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THE CHOICE OF A PIVOT FOR PARITIES



JOHN WILLIAMSON



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

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The author, John Williamson, received a B.Sc. (Econ.) degree from the London School of Economics, and a Ph.D. in Economics at Princeton University. He was formerly Lecturer in Economics at the University of York, England, and subsequently spent two years as an Economic Consultant to H.M. Treasury. He is now Professor of Economics in the University of Warwick, England. He contributed **THE CRAWLING PEG**, published in 1965, to the *Essays in International Finance* series.

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PETER B. KENEN, Director
International Finance Section

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THE CHOICE OF A PIVOT FOR PARITIES

During the recent discussions on exchange-rate reform it has generally been taken for granted that the dollar would not participate in any arrangements for increased flexibility that might ultimately emerge. The assumption has been that a widened band would merely involve other countries pushing their dollar intervention points further away from parity, while a crawling peg would be implemented by other countries making periodic modest changes in the dollar parities of their currencies; in either case, there would be no scope for an American policy regarding the exchange rate of the dollar. So far as a wider band is concerned, this presumption is unexceptionable; intervention by the United States on the exchange markets would raise the risk of inconsistent intervention and create ambiguity regarding the responsibility for maintaining rates within the band without achieving any significant objective. But if one is envisaging a change to the crawling peg, there is a real choice between a system in which the dollar remains passive, and thus acts as a pivot around which other currencies are adjusted, and a system in which some suitable international unit is adopted as the pivot and the dollar is treated like any other national currency in its ability to adjust actively relative to that pivot.

A "pivot" will be defined as the numeraire, or unit of account, in terms of which currency parities are expressed. It therefore corresponds to what Cohen has described as a "unit-of-account currency" (Benjamin J. Cohen, *The Future of Sterling as an International Currency*, London, 1971, p. 17). The use of the special term "pivot" to describe the unit in terms of which parities are expressed seems preferable to the use of a more general term (such as "numeraire" or "unit of account") in that it emphasizes that the use of gold as a pivot would in no way be inconsistent with the dollar remaining a widely used unit of account, or numeraire, for private transactions.

The present essay is devoted to exploring the economic issues raised by the choice of a pivot, under both the adjustable peg and the crawling peg. Most of the analysis compares the two principal contenders for the role of pivot—the dollar on the one hand, and the gold/SDR unit on the other. It is argued that the major issue involved in this choice is whether or not it is desirable for one country to pursue a balance-of-payments policy of "benign neglect" (since an active payments policy

requires the possibility of initiating an exchange-rate change), and it is concluded that passivity is not desirable. The objection that inconsistent payments objectives might lead to a scramble for reserves if all countries pursue active payments policies is shown to be surmountable by the adoption of an appropriate convention governing the rate of SDR creation. The essay concludes with a consideration of the feasibility of introducing the changes that the analysis has suggested to be desirable.

The Alternative Pivots

Under a dollar pivot, the United States would not have the opportunity of changing the parity of the dollar. All other countries would declare the parities of their currencies in terms of the dollar. Since it is widely believed that the option of an exchange-rate change is not open to the United States under the system as it has evolved in the postwar period, one can say that the present system is on a *de facto* dollar pivot.

Under a gold/Special Drawing Rights pivot, all countries—including the United States—would declare their parities in terms of gold (to which the value of SDRs is rigidly linked). It follows that the United States would have the same legal right to initiate a parity change as any other country. This is, in fact, the system that is enshrined in the existing Articles of Agreement of the International Monetary Fund. Article IV, Section 1(a) states:

Expression of par values. The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944.

In principle, therefore, the United States could request permission from the IMF to devalue the dollar (or act unilaterally for a devaluation of less than 10 per cent, since the initial leeway of a 10 per cent par change has never been utilized), and Congress could authorize the necessary increase in the dollar price of gold. It is not true, as is sometimes supposed, that such action would automatically result in a proportionate increase in the price of gold in terms of all currencies that have chosen to express their par values in terms of the dollar, because "the dollar" for the purpose of expressing parities is the 1944 gold dollar and not the current dollar. It would therefore be necessary for other countries to undertake a devaluation if they wished to avoid revaluing against the dollar. The present system is *de jure* on a gold pivot.

While remaining on the purely mechanical level of how a gold/SDR pivot would operate, it may be helpful to give a simple example of the repercussions of a decision by the United States to devalue the dollar

by (say) 1 per cent. Assuming that the dollar remained the intervention currency, other countries would have to alter their intervention limits. The intervention limits of the Bank of England, for example, would rise from \$2.38 and \$2.42 to \$2.404 and \$2.444. Calculation of the parities and intervention limits in terms of the intervention currency, the dollar, from the set of parities in terms of the pivot, gold, and the band widths is no more than a trivial arithmetical exercise.

There are other possible pivots besides the dollar and gold/SDRs. After all, there are over a hundred other members of the IMF, most of which have a currency: any of these could be chosen for the role of pivot if any advantage were seen in such a step. In practice, of course, the position of the dollar as the dominant form of international money makes it virtually inconceivable that any other national currency would be selected for this one (international) monetary role in preference to the dollar. And, in any event, the principles involved would be essentially the same if one were considering casting any other national currency in the role of pivot. There is therefore no serious loss in restricting discussion to the case of a dollar pivot.

There is also the hypothetical possibility of breaking the link between gold and SDRs and adopting the latter as pivot. This suggestion was aired by Stephen Marris (*The Bürgenstock Communiqué: A Critical Examination of the Case for Limited Flexibility of Exchange Rates*, Essays in International Finance No. 80, Princeton, 1970, pp. 47-50) in the course of the most thorough previous discussion of the issues involved in the choice of a pivot. The principal argument advanced in favor of this proposal is that it might circumvent any American objection to breaking the letter of their past commitment not to raise the dollar price of gold, since gold could remain rigidly tied to the dollar while the gold dollar crawled against SDRs. The proposal has the disadvantage of failing to use gold in the one monetary role—that of unit of account—which its long history makes it suitable to fulfill, as well as requiring an additional (and probably controversial) amendment to the IMF Articles to break the link between gold and SDRs. On economic grounds the SDR pivot would not differ significantly from the gold/SDR pivot, so that the former does not require separate discussion: the choice between the two is a matter of cosmetics, not economics.

