

ESSAYS IN INTERNATIONAL FINANCE

No. 80, May 1970

THE BÜRGENSTOCK COMMUNIQUÉ:
A CRITICAL EXAMINATION OF THE
CASE FOR LIMITED FLEXIBILITY
OF EXCHANGE RATES

STEPHEN MARRIS



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

This is the eightieth in the series ESSAYS IN INTERNATIONAL FINANCE *published from time to time by the International Finance Section of the Department of Economics of Princeton University.*

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International Finance Section

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FOREWORD

This essay was written as a result of my participation in a series of conferences on proposals for greater flexibility of exchange rates organized by C. Fred Bergsten, George N. Halm, Fritz Machlup, and Robert V. Roosa. Four meetings of economists and officials of banking and business firms were held between January 1969 and January 1970. The papers prepared will be published shortly in *Approaches to Greater Flexibility of Exchange Rates: The Bürgenstock Papers*, Princeton University Press.

Like the other participants, I benefited greatly from these discussions. It should be made clear, however, that this essay is in no way a summary of the wide variety of views expressed. I am also indebted to the Brookings Institution, where an appointment, under a grant from the Rockefeller Foundation, provided the opportunity to collect my thoughts on this subject.

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THE BÜRGENSTOCK COMMUNIQUÉ: A CRITICAL EXAMINATION OF THE CASE FOR LIMITED FLEXIBILITY OF EXCHANGE RATES

INTRODUCTION

In June 1969, a communiqué issued from Bürgenstock in Switzerland at the end of a conference on greater flexibility of exchange rates indicated general agreement that the operation of the international monetary system would be improved if changes in exchange rates took place sooner, and thus were generally smaller and more frequent than during the past two decades. A majority favored a reinterpretation of the present rules, widening the band within which exchange rates may respond to market forces, and permitting a more continuous adjustment of parities. There are many, especially among those who have been directly concerned with the operation of the present system, who do not accept this diagnosis, or are dubious about the suggested cure. This essay attempts to pick out the more important differences in judgment about economic and political behavior, and different value judgments, lying behind this disagreement. Some conclusions are suggested in Section VII. Extracts from the Bürgenstock Communiqué are annexed at the end of the essay.

Among those in favor of more flexible exchange rates, there are several schools. Some feel simply that countries should be more ready to adjust their parities under the existing rules. Some envisage a modest widening of the band around parity as an essentially technical device to dampen speculative capital movements. Some are in favor of a much wider band as a halfway house (and second-best solution) to freely floating rates. Some advocate a system of limited flexibility of the "band-and-crawl" variety. This essay deals only with proposals of the latter type.

For the sake of clarity, the main body of the discussion centers on a specific proposal under which the existing IMF rules on par values would be reinterpreted to give the overwhelming benefit of the doubt to countries wishing to change their par values by an amount not exceeding 1 per cent in any period of six months. These parity options would not be cumulative; that is, if they had not been used they could

not be carried forward. In addition, for essentially operational reasons, a derogation from the present rules would permit countries to allow rates of exchange in the market to differ from parity by up to ± 2 per cent (instead of the present ± 1 per cent). This would be an entirely discretionary system. The initiative for parity changes would, as at present, remain with national authorities, who would also be free to fix their own intervention points up to the 2 per cent limit, and to intervene in the market between these points as and when desired. These provisions are reconsidered later with regard to the amount of crawl, the width of the band, the rules governing large parity changes, and the desirability of modifying the purely discretionary aspect (Section VI).

The adoption of these rules, innocuous as they may sound, could have far-reaching consequences for the international monetary system. Whether these would on balance be favorable or unfavorable involves judgment on a very wide range of economic and political issues. Four areas of disagreement have therefore been picked out for special attention. First, there are different views as to whether failure to adjust exchange rates in time has been a major cause of existing difficulties, or whether the real problems lie elsewhere; there is disagreement about the role of parity changes in the adjustment process (Section I). Second, there are differences between those who fear that more external flexibility would weaken internal discipline, in particular resistance to inflation, and those who either disagree, or feel that any loss in this respect would be more than made up by less of what they regard as masochism—unwanted inflation in surplus countries, unnecessary unemployment in deficit countries, and controls on trade and payments harmful to other countries and to the country itself. This is called here the masochism/discipline trade-off (Section II). Third, there are differences between those who believe that fixed—or at least “sticky”—exchange rates help to promote international cooperation and pave the way for economic and political integration, and those who hold that they may often hinder countries from achieving legitimate national objectives. There are also some who feel that more flexibility would not lessen but rather increase the scope for meaningful international cooperation. This is called the nationalist/internationalist trade-off (Section III). Fourth, there is the question of whether a system of limited flexibility would be workable in practice, both for the authorities and the private sector (Section IV).

The present concern about the exchange-rate system has arisen principally because of successive crises affecting sterling, the French franc, and the mark. To further narrow the ground, attention is focused on the adjustment problems of medium-sized industrial countries—coun-

tries with a GNP of the order of \$100 billion. The special position of the United States in a system of limited flexibility, and (more briefly) that of smaller industrialized countries and developing countries, is discussed in Section V.

One final point by way of introduction. A major difficulty of this subject is that there is so little to go by. The historical record is inconclusive. Both critics and advocates can find some evidence to support their views, but both would probably agree that history provides little guide as to how a generalized system of limited flexibility might work in the modern world. One is forced to try and project from the present into the future, to judge in the abstract which vices and virtues would be modified and which would remain. But simple projection can easily be misleading. When the forward pass was introduced into American football it may have seemed obvious that the running game would be demoted; on second thought it should have been realized that the needs of pass defense would give new opportunities to the running attack; further thought again must have shown that a strong running game would be needed to make a pass attack effective. (The analogy can be internationalized by trying to envisage the consequences of abolishing the off-side rule in soccer.) The key issues under discussion here involve very similar judgments about the interaction between the likely behavior of governments, private enterprises, and public opinion under a different set of rules. What is needed is not so much insight into international economic relationships, as insight into the decision-making processes of governments in democratic societies, in a world in which nation-states still retain a great deal of autonomy and a strong sense of national identity.

1. THE ROLE OF EXCHANGE RATES IN THE ADJUSTMENT PROCESS

Balance-of-Payments Equilibrium

It is necessary to discuss briefly the sense in which the terms balance-of-payments equilibrium and disequilibrium will be used in this essay. It is convenient to start from two striking characteristics of the post-1958 world: the great sensitivity of trade balances (and current balances more generally) to small deviations in relative demand pressures, and the massive offsetting swings in capital balances.

The visible imports and exports of a \$100 billion economy typically run at about 15 to 20 per cent of GNP (average of trade each way). Including other current transactions the ratio is higher. With considerable variations, the average level of official reserves amount to one-quarter to one-third of current imports. For such an economy a \$2 to \$3

billion swing in the current account over the course of a typical postwar conjunctural cycle is quite normal. This is equivalent to 10 to 15 per cent of visible trade, or as much as one-half of official reserves. The inverse swings in the capital balance, however, have been such that reserve gains and losses of more than \$500 million in one year have been relatively rare, with no systematic relation to the high and low points of the conjunctural cycle. Although these equilibrating capital movements have been partly engineered, the main factor has been strong natural forces, reflecting both endogenous swings in the supply and demand for credit over the course of the cycle, and corresponding shifts in the posture of monetary policy.

One obvious consequence of this experience has been a natural tendency to stress the role of demand management in balance-of-payments adjustment. With the benefit of hindsight it may be easy to conclude that the currency of a certain country has been becoming undervalued. But the honest observer must admit that at any given time it has been extremely difficult to judge how much of any apparent disequilibrium could be attributed to an existing small short-fall or excess of domestic demand.

More fundamentally, the demonstrated mobility of international capital greatly complicates the search for a simple definition of balance-of-payments equilibrium. Recent experience, for example in the United States, shows that it is quite possible for a country with domestic overheating to be in overall surplus. (As used here the overall balance includes private-sector monetary movements and unrecorded transactions—that is, it is equivalent to the balance on official settlements.) In fact, it seems to be increasingly the case that the traditional view that excess demand leads to serious reserve losses only holds good when there are factors *other than* prevailing demand conditions undermining confidence in the currency. Equally, on the other side, there is the example of the recession and recovery in Germany in 1966-69, when the large and at least initially mainly demand-induced current-account surplus, was covered, and at times more than covered, by massive capital outflows. Increasingly, therefore, attention has shifted to the *sustainability* of the overall balance, and in particular the structure of the balance of payments as between current and capital transactions.

Underlying disequilibrium will be used here to mean a situation in which imbalance would persist even if the country concerned and all its important trading partners were at their normal or desired levels of demand, employment, and rates of price increase. In the abstract, it can be defined as a situation where under such conditions the outcome of current transactions at the prevailing exchange rate fails to match the

willingness of domestic citizens and foreigners to absorb a corresponding change in net foreign assets and liabilities at prevailing interest rates, profit levels, and price expectations; or where, even though there is overall balance, the distribution of the accumulating balance-sheet position as between monetary and nonmonetary financial assets is not sustainable.

This definition may not, however, be felt to be very useful as a guide to policy in the real world. First, as already noted, it is extremely hard to disentangle underlying disequilibrium from demand-induced disequilibrium. Second, international trade in financial assets is very far from perfect; there are institutional peculiarities, there are tax loopholes, there is a whole array of types of official intervention. A true "market test" of the sustainability of a given outcome is hardly conceivable. Third, it is held that governments have considerable latitude to influence the structure of their balance of payments, without sacrificing domestic objectives, by twisting the mix between fiscal and monetary policy; for instance, by combining tight monetary policy with fiscal stimulus in order to cover a weak current balance by capital inflows.

Finally, in the real world there may well often be outcomes which are sustainable in economic terms but not in terms of domestic or international politics. On nationalistic grounds, it may be felt that, whatever the economic benefits derived from drawing on foreign savings, large debts and/or foreign control over domestic production facilities involve an unacceptable infringement of national sovereignty. Or, conversely, that, whatever the benefits certain sections of the community draw from taking advantage of high rates of return abroad, beyond some point the export of domestic savings becomes unacceptable on grounds of national welfare. More generally, international considerations—national security, diplomatic influence, assistance to less developed countries—may be felt to dictate the need for a large surplus on current account, or influence in other ways views about the desirability of a particular structure of the balance of payments.

Already at this point differences of view carry over into the controversy about exchange rates. Advocates of freely floating rates will argue that the real-world difficulties of definition and identification can only be solved by allowing the exchange rate to be freely tested in the market. They tend to be strong believers in the welfare-maximizing properties of international capital movements. They recognize the importance of the structure of a country's balance of payments, but argue that for a government to have fixed objectives in this respect is to put the cart before the horse. Governments should direct their policies to achieving their domestic objectives. If, having achieved these objectives, they

do not like what is happening to their exchange rate, they should modify their policies so as to alter the propensities to generate real savings or acquire foreign financial assets and liabilities accordingly.

From the same starting point, advocates of fixed rates reach very different conclusions. Because of the difficulties of definition and identification and the unpredictability of future developments in the balance of payments, they feel that what really matters is the overall balance. They are often dubious about the real economic benefits from large net capital flows between developed countries. So long as a country follows sensible demand-management policies, it is sufficient for it to manage its affairs so as to maintain approximate overall balance, using to this end an appropriate policy mix and the many devices at its disposal to bring the capital account into line with the current balance.

Advocates of limited flexibility occupy the middle ground. They will agree that many adjustment problems are mainly or exclusively a matter of bad demand management. They may also be dubious about the utility of at least some types of capital movement, but generally feel that in time capital controls either become ineffective or do harm. They agree that the concept of the "right" structure for a country's balance of payments must be somewhat ambiguous in practice, but they feel nevertheless that there are definite limits beyond which different structures become undesirable or unsustainable. They are likely to be found among those who have become sceptical about the scope for twisting the policy mix to reconcile conflicts between internal and external objectives. This scepticism has been fostered by recent experience with stabilization policies in a number of major countries, which appears to support the view that within rather narrow limits fiscal and monetary policy should work in tandem. (This empirical observation has been paralleled by recent theoretical work on the adjustment process pointing in the same direction.) Advocates of both limited and fully flexible rates are likely to agree on this last point, but the former are more likely to feel that balance-of-payments equilibrium is not in many important respects a purely market-determined phenomenon, although signals from the market may provide useful clues as to whether it exists or not.

For what follows, it is useful to note here that advocates of limited flexibility tend to lay special emphasis on the distinction between underlying disequilibrium and demand-induced disequilibrium. Many of them believe that greater flexibility of exchange rates is needed to deal with "dilemma" cases where imbalance would persist even if all countries were at preferred levels of employment, but is unnecessary or undesirable in "nondilemma" cases when all that is needed is action to correct demand discrepancies at home or in important partner countries. They

would presumably admit, however, that this distinction is not easy to apply in practice. Furthermore, a nondilemma situation will nearly always contain the seeds of a dilemma problem; as domestic overheating pushes up costs and prices it begins to do permanent damage to the country's competitive position, and vice versa.

The Impact of Exchange-Rate Changes on the Structure of the Balance of Payments

The importance of exchange-rate changes lies in their asymmetrical impact on current and capital transactions. For current transactions a devaluation alters relative prices or profitability of sales in domestic and foreign markets—permanently, unless eroded by subsequent changes in the general price level at home and abroad. The direct impact on capital transactions is, however, neutral, since rates of return are unchanged; foreign-currency values of both capital and yield change proportionately. Further effects are mixed. Devaluation may stimulate capital inflows because of a shift to profit in the devaluing country and higher rates of return in export-oriented industries; interest rates may also rise because of the need to combat inflationary tendencies. Against this, devaluation may increase expectations of further currency depreciation with unfavorable effects on the capital balance.

Because of this asymmetry, and starting from a world of fixed rates, a parity change can be thought of as a powerful means of altering the structure of a country's balance of payments. Starting from a world of flexible rates, on the other hand, the exchange rate may be thought of as simply the fulcrum of the balance between demand pressures, price levels, and interest rates at home and abroad, with the payments structure determined by the respective propensities to generate exportable surpluses of goods and services and to acquire foreign assets. Synthesizing, one gets the widely accepted proposition that parity changes may be needed to correct underlying disequilibrium, but will only be effective if accompanied by other appropriate measures of general economic policy. Wide differences of view remain, however, about the size and timing of the effects of a change in the exchange rate.

Current Transactions

Exchange-rate sceptics are apt to observe that price effects in international trade are surprisingly elusive. The domestic price level in a country with a weak current balance often does not seem abnormally high, and sometimes appears to be lower than those of its main competitors. Some countries with above-average export performance and/or a below-average propensity to import have also shown an above-average

rate of increase in the domestic price level (Japan, Italy). Furthermore, there are not infrequent cases of countries scoring above average on their trade balance at times when the movement of relative costs and prices has been unusually unfavorable to them.

There are various counter arguments. First and foremost, price effects—particularly in the short run—tend to be swamped by the much more sensitive demand effects already discussed. Even using sophisticated econometric techniques it is not easy to separate out price and demand effects in international trade. Second, it is pointed out that only a rather specific range of goods and services enters into international trade. This excludes a large segment of national output: construction, much of agriculture, many personal services. It is held that this explains why differences in domestic price levels, which are often due to important structural differences in precisely these sectors, are not fully reflected in a country's competitive performance in the world economy. Furthermore, differences in the trend through time of general price levels in different countries are also strongly influenced by essentially domestic factors, often in these same sectors. It is noted that there is a much better longer-run correlation, indeed rather a close one, between the export performance of major countries in manufactured products and the trend in the (somewhat dubious) indicators of their export prices for manufactured products.

Many of those who believe in the importance of the price mechanism in international trade would admit, however, that it seems to work rather slowly, probably a good deal more slowly than in domestic markets. Econometric studies tend to throw up low or nonexistent price elasticities for periods of up to a year, and require lags of two, three, or more years before substantial and statistically significant price effects can be obtained. Common observation also suggests that over the first year or more the impact of a change in the exchange rate may well be perverse; that is, the current account of a devaluing country deteriorates, and vice versa.

Some advocates of greater flexibility hold that important conclusions should be drawn from this apparently slow response to international price changes. They believe it suggests that the forces that build up when a currency becomes overvalued or undervalued acquire an inertia of their own. Breaking into and holding a foreign market involves a considerable investment in product design, distribution, and advertising. Once this has been made there will be reluctance to withdraw when profits fall somewhat below expectations. Outside the trade field, large investments are required in tourist facilities, transport equipment, and other services, and these will not lightly be written off. More generally,

if underlying disequilibrium persists for many years, a whole generation of management will grow up to the idea that the export side is a promising—or unpromising—step on the way to the board of directors. For reasons of this kind, whole industries may become export-minded or oriented towards the domestic market, so that competitive performance responds only slowly to changes in relative costs and profitability.

