balances of reserve currencies to present them to the IMF in exchange for SDR. The Germans proposed more generally that only working balances should be retained in reserve currencies and the bulk of reserves should be consolidated into SDR.

[14] ‘Approaches to consolidation, convertibility and asset settlement’, 28 February 1973. IMF Archives SM/73/32.

The US was prepared to envisage a one-time conversion of existing USD claims into SDRs, which would shift their liability to an IMF Substitution Account rather than sundry national creditors, but they were wary of the financial obligations of exchange guarantee and interest burden. They thus kept an open mind on the need for consolidation and concentrated on the need for a symmetrical adjustment mechanism for surplus countries. As the US representative, Dale, put it at the Executive Board, 'while the broad analytical issues were of great interest, the more fundamental questions lay in the financial obligations' and 'Unless the proponents of the various schemes [for consolidation] had some practical way of dealing with the problem of financial obligation on the part of the reserve centers, little progress could be made'.[15] Certainly without American support or at least acquiescence, no arrangement to replace or supplement the USD would be possible.

The official US position presented in 1973 was that 'the US supports an increasing reliance on the SDR as the primary source of world reserve growth over time; favors a progressive reduction in the role of gold; and envisages a much reduced but some continuing role for foreign exchange.' They thus rejected Germany's proposal to limit foreign exchange holdings to some pre-defined working balances while the rest was consolidated into SDR, and also the British suggestion of a cap on foreign exchange holdings. However, 'the system should not be dependent on large and growing official foreign exchange holdings as it sometimes has in the past'. Countries should be able to exchange their USD balances for primary reserve assets (such as SDR). The issuing country should also have the right to limit or prohibit further accumulations by creditors and require them to hold SDR instead. These two provisions would mean that currency reserves would not be held against the will of either the issuing or the surplus country. The US also promoted the use of the SDR as the main unit of account for the international reserves system. Their major concern, however, was that the onus of adjustment should fall on creditors as well as debtors as a way to further limit the accumulation of 'excessive' USD reserves and relax the burden on the USA.

Despite being willing to discuss a substitution account in theory, the Americans at this stage were not convinced of the need for it. 'In general, Mr. Dale concluded, it was not the case, so far as the United States was concerned, that there was a complete consensus on the need for asset settlement as such or for that matter on the need for a substitution or consolidation facility'.[16] The Italian representative Palamenghi-Crispi remarked ominously that 'He did not see how the United States could deal with the

[15] IMF Archives, EBM/73/19, 23 February 1973.
[16] IMF Archives EBM/73/19, 23 February 1973.

problem of the dollar overhang and return to a system of convertibility without paying some attention to consolidation. The fact that the United States did not have a plan might be regarded as a plan in itself.' Finally, it should be noted that the USA was not the only sceptic about the use of the SDR as a genuine reserve asset. Lampe, for example noted that 'The credibility of special drawing rights would not be enhanced by making them available to all who desired them,' a view shared also by Australian Treasurer Wheeler.[17] On the other hand, any form of compulsion to acquire SDR would further reduce its attractions.[18]

At the meeting of C20 Deputies in Nairobi in September 1973, technical groups were set up to discuss particular aspects of reform. The Group on Global Liquidity and Consolidation was chaired by Alexandre Kafka, the Executive Director for Brazil, and met four times before submitting its report in March 1974. As with other aspects of the C20 deliberations, there was no consensus, merely suggestions and areas of disagreement. Kafka's report emphasized that any conclusions were impossible in the rapidly changing international context, particularly regarding the appropriate level of global reserves and consolidation of existing reserve currency balances. Rather than consolidation, the IMF quickly turned to the distribution of reserves by arranging for the recycling oil surpluses through special oil facilities.

After two years of complex technical discussions the Committee of 20 submitted its report in June 1974. By this time the international context had been transformed by the advent of floating exchange rates for the core international currencies, the development of the European monetary system, the explosion of the Eurodollar market and the global imbalance associated with the oil crisis. These developments reduced the collective interest in reforming the reserves system and the Committee's vague recommendations were not taken up. These included the American proposal for reserve indicators to prompt more symmetrical adjustment, making the SDR 'the principal reserve asset, with the role of gold and of reserve currencies being reduced and greater IMF surveillance of the adjustment process and levels of international liquidity.[19] The C20 Report offered no agreed blueprint, but rather listed suggestions; including a Stabilisation Account, changing the name of the SDR to reflect its changed status as a reserve asset, relaxing the restrictions on its use and determining an appropriate yield to make it more attractive. The one tangible

[17] IMF Archives EBM/73/19, 23 February 1973.
[18] A. Kafka, Report of Technical Group on Global Liquidity and Consolidation, March 1974. para 10.
[19] Committee of 20, *Report to the Board of Governors of the IMF by the Committee on Reform of the International Monetary System and Related Issues*, June 14 1974., p. 5.

outcome was the valuation of the SDR as a basket of currencies rather than valued in gold.

The C20 was arguably too large and unwieldy a forum to achieve constructive reform. If there had been a commitment among the key stakeholders (in particular the USA and Europe) it is more likely that consensus for an outline scheme might have gathered momentum. However, in the context of profound economic uncertainties of the early 1970s (particularly over exchange rates), this was not a likely outcome.