It would be possible to use either a dollar pivot or a gold/SDR pivot with either the adjustable peg or most versions of the crawling peg. A decision-variant crawling peg (that is, one that involves parity changes which, though small, are a matter of deliberate government decision) could operate with either pivot. A formula-variant crawling peg is one where parities are determined according to some automatic formula

such as an average of past market rates of exchange or a relationship based on the level of, or change in, reserves. Formulae that utilize changes in reserves or the deviation of reserves from a target level could again employ a gold/SDR pivot (or, of course, a dollar pivot) without any problem, since the United States holds reserves much like any other country. The only problem would arise in the (highly improbable) event of a desire to introduce a formula-variant crawling peg based on past market rates of exchange: this would be inconsistent with a gold/SDR pivot unless the gold markets were reunified so as to provide a market from which to calculate gold-currency relationships. However, John Black ("A Proposal for the Reform of Exchange Rates," *Economic Journal*, June 1966) has argued that under such a system one does not need a pivot at all; each parity can be directly calculated in terms of all other parities.

The Grounds for Choice

It is natural to commence a comparison of the dollar pivot with the gold/SDR pivot by asking why the *de jure* gold pivot has evolved into the present *de facto* dollar pivot. The answer would seem to be that it has been believed, rightly or wrongly, that the United States did not have the ability to engineer a small devaluation of the dollar against the generality of other currencies by simply implementing a modest change in its parity. In part, this was because other countries were presumed to be reluctant to accept revaluation against the dollar, which would imply that they would choose to follow the dollar down—unless, at any rate, the dollar was devalued so much as to grossly inflate the purchasing power of gold reserves. The more cogent reason for doubting the practicality of a small unilateral change in the dollar exchange rate related to the effect on gold speculation. Any change in the dollar parity, which is expressed in terms of gold, would have been interpreted as a sign that the authorities were weakening in their resolve to prevent a large revaluation of gold and would therefore have precipitated a massive flight into gold. Prior to the abandonment of the gold pool, this would have threatened the existence of the gold-exchange standard—as in fact occurred in March 1968, when the system was abandoned in the face of unsustainable speculative pressure. Since the introduction of the two-tier gold market, the argument has been modified somewhat: it is now contended that an attempted flight into gold would drive the price up so much as to tempt some of the smaller central banks to sell official gold on the private market, thus jeopardizing the functioning of the two-tier system.

Although it is not clear that it has been influential in determining

policy in the past, one further consideration deserves mention. This is the possibility that American-initiated changes in the exchange rate of the dollar would be unsettling to foreign holders of dollars and thus undermine the usefulness of the dollar as international money. Like the danger of provoking gold speculation and the fear that an American depreciation would be nullified by widespread imitation, this is certainly not a frivolous point. My judgment is that a gold/SDR pivot would not be advantageous if it were introduced in circumstances that led to any of these three dangers materializing. It is therefore important to discover whether and how the dangers may be avoided; for this purpose, each of the topics is considered at greater length in a subsequent part of this essay.

A gold/SDR pivot enjoys a number of advantages. One may start by outlining a few of them that are straightforward, though perhaps of only modest importance. The first arises only under a crawling peg. Under a gold/SDR pivot the maximum rate of parity change between the dollar and any nondollar currency is the same as that between any two nondollar currencies, whereas under a dollar pivot any currency crawling up at the maximum rate would be appreciating relative to one crawling down at the maximum rate at twice the speed that either was changing relative to the dollar. So long as American price performance was modal this difference would be unimportant, because some countries would be wishing to appreciate relative to the dollar and others to depreciate, and no additional constraints would be imposed by the dollar's special status. If, however, American price performance were extreme—in *either* direction—then a dollar pivot would reduce the effective amount of flexibility conferred by any specified maximum rate of crawl. One could, of course, seek to compensate for this by increasing the permissible rate of crawl. But one of the attractions of crawling, as opposed to more extreme forms of flexibility, is the limitation it places on the uncertainty caused by exchange-rate variations; a faster permissible rate of crawl would tend to increase this uncertainty. Moreover, the ability of the crawling peg to eliminate hot-money flows without excessively large interest-rate differentials is dependent upon expectations that rates of parity change will be modest. Such expectations would be rather harder to maintain if it were necessary to increase the maximum rate of crawl in order to accommodate an atypical American price performance. It is true that the parity between any nondollar currency and the dollar could not change more rapidly under a dollar pivot than under a gold/SDR pivot unless the maximum rate of crawl was more than twice as great in the former case as in the latter, but the potential rate of change of cross-parities between nondollar currencies would increase *pari passu* with the

increase in the permitted rate of crawl, and these cross-rates are also major determinants of the extent of uncertainty and the necessary interest-rate differentials.

The second advantage applies under both the adjustable peg and the crawling peg but would be especially important under the former. It concerns the ease of rectifying a situation where the dollar has become inappropriately valued without corresponding misalignments among other currencies. The absence of an American exchange-rate policy that results from operating with a dollar pivot means that the restoration of an appropriate set of relationships would require the organization of a series of parallel parity changes by other countries, whereas under a gold/SDR pivot the United States could simply change the dollar parity. It is virtually impossible to arrange concerted parity changes under the adjustable peg, for the obvious reason that the inevitable rumors would spark hot-money movements: it is notable that the franc and deutsche-mark parity changes in 1969 were not in the end synchronized, despite the fact that everyone knew both changes were coming. Concerted parity changes should be rather easier under a crawling peg, but it would still be simpler to change a single parity than a large number.

Although the August crisis suggests that the second advantage would have been relevant to the circumstances of 1971, it is probably true that these considerations would be of dominant importance only if the United States ceased to be reasonably modal in its price behavior. One may not regard this as particularly probable, but one might still wish to insure against such an eventuality if one believes that history's most convincing lesson is the danger of naively extrapolating the recent past.

A third advantage of a gold/SDR pivot, which was in fact the major point advanced in its favor by Marris, is that it would prevent the competitive position of the United States from being undermined by any "devaluation bias" that the system may contain. Instead of the United States finding it necessary to pressure other countries into revaluation (a process that does not seem calculated to enhance friendly relations with its partners), it could exercise the option of itself devaluing. Although evidence that the system suffers from a devaluation bias has never been produced, there must be advantage in providing a way of countering any such effect that may exist.

Is Neglect Benign?

The preceding section identified three possible difficulties of a gold/SDR pivot and three ways in which it would be clearly superior to a dollar pivot. The present section takes up the central issue as to whether it is desirable for the United States to pursue an active payments policy

aimed at maintaining suitable balance in its external transactions. Or should it pursue a policy of "benign neglect"?

The issue is central because it is impossible to conceive of a dollar pivot working satisfactorily in conjunction with an active American payments policy. It is, of course, possible for a country without command of its exchange rate to ensure payments equilibrium by subjecting its internal demand-management policy to the needs of the balance of payments on gold-standard lines, but no one imagines that a large country with a small foreign-trade sector like the United States either would or should behave in that way. Neither is there any prospect that controls would provide an acceptable alternative method of payments adjustment. If the United States is required to seek payments equilibrium but is denied its own exchange-rate policy to accomplish this, one has a combination guaranteed to generate regular crises. Import surcharges and attempts to bully other countries into changing their parities in accordance with American interests are just the sort of event that one could expect from willing the payments end without the exchange-rate means. A dollar pivot makes sense only in conjunction with a passive American payments policy.