This school argues that there is an important *dynamic* element in balance-of-payments disequilibrium. They believe that the longer underlying disequilibrium persists, the larger will be the change in relative costs and profitability needed to remedy the situation over a reasonable period of time. If, on the other hand, exchange rates were adjusted sooner, these dynamic factors making for disequilibrium would have less time to gather momentum, and might not emerge at all. More generally, they would subscribe to what is known as the “vicious and virtuous circle” theory of economic growth. A country with a strong competitive position in international markets will benefit from a self-perpetuating process of high investment, large productivity gains, stable or gently rising unit-labor costs, absence of “stop-go,” and so on. A converse vicious circle will build up in a country whose prices and products are not competitive at the going exchange rate.

Capital Transactions

It seems to be widely accepted that uncertainty about exchange rates has little impact on long-term investment decisions involving real assets, particularly in relation to the other uncertainties inherent in such decisions. Canadian experience under a floating rate with direct investment from the United States, and much more extreme examples from Latin America are cited to support this view. When planning activities abroad over periods of up to ten years or more, the direct investor can assume that if there is above-average inflation in a foreign country the exchange rate will eventually be adjusted. Over time, therefore, parity changes will roughly equalize, in terms of his own currency, the high or low capital gains and rates of return in foreign currencies resulting from differential rates of inflation. Similarly, it can be expected that, in general, overseas subsidiaries will benefit or suffer from other general economic developments in the host country—differential productivity growth, changing trade-union attitudes—which may affect its exchange rate.

It can be argued, however, that sticky exchange rates do distort the pattern of direct investment. Incoming direct-investment capital will be inhibited if the exchange rate remains overvalued over a period of years. As long as it lasts, this places the subsidiary at a competitive dis-

advantage in third markets and vis-à-vis imports into the domestic market. Expectation of eventual devaluation may reduce the capital available to the subsidiary because of the incentive to speed up the repatriation of profits. And as the crisis worsens the danger of government interference with profit repatriation and in other ways steadily increases, as does the likelihood of having to write off embarrassingly large book losses.

The same factors work in the opposite direction to stimulate direct investment in countries with undervalued currencies. Fixed exchange rates do not therefore necessarily reduce direct-investment flows in total. But those most closely concerned with this subject stress that what really holds back direct investment is not uncertainty about exchange rates or other general economic developments, but political uncertainty as to how governments will behave in response to ever-present economic nationalism. If, under a different exchange-rate system, there was less risk of government interference, they believe this would be a powerful stimulus to direct investment.

The impact of exchange-rate changes on international trade in financial assets raises some essentially different issues. While it is true that for an asset sold before a change, or bought after it, the rate of return is not affected, the fact that a capital gain or loss has been made obviously cannot be ignored; it becomes increasingly important the more easily marketable and the shorter the maturity of the asset. Critics of more flexibility are inclined to believe that the relative stability of exchange rates between the major financial centers has been a key factor in the vast growth of international money and capital markets since 1958. They argue that with more flexibility the expectation that once a change had begun it would continue in the same direction would set off uncontrollable movements between these markets. At best this would halt or reverse a development which they regard as having been beneficial to the world as a whole; at worst, the system would be unworkable.

The first rejoinder is that it is not obvious that speculative movements would be larger than those that occur when "one-way-option" situations build up under the present system. Some advocates of limited flexibility go on to suggest that, since only relatively small parity changes would be permitted, speculation could be held in check by maintaining correspondingly small interest differentials between countries whose currencies are expected to appreciate or depreciate. Against this, there is concern that the need to maintain such differentials would involve an undesirable limitation on the use of monetary policy for domestic purposes.

How exchange-rate expectations might change under a discretionary

band-and-crawl system is discussed further in Section IV. Some reasons to suppose that the constraints on domestic monetary policy in this respect would not be serious may be noted here. There is the general argument that, if a country's exchange rate is depreciating because of a high rate of inflation, it is both likely and appropriate that interest rates will be higher than in other countries with less inflation. Over the longer run there is a similar argument—albeit rather theoretical—that real rates of return should tend to be roughly the same in different countries, so that money rates of interest should largely reflect divergent rates of inflation, which will in time be carried into the exchange rate. At the more practical level, it has also been suggested that the wide range of selective instruments already developed to influence movements of short-term and portfolio capital could be effectively and appropriately used to deal with this problem. Although this runs counter to the aim of reducing reliance on controls, it is argued that such devices would be less objectionable than under the present system insofar as adjustment was simultaneously being brought about on the current account. (One writer has suggested that a “crawl-equalization tax” could be used if necessary.)

Does Devaluation Work?

The discussion up to this point, the exchange-rate sceptic may feel, has been far too abstract. He need only point to the most widely and scientifically analyzed devaluation of recent history—of the pound sterling in 1967—to prove that devaluation does not work.* The facts of this case will not be considered here, but it may be useful to review some of the arguments commonly put forward by those who take this position.

One view is that it was not the sterling exchange rate that was the trouble but an inadequate level of domestic savings. (It is similarly argued that revaluation will not reduce Germany's trade surplus, because of the thrifty habits of that country's citizens.) Statements of this kind would seem to involve a logical misunderstanding between critics and advocates of greater flexibility. One can say either that a parity change is needed in order to shift resources to the foreign sector, or that such a shift in resources—which involves higher domestic savings,

* Between the beginning and end of 1969 there was a great swing from pessimism to optimism about the prospects for the United Kingdom's balance of payments. To those who believe that price effects come through relatively slowly, this was not altogether surprising. Given, however, the importance of changes in relative demand pressures, some may feel that it is still too soon to say whether this large devaluation, taken under crisis conditions, will turn out to have been exactly what was needed to restore and maintain underlying equilibrium in the sense defined above.

or reduced domestic investment—is needed to defend the exchange rate; conceptually it comes to the same thing. What is probably really at issue here are different views about whether net domestic savings can be or should be stimulated by increasing taxes, or rather by high interest rates, control over domestic liquidity creation, and cuts in government expenditure. This controversy (fortunately) lies outside the scope of this paper.

A second, more widely held view is that the United Kingdom's balance-of-payments difficulties have had little to do with the level of prices, but result from basic structural weaknesses in the economy. The factors cited include trade-union attitudes and organization, the background and training of management, insufficient labor mobility, out-of-date industrial structure, a bias in the tax system against manufacturing industry or business enterprise in general, an excessive burden of overseas commitments, overambitious social-security arrangements, and more. The list is a long one even if limited only to weaknesses which have received serious attention in the press and in academic writings.

Advocates of more flexible exchange rates are likely to be among the first to agree that factors other than price levels and differential rates of inflation may cause external disequilibrium. Some would point out, however, that all countries have their strengths and weaknesses, and perhaps suspect that there is a tendency for the spotlight to fall on the strong points in surplus countries and the weak points in deficit countries. Such a tendency will be accentuated if the exchange rate is regarded as not fit for public discussion; this may be one way in which the present system perpetuates the often dubious association of external surplus with national virtue, and deficit with national vice.

Nevertheless, it would be agreed that real weaknesses of this kind may exist. Almost by definition, however, they will take time to eradicate. Within national frontiers disequilibrium arising from similar structural problems is financed by private capital, and public transfers and investment. The amount of international finance available is more limited, and many would give priority to financing imbalance between developed and developing countries rather than between the industrialized countries. Advocates of greater flexibility would argue that currency depreciation reduces the need for finance and, by providing a stimulus to efficient firms able to compete in international markets, will generally tend to support other governmental action aimed at improving the efficiency of the economy. Also, the elimination of these weaknesses is desirable in itself, quite apart from external repercussions; there can therefore be no guarantee that success in incomes policy, manpower policy, tax innovations, and so on will not be paralleled or copied in other countries.

A third view is that external equilibrium depends above all on main-

taining confidence in the currency, especially for a country with large external liabilities. The simple rejoinder is that confidence depends ultimately on an ability to meet all current claims out of current income, and this requires a competitive exchange rate. But sceptics can point out that, whatever the theoretical arguments, a foreign investor is likely to be much more conscious of the capital loss resulting from devaluation than of the capital gains and high rates of return he may have enjoyed in the period running up to it; and this cannot be ignored by countries that rely heavily on interest and dividend payments for their current foreign income. They may go on to point out that in a wider sense categorical denials about parity changes subsequently reversed destroy confidence in a country's government, which may also be undermined by inflationary problems and political dissension sparked off by devaluation.

It is presumably because of the importance they attach to the confidence factor, however intangible, that some observers have suggested a multiple-exchange-rate approach, with a generalized system of border taxes and subsidies used to promote current-account adjustment, leaving capital values unchanged at the fixed exchange rate. Critics argue that this would be cumbersome to apply in practice, would almost inevitably involve undesirable discrimination between different kinds of current transactions, and would probably be ineffective in the longer run because of expectations that the exchange rate will eventually be adjusted. They would nevertheless agree that the confidence factor can be an important problem, but are likely to go on to suggest that it would be less acute if parity changes were made sooner and were hence much smaller.

II. DECISION-MAKING: THE MASOCHISM/DISCIPLINE TRADE-OFF

Those opposed to a change in the exchange-rate rules can point out that under the Bretton Woods system countries already have the right to propose a parity change in cases of underlying—or “fundamental”—disequilibrium. Even if it is agreed that there have been times when countries have not chosen to exercise this option when they should have, what reason is there to believe that they would be more willing to do so under different rules? At best one might be no better off, at worst there might be a much greater temptation to resort to parity changes when other action would be more appropriate. On this line of thought what is needed is not a change in the rules, but better use of the present system. Governments should learn that beyond a point it is bad policy to put off parity changes indefinitely; and they should acquire a better understanding of the conditions necessary for a successful adjustment.

International organizations should be more prepared to urge parity changes in dilemma cases, less willing to tolerate defensive action interfering with international transactions, and, if necessary, should be given greater power to bring influence to bear on national authorities.

Advocates of greater flexibility would agree that what is required is essentially a change of attitudes towards exchange rates. But they would argue that the mechanics of parity changes are such that if they are limited to large changes, the scope for better decision-making will remain very limited. They would further argue that a careful examination of how governments would be likely to behave if they felt freer to make small parity changes shows promise of a much more significant improvement.

Decision-Making Under the Present System

It is useful to start by considering the obstacles to parity changes under the present system. It is sometimes suggested that with the devaluation of the pound sterling and the French franc, and the revaluation of the deutsche mark, we have moved into a new era of small, say, 10 to 15 per cent, parity changes. Certainly, these changes were much smaller than those of the 1930's and the postwar period up to the return to convertibility. But advocates of greater flexibility would argue that they are still, in economic terms, very large. For a \$100 billion economy:

(1) A parity change of 10 to 15 per cent has a very big impact on the general *level* of economic activity. At the time of sterling devaluation it was officially estimated that the stimulus to exports and the restraining effect on imports would, other things being equal, increase total demand by an amount rising to the equivalent of 3 per cent of GNP over a period of one and a half to two years, and this was thought to be based on a relatively conservative estimate of international price elasticities. Subsequent events may be interpreted to indicate somewhat lower elasticities or longer lags; but it would probably be agreed that the potential impact of a parity change of this size is bound to be large in relation to normal annual increments of GNP.

(2) A parity change of this size also has a big impact on the *distribution of income*—if it is successful, that is, is not nullified by subsequent price-wage interactions. Taking the example of the United Kingdom, there should be a devaluation shift from personal income to corporate profits equivalent to up to 2 percentage points of national income, with big shifts in the distribution of profits and of rates of return on capital among different firms, industries, and sectors of the economy.

Critics of the present system argue that the economic consequences

of an overnight change of 10 to 15 per cent in all prices entering into transactions amounting to as much as one quarter of GNP are so great as to limit severely the authorities' freedom of action on exchange rates for both technical and political reasons. At the technical level, the necessary adjustment of demand-management policies poses severe problems, particularly with devaluation. Domestic demand has considerable momentum of its own, and attempts to alter its direction suddenly meet great resistance. Sharp tax increases provoke offsetting falls in savings ratios; deep cuts in public expenditure may cause permanent damage to essential programs; brutal use of monetary policy, which has a relatively long braking distance, is open to many objections and leads to evasive action by the financial community. Even in the absence of parity changes there seems to have been a tendency to underestimate the amount of slippage inherent in a normal restrictive policy package. Some hold that experience has shown that the design of a package appropriate to accompany a 10 to 15 per cent devaluation is a herculean, if not impossible task, so that much of the benefit expected from the devaluation is inescapably wasted.

The political restraints may be even more serious. For a \$100 billion economy, if the figures above are accepted, the required policy change is likely to be larger than the largest ordinary conjunctural demand-management package; and the impact on income distribution equivalent to that of a major tax reform. In a devaluation case the measures of restraint needed (unless domestic demand is already weak or weakening) will be extremely unpopular. Similarly, in a revaluation situation the restrictive impact of the parity change will also be unpopular, except at times when popular resistance to inflation has risen to the point where it outweighs the political forces favoring expansion.

In cases of both devaluation and revaluation there will be strenuous objections to the income effects; there is a well-known tendency to regard the existing distribution of income and pattern of rates of return as "fair" and therefore an acquired right. The government will feel obliged to try to buy off the most politically vocal interest groups and, apart from being expensive, this will normally tend to frustrate the desired external adjustment. There are also psychological problems. Devaluation is thought of as a blow to national prestige. This may be asymmetrical: the fact that at the time of the May 1969 crisis 87 per cent of the German electorate were reported to be against revaluation may suggest a natural tendency in a democracy for those who stand to lose to make themselves better heard than those who stand to gain.

There are other ways in which a "large-change-or-not-at-all" system may inhibit rational decision-making. Since many people stand to make

large overnight capital gains and losses, there is a pressing need for secrecy. But for the technical and political reasons discussed above wide consultations may be needed, particularly if the government's support depends on more than one political faction. All major ministries stand to be deeply affected: finance, foreign affairs, industry and trade, agriculture, social affairs, labor. Proper consultation, however, is usually not possible. At levels of government below the top, devaluation (or revaluation) may become a forbidden subject. Analysis and policy advice may become distorted through excessive emphasis on methods of adjustment other than the exchange rate (for instance, incomes policy, which is probably more effective if it is not thought of as something which can be turned on or off according to external circumstances). Finally, if a decision is put off too long and a crisis develops, short-term considerations—the amount of the central bank's forward commitments, fear of a public outcry about “letting the speculators get away with it”—may lead to a virtual paralysis in the decision-making process.

Although less obvious to the outsider, it also seems clear that the present system inhibits rational decision-making on exchange rates at the international level. The spectacular growth of international economic consultation is often cited as one of the most encouraging aspects of the way the Bretton Woods system has developed; it is also criticized in some quarters as self-serving, with a built-in tendency to produce patch-up jobs rather than proper adjustment. An important question is whether the weaknesses may have arisen, at least in part, from insufficient consultation on exchange-rate questions. It is hard to substantiate this without being privy to the inner secrets of the last few years. But there is circumstantial evidence in that, at the time of the Bonn meeting of the Group of Ten in November 1968, it was claimed as a major advance that there had for the first time been multilateral discussion of exchange rates.

In fact, it seems obvious that there must be inherent limitations on the efficacy of international consultation on exchange rates under the present system. There are various ways in which collective pressure can be brought on a country by other countries and international organizations, ranging from suasion through conditional aid to the threat of retaliation. But when the question at issue is a 10 to 15 per cent parity change by a major country there will be inhibitions.

First, there is straightforward economic self-interest. Even though objective analysis indicates that devaluation would be appropriate, other countries are aware that it will somewhat weaken their own position, and, in a world in which autarkic instincts still run deep, will hesitate to take the lead in pressing for a change. Even in revaluation cases,

some other countries with strong currencies may hold back because of fear that they might be forced to follow suit.

Second, there is political self-interest. For the reasons already given, a large change in the exchange rate is a major political act, one that may be expected to involve heavy political costs for the government taking it. In the ill-defined twilight zone of residual national sovereignty of today, other countries will hesitate to pressure a government into paying this price; they are highly conscious that they might find themselves in the same uncomfortable position at some later date. More altruistically, other countries, as well as international organizations, are likely to be worried about public opinion in the country concerned—about nationalistic resentment against being told what to do by foreigners. Both economic and political self-interest may mean that it is a big step from agreeing to a 10 to 15 per cent parity change to positively *urging* it. The typical attitude may tend to be: "If I were in his shoes, I would change the exchange rate, but it is his business not mine."

