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THE CASE FOR THE PAR-VALUE SYSTEM, 1971

by

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The commitment of each member to maintain a par value and to consult the Fund before changing it constitutes the heart of the international monetary system established at Bretton Woods. Economists in general have tended to be critical of these arrangements. The professional literature has stressed the role of exchange rates in clearing foreign-exchange markets and economists, in general, have preferred arrangements under which exchange values would fluctuate enough to clear exchange-markets in an orderly fashion. The one-sided support economists have given to flexible exchange-rate arrangements has largely rested upon an overwhelming professional preference for making shifts in economic resources through market processes. Perhaps elements of nationalist unilateralism may sometimes have contributed to this preference. In any case, many critics were convinced that the par-value system would inevitably lead, in a world of discordant national policies, merely to networks of governmental controls and to financial crises. There have been frequent enough financial disturbances in recent years to confirm that such misgivings were not altogether unjustified.

And yet the par-value system established at Bretton Woods in 1944 survived these adversities, and this criticism, for a generation. During this period, to be sure, adjustment decisions by major trading countries were often avoided or postponed until conditions in financial markets reached crisis intensity. But needed changes in par-values were eventually made and the Bretton Woods arrangements were maintained because practical men were not prepared to abandon them. The one-sided, though not unanimous, preference for flexible-rate arrangements within the academic community was matched by an equally one-sided, though not unanimous, preference for stable exchange rates among government and banking officials and private entrepreneurs.

But the adaptability of the Bretton Woods arrangements to adjust to contemporary needs was severely challenged by developments in mid-1971. For these struck at the heart of the international commitments which had been the basis for world monetary cooperation since 1946. The key elements of that system were placed in jeopardy by the decisions of Germany and the Netherlands "not to maintain the exchange rates for its currency within the established margins"[1/] and by the decision of the United States "no longer, for the settlement of international transactions, in fact, to freely buy and sell gold."[2/] Earlier, in June 1970 of course the Canadian authorities had decided for the second time since 1946 to float the exchange rate.

The temporary suspensions of par-value obligations by three, and of the gold-convertibility obligation by one, Fund members unques-

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1/ I.M.F. Press Release No. 839, May 9, 1971.

2/ I.M.F. Press Release No. 853, August 20, 1971.

tionably marks an historic turning-point in world monetary affairs. On the eve of the Fund's annual meeting in September (1971), the leaders of the international community are seeking ways to reach agreement on an appropriate structure of exchange rates -- fully mindful that the most widespread changes in parities since the general devaluations in 1949 may be implied by this criterion -- and on changes in exchange-rate practices in the interest of improved adjustment performance and liquidity arrangements. Whether these negotiations proceed smoothly in the months ahead, or only with difficulties, there is implied in these efforts the most sweeping changes in the mechanics of international finance since the International Monetary Fund itself was agreed upon at Bretton Woods in 1944.

The intensity with which world financial arrangements are currently being scrutinized provides an appropriate occasion for a re-evaluation of the economic rationale of the par-value system. A review of the benefits of such arrangements, and of some of their difficulties, is also recommended by the conspicuous imbalance in the professional literature on the subject of the adjustable-peg. There are a number of distinquished critiques of the par-value system, several excellent -- and a few classic -- pieces in defense of flexible-rate arrangements, but few attempts to develop the case for the adjustable-peg. This paper is an attempt to consider the case that can be made in favor of such an exchange-rate system.

Par-value system: its distinguishing characteristics

An analysis of the economic case in favor of the par-value system requires, at the outset, an identification of its distinguishing characteristics. We must ask in particular in what respects such a system differs from a system of fixed, and from one of flexible, exchange rates.

It would be convenient, and in the abstract acceptable, to compare the par-value system with the alternative exchange-rate options found in standard textbooks: that is, with systems of permanently- or credibly-fixed exchange rates and of freely-flexible or freely-fluctuating exchange rates. But both of these abstract models are remote from the conditions of the contemporary world. The model of credibly-fixed exchange rates might be relevant to the world of the pre-1914 gold standard but not to a world which accords such a high priority to domestic high-employment in all countries. Similarly, it is hardly profitable to accept the model of freely-fluctuating exchange rates in a world in which we know that governments are not prepared to permit their currencies to fluctuate in the exchange market without official intervention in any form.

Because a commitment to exchange-rate rigidity is no longer credible in the contemporary environment, the three alternatives -- flexible, fixed and adjustable exchange-rate arrangements -- have to be distinguished in terms of the technical characteristics of flexibility summarized in Table 1. Flexible-rate systems are readily distinguishable from the other two: there is the absence of a commitment to a formal parity, to specific intervention points and to conditions which must be complied with before a change in parity can be made. (See Table 1.)

As to the two variants of a fixed-rate system, they have in common the commitment to a formal parity and to announced intervention points -- that is, to the objective of rate-stability in the short-run. Both require international review before changes in par-value can be made. They differ in their long-run objective. That is, the conditions under which the par-value could be altered become conspicuously more rigorous under a "last resort" fixed-rate system (which could be regarded as equivalent for our generation to the pre-1914 international gold standard) than they would be under the system of the adjustable-peg.