Some economists who have endorsed a passive payments strategy (e.g., William Branson, in Lawrence B. Krause, "A Passive Balance-of-Payments Strategy for the United States," *Brookings Papers on Economic Activity*, Washington, D.C., 1970, p. 361) have simply asserted that the United States "cannot do much about" any dollar overvaluation and that it is inappropriate for such a large country to devote its demand-management policy to external rather than domestic objectives. The question at issue is precisely whether it is *desirable* for the United States to be *able* to do something about an overvaluation of the dollar. The case for some exchange-rate flexibility is largely based on the proposition that it is undesirable for large countries to distort their internal policies so as to seek external balance, and the United States is a good example of a country that should not sacrifice either output and employment or price stability to defense of a rigid exchange rate. But the same is true of other countries. If the world wishes to maintain a fixed exchange-rate system, then it seems only equitable that the burden of doing so should be shared. If some countries do not, because they attach a high priority to the achievement of domestic goals, then it seems only natural for those countries to be the ones with the onus of changing their exchange rate. A passive payments policy represents a claim to have one's cake and eat it too, to enjoy the benefits of exchange-rate stability without making the sacrifices that system imposes.

Gottfried Haberler and Thomas D. Willett (*A Strategy for U.S.*

Balance of Payments Policy, American Enterprise Institute, Washington, D.C., 1971) make a point of showing that any option open to surplus countries to counteract an unwanted influx of dollars (financing the deficit by accumulating dollars, appreciation, monetary expansion, or reduced controls) would be acceptable to the United States, provided that she is able to direct fiscal and monetary policies solely to domestic objectives. There is no ground to doubt that this is true, other than the quaint belief that balance-of-payments discipline is the main protection of American citizens against the inflationary impulses of their political masters. Personally, I have always found it difficult to believe that inflation is electorally popular (as this theory presupposes) and impossible to understand how economists and bankers can convince themselves that they have a duty to thwart the wishes of the electorate if the latter do, in fact, want inflation. This implies that payments discipline is in the first place unnecessary and, even if not redundant, improper. Hence benign neglect is a luxury for the United States that others can only envy.

But the proponents of a passive American payments policy do not admit that this would amount to sacrificing the rest of the world's welfare to that of the United States: they contend that such a policy would also be advantageous to other countries. The principal argument deployed to support this contention is what has been termed the "redundancy problem":

In a world of N countries, if $N-1$ have targets for their balances of payments which they successfully achieve, this automatically determines the payments position of the N th. . . . Unless at least one of the N countries reacts passively or sponge-like to the policies of the others, a high probability of conflict arises. (Ronald I. McKinnon, *Private and Official International Money: The Case for the Dollar*, Essays in International Finance No. 74, Princeton, 1969, p. 29.)

Ironically, only two paragraphs before this quotation McKinnon (then discussing a different topic) wrote:

It is true that official portfolio adjustment is a very haphazard affair, impeded by a variety of commitments . . . in domestic policies. Nevertheless, most countries have vague long-run targets in reserve holding. . . ." (*Ibid.*, pp. 28-29.)

To the extent that reserve targets are vague and that reserve adjustment is haphazard, the redundancy problem is not a serious one—because nothing very terrifying will result from the failure of some countries to achieve their targets. Despite this, it is probably reasonable to contend that the system needs to have sufficient elasticity in the long run to pre-

vent a self-defeating scramble for reserves from developing. (The note of doubt is occasioned by an analogy with domestic monetary theory. The argument presented by the dollar-standard proponents for a supply of reserves that is sufficiently elastic to respond to changes in the demand for them bears a distinct resemblance to the real bills doctrine, which is a contender for the title of the most thoroughly discredited economic theory of all time. Yet it is difficult to see how any good could emerge from a struggle among countries with inconsistent payments targets occasioned by a fixed stock of reserves. The difference between the domestic and international cases would seem to stem from the fact that individual nations, unlike individual firms, can be presumed to pursue stabilization policies and therefore do not need to be tempted into acting in the general interest by variations in the availability of credit.)

What this suggests is that the attractiveness of a passive American policy to other countries will depend very much on the alternative system with which it is compared. If one compares it with a system in which the stock of reserves is either fixed or changing at a rate that cannot vary in response to the desire for reserves, such as General de Gaulle would have wished upon us, then the dollar standard backed by a passive American payments policy has a great advantage. But if one compares it with a system that contains a reserve asset whose supply is amenable to conscious international control and where that control is exercised to ensure consistency among reserve targets, the dollar solution has no advantage at all. The question that needs asking is, therefore, whether one could determine the rate of SDR creation that would be needed to ensure consistency of objectives. It is argued in the next section that this would indeed be feasible under a gold/SDR pivot. This being so, the appropriate state to compare with the passive payments policy of the United States is an active policy in a world where targets are consistent.

If reserve targets are consistent but are not being met, there is a need for adjustment. The extent to which any one country needs to introduce adjustment measures depends upon the extent to which others do so. In the extreme case, if all countries except one adjust successfully, then the *n*th country can remain passive. Typically, if one country does more, then others need do less. In particular, if one country contracts out of participation in the adjustment process, then the others will be obliged to take more extreme actions than would otherwise have been necessary. This will impose a burden on them to the extent that the burden of adjustment tends to fall on the country that initiates adjustment. In popular discussion it is often taken as axiomatic that the burden of adjustment is associated with the initiation of adjustment—perhaps the best example

of this being the 1968-vintage anti-revaluation slogan in Germany that "one should operate on the sick man, not the healthy man." It is easy to smile at the error involved here, but the subject demands closer consideration than it has received from economists in the past.