The need for secrecy must also be a strong inhibiting factor at the international level. Countries considering a parity change will want to know what other countries are going to do, but will be fearful of news leaks and speculation. In fact, one of the paradoxes of the present system may be that, while it strongly inhibits countries from taking the *initiative* in making parity changes, it is difficult to prevent a chain reaction once a major parity change is announced. Other countries feel they must make an overnight decision, and may well be tempted to decide that they have a golden opportunity to put the blame for unpopular action on forces outside their control.

Despite evidence of some increase in prior consultation on parity changes, recent experience suggests that we are still not far from the jungle where the rule is to shoot first and ask questions afterwards. Presumably this means that the same element of distortion colors international discussions as well as it does those within national governments. Attention may be focused on all methods of adjustment *other than* exchange rates. Since these are not on the agenda, most of the time will be devoted to cross-examination of fiscal policy, monetary policy, incomes and other policies, and when eventually a change in the parity can no longer be put off there will be too little time for proper analysis and discussion of the effects on the country concerned and on other countries.

To sum up the foregoing, at least three tough conditions need to be fulfilled to pull off a successful 10 to 15 per cent devaluation. In terms of domestic economics, overall demand should already be weakening or it must be technically possible to put together a large and effective

package of demand restraint. In terms of domestic politics, the government's majority must be large enough, or the time to the next election long enough, to enable it to weather a great deal of unpopularity, or (preferably) it must be able to pin the blame for the devaluation on the opposition or on outside events beyond its control. On the international side there must be reasonable assurance that the devaluation will be acceptable to other major countries, that sufficient credit facilities will be available to support the new rate, and that devaluation will not interfere with major foreign-policy objectives. Finally, with all these conditions fulfilled it should, if possible, be nevertheless a complete surprise.

Many outside observers are inclined to attribute refusal to devalue, even when this involves evident masochism, to human weaknesses—misplaced chauvinism, ultra-conservative central-bank attitudes, failure of those responsible for managing the system to do their job properly, and so on. But it may well be that excessive reluctance to make parity changes under the present system is entirely explicable in terms of the economic and political facts of life. Under the present rules good reasons for putting off exchange-rate decisions abound. There may be too much domestic overheating (or, in revaluation cases, a temporary weakness of domestic demand). There are inevitable hiatuses in the democratic process, opposing political factions may be very evenly balanced, it may be felt that no major decision can be taken before the next election. There may be uncertainty about how many other countries might follow suit, a desire to wait until economic developments in other major countries become clearer, to know the outcome of upcoming trade negotiations, and so on. The list could be a very long one.

Decision-Making in Dilemma Situations

The obstacles to making large parity changes have been discussed at some length because they would obviously be reduced if national authorities felt freer, at the technical level, to make small changes. Whether, in practice, a discretionary band-and-crawl system would give this freedom is discussed in Section IV. Supposing that it did, then at the national level the accompanying demand-management measures required would be smaller and could be better graduated, there would be less outcry from interest groups unfavorably affected by income shifts, the need for secrecy would be greatly reduced. More generally, exchange rates would become less newsworthy. They would no longer be headline news (a point of great importance to political leaders). The overall

exchange-rate policy to be followed would still be a matter of concern to the cabinet as a whole, as is, for example, the overall balance of the annual budget; but implementation—timing, size—could be left to the monetary and fiscal authorities, in the same way as, for example, open-market or discount-rate policies.

There should be an equally significant improvement in decision-making at the international level. It should become both possible and normal for a country's exchange-rate policy to be collectively examined in the same way as its fiscal, monetary, and other policies are already closely scrutinized in such organizations as the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), the Bank for International Settlements (BIS), and the institutions of the European Economic Community (EEC). Those sceptical of the achievements of international cooperation may doubt whether this would make much difference. Others hold that it would make a great difference if exchange-rate questions were on the agenda as part of the normal course of business, and that it would be wrong to underestimate the powers of objective analysis and moral suasion.

With so much less at stake, it should be easier to bring collective pressure to bear. In devaluation cases, other countries should be less willing to give tacit or formal approval to the imposition of controls when the alternative of small exchange-rate changes existed and could be openly advocated. Willingness to give conditional credit to deficit countries, which already involves detailed multilateral examination of other aspects of a country's policies, would come to require a consensus that its exchange-rate policy was appropriate, and in cases of doubt creditors could insist that some use should be made of the provisions for small parity changes.

There might be some asymmetry, because it is generally less easy to bring effective pressure to bear on surplus countries. Intrinsicly, however, there should be less domestic political resistance in the country concerned to revaluation than to devaluation. Certainly, once domestic overheating develops, a small upward change in the parity should be much less unpopular than measures restricting *domestic* demand by an equivalent amount. With small changes, the authorities would not have to worry so much that revaluation might, through unforeseen circumstances, turn out to have been a mistake; and nationalistic emotions—"letting the deficit countries get away with it"—would be less of an obstacle. And, with less domestic political sensitivity, it would be easier for other countries and international bodies to bring the issues out into the open.

Decision-Making in Nondilemma Situations

The obstacles to rational decision-making and constructive international cooperation on exchange rates are of course evident to both supporters and critics of the present system alike. It can hardly be contested that they would be reduced if parity changes were smaller and more frequent, and thus that there would be less masochism in dilemma cases. This is little more than saying that prevention is better than cure. Many will feel that the more important question is whether improved performance in dilemma cases would be offset, or more than offset, by a greater likelihood of currency depreciation in cases where the appropriate and sufficient remedy would be to restrict domestic demand, and, in the opposite case, where the appropriate and sufficient remedy would be to stimulate domestic demand.

It is a wry—and surely satisfying—reflection that the danger of less discipline in the sense of competitive attempts to export unemployment, which was uppermost in many people's minds at Bretton Woods, appears small if not negligible twenty-five years later. Governments are now fully aware of the many means at their disposal for stimulating domestic demand and, given the political attractions of increasing the purchasing power of their own citizens rather than that of foreigners, no longer seem very likely to choose devaluation as a remedy for recession.

If desired, of course, it would be possible to frame a reinterpretation of the rules to proscribe the export of deflation, for example, by limiting the benefit of the doubt for small devaluations to countries where there is evidence of external weakness. But, if it were accepted that in practice this hardly seems necessary, considerable weight would have to be given to the need to keep the rules as simple as possible, and to the objection that such a clause might inhibit countries from taking prompt action in the face of an emerging dilemma situation. A more important consideration might be the possible need to qualify the rules so as to discourage competitive devaluations arising from conflicting *external* objectives among participating countries. This, in many ways a different problem, will be discussed in Section VI.

Critics of greater flexibility are of course much more concerned about the possibility that less discipline would lead to a more inflationary world. The main counterarguments can be summarized as follows:

(1) The immediate relief to the balance of payments through the effect on price-sensitive current transactions of a *small* change in the exchange rate is likely to be small relative to the costs of failure to bring domestic overheating under control. More generally, if decision-making on exchange rates can be de-dramatized, governments will be

freer to determine the timing of changes in such a way as to facilitate the maintenance or restoration of price stability.

(2) Under a system of more flexible exchange rates the behavior of volatile capital movements should put more external pressure on the authorities than at present, at least in cases where there are doubts about the technical ability or political will of the country to bring overheating under control.

(3) Over the longer period, currency depreciation will provide as strong an incentive to keep inflation under control as reserve losses or foreign borrowing.

Before going on to discuss these arguments, it should be noted that advocates are assuming that with limited flexibility serious dilemma cases would become more rare, and this should be borne in mind when trying to assess how governments would behave in nondilemma situations. They would argue, for instance, that an instinctive feeling that under different rules countries would be more tempted to devalue when facing inflationary problems may be derived mainly from knowledge of the thought and actions of the authorities in countries where there has in fact been an underlying weakness in the balance of payments, and that this experience is not necessarily applicable to a world in which satisfactory arrangements exist to deal with genuine dilemma cases.

Starting with the first point listed above, assume that in a country where significant overheating is seen to be developing, the political or social conditions are such that the authorities are doubtful about the prospects of bringing the situation under control and decide to make immediate use of the devaluation options permitted under a system of limited flexibility. But, it is argued, a series of very small devaluations will not bring much immediate relief to the balance of payments. Over the short run any benefits would be much smaller than the cost to the balance of payments of failure to bring domestic overheating under control. Small parity changes would therefore be only a very partial and inadequate substitute for demand restraint, so that external discipline should not be significantly reduced. Indeed, the desire to ensure that this should be the case is one of the main reasons why members of this school advocate only *limited* flexibility.

The validity of this argument depends essentially on the respective price and income elasticities of current external transactions over the time period during which a country has sufficient reserves to finance a continuing payments deficit. An advocate of limited flexibility might suggest, for example, that over the first six to twelve months following a devaluation the gains in foreign currency tend to be negligible or negative because of the deterioration in the terms of trade, and that in

the second year they are unlikely to exceed 1 to 2 per cent of the volume of transactions for each 1 per cent reduction of the exchange rate. Against this he would argue that domestic overheating sufficient to endanger the price level quickly leads to a widening gap between the growth of imports and exports, which can easily reach as much as 10 percentage points after twelve to eighteen months.

Critics of greater flexibility may dispute such figures, and may in any case argue that they would be opposed to *any* easing of external constraints in this context. A counterargument is that any loss in this respect should be made up for by the greater freedom to follow well conceived demand-management policies that should result from a system that dramatizes parity changes. A responsible government, faced with domestic overheating, may prefer not to see its exchange rate depreciate immediately, since this will push up import prices and increase the need for restrictive action. A more sensible course may be to take the necessary restrictive action, and then, if when demand pressures have eased some permanent damage seems to have been done to the balance of payments, to use a small devaluation as an early step in a reflationary program. A country's willingness to follow such a course, it is argued, will be greater the more it feels free, in terms of domestic politics and market behavior, to make parity changes at the time of its own choosing.

The French devaluation of August 1969 might be cited as an example of the weakness of the present system in this respect. Some observers, while agreeing that a change in the parity was required, have suggested that the timing was unfortunate from the domestic point of view because of the degree of overheating in the French economy at that time. But the French authorities clearly felt that other considerations were more important, and that the market situation was such that the sooner the decision was taken the better. Many would also hold that the German revaluation of October 1969 was badly timed. From the domestic point of view it would have been better if it had come at an earlier stage of the cyclical upswing.

Turning to the second argument listed above concerning volatile capital movements, the strong tendency for a deterioration in a country's external current balance due to domestic overheating to be offset by an improvement in its capital balance under the present system has already been noted in Section I. By cushioning the loss of reserves this has been an important factor reducing the external pressure on countries to take prompt action to deal with emerging nondilemma situations. How, if at all, would the position be altered in this respect with a discretionary band-and-crawl system?

One argument is that under such a system, if a country showed signs

of overheating, then, whatever was currently happening in the foreign-exchange market, there would be greater uncertainty because of the possibility of larger movements of the rate within the wider band, and a stronger presumption that the parity might be lowered in the relatively near future. Forward discounts would be wider than they would be for countries starting from a relatively comfortable external position under the present system, and larger interest-rate differentials would be required to induce capital inflows. Similar considerations would apply in reverse to capital outflows from a country with deficient domestic demand. In general, therefore, equilibrating short-term capital movements would be discouraged, and it would be less easy to avoid large gains or losses of official reserves. By the same token, the effectiveness of monetary policy for achieving domestic aims would be enhanced, because it would be less likely to be undermined by large inflows or outflows of interest-sensitive funds.

This line of argument can, however, be turned upside down. It can be held that, for a country starting from a *nondilemma* situation, the normal expectation in the exchange markets will be that any change will be self-reversing, and thus will call forth speculation in the opposite direction. Equilibrating capital movements might be encouraged rather than inhibited. Furthermore, countries might use their greater freedom with respect to their exchange rates deliberately to induce capital movements; thus, for example, a country facing domestic overheating might be tempted to permit or engineer some currency depreciation so that the resulting speculative inflows reduced the need for other more unpopular action to protect official reserves.

There is a considerable body of somewhat confusing and at times conflicting literature on this subject. Part of the confusion arises from differing assumptions as to whether, in a typical *nondilemma* case of overheating, the current account will normally deteriorate more than the capital account improves, or vice versa. More fundamentally, this is an area where it is particularly dangerous to project from the present into the future, and where it is hard to avoid circular argument of the kind: market behavior will depend on government actions, government actions will depend on market behavior. Take for example the second line of argument just described. Suppose that a country is successful in inducing capital inflows by pushing down the exchange rate. If, however, subsequent events confirm that what was really needed was domestic restraint, it will find it much less easy to pull this trick a second time. But, equally, those who take the first line of argument are suggesting that, because the effectiveness of domestic monetary policy would be enhanced (and for other reasons), countries should be more successful

in preventing nondilemma situations from deteriorating to the point where a parity change is required. The more this proved to be true, however, the stronger would be expectations that changes in the market rate would be self-reversing. In other words, the inhibiting effect on volatile capital movements for which credit is being taken would be less marked the more successful the system proved to be.

It may help to cut through this maze to recognize that the concept of starting from "initial equilibrium" is an abstraction which, while useful at some stages in the argument, can only be applied with caution to the real world. At any one time market sentiment about a particular currency depends not only on the current situation in the country, but probably to a greater extent on its past record of economic and political stability. Under any new system, as at present, there would be a spectrum of harder and softer currencies. The pecking order might change as different countries responded to the new opportunities for good and bad decision-making under the new rules, but the spectrum would still exist. At this very broad level of generalization, it would seem likely that the effects of greater exchange-rate flexibility on volatile capital movements would be such that disciplinary pressures would build up more quickly on "weak" currencies and less quickly on "strong" currencies than under the present system. This would be more true the more countries' behavior—and hence their exchange rates—tended to diverge.

The discussion up to this point has been concerned mainly with behavior in the short run in response to unexpected or unavoidable bursts of inflationary pressure. Critics may argue that this is not the real issue. Countries—or at least some countries—are just inflation-prone. Under a discretionary band-and-crawl system they would tend to use their parity options all the time in the hope of staving off external discipline, whether or not this was sensible in terms of rational cost-benefit analysis. This leads to the third argument listed above, about the amount of "political pain" associated with currency depreciation as opposed to reserve losses and foreign borrowing. Here again, advocates of greater flexibility argue that it is necessary to project forward into a different world. Under the present system it is natural to think of the fixed rate as a bulwark against political irresponsibility. Policy advisers can go to the government and insist that restrictive action be taken because otherwise reserves and credit facilities will run out. Thus, to those who have been operating under the present rules, it seems obvious that currency depreciation would seem an easy way out.

In the first instance, and in an unchanged political setting, this may well be true. But it is argued that if one is concerned with a *persistent* tendency to devalue rather than restrain demand, then allowance must

be made for the likelihood that the political setting will change. Under the present system the exchange rate, for obvious reasons, can never be the subject of constructive political debate; at best it leads to mutual recrimination after the event. If the drama were removed, exchange-rate policy would become subject to exactly the same comment and criticism as fiscal or monetary policy. In a country which continuously devalued, the government would soon find itself under attack from the opposition. Devaluation has price-raising effects and, rightly or wrongly, is regarded by public opinion as a blow to national prestige. Unlike reserve losses, it cannot be concealed from public opinion, nor are its consequences put off into the future, as with foreign borrowing.

Thus, there is a question as to how far sticky exchange rates do provide an effective defense against inflation under the present system. Foreign borrowing may in practice be a relatively easy option for a major country, because of reluctance on the part of its creditors to envisage a large devaluation. Resort to controls may often be an even easier option, in political terms, since a large part of the burden is either obscured or put onto other countries. Some advocates of greater flexibility believe that the external consequences of inflation would be both more obvious, and more easy to bring home to public opinion, if they showed up sooner as a persistent decline in the external value of the currency, rather than reserve losses, large-scale foreign borrowing, and, eventually, a large devaluation (which, with luck, can be blamed on someone else).