In essence, the two variants of the fixed-rate system in Table 1 differ primarily in the role exchange-rate changes are expected to play in the adjustment of international payments. Under the fixed-rate variant, the par-value would be regarded as credibly fixed as it was under the former gold standard: that is, the authorities in each country would accord a priority to this intention so that "for all practical purposes variations of exchange rates will in the future, as at present, be used only in exceptional cases as a method of balance-of-payments adjustment among the major industrial countries."[1/] With

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1/ Otmar Emminger "Practical Aspects of the Problem of Balance-of-Payments Adjustment," Journal of Political Economy, Supplement Part II, August, 1967, p. 512.

Table 1

Rate-Flexibility Under Three Alternative Exchange-Rate Arrangements

Exchange-rate System	Formal parity	Formal intervention limits	Conditions for change parity	Exchange values in short-run	Exchange values in long-run
Market flexibility	None	None 1/	None	Flexible	Flexible
Fixed rates	Formal	Announced	"Last-resort"	Fixed	"Last-resort" flexibility
Par-value or adjustable-peg	Formal	Announced	"Fundamental disequilibrium"	Fixed	"Internationally-agreed" flexibility

1/ Some advocates of flexible exchange rates recommend, and others oppose, formal intervention by the central bank in the foreign-exchange market.

this approach, exchange-rate adjustment would be regarded as a "last resort" instrument of national policy to be tried only after alternative methods of external adjustment had failed.

The adjustable-peg would differ from the fixed-rate variant in regarding rate-flexibility in the long-run as desirable in itself. Under its terms, exchange-rate action becomes a policy option open to the national authorities of each country, subject to specific and to general international constraints. For the international community -- in the words of the recent Fund report -- "accepts the right of individual countries, subject to the international obligations just mentioned, to adjust their exchange rates to fulfill legitimate domestic objectives, as well as agreed international objectives."1/

These differences can be more clearly drawn in a theoretical exercise than in practice. For there have been, and continue to be, widely differing notions about how much rate-flexibility is consistent with the intent and objectives of the Fund's Articles of Agreement. There might be agreement, at least in principle, that the historic innovation at Bretton Woods was to recognize in a formal international agreement that a member-country could, subject to international review, choose to employ exchange-rate policy to protect its domestic economic stability from international disturbance. But in practice there was a high degree of exchange-rate rigidity among the industrial countries,

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1/ The Role of Exchange Rates in the Adjustment of International Payments, International Monetary Fund, Washington, 1970, p. 5.

especially between 1958 and 1967, so that the Bretton Woods system of the adjustable-peg seemed to be more nearly akin to a fixed-rate system of the pre-1914 type than to any recognizable form of limited and internationally-controlled flexibility. Over the past few years, however, political leaders as well as government and financial economists have accorded to exchange-rate policy a more active role in international payments adjustment than they had been prepared to accept prior to 1967 and much recent attention has been focused on the role of a limited increase in exchange-rate flexibility in a par-value system, and the ways it could be attained.

There remain widely differing opinions about how much exchange-rate flexibility is consistent with the Fund's Articles of Agreement and the differences extend even among the partners of the European Common Market. For our purposes, however, the par-value system will be defined in terms of the flexibility characteristics in Table 1: it will be regarded as an attempt to combine fixed exchange rates in the short-run with internationally-controlled flexibility in the long-run. It differs from both the systems of market-flexibility and of fixed-rates in those characteristics identified in the Table. Thus, it can be regarded as an attempt to promote -- through its elements of exchange-rate fixity -- the international division of labor and international trade and capital flows, just as the international gold standard was intended to do when foreign-exchange market participants were expected to regard parities as credibly permanent. But the adjustable-peg also has essential elements of rate-flexibility which allow exchange values to be altered as needed, but only as needed, to promote orderly adjustment of international disequilibrium and orderly exchange-rate arrangements among member-countries.

In this paper, we shall first consider the arguments in favor of a par-value system with the technical elements of flexibility attributed to it in Table 1 and then review some of the difficulties which have emerged with it in the past-1945 world. The difficulties which have arisen, as we shall see, have spurred attempts to encourage an acceptance of modifications of recent exchange-rate practices in order to realize a greater (though still internationally-limited) degree of rate-flexibility during the 1970's than had been achieved in the preceding decade. These innovations have been encouraged because the difficulties experienced in international financial markets since mid-1967 have raised questions about whether it would be possible to create, within the contemporary economic environment, orderly processes of international adjustment consistent with the Articles of Agreement accepted at Bretton Woods 25 years ago.

Domestic priorities and the exchange-rate system

The case for the par-value system, as compared with either a system of credibly-fixed or of market-flexible exchange rates as we have defined them, would be weaker if, in practice, particular policy instruments could be assigned to particular target variables in accordance with assignment-theory analysis. If the authorities had an instrument-variable appropriate and effective for each policy-target, there would be no analytical basis for being pessimistic about the prospects for external economic balance under the types of fixed rates currently in effect even in a world in which national policies are only partially harmonized.

