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THE CASE FOR THE
PAR-VALUE SYSTEM, 1972

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

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This is the ninety-second number 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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The Case for the Par-Value System, 1972

The commitment of each member nation to maintain a par value for its currency and to consult the International Monetary Fund before changing it constitutes the heart of the international monetary system established at Bretton Woods. Economists have tended to be critical of this commitment. The professional literature has stressed the role of the exchange rate as a market price, and economists in general have preferred arrangements under which exchange values would fluctuate enough to clear exchange markets in an orderly fashion. The one-sided support economists have given to flexible exchange-rate arrangements has largely rested upon an overwhelming professional preference for shifting resources through market processes. The desire for more autonomy in national policy making has sometimes contributed to this preference. In any case, critics over the years have been convinced that the par-value system would inevitably lead, in a world of discordant national policies, to networks of governmental controls and to financial crises. There have been frequent enough financial disturbances in recent years to provide some justification for these misgivings.

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

But developments in mid-1971 struck at the heart of the international commitments that had been the basis for world monetary cooperation since 1946. The key elements of that system were placed in jeopardy by the decisions of Germany and the Netherlands in May "not to maintain the exchange rates for its currency within the established margins" (IMF Press Release No. 839, May 9, 1971) and by the decision of the United

The analysis and conclusions of this paper represent the personal opinions of the author and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or of its staff.

States in August "no longer, for the settlement of international transactions, in fact, to freely buy and sell gold" (IMF Press Release No. 853, Aug. 20, 1971). Earlier, in June 1970, of course, the Canadian authorities had decided for the second time since 1946 to float the exchange rate.

The temporary suspension of par-value obligations by three Fund members, and of the gold-convertibility obligation by one, unquestionably marks a historic turning point in world monetary affairs. By December 18, however, after a series of international meetings under the auspices of the Group of Ten and of the International Monetary Fund, the industrial countries were able to announce agreement on a realignment of the world's major currencies and on several related measures affecting the international monetary situation: the introduction of a system of central exchange rates, a temporary widening of the margin of exchange-rate fluctuation to $2\frac{1}{4}$ per cent above and below the new exchange rates, and prompt discussions on reform of the international monetary system over the longer term.¹ The new central rates constitute the most widespread changes in the exchange-rate structure since the general devaluations in 1949. These changes, together with the continuing negotiations on questions of longer-term monetary reform in the interest of improved adjustment performance and liquidity arrangements, imply the most sweeping changes in the mechanics of international finance since the International Monetary Fund itself was agreed upon at Bretton Woods in 1944.

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

The Par-Value System: Its Distinguishing Characteristics

An analysis of the economic case in favor of the par-value (or adjustable-peg) system requires, at the outset, an identification of its distinguishing characteristics. We must ask in particular in what respects such a sys-

¹ See "Agreement on International Monetary Arrangements," *International Financial News Survey*, IMF (Dec. 22-30, 1971), pp. 417-419.

tem differs from the systems of fixed, and of flexible, exchange rates described in the standard textbooks on international economics.

We could readily distinguish the par-value from the other two mechanisms if we could choose the full-fledged international gold standard as the representative fixed-rate system, and a freely flexible or purely market-determined arrangement as the representative flexible-rate system. But the pre-1914 gold standard is not a relevant model for a world that accords such importance to high employment in all countries. Similarly, it is hardly profitable to choose a model of freely fluctuating exchange rates in a world in which we know that governments are not prepared to permit their currencies to fluctuate in the exchange market without official intervention in any form.

Accordingly, we must accept the reality that contemporary exchange-rate systems will have elements both of government intervention and of rate flexibility; they will differ in the ways these elements are combined. The distinctions among the three alternative systems in terms of the technical characteristics of flexibility are summarized in Table 1. Flexible-

TABLE 1
RATE FLEXIBILITY UNDER THREE ALTERNATIVE EXCHANGE-RATE ARRANGEMENTS

<i>Characteristic</i>	<i>Exchange-Rate System</i>		
	<i>Market Flexibility</i>	<i>Fixed Rates</i>	<i>Par Value or Adjustable Peg</i>
Formal parity	None	Formal	Formal
Formal intervention limits	None ^a	Announced	Announced
Conditions for change in parity	None	"Last resort"	"Fundamental disequilibrium"
Exchange values in short run	Flexible	Fixed	Fixed
Desired exchange values in long run	Flexible	Fixed	"Internationally agreed" flexibility

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

rate systems are readily distinguishable from fixed-rate and par-value systems by the absence of a commitment to a formal parity, to specific intervention points, and to conditions that must be met before a change in parity can be made.

