University of Baltimore Law Review

Volume 12
Issue 3 *Spring 1983*

Article 13

1983

Book Review: The Rules of the Game: Reform and Evolution in the International Monetary System

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BOOK REVIEW

THE RULES OF THE GAME: REFORM AND EVOLUTION IN THE INTERNATIONAL MONETARY SYSTEM. By Kenneth W. Dam.† University of Chicago Press, Chicago, Illinois, 1982. Pp. 382. Reviewed by Kenneth D. Auerbach.††

During a conversation about the float of the British pound and the devaluation of the Italian lira, former President Nixon remarked as to the float of the pound, "[i]t's too complicated for me to get into . . ." and as to the devaluation of the Italian lira, "I don't give a (expletive deleted) about the lira."[1] The President's response probably mirrors a widespread perception about international monetary affairs. Therefore, Kenneth W. Dam's book, *The Rules Of The Game: Reform and Evolution in the International Monetary System,*[2] is a welcome addition to the literature in this area because it explains monetary affairs by interweaving legal, economic, and diplomatic considerations. *The Rules of the Game* is written for those "lawyers who shy away from international monetary matters under the impression that the economics is too difficult [and] the institutions too mysterious."[3] The book serves as must reading for both the professional involved in international monetary affairs and for the informed generalist seeking to understand international financial developments.

Organized historically, the volume analyzes the interaction between substantive/procedural rules and the political and economic periods of the past one hundred years.[4] Throughout the volume, two central concerns link the discussions about each political and economic period: the type of exchange rate regime[5] and the type of reserve as-

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1. A.F. LOWENFELD, THE INTERNATIONAL MONETARY SYSTEM 1 (1977). The quote is from a transcript of a meeting between former President Richard Nixon and H.R. Haldeman on June 23, 1972, which was released pursuant to the order of the United States Supreme Court in United States v. Nixon, 418 U.S. 683 (1976).
2. The book is hereinafter cited as THE RULES OF THE GAME.
3. THE RULES OF THE GAME xv.
4. The specific political and economic periods covered are: The Gold Standard Era (1870-1914); the Interwar Period (1919-1939); the Bretton Woods Era (1946-1971); and the Floating Exchange Rate Period (1972-present). In addition to this historical and legal analysis, THE RULES OF THE GAME also presents a concise introduction to the international monetary system.
5. An exchange rate regime is a set of rules or practices that national monetary authorities obey to alter the rate at which their currencies may be exchanged for other currencies, gold, or valuable assets. Changes in an exchange rate regime arise from the growth of new rules as the "old rules no longer corresponded to monetary reality." THE RULES OF THE GAME 6. Rule changes depend, in Professor Dam's analysis, upon the accumulated departures from the rules of an existing monetary regime. *Id.* at 5. This departure forces the "international community to

set.[6] This review addresses Profesor Dam's analysis of monetary regimes and the political and economic periods in his book.

All exchange rates are determined by transactions in the market place. When national monetary authorities refrain from intervening in the market place and the exchange rates are set by supply and demand, a "floating exchange rate system" operates. "When national monetary authorities enter the market either on the buying or selling side to assure that the [exchange] rate bears a close relationship to an officially specified rate,"[7] a fixed exchange rate system operates. Of course, national monetary authorities may advocate a floating exchange system, and yet at times intervene in the national market. This creates a so-called "dirty float," and when followed, makes the exchange rate regime take on the attributes of both a fixed and floating system — especially a floating system if the margins around the official rate are wide.

In addition to rules and practices about market intervention, monetary regimes determine which assets will be considered numeraires. Generally, numeraires consist of reserve assets such as gold, reserve currencies, or special drawing rights (SDRs).[8] The significance of these reserve assets is that national currencies are valued against and traded for them. In addition, sellers of depreciating national currencies[9] prefer to hold such reserve assets because they are widely acceptable in settling international accounts. Professor Dam views "[t]he history of . . . international monetary systems [as,] . . . in part, . . . the shifting mix of [such] reserve assets."[10] Consequently, his book describes and analyzes the events and practices that created this shifting mix — events which ultimately produced the change from the gold standard to the Bretton Woods System and beyond.