But, in practice, policy instruments are often not separable and it is seldom that they are uniquely assigned to a specific target variable. Too often national authorities are beset with more objectives than policy instruments or with goals that are contradictory; they are seldom free to allocate tools-to-goals so as to ensure the achievement of multiple goals simultaneously. As a result, they usually assign the instruments they have available to their priority targets and are forced to neglect secondary objectives which, all too often, include the nation's international objectives.

For example, economists have often recommended that, with fixed exchange rates, monetary policy could be effectively employed for external balance and fiscal policy for internal balance. Between 1958 and 1967, however, European central bankers were not prepared to abdicate their primary responsibility for domestic stability, even where balance-of-payments factors threatened the central bank's control over the domestic credit situation. Instead they fashioned new tools of central banking, making credit restraint an effective tool of domestic stabilization by devices to insulate the domestic economy from external sources of liquidity. Even in this period when balance-of-payments surpluses were excessive and local spending aggregates high, these countries made monetary policy the primary instrument of domestic stabilization, often with only limited support from fiscal policy.1/

The overriding priority for domestic policy goals which is asserted in the industrial countries has dimmed the prospect that external balance could be expected from an instruments-target approach to economic stabilization. To be sure, the national monetary authorities may have acquired a growing capability -- based upon political consent -- to direct government tools toward priority economic goals. But, as a general rule, considerations of external balance have been assigned only a modest priority in formulating stabilization objectives, except in the most unusual circumstances.

Because the industrial countries agree in this relative neglect of external factors, the problem arises: How can we hope for a tolerable

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1/ Samuel I. Katz, External Surpluses, Capital Flows, and Credit Policy in the European Economic Community, 1958 to 1967, Princeton Studies in International Finance No. 22, February 1969, esp. pp. 1-10 and 32-45.

balance in international transactions so that the reconstructed liberal international trade and payments structure can be maintained? If in our fixed-rate world external economic balance (without controls) is to be regarded by the industrial countries to be only a subsidiary priority, it is evident that we cannot expect these countries to follow policies for external balance which conflict with the goal of internal balance; instead the national authorities must be able to choose measures of domestic balance which, in all situations, can be consistent with the requirements for external balance.

<u>Unique adaptability of par-value system</u> - In this environment, the unique adaptability of the par-value system to offer the authorities an option through which external balance can always be made consistent with measures of domestic balance becomes a major argument in its favor. This particular adaptability of the par-value system is in direct contradiction to the two main alternative exchange-rate systems -- that is, credibly-fixed and market-flexible rates, as we have defined them -- which cannot as readily accommodate policies for internal balance which will prove to be consistent with the requirements for external balance.

The weaknesses or limitations of these two alternative systems can be identified directly from an analysis of "dilemma" and "non-dilemma" situations. Under the variants of fixed rates currently in effect, the authorities will find an external-internal policy conflict in the "dilemma" situations in which surplus countries have excess, and deficit countries inadequate, internal demand. With flexible rates, by contrast, they will find a conflict in the "non-dilemma" situations where surplus countries have inadequate, and deficit countries excess, internal demand.

Economists who have recently been exploring these conflicts in terms of "dilemma" and "non-dilemma" situations have largely been covering ground which was pretty fully sketched out in Meade's monumental treatise twenty years ago.[1/] It was Meade who approached external-internal balance as a policy problem in international economics in which target variables were specified and the corresponding values of the policy tools were then to be determined.

The four "non-dilemma" and "dilemma" situations under existing fixed-rate arrangements are summarized in Table 2. There actual domestic expenditures (E) are compared with the level of domestic output which is consistent with domestic employment and price goals (which is designated as Y*). Actual foreign receipts (R) are then compared with actual foreign payments (P). Finally, the effects on domestic spending aggregates (E) of the adjustment processes under fixed and flexible exchange-rate systems in the four internal-external balance situations are summarized in columns 3 and 4.

This policy-oriented schema is intended to distinguish (i) the effects of domestic policy actions on internal spending aggregates

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1/ J. E. Meade, The Balance of Payments, (London: Oxford University Press, 1951), esp. Chapters VIII to XI, pp. 99-162.

from (ii) the effects on external balance. We will assume that the national authorities can, and almost always will, be primarily concerned to alter domestic spending aggregates in an endeavor to attain their Y* target priority. We will consider the ways the policies to achieve domestic balance will affect the external balance in the four situations first explored by Meade. Our concern will be to observe how policy measures designed to bring E closer to Y* will alter the difference between R and P.

The "non-dilemma" situations - There is one key characteristic which identifies the two "non-dilemma" situations under existing exchange-rate arrangements: measures to restore internal balance will also improve the external balance. That is, the internal economy is out of balance because actual spending is below the Y*-target in the surplus country, (Case 1) and it is above Y*-target in the deficit country (Case 2). In these two cases, measures to push domestic spending aggregates toward the Y*-target level will also reduce the inequality between R and P. In order to realize the overriding priority assigned to the domestic Y*-target, the national authorities would make changes in domestic demand aggregates; these would necessarily promote external balance.

In these two positions, changes in the exchange rate could also be used to improve the trade balance. But in both cases, the movements of the exchange rate would have the effect of altering the trade imbalance in ways which would worsen the internal disequilibrium. That

Table 2

Summary of internal-external balance in "non-dilemma" and "dilemma" cases

			Effects on domestic spending (E) if there were in effect only:	
	Internal position	External position	Credibly-fixed rates	Market-flexible rates
Non-dilemma cases:				
1. Surplus-deflation	$Y^* > E$	$R > P$	+	-
2. Deficit-inflation	$Y^* < E$	$R < P$	-	+
Dilemma cases:				
3. Deficit-deflation	$Y^* > E$	$R < P$	-	+
4. Surplus-inflation	$Y^* < E$	$R > P$	+	-

Note: Y* is the level of domestic output consistent with domestic employment and price goals; E is actual domestic spenditures (including trade balance); R is foreign receipts, and P is foreign payments.

is, the surplus country would find the exchange rate higher and, hence, the trade surplus reduced; but the lower trade surplus would further contract domestic spending, widening the shortfall between E and Y*. Similarly, the deficit country would find the exchange rate lower and, hence, the trade deficit reduced; but this improvement would further add to domestic spending, widening the excess of E over Y*.

This analysis is a reiteration of the doctrine, accepted since Meade, that the "pure" demand cases require changes in internal spending and not external policy measures. To be fair to the advocates of flexible rates, however, we must add that "non-dilemma" situations can -- often with unexpected rapidity -- turn into "dilemma" situations. That is, a country with deficient demand may find revaluation unavoidable; for example, Germany between 1966 and 1969 may or may not have been a pure example of a "non-dilemma" case which turned into a "dilemma" case; but the German economic "pause" in 1966-67 materially helped to build up the trade surplus to levels which made revaluation inevitable in 1969. Similarly, the United Kingdom may or may not have been a "non-dilemma" case in 1964 but the protracted excess demand in that country had, by 1967, created a "dilemma" situation in which devaluation became unavoidable.

<u>The "dilemma" situations</u> - There is one key characteristic which identifies the two "dilemma" situations: measures to restore internal balance will worsen the foreign-trade balance. That is, the requirements for external balance will further worsen the internal

disequilibrium because the surplus country already has excess domestic spending (Case 4) and the deficit country already has significant amounts of unused domestic resources (Case 3).

In these situations, internal and external goals cannot be achieved through changes in internal demand policies. For changes in domestic spending intended to reach the Y*-target in both the deficit and surplus countries will worsen the trade balance, and changes in demand to reduce the external disequilibrium will worsen the internal balance in each of them. On the other hand, the trade balance can be improved by external policy action -- that is, by appropriate changes in the exchange rate. In both cases, the exchange-rate action will improve the trade balance and the internal disequilibrium. The surplus country will experience internal deflationary impulses from the higher exchange rate through: (i) the domestic income-effects of a declining export surplus and (ii) the domestic price-effects of lower costs for imported goods. Similarly, the deficit country with sluggish demand should experience expansionary impulses through the improved export position once the exchange rate is reduced.

Adaptability of par-value system - The case for the par-value system rests on its adaptability to enable the national authorities to avoid situations of internal-external balance conflict. In two of the four situations Meade identified, as we have seen, fixed rates and, in the other two situations, flexible rates could by themselves solve the external problem only at the expense of the internal problem. On the other hand, changes in parity can be reserved, in the par-value system, for the "dilemma" cases.

The recent revaluations and devaluations by major industrial countries have been attempts to avoid an excessive domestic cost as the price for external balance. In the German revaluation, for example, the late President Blessing came to recommend revaluation in 1969 because in his words,

> "I have since been forced to admit that we live in a world which is no longer ... prepared to accept really severe disinflationary measures, and that the healthy can protect himself against inflation only by means of a change in parity." 1/

Similarly, Prime Minister Wilson finally decided to devalue in 1967 because his government was not willing to accept the conditions -- the internal policy constraints -- on which additional international financial aid might have been forthcoming.2/

Fund report on exchange-rate flexibility - This particular adaptability of the par-value system to be adjusted to the requirements of internal balance is confirmed in the Fund's recent report on exchange-rate flexibility. Member countries are encouraged to take other measures -- in preference to exchange adjustment -- in situations where "other measures can be taken to restore payments balance without damage

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1/ Herr Karl Blessing, President of the Bundesbank, speech before the German Cooperatives at Mainz (Germany), October 10, 1969.

2/ Television address by Prime Minister Wilson to the British nation on November 19, 1967 announcing the devaluation of the pound.

to national or international prosperity" because in those cases "where the domestic measures that would contribute to external balance would also help to preserve or restore internal balance, domestic measures will be needed in any case."1/

On the other hand, the national authorities can, subject to the standards of the Articles of Agreement and to international review, choose to employ exchange-rate policy to protect their domestic economies from disturbance through the balance of payments. For, the report added, "where the requirements of internal and external stabilization point in opposite direction for domestic policy ... there is then no such presumption in favor of domestic measures directed to restoring external equilibrium, since such measures, at least if unaccompanied by exchange adjustment, will intensify the domestic disequilibrium." The report goes on to note that, in the prevailing international environment of excess demand and generalized inflationary trends, the external-internal balance conflict "is more likely to occur for countries with persistent or excessive surpluses than for countries with persistent deficits." (p. 49)

The member proposing to employ exchange-rate action is required only to demonstrate to the Fund's satisfaction that "the change is necessary to correct a fundamental disequilibrium"2/ Even

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1/ The Role of Exchange Rates in the Adjustment of International Payments, op. cit., esp. pp. 49 ff.

2/ Article IV, Section 5(f), Articles of Agreement of the International Monetary Fund.

though this concept was not defined in the Articles and the Fund has never attempted to formulate a rigorous definition, this critical concept which is at the heart of the Bretton Woods system "has been tested by experience,"1/ as the decisions by three major countries to use exchange-rate action -- the pound in late 1967, the French franc in mid-1969 and the DM in late 1969 -- effectively demonstrate.

This special adaptability to reconcile internal-external balance conflicts by subordinating the requirements of external balance to those of internal balance makes the par-value system a <u>first-best</u> solution to the problem of international balance in a world which accords an unquestioned priority to domestic as compared to external economic goals. From the point of view of their effects on domestic demand aggregates, there is a complementarity between adjustment under fixed and flexible exchange rates. As may be seen in Table 1, the surplus country should seek external balance through the fixed-rate adjustment process when internal demand is deficient and should adopt the flexible-rate mechanism when local spending is regarded as excessive. By contrast, the deficit country should seek external balance through the flexible-rate process when internal demand is regarded as deficient and the fixed-rate mechanism when it is excessive.

1/ <u>Op. cit</u>., p. 47.

Short-term stability of exchange rates

Thus far, the longer-term adaptability of the par-value system has occupied our attention. But the short-term stability of spot exchange rates which the system is designed to ensure is a more important consideration than this longer-term adaptability in explaining the preference among practical men for the par-value system.

Government officials and private entrepreneurs have a strong preference for the par-value system with limited flexibility, though for different reasons. Government authorities recognize that the exchange rate is a key price in the economy and a major instrument of domestic economic management available to them. They are reluctant to surrender control over it. At the same time, they recognize that exchange rates can no longer be regarded as a matter chiefly within the province of national decision-making. Because the determination of the rate of exchange for each currency is a matter of international concern, they value the commitment under the Fund's Articles of Agreement which make changes in exchange rates a matter of common concern and subject to established procedures for multilateral review. National authorities also value the commitment of Fund members, in a world of independent nations, to a code of good behavior in international financial affairs which is of juridical validity binding on each of them. They regard their fears of competitive depreciation, and of the use of exchange-rate policy to seek advantages over trading partners, in a world without a par-value commitment as fully justified by the historical record and by practical experience in dealing with other governments on international financial matters. Finally, they can regard the procedures of the Fund as the basis for cooperative modernization of the international monetary system as was realized in the big step toward the orderly creation of international liquidity, subject to multilateral agreement, when the Special Drawing Rights facility was activated in 1970.

Support for the par-value system among the business and financial community clearly rests in part upon self-interest. Why should entrepreneurs and bankers not welcome the shift to a central bank of a substantial part of the exchange risk associated with their foreign transactions?

Private entrepreneurs generally support some variant of a fixed-rate system in part because they perceive their exchange-risks in their international transactions to be less when there is a declared par-value than they are when there is none. Academic economists in particular have repeatedly challenged this judgment. They have argued that this perception places what they (as critics of the par-value system) would regard as an excessive weight on the benefits of the greater short-term rate-stability provided by the par-value system and too little weight on the longer-run vulnerability of exchange rates under the adjustable-peg as compared with a system of market-flexibility. But practical men have not shifted away from what can only be described as a one-sided preference for fixed-rate exchange arrangements. The recent willingness among them to accept within the par-value system a limited increase in exchange-rate flexibility suggests that they may regard the longer-run vulnerability of par-values under the adjustable-peg to be a lesser concern than the immediate and more distasteful alternative: ever-widening use of governmental controls over private capital and trade transactions in order to avoid changes in par-values.

Changing par-values: the compromise between stability and flexibility

In practice, critical difficulties have been created for the functioning of the Bretton Woods arrangements by the unexpectedly high domestic political cost of any exchange-rate action. Because government officials have been conscious of the domestic political repercussions of a change in par-value, exchange-rate decisions in both deficit and surplus countries have too often been dominated by local political -- rather than by economic or financial -- considerations. As it has turned out, political leaders in deficit countries have often concluded that the competitive benefits to the export sector from a devaluation would be outweighed by the domestic political disadvantages of such an action. On the other hand, political leaders in surplus countries have resisted revaluation because they were not prepared to take from their exporters a portion of foreign markets which they had managed to acquire only in strenuous competition with entrepreneurs from other countries.

The sluggishness in changing par-values, especially in the period between the restoration of European convertibility in 1958 and the devaluation of the U.K. pound in late 1967, introduced an element of rigidity into the Bretton Woods arrangements. In addition, the processes of balance-of-payments adjustment under the par-value system established under the Fund's Articles of Agreement proved to be more uncertain than the founding fathers had anticipated.

The neglect of adjustment requirements in practice, combined with this rigidity in exchange-rate practices, had the consequence of creating mounting strains in international financial markets. These strains, and the difficulties in achieving orderly processes of international economic adjustment, have produced since mid-1967 a series of shocks in international financial markets which have been remarkable for their severity and their variety. Because of these repeated crises, the longer-run stability of par-values proved to be at the expense of the short-term stability of world financial markets. It was evident that financial markets could not function smoothly from day to day, and exchange rates could not be regarded as stable, if ways could not be found to render the processes of adjustment more orderly and more effective.

As a result, government officials, academic economists and private specialists have been concentrating on the role which limited exchange-rate flexibility could assume in a par-value system. In the report of the Fund's Executive Directors in 1970, there was much emphasis upon the need, in appropriate cases, to achieve the prompt adjustment of parities and an extended review of ways to achieve this end.[1/] The study explored in detail ways by which adaptations could be made in the par-value system to achieve prompter and smaller changes in par values as a means of improving the processes of adjustment under the Fund's Articles. Technical modifications -- prompter and smaller adjustments in parities; a slight widening in the margins around parity; and temporary deviations from par-value obligations on a transitional basis -- were regarded as adaptations consistent with the basic principles of the par-value system.

Distribution of adjustment burden - But it would be unfortunate to place all the blame for this rigidity on domestic political factors, however convenient it may be to blame our international financial difficulties on politicians. For this emphasis would lead us to neglect what is the basic weakness of a par-value system: the lack of any systematic basis for determining the responsibility for initiating adjustment action between surplus and deficit countries. In practice, it has been found, "it may often be difficult to identify the causes of a particular imbalance with any certainty, and to assess the country, or group of countries, which should be regarded as out of line."[2/]

It is widely recognized that a fixed-rate system tends to impose "the more urgent need for action and the bulk of the adjustment

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1/ Op. cit., esp. pp. 51 ff and pp. 71-78.
2/ Balance of Payments Adjustment Process, Report of Working Party No. 3, Organization for Economic Co-operation and Development, Paris, August 1966, p. 26.

burden on deficit rather than surplus countries.[1/] Under flexible rates, by contrast, neither the surplus nor the deficit country is required to initiate adjustment action. Each of them avoids the high political costs associated with a decision to change the par-value and the variations in exchange quotations initiate a process of adjustment which is simultaneous in time as between them. The avoidance of this conflict of interest under flexible rates deserves to be stressed. Yeager even understates this point when he writes: "This two-sidedness is a distinctive feature which deserves emphasis."

In a world in which officials in the major trading countries prefer to operate under some variant of fixed rates, however, the need to create procedures for agreeing upon adjustment action becomes a matter of substantial international concern. For this reason, the attempts by Scitovsky,[2/] Mundell,[3/] and Officer-Willett[4/] to develop agreed criteria which would determine this responsibility in practice

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1/ Leland B. Yeager, International Monetary Relations, (New York: Harper and Row, 1966), p. 104.

2/ Tibor Scitovsky, Money and the Balance of Payments (Chicago: Rand McNally & Co., 1969), esp. pp. 161-168.

3/ Robert A. Mundell, "The Proper Division of the Burden of International Adjustment" in International Economics (New York: Macmillan, 1968) pp. 187-200.

4/ Lawrence H. Officer and Thomas A. Willett "Reserve-Asset Preferences and the Confidence Problem in the Crisis Zone" in Quarterly Journal of Economics, November 1969, pp. 688-695 and the paper by the same authors, "The Interaction of Adjustment and Gold-Conversion Policies in a Reserve Currency System," Western Economic Journal, March 1970.

are constructive even if their results so far can be regarded as of only limited practical relevance. Perhaps more directly relevant to improved international cooperation on adjustment action are the attempts by Tobin1/ and Fleming2/ to establish international norms of behavior, applicable symmetrically as between surplus and deficit countries. Under Tobin's scheme, each country would accept "an assignment of adjustment obligations ... with ... a set of financial rights and duties" (p. 205). Under Fleming's proposal, each country would accept a "code of good behavior ... more detailed and comprehensive than any that could be derived from the present framework of international legal obligations" (p. 2) which imposed both adjustment and financing responsibilities on both surplus and deficit countries. Each of these approaches represents an attempt to develop an internationally-agreed set of principles or presumptive criteria, symmetrical in character, which would determine responsibility for, and resolve conflicts about, initiating corrective measures.

Postponing the adjustment decision - Because of the uncertainties about which trading partner should initiate adjustment action

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1/ James Tobin, "Adjustment Responsibilities of Surplus and Deficit Countries" in Felner, Machlup, Triffin et al, Maintaining and Restoring Balance in International Payments (Princeton: Princeton University Press, 1968), pp. 201-211.

2/ J. Marcus Fleming, Guidelines For Balance-of-Payments Adjustment Under The Par-Value System, Essays in International Finance No. 67, May 1968 (Princeton University, International Finance Section).

under the par-value system, countries have incentives to postpone adjustments decisions. Officials in surplus countries can hope to avoid the need to act altogether, since there are only limited international constraints on them, and those in the deficit countries can hope that their trading partners may have enough internal inflation (or take other steps) so that they can avoid both devaluation and internal deflation.

In this sense, therefore, the international adjustment process under the par-value system becomes a mixed-motive game. Officials in both surplus and deficit countries have an interest in having the payments system function smoothly; but each of them also has an interest in minimizing the costs of the adjustment decisions which must be made. In practice, each of them has had an incentive to play a waiting game. But the cards are stacked against the deficit countries to the extent that they can postpone corrective action only so long as they have adequate liquidity or can get access to international credits. For this reason, officials in the surplus countries have attempted in the international liquidity negotiations of the past decade to limit the liquidity available to deficit countries, and to impose conditions on access to whatever international financing is provided to borrowing countries.

The apparent high political costs of any exchange-rate action, together with the incentives for each partner to postpone the adjustment-decision, contributed to the high degree of exchange-rate rigidity associated with the Bretton Woods arrangements, especially among the currencies of the major industrial countries between 1958 and 1967. Decisive exchange-rate action has been taken by several of them since mid-1967: the U.K. pound, the French franc, and the Danish krona were devalued and the German mark, Dutch guilder, Swiss franc and Austrian schilling revalued.

But these decisions were often postponed and then made only after international financial markets had become seriously unsettled. Furthermore, three of the countries -- Canada in 1970 and Germany and the Netherlands in 1971 -- decided to float their currencies rather than to choose a new par-value. Hence, they chose an adjustment alternative in which they abandoned the commitment to maintain a par-value, even if only on a temporary basis. Finally, the critical element in the entire par-value system was disturbed when, on August 20 (1971), the United States notified the Fund that it was no longer prepared to buy and sell gold freely for the settlement of international transactions, and in President Nixon's words, would "press for the necessary reforms to set up an urgently needed new monetary system" in which "American products will not be at a disadvantage because of unfair exchange rates."[1/] Thus, there had developed a situation in which,

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1/ Address of President Nixon August 15, 1971 reproduced in IMF International Finance News Survey, supplement, August 18, 1971, p. 258. Earlier in an article in the IMF Staff Papers for November 1970 entitled "An Indicator of Effective Exchange Rates," Fred Hirsch and Ilse Higgins had estimated that the balance of revaluations and devaluations by the 13 other industrial countries between 1959 and 1969 had produced an

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at best, needed adjustments in the policies of major trading countries were to be made once again in an atmosphere of financial crisis and, at worst, the continuity of the par-value system itself was in apparent jeopardy.

Concluding observations

These recent decisions by Fund members have placed a severe test upon the adaptability of the Bretton Woods arrangements and upon the precedures for international cooperation in monetary affairs which have developed since the major European currencies became convertible at the end of 1958. Even before the recent disturbances, there was a widespread support to bring the working rules and practices of the International Monetary Fund up-to-date. The effect of the mid-1971 currency upheaval has been to add an urgency to the search for agreed procedures for cooperative consultations on monetary affairs among the major trading countries.

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"effective appreciation" of the dollar against them by 4.7 percent. (P. 474 and Table 3, p. 473.) This upward thrust in the dollar's competitive valuation came during a period when the United States was losing, and the other industrial countries as a group (excluding Britain) were gaining, reserve-assets at an unsustainable rate. This devaluation-bias against the dollar can be viewed against the Fund's effective multilateral surveillance concerning the policies of borrowing countries and its limited surveillance concerning those of surplus countries. This asymmetry as between international constraints on surplus and deficit countries is discussed in my review of the Fund's history in The Journal of Finance, December 1970, pp. 1218-19, and in the contribution of General Counsel Gold in The International Monetary Fund, Vol. II (1969), esp. pp. 586-88.

Even though these consultations often appear from newspaper reports to have a rather technical financial cast, it must be stressed that there are really no technical solutions to the underlying factors which have created strains in the world's payments mechanism in recent years, no matter how ingenious, or elegant, the various proposals have been. For these strains often represent not merely technical inadequacies in the machinery of world finance but the fact that independent national interests are in conflict or that national economic priorities are not fully harmonized. Only through a process of reconciling many different sovereign interests is there hope that such disparities can be reduced.

It is a curiosity, in fact, that Dean Acheson should make an unfavorable comparison between what he has called the technician's complexities incorporated in the Fund's Articles of Agreement with what he regarded as the effective legal drafting of the charter prepared for the International Bank for Reconstruction and Development.[1/] For the Charter of the International Bank was designed to facilitate the kinds of lending transactions which are the ordinary business of commercial life all over the world. By contrast, within the technical verbiage of the Fund's Articles of Agreement was an unprecedented extension of international regulation and international law into national

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1/ Dean Acheson, Present at the Creation (New York: Norton, 1970), p. 83. In his words, "As contrasted with the fund, whose charter was largely dictated by monetary experts and narrowly hedged about, the bank management could do anything it wanted to do."

financial affairs. Member-nations agreed to limit their unilateral right to determine the value of their currencies; instead they committed themselves "to consult the Fund on all proposed adjustments in their parities, and to accept the right of the Fund to concur or object to such proposals in all but certain specified cases."[1/]

It is precisely the fact that the exchange rate has now become a matter for international decision which raises so many difficult problems in international financial relationships. Because of these complication, in fact, economists are often tempted to break through these international commitments -- hoping thereby to eliminate these non-economic sources of financial disturbance -- and to regain for each country a high degree of national autonomy in making exchange-rate decisions.[2/] But these recommendations have thus far found only scattered support outside professional circles. Countries have been anxious to retain the structure of the Bretton Woods arrangements because they have benefitted so widely from the unprecedented postwar expansion in international trade and investment achieved under the par-value system. The modifications in exchange-rate practices thus far considered have been regarded merely as adaptations of, and not the supplanting of, the adjustable-peg variant of fixed rates.

1/ The Role of Exchange Rates, op. cit., p. 5.

2/ This aspect of the Bretton Woods structure is considered in my review of the Fund's history in the Journal of Finance, December 1970, pp. 1216-1222.

<u>Problem of short-term capital flows</u> - Despite the recent attention to matters of exchange-rate practices, events in 1971 have demonstrated once again the need for closer consultations on national economic policies and not merely for agreements on international rules to achieve a greater, though limited and internationally-controlled, exchange-rate flexibility. For national stabilization programs aimed at a reconciliation of internal and external goals were threatened, both in the United States and in Germany, by unprecedented flows of volatile capital, provoked largely by cyclical disparities in interest rates, rather than by the disequilibrium in current- or long-term-capital transactions.

The recent flows in response to major cyclical disparities, as occurred between the United States and Europe, merely highlighted the rapid financial and economic integration which has been occurring among the industrial countries since the major European currencies became convertible at the end of 1958. These flows have created for the United States and for Europe a common problem: How can the individual industrial countries retain some autonomy in policy-making in a world in which major financial markets are now so closely integrated?

In fact, this process of financial integration now threatens the realization of what we have pointed to as the major <u>raison d'etre</u> of the par-value system. For it must be recognized that international capital flows, even in response to minor interest-rate differentials, have become major sources of disturbance in the world monetary system.

When there are gross disparities in the phasing of the business cycle, and hence in national monetary policies, their effects are much intensified because they can eventually set off doubts about the sustainability of existing parities as well.

<u>Three-pronged attempts to strengthen par-value system</u> - The authorities in the leading trading countries are, accordingly, in the process of attempting to bring the Bretton Wood arrangements up-to-date in three particular critical areas. They are attempting:

a. To establish an appropriate structure of exchange rates which will remove the main sources of payments disequilibrium rampant in the 1960's;

b. To agree upon improved, or at least additional, procedures for orderly changes in exchange rates as needed to improve adjustments performance in the current decade; and

c. To bring under more effective control the disruptive short-term private capital flows which have become so direct a threat to national autonomy in economic policy-making in the recent past.

In addition to these efforts to achieve greater stability and more orderly processes of international adjustment, there are also likely to be decisions made -- in an attempt to strengthen confidence and liquidity arrangements -- which would affect the role of the dollar as an international currency and that of gold and to be deliberations on proposals to stabilize reserve-asset holdings and to achieve a more orderly creation of reserve assets by the international community.

These efforts should be recognized as attempts by officials in the major industrial countries to adapt international monetary arrangements to the reality of a world economy far more closely integrated than the founding fathers could have conceived of in the 1940's when the principles underlying the Fund's Articles of Agreement were being developed. The emphasis of these recent efforts is similar to that of the earlier ones: to achieve through a framework of international cooperation effective ground rules for adapting national economic policies to an ever-changing world economy.

A continuation of this cooperation can be possible, however, only where the participants are able to work out ways to accommodate the varying and sometimes conflicting priority objectives of the many trading partners. For all of them, it may be safely asserted, a freedom to achieve reasonable domestic stability will continue to be the main goal of their national stabilization effort.

The case for the par-value system remains in theory, therefore, the same as it always has been. In practice, however, there is an additional argument: the experience over 25 years of functioning within the Fund's Articles of Agreement in which the major trading countries have been able -- however imperfectly at times -- to reconcile priority domestic objectives with the needs for orderly international economic processes. Because most of them regard this experience as relatively favorable, there is no evidence that government officials and the business community are prepared to agree with the choice many economists still favor -- a system of substantial exchange-market flexibility over the long-run, without any commitment to a par-value or to limited spreads for spot rates, either by individual countries or even between a limited number of major currency and trading blocs. Because this alternative is not highly regarded by "practical" men, a system of flexible exchange rates is not likely to be achieved by international agreement but -- if it were to come at all -- only by unilateral decision of various Fund members -- that is, as a by-product of a breakdown of the Bretton Woods structure of international cooperation.

Because such a breakdown would be a risky and, at best, a disruptive experiment, a continuation of the Bretton Woods system of par-values, and internationally-agreed limitations of flexibility, must be regarded as the first-best solution of the world's exchange-rate problem. Such a system can function, however, only if member-nations are prepared to compromise among the important national objectives of each of them in a increasingly interdependent world environment. It is this willingness to compromise which will be tested as the essential condition for a continuing functioning of the par-value system and of the Bretton Woods code of good international behavior in the years immediately ahead.