Benjamin Cohen (*Adjustment Costs and the Distribution of New Reserves*, Studies in International Finance No. 18, Princeton, 1966) argued that there is a "continuing cost" of adjustment that must necessarily fall on the deficit country, since in the new equilibrium the deficit country's proportion of total absorption must necessarily be lower, but that there is also a "transitional cost" whose location (as well as size) would depend upon the technique employed to restore balance. But even Cohen failed to consider the relationship between the location of the transitional cost and the question as to which country initiated the adjustment. Apart from the continuing cost of the cut in absorption that is the necessary counterpart of an improved current balance, the adjustment burden to a deficit country consists of such things as the distortion of the fiscal-monetary mix required to finance a basic deficit until adjustment has been effected; the super-optimal unemployment needed while one creeps down the Phillips curve to improve competitiveness without devaluation; the inconvenience caused to traders, the speculative losses endured by the central bank, the cost inflation, and the political opprobrium associated with devaluation; and the inefficiency caused by controls. To a country in surplus, the transitional adjustment burden includes the straitjacket imposed on monetary policy by the attempt to repel hot-money inflows; the excess inflation that has to be accepted to eliminate excessive competitiveness without revaluation; the inconvenience, speculative losses, and political disrepute associated with revaluation, though this is partially offset by the easing in cost inflation; and any inefficiencies that might be caused by "negative controls" (against which should be offset any gains in efficiency caused by relaxing previous positive controls).

Some of these items, such as the cost inflation resulting from exchange-rate changes and which country pays the bonuses to speculators who correctly guess discrete parity changes, are independent of which party initiates the adjustment process. But this is by no means true of all the burdens involved. The classic example to the contrary arises when at existing relative prices two countries with a fixed exchange rate suffer from an unacceptable current-account imbalance when both are at full employment. In these circumstances, the deficit country would benefit if the surplus country took action to inflate and so corrected the disparity in relative prices without any need for the deficit country to deflate (beyond the cut in absorption needed to make room for correction of the

payments imbalance). Similarly, the surplus country would benefit if the deficit country were to deflate enough to correct the imbalance without the need for inflation in the surplus country. An equally clear example of the burden resting on the party that initiates the adjustment concerns the use of monetary policy to finance a current-account imbalance by influencing the capital account. A deficit country that would otherwise need to raise interest rates to attract a capital inflow would benefit if a surplus country lowered its interest rates instead, since it would then get the benefit of the desired change in its capital account without the cost of a distortion in the internally desired fiscal-monetary mix. Similarly, a surplus country would benefit from a more restrictive monetary policy in the deficit country.

In other cases there is more ambiguity about the association between initiation of adjustment and the location of the burden. Exchange-rate adjustment is not only less costly than inflation and deflation, but its costs tend to be distributed more symmetrically between the party that initiates the change and the one that does not. In a two-country world, indeed, there would be only a cosmetic difference, and its sole importance would be in assigning political blame. In an N -country world there may be additional factors: the countries that move will do so against the generality, which will both be inconvenient and tend to result in losses to speculators. Finally, the costs resulting from the imposition of controls will tend to fall on the country that imposes them as long as countries respect their international obligations, for the simple reason that controls that impinge mainly on foreigners have been largely prohibited through such international agencies as GATT. Unfortunately, there are still occasional instances of countries abrogating their international undertakings and adopting controls that shift the burden to their partners.

This brief discussion should make it clear that the notion of an adjustment burden is fairly complex. The size and distribution of this burden will depend, *inter alia*, on the size of the necessary adjustment, the policy tools that are adopted to effect adjustment, and the country that initiates the adjustment. But two generalizations suggest themselves. First, initiation of adjustment is liable to impose some burden additional to that which would result from a passive reaction to another country's measures that produced the same outcome. Second, this element of the burden is liable to be very considerable under fixed exchange rates but a good deal less with flexibility—because the burden is both absolutely smaller and more symmetrically distributed.

It follows that American exemption from the obligation to seek payments balance would transfer part of the adjustment burden from her to her partners. It is not clear on what grounds of equity this privilege is

claimed. Many would consider that her contemptible aid performance in recent years—which forms such a sad contrast to the unparalleled generosity of Marshall Aid in an earlier age—deprives her of any right to claim special privileges in return for the “burdens of world leadership.”

But it is not just that a passive payments policy would transfer an adjustment burden to America's partners that they will regard as being rightfully hers. It is also likely to increase the total burden on the system as a whole. The most obvious, though not in practice the most important, case of this arises when the nonadjusting country is atypical. Under fixed exchange rates, a nonmodal American price performance would force other countries to follow suit, and if they were in aggregate larger than the United States then the system as a whole would suffer loss.

Since exchange rates are not fixed in the long run and since American price performance seems unlikely to be greatly atypical, the above case is of limited practical interest. This is certainly not true of a second case, which concerns the so-called “assignment problem.” There seem good reasons to suppose that it is politically easier to vary monetary policy than fiscal policy, so that a country that lacks an effective payments constraint will thereby lack incentive to develop flexible contracyclical fiscal tools. But it is well known that the international spillover effects of monetary policy are far more acute than those of fiscal policy: the \$20 billion-odd that crossed the Atlantic between 1969 and mid-1971 give a useful first measure of how much more acute.

A third way in which the total adjustment burden could be increased arises from the greater probability of a sub-optimal use of exchange-rate policy. It was argued by Marris (*op.cit.*, p. 47) that “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. . . .” Even if they did accept that they were in underlying surplus, however, it is possible that they would tend to adjust through inflation rather than through revaluation, since the desirability of using exchange-rate policy is in part a function of the size of the economic unit in question (see Ronald I. McKinnon, “A Theory of Optimum Currency Areas,” *American Economic Review*, September 1963). But where it is a misalignment between the dollar and the generality of other currencies rather than between nondollar currencies that is the cause of the problem, it is clearly preferable for exchange-rate policy to be employed. And that is the choice that the United States, if it were confronted with making the choice and if it were rational, would adopt.

The above analysis is of assistance in dissecting such other arguments as the proponents of passivity have developed. For example:

A passive U.S. strategy will help improve the [adjustment] mechanism because the United States will no longer be suppressing its deficit or surplus and therefore will help expose maladjustments in the system so that they can be more easily corrected by others. (Krause, *op.cit.*, p. 347.)

It is not clear that, from the viewpoint of the rest of the world, adjustment by others *is* superior to suppression by the United States. But, even if it is, adjustment by the United States is better still, from the standpoint of the world as a whole and especially from that of the world excluding the United States.

Or again:

. . . it is suggested . . . that the United States abandon policy consciously directed at the outside world and concentrate on maintaining a stable internal economy toward which the rest of the world can accommodate itself. A multiplicity of policy goals leading to numerous short-run shifts in policy, whose full consequences are uncertain, can easily lead to destabilizing behavior. Steady and predictable monetary expansion by the Federal Reserve is one way of dealing with this uncertainty domestically and of also providing an independent point of reference for the rest of the world. (McKinnon, *The Case for the Dollar, op.cit.*, pp. 32-33.)

What this argument overlooks is that the American payments position has a more direct impact on the rest of the world than level of American income, so that stabilization of the former would provide a more valuable point of reference. It would not be much consolation to Europe to know that American income had been perfectly stabilized if the weapon used to achieve this was a monetary policy subject to gyrations such as those observed in the past five years. One can argue that endeavoring to stabilize income would be preferable only if one believes that this would in fact lead to greater stability in the payments outcome than a policy aimed at this objective. Economic policy no doubt leaves a lot to be desired, but most of us believe it is rather better than random!