As already discussed in Section I, a large devaluation has a major inflationary impact which is extremely difficult to contain. It is held that a careful examination of how decision-making might evolve over time suggests that there might, on average, be *less* rather than more inflation with a system of limited exchange-rate flexibility. Critics disagree. This is an issue where there is a great danger that factual analysis becomes clouded by differences in value judgments. First, there are different views as to what priority should be given to price stability, as opposed to high levels of resource utilization, freedom for international transactions, and liberal development assistance in considering possible changes in the international monetary system. Second, views differ on how much trust can or should be placed in democratic political processes. Some feel that there is a strong built-in bias toward inflation in parliamentary democracy which should be kept in check by national and international arrangements that help to keep important decisions out of the hands of politicians. Others believe that ultimately defense against inflation must rest on the verdict of public opinion expressed after informed debate of all the relevant questions, including the exchange rate.

To sum up, the main questions on the inflation issue center on judgment as to how far the rate of inflation in today's world is determined primarily by the political will and technical competence of the individual countries making up the system, and to what extent it is, can, or should be influenced by the institutional arrangements governing economic relations between the participating countries.

III. THE NATIONALIST/INTERNATIONALIST TRADE-OFF

Many critics feel that more flexible exchange rates would be a retrograde step on the road to closer international economic and political integration. They are only reinforced in this view when they hear advocates claiming as advantages for their proposals that they would "increase national autonomy," "enhance the effectiveness of policies designed to achieve national objectives," "insulate countries from external disturbances," and "allow them to follow their own preferences with regard to major economic options." They may note that the obstacles cited as condemning a fixed-rate system to failure—insufficient mobility of goods, capital, and labor; inadequate or nonexistent provisions for inter-country income transfers to alleviate social inequities; insufficient harmonization of policies concerning money creation and public expenditure—are precisely what the charter of one or more international bodies pledges them to seek to eliminate.

A more specific concern is often expressed about proposals for greater flexibility. It is feared that this could lead to the emergence of two or more economic blocs made up of countries with similar economic circumstances or preferences, clustered around rival power centers. It is held that this could be a divisive development cutting across existing historical, geographical, and cultural affinities and creating new nationalisms. In particular, the possible emergence of rival blocs—perhaps a gold bloc and a dollar bloc—would be extremely unfortunate at a time when the world is moving towards the collective management of international reserve assets.

The true internationalist looks forward to the day, however distant, when exchange rates are not just fixed, but have ceased to exist. He is worried that, if exchange rates were more flexible, countries would be less interested in what was going on in other countries. They would be less inclined to seek collective solutions to common economic problems. If there were less pressure to harmonize economic policies in areas where this involved some sacrifice of domestic interests and willingness to incur domestic political disfavor, there would be less fallout in terms of willingness to harmonize policies in the wider and more important areas of foreign policy and collective security.

The internationalist must recognize, however, that the arguments do not all run in one direction. The trade-off referred to in the title of this section arises from the fact that, whether one likes it or not, we live in a world of nation-states. An adequate degree of social and political stability in individual nations is a prerequisite if international strife is to be avoided; beyond a certain point pressures making for the harmonization of economic policy objectives will be counterproductive if they undermine this social and political stability, or if they keep alive or engender nationalist sentiment.

It is not easy to pin down the key issues, because different views are strongly colored by deeply held value judgments, and because many of the important questions lie outside the area of economic analysis. It may help to start by identifying two important differences in value judgments. First, it is natural that citizens of small countries, and perhaps particularly European countries, tend to attach a high priority to rapid progress toward political integration. To them it is a matter of direct self-interest in terms of national security, influence on the world scene, and so forth. An American will tend to give greater weight to national self-reliance and national objectives—although of course he is also motivated by more altruistic and longer-run considerations.

Second, different people attach different priorities to the economic as opposed to political benefits expected from integration. Some are concerned primarily with the economic advantages of large integrated markets. Many in this school are liberal economists who tend to assimilate *national* attitudes and characteristics with *individual* preferences and capacities, often with the implication that nations should have the same freedom of choice as individuals. They may also have an implicit bias in favor of the smallest possible decision-making centers. The political integrationist has a quite different scale of values. He is primarily concerned with diminishing nationalist tensions and increasing the cohesion, power, and prestige of his region, or of the western world as a whole. To achieve these aims he is prepared to accept considerable costs in terms of economic welfare: for example, the stimulation of high-cost agricultural production, temporary or even quite permanent distortions in national tax systems on the way to harmonization, and a strong "spill-over" effect of inflation and deflation from one country to another. In contrast to the liberal economist, he is likely to be less averse to government intervention.

Questions of political judgment are also important. One school holds that, however desirable, political integration will take a long time to achieve and will depend essentially on a change in political attitudes. In the meanwhile attention should be concentrated on maximizing eco-

conomic welfare. Others, following the founders of the postwar European movement, believe that there is a strong fallout from economics to politics, and that by pushing ahead with quite rigid forms of economic integration situations will develop requiring increasingly important political compromises, paving the way for further institutional advances.

The European Economic Community

Within the European movement, orthodox opinion strongly favors fixed parities and narrow or zero bands for EEC currencies, largely on the general grounds discussed above. There are signs, however, of a growing tendency to question this position. Indeed, it has been suggested that progress towards achieving the political aims of the Community would be facilitated, rather than retarded, by the adoption of a carefully designed system of limited exchange-rate flexibility. In other words, it is held that, if the studies now under way led to a consensus that limited flexibility would be workable in practice and gave promise of better economic management for other countries, then it might be particularly well suited to the EEC.

Those who take this position feel that experience since 1958 has shown that the conditions required for monetary integration within the Community have not yet been achieved, and are unlikely to be achieved for some time. Divergent trends in national wage and price levels are likely to continue. In this case the attempt to fix exchange rates rigidly, or continue with the present system of large step-like changes, will create distortions and frictions which will tend to hold back progress toward integration on a broad front. It is held that a system of limited flexibility could be designed which would exert continuous pressure on member countries to make progress along the road to monetary integration, without demanding the impossible in terms of current economic and political realities. If *large* parity changes were from now on ruled out, and member countries proved able to harmonize their policies to the extent necessary to operate a system which permitted only gradual changes, it is argued that this would be more concrete evidence of progress towards monetary integration than a period of fixed parities followed five or ten years later by another major upheaval.

This school also believes that with limited flexibility it would be easier to get on with the laborious but essential task of promoting functional integration, that is, breaking down remaining barriers at the frontier, harmonizing national legislation, and creating the conditions necessary for the proper operation of a unified market. First, member countries should be more willing to accept new commitments in this respect, because, with limited flexibility, they would have a safety valve

in the event of unforeseen consequences for their balance of payments. (Conversely, the danger of member countries being forced to re-impose exchange controls and other defensive measures quite contrary to the aims of the EEC should be significantly reduced.)

More specifically, it can be argued that so long as national price levels continue to diverge, it would be easier at both the technical and political level to push ahead with functional integration with an exchange-rate system that eliminated large abrupt changes and tended to produce gradual adjustments roughly in line with purchasing-power parities. This is best illustrated by the EEC's common agricultural policy. The aim of this policy is to achieve a *uniform* level of support for agriculture throughout the Community, the object being both to rationalize European agriculture across national frontiers, and at the same time provide a legitimate basis for shifting the financing, from a national to a Community-wide basis. This is an ambitious aim consistent with the political objectives of the Community. It means that farmers in similar circumstances in different member countries should face roughly the same inducements either to stay on the land or to seek employment elsewhere: that is, it requires uniform "terms of trade"—or more accurately income-earning opportunities—between the agricultural and nonagricultural sectors in each member country.

The main method chosen was to set uniform market support prices, denominated in units of account and converted into national currencies at the going exchange rate, with a built-in preference favoring first domestic and then other EEC suppliers. Uniform nominal prices, however, will only yield a uniform level of support in real terms if the initial exchange rates have been roughly in line with purchasing-power parities, and subsequently any divergence in national price levels is offset by exchange-rate changes. In the event, nonagricultural prices rose faster in France than in Germany. In both countries the terms of trade for agriculture deteriorated, but German farmers did better than French farmers. (In setting the initial support prices some allowance was made for erosion due to subsequent inflation. In practice, of course, agricultural productivity has improved more rapidly than expected, with resultant excess production.) Then came the parity changes of 1969, with the cross-rate between the French franc and the mark going down by around 20 per cent, that is, by far more than the divergence in price levels over the preceding few years. To have reestablished uniform support prices at the new parities would have involved raising them in France and/or lowering them in Germany, by amounts adding up to a net change of 20 per cent. But German farmers naturally tended to regard their gains as an acquired right, while a sharp rise in food prices

could not be tolerated by the nonagricultural sector in France. So it is hardly surprising that, faced with abrupt changes of this magnitude, it was decided instead to put the principle of uniform support prices into cold storage and introduce a complex system of temporary taxes, subsidies, and frontier controls.

The problem of how to maintain roughly uniform terms of trade for agriculture throughout the Community will persist until the conditions for full monetary integration have been achieved. But it is argued that they would be *easier* to solve with a system of limited exchange-rate flexibility. Instead of allowing distortions to build up to the point where their eradication raises insuperable political obstacles, they could be warded off. If there were an annual agricultural-review procedure, the real debate would be about the evolution of agricultural incomes in real terms, and supply and demand for individual products—as it should be. It should come to be regarded as normal, indeed equitable, that when translated into national currencies the decisions taken on these grounds would also reflect the relatively small exchange-rate changes which had taken place since the previous review.

It is sometimes argued that the problems arise, not from the exchange-rate system, but from the heavy reliance on market support prices in the Community's agricultural policy, and the level at which these have been set. It can be shown, however, that whatever the merits of other techniques of supporting agriculture, the same question of how to adjust subsidies paid in national currencies for diverging national price trends would still arise in one form or another.

Similar examples of the difficulty of trying to harmonize subsidies, taxes, and social benefits before monetary integration has been achieved can be found in the fields of regional policy, social policy, transport policy, energy and other policies. The basic point made by advocates of greater flexibility is that it would be easier to concentrate on finding the best solution to the specific problem under consideration, without having to worry so much about the distorting effect of divergent national price levels or the possibility of large and disruptive parity changes.

A somewhat different example can be drawn from the field of tax harmonization. A declared aim is to eliminate fiscal frontiers, after harmonizing indirect tax systems and moving towards a common rate for the value-added tax. But, so long as conjunctural differences do in practice persist between member countries, governments are likely to want to retain some power to vary indirect tax rates for demand-management purposes. With limited flexibility, it might be possible both to accelerate the abolition of fiscal frontiers and retain some scope for conjunc-

tural tax changes. Suppose that rates for the value-added tax were harmonized within a few percentage points and fiscal frontiers for this tax were abolished. Then when a country wished to make an anti-inflationary indirect tax hike it could decide, according to its external circumstances, either to lower its parity slightly in order to maintain its competitive position or, if there were signs of dilemma-surplus position, to let the tax rise contribute to external adjustment. (Practical examples of both possibilities could be drawn from French and German experience over the 1968-69 period.)

To sum up, it is argued that the attempt to force the pace of monetary integration by fixing exchange rates with no provision for limited adjustment was a gamble which did not come off. It may well have been worth trying—the “great-leap-forward” approach has been used successfully in other areas, and nobody could tell in advance how fast integrating forces would gather momentum. But national price levels have diverged, and this is likely to continue. If monetary integration is to be achieved, some member countries will have to learn to live with more inflation than they have been used to, others with less. This may be a comparatively small price to pay in relation to the prize at stake. But it will take time, and nationalistic sentiment still runs deep in Europe. According to this school, trying to force too fast a pace in this respect may well use up reserves of political will and popular support which are badly needed to achieve other more immediately important and realizable objectives in the area of functional integration.

Given the political aims of the EEC, the provision for limited flexibility might be somewhat different than for other countries. It might be decided to set a lower maximum rate of crawl and/or operate within a narrower band. In particular it might be desirable to impose more stringent restrictions on parity changes larger than those permitted under the crawl provisions, either by making these subject to qualified majority voting or banning them altogether. As time went by, progress towards monetary integration could be reviewed, and the exchange-rate constraint could be progressively strengthened.

Those in the European movement who remain firmly attached to the idea of fixed exchange rates are, of course, well aware of the technical and political difficulties resulting from large parity changes discussed above. In their view, rather than take what they would regard as a step backward, the right answer is to accelerate progress towards monetary integration, by more intensive coordination of economic policy, setting up what should in time become a European Monetary Board, elaborating Community guidelines for fiscal policy, and in other ways. An optimistic view is that in this way it should become possible to introduce a common European currency within a decade. Others, who are less

optimistic, nevertheless favor fixed rates because they believe that recurrent crises are positively useful; they are the only way that governments can be shocked into making the necessary surrender of national sovereignty.

To sum up judgment on the EEC issue depends in the first place on an assessment of the strength of the economic and political forces which have produced divergent wage and price trends within the Community, and the likelihood that they can be brought under control in the reasonably near future, bearing in mind the new initiatives now under consideration. Second, there is the question of the relative priority given to monetary as opposed to functional integration, taking into account the political costs and benefits of success or failure in each area. Finally, there is the choice between the high-risk approach which welcomes the prospect of further crises, as against the controlled experiment of a system of limited flexibility, which could be progressively tightened up as member countries demonstrated their willingness and ability to accept the full consequences of monetary integration.

International Cooperation in the Wider Sphere

The nationalist/internationalist trade-off has been discussed so far in terms of the EEC, because to many this is where it is posed in its most acute form. Similar considerations apply to looser forms of international cooperation in the General Agreement on Tariffs and Trade (GATT), the IMF, and the United Nations Conference on Trade and Development (UNCTAD). As already noted, advocates of greater flexibility tend to believe that balance-of-payments difficulties arising from attempts to maintain unrealistic exchange rates are a prime cause of economic nationalism. They prompt countries to resort to controls which are all the more insidious if the harm done is not immediately apparent. They inhibit new initiatives towards lowering tariffs and removing other obstacles to trade, invisible transactions, and capital movements. And they have almost certainly reduced the volume and quality of aid to the developing countries, through the ratchet effect whereby cuts by deficit countries are not fully matched by additional efforts by surplus countries.

For the internationalist, the basic question is one of priorities. Does the aim of harmonizing exchange-rate policies, and through them rates of inflation among different countries, override his other objectives in the field of trade and aid policies? Or would overall upward progress actually be faster if the climbers were given a bit more rope to adapt their pace to that of their partners? Some would argue that with a new interpretation of the exchange-rate rules, the stage would be set for new initiatives in the field of trade liberalization and aid to the developing

countries, and for a new look at the other rules governing international behavior, some of which are becoming rather dated (for example, GATT rules on quantitative restrictions, inadequate commitments regarding the freedom of invisible and capital transactions, aid-tying, and so forth).

How Much Would Exchange Rates Diverge?

Most of the above questions involve value judgments and conflicting views about the technical and political aspects of international cooperation. There is also the more factual question of whether exchange rates would in practice diverge more under a system of limited flexibility than they do under the present system. Critics will argue that this would be inevitable, since, as many advocates point out, countries would be freer to pursue their own preferences with regard to acceptable rates of inflation, and with a somewhat reduced external constraint these preferences would be reflected over time in larger parity changes. Many advocates may dispute this. First, as regards differential rates of inflation, they would agree that there should be less inflation in surplus countries which now find themselves "importing" inflation from abroad, but some also believe that there should on average be less rather than more inflation in deficit countries if the need for large devaluations were to be successfully avoided (Section II). Second, and perhaps more important, is the view that if parity changes were made sooner the dynamic forces making for disequilibrium would have less time to gather momentum. There would be less tendency for countries to separate into overcompetitive fast-growth, and undercompetitive slow-growth categories, and hence over the long run less need for adjustment of parities (Section I).

IV. WOULD A DISCRETIONARY BAND-AND-CRAWL SYSTEM WORK IN PRACTICE?

Critics of limited flexibility may be impressed by many of the arguments discussed above, and yet remain sceptical. They can see advantages and disadvantages in both freely floating and fixed rates, but suspect that in practice limited flexibility might combine the disadvantages of both with the advantages of neither. It would be letting the genie out of the bottle without enough room to do his tricks. There are two opposite but closely related aspects of this question. First, would the behavior of the exchange markets be such that the authorities did, in fact, feel freer to make small parity changes at times of their own choosing? Second, would the behavior of the exchanges, as determined by the actions of the authorities and the reactions of the private sector, be such as to facilitate the growth of private international transactions, or, on the contrary, to inhibit it?