During the Gold Standard Era, currency was valued against gold (the principal reserve asset) at a fixed parity price, paper currency was fully convertible into gold, coins were valued by their gold content, and gold was available for public or private transactions. In his discussion

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recognize that the system itself has changed, [a]nd [that] . . . a flurry of rule changes is likely to follow." *Id.*

6. Reserve assets are those currencies or valuables (*e.g.*, gold or silver) which are held by national monetary authorities for intervention in currency markets.
7. THE RULES OF THE GAME 8.
8. THE RULES OF THE GAME 9. For a discussion of SDR's see notes 40-42 and accompanying text.
9. Depreciation occurs when the price of a foreign currency rises relative to a domestic currency. Thus the domestic currency depreciates and the foreign currency appreciates. *See* P.A. SAMUELSON, ECONOMICS 611 (11th ed. 1980). The term devaluation is largely of historical application, originally referring to an officially induced increase in the currency price of gold. Although there is no longer an official price of gold, the term is important in discussions about monetary matters referring to official increases in the price of a currency in terms of another currency or the SDR. *See id.*
10. THE RULES OF THE GAME 9 (italices omitted). Gold, silver, the British pound, the American dollar, and the SDR are or have, at one time, been used as reserve assets.

of the gold standard, Professor Dam compares the widely believed myths about the system with its actual operation.[11] One of these myths is that the system automatically corrected both trade deficits and inflationary expansion.[12] Another myth presupposed that a booming English economy based on the gold standard would have an automatic check against inflation.[13]

In reality, however, the gold standard was not quite the automatically self-adjusting mechanism that these myths suggested. As Professor Dam notes, statutes fixed the lowest price that the Bank of England paid for gold bullion, but nothing prevented the bank from paying more.[14] Moreover, the fixed selling price for gold coins "did not prevent the Bank from charging more for gold bars, so long as it was willing to make [gold coins] available at [the statutory] price when there was a shortage of bullion in the market."[15] Thus, the Bank could discourage gold outflows by manipulating the price. To stimulate gold inflows, the Bank could pay an importer's brokerage charge or buy the gold upon shipment, in effect granting the importer an interest free loan.[16] These and other "gold devices" helped induce some modest

11. In his book, Professor Dam notes: "[i]f the automatic self-adjusting concept of the gold standard is a myth, it is a myth that was widely believed at the time or was hastily created after the demise of the gold standard at the outset of World War I." THE RULES OF THE GAME 15.

12. The First Interim Report of the Committee on Currency and Foreign Exchanges after the War (1918) (the Cunliffe Committee) illustrates this: Suppose a balance of payments deficit (resulting in an outflow of gold) existed in England during the use of the Gold Standard. This would eventually cause the Bank of England, a private commercial bank as well as the central bank, to raise the rate at which it would discount commercial paper — a normal response to declining reserve rates. The increased discount rate would force banks to raise interest rates for commercial loans, which in turn would make capital spending more expensive. With reduced capital spending, unemployment would increase eventually lowering the wage rate and prices. The increase in interest rates would also reverse the outflow of gold as investors took advantage of the now higher interest rates and increase their investments in England. Imports to England would then decline in the face of higher prices (in terms of the pound). Eventually exports from England would increase as lowered prices and wages, measured in pounds that now could be purchased cheaply in terms of foreign currency, made English exports less expensive. The end result would be a stimulus for employment and production in England. THE RULES OF THE GAME 15-17.

13. The following, also from the Cunliffe Committee, illustrates this: As credit expands and prices increase, the demand for currency by both the public and banks (to maintain their proportion of cash to liabilities) would increase. Eventually the demand would be passed to the Bank of England which would have to raise its discount rate in order to prevent a fall in its currency reserve. In turn, as noted above, the increased interest rates would dampen economic activity. *Id.*

14. THE RULES OF THE GAME 25, 34.

15. *Id.* at 34.