Is neglect benign? To Americans, yes; to America's partners, no. Their loss exceeds her gain. It is important to add that the best way to decrease the sums at stake is to increase the flexibility of the exchange-rate system.

The Role of Creation of Special Drawing Rights

It was argued in the previous section that the "redundancy problem" can be solved by creating the number of SDRs needed to ensure con-

sistency between payments objectives. While the haphazard nature of adjustment makes it unnecessary to worry about consistency on a year-by-year basis, it is important that the system contain a mechanism to ensure approximate consistency over a longer time horizon. The problem this poses is to discover a criterion that will result in the creation of SDRs at the appropriate rate.

The orthodox view, which is widely held in Europe and was embodied in the agreement that created SDRs, is that since SDRs are the sole source of new reserves under conscious international control, their supply should be such as to satisfy the residual need for additional liquidity after allowing for the sums likely to be provided by such capricious sources as the American deficit. It follows that a larger American deficit requires offsetting by a smaller rate of SDR creation.

There is a striking contrast between this view and the analysis of one of the advocates of benign neglect:

. . . all permanent increases in reserves should be through SDRs. If the United States is following a monetary policy suited to its domestic needs, and other countries on balance are accumulating dollars in official holdings (not matched by U.S. accumulations of SDRs above its allocated amounts), then insufficient SDRs are being created and the United States should press for increases in the allocations. It should urge a reduction in SDR creation if dollar holdings are on balance being reduced. . . . In the absence of alternative criteria, revealed liquidity desires can be utilized as the guide for sufficient liquidity creation. (Krause, *op.cit.*, p. 351.)

According to Krause, therefore, a bigger American deficit is an indication that more, not less, SDRs need to be created. The difference in prescription stems from a different interpretation of the determinants of the American deficit. The orthodox view holds that the size of the deficit is supply-determined and therefore capricious in the sense that it is independent of the demand for international liquidity, whereas Krause's view is that other countries determine the size of surplus that they desire, so that the American deficit is demand-determined and simply a reflection of the rest of the world's desire for liquidity. It follows that, if one wishes all additional reserves to take the form of SDRs, an American deficit is a signal that the previous rate of SDR creation was too low. An increase in this rate would permit countries to achieve their reserve targets with smaller surpluses, which would induce them to adjust so as to reduce the American deficit.

The key question is whether actual reserve accumulation by the $N-1$ countries other than the United States is a satisfactory measure of their desired reserve accumulation. It is clear that this will not be the case to the extent that the American payments balance reflects changes in Ameri-

can conditions or policies. It is not true, as the proponents of passivity sometimes seem to assume, that a passive policy is equivalent to not influencing the payments outcome. In particular, monetary policies chosen with domestic ends in view can be relied upon to have very powerful effects on the balance of payments. The official settlements balance of the United States (which measures the change in dollars held in reserves and is therefore presumably what is supposed to be demand-determined) showed a surplus of \$0.2 billion in 1966, a deficit of \$2.1 billion in 1967, a surplus of \$1.6 billion in 1968 and of \$2.7 billion in 1969, and a deficit of \$10.7 billion in 1970; it is evident that there will again be a large deficit in 1971. (See the Annual Reports of the Bank for International Settlements.) It is transparently clear that these figures primarily reflect the gyrations of American monetary policy and not variations in the rest of the world's liquidity desires.

If in fact American policy, rather than the liquidity desires of other countries, is the major determinant of the American payments balance in the medium run, then Krause's proposal to tailor the rate of SDR creation so as to eliminate the American deficit would be actively pernicious. Suppose that the United States were to introduce a tight monetary policy which sucked \$10 billion out of other countries' reserves. If the system were really being operated in the interests of these other countries, the appropriate response would be creation of more than \$10 billion SDRs, so as to neutralize the impact of the American policy change on reserves in the rest of the world. But Krause's proposal would misinterpret this reserve loss as a signal that the desire for reserves had declined, and SDRs would be *destroyed* until other countries had adjusted so as to eliminate the American surplus. Similarly, a relaxation of American monetary policy would initially produce an American deficit; the Krause formula would require that the resulting reserve accretion be reinforced by SDR creation of a magnitude sufficient to induce other countries to cure America's payments problem for her. Krause might retort that this misrepresents his proposal, because he specified only that *permanent* reserve increases should be through SDRs, and so reserve changes resulting from anticyclical policies should not lead to reinforcing variations in the rate of SDR creation. But this immediately raises the problem of distinguishing that part of the American payments balance which depends on reversible American policy: it is no longer possible to use the observed American deficit as a measure of liquidity desires. Moreover, at best this would modify the problem only in degree rather than in kind. Long-run changes in American policies, or in American propensities (for example, to invest abroad), would still create long-run changes in the American deficit which other countries would then

be expected to correct, being flooded with or starved of international liquidity to the extent necessary to induce them to adopt policies consistent with those chosen by the United States.

The fact is that, although American deficits seem to be largely capricious in the medium run, the longer-run trend is almost certainly influenced by liquidity desires. If the deficit is in fact the result of both demand and supply factors, it follows that either of the simple rules for relating SDR creation to the American deficit (the orthodox view that an inverse relationship is desirable or the Krause rule for a direct relationship) could lead to inappropriate results. There is a need for a more sophisticated rule that will discriminate between the two different classes of causes of an American deficit. It is difficult to see how such a rule can be devised so long as the system remains on a dollar pivot and the United States is denied an exchange-rate policy, because this system creates an incentive for countries to give stylized responses regarding their interpretation of the cause of an American deficit. Specifically, deficit countries (in the sense of any country with a deficit greater than its desired rate of reserve rundown) will always find it in their interest to interpret an American deficit as the product of liquidity desires in the rest of the world, since this diagnosis establishes a case for increased creation of reserves with a consequent easing in their payments constraints. Conversely, countries with undesirably large surpluses will always find it advantageous to blame the deficit on lax American policies, since this diagnosis points to the need for the United States to undertake the main adjustment burden and so eases the problems of the surplus countries. In the absence of any acid test that will discriminate between the two cases, it seems all too likely that conflict will emerge. One of the first casualties of this conflict might well be the SDR scheme, as Ossola has warned:

One must point out . . . that among European monetary authorities the conviction is spreading that there should not be a second activation of SDRs in the near future (or, at least, any such activation should be very small, not to say symbolic). This conviction stems from the considerable increase which has taken place in official dollar reserves during 1970, an increase which is moreover considered likely to continue in 1971. (Rinaldo Ossola, *Towards New Monetary Relationships*, Essays in International Finance No. 87, Princeton, 1971, p. 8.)