The Authorities

Under any essentially discretionary rules one feature of the present system would remain: parity changes would be made by a single decision-making unit at a given point of time, rather than be the result of the interaction of supply and demand at the margin. In addition there is a presumption that parity changes will be made *sooner* than under the present system. Critics of limited flexibility—including in this case those who favor freely floating rates—can argue that a discretionary system might in practice tend to freeze up. Because of increased expectations of parity changes in the near future, the authorities might find that they were having to pay out or take in *more* reserves to keep the rate within the intervention limits than at present. Faced with this, they might feel it necessary to state publicly that they did not intend to use their parity options over a given period, thus putting off—but ultimately intensifying—speculative pressures, and eventually destroying the flexibility supposedly built into the system.

Advocates argue that this danger can be avoided by careful design of the rules, the critical element being the rate of crawl relative to the width of the band. These should be set in such a way that the authorities can normally decide to change the *parity* in the knowledge that this need not have any significant effect on the *exchange rate* in the immediate future. Suppose that, with the rules set out in the introduction, a currency's par value is 100 units of the numeraire, with upper and lower intervention points at 102 and 98. In the market the rate has fallen to between 98 and 99. Reviewing the situation, the authorities conclude that some permanent damage has been, or is being done to the country's competitive position, and decide to lower the parity by 1 per cent. The rate already prevailing in the market would still, however, be well within the new intervention points of 97 and 101, so that this action would not in itself have any effect on the market rate.

Of course the market may well interpret the parity change as signalling the likelihood of further steps to come in the same direction. But under a discretionary system the authorities would be free to intervene in the spot or forward markets to prevent any immediate further decline in the spot rate, and thus keep the market guessing as to their own expectations concerning the future trend of the market rate and the parity. There is a close parallel here with changes in the discount rate. According to the circumstances and their own operational experience, the authorities may decide either to lead the market or to follow it. So long as they have this choice, most of the drama surrounding parity changes should disappear; they would not overnight make a lot

of people richer or poorer. Movements in the exchange rate would be in part a function of what was happening in the market, but would over time depend on how the authorities interpreted signals coming from the market, and what policies—including exchange-rate policy—they decided to adopt to meet the situation.

It is claimed as an advantage for a system of this kind that parity changes would still be made in distinct discrete steps over intervals which allowed time for a new assessment of how the situation was evolving and, if necessary, for consultation with partner countries and international organizations. But, at the same time, it is held that they could be small enough to be undramatic and without great impact on exchange and money markets. Whether, in practice, things would work out like this—whether market pressures on the decision-making process would be effectively muzzled—would depend a great deal on the willingness of the authorities to make use of the flexibility written into the new rules.

In the first place, governments would have to be prepared to make use of their parity options without waiting for all the evidence to come in. If they hung on until the market became convinced that a change of significantly more than 1 per cent was needed, speculative crises could build up which might be even more difficult to handle than those under the present system. Critics may argue, however, that it is quite impossible to know with any certainty that a parity change of 1 per cent (or even 5 per cent) is needed in any given situation. The rejoinder is that the same is true for other major policy instruments such as fiscal and monetary policy. Because of the lags and unknowns, the authorities can never have more than a rough idea about the precise timing and magnitude of changes in taxes and monetary variables required to meet a given situation. What they in fact do is take a view about the direction in which they should be moving, modify policies accordingly, and then stand ready to make further changes in either direction as the situation develops. Advocates of greater flexibility would argue that is exactly how they could, and should, behave with regard to exchange rates.

Second, the market's anticipation of, and response to, small parity changes will be conditioned by the policy adopted by the authorities with regard to intervention *within* the band around parity. If it were known that the authorities preferred to keep the market rate stabilized close to parity, then any significant divergence would create strong expectations of an imminent parity change. If, on the other hand, the authorities were prepared to let the market rate fluctuate relatively freely within the band, it should be easier for them, in terms of market behavior, to make small parity changes at times of their own choosing,

in accordance with their judgment of the longer-run needs of the situation. In other words, the market impact of parity changes of a given size would be minimized if they were no bigger, and preferably smaller, than the short-term fluctuations in the exchange rate which the authorities were prepared to tolerate; or, to put it the other way round, which the market had become accustomed to seeing quite often reversed without triggering parity changes.

This essentially operational consideration raises the more substantive issue of how much short-term fluctuation in the exchange rate the authorities should be prepared to allow. Some advocates of limited flexibility would regard such fluctuations as useful in themselves—this is the school which sets great store on enhancing a country's ability to insulate itself from external disturbances. Others, however, believe that any benefit in this respect would be small or negligible, or regard short-term fluctuations within the band as a necessary evil. (Some proposals envisage a crawling parity with either no band or a very narrow one.) The case against short-term fluctuations is the same as that levelled at freely floating rates. A country's exchange rate will always be subject to a number of essentially random shocks of domestic or foreign origin. If the currency is allowed to depreciate, this may push up the domestic price level, set off a price-wage spiral, and cause a permanent rise in domestic costs and prices. Because it is asymmetrical, this ratchet effect could both magnify divergent trends in the exchange rates of different countries and be a factor making for a generally higher rate of inflation in the world.

This problem is the more serious the smaller the country and the larger its foreign sector. A small change in the exchange rate of the U.S. dollar vis-à-vis other currencies would probably have a negligible effect on domestic prices in the United States. In a \$100 billion economy, however, up to one-fifth of an exchange-rate change may get carried into the domestic price level. With small changes, some of the subsequent upward leverage on the domestic price level would probably be absorbed by the lags normally present in price-wage relationships. More important is the question of whether relatively small exchange-rate changes, which may well be reversed, would be carried into the domestic price level at all. To the extent that exporters regard foreign markets as a long-term investment, it can be argued that they will not base their pricing policy on short-term fluctuations in the exchange rate. (Empirical evidence can be cited to support this view—for instance, pricing behavior while the United Kingdom's import surcharge was in force.)

Advocates of the band-and-crawl system would therefore argue that most national authorities should be able to tolerate short-term fluctuations in the exchange rate of the order of at least 1 to 2 per cent. They

would probably tend to regard as largely irrelevant the fact that national authorities have made little use of the flexibility incorporated in the existing IMF rules, since the band would have a much more important operational *raison d'être* in a discretionary band-and-crawl system than it does at present.

Managing a Depreciating Currency

Even supposing that national authorities were prepared to make full use of the flexibility written into the rules, there are nevertheless many people who find it hard to believe that a system of small and fairly frequent parity changes could be made to work in practice—although they are in other respects quite sympathetic to the idea of greater flexibility. They can envisage a country *appreciating* its currency in small steps, but feel that the problems of managing a depreciating currency under a system of limited flexibility would be insuperable. This is one reason why some writers have proposed an “upward-crawl-only” system. It is worth noting that logically, if the necessary adjustment in cross-rates takes place (and abstracting from the role of the numeraire in the system), the problems facing the deficit country would be much the same whether they came from devaluation on its part or revaluation by others—that is, there is little difference in theory between managing a depreciating currency, and managing a stable currency in a world of appreciating currencies. In practice, however, it seems likely that at least during a transitional period the psychological impact of small devaluations would be greater than that of revaluation by others, which would be less immediately obvious and more diffused through time. This could be important for countries with large, relatively liquid foreign liabilities (for example, the United Kingdom).

Government officials, with experience at operating the present system, find it hard, if not impossible, to conceive of circumstances in which they would advise their government to lower the parity by as little as 1 per cent. One argument is that the shock effect of a large devaluation is needed to rally support for the necessary accompanying measures. It is hard fully to accept or reject this argument. The clinical history of democratic decision-making yields many examples of both the success and failure of shock treatment. It can be pointed out, however, that in this case the shock therapy of devaluation depends essentially on nationalistic reflexes. With increasing economic sophistication and, it is to be hoped, diminished economic nationalism, public opinion is likely to become less ready to regard devaluation as an unmitigated national disaster, and more aware that it is simply an economic adjustment bringing benefits to some sections of the community while penal-

izing others. Interest groups will probably become less inclined to respond to calls to rally around the flag, and more determined to shift the burdens onto someone else. In this case the arguments put forward in Section II about the greater ease of making gradual adjustments would appear to carry increasing weight.

A second argument is that more frequent devaluations, even if they were much smaller, would over time increase the sensitivity of wages to prices, thus reducing the moderating forces at work in the price/wage spiral and eventually rendering the exchange-rate mechanism ineffective. It is not obvious, however, why labor should be more sensitive to price rises coming from the import sector than those which are domestically generated (with a qualification for countries which are heavily dependent on imported food). The demand for, say, price-indexation clauses in wage contracts is surely a function of the rate of increase in the *general* level of consumer prices. Thus, the central question would seem to remain the one discussed in Section II as to whether there are grounds for believing that the authorities would be more or less inclined (and able) to follow appropriate demand-management policies under a system of limited flexibility.

There may be another point of some relevance here. It has been suggested that there has been a steady erosion of the "money illusion" in several major countries over the last decade or so. If this is correct, it is a development which will tend to reduce the efficacy of *all* methods of manipulating an economy through the price mechanism, including the use of exchange-rate changes. It has just been argued, however, that there seem to be no obvious *a priori* reasons why the adoption of greater flexibility should accelerate this process, which is surely linked to the persistence of high domestic rates of inflation.

A third argument is that the detrimental effect of a 1 per cent devaluation on confidence would far outweigh any benefits in other respects. Here again advocates of limited flexibility would counter that this is an illegitimate projection from past experience into a different world. We have been living in a black-and-white world in which exchange rates have been regarded either as completely innocent, or definitely suspect. In such a world a 1 per cent devaluation would of course simply confirm the worst suspicions and set off massive speculation. But if national authorities were prepared to make proper use of the flexibility incorporated in the new rules we should move into a world of different shades of grey, in which each small parity change would be judged on its merits in the light of the overall policies being followed, interest-rate differentials, and so on.

But what about a country whose currency depreciates fairly steadily

over a considerable period of time? Is there not a danger that cumulative forces will build up, undermining confidence and spurring ever larger capital outflows? One rejoinder, already discussed in Section I, is that with a succession of small parity changes it should be easier to use monetary policy and selective devices to neutralize speculative capital movements. More generally, there is the question of whether the overall effects on confidence of a fairly steady depreciation, averaging, say, 1 per cent a year, might not be less than those resulting from a period of 5 to 10 years with a fixed rate, followed by increasingly severe crises, and eventually a large devaluation (which, for the reasons given in Section I, may well have to be larger than the sum of the smaller changes). Furthermore, the events of the last two or three years may tend to have exaggerated the importance of parity changes as a determinant of capital movements. If, with limited flexibility, deficit countries were less tempted to resort to controls and better able to meet the requirements of internal and external equilibrium, this would in itself be a factor tending to moderate disruptive capital movements.

To sum up, advocates of greater flexibility argue that if the exchange rate is taken down from its pedestal and stripped of its nationalistic trappings, it can be seen to be very much like other major policy instruments. True, it has significant price effects, demand effects, income-distribution and wealth effects, but so do the other instruments. With suitable institutional arrangements, managing a depreciating currency should not be so very different from managing a declining government-bond market. They believe that the problems would in practice be less acute than those arising from prolonged efforts to defend an overvalued currency. Critics remain dubious, and as the debate proceeds this question seems to be emerging as one of the key points at issue.

The Private Sector

Instinctively, the most obvious and powerful objection to more flexible exchange rates is that they would inhibit the growth of international trade and payments. Indeed, this was the thought uppermost in many people's minds at Bretton Woods. It has nevertheless been left to this stage of the discussion because its validity depends critically on judgment as to how exchange rates would, in fact, move under a different set of rules; and this in turn depends on the key questions about the likely behavior of the authorities and the exchange markets discussed up to this point.

Advocates would agree that under a band-and-crawl system exchange rates would be more *variable*—the sum, without regard to sign, of changes would be significantly higher than under the present system.

This would be the inevitable consequence of the somewhat greater short-term fluctuation which many feel would be a necessary condition for successful operation of the system. As discussed in Section III, however, they can argue that over the longer run the *divergence* of exchange rates—the algebraic sum—might not be more, and some would say could well be less, than under the present system.

Logically, it would follow that over the short and medium run, while the probability of small changes would be greater, the probability of large changes would be *less* than under the present system. Under the rules set out in the introduction, for a currency at par the chances of a change over the next twelve months of up to 4 per cent (half the band plus the maximum permitted crawl) would be greater, but the chances of a parity change of 10 to 15 per cent should, if the system worked as intended, be very much smaller—if not negligible. It cannot therefore be determined *a priori* whether exchange risks involved in commercial transactions would be felt to have increased or decreased. For spot transactions there is the possibility of unexpected loss or windfall profit between contract and payment. Some traders, with less likelihood of large losses or profits, might feel more prepared to take the rough with the smooth as far as the greater likelihood of small gains and losses is concerned, and no longer feel it necessary to take forward cover.

It seems to be fairly widely agreed, however, that, at least in the period immediately following the introduction of greater flexibility, there would be an increased demand for forward cover (that is, to opt out of making either losses or profits on exchange-rate changes). Critics argue that this greater need for forward cover will raise the cost of international transactions, and that the increased demand may push up its price. The counter arguments are as follows:

- (1) Transactions would simply be shifted from the spot market to the forward market. There are no very obvious reasons why the unit cost, as measured by the difference between bid and offer prices, should continue to be higher for the latter than for the former. The real resources—manpower, communications, and so forth—are the same. With the changed probability distribution of the risks, that is, the smaller risk of large overnight losses, the supply price of the risk capital underpinning both the spot and forward markets might decline. (The changed risk distribution should reduce the supply price for a given volume of funds but, if the supply was inelastic and demand increased, this would tend to push up the price.) More generally, it is to be expected that in a competitive system the banks and other in-

stitutions involved would over time be able to meet the increased demand at competitive prices.

- (2) There may have been a golden age a few years back when it was possible for many market operators to believe that parities were fixed for good. Recent behavior in the forward markets shows that this confidence has been undermined and it seems unlikely ever to be fully restored. It is argued that forward markets should perform better with limited flexibility; there would be more likelihood of short-term reversible movements in spot rates, less chance of large parity changes, and, it is hoped, less restrictions inhibiting the flow of arbitrage funds. Forward discounts and premiums should therefore be tied more closely to interest differentials, with less likelihood of serious discrepancies arising from the one-way speculation typical of recent crisis conditions.

Critics may not be very impressed by these arguments, and may feel that with greater flexibility there would, almost by definition, be more uncertainty about exchange rates. Advocates point out that other uncertainties should be reduced. They believe that the risk of direct government interference with commercial transactions, in their view a powerful source of uncertainty, should be reduced. They can point out that if the exchange rate is fixed, then there is uncertainty about the relative movement of costs at home and abroad. Importers and exporters planning their operations over the years ahead have to assume that if costs get seriously out of line the parity will in the end be changed. But under the present system there must be much uncertainty as to how long a serious discrepancy may persist before the government will act to correct it. Windfall profits are made by exporters of countries whose currency is becoming undervalued; but the stimulus thus provided is outweighed by discouragement to exporters whose currency is becoming overvalued. With a smoother adjustment of exchange rates, international traders would be able to concentrate more exclusively on their own efficiency, and would have to worry less about the economic performance of their government vis-à-vis that of other countries.

Possibly both sides could agree that, if a discretionary band-and-crawl system worked as its proponents envisage, the private sector would not be worse off; any increased uncertainty or costs in certain respects would be offset or more than offset by reduced uncertainty in other areas. In fact this may be an essentially secondary issue. If the case for greater flexibility were to fail to pass the test on the central issues discussed earlier—if it were felt that it would lead to more inflation, growing

differentiation in national economic policies and performance, and so forth—many would feel that this was sufficient grounds for rejecting it, without going on to consider the likely inhibiting effects of international trade. (The impact of greater flexibility on the private sector is discussed at greater length in several of the papers in *Approaches to Greater Flexibility of Exchange Rates: The Bürgenstock Papers*, *op. cit.*)

V. THE SPECIAL POSITION OF INDIVIDUAL COUNTRIES

The Bürgenstock Communiqué stressed that “innovations should be so framed as to facilitate continued international cooperation while leaving individual countries free to adapt their own approach to their own individual circumstances.” As stated earlier, the main focus of this paper is on the exchange-rate and adjustment problems of industrialized countries the size of France, Germany, and the United Kingdom. The present section deals with the applicability of a system of limited flexibility to the United States, and (more briefly) to smaller industrialized countries and developing countries.