The fixed-rate and adjustable-peg systems have in common the commitment to a formal parity and to announced intervention points—that is, to the objective of rate stability in the short run. Both require international review before changes in par value can be made. They differ, however, in their long-run objectives. The conditions under which the par value could be altered become conspicuously more rigorous under a “last resort” fixed-rate system (which could be regarded as equivalent for our generation to the pre-1914 international gold standard) than they would be under the system of the adjustable peg. For the parity would be changed under a fixed-rate system only after available reserves and credits had been used up—that is, bankruptcy would be approaching. Under the par-value arrangement, by contrast, a change in parity could be justified in terms of an unwillingness to sacrifice domestic objectives. In other words, a change in parity under a fixed-rate system would reflect a failure of national policy, but under an adjustable peg it would reflect a change in policy mix.

In addition, the limitations on exchange-rate variations would be much more rigorous for a fixed-rate system than they would be under the adjustable peg. The Fund’s Executive Directors recently released a report (IMF, 1970, pp. 70–78), in fact, in which they found that, in certain specific forms, rate flexibility greater than that provided by the existing arrangements would be consistent with the Articles of Agreement. These forms included (1) proposals to achieve prompter and smaller adjustments in parities and (2) a slight widening in the margins around parity. The report also explored the role of temporary deviations from par-value obligations in a par-value system.

Flexibility in these forms would be contrary to fixed-rate concepts. Thus, in practical terms, many forms of greater flexibility—such as the crawling peg or gliding parity—could be accommodated under the par-value, but not under a fixed-rate, system. In the view of the Fund’s Executive Directors, in fact, the only forms of exchange-rate flexibility specifically regarded as “inconsistent with the par-value system” were (1) freely floating exchange rates, (2) substantially wider margins, and (3) automatic adjustment of parities (IMF, 1970, esp. pp. 42–46).

Perhaps the critical difference between the par-value and fixed-rate mechanisms lies in the different roles exchange-rate changes are expected to play in the adjustment of international payments. Under the fixed-rate variant, the par value would be considered to be as credibly fixed as it was under the former gold standard, that is, the authorities in each country would accord so high a priority to this intention that “for all practical purposes variations of exchange rates will in the future, as at present, be used only in exceptional cases as a method of balance-of-pay-

ments adjustment among the major industrial countries" (Emminger, 1967, p. 512). The national authorities would turn to exchange-rate policy as a tool of international adjustment only after other methods of adjustment had been tried and failed.

By contrast, under the adjustable peg, exchange-rate change would be regarded as an ordinary policy tool, and rate flexibility in the long run as desirable in itself. With the adjustable peg, exchange-rate action becomes a policy option open to the national authorities of each country, subject to specific and general international constraints. The principle was recognized—as the historic innovation at Bretton Woods—that a member country could, subject to international review, choose to employ exchange-rate policy to protect its domestic economic stability from international disturbance. In the words of the recent Fund report, the international community "accepts the right of individual countries, subject to the international obligations just mentioned, to adjust their exchange rates to fulfill legitimate domestic objectives, as well as agreed international objectives" (IMF, 1970, p. 5).

Thus, the distinctive characteristic of the par-value system is the acceptance of flexibility of exchange rates in various forms, but within specified limits and in accordance with internationally agreed-upon criteria and procedures. As we have seen, the definition could encompass some proposals for technical modification of exchange-rate practices currently being discussed, as well as the arrangements that have thus far been in effect under the Articles of Agreement. In contrast to a "last resort" view of the role of exchange rates in the adjustment process, the adjustable-peg system has essential elements of flexibility that would allow exchange values to be altered as needed—but only as needed—to promote orderly adjustment of international disequilibrium and orderly exchange-rate practices among member countries. There is, under the par-value system, "the preference for devaluation over deflation" (Yeager, 1966, pp. 101–102) in many situations in which advocates of fixed rates would choose deflation as the appropriate corrective.

There have been, and continue to be, widely differing notions among Fund members about how much rate flexibility is consistent with the intent and objectives of the Fund's Articles of Agreement. It is precisely these differences of interpretation that help to explain the current controversy over rate flexibility among the partners of the European Common Market. The high degree of exchange-rate rigidity among the industrial countries, especially between 1958 and 1967, made the Bretton Woods system of the adjustable peg—as it worked out in practice prior to the U.K. devaluation in November 1967—seem to be more nearly akin to a fixed-rate system of the pre-1914 type than to any recognizable form

of limited and internationally controlled flexibility. Recently, however, political leaders as well as government and financial economists have responded to international currency disorders by accepting a more active role for exchange-rate policy in international payments adjustment than they had been prepared to accept prior to 1967.