Consider instead the situation that would exist under a gold/SDR pivot. If the American authorities judged that they were faced with a deficit that was more than transitory, they would indicate their intention of making a downward parity revision. If the deficit had arisen because other countries were short of liquidity, then those other countries

would clearly wish to match the American devaluation in order to avoid the erosion of their surpluses. But there would be no point in devaluing the dollar if most other currencies would follow suit, because the cause of the American deficit was a liquidity shortage; the appropriate remedy to this situation would be increased SDR creation. If, on the other hand, the deficit was pumping out unwanted liquidity to the rest of the world as a result of developments in the United States, other countries would not wish to follow the dollar in any devaluation; they would prefer the United States to eliminate its deficit. *The existence of a liquidity shortage would be signaled by a preponderance of devaluing currencies.*

Provided (1) one accepts that it is desirable for countries in aggregate to be able to satisfy their reserve targets, (2) one interprets a parity change as a signal that a country is dissatisfied with its existing rate of reserve accumulation, and (3) parity changes are used as a routine part of the adjustment mechanism rather than deficits being suppressed by controls, it follows that the optimal rate of SDR creation is that which will hold constant the value of the gold/SDR unit in terms of an appropriately weighted average of currencies. An excess of devaluations over revaluations is evidence of a reserve shortage that demands increased SDR creation, while an excess of revaluations over devaluations is evidence that on average countries are seeking to repel imported inflation, so that the rate of SDR creation needs to be cut back.

It would seem straightforward to apply this criterion for SDR creation in a world of crawling pegs. At the end of each "basic period," the IMF would consider whether the preponderant direction of parity changes in the previous period had been up or down and would then modify the rate of SDR creation by an amount judged to be sufficient to offset any tendency that had emerged during the period. It might well prove desirable to continue the precedent of the first basic period of working in terms of three-year periods rather than the five-year periods originally contemplated, so as to allow a reasonably prompt response to the signals that would be generated by parity changes. There is, perhaps, some danger that overinflationary countries with a continual need to depreciate would give an excessive boost to the rate of SDR creation if the suggested formula were to be applied literally. It would not seem difficult to safeguard against this. In the first place, the criterion would probably be treated as presumptive rather than mandatory. In the second place, the "appropriate weight" when calculating an appropriately weighted average of currencies could be deemed to be zero for a country with an inflation rate in excess of x per cent.

It is rather more difficult to visualize the system operating smoothly under the adjustable peg. For one thing, it would seem necessary to co-

ordinate the timing of decisions on SDR creation with those on changes in the American parity. Failure to do this could result in pointless all-round devaluations when the appropriate remedy was additional liquidity. To avoid this danger, one must envisage a *tâtonnement* process, including a modification of the rate of SDR creation, being sparked off by a proposed change in the parity of the dollar (or, for that matter, in the parity of any other currency that is sufficiently important for a change to provoke widespread imitation). An American application for a devaluation of x per cent would be submitted to the Fund, which would then ask all its members what parity changes they would plan to make in response to this move. If a weighted majority was planning to change, the Fund would announce increased SDR allocations and ask for new bids from all countries, including the United States. The *tâtonnement* would converge when the weighted average remained constant; one would have to hope that convergence would be rapid enough to prevent widespread starvation of tourists.

Provided that this difficulty was overcome, it is evident that the proposal would resolve several of the important problems that at present confront the international monetary system. Mention has already been made of Ossola's fears for the future of the SDR scheme; these arose because of the lack of any way of distinguishing the true cause of the American deficit, and the danger should be resolved once such a method is provided. A typical statement of another supposed problem is the following:

If the U.S. changed the par value of the dollar (in terms of gold), practically all countries of the world (with the exception of probably not more than two or three important ones) would also depreciate their currencies (in terms of gold), because only very few countries would be prepared to expose themselves to the intensified competition from American industries that would result from an appreciation of their currencies in terms of the dollar. [Footnote] Admittedly, many countries complain that they have to "import inflation" from the U.S. But . . . the foreign critics are extremely reluctant to accept the logical implication of their complaints, that is, to let their currency appreciate. (Haberler and Willett, *op.cit.*, pp. 9-10.)

Enough has been said by now to establish that there is a substantive difference between being willing to appreciate one's currency in terms of the dollar, thereby simultaneously appreciating in terms of the general-ity, and being willing to allow the dollar to depreciate against one's currency, if that would result in leaving one's competitiveness against most third countries unchanged. Evidence on the frequency of the former occurrence provides no basis whatsoever for predicting what would happen in the eventuality of a modest dollar devaluation. Obviously, this

ignorance does not establish the counterproposition that other countries would *not* follow the dollar. But the criterion for SDR creation would mean that, if this reaction did occur, the rate of SDR creation would be increased, and it would go on being increased until either sufficient other countries decided to stop depreciating or else the United States found it had acquired sufficient liquidity to be able to dispense with devaluation. Thus an American attempt to devalue could result in either a successful change in the exchange value of the dollar in terms of other currencies or else an increase in international liquidity sufficiently large to enable the United States to finance her deficit. Which of these outcomes materialized would depend on countries other than the United States. There would be no danger at all of other countries simply following the dollar down.

Those who agree with Milton Gilbert (*The Gold-Dollar System: Conditions of Equilibrium and the Price of Gold*, Essays in International Finance No. 70, Princeton, 1968) that the system is in disequilibrium because of an inadequate supply of "gold" would expect an American attempt at dollar devaluation to provoke widespread imitation. This, under the proposed rules, would lead to a big increase in the supply of SDRs. So long as SDRs are viewed as good substitutes for gold in official portfolios, the increased quantity of SDRs is a satisfactory solution to the problem. If, of course, central bankers prefer gold metal to interest-bearing gold certificates, an increase in the supply of SDRs would not solve the problem. But there is reason to suppose that most governments are sufficiently hard-headed to restrain their central bankers from carrying sentiment to that extreme.