The United States

Most proponents of limited flexibility have indicated that any reinterpretation of the exchange-rate rules should not apply to the United States. They envisage that, as at present, the parity of the United States dollar should be fixed in terms of the numeraire in the system—be it gold, SDR's, or both. There are, of course, differences between those who feel that this parity should be fixed immutably, with the quantity of the numeraire being determined by collective decisions regarding creation of SDR's, and those who feel that room should be left for unilateral or collective decisions to alter the official price of gold. But in either case it is envisaged that the *exchange rate* of the dollar, by which is meant its purchasing power over goods, services, and financial assets outside the United States, would at any one time be determined uniquely by the sum of the decisions of other countries regarding the exchange rates and parities of their currencies vis-à-vis the dollar.

Over time, of course, these decisions will be influenced by the rate of liquidity creation, either in the form of SDR's or changes in the supply or price of monetary gold. The point being made is simply that in either case the *initiative* for decisions which effectively determine the cross-rate for the dollar vis-à-vis other currencies would be left entirely to countries other than the United States. (There is an exception in that some advocates of raising the price of gold have argued that this would have provided a possibility—they would argue perhaps the only practical possibility—of negotiating agreement on a simultaneous change

in the exchange rate of the dollar in terms of an important number of other currencies.)

A number of arguments favor a solution along these lines. In the first place it is pointed out that, as a matter of mathematical logic, if all but one of the countries in the system are free to alter their parity in terms of the numeraire, there is no *need* for the remaining country to have a similar freedom. Indeed, if it were to have such freedom, the system would be "over-determined" and would, at the least, run into operational difficulties. More important issues relate to the role of the U.S. dollar as a vehicle and reserve currency. If it is accepted that satisfactory adjustment between the United States and other countries can be achieved without flexibility between the dollar and the numeraire, then it can be argued that fixity has the advantage of reducing the confidence problem. A system that made the same provisions for parity changes for the United States as for other countries, would, it is held, undermine the use of the dollar as an international currency, from which the system as a whole derives important benefits.

One reason often put forward why there is no need for exchange-rate changes at the initiative of the United States derives from a view that the concept of underlying disequilibrium is not really applicable to a reserve-currency country. If other countries hold dollars in their official reserves in excess of their need for working balances, there can be no meaningful "market test" of a given outcome for the United States' balance of payments. Official willingness or reluctance to hold dollars is only in part determined by rate-of-return versus capital-value considerations; it is influenced by many other factors, including political links between individual countries and the reserve center, and considerations regarding the stability of the reserve-currency system as a whole. For these reasons, it is held that it is only countries other than the United States that can judge whether these dollars are "willingly held." It is therefore both appropriate and sufficient that they only should have the right to alter the parity of their currency in terms of the numeraire, and hence the dollar.

Another somewhat different argument can be advanced to support the same conclusion. Some hold that the disproportion between the economic and political size of the United States and other countries is so great that, no matter what is written into international agreements, in reality the United States is subject to little effective external pressure to conform to the value judgments and economic performance of other countries. This is the case both because the United States is less dependent on international transactions for its well-being, and because bringing effective pressure to bear on the center of a reserve-currency

system requires a willingness on the part of other countries to carry things to the point where the stability of the whole system is threatened, involving the obvious likelihood of a credibility gap. According to this "realistic" school, other countries should recognize that they cannot expect to influence the domestic economic policies of the United States, and that the only options open to them are either to mesh in with the rate of inflation in the United States, as determined by the domestic political decisions taken in that country, or, if they prefer, to alter the parity of their currency in terms of the U.S. dollar as and when required.

Both these lines of argument support a view that, while for any other country the appropriateness of a parity change can and should be judged by looking primarily at the situation of the country itself and the initiative for making changes should lie essentially with that country, the nature of today's world and the mechanics of a reserve-currency system are such that the necessity of change in the exchange rate of the U.S. dollar should be judged primarily by looking at the position of the other countries in the system. Thus, it is appropriate and/or inevitable that the initiative for making decisions which have the effect of changing the dollar exchange rate should lie with them.

Looked at strictly in terms of the mechanics of a reserve-currency system, overvaluation of the dollar can only mean that other countries prefer to accumulate liquid claims on the United States rather than increase the purchasing power of their currency over American goods and services (by revaluation), to a degree that is not acceptable to the United States and/or threatens the stability of the whole system. The "liquidity school" argues that this is evidence of disequilibrium in the system as a whole; it is suffering from an unsatisfied demand for liquid assets. Their solution is to increase international liquidity to the point where surplus countries become willing to let their currencies appreciate, or in other ways follow policies that would eliminate their surpluses. Advocates of flexible exchange rates, however, would argue that although there is a logical link between reserve policy and exchange-rate policy, the irrationality surrounding exchange-rate policy under the present system can make it an *independent* cause of disequilibrium.

This seems to be the central point at issue between the liquidity school and the exchange-rate school. According to the former there is a relatively direct and immediate relationship between the rate of liquidity creation and the adjustment policies followed by the countries making up the system. More flexible exchange rates are regarded as an essentially technical change which would be, at best, only a marginal improvement. The contrary view is that, in practice, the level (and growth) of official reserves does not play such a central and sensitive

role in the decision-making process. Appropriate arrangements for the provision of additional international liquidity are needed to ensure the right balance between expansionary and restrictive policies in the system as a whole over the longer run. But this will not, by itself, be enough to overcome the obstacles to rational decision-making on exchange rates inherent in the present system. An attempt, for example, to remedy a supposed overvaluation of the dollar by pumping additional liquidity into the system would, it is held, have to be carried to undesirable lengths before it was likely to have the intended effect on exchange-rate policies.

From the point of view of the proper management of the system, therefore, this school does not find it particularly helpful to think of the balance of payments of the United States as the residual in a general-equilibrium model. The special position of the United States is better thought of as a matter of degree, not of kind. Beyond a certain point, the same considerations concerning adjustment policies apply as for other countries. Although judgment will be more difficult, there is a meaningful sense in which—even with the “right” amount of international liquidity—the dollar can become overvalued or undervalued, and it is important to consider whether the present exchange-rate system, or any alternatives under consideration, can deal adequately with such a situation should it arise.

It is often suggested that the present system actually has a strong devaluation bias tending towards overvaluation of the dollar. It is a fact that under the Bretton Woods system there have been far more, and larger, devaluations than revaluations. Insofar as this merely reflects higher rates of inflation in other countries in general than in the United States it need not cause concern. But it can be argued that in a large-change-or-not-at-all exchange-rate system there is a strong tendency for devaluing countries, having decided on what seems to be the appropriate new parity on objective grounds, to add something to provide a margin of safety, while revaluing countries tend to subtract something for the same reason. Both because of this, and because it is easier for surplus countries to put off revaluation than for deficit countries to stave off devaluation, there may be a built-in tendency for the dollar to become overvalued more or less whatever the rate of inflation in the United States.

It can be further argued that if such a situation develops it is very hard to rectify under the present system. If the official dollar price of gold is regarded as immutable, the initiative must come from countries other than the United States. But no country, unless it is in an extreme surplus position, is likely to be prepared to revalue its currency signifi-

cantly in terms of the dollar without knowing whether other important countries are prepared to follow suit. And since, as discussed in Section II, there are many rational (and irrational) reasons why countries may consider a large parity change to be inopportune at any particular point in time, the prospects for a successful multilateral approach to the problem are probably rather limited. Equally, it is often thought that even if the official gold/dollar parity were not regarded as sacrosanct, similar difficulties would arise if the problem was turned around the other way: that is, that if the United States were to try, at its own initiative, to devalue the dollar by a moderate amount in terms of other currencies, the real and psychological importance of the dollar is such that most other countries would follow suit.

Advocates of limited flexibility would argue that the problem under discussion here should be much less serious with a band-and-crawl system, even in its simplest discretionary form. First, individual surplus countries, for the reasons discussed earlier, would be more likely to resort to revaluation. Second, the devaluation bias resulting from the tendency to leave a margin for safety would be reduced: devaluing countries would know that if necessary they could make further changes in the same direction without great drama if this proved necessary; revaluing countries would know that it would be much easier to reverse their previous decision. Third, the "follow-my-leader" problem would be less acute. One surplus country may decide to make a small upward change in its parity; other less strong surplus countries need not make an overnight decision, but, if after a while they find that their own external disequilibrium has been accentuated, they would feel much freer, and hence be more inclined, to follow suit. Thus, with smoother and more continuous parity changes, the likelihood of the system developing a devaluation bias vis-à-vis the U.S. dollar should be much reduced.

It is clear, however, that some advocates of limited flexibility feel that with a purely discretionary system some devaluation bias might persist, even if less marked. It is concern on this point that seems, implicitly or explicitly, to be an important consideration behind many proposals for variants of the band-and-crawl scheme which would introduce some degree of asymmetry or automaticity into the system. This is most obvious and explicit in the proposal for an asymmetrical band, with a wider margin for currencies other than the dollar to appreciate above parity than below it. Proponents of this approach clearly envisage that countries which found their currencies tending to push towards the upper intervention point would in due course alter their parities accordingly, so that the asymmetry in the band would neutralize the devaluation bias. (In some variants, provision would be made for an upward *crawl* only,

with or without wider bands.) Many of the suggestions along these lines probably come from people who suspect that the dollar has already become overvalued. Some critics may simply disagree with this judgment; others may query whether it would not be easier to deal with any supposed overvaluation of the dollar through a multilateral realignment of parities rather than by trying to twist the rules. (Some more general objections to an asymmetrical system are discussed in Section VI.)

Another approach is to suggest that this problem should be met by framing the rules in such a way as to put more pressure on surplus countries to revalue than would be the case with a purely discretionary system. This could be done by obliging countries to take account of market signals in formulating their exchange-rate policy either by introducing some degree of automaticity between the movement of the exchange rate in the market and parity changes, or by a set of "presumptive rules" whereby if a country's currency was above par in the spot market, at a premium in forward market, and/or if its reserves were increasing, there would be a presumption that its parity should be appreciated.

The general question of relying to some extent on market signals in the operation of the system is discussed in Section VI. When considering the special position of the United States, however, it is important to note that, with limited flexibility for all currencies other than the dollar, a situation could develop in which the counterpart of a significant underlying deficit for the United States was widely diffused throughout the rest of the system. Individually, other countries might not regard it as evident that they were in underlying surplus, and be disinclined to heed the relatively faint signals from the market to this effect. It seems likely, therefore, that a system relying on presumptive rules might have to be rather sensitive and rigorous to deal with this particular problem. (Although it applies more or less throughout the discussion, it should be noted that the terms underlying surplus and deficit are being used here as defined in Section I—a situation in which, abstracting from cyclical fluctuations, the structure of a country's balance of payments is considered unsustainable or undesirable, regardless of what may be currently happening to its official reserves.)

A radically different approach is to suggest that the United States should be given the same freedom to alter its parity vis-à-vis the numeraire as other countries. Apart from anything else, this has the obvious political advantage that all countries would be treated on the same footing. Critics argue, however, that this solution would be either unworkable or undesirable: unworkable, because the psychological importance of the dollar is so great that in practice the American author-

ities would be unwilling to exercise their parity options and/or other countries would automatically follow suit; undesirable, because any improvement with regard to the adjustment process would be outweighed by unfavorable effects on confidence, and hence on the international role of the dollar.

Until the advent of SDR's, these criticisms clearly carried great weight; so long as the possibility of a large increase in the official gold price remained open, the idea of introducing limited flexibility between the dollar and the numeraire was obviously impracticable. Now that provision has been made for the controlled expansion of international liquidity, however, it may be appropriate to reconsider the advantages and disadvantages of having, *de facto*, a fixed parity between the dollar and the numeraire, with particular reference to the desire to improve the international decision-making process on exchange rates.

In a system in which all countries had the option to make small parity changes in terms of the numeraire, countries would probably still find it convenient to intervene in the exchange market using dollars, and hold working balances in dollars for this purpose. Since, technically, the system would be over-determined, and there would be some risk of the authorities operating at cross-purposes, it might be agreed that the United States should not intervene in its foreign-exchange markets, leaving it, as now, to intervention by other countries to keep market rates for the dollar within the band around parity. (In fact, intervention by the United States authorities would be possible—and has occurred—so long as there was sufficiently close cooperation between central banks.)

The United States would, however, have the right—*de facto* as well as *de jure*—to notify the IMF of a change in its parity by the amount permitted under the crawl provisions. The practical effect of this would be to alter the intervention points vis-à-vis the dollar for the currencies of all other Fund members. Any country which found this unacceptable would then have to decide whether it should also make a parity change. In the context of neutralizing a devaluation bias vis-à-vis the dollar, the important point is that the roles would be reversed. If the parity of the dollar is fixed, the rectification of such bias would require spontaneous or collectively agreed action by an important number of other countries; but if the United States also had parity options, and could take the initiative in this way, it would be up to other countries to demonstrate that their own individual position required them to follow suit. The onus of proof would be shifted. This, in itself, might make it easier to maintain a rational pattern of exchange rates.

Although, logically, there is no *need* for all countries to have parity options, and although ultimately, in terms of cross-rates, it makes no

difference who takes the initiative in making a parity change, the fact that the responsibility for taking the initiative would be shared out right around the table might in practice make it considerably easier to take the right decisions. Whether relevant or not, views as to whose "fault" it is that a parity change has become necessary are bound to enter into the discussions, and have political repercussions. With this in mind, there are obvious advantages in leaving open the possibility of action on both sides of any exchange-rate relationship. (As in a quarrel between children, the best formula may often be: "I don't care who started it, you're *both* going to help clean up the mess.")

It may, nevertheless, be held that in practice virtually all other countries would decide to follow a parity change by the United States. From the decision-making point of view, therefore, the question boils down to whether, rather than attempt to design rules sufficiently sensitive and rigorous to eliminate the risk of a devaluation bias vis-à-vis the dollar in a system of limited flexibility in which its parity is fixed, it might not be better to seek arrangements designed to prevent any generalized and self-defeating tendency for other countries to follow a small change by the dollar, in a system in which it had the same parity options as other countries.

On the confidence question, advocates of this approach can point out that as far as private dollar holdings are concerned the exchange risk is the same for the foreigner whether it is his currency that is revalued or the dollar that is devalued. As noted earlier, there might be some difference in the psychological impact, but this would hardly be enough to diminish the fundamental advantages of the dollar as a vehicle currency—the size of the money and financial markets in the United States, the status of the Federal Reserve System as the lender of last resort, and so forth.

The more relevant question is the possible impact on the role of the dollar as an official reserve asset. Although it would seem logical to regard SDR's as the numeraire in such a system, so long as there were a rigid link between gold and SDR's the exercise of downward parity options by the United States would involve a rise in the official dollar price of gold. With a very unlikely maximum of 2 per cent a year, and no direct link to the free-market price, this would hardly alter the underlying supply and demand position of gold in the private sector. An alternative would be to modify the Articles of the IMF so that the exercise of its parity options by the United States would not necessarily involve a change in the official dollar price of gold, but rather the gold content of SDR's (a downward parity change by the United States

would, for example, increase the gold content of SDR's proportionately).

Views on this depend in part on whether it is felt that the question of a substantial general increase in the official price of gold has now been settled, or not. Those who feel that it has, can argue that the possibility of a strictly limited depreciation of the dollar in terms of gold and/or SDR's would do little to reduce its attractiveness as an interest-earning reserve asset. Others might go further and welcome putting the dollar on the same footing as other currencies in this respect as a step paving the way for a gradual phasing-out of the dollar as a reserve currency. Even those who feel that this is, at the least, premature, might agree that looking to the longer-run evolution of the international monetary system it would be a mistake to frame any reinterpretation of the exchange-rate rules in such a way as to *rule out* the possibility of some flexibility between the dollar and the numeraire.

Small Countries

Some advocates of greater exchange-rate flexibility argue that it should be particularly attractive to small industrialized countries heavily dependent on international trade. With fixed rates these countries are at the mercy of the outside world; flexible exchange rates would provide a means of insulating themselves, at least in part, from outside influences. This line of argument will appeal to those in small countries who feel that the rate of inflation in the world has been excessive and would like to have greater freedom to settle for a lower rate. Against this, for a small country, rather large and frequent parity changes are likely to be necessary if it is effectively to isolate itself from the fluctuating fortunes of its larger neighbors (if only because, with a higher import content of exports, a given change in the exchange rate has much smaller impact on the relative level of domestic and foreign costs and prices). But large fluctuations may be unacceptable to small countries, both because of their impact on the domestic price level and possible inhibiting effects on trade and capital movements. Also, as already noted, small countries have a larger stake in progress towards closer international cooperation and integration, both economic and political. As a matter of national policy, therefore, they may prefer to subordinate their own political preferences regarding such questions as inflation to those of other countries with which they are seeking to promote increasingly close economic and political ties.