As a result of this change in view, much recent attention has been focused on the role of a limited increase in exchange-rate flexibility in a par-value system, and the ways it could be attained. The economist can find evidence of this alteration in viewpoint by comparing the 1966 report on *The Balance of Payments Adjustment Process* of Working Party No. 3 (OECD, 1966, esp. pp. 20-23, pars. 45-51) with the Fund report on *The Role of Exchange Rates in the Adjustment of International Payments* in 1970. Both reports concentrated on the possibilities of, and proposals for, improving the balance-of-payments adjustment process. But the 1966 report assumed a system of exchange rates within narrow limits around a fixed parity and with changes in the exchange rate "relatively rare among the OECD countries" (OECD, 1966, p. 8, par. 6); accordingly, it contains only infrequent and guarded references to changes in parity as an available instrument of national policy. By contrast, the title of the Fund report highlights the role of the exchange rate, and the discussion in it concentrates on the ways to make effective exchange-rate policy in the adjustment process. It is striking, in retrospect, that it was regarded as realistic in 1966 to explore the workings of the adjustment process without considering more fully than was the case the possible need for changes in parities, for changes in technical aspects in exchange-rate practices, and even for changes in rather fundamental aspects of the exchange-rate system itself. The changed climate of opinion is also indicated by a comparison of the suggestion in 1967 that it was "unlikely that in practice exchange-rate variations will be used in a more generalized and permanent way as an instrument of adjustment among industrial countries" (Emminger, 1967, p. 512) with the recent assertion in 1971 by the Managing Director that "the Fund has always been opposed to exchange rate rigidity. Indeed, it has favored a considerable degree of exchange rate flexibility in appropriate circumstances."²

The extent to which attitudes about rate flexibility have altered over the past few years makes it necessary to define the flexibility characteristics of the par-value system in broad terms, as in Table 1, and to recognize that there could be substantial modification of exchange-rate practices in the form of internationally controlled flexibility within the terms

² Pierre-Paul Schweitzer, Managing Director of the IMF, before the Economic and Social Council of the United Nations on Oct. 27, 1971, in *International Financial News Survey*, IMF (Nov. 3, 1971), p. 355.

of the definition. In brief, the adjustable-peg model can be regarded as an attempt to combine fixed exchange rates in the short run with internationally agreed-upon variations in the long run. A wide variety of reform proposals would clearly be consistent with this model. Because it combines elements of rate flexibility and elements of rate fixity, the par-value system can be regarded as a halfway house between flexible and fixed rates (as defined in Table 1) or, if you prefer, as a defensive arrangement among the major trading countries designed to guarantee that the desired degree of flexibility occurs on an internationally agreed-upon basis.

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

Domestic Priorities and the Exchange-Rate System

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

But, in practice, policy instruments are imprecise and often not separable; it is seldom that they can be uniquely assigned to a specific target variable. Too often, national authorities are beset with more objectives than readily usable policy instruments or with goals that are contradictory; they are seldom free to allocate tools to goals so as to ensure the achievement of multiple goals simultaneously. As a result, they usually assign the instruments they have available to their priority targets and are

forced to neglect secondary objectives that, all too often, include the nation's international objectives.

For example, economists have often recommended that, with fixed exchange rates, monetary policy could be effectively employed for external balance and fiscal policy for internal balance. Between 1958 and 1967, however, European central bankers were not prepared to abdicate their primary responsibility for domestic stability, even where balance-of-payments factors threatened the central bank's control over the domestic credit situation. Instead they fashioned new tools of central banking, making credit restraint an effective tool of domestic stabilization by devices to insulate the domestic economy from external sources of liquidity. Even in this period, when balance-of-payments surpluses were excessive and local spending aggregates high, these countries made monetary policy the primary instrument of domestic stabilization, often with only limited support from fiscal policy (Katz, 1969, esp. pp. 1-10 and 32-45).

The overriding priority given to domestic policy goals in the industrial countries has dimmed the prospect that external balance could be expected from an instrument-target approach to economic stabilization. Because there is a relative scarcity of usable instruments available to them in the best of circumstances, government officials are apt to deploy the policy tools at hand for domestic purposes. To be sure, the national monetary authorities may have acquired a growing capability—based upon political consent—to direct government tools toward priority economic goals. But, as a general rule, considerations of external balance have been assigned only a modest priority in formulating stabilization objectives, except in the most unusual circumstances.

Because the industrial countries agree in this relative neglect of external factors, the problem arises: How can we hope for a tolerable balance in international transactions so that the reconstructed liberal international trade and payments structure can be maintained? In a world in which external payments balance (without controls) is accorded only a subsidiary priority, we cannot expect the industrial countries to follow policies for external balance that conflict with the goal of internal balance. Instead, the national authorities must be able to choose measures for domestic balance which, in all situations, can be consistent with the requirements for external balance.

The unique adaptability of the par-value system. In this environment, the par-value system has the unique adaptability to offer the authorities a policy option through which external balance can always be made consistent with measures of domestic balance. This adaptability is not shared

by the two main alternative exchange-rate systems identified in Table 1—credibly fixed and market-flexible rates. Neither of them can as readily accommodate policies for internal balance that will prove to be consistent with the requirements for external balance.