Despite the failure to devise a blueprint for reform through the unwieldy C20 forum, the presentational attractions of a scheme to replace the USD as a reserve currency were strong, and an Interim Committee on a Substitution Account was established to press forward with proposals. Once the US Treasury had reached its goal of formal recognition of greater flexibility of exchange rates to promote international adjustment with the Jamaica Agreement, they retreated even more from their support for more fundamental reform. By the start of 1976 the Assistant Secretary of State for Economic and Business Affairs reported to Kissinger that

> The U.S. (Treasury), in fact, is backing away from its agreement to the earlier language on the reduction of the role of reserve currencies (on the ground that the premises of the earlier agreement have been altered by the adoption of floating rates). It is now taking a distinctly unfriendly attitude towards proposals such as an IMF substitution account that would replace official reserve holdings of national currencies and/or gold with a special issue of SDRs. We are not likely to be pressed hard for action on this residual issue of monetary reform for a while. Active pressure from the other industrialized countries has almost completely subsided, possibly as the result of adamant U.S. opposition and higher priorities in other areas of the monetary agreement.[20]

As in the 2000s, the ultimate US goal was greater exchange flexibility to reduce global imbalances. The burden of sustaining momentum rested for the moment with less developed countries. Their enthusiasm for reform arose from their interest in the SDR as a less politicized source of international liquidity that might afford better opportunity for financial support for development than the US dollar.

Despite the failure to devise a blueprint for reform, the presentational attractions of a scheme to replace the USD as a reserve currency were strong, and the Interim Committee of the IMF pursued the idea of a Substitution Account from 1979. By April 1980 the Executive Board of the IMF had come to a tentative agreement to some

[20] Briefing Memorandum from the Assistant Secretary of State for Economic and Business Affairs (Enders) to Secretary of State Kissinger, January 15, 1976. FRUS Vol XXXI, 15 January 1976.

principles for an outline Substitution Account.[21] On a purely voluntary basis all members of the IMF would be able to deposit USD reserves (which would then be transferred to a special account at the US Treasury) in exchange for claims on the Substitution Account denominated in SDR. The SA would be operated as a trust administered by the IMF with an 'Assembly of Participants' who would manage and control it, although the voting rights and governance were controversial. The SA was thus not to be a legal part of the structures of the IMF in the first instance. The SDR claims on the SA would be freely transferable among participants and also to the private sector. Transfer would be on the basis of balance of payments need and payment of a transfer fee, and there would be some element of designation analogous to that of other SDR balances, although at a lower level. If countries could not find partners to accept their SDR claims on the SA, they could be converted back to USD as a last resort, although having a 'two-way' exchange through the SA raised fresh obstacles, particularly for the USA, and might allow speculative transactions through the SA. The maximum value of the SA in the first instance was not to exceed SDR50 billion. The US Treasury would pay interest to the SA on the USD liabilities and the SA would in turn pay interest to holders of SDR claims. The rates of interest were controversial, as was the burden of exchange risk for variations of the USD-SDR exchange rate. These profits or losses were to be shared between the USA and depositors and covered by part of the gold reserves of the IMF, but the balance of burden was never agreed. Developing countries also worried that the increase in SDRs through the SA would lead to a reduction of conventional SDR issues in the future. An even more impregnable obstacle was the unwillingness to condone the devotion of about 25 million ounces of the IMF's gold to underwrite the Substitution Account, which would mainly benefit richer countries with large reserves. With waning interest from both the developing and developed world, the plans were quietly abandoned.

The failed discussions for reform reveal a range of obstacles to the use of the SDR as a primary reserve asset; the currency weighting was considered inappropriate for some LDCs, there were limits on transferability and liquidity, it cannot be transferred between the private and public sectors. The major obstacle to a substitution account that would widen the use of the SDR (or particular SDR assets issued by the SA) was how to distribute the burden of exchange rate risk among

[21] Report of the Executive Board to the Interim Committee on a Substitution Account, 3 April 1980. SM/80/65 Revise 1. See also, J. Boughton, *Silent Revolution: the IMF 1979-89*, IMF, p. 936-43 and P.B. Kenen, 'Reforming the global reserve regime; the role of a substitution account', *International Finance*, 13(10), 2010, pp. 1-23.

creditors and debtors, a risk that became greater as the flexible exchange rate system emerged as a more or less permanent feature of the international monetary system. Ancillary concerns were the potential for speculation through a ‘two-way’ exchange with the SA, the desire among states to retain control over the portfolio distribution of their reserves, the limitations of the SDR and a lack of commitment in the USA for an ongoing rather than one-off (and one way) consolidation of a proportion of existing USD reserves, which was too limiting for other countries to accept.

Although a fund of SDR50 billion would have amounted to 15% of total world reserves (minus gold) in 1980, it would comprise only 7.5% by 1990 so unless provision was made to keep the account open it was not providing an important contribution to the diversification of global reserves. Moreover, Kenen’s (2010) simulations suggest the account would have fallen into deficit by 1988 and stayed in the red until 1995. The terms of the Substitution Account discussed in 1979/80 required consideration of liquidation as soon as a deficit arose, so it is not clear that the Account would have survived even ten years unless the USA made good the losses. At the time, however, the changing international environment as well as a lack of political will to embark on a risky scheme that offered only limited contribution to the challenges of diversification led to the abandonment of the plan. As the dollar recovered and momentum toward European monetary integration was renewed from 1979, the prospects of a future European currency pushed reforms over international reserve currencies further down the agenda of key stakeholders in reform in Europe and the USA.