It might be useful to sketch the sequence of events that I would have regarded as more probable if the crawling peg with a gold/SDR pivot had been introduced in the circumstances of spring 1971. One may presume that the American authorities would have found it advantageous to start crawling downward, so as to have corrected "unfair exchange rates." Most other countries would have welcomed this in the first instance as introducing a long-overdue correction in relative prices. There might well have been more danger that some countries that *should* have followed the dollar down would fail to do so (because hot-money inflows made it easy for them to dismiss the evidence of declining long-run competitiveness) than of the widespread imitation so often talked about. After two or three years and a dollar devaluation of perhaps 5 to 10 per cent, a substantial number of other countries would probably have sought to join in. As they did so, discussions would have commenced in the Group of Ten and the IMF about the increased rate of SDR creation required in the next basic period. This, together with the

improved current balance resulting from dollar devaluation, would have eliminated the American deficit and the need for a further downward crawl. In the new situation one might have expected the reserves of the United States to be greatly increased, without any significant change in those of either the rest of OECD or the non-OECD countries: the new SDRs would have ended up being used to eliminate the weakness in the American reserve position. The improvement in the American current balance would have come partially at the expense of other OECD countries (who could have afforded to allow such a deterioration in view of their increased SDR allocations) and partially at the expense of non-OECD countries (who could have been expected to welcome the chance of increasing their current deficit without jeopardizing their reserve holdings, a chance that would again have been provided by increased issues of SDRs). In the new situation the United States would have been worse off to the extent that it would have lost the seignorage from the dollars that would have been replaced by SDRs in other countries' reserves. Unless one believes it is desirable for the United States to maximize its seignorage gains, it is difficult to argue that the alternative situation envisaged would not represent a clear improvement over the situation of early 1971.

Is Change Possible?

A number of arguments have been advanced for believing that a gold/SDR pivot would make a substantial contribution to the evolution of an equitable and smoothly functioning international monetary system. But it will be recalled that the Bretton Woods system was founded on a *de jure* gold pivot and that this evolved into a *de facto* dollar pivot for reasons that were at the time regarded as compelling. It is therefore necessary to ask whether there is a practical possibility of reverting to a gold/SDR pivot despite the factors that led to its abandonment.

Three such factors were identified in an earlier section. The first was the belief that a small American-initiated change in the dollar parity was impractical because it would stimulate widespread imitation. This possibility has been discussed at length in the previous section and, under the criterion there proposed regarding the rate of SDR creation, the danger that other countries would follow the dollar down can be dismissed. The second was the belief that any change in the dollar price of gold would lead to massive gold speculation. The third was the danger that American-initiated changes in the dollar exchange rate might destabilize foreign dollar holdings and so undermine the usefulness of the dollar as international money.

Consider the latter danger first. Foreign dollar holders can switch

into either foreign currencies or gold. So far as switching into other currencies is concerned, it would seem to make little difference whether the dollar was being devalued or other currencies were being revalued. There might be some psychological difference, especially if a dollar devaluation meant that those holding dollars were suffering a capital loss in terms of virtually every other currency. But this is precisely the situation that the Nixon Administration set out to create when it initiated its campaign to induce a general revaluation against the dollar: if the dollar's international role survives the crisis of 1971, it could also survive a formal dollar devaluation. Naturally, such a step would be disruptive if engineered under the adjustable peg, because parity changes are inevitably disruptive under this system, but there seems very little reason to suppose that an American option to devalue the dollar would significantly aggravate the situation. The way to eliminate the disruption involved in parity changes is to abandon discrete changes in favor of crawling, not to pretend that one currency is different from all others.

There is also the option of switching into gold. In this respect a gold/SDR pivot would change the incentives more significantly, because it would introduce changes in the official gold price that would not occur under the dollar pivot. It is necessary to distinguish between attempts by official and private holders to switch into gold. Attempts by official holders would place intolerable strains on the system, but they would be made if advantage were seen in them. If such attempts to convert were thwarted by American "persuasion" or the maintenance of gold inconvertibility, there is no doubt that the resulting capital losses would be highly resented. This implies that the adjustable peg would be impractical unless the United States gave a gold guarantee on dollars held as reserves. In contrast, the crawling peg would not necessitate any such provisions. As is well known, one of the constraints imposed by the crawling peg is the necessity of interest-rate differentials sufficiently large to reduce interest-sensitive capital flows to a size that can be financed from available reserves. In this instance the constraint would take the form of requiring the United States to maintain its interest rate above the rate of appreciation of gold in terms of the dollar. Provided this was done (and it is hardly likely to be an onerous constraint), the dollar would remain the higher-yielding asset and there would be no incentive for central banks to shift into gold.

That leaves the problems posed by an attempt by private dollar holders to switch into gold, which is the problem of gold speculation. So long as the two-tier gold market is maintained, such switches are of importance to the functioning of the international monetary system only insofar as they create the possibility of leading to a (big) increase in the

official price of gold. I am among those who believe that a big increase in the official gold price would be a major international disaster. The least important reason for this belief is the fact that digging gold out of the ground is an inherently wasteful way of satisfying the need for tokens to circulate among central banks. Of slightly greater importance is the fact that a higher gold price would tend to suck existing gold stocks out of the private market into official reserves, and so would reduce the dental, artistic, and industrial uses of the metal. A third consideration is that an increased stock of monetary gold might tend to aggravate the arguments about the distribution of the burden of adjustment among surplus and deficit nations, insofar as this conflict of interest is worsened by the use of zero-yielding reserves to settle international debts. (Incidentally, a logical implication of this reasoning is that it would be desirable to increase the rate of interest on SDRs to a point where their use no longer involves seignorage.) Fourth, a sudden increase in the value of reserves could well unleash inflationary forces. Fifth, a big gold revaluation would arouse expectations of a repeat performance the next time that gold ceased to flow into official reserves, and this would add a new source of instability to the world monetary system as central banks sought to shift their assets between foreign exchange and gold so as to maximize the long-run yield of their portfolios. Sixth, the resulting redistribution of income and wealth would be not just arbitrary and capricious but—by commonly accepted standards—actively perverse, with the South Africans, the Russians, and the rich gaining and the indebted (insofar as they had gold-guaranteed debts), the poor (since they are the countries that have felt unable to forego the interest paid on reserve currencies), and those who were responsible enough to have avoided disrupting the system losing. Finally, and most important, the breach of faith involved in renegeing on the solemn commitments of a decade without compelling reason would jeopardize the chances of future monetary cooperation. And it should be emphasized that no constructive purpose would be achieved by gold revaluation, for there is no evidence that the stock of international liquidity is as yet too small, and, even if it were, that could be remedied through additional creation of SDRs.

For these reasons one should applaud the past determination of the American authorities to resist an increase in the price of gold. And that certainly means that, in the world of the 1960's, one could only welcome the refusal of the United States to consider any devaluation, no matter how small, of the dollar. When the private and official gold markets were linked through the gold pool and when SDRs were no more than a gleam in the visionaries' eyes, it is certain that any mention of a change

in the dollar parity would have sparked a run into gold that would have led to a precipitate fall in the stock of reserves.