The policy conflicts the authorities would have to face in their attempts to achieve both internal and external balance under alternative exchange arrangements can be analyzed in terms of the “dilemma” and “nondilemma” situations outlined in Table 2. In a world in which the authorities

TABLE 2
SUMMARY OF INTERNAL-EXTERNAL BALANCE IN
NONDILEMMA AND DILEMMA CASES

	Internal Position (1)	External Position (2)	How Domestic Spending (<i>E</i>) Would Be Affected with Only	
			Demand- Management Measures ^a (3)	Exchange- Policy Measures ^b (4)
<i>Nondilemma cases:</i>				
1. Surplus-deflation	$Y^* > E$	$R > P$	+	-
2. Deficit-inflation	$Y^* < E$	$R < P$	-	+
<i>Dilemma cases:</i>				
3. Deficit-deflation	$Y^* > E$	$R < P$	-	+
4. Surplus-inflation	$Y^* < E$	$R > P$	+	-

^a (Fixed-rate adjustment measures.)

^b (Flexible-rate adjustment measures.)

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

are not to be allowed to depend either upon freely flexible exchange rates or upon controls to preserve external balance, they would encounter policy conflicts as they pursued either demand-management measures in accordance with the fixed-rate adjustment process or, alternatively, exchange-rate policy in accordance with the flexible-rate adjustment process. The nature of the policy dilemma would depend upon the type of exchange-rate system and upon the nature of the disturbance. If the authorities had a preference for fixed-rate adjustment measures, they would find an external-internal policy conflict in the dilemma situations, that is, when the surplus country had excess, and the deficit country inade-

quate, internal demand. By contrast, they would find a policy conflict if they had a preference for flexible-rate adjustment processes in the non-dilemma situations, that is, when the surplus country had inadequate, and the deficit country excess, internal demand.

Economists who have recently been exploring these conflicts in terms of dilemma and nondilemma situations have largely been covering ground that was pretty fully sketched out in Meade's (1951, esp. Chaps. VIII–XI, pp. 99–162) monumental treatise twenty years ago. It was Meade who approached external-internal balance as a policy problem in international economics in which target variables were specified and the corresponding values of the policy tools were then to be determined.

The four dilemma and nondilemma situations under existing fixed-rate arrangements are summarized in Table 2. There, actual domestic expenditures (E) are compared in column 1 with the level of domestic output that is consistent with domestic employment and price goals (which is designated as Y^*). The assumed levels of foreign receipts (R) are then compared in column 2 with foreign payments (P). Finally, the fact that the effects on domestic income of demand-adjustment measures (of the fixed-rate adjustment process) and of exchange-rate variations are complementary in both the surplus and the deficit country is brought out in columns 3 and 4.

This policy-oriented schema is intended to distinguish the effects of domestic policy actions on internal spending aggregates from the effects on external balance. It is assumed that the national authorities can, and almost always will, be primarily concerned to alter domestic spending aggregates in an endeavor to attain their Y^* target priority. The analysis will consider the ways the policies to achieve domestic balance will affect the external balance in the four situations first explored by Meade. Our concern will be to observe how policy measures designed to bring E closer to Y^* will alter the difference between R and P .

The analysis will be following Meade, it will be noted, in concentrating on a trade-only model of the international adjustment process. This choice in part follows logically from the emphasis upon high employment as the overriding economic goal in all industrial countries: after all, exports have a direct, and capital flows only an indirect, impact on domestic employment. The concentration on current flows of goods and services also follows logically from the distinction in the Fund's Articles of Agreement: members are permitted "such controls as are necessary to regulate international capital movements" but not in ways which would restrict payments for current transactions (Art. VI, Sec. 3). This distinction was reaffirmed in the Working Party No. 3's report that controls on current transactions "can only be regarded as a temporary expedient" but that

“measures to affect capital movements may in some circumstances be needed in the interests of internal monetary policy” (OECD, 1966, pp. 23-24).

There are two other reasons why the trade-only model is an acceptable first approximation for our particular purposes. The major countries have not one but at least two external payments targets; one is defined in terms of a goods-and-services objective and the other a balance-of-payments or reserve target. Where our concern is with high-employment goals, clearly the current goods-and-services and not the balance-of-payments target is of primary importance. The separableness of these two external targets is illustrated by the course of current international negotiations over a new structure of par values; several countries have indicated a willingness to forego additional reserve accruals but are less willing to accept a curtailment in export sales.

Finally, we must recognize the lack, in the present state of international economic theory, of a model that integrates capital and trade flows into a systematic adjustment process. In practice, capital flows may sometimes be an essential part of the adjustment process and may sometimes serve only a temporary financing role. Furthermore, there are situations when the changes on capital account reinforce, and others when they offset, changes on current transactions.

In our present analysis, capital flows cannot be introduced either as a source of disturbance or as a part of the adjustment mechanism under alternative exchange-rate arrangements. Accordingly, we shall concentrate on how alternative national policy measures intended to restore domestic economic balance would also alter the trade balance. The changes in the trade balance would alter *net* exports in the domestic-GNP process and, to that extent, would also alter foreign receipts (R) or foreign payments (P).