16. *Id.* at 35. In addition, Professor Dam analyzes other departures from the rules of the gold standard. For instance, countries went on and off the gold standard and intervened in the market to maintain official exchange rates. Moreover, central bankers loaned foreign currency to one another to defend a parity rate and discourage decisions to make currency inconvertible. *Id.* at 37-38.

flexibility in the gold market (located in London) and allowed the Bank to counteract inflationary expansion and balance of payments deficits before their full effects were experienced.

England's position as the major trading and financial center aided the myths that surrounded the gold standard. Because England was the world's principal creditor, the pound became an international currency, widely acceptable for account settlements not only between debtors and England but also among third and fourth states *inter se.* As a result, the Bank of England came to be known "as [the] central banker to the world."[17] In fact, "London as a financial center was the principal source of liquidity for the international monetary system of the time."[18] Thus, the pound supplemented gold holdings as an international reserve asset.

The legal foundations of the gold standard rested far more heavily upon national legislation and central bank practice than upon international agreements. Professor Dam suggests, therefore, that the gold standard as an international legal order is better characterized as a nonregime, because it resulted from a series of national decisions that reflected national interests. His reasoning for this assertion is threefold. First, the system's linchpins of freely-convertible, gold-backed currencies, and free trade in gold by private parties were enforced by national legislation.[19] Second, except for the short-lived Latin Monetary Union (1865-1871) and some international conferences primarily concerned with the roles of gold and silver, only the informal "rules of the game" (*i.e.,* the personal understandings for acceptable behavior among central bankers) hinted that the gold standard might be an international regime. Finally, even though the lending among central bankers to encourage allegiance to the gold standard intimated the existence of an international regime, such lending seems to have been much less common during the Gold Standard Era than during the Interwar Period and the Fixed Exchange Rate regime.[20] Despite the character of the international aspects of the gold standard or the methods of its operation, Professor Dam views the gold standard as having provided significant monetary stability during a period of increased trade.[21]

Professor Dam describes the 1919-1939 period both as remarkably consistent with the pre-World War I regime and as the precursor of a new system after World War II. In this section of his book, Professor Dam demonstrates how the events of this period shaped international monetary policy. For example, governments regulated foreign currency transactions, used foreign currencies to stabilize exchange rates, and increased paper currency in circulation to promote economic

17. *Id.* at 30.
18. *Id.*
19. *Id.* at 24-26.
20. *Id.* at 37.
21. *Id.* at 38-40.

growth. Moreover, the wartime practice of international consultation on economic and financial matters increased. The formation of the Economic and Financial Commission of the League of Nations, and the Brussels (1920), Genoa (1922), and London (1933) economic conferences constituted fledgling steps in international economic diplomacy through multilateral forums.[22] Not only did the central banks begin to cooperate formally and legally during this period, but they developed a "practical and personal" relationship creating an international network of like-minded bankers who opposed political control of monetary affairs.[23] But, as Professor Dam points out, with increased government involvement in domestic and international economic affairs arising from the Depression, monetary affairs surrendered to government intervention, thus undermining central bank independence.[24]

Professor Dam also demonstrates how the events of this period were inconsistent with the rules of the gold standard. In this regard, the author describes how, one by one, the principles of the gold standard yielded to the economic and political realities of the time. Individuals no longer had rights to redeem paper money for gold. Paper currency proliferated as domestic legislation decreased the gold backing for currency. Only a few countries remained as gold centers with free gold markets, keeping their currencies redeemable in gold.[25] What emerged was a gold exchange system in which reserves would be held as either gold or foreign exchange. After the economic collapse and political and military conflicts of 1919-1945, demands for an organized international economic order increased.

In 1944, forty-four governments sent representatives to Bretton Woods, New Hampshire to plan the post-World War II monetary system and to take steps for global reconstruction and development. Plans for two institutions emerged: The International Bank for Reconstruction and Development (The World Bank)[26] and the International Monetary Fund (IMF), each with its own legal personality, charter (Articles of Agreement), and sphere of activity.[27] Professor Dam thoroughly

22. *Id.* at 50.
23. *Id.* at 52.
24. *Id.* at 53-54.
25. As to these countries, Professor Dam notes that "[a] given quantity of gold in the vaults of a central bank [in a gold center would serve] as reserves, not simply for the gold center country but also at one remove for those countries that held its currency as their foreign exchange reserves." THE RULES OF THE GAME 57 (footnote omitted).
26. Professor Dam's analysis centers on the International Monetary Fund's evolution and organizational make-up. Therefore, this review will not discuss the World Bank and its operational intricacies.
27. Formally called The United Nations Monetary and Financial Conference (Bretton Woods, New Hampshire, July 1-22, 1944), the Conference hammered out the structures of The World Bank and the IMF. The organizations are designed to serve different purposes: The IMF oversees and facilitates international monetary affairs, while The World Bank lends capital to countries unable to obtain financing from commercial sources on reasonable terms. For a history of the World

discusses the IMF organization and its evolution; however, his discussion will only be highlighted here.

The IMF is an international organization of states, and each member state is required to contribute a share of the IMF's assets. Each member's share — its quota — is payable in gold and national currency.[28] A country's quota ultimately affects both the member's voting rights in the IMF and the member's ability to use the Fund's resources to correct short-term balance of payments deficits.[29]

Prior to the creation of the IMF, there was substantial agreement among the post-war planners that changes in exchange rates were of international concern. As a result, extended discussions ensued both before and during Bretton Woods on proposals concerning the extent to which the IMF should be allowed to affect a member's decision to alter its exchange rate. A compromise provided that: (1) changes in exchange rates should be allowed only to correct a "fundamental disequilibrium" and only after consultation between the member and the IMF, which could object (except for a one time only ten percent change); (2) changes not authorized by the Articles could lead to a cut-off of the Fund's resources or to a forced withdrawal of the member; and (3) "fundamental disequilibrium" was left undefined.[30] Subsequent events show how prescient the negotiators were, because "only on one occasion did the [IMF] ever . . . treat an exchange rate change as unauthorized . . . [and] it became apparent that a key problem . . . was not the instability [of exchange rates] but rather an unwillingness [of governments] . . . to make . . . changes promptly enough . . . ."[31]

The IMF Articles of Agreement created a par value system of semi-fixed exchange rates. The United States guaranteed that it would

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Bank, see E. Mason & R. Ascher, The World Bank Since Bretton Woods (1973). For the historical perspective of the IMF from 1946 to 1971, see Horsefield, The International Monetary Fund 1945-1965: Twenty Years of International Monetary Cooperation (1969) and M. De Vries, The International Monetary Fund: 1966-1971: The System Under Stress (1976).

28. The Rules of the Game 101.

29. The chief executive officer of the IMF is called the Managing Director. Each member appoints a governor to the IMF, usually the member's finance minister or head of its central bank, who may cast the votes alloted to the member. The Board of Governors meets as a body at its annual meeting.

The IMF equivalent to a board of directors is its Executive Board, which currently comprises 22 Executive Directors. The five members of the IMF with the largest quotas each appoint one director to cast its votes. If the one or two members whose currency holdings by the IMF are most below their quotas have not already appointed a director, then that member may appoint a director. Articles of Agreement art. XII, § 3(a)-(c) (1945 & 1978 as amended). Currently, there are 6 appointed directors and 16 elected directors. The remaining members of the IMF elect the other directors, and each of them then casts the votes that comprises the coalition of members that elected him. The Board of Governors may increase or decrease the number of elected directors by an 85% majority of the total voting power.

30. The Rules of the Game 89-90.

31. *Id.* at 91-92.

buy or sell gold at the established price of thirty-five dollars per ounce, and each member expressed the par value of its currency in terms of dollars or gold. Thus the members implicitly accepted a reserve role for gold. Members were obligated "to buy and sell foreign exchange [at the official price] . . . in order to prevent the market [price of their currency] from rising above the upper margin or falling below the lower margin,"[32] which was set at one percent above or below par. As Sir Joseph Gold, the former General Counsel of the IMF, wrote: "the system of par values *in practice* was a solar system in which the U.S. dollar was the sun."[33] Nonetheless, gold retained its luster as a reserve asset of the IMF.

As a currency pool, the IMF makes foreign exchange available to members to meet short-term balance of payments problems under certain circumstances. As a legal regime, the IMF interprets its Articles, which record the evolution of rules of international monetary relations. Professor Dam characterizes the IMF's rule-making techniques as interpretation and legislation.[34]

In characterizing the IMF's interpretation duties, Professor Dam analyzes conditionality,[35] changes in exchange rates, and the role of gold in order to demonstrate how events, ambiguities in drafting, and concern for the consequences of alternative rules produced evolutionary change in international monetary relations. For example, the Articles left ambiguous the question whether a member would have automatic access to the IMF resources. Under the original Articles, "a member shall be *entitled* to buy the currency of another member"; however the purchasing member must represent that it has an immediate need for this currency to make "current payments which are consistent with the provisions of [the Articles]."[36] In Professor Dam's opinion not "only is the latter clause ambiguous as to whether a member has automatic access to the IMF's resources, but it also raises issues as to which provisions of the Articles are drawn into consideration by the 'consistent with' requirement."[37] The resulting interpretation by the IMF allowed members virtually automatic access to the "gold tranche" (*i.e.*, the part of a member's quota subscribed in gold) but the

32. *Id.* at 94.
33. *Id.* at 94-95. (footnotes omitted).
34. *Id.* at ch. 5. Dam also employs the concept of "jurisdiction" to indicate that the IMF and the international monetary system are not coterminous. Institutions such as the European Payments Union, the Bank for International Settlements, and the Group of Ten also affect international monetary affairs. The discussion here, however, will only focus on "interpretation" and "legislation." THE RULES OF THE GAME 142.
35. Conditionality refers to the policies in accordance with which a member may obtain access to IMF resources beyond the "gold tranche." The "gold tranche" is that part of a member's quota which is subscribed in gold.
36. *Id.* at 108. The purchasing member is required to reverse its purchase transaction with the IMF after a certain time.
37. *Id.*

IMF could place conditions on drawings beyond that amount. As a result, members make representations about their need for and intended use of IMF resources, and the IMF may look beyond those representations. Thus, international concern for a member's economic policy is brought to bear upon the member.

As an example of IMF legislation, Professor Dam presents a discussion of the Special Drawing Right (SDR) based on extensive citations to publicly available sources and commentary. In brief, two international economic issues of the 1960's were the rate at which international reserves were growing and their composition, which included gold, foreign exchange (especially the dollar), and unconditional claims, such as a member's gold tranche position in the IMF. To prevent appreciation in currency, certain national monetary authorities intervened in currency markets to buy dollars. Thereafter, some of these monetary authorities continued to hold dollars as the United States' balance of payments deficits increased. Countries that held dollars could insist that the United States honor its obligation to convert dollars to gold. Conceivably, as Professor Dam notes, this could have created a panic if the dollars to be exchanged exceeded the United States' gold supply valued at the official price.[38] Despite three earlier efforts to solve this "liquidity" problem, *i.e.* increases in member quotas, agreements to permit the IMF itself to borrow from countries having currencies convertible into the dollar, and swap agreements among central banks (which are essentially reciprocal lines of credit) the members legislated the creation of the Special Drawing Right (SDR).

Professor Dam's analytical description of the SDR emphasizes the legal and economic aspects of the IMF's solution to the liquidity problem. The SDR is both a unit of account and a reserve asset, allocated in proportion to quota and created without any backing in the form of additional international reserves.[39] But as Dam extensively illustrates,

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38. Kenneth Dam notes:

> [D]ependence on the solvency of the reserve countries is . . . an Achilles' heel of a gold exchange system that was not widely perceived when the Bretton Woods planners drew their lessons from the interwar experience.
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> This dependence put considerable pressure on many countries to refrain from converting their dollar holdings into gold . . . . This . . . led to the argument that a new form of liquidity should be found that would not have the disadvantage of generating disputes over the composition of reserves and would not threaten the very underpinnings of the Bretton Woods system.

THE RULES OF THE GAME 145-46.

39. In analyzing the SDR, Professor Dam states:

> [T]he decision to forego any backing . . . simply shifted the issue to the attributes the SDR had to be given to make it acceptable to national financial officials. In the end, acceptance could not be left to chance, and an 'acceptance obligation' — a kind of international legal tender requirement — had to be negotiated. Just as national legal tender statutes normally require creditors to accept the national currency in the dis-

the SDR regime had to contend with the reluctance of central banks to engage in such novel ideas without first having available a complex set of regulations which defined the interest to SDR holders, the valuation of SDRs (and changes in valuation), and the mechanics of subsequent allocations of SDRs.[40] In each discussion, Professor Dam summarizes the contending positions, evaluates their logic, and clearly indicates how the solutions balanced conflicting economic interests while constructing procedural and substantive rules for the SDR regime.[41]

Like his discussion of the gold standard and the inter-war period, Professor Dam presents the collapse of the Bretton Woods system as a series of events that challenged the system's fundamental premises.[42] First, deficit countries were presumed to have the burden of changing exchange rates, usually by discrete devaluations. Three countries, however, permitted a float of their currency for a limited time and then pegged the new rate at the end of the period, thus making floating a respectable option.[43]

The dollar, already under threat during the 1960's, continued to weaken, and the United States' gold (valued at the official price) equalled about twenty-five per cent of the total outstanding dollar liabilities at the end of 1970. "External liabilities continued to mount rapidly . . . [a]nd, ominously, private holders were diversifying out of dollars . . . ,"[44] which required official holders to increase their dollar reserves. Accordingly, on August 15, 1971, the United States suspended dollar convertibility into gold for fear that requests would generate a run on gold reserves. Intense international negotiations ensued, resulting in the Smithsonian Agreement, which included a generalized realignment of pegged currencies that eventually succumbed to an even more widespread general float of currencies beginning in 1972.[45] Eventually guidelines were negotiated to manage the floating of exchange rates. These guidelines were ultimately replaced by the IMF's exercising surveillance over exchange rates.[46] According to Professor Dam, these guidelines "have historical importance [because they represent] the first attempt to develop a set of rules for a floating system [of exchange rates] comparable to the Bretton Woods rules for a par value system."[47]

Professor Dam continues his analysis of the post-Bretton Woods era by charting the changing roles of the SDR, gold, and the dollar in

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> charge of debts, so too the first amendment to the Articles required acceptance of the SDR.

THE RULES OF THE GAME 153.

40. *Id.* at 152-53.
41. *Id.* at 151-68.
42. *Id.* at ch. 6.
43. The three countries were Canada, 1950-1962 and 1970, Germany in 1969 and 1971, and the Netherlands in 1971. *Id.* at 176.
44. *Id.* at 187.
45. *Id.* at 189-92.
46. *Id.* at 259.
47. *Id.* at 199.

an era of floating exchange rates and limited intervention into foreign currency markets.[48] He then surveys the changes in the IMF as an organization,[49] devoting a chapter to the Jamaica Agreement,[50] which presaged a thorough reform of the Articles to prepare for the period of floating currency rates. Thereafter, Professor Dam illustrates how special accounts, or "windows," became available for: (1) drawings for balance of payments problems arising from export fluctuations; (2) buffer stock financing requirements; and (3) sharp increases in oil prices. During this analysis, Dam elucidates how all of these changes have increased the IMF's financial and organizational complexity.[51]

By now the persevering reader has obtained a very brief glimpse of the breadth of Kenneth Dam's endeavor. Undertaking no less a task than to place into historical context the economic and diplomatic developments that have influenced the institutional and legal development of international monetary affairs, this book deserves to be read by the serious student, the informed generalist, and even by the overworked executive who may give an "expletive deleted" about monetary affairs. All of us owe Kenneth W. Dam a debt for producing a volume so completely backed by the "hard currency" of high scholarship.

48. *Id.* at 243-47 (SDR, gold, and the dollar); 269-81 (gold and the dollar); 307-10 (SDR); 336-41 (gold).
49. *Id.* at 251-52; 281-84.
50. *Id.* at ch. 8.
51. *Id.* at 284-87.