DID CONFIDENCE KILL THE TRIFFIN PLAN?

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ABSTRACT

I examine two competing proposals for reforming and reviving confidence in the international monetary regime. Robert Triffin introduced and championed the proposal for centralized reserves. Fritz Machlup championed the proposal for flexible rates originally introduced by Milton Friedman. Triffin claimed that Fritz Machlup did more than anyone to ensure that floating exchange rates won the policy debate because of his influence on academic economists and policy makers. I examine Machlup's influence on these opinion molders through his leadership of the Bellagio Group conferences.

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KEYWORDS: Triffin Plan; world monetary regime reform; confidence, liquidity and adjustment

INTRODUCTION

Long before the financial crisis of 2008, reforming the world monetary regime was on everyone's lips. In this paper, I examine two competing proposals for reform. Robert Triffin introduced and championed centralized reserves. Fritz Machlup championed and popularized flexible exchange rates, first introduced by Friedman (1953). We know in the end that flexible exchange rates prevailed and there was no overall reform. Triffin credited adoption of flexible exchange rates to Fritz Machlup influence on policy markers and academics through his leadership of the Bellagio Group conferences (Triffin 1960, p. 8). If Triffin is right, how did Fritz Machlup come to exert so much influence on the move from the gold-exchange standard to flexible exchange rates?

This paper begins with a review of the literature on confidence and framing, and then turns to the critical balance of payments problems facing the world after World War II. An exploration of the Triffin and Machlup arguments follows. I then examine Fritz Machlup's leadership role in the Bellagio Group conferences and the clash of ideas in the conferences and journals of the day. In the final section, I return to the question posed in the introduction and draw conclusions.

LITERATURE REVIEW

Dow (2008) explains that framing refers to the way in which presentation influences how we understand ideas. Different disciplines frame subject matter in their own characteristic ways (economics versus sociology, for example). Even within disciplines there can be framing differences, ranging from differences in the meaning of terms to differences in the underlying theory, resulting in different policy recommendations. Framing follows from logical positivism, which demands that scientific statements be testable against facts. For example, confidence is a term that has long been important to framing capital markets; we hear about investor confidence all the time. Confidence was outside the frame of the Bureau of International Settlements (BIS), an organization capturing data on international monetary flows. Nor was confidence part of the analysis of the International Monetary Fund (IMF), responsible for capturing data on money supply and interest rates. Nelson, Oxley and Clawson (1997) examine how framing influences political attitudes and finds that framing effects are stronger among respondents with a sophisticated understanding of the issues. For them, framing reinforces existing beliefs and arguments. The authors suggest framing as well as social interaction are critical to mobilization and collective action. In public policy, Mintz and Redd (2003, p. 195) identify framing with manipulation. They distinguish two subtypes that are relevant here. In evaluative framing, the frame anchors assessment of the

environment. In productive framing, the frame guides thinking toward an intended result. In this paper, Machlup emerges as the principal actor. Through the Bellagio Group conferences, he created an opportunity for evaluative and productive framing. Machlup manipulated the discussion to focus on three results --- adjustment, liquidity and confidence.

DATA AND METHODOLOGY

The paper takes an historico-biographical approach, drawing on the personal and published papers of Robert Triffin and Fritz Machlup.

RESULTS

A Crisis in Confidence

From 1946 to 1973, the Bretton Woods Agreement of 1944 was in force. Bretton Woods established gold as the universally accepted reserve asset for international payments and effectively fixed exchange rates. Supplies of gold were limited and new gold stores were under the control of gold-mining countries like Russia and South Africa. US dollars and British pounds sterling substituted for gold in all international payments, although they were convertible to gold on demand. Convertibility ended in Britain in 1947 and did not resume until 1958, leaving the US dollar the sole reserve currency backed by gold. Foreign trade depended on dollars available through the Eurocurrency market. The Eurocurrency market was heavily dependent on monetary policies in the US, as concern spread about the War in Vietnam and Johnson's Great Society program. Nevertheless, by the late 1960s, the size of this market was huge (Toniolo 2005, p. 461). From 1958 to 1968, the Bretton Woods financial system needed a whole series of agreements, regimes rules, and institutions to ensure it worked (Gavin, 2004). Nevertheless, the imbalance in international payments and flows of short-term capital that emerged in the mid to late 1960s became increasingly hard to resolve (De Vries 1976, p. 3). US and European policy-makers feared that loss of confidence in the dollar might trigger a run on the US Treasury gold window. Both saw loss of confidence as a threat to national and economic security.