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

In these two positions, changes in the exchange rate could also im-

prove the trade balance. But, in both cases, the movements of the exchange rate would have the effect of altering the trade imbalance in ways that would increase the internal disequilibrium. That is, the surplus country would find the exchange rate higher and, hence, the trade surplus reduced; but the lower trade surplus would further contract domestic spending, widening the shortfall between E and Y^* . Similarly, the deficit country would find the exchange rate lower and, hence, the trade deficit reduced; but this improvement would further add to domestic spending, widening the excess of E over Y^* .

The internal-external conflict produced by an exchange-rate change is explained by the fact that the source of disturbance is mismanagement of internal demand. In some circumstances, nondilemma situations characterized by demand mismanagement can turn into dilemma situations. That is, a country with deficient demand for a period may later find revaluation unavoidable; for example, Germany between 1966 and 1969 may or may not have been a pure example of a nondilemma case that turned into a dilemma case, but the German economic "pause" in 1966-67 materially helped to build up the trade surplus to levels that made revaluation inevitable in 1969. Similarly, the United Kingdom may or may not have been a nondilemma case in 1964, but the protracted excess demand in that country had, by 1967, created a dilemma situation in which devaluation became unavoidable.

Furthermore, in a situation of demand mismanagement, the flexible-rate adjustment process would increase the chances for a nondilemma case to be converted into a dilemma one. That is, a declining exchange rate would increase the inflationary, and a rising exchange rate increase the deflationary, pressures already present in the domestic economy. It would be one of the advantages of the par-value system, in practice, to give government officials additional time to consider the sort of problem the country faces before choosing their corrective measures—thereby diminishing the chance that the adjustment process itself would compound the threat to internal and external stabilization.

The dilemma situations. One key characteristic identifies the two dilemma situations: measures to restore internal balance will worsen the foreign-trade balance. That is, the requirements for external balance will further worsen the internal disequilibrium, because the surplus country already has excess domestic spending (Case 4 in Table 2) and the deficit country already has significant amounts of unused domestic resources (Case 3).

In these situations, internal and external goals cannot be achieved through changes in internal demand policies. Changes in domestic spend-

ing intended to reach the Y^* target in both the deficit and surplus countries will worsen the trade balance, and changes in demand to reduce the external disequilibrium will worsen the internal balance in each of them. The trade balance, however, can be improved by external policy action, that is, by appropriate changes in the exchange rate. In both cases, the exchange-rate action will improve the trade balance and the internal disequilibrium. The surplus country will experience internal deflationary impulses from the higher exchange rate through (1) the domestic income effects of a declining export surplus and (2) the domestic price effects of lower costs for imported goods. Similarly, the deficit country with sluggish demand should experience expansionary impulses through the improved export position once the exchange rate is reduced.

The range of options under the par-value system. The case for the par-value system rests, in part, upon the greater choice of policy measures it gives the authorities to avoid conflicts of internal-external balance. This argument should not be interpreted as denying the theoretical possibility of choosing a combination of policies—under either fixed- or flexible-rate arrangements—through which the authorities could always achieve both internal and external balance. Advocates of fixed-rate adjustment measures could maintain that exchange-rate action would be required only in rare instances, if at all, were the authorities in each major trading country to adopt appropriate demand-management policies in all situations. Similarly, advocates of the flexible-rate adjustment mechanism could deny the existence of external balance as a policy problem were the authorities to allow the exchange rate to vary enough to clear the foreign-exchange market at all times; alternatively, dilemma situations could be resolved through exchange-rate action and, in non-dilemma situations, proper demand-management adjustments could effectively keep exchange-market quotations from varying unnecessarily.

But the national authorities must function in a world of uncertainty and imperfect knowledge and one in which there are practical limitations on both the character and the timeliness of their policy decisions. In practice, they sometimes encounter disturbances arising from improper demand-management episodes or from exchange rates no longer appropriate to a country's cost or demand position. In the two situations identified by Meade as arising from demand-management disturbance, policies chosen to correct the external balance in accordance with the flexible-rate adjustment process would also worsen the internal situation. By contrast, the use of demand-management correctives (in accordance with the fixed-rate adjustment process) in the two situations where the disturbance does not arise out of inept domestic demand management

would create an external-internal policy conflict. Under the par-value system, the authorities can choose policies of demand-management adjustment (consistent with the fixed-rate adjustment process) in non-dilemma cases and reserve parity changes for the dilemma situations.