But one should be perfectly clear that all the objections to gold revaluation apply specifically to large, discontinuous changes. It is mistaking form for substance to resist small variations in the dollar-gold parity that are intended to be a means of securing desired changes in the value of the dollar in terms of other currencies. Such changes would not have a noticeable impact on the real resources devoted to gold production or lead to a significant curtailment of gold consumption. They would not threaten destabilizing shifts between gold and reserve currencies (provided, at least, that the changes in the dollar-gold parity were of a "crawl" nature, sufficiently small to be offset by interest rates). There would be no sudden unleashing of inflationary pressures, no significant redistribution of income and wealth, and no cause for charges of a breach of faith. The only objection to small changes in the gold-dollar parity would be if they still posed a threat of provoking a speculative run that would threaten the stability of the system.

Although the system is embroiled in one of its periodic crises while this is being written, a longer-run view suggests that the developments of the past four years have considerably reduced the threat that collapse would be precipitated by any suggestion of change in the gold-dollar parity. The two-tier gold market eliminates the one-way option that was previously available to gold speculators. It has also insulated the reserve stock from the influence of private speculation, while the existence of SDRs means that, even if leakages to the private market did occur, it would be possible to compensate for them by increasing the supply of SDRs. It is no doubt possible that a modest step devaluation of the dollar might still provoke a run on gold, although the absence of the one-way option should result in such a run being self-limiting. If, however, the adjustable peg had already been replaced by the crawling peg, it seems a little far-fetched to suppose that even the most ignorant of speculators would misinterpret a proposed 1 per cent devaluation of the dollar as the precursor to a 100 per cent increase in the price of gold. The two things would look as different as they in fact are.

Any American move toward a gold/SDR pivot, with or without a crawling peg, would presumably be preceded by lengthy public debate and congressional hearings. No doubt these would provide a platform for the gold lobby and the free-market gold price would respond to the course of the debate, but at the time of writing it hardly seems likely that the alternative foregone will be one of placid serenity in the markets. Indeed, one can argue that proposal of a gold/SDR pivot might well prove to be the best way of calming the markets, because it would

reconcile the European desire to maintain a vestigial monetary role for gold with the American aim of not renegeing on the spirit of its oft-repeated pledge to avoid an increase in the gold price. It is true that "the essence of any successful operation in the exchange market, as in nuclear deterrence, is to achieve credibility" (F. Hirsch, *The Pound Sterling*, London, 1965, p. 116), but credibility is in large part a function of the objective viability of the proposal being advanced. The reason speculators sometimes "win" is that there is an objective need for parity changes, whereas there is no objective need for a large increase in the monetary price of gold. In this respect the dangers of costly speculation are a good deal less than those that some European countries had to face when consenting to a study of the exchange-rate mechanism in early 1969. One may hope that Americans who are convinced of the intellectual merits of the case for reversion to a gold/SDR pivot will be as ready to face the possible difficulties of considering such a change as they formerly were to urge Europeans to overcome their reservations about discussing flexibility when Europe's exchange rates were in evident disarray.

Conclusion

Maintenance of a fixed (or even semifixed) exchange-rate structure imposes adjustment costs that both equity and efficiency suggest would be best shared. If the United States agrees with the aim of maintaining this structure, it should be prepared to contribute to the costs involved by participating in the adjustment process. Since an American claim to be able to adjust without employing exchange-rate policy is either hypocritical or ludicrously ill-advised, American participation requires that the power to vary the dollar exchange rate at the option of the United States be reinstated. Provided the criterion is adopted that the rate of SDR creation be such as to keep the value of the pivot (the gold/SDR unit) stable in terms of a weighted average of currencies, payments targets would be consistent and there would be no question of dollar devaluations being negated by imitation.

It is, of course, possible that the United States does not have any interest in maintaining as much stability in the exchange-rate structure as other countries wish for. In that event it would be unreasonable to expect her to contribute to the costs of preserving the system. The rest of the world might then be expected to re-examine its position to decide whether it is primarily concerned with the maintenance of stable exchange rates among its own members or whether stability against the dollar is equally important. In the latter eventuality, it would be well-advised to accept the dollar standard and learn to like it. In the former

case, it would presumably wish to make arrangements to demonetize the dollar in the Eastern Hemisphere. No doubt this would include floating between the dollar and a bloc comprising at least some part of the rest of the world.

If, however, the attempt is to be made to preserve a worldwide system with all the members playing a reasonably symmetrical role, then a gold/SDR pivot would seem to be an almost essential part of such a design. There might be difficulties in reinstating the gold/SDR pivot within the adjustable-peg framework of the Bretton Woods structure—partly because of the difficulty of synchronizing decisions on SDR creation with parity changes, partly because of the danger of provoking switches of reserves between dollars and gold (though this could be mitigated by having the United States provide a gold guarantee), and partly because of the danger that a proposed dollar devaluation might still introduce speculative pressures in the gold market. But since the advantages of a gold/SDR pivot are greater under the adjustable peg—because there is less possibility of a concerted move by other countries to correct any misalignment between the dollar and the generality of other currencies—it might still be worth reverting to the gold/SDR pivot even if the adjustable peg is maintained. In view of the difficulties that this would pose, however, one may count the ease with which a gold/SDR pivot would fit into a crawling-peg framework as yet another advantage of abandoning the crisis-prone system of step changes in parities in favor of crawling. If the United States is really interested in obtaining greater flexibility, she has the opportunity of leading from in front, rather than her recent invidious position of urging others on while taking no action herself, by advocating a crawling peg with a gold/SDR pivot.

POSTSCRIPT

The first draft of this essay was completed in July 1971. It has been revised while the exchange markets were closed as a result of the crisis provoked by American suspension of gold convertibility and imposition of an import surcharge. It is to be feared that this crisis may have impaired the air of timelessness that should characterize academic writings. It certainly raises the danger that developments between this writing and publication will have a major impact on the subject discussed. If, however, the immediate response to the crisis is the adoption of temporary measures to provide time to engage in a fundamental reconstruction of the international monetary system, then it may be hoped that the essay will contribute to that reconstruction by airing one of the fundamental issues that will have to be resolved.

In its first week the crisis has emphasized the desirability of a gold/SDR pivot in two ways. First, it has shown that the United States has not adopted a passive payments policy but is still actively seeking to achieve a payments target; as argued earlier, to combine this with a dollar pivot is virtually certain to get the worst of all worlds and generate successive crises. Second, it has demonstrated that the method the United States is using to achieve payments balance is to try to engineer a general revaluation against the dollar, which involves seeking a set of parity changes that could more simply and with less acrimony have been achieved by a dollar devaluation. If the system continues along this road, with the specter of a trade war being unleashed every time the dollar gets slightly misaligned with other currencies, it is virtually inevitable that the specter will one day materialize.

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