In practice, some small countries might wish to take advantage of greater flexibility to pursue a more independent economic policy, while others preferred to keep their parity in line with that of a larger country

with which they feel a political affinity, or whose economic policy inspires confidence, or, preferably, both.

Apart from these general considerations other factors may be relevant. Switzerland is dependent not only on international trade, but to a high degree on international banking and finance. On confidence grounds such a country may find it desirable to peg its currency to that of a major financial center, in this case presumably the dollar. Other small countries are highly dependent on the export of one or two primary products. They may find it is best to deal with fluctuations in external demand through a system of export taxes and subsidies, and keep their currency pegged to that of the country which has been, or is expected to be, their major source of external finance.

Developing Countries

The controversial question whether a relatively high rate of inflation in developing countries is a necessary and acceptable price to pay for rapid economic development lies outside the scope of this paper. If this view were accepted, however, it might follow that a band-and-crawl system suitable for the developed countries would not be appropriate for many developing countries. The solution might be to limit the search for a new interpretation of the exchange-rate rules in the first instance to the major developed countries (Group of Ten or Article VIII countries), leaving as a separate issue the question whether existing IMF practices regarding the exchange-rate policies of developing countries could be improved.

VI. FURTHER CONSIDERATION OF THE OPERATIONAL PROVISIONS OF A BAND-AND-CRAWL SYSTEM

Rate of Crawl

For the genuine advocate of *limited* flexibility, the maximum permissible rate of parity change should presumably be sufficient—but no more than sufficient—to offset factors which legitimately or unavoidably alter a country's underlying competitive position. Apart from changing price levels, a host of other factors may be at work: discovery or depletion of natural resources, supply and demand changes in important geographic or product markets, tariff discrimination or agricultural protection, loss of foreign assets. Many such developments may be beyond the control of the authorities of the country concerned. Others may be susceptible to corrective action, but this may require more time than is available in terms of foreign finance.

Although in the abstract it would seem these nonprice factors could

be important, they are likely to be difficult to isolate in practice from the more pervasive impact of changing demand pressures and price levels. Moreover, it can be argued that for a relatively large country, with a large and diversified foreign sector and well-developed money and capital markets, the amount by which its underlying balance-of-payments position can change as a result of such factors in any one year is probably rather small. It may be reasonable to assume, therefore, that if the maximum permissible rate of crawl were sufficient to deal with divergent price levels it would also be sufficient to deal with other causes of disequilibrium.

As regards divergent price levels, advocates of greater flexibility would suggest that some errors of demand management are simply unavoidable. An honest review of experience over the last few years shows that it has been common for total demand to be 1 or 2 per cent above or below what had been expected a year earlier, because of errors of judgment about the effects of policy action or the strength and direction of exogenous forces at work at home or abroad. It would presumably be admitted, however, that errors of judgment have also often been compounded by delays and hesitations in democratic political processes. Again, advocates may argue that up to a point this is unavoidable—or rather is an acceptable price to pay for living in a democracy. They can point out, for example, that the annual budget is not just an instrument of demand management, but also a major vehicle for promoting social justice and economic efficiency. If its merits are to be properly weighed by democratic political processes, there will be times when a good result in the latter respect gives less than perfect results as far as the former is concerned.

For both economic and political reasons it is argued that from time to time there are bound to be periods of excess demand in any country, typically lasting from one to two years, which are likely to push up costs and prices by perhaps 2 to 3 per cent more than they would otherwise have risen. Once this has happened, it is politically unrealistic to expect it to be wiped out by subsequently running the economy below capacity. On the other side, the political reaction time to deficient demand may be somewhat shorter; the mini-recessions of recent years have generally not lasted more than twelve months. In this case, however, it is perhaps more likely—but no less undesirable—that below-average price increases during the recession are subsequently offset by inflationary developments.

Critics may not be very impressed by these arguments. They can point out, with justice, that pure accidents should tend to cancel out over time and between countries; if they do not, it must be because

different priorities are given to price stability in different countries. To them, the crawl provision is primarily a device allowing countries to follow different preferences as regards the tolerable rate of inflation, and many of them would hold that this should be narrowly restricted. Advocates of limited flexibility, on the other hand, often point out that the social and political consequences of similar rates of inflation or unemployment can differ greatly between countries: for example, according to whether the impact of unemployment falls mainly on foreign workers who leave the country, or, conversely on a disadvantaged and politically vocal group within the national economy. They feel that countries should have a reasonable freedom of choice on what they regard as an essentially political matter, which, until there is real progress towards political integration, can only be settled by domestic political processes.

There is an important difference in philosophy here. But it is also true that in the real world accidents may not cancel out very quickly; misjudgment, domestic disorder, and foreign engagements may well have consequences sufficiently long-lasting to require exchange-rate adjustment. In practice, divergent price levels will reflect both intentional and unintentional elements, and one is tempted to suggest that it is neither possible, nor perhaps profitable, to try to make any rigid distinction between the two.

Over the last ten years the rise in the general price level for the major countries, measured in terms of the GNP price deflator, has generally been between $1\frac{1}{2}$ and 4 per cent a year, giving a maximum divergence of around $2\frac{1}{2}$ per cent. It was suggested in Section I that some part of these trends in general price levels reflects structural changes in the economy having little to do with the country's competitive position in international markets. Careful empirical work seems likely to show a narrower range for the divergence in the cost levels relevant to international trade, possibly of the order of an average of only 1 to 2 per cent a year. This would be well within the crawl provision of ± 2 per cent—a range of 4 per cent—suggested in the introduction (chosen because it is the figure most commonly suggested). It would probably be agreed, however, that the maximum permissible rate of crawl should be significantly more than that likely to be needed in the normal course of events. There would be times when it was not clear that a further change was required, or not opportune to make it; more generally some leeway would help the authorities to keep the market guessing.

In some of the literature, dealing mainly with an automatic or semi-automatic crawling peg, it has been suggested that the need to maintain interest differentials sufficient to neutralize speculative capital movements might set an upper limit of 2 per cent or less on the rate of crawl.

Arguments developed earlier in the essay suggest that this may not be a very important consideration. First, the constraint on monetary policy in countries whose parity was crawling up or down could be eased considerably by the use of selective monetary and fiscal devices (Section I). Second, with a discretionary system with a wider band the authorities would have considerable scope to keep the market guessing and prevent the emergence of clear-cut expectations about the timing and magnitude of future movements in the exchange rate (Section IV).

Frequency of Parity Options and Width of Band

The frequency of parity options, together with the permissible annual rate of crawl, would determine the maximum parity change which could be made at any one time. With a 2 per cent annual rate of crawl one could stipulate a maximum of 1 per cent in any six months, $\frac{1}{2}$ of 1 per cent in any three months, or $\frac{2}{52}$ of 1 per cent in any week. There are conflicting considerations here. The smaller the maximum parity change at any one time, the less should be the direct impact on the going exchange rate; but the more likely will be expectations of further changes in the same direction. At the same time there is a rather close interconnection between the annual rate of crawl, the frequency of parity options, and the width of the band, since, as noted in Section IV, the wider the band the easier it should be to make a parity change of a given size with relatively little immediate impact on the exchange market.

A number of writers favor making extremely small parity changes at very frequent intervals. This is sometimes coupled with the suggestion that the authorities might announce *in advance* their intention gradually to raise or lower the parity over some given period, or until further notice. These ideas are intellectually interesting in that they carry the idea of getting away from the present large and unpredictable parity changes to its logical extreme. But to many they may smack too much of "fine tuning," and seem unrealistic in terms of the decision-making processes involved. The alternative is to look for a workable compromise between the two extremes, whereby parity changes would still be made in distinct discrete steps over intervals which allowed time for a new assessment of how the situation was evolving, but would still be small enough to be undramatic and without great impact on the money and exchange markets.

This is a question which probably requires further study at the technical level. The suggested combination of a maximum change at any one time of 1 per cent over any period of six months with a band of ± 2 per cent, used for illustrative purposes in this essay, could be justified as follows:

(1) A 1 per cent parity change may be regarded as a fairly significant correction for underlying disequilibrium. Put another way, it may be thought unlikely that in the normal course of events anything can happen to a country in six months which would alter its basic competitive position by more than could be corrected *in time* by a 1 per cent parity change, nor that new information becoming available over six months would be likely to alter a previous assessment of the underlying position by more than this amount.

(2) For these reasons the market may be quite likely to regard a 1 per cent parity change as a sufficient correction for a country starting from a nondilemma position. Anything much less would be likely to be regarded as only a first step, and hence set off market movements putting pressure on the authorities to make further changes. In addition, a six-month period provides time to reassess trends in the economy, analyze the effects of previous policy measures, and consult with partner countries and international organizations. (Under the suggested rules countries would, however, be free to make smaller and more frequent changes if desired, so long as they did not come to more than 1 per cent over any six months.)

(3) Looked at the other way round, a 1 per cent parity change is relatively small in terms of a band width for the exchange rate of ± 2 , thus giving the authorities elbow room to maneuver in the market. As indicated in Section IV, however, the substantive question is not so much the band width as how much short-term fluctuation in the rate the authorities felt they could, in practice, tolerate.

Provision for Larger Parity Changes

From the confidence point of view there might be something to be said for making large parity changes more difficult (that is, larger than the crawl provision, or larger than some figure such as 5 or 10 per cent). This could be done, for example, by making them require a qualified majority vote in the IMF, instead of a simple majority under the present Articles. Against this, however, it can be argued that there would be a danger that a provision of this kind would be an incentive to make maximum and overhasty use of the crawl provision, and that the existing obstacles to large parity changes discussed in Section II are already quite sufficient.

Events in France after May 1968 are cited as an example of how the need for a fairly large parity change can arise. There are, however, counter arguments. It was estimated at the time that the *additional* rise in aggregate money incomes resulting from the strike settlements was of the order of 3 per cent, of which perhaps a half could be absorbed

by additional productivity gains. Subsequently, the position was exacerbated by the political hiatus during the election campaigns in the spring and early summer of 1969, and recurrent bouts of speculation in favor of the German mark. Some might argue, therefore, that the decision to devalue by 11 per cent in August 1969 gives a greatly exaggerated idea of the amount of damage that had been done the underlying position of the French balance of payments over the preceding fourteen months. It might also be noted that—if both currencies had been at par at the outset—with full use of the provisions under discussion here by both countries the French franc/German mark cross-rate could have been altered by over 10 per cent between June 1968 and December 1969. This might be much closer to the actual divergence between the competitive positions of the two countries over this period than the change in the cross-rate of over 20 per cent produced by the parity changes of August and October 1969 under the present system.

Provisions to Counter a Devaluation Bias

There are a number of proposals for provisions to counter what is thought likely to be a continuing devaluation bias under a purely discretionary system of limited flexibility. These take various forms, the most radical of which would permit only small *upward* parity adjustments. The important general objection to “asymmetrical” rules of this kind is that by limiting countries’ freedom of action in a downward direction in one way or another they would reduce the flexibility built into the system to deal with genuine dilemma cases. Theoretically, for example, an upward-crawl-only system would have to have a maximum crawl provision of +4 per cent to give the same flexibility as a ± 2 per cent provision. In practice it would probably still give less scope for dealing with dilemma cases because the onus for action would lie on only one group of countries—the creditors—rather than on two. One could try to devise rules to bring strong pressure to bear on surplus countries, but this is not easy. Before long, therefore, the system might freeze up; deficit countries would find themselves getting into a situation where a comparatively large devaluation was necessary, and one would be back to the well-known difficulties of the present system.

In other words, although in principle there can be no objection to rules or other devices to safeguard the system from abuse, it should be recognized that in practice they may involve a basic contradiction. If a system of limited flexibility is to operate as intended and yield the advantages claimed for it, the first and overriding rule is that *large* parity changes should be avoided. Proposals for added refinements should therefore be scrutinized carefully to see that they would not

limit countries' freedom of action to the point where this became impossible. With this in mind, it seems important to try to distinguish between the rather different causes for concern about the possibility of a devaluation bias, and consider whether they could not be dealt with more directly.

One cause for concern is that a devaluation bias might be evidence of an inflationary tendency resulting from easing the exchange-rate constraint. It should first be noted that as far as the *adjustment problem* is concerned, it makes little difference whether a surplus country revalues or a deficit country devalues. In a two-country world the impact would be exactly the same. In the real world of many countries there are likely to be a cluster in approximate equilibrium, with a few tending to get into underlying surplus at one end, and into underlying deficit at the other. If only revaluation is permitted, the surplus countries will, as already noted, have to make fairly large parity changes. This, in turn, will tend to push the countries previously in equilibrium into moderate surplus, and if the original disequilibrium is to be eliminated they also will have to make smaller upward parity changes. Over time, therefore, the net inflationary impact on the deficit countries, requiring restrictive demand-management policies on their part, will be just the same as if they themselves had taken the initiative for making the parity changes.

A devaluation bias might, nevertheless, be evidence that individual countries were too often tempted to resort to devaluation in nondilemma situations where anti-inflationary policies were called for. The substantive issues involved here were discussed in Section II. In the present context, the question is whether, rather than trying to bias the whole system in favor of revaluation, thereby inevitably reducing the scope for dealing with genuine dilemma-deficit situations, it would not be better to tackle this problem more directly; for example by arrangements under which a country that persistently exercised its devaluation options would after some specified period have to obtain the approval of the IMF before making any further parity changes.

An opposite cause for concern, which has received less attention, is that under a discretionary system continued reluctance of surplus countries to revalue might unduly reduce the amount of flexibility needed to deal with underlying deficits. (If no country were prepared to revalue, the point made above would apply in reverse: one would need to allow at least double the amount of downward crawl to produce the same amount of flexibility in cross-rates.) One solution might be a provision that the benefit of the doubt for small parity changes in any one direction would be suspended if countries accounting for some given

proportion of IMF quotas had used their parity options in the same direction over a given period. This might, however, be cumbersome, and perhaps provide an incentive to make too hasty use of the crawl provision.

An alternative would be to suggest that if such a situation arose it should be regarded as evidence of conflicting *external* objectives—a collective desire to acquire more official reserve assets than were entering into the system. If this were accepted, the appropriate solution would presumably be to increase the rate of SDR creation accordingly. Indeed, it could be argued more generally that the way in which parity options were being used under a system of limited flexibility would provide a much more useful and sensitive guide as to whether there was a shortage or excess of official liquidity than can be obtained under the present system.

A quite different cause for concern is the possible detrimental effect on the U.S. dollar of a devaluation bias in a system in which its parity vis-à-vis the numeraire is regarded as being *de facto* fixed indefinitely. This question has already been discussed at some length in Section V. It was suggested that it is this concern which lies behind many of the proposals for automatic, or semi-automatic, or asymmetrical versions of the band-and-crawl system. It was also noted that some may feel that this would be a cumbersome and possibly ineffective way of tackling this particular problem, which in their view could be better handled by giving the dollar the same parity options as other currencies, with provisions to restrain other currencies from following the dollar except where this was clearly justified.

One reason for the apparent popularity of asymmetrical systems with a bias in favor of revaluation is that they attract support both from those whose main concern is the special position of the dollar, and from those who are mainly interested in how dilemma-surplus countries can insulate themselves from external inflationary pressures. There is, of course, nothing wrong with a medicine that cures two different diseases at the same time; but, given the need to cater also for potential dilemma-deficit countries, there is a question whether it would not be better to look for more specific remedies.

Reliance on Market Signals

A discretionary system of limited flexibility would be the easiest to negotiate, and would leave countries with the maximum of freedom to adapt their exchange-rate policy to their own preferences and circumstances. Many, however, dislike the idea of a purely discretionary system, and favor arrangements which would oblige national authorities

in one way or another to take heed of signals coming from the market.

Support for a system relying to a greater or lesser extent on market signals comes from several rather different directions. First, there are those who see this mainly as a way of dealing with the devaluation-bias problem discussed above; it would, in their view, put more pressure on surplus countries to revalue than would otherwise be the case. It is this aspect that is likely to appeal to those whose major concern is the position of the U.S. dollar. Second, there are those who argue on much broader grounds that the "market knows best," and hence favor solutions that would reduce government intervention to a minimum. Finally, there are those who accept that national authorities should retain close control over exchange rates, but feel that even with new rules favoring small changes, governments will still be reluctant to make necessary parity changes unless they are prodded in some way. Although these three positions are not mutually exclusive, they easily become confused in the course of debate.

The analytical problems involved in the question whether governments can or should have clearly defined objectives with respect to the structure of their balance of payments were discussed in Section I. Obviously, views on this issue are also greatly influenced by deeply ingrained value judgments about the role of the price mechanism in general. Among some it is an article of faith that only free markets are truly efficient and that government interference in exchange markets, as in any other market, involves misallocation and welfare losses.

Others may agree with this proposition in the abstract, but believe that it has to be heavily qualified when applied to exchange rates. First, as a practical matter, they may feel that there is an element of instability in exchange markets; the magnitude and duration of short-term fluctuations which would have to be tolerated before the market could be expected to give unequivocal evidence of the emergence of a dilemma situation could, in their view, open up the possibility of self-perpetuating speculation. More fundamentally, they may believe that there are quite often occasions when the authorities would be right to rely on their own judgment rather than that of the market. One of the advantages they would hope to obtain from greater flexibility would be the possibility to use small parity changes to give additional support to well conceived demand-management policies, but that this would be lost if the authorities were committed to respond in some automatic way to market signals. More generally, they may feel that on occasion it is quite appropriate for the authorities to lean against the market to lend support to other measures aimed at achieving legitimate objectives of domestic or international economic policy. Given this, they feel that, *de facto* governments

would not—and probably should not—accept any significant limitation on their freedom of action with regard to exchange rates.

Automaticity and Presumptive Rules

Much ingenuity has been devoted to devising schemes providing some institutional link between market signals and parity changes. Many of the early proposals for a band-and-crawl system involved an *automatic* link; typically, the authorities would be expected to refrain from systematic intervention in the foreign-exchange market within the band, and the parity would be determined by a moving average of the rates obtaining in the market over some previous period. This approach has been criticized as being cumbersome, with insufficient flexibility to deal with situations where the trend is changing; it would also produce rather clear-cut market expectations of future movements in the rate, with attendant difficulties for the control of speculative capital movements.

More recently, there has been increasing interest in a semi-automatic system or one with presumptive rules. Examples of a *semi-automatic* system are proposals under which the authorities would be free to intervene in the market so long as their official reserves remained within some band or “fork” around a given level; or where, with a fairly wide band for exchange-rate fluctuations, there would be an “inner band” within which they were not expected to intervene in the market. In either case, countries would be expected or obliged to make use of their parity options when either their reserves or their exchange rates were getting pushed outside the prescribed range. This approach has been further elaborated in proposals for a set of criteria covering several relevant variables, for instance, spot and forward exchange rates, official reserves, use of direct controls, with *presumptive rules*, under which there would be a presumption that a country would be expected to make use of its parity options under a specified combination of circumstances, and possibly also specifying sanctions which could be applied to countries which persistently failed to respond.

One general criticism leveled at proposals of this kind is that, as a practical matter, it might be difficult, if not impossible, to draw up a watertight set of rules preventing countries from using the various devices at their disposal to influence the exchange market and official reserves to frustrate the intended operation of the system. Apart from normal monetary techniques such as changes in the discount rate and open-market operations (which, of course, are quite likely to be appropriate), these include intervention in the forward market and a whole array of selective methods for influencing international monetary move-

ments, ranging from differential reserve requirements to direct controls. Furthermore, even if it were possible to draw up sufficiently rigorous rules, they might be unacceptable to countries which regard these devices as a useful adjunct to more general monetary instruments for controlling the domestic economy.

The more fundamental question, already touched on above, is that movements in the exchange rate or in official reserves may not provide a reliable guide to what at any given time would be the most appropriate exchange-rate policy for a country trying to correct or prevent the emergence of a dilemma situation. The balance on official settlements has not varied in any systematic way over the trade cycle under the present system, and it is not obvious that it would do so under a system of limited flexibility. There have, moreover, been some rather clear examples of substantial speculative capital movements based on a mistaken view of a country's underlying economic position (for example, out of Canada in the first quarter of 1968).

These criticisms apply with less force to a system based on presumptive rules. It is envisaged that, as at present, there would be close consultation with the IMF and with other countries. This, it is argued, should be sufficient both to ensure that countries did not try to evade the spirit of the rules, and that they would be given a proper hearing in cases where, although there was a presumption under the rules that the parity should be changed there were, in practice, good grounds for not changing it.

Even those who favor an essentially discretionary system would probably agree that, at least in principle, there would be no objection to a set of general rules or guidelines. What would be involved would be to define what is meant by a dilemma situation, indicating with as much precision as possible what symptoms should be regarded as evidence that it exists, and elaborating procedures designed to ensure that parity options were exercised in these cases but *not* in nondilemma situations. Some believe that this would be necessary to overcome political inertia and give assurance that the system would operate as intended. Others are sceptical as to whether in practice it would add much to the effectiveness of the system. They are likely to argue that a more solid assurance against misuse should come from the much improved scope for better decision-making, and more effective international consultation, which they would in any case anticipate under a band-and-crawl system. They may feel that if, despite this, countries continued to pursue irrational exchange-rate policies, it is unlikely that presumptive rules would help very much.

To sum up, the basic question is how far the market can be relied

upon to give reasonably prompt and accurate signals of emerging underlying disequilibrium. Those who are optimistic on this score (and/or pessimistic about the clairvoyance of governments) feel that it is worth devoting considerable effort to the search for an acceptable set of presumptive rules. Those who are doubtful believe that any new system will have to rely primarily not on ingenious rules, but simply on the opportunities it offers for better decision-making at the national and international level.

VII. CONCLUSIONS—AND PITFALLS

The main purpose of this essay has been to identify the issues and summarize the arguments on both sides as objectively as possible. To conclude, it is necessary to take sides. For what it is worth, therefore, my own view is that the balance of the argument lies in favor of a re-interpretation of the present exchange-rate rules.

The logical case for smaller and more frequent parity changes is fairly straightforward. Postwar experience has shown that major countries do from time to time get into a position where the restoration of external equilibrium would, in the absence of a change in the exchange rate, involve consequences which are rightly regarded as unacceptable. And, despite the scepticism in some quarters, the record also shows that a change in the exchange rate can, so long as it is accompanied by appropriate other measures, achieve the desired results. Under the present rules, however, governments are expected to wait stoically, while the evidence accumulates, until a change is needed of a size that is bound to cause a major economic and political upheaval.

The essence of proposals for limited flexibility is that the thrust of the rules should be reversed; they should be designed to encourage countries to conduct their affairs in such a way that *large* parity changes can as far as possible be avoided. It seems reasonable to believe that this could be achieved by a modest widening of the band within which exchange rates may respond to market forces, combined with rules designed to encourage countries to make parity changes of no more than, say, 1 per cent at any one time. The discussion in Section IV does not suggest that the operation of a system of this kind would pose insuperable problems for the authorities, and that it should, if anything, reduce the uncertainties faced by those engaged in international trade and finance.

It seems likely that such a system would have to be essentially discretionary and not rely to any important degree on complex rules or formulae (Section VI). It should nevertheless provide considerable scope for better decision-making. With smaller and more frequent parity

changes, the shift in demand-management policies required at any one time would be smaller and raise fewer technical and political difficulties. There would be less outcry from domestic pressure groups. Exchange rates would become less newsworthy, less likely to arouse irrational nationalistic reactions, and more easily subject to informed political debate. At the international level, governments would feel freer to consult with their partners. It would be easier to bring a country's exchange-rate policy into the existing framework of bilateral and multi-lateral discussion, and easier for other countries and international organizations to bring pressure to bear on a country thought to be following policies contrary to the general interest.

Although, however, the logical case for greater flexibility seems compelling, advocates must admit that in defending their proposals they are forced to rely heavily on an anticipated change in attitudes. "Once people have got used to it, that should not be a problem" is a recurrent theme applying not only to governments but also to exchange markets, businessmen, and even in some places to public opinion in general. There is, therefore, at the minimum, a very real transitional problem. To revert to the football analogy used in the introduction, a major change in the rules in the middle of a game would inevitably cause quite a lot of confusion. For many, the question is not so much whether greater flexibility would be an improvement, as to how, if at all, it can be achieved.

Accepting that a change in attitudes is to some extent a precondition for success, it seems clear that change cannot be brought about just by commissioning a group of experts to draw up a detailed blueprint of the brave new world. At the other extreme, there are proposals for a gradual and piecemeal approach, with, for example, minimum changes in the Articles of the IMF permitting the Fund to approve or suggest deviations from the present exchange-rate rules for individual countries according to circumstances. The trouble is, however, that there may well be a problem of "critical mass"—in other words, that unless and until a significant number of major countries are prepared to commit themselves to a new approach the system cannot be given a fair trial. Isolated experiments on an *ad hoc* basis could in practice turn out to be counter-productive.

Is there somewhere a middle course between evolution and revolution with regard to more flexible exchange rates? Enthusiasts suggest that one essential ingredient is an intensive process of education enabling those most directly concerned to familiarize themselves with the issues, and, as it were, to think their way into a world of limited flexibility. (This was, on a limited scale, the laudable aim of the Bürgenstock series of con-

ferences.) But beyond this, there would seem to be a need for some signposts indicating the way ahead. These could take various forms. Official declarations by governments and/or important private bodies accepting the basic premise of the Bürgenstock communiqué—that parity changes should take place sooner and thus generally be smaller and more frequent—might have a role to play. A lead could come from the IMF, either in the form of a general policy statement, or more concretely through proposals for amendments to the Articles which would open the way for a more flexible approach, without necessarily trying to lay down a detailed set of new rules.

The present period of relative calm in the exchange markets following the major parity changes of 1967-69 provides a favorable opportunity to pursue the search for a better set of exchange-rate rules. At the time of writing, however, it is far from clear whether advantage will be taken of this opportunity, or whether the evolution of the system will continue to be dictated by events—probably in the form of further unpleasant crises resulting from continued failure to make prompt parity adjustments.

Exchange rates are a highly technical subject. At the same time the debate about greater flexibility touches on several issues involving deep-rooted value judgments. Economists are expected to be able to be objective about their own value judgments (with varying success). But, if, as it seems, there is need to widen the debate to include political and business circles, there is an inevitable temptation to appeal to emotion and prejudice rather than objective analysis. The three issues where this seems most evident concern inflation, European integration, and the position of the U.S. dollar.

It is only too easy to argue that with greater flexibility governments could get away with more inflation, and that, since inflation is bad, so is greater flexibility. There is no need to repeat the technical discussion in Section II, which suggested that there are at least some arguments pointing the other way (particularly with limited flexibility). What is perhaps more important is the view that in reality defense against inflation depends far more on public attitudes and the political will and technical competence of national governments than on rules written into international agreements. It is not inconsistent, therefore, to be seriously concerned about the difficulty of controlling inflation in a democratic society, and at the same time be in favor of greater flexibility as a means of improving the decision-making process on exchange rates and economic policy more generally.

Among many of those dedicated to European integration there is an even stronger instinctive reaction against the idea of more flexible ex-

change rates within the EEC. Here also, it is easy to put forward simple and apparently convincing arguments for popular consumption: fixed parities are needed to promote trade within the Community, without them countries would be free to pursue divergent policies, and so forth. In practice, of course, the issues are much more complex, and it is quite possible to argue that progress towards economic and political integration would be facilitated, rather than retarded, by the adoption of a carefully designed system of limited flexibility.

Because the cause of European integration inspires, and requires, an emotional commitment, it is particularly important to make a clear distinction between ends and means. Thus, among those who share the political objectives of the Community, the real issues on the exchange-rate question concern priorities and timing, and involve difficult judgments about the economic and political facts of life, now and over the next decade or so. These are the issues that need to be thoroughly explored before a decision can be taken as to whether the adoption of monetary union as an explicit objective by the Community should be taken, as of now, to rule out greater flexibility. Or, on the contrary, should not the first step be to try to prevent the recurrence of large and disruptive parity changes of the 1969 variety through the adoption of a system of limited flexibility to apply during a transitional period?

The third area where emotions lie close beneath the surface, and hackles rise easily, is the position of the U.S. dollar in the system. This is very evident in oversimplified arguments, from one side of the Atlantic, that greater flexibility is an American trick to avoid the need for adjustment and, from the other, that it is necessary to force other countries to accept a fairer share of the burden of adjustment.

At their crudest, these arguments simply reflect a failure to realize that there are two sides to every exchange rate. (In many cases this is coupled with excessive emphasis on the parity of a currency in terms of gold, rather than its purchasing power over foreign goods, services, and financial assets.) When a small country is in a dilemma-deficit situation, it seems obvious to all concerned that its choice lies between borrowing and devaluation. The larger the country, however, the easier it becomes to turn the problem around, and say that the choice is for other countries to lend or revalue. From the international point of view, however, the question is not ultimately who takes the initiative in financing surpluses and deficits or in altering exchange rates. It is rather that borrowing and lending should serve some useful purpose in promoting adjustment, and that countries on both sides of a changed exchange rate should accept the need for adjustment and be prepared to permit or

promote the required shift in the flow of goods and services and willingness to acquire foreign assets or liabilities.

It follows that "external discipline," or in other words the pressure the collectivity can bring to bear on one of its members, depends essentially on the extent to which the collective interest can be injected into the decision-making process concerning finance and exchange rates. Given this, and faced with the anachronism of nation-states, it is always tempting to propose rules of good behavior, be it the gold-standard rules, the automatic crawling peg, or more elaborate rules covering a whole range of policy instruments. Or one may propose that important powers of decision should be transferred to an international institution. But, however desirable, all such arrangements are bound to be fragile so long as international political institutions are lacking.

Existing rules to safeguard against self-defeating protectionism have stood up surprisingly well under considerable strain. And, in the field of finance, although much remains to be done, there has been steady progress, culminating in the creation of a means of settlement subject to majority voting, rather than the vagaries of gold or the monetary policy of a single country. For exchange rates, which impinge even more directly on national sovereignty, progress has been slower. The present rules have served their original purpose, the prevention of large competitive devaluations, rather well. Beyond this, however, they have, *de facto*, left the power of decision almost entirely with national authorities. How best to handle the problems posed by the disproportionate economic and political weight of the United States in designing a system of limited flexibility has been discussed at some length in Section V. But one of the great attractions of such a system is that it should provide a mechanism whereby, within the (narrow) limits of present-day political realities, it would be easier to evolve a *collective* approach to exchange-rate questions. This would seem to be the right answer to those who attack the proposals now under discussion as simply a device to enable one country, or group of countries, to impose its will on others.

The history of the SDR negotiations shows that proposals for better collective man-management of the international monetary system can—events aiding—build up considerable momentum and prevail in the face of widespread scepticism and adverse political currents. The same should be true of the search for a better compromise between excessive rigidity of exchange rates, and excessively large changes. It will require, however, a willingness to recognize our world of fallible democratic semi-sovereign states for what it is, and not what one would like it to be. The product, moreover, should not be oversold. To make rational decision-making on exchange rates easier is one thing; to take the right

decisions is another. Questions concerning the right trade-off between price stability and full employment domestically, and the right pattern of transfers of real resources and financial assets internationally, are intrinsically difficult and highly political. With limited flexibility it should be easier for countries to make honest women out of their exchange rates, or rather keep them honest; but in a world full of temptations the recognition and pursuit of virtue would still be the real problem.

ANNEX: *Extracts from a Press Communiqué Released from Bürgenstock, Switzerland, on June 30, 1969.*

"Twenty officials of banking and business firms and eighteen academic economists from ten different countries have been reviewing proposals for increasing flexibility in exchange rates. Various methods by which countries could adjust the parities of their currencies in terms of the US dollar were considered, as well as possibilities for widening the range of permissible fluctuation in the market rates of these currencies . . .

"After reviewing the recent experience of the international monetary system, the participants recognized that structural changes in international supply and demand and in capital movements, as well as divergent rates of economic growth, differences in economic objectives and policies, and varying price and cost trends among nations would from time to time call for changes in the exchange rates of particular currencies. There was a consensus that such changes when appropriate should take place sooner, and thus generally be smaller and more frequent, than during the past two decades. Following their analysis of all of the current proposals for change, some participants pointed toward a need for greater readiness by countries to adjust the established parities of their currencies within the existing framework. A majority favored both widening the range (or 'band') within which exchange rates may respond to market forces, and permitting a more continuous and gradual adjustment of parities. They stressed that such innovations should be so framed as to facilitate continued international economic co-operation while leaving individual countries or groups of countries free to adapt their own approach to their own individual circumstances.

"Throughout, the participants had in mind the need for improvements which would facilitate balance of payments adjustment in ways consistent with the domestic objectives of governments and the elimination of many restrictions on trade, current payments, and capital movements."

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