The use of exchange-rate action to limit the excessive domestic disturbance from balance-of-payments disequilibrium can be found in the recent (pre-August 15, 1971) decisions by several major industrial countries to revalue and to devalue their parities under the Fund's procedures. In the German revaluation in 1969, for example, the late President Blessing came to recommend revaluation in 1969 because, in his words,

I have since been forced to admit that we live in a world which is no longer . . . prepared to accept really severe disinflationary measures, and that the healthy can protect himself against inflation only by means of a change in parity.³

Similarly, Prime Minister Wilson finally decided to devalue in 1967 in part because his government was not willing to accept the conditions—the internal policy constraints—on which additional international financial aid might have been forthcoming.⁴

The Fund report on exchange-rate flexibility. The Fund's recent report on exchange-rate flexibility confirms this particular ability of the par-value system to be adjusted to the requirements of internal balance. Member countries are encouraged to take other measures—in preference to exchange adjustment—in situations where “other measures can be taken to restore payments balance without damage to national or international prosperity,” because in those cases “where the domestic measures that would contribute to external balance would also help to preserve or restore internal balance, domestic measures will be needed in any case” (IMF, 1970, esp. pp. 49ff.).

On the other hand, the national authorities can, subject to the standards of the Articles of Agreement and to international review, choose to employ exchange-rate policy to protect their domestic economies from disturbance through the balance of payments. For, the report added, “where the requirements of internal and external stabilization point in opposite directions for domestic policy . . . there is then no such presumption in favor of domestic measures directed to restoring external equilibrium, since such measures, at least if unaccompanied by exchange adjustment, will intensify the domestic disequilibrium.” The report goes

³ Herr Karl Blessing, President of the Bundesbank, speech before the German Cooperatives at Mainz (Germany), Oct. 10, 1969.

⁴ Television address by Prime Minister Wilson to the British nation on Nov. 19, 1967, announcing the devaluation of the pound.

on to note that, in the prevailing international environment of excess demand and generalized inflationary trends, the external-internal balance conflict "is more likely to occur for countries with persistent or excessive surpluses than for countries with persistent deficits" (IMF, 1970, p. 49).

The member proposing to employ exchange-rate action is required only to demonstrate to the Fund's satisfaction that "the change is necessary to correct a fundamental disequilibrium" (Art. IV, Sec. 5f.). In spite of the fact that it was not defined in the Articles and the Fund has never attempted to formulate a rigorous definition, this critical concept, which is at the heart of the Bretton Woods system, "has been tested by experience" (IMF, 1970, p. 47), as the decisions by three major countries to use exchange-rate action—Britain in late 1967, France in mid-1969, and West Germany in late 1969—effectively demonstrate.

The option under it to choose either demand-management or exchange-rate policies makes the par-value system a preferred solution to the exchange-rate problem, especially in a world in which the leading trading countries accord an unquestioned priority to domestic economic objectives. So far as their effects on domestic spending aggregates, in fact, the processes of adjustment under fixed and flexible rates are complementary, as may be seen in columns 3 and 4 of Table 2: the surplus country should seek external balance through the fixed-rate adjustment process when internal demand is deficient and should adopt the flexible-rate mechanism when local spending is excessive. By contrast, the deficit country should seek external balance through the flexible-rate process when internal demand is deficient and through the fixed-rate mechanism when it is excessive.

The greater range of policy choices is particularly valuable in a world of uncertainty and imperfect information and stabilization performance. If the relative frequency of dilemma and of nondilemma situations or the relative frequency of errors in national policy making could be determined in advance, this greater adaptability would have a reduced value. That is, the fixed-rate adjustment process could be recommended in a world in which disturbances were mainly the result of poor demand-management policies (especially of an inflationary character, as gold-standard partisans have traditionally maintained) *and* if the propensity to error was more or less uniformly distributed among the major trading countries. On the other hand, the flexible-rate adjustment processes would be appropriate for a world in which there were wide variations in the effectiveness of demand-management policies among the major trading countries or the authorities were demonstrably unwilling—or merely as a practical fact unable—to alter the parity as needed.

The par-value system becomes a preferred option in a world in which economic disturbances are frequently random in character and in which there is moderate variation among industrial countries in the effectiveness of the stabilization effort.

In brief, the par-value system can be regarded as a mechanism to guarantee *controlled flexibility* of exchange rates. It combines, as a second-best choice, limits on exchange-rate variations in the short run, for the convenience of private entrepreneurs, and flexibility of exchange rates in the long run in accordance with internationally agreed-upon criteria and procedures for multilateral consultation and coordination. Alternatively, it enables the national authorities to maintain exchange-rate limits in the short run and to alter those limits whenever the old parity threatens to create unwanted disturbances in the domestic economy.

Short-Term Stability of Exchange Rates

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

Government officials and private entrepreneurs have a strong preference for the par-value system with limited flexibility, though for different reasons. Government authorities recognize that the exchange rate is a key price in the economy and a major instrument of domestic economic management. They wish to be able to attempt to control that rate through operations in the foreign-exchange market and through negotiations with their trading partners.

At the same time, they recognize that exchange rates can no longer be regarded as a matter chiefly within the province of national decision making. Because the determination of the rate of exchange for each currency is a matter of international concern, they value the commitment under the Fund's Articles of Agreement that makes changes in exchange rates a matter of common concern and subject to established procedures for multilateral review. They also recognize that the major countries must try to make their domestic and external objectives more consistent through these international consultations.