Robert Triffin – Liquidity and Adjustment Problems Trigger Loss of Confidence

Robert Triffin was born in Belgium and educated at the Catholic University of Louvain and later Harvard University. He was a Yale economist (1951-1977) and a former member of the Federal Reserve Board, serving as chief of the Latin American section from 1942 to 1946. From 1946 to 1949, Triffin played various roles at the International Monetary Fund. Triffin committed his efforts to the reform of the Bretton Woods system. At the same time, he was also a member of Jean Monnet's Action Committee for the United States of Europe.

Like the architects of Bretton Woods, Triffin shared distrust for free capital markets and flexible exchange rates. Nevertheless, his experience of the pre-1914 gold standard led him to decide that, in practice, gold was neither self-managing with central bankers as passive facilitators nor self-correcting. Triffin believed a single key currency to be fundamentally unstable. Key currency countries will therefore fall from grace and will not provide the basis for a sound international financial order. In *Europe and the Money Muddle,* Robert Triffin argued the growth of foreign countries' reserves had depended on a vast redistribution of net reserves from the United States to the rest of the world. He said further that such a movement could not continue without eventually undermining confidence in the dollar itself. (Triffin 1957, p. 296-297). Triffin expanded on this argument in his statement to the Joint Economic Committee of Congress in October 1959. If the United States ever stopped running balance of payments shortfalls and supplying reserves, the resulting shortage of liquidity would cause the global

economy to contract. Nevertheless, if the deficits continued, inflation and loss of confidence would result (Triffin 1959). This diagnosis is known as "Triffin's Dilemma" or "Triffin's Paradox."

Triffin's 1959 prescription was to replace gold and foreign currency reserves by gold-guaranteed deposit accounts at the IMF. Triffin's later writings placed increasing stress on the inflationary potential of continuing US deficits and the threat of a gold and dollar crisis. He admitted that he had underestimated the US deficits that foreign central bankers would be willing to absorb (Triffin 1978, p. 5).

<u>Fritz Machlup – A Failure of Confidence Triggers Adjustment and Liquidity Problems</u>

Fritz Machlup (1966a) was the first economist to credit adjustment and liquidity to a failure of confidence. He was also the first to argue that a restoration of confidence would make adjustment and liquidity moot. For Machlup, the French (and German) focus on payments adjustment had a simple explanation. For many years, the United States had spent, lent and invested money abroad. The US had paid largely in dollars which the monetary authorities of many nations now held in their monetary reserves. The French government disapproved of some of this spending and investing, for example the war in Vietnam and foreign direct investment in French firms. The French regarded adjustment as the most urgent need (Machlup 1966a, p. 2). The growing wealth of the Bank of France made it hard for the French to understand a present or imminent shortage of reserves in the world (Machlup 1966a, p. 2). To the American argument for a new reserve asset, the French reply was the deficit must end first. While Machlup argued that the French position was understandable, he saw the problem differently. The American difficulties in achieving balance had nothing to do with an absence of safeguards. "[Future] contingencies, as I see them (or fear them) are less likely to arise from inadequate liquidity than from inadequate confidence." (Machlup 1966a, p. 2)

According to Machlup, the American position rested on two optimistic assumptions. First, the US assumed that it could eliminate its payments deficits in short order. Second, the US believed that its dollar would remain as good as gold despite its deficits. To provide liquidity was the first order of business (Machlup 1966a, p. 2-3). Foreign trade liberalization and convertibility were critical to the growth of world trade and prosperity. Both depended on ample liquidity. Without US deficits, more countries would suffer shortfalls in their international payments. To stop losses in their reserves, countries might adopt restrictive commercial policies and place new limits on convertibility, halting or reversing world trade and finance. Nations must agree on a method of creating satisfactory annual increments in world liquidity with no time to lose. (Machlup 1966a, p. 3)

Machlup saw the weakness of the American position in its assumptions. The American attitude about the problem of confidence reflected a debtor position. One can hardly expect a debtor to propose measures to safeguard against loss of confidence in his ability to pay. Machlup argued that the balance of payments of the United States and confidence in the dollar were not separate problems. "[A] weakening of the confidence – private, not official – in the dollar has for the past few years caused the deficit in the balance of payments. To seek adjustment without confidence is probably hopeless." (Machlup 1966a, p. 3) Changes in the flow of private short-term capital often reflect changes in confidence in the convertibility of the gold and foreign exchange value of a currency. Given that short-term capital also moves in response to interest rate differences, it is sometimes difficult to untangle the two. From 1951 to 1959, private short-term capital had moved into the United States every year except 1954. Beginning in 1960, large outflows followed for five years. (Machlup 1966a, p. 4-5) The cause of the outflows was loss of confidence in convertibility of the dollar (Machlup 1966a, p. 5).

Machlup argued, "I submit that a system of securing confidence would all of itself restore balance in the payments position of the United States (Machlup 1966a, p. 6). To what extent did the world surplus of reserves add to confidence? Machlup argued it was not a final amount but annual additions to reserves that had a positive impact on confidence. In countries suffering losses in foreign reserves, the authorities would eventually restrict international trade and capital movements. Annual additions to reserves were essential to reduce or avoid deficits (Machlup 1966b, p. 30).

The Confidence Issue at the Bellagio Group Conferences

On October 2, 1963, US Secretary of the Treasury and Governor of the International Monetary Fund Douglas Dillon announced he was launching two studies of the international monetary regime. Three academic economists (Fritz Machlup, William Fellner and Robert Triffin) heard Dillon's announcement and decided to embark on an independent study. They prepared to invite economists with widely divergent views with no problem or proposal considered "out of bounds" (Machlup 1964, p. 8).

Table 1: Attending Bellagio Group Members, Their Institutional Affiliations and Public Policy Experience

Member	*Institution (University)*	*Former Public Policy Role*	**Country of Citizenship (birth)**
Prof. Arthur L. Bloomfield.	Pennsylvania	Federal Reserve	US (Canada)
Prof. Lester Chandler	Princeton	Federal Reserve	US
Prof. Alan C. L. Day	London	Radcliffe Committee	UK
Prof. Pierre Dieterlen	National Center of Scientific Research	European Monetary Union	France
Prof. Leon Dupriez	Louvain	National Bank of Belgium	Belgium
Prof. William J. Fellner	Yale	Council of Economic Advisors	US (Hungary)
Prof. Alberto Ferrari	Rome	Bureau of International Settlements	Italy
Prof. Gottfried Haberler	Harvard	Federal Reserve, National Bureau of Economic Research	US (Austria)
Prof. Albert Hahn	Frankfurt	Banker, Bankhaus L. Albert Hahn	Switzerland (Germany)
Prof. George Halm	Fletcher School of Law and Diplomacy		US (Germany)
Sir Roy Harrod	Oxford	Advisor to Harold Macmillan; International Monetary Fund	UK
Prof. Michael Heilperin	Institut Universitaire de Hautes Etudes Internationales		US (Poland)
Mr. Fred Hirsch	The Economist	International Monetary Fund	UK (Austria)
Prof. Harry G. Johnson	Chicago		Canada
Prof. Fritz de Jong	Groningen	Labor Party of Groningen	Netherlands
Prof. Peter B. Kenen	Columbia	Federal Reserve	US
Prof. Charles Kindleberger	MIT	Federal Reserve, Bureau of International Settlements	US
Prof. Kioshi Kojima	Hitotsubashi	Pacific Free Trade Agreement	Japan
Dr. Alexandre Lamfalussy	Banque de Bruxelles	Banker, Banque de Bruxelles; Bureau of International Settlements	Belgium (Hungary)
Prof. Friedrich Lutz	Zurich	International Monetary Fund	Germany
Prof. Fritz Machlup	Princeton	Consultant, US Treasury	US (Austria)
Prof. Burton Malkiel	Princeton	Council of Economic Advisors	US
Prof. Hans Moller	Munich	Banker, Bank Deuscher lander;	Germany
Prof. Robert Mundell	McGill	United Nations, International Monetary Fund, World Bank, Federal Reserve US Treasury, Government of Canada	Canada
Prof. Jurg Niehans	Zurich	Swiss Diplomatic Corps	Switzerland
Prof. Bertil Ohlin	Handelshogskolan	Swedish Minister of commerce (1944-45); member , Riksdag from 1938 to 1970	Sweden
Prof Jacques Rueff	Consul for Economic and Social Affairs	Advisor to French President Charles de Gaulle	France
Dr. Walter Salant	Brookings	Treasury Department, Securities and Exchange Commission, Commerce Department, NATO	US
Prof. Tibor Scitovsky	California	Organization for Economic Cooperation and Development	US (Hungary)
Prof. Egon Sohmen	Saar	European Monetary Union	Austria
Prof. Robert Triffin	Yale	Federal Reserve, International Monetary Fund	US (Belgium)
Dr. Pierre Uri	Atlantic Institution	European Monetary Union	France

This table identifies the members of the Bellagio Group, their university or organizational affiliation, former public policy role, and country of citizenship and birth. Note that country of birth is in parentheses. Source: Machlup, F. International Monetary Arrangements: The Problem of Choice (1964a) and author's research into former public policy roles.

Most economists invited to join the Bellagio Group conferences had played an active public policy role before moving into academe. See Table 1 Attending Bellagio Group Members, Their Institutional

Affiliations and Public Policy Experience. The selection was deliberate, since political judgments would play an important role in discussions of policy alternatives. Some members continued to be active in efforts toward European integration.

Machlup's invitation suggested the conferences were an experiment to understand sources of disagreement by examining the assumptions underlying major policy approaches. Fritz Machlup set the preconditions for discussion. Assumptions betraying political attitudes were especially important to Machlup. He saw that judgments about what is politically "unacceptable" or "impossible" might be responsible for wide disagreement among economists. Machlup warned against confusing political assumptions with value judgments (Fritz Machlup Papers, box 282, folder 6).

Participants agreed to evaluate reform policies based on improved payments adjustment, liquidity and confidence. At Machlup's urging, conference participants agreed to a definition of terms (Machlup 1964, p. 43-45). For example, conferees sorted payments imbalances into three types depending on frequency and cause. They agreed that each reform policy should include a solution to the provision of currency reserves (Machlup 1964, p. 53-58). Conferees agreed that problems of confidence in reserve currencies arise for two reasons. First, monetary authorities may want to change the composition of their reserves by substituting one reserve asset for another. Second, they may not wish to accept more of a particular asset they already hold and to convert additional amounts acquired into gold. In either case, the presentation of a large dollar or sterling claim for conversion into gold might lead other holders to run down their dollar or sterling balances as well. This could trigger drastic action by the US or UK in defense of its gold reserves (Machlup 1964, p. 58-65).

Table 2 summarizes the differences in fundamental assumptions underlying four major policy approaches. Many members of the Bellagio Group had preferred policy approaches. Some, like Harrod and Lutz, had several preferred approaches. As well as differences, the Bellagio Group discussions threw some likenesses into relief. For example, supporters of centralized reserves and multiple currency reserves policies faulted the current gold-exchange standard and proposed semi-automatic gold standard for the same haphazard approach to gold production and failure to ensure against liquidity problems.

They also shared the assumption that payments adjustment would fail to work fast enough to enable countries to finance their shortfalls with available reserves and borrowing. Therefore, gold-based policies could meet neither liquidity nor adjustment tests. Supporters of flexible rates agreed, adding that delayed payments adjustment would lead to tariffs to limit imports or foreign aid tied to military purchases.

Bellagio Group members carried the debate on policy options into their own publications. Burton Malkiel saw Triffin walking a tightrope between two irreconcilable goals: a central bank and emancipation from gold and distrust of big government institutions (Malkiel 1963, p. 515). Charles Kindleberger argued that many economists saw the Triffin solution "the first-best solution economically," but "most of them think that it is politically out of the question" (Kindleberger 1970, p. 216). Outside the Bellagio Group, Oscar Altman of the IMF attacked Triffin's assessment of the liquidity needs of growing international trade. He argued an expanded IMF would find itself intervening in the money markets of the US and UK. He argued further that the composition of IMF assets would need to change from currency and short term loans to long-term investment (Altman 1961, p. 187). Leland Yeager faulted the Triffin plan for focusing on the liquidity problem with its high potential for inflation with no mechanism to resolve balance of payments problems (Yeager 1961, p. 312).

Table 2: Exchange Rate Policies and Their Advocates

Policy	Fundamental Assumptions	Desired Impact	Bellagio Group Advocates
Semi-automatic gold standard	Raise the price of gold to allow the removal (redemption) of all reserve-currencies from the system. Leave gold as sole reserve asset. Fix exchange rates.	Eliminate payments imbalances. Removal of reserve currencies and increase in gold price raise	Pierre Dieterlen, Albert Hahn, Sir Roy Harrod, Michael Heilperin, Jacques Rueff
Centralized Reserves	Major reserve holders agree to keep fixed proportion of gross reserves as gold - guaranteed deposits, with IMF authorized to adjust quantity of reserves through open market operations, overdrafts, or bonds.	Addresses liquidity. Confidence in system depends on confidence in IMF.	Robert Triffin, ACL Day, Sir Roy Harrod (alternative plan), Alexandre Lamfalussy, Pierre Uri
Multiple Currencies	Monetary authorities of reserve currency countries agree to diversify foreign exchange holdings to include mixed currencies (not only US and UK) and gold as reserves, ensure no abrupt and destabilizing changes.	Permits growth of reserves for payments adjustment under conditions of full employment, stable prices, and fixed exchange rates.	Friedrich Lutz, Burton Malkiel, Sir Roy Harrod (alternative plan)
Flexible Exchange Rates	Market forces increase export revenues for deficit countries decrease import expenses for surplus countries. International agreements restrict monetary authorities from intervening in market.	Payments balance achieved through adjustment of the exchange rate to market supply and demand.	Milton Friedman, Fritz Machlup, Gottfried Haeberler, Albert Hahn , George Halm, Harry G. Johnson, Friedrich Lutz (alternative plan), Egon Sohmen

Table 2 summarizes the fundamental assumptions and desired outcomes of the four major policy approaches explored by the Bellagio Group. Many members had preferred policy approaches; see "Advocates" column. Some members, like Harrod and Lutz, had several preferred approaches. Source: Report on International Monetary Arrangements: The Problem of Choice (1964) and author's own research.

The semiautomatic gold standard and flexible exchange rates shared an appealing feature. Both substituted fixed rules and automatic mechanisms for governmental discretion (Machlup 1965, p.168). Indeed, distrust for government intervention (big government or government institutions) was the reason the Monetary Committee of the European Economic Community disapproved the Triffin Plan (Robert Triffin Papers, MS 874, Box 1, folder 1). Disapproval did not end the Triffin Plan.

The publications of the Bellagio Group and media attention created by the conferences gave the Bellagio Group a high profile. We learn from Triffin's notes that Group of Ten members saw the usefulness of the Bellagio Group as a non-governmental, independent think tank. Otmar Emminger, in his role as chair of the deputies of the Group of Ten, found the Bellagio Group conferences invaluable to policy deliberations. Members of the Group of Ten would become close working partners with the Bellagio Group, joining them for seminars some 15 times through 1974. (Robert Triffin Papers, MS 874, box 12, folder 2)

In November 1965, Otmar Emminger asked the Bellagio Group to devise adjustment policies for countries in payments imbalance and to investigate the use of special reserve assets. They were to assume no change to fixed exchange rates. Fritz Machlup asked the Bellagio conferees to consider and rank order their preferred exchange rate solutions to liquidity, adjustment and confidence problems.

Table 3 reflects the Bellagio Group members' preferred solutions to the liquidity, adjustment and confidence problems, based on Robert Triffin's calculations at the fourth conference. Ignoring the request to consider fixed exchange rate solutions only, the Bellagio Group voted the Triffin plan with flexible exchange rates their number 1 choice. The Bellagio Group recommended to the Group of Ten the

hybrid solution of flexible rates and Triffin's plan for increased credit reserves under the control of the IMF.

Table 3: Adjustment, Liquidity and Confidence Preferences

Goal	*Mechanism*	Member Votes
Adjustment	Adjustable pegs/wider margins (Managed flexibility) outvote unlimited flexibility	**14/17**
Liquidity	**Credit Reserves**	**14/17**
Confidence	Consolidate into IMF deposits	**14/17**

This table shows the Bellagio Group members' preferred solutions to the liquidity, adjustment and confidence problems. The results are based on a survey made by Fritz Machlup at the end of the fourth Bellagio Group conference. Robert Triffin calculated the survey results, based on 17 attendees. The data are available in Triffin'a hand-written notes in Robert Triffin Papers, MS 874, Box 12 folder 2.

CONCLUSION

The goal of this paper was to examine Triffin's claim that Fritz Machlup turned the tide of opinion toward exchange rates as an instrument to correct balance of payments adjustment problems and restore confidence in the international monetary regime. Of particular importance to this interpretation are the archival records of Fritz Machlup at the Hoover Institution and Robert Triffin's papers at Yale University. Because of Triffin's involvement with both European integration and the Bellagio Group, the Triffin papers reveal the many points of tangency between the two efforts.

The findings support Triffin's claim. The current paper attributes Machlup's influence to his selection of economists to join the Bellagio Group; his close working relationship with the deputies of the Group of Ten; his creation of a broad platform of joint conferences, papers and books to promote their work, and his framing of the problem of world monetary system reform.

While Fritz Machlup was a powerful advocate for flexible exchange rates, the archives show us that his leadership of the Bellagio Group conferences gave him incomparable reach and influence. Beginning with his choice of invitees, Machlup selected academic economists who were associated in print with a specific exchange rate policy, most of whom had had prior public policy experience. He built a close relationship with Otmar Emminger and the deputies of the Group of Ten. Robert Solomon, American representative on the Ossola Committee of the Group of Ten, distinguished the Bellagio Group's work from that of the IMF or Group of Ten. "More stress was placed on the desirability of changing exchange rates as a means of balance of payments adjustment…. more concern was expressed about the instability that could arise from the 'overhang' of foreign exchange reserves. (In general the report of the Bellagio Group holds up well in the light of subsequent developments)" (Solomon 1977, p. 71).

Machlup continued to extend invitations to academics and former policy-makers with very different policy approaches to co-lead future Bellagio Group. New leaders extended the policy and intellectual reach of the conferences. Machlup's continued involvement ensured that policy rivals had the opportunity to put their arguments through the same rigorous methodological analysis. Machlup also had access to conferences like the American Economic Association, the American Banking Association and the American Enterprise Institute, that sought to give the Bellagio Group members access to larger and more international audiences. As senior editor of the Princeton University Finance Section, Machlup published many dozens of papers on international monetary reform written by Bellagio Group members and officials who had attended extended group meetings.

Finally, it was in Machlup's framing of the issues in terms of adjustment, liquidity and confidence that he had a distinctive advantage. The (potential) shortage of liquidity and its devastating effect on confidence and stability, originally exposed by Triffin, had an important influence on the plan to create Special

Drawing Rights. The hybrid solution recommended by the Bellagio Group (and finally adopted) put the primary focus on flexible rates to moderate confidence in reserve media. Special Drawing Rights relieved a shortage of international reserves while convertibility of the dollar was still an issue (IMF 1987, p. 12). With the growth of international credit markets and elimination of gold convertibility and par values in the 1970s, other attributes of the SDR have become important. The SDR is a source of cost free, lower-risk, supplemental owned reserves (Clark and Polak 2004). The SDR is also a potential alternative to credit markets when confidence in the system is in crisis. Not actual currency, the SDR might serve as the basis for a universal currency, similar to Keynes' bancor (Alessandrini and Fratianni 2009).

A limitation of this paper is the narrowness of its focus. The collapse of the Bretton Woods Agreement and the integration of Europe is a complicated story with many interrelationships. My continuing research into the Bellagio Group focuses on the group's contribution to public policy and international trade and finance scholarship.

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BIOGRAPHY

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