National authorities also value the commitment of Fund members, in a world of independent nations, to a code of good behavior in international financial affairs that is of juridical validity binding on each of them. They regard their fears of competitive depreciation, and of the use of exchange-rate policy to seek advantages over trading partners, in

a world without a par-value commitment as fully justified by the historical record and by practical experience in dealing with other governments on international financial matters. Finally, they can regard the procedures of the Fund as the basis for cooperative modernization of the international monetary system, as was realized in the big step toward the orderly creation of international liquidity, subject to multilateral agreement, when the Special Drawing Rights facility was activated in 1970.

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

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

Changing Par Values: The Compromise between Stability and Flexibility

In practice, critical difficulties have been created for the functioning of the Bretton Woods arrangements by the unexpectedly high domestic political cost of *any* exchange-rate action. Because government officials have been conscious of the domestic political repercussions of a change in par value, exchange-rate decisions in both deficit and surplus countries have too often been dominated by local political—rather than by economic or financial—considerations. As it has turned out, political leaders in deficit countries have often concluded that the competitive benefits

to the export sector from a devaluation would be outweighed by the domestic political disadvantages of such an action. On the other hand, political leaders in surplus countries have resisted revaluation because they were not prepared to take from their exporters a portion of foreign markets they had managed to acquire only in strenuous competition with entrepreneurs from other countries.

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

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

As a result, government officials, academic economists, and private specialists have been concentrating on the role that limited exchange-rate flexibility could assume in a par-value system. In the report of the Fund's Executive Directors in 1970, there was much emphasis upon the need, in appropriate cases, to achieve the prompt adjustment of parities and an extended review of ways to achieve this end (IMF, 1970, esp. pp. 51ff. and 71-78). The study explored in detail ways in which adaptations could be made in the par-value system to achieve prompt and smaller changes in par values as a means of improving the processes of adjustment under the Fund's Articles. Technical modifications—prompt and smaller adjustments in parities, a slight widening in the margins around parity, and temporary deviations from par-value obligations on a transitional basis—were regarded as adaptations consistent with the basic principles of the par-value system.

Distribution of the adjustment burden. It would be unfortunate to place all the blame for this rigidity on domestic political factors, however

convenient it may be to blame our international financial difficulties on politicians. For this emphasis would lead us to neglect what is the basic weakness of a par-value system: the lack of any systematic basis for determining the responsibility for initiating adjustment action between surplus and deficit countries. In practice, it has been found, "it may often be difficult to identify the causes of a particular imbalance with any certainty, and to assess the country, or group of countries, which should be regarded as out of line" (OECD, 1966, p. 26).

It is widely recognized that a fixed-rate system tends to impose "the more urgent need for action and the bulk of the adjustment burden on deficit rather than surplus countries" (Yeager, 1966, p. 104). Under flexible rates, by contrast, neither the surplus nor the deficit country is required to initiate adjustment action. Each avoids the high political costs associated with a decision to change the par value, and the variations in exchange quotations initiate a simultaneous process of adjustment between them. The avoidance of this conflict of interest under flexible rates deserves to be stressed. Yeager even understates this point when he writes: "This two-sidedness is a distinctive feature which deserves emphasis" (p. 104).

In a world in which officials in the major trading countries prefer to operate under some variant of fixed rates, however, the need to create procedures for agreeing upon adjustment action becomes a matter of substantial international concern. For this reason, the attempts by Scitovsky (1969, esp. pp. 161-168), Mundell (1968, pp. 187-200), and Officer and Willett (1969, 1970) to develop agreed-upon criteria that would determine this responsibility are constructive even if their results so far can be regarded as of only limited practical relevance.

Perhaps more directly relevant to improved international cooperation on adjustment action are the attempts by Tobin (1968, pp. 201-211) and Fleming (1968) to establish international norms of behavior, applicable symmetrically as between surplus and deficit countries. Under Tobin's scheme, each country would accept "an assignment of adjustment obligations . . . with . . . a set of financial rights and duties" (p. 205). Under Fleming's proposal, each country would accept a "code of good behavior . . . more detailed and comprehensive than any that could be derived from the present framework of international legal obligations" (p. 2) which imposed both adjustment and financing responsibilities on both surplus and deficit countries. Each of these approaches represents an attempt to develop an internationally agreed-upon set of principles or presumptive criteria, symmetrical in character, which would determine responsibility for, and resolve conflicts about, initiating corrective measures.

Postponing the adjustment decision. Because of the uncertainties as to which trading partner should initiate adjustment action under the par-value system, countries have incentives to postpone adjustment decisions. Officials in surplus countries can hope to avoid the need to act altogether, since there are only limited international constraints on them, and those in the deficit countries can hope that their trading partners have enough internal inflation (or take other steps) so that they can avoid both devaluation and internal deflation.

In this sense, therefore, the international adjustment process under the par-value system becomes a mixed-motive game. Officials in both surplus and deficit countries have an interest in a smoothly functioning payments system, but each also has an interest in avoiding the onus of initiating the necessary adjustment decisions, as evidenced, for example, by the French-German deadlock in November 1968 over whose parity should be altered. However, this conflict is not merely a matter of which government is to be *blamed* for making the parity change; German exporters would find their position no different in France, whether the franc had been devalued or the Deutsche Mark appreciated in 1968, but their competitive position would have been much different in third markets if the Deutsche Mark were revalued than if, instead, the franc were devalued to an equivalent extent.

Under the par-value system, each side has had an incentive to play a waiting game. But the cards are stacked against the deficit countries to the extent that they can postpone corrective action only so long as they have adequate liquidity or can gain access to international credits.⁵ For this reason, officials in the surplus countries have attempted in the international liquidity negotiations of the past decade to limit the liquidity available to deficit countries, and to impose conditions on access to whatever international financing is provided to borrowing countries.

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

These decisions, however, were often postponed and then made only after international financial markets had become seriously unsettled.

⁵ This asymmetry is explored in my forthcoming article.

Furthermore, three of the countries—Canada in 1970 and Germany and the Netherlands in 1971—decided to float their currencies rather than to choose a new par value. Hence, they chose an adjustment alternative in which they abandoned the commitment to maintain a par value, even if only on a temporary basis. Finally, the critical element in the entire par-value system was disturbed when, on August 20, 1971, the United States notified the Fund that it was no longer prepared to buy and sell gold freely for the settlement of international transactions and, in President Nixon's words, would "press for the necessary reforms to set up an urgently needed new monetary system" in which "American products will not be at a disadvantage because of unfair exchange rates."⁶ Thus, there had developed a situation in which, at best, needed adjustments in the policies of major trading countries were to be made once again in an atmosphere of financial crisis and, at worst, the continuity of the par-value system itself was in apparent jeopardy.

Concluding Observations

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

Even though these consultations often appear from newspaper reports to have a rather technical financial cast, it must be stressed that there are really no technical solutions to the underlying factors that have created strains in the world's payments mechanism in recent years, no

⁶ Address of President Nixon on Aug. 15, 1971, reproduced in the IMF *International Financial News Survey* (supp., Aug. 18, 1971, p. 258). Earlier, Hirsch and Higgins (1970) had estimated that the balance of revaluations and devaluations by the thirteen other industrial countries between 1959 and 1969 had produced an "effective appreciation" of the dollar against them of 4.7 per cent (p. 474 and Table 3, p. 473). This upward thrust in the dollar's competitive valuation came during a period when the United States was losing, and the other industrial countries as a group (excluding Britain) were gaining, reserve assets at an unsustainable rate. This devaluation bias against the dollar can be viewed against the Fund's effective multilateral surveillance concerning the policies of borrowing countries and its limited surveillance concerning those of surplus countries. This asymmetry as between international constraints on surplus and deficit countries is discussed in my review (1970, pp. 1218-1219) of the Fund's history and in the contribution of General Counsel Gold in Horsefield (1969, pp. 586-588).

matter how ingenious or elegant the various proposals have been. These strains often represent not merely technical inadequacies in the machinery of world finance but the fact that independent national interests are in conflict or that national economic priorities are not fully harmonized. Only through a process of reconciling many different sovereign interests is there hope that such disparities can be reduced.

It is a curiosity, in fact, that the late Dean Acheson should make an unfavorable comparison between what he has called the technician's complexities incorporated in the Fund's Articles of Agreement and what he regarded as the effective legal drafting of the charter prepared for the International Bank for Reconstruction and Development.⁷ For the Charter of the International Bank was designed to facilitate the kinds of lending transactions that are the ordinary business of commercial life all over the world. By contrast, within the technical verbiage of the Fund's Articles of Agreement was an unprecedented extension of international regulation and international law into national financial affairs. Member nations agreed to limit their unilateral right to determine the value of their currencies; instead they committed themselves "to consult the Fund on all proposed adjustments in their parities, and to accept the right of the Fund to concur or object to such proposals in all but certain specified cases" (IMF, 1970, p. 5).

It is precisely the fact that the exchange rate has now become a matter for international decision that raises so many difficult problems in international financial relationships. Because of these complications, in fact, economists are often tempted to break through these international commitments—hoping thereby to eliminate the noneconomic sources of financial disturbance—and to regain for each country a high degree of national autonomy in making exchange-rate decisions (for this aspect of the Bretton Woods structure, see Katz, 1970). But these recommendations have thus far found only scattered support outside professional circles. Countries have been anxious to retain the structure of the Bretton Woods arrangements because they have benefited so widely from the unprecedented postwar expansion in international trade and investment achieved under the par-value system. The modifications in exchange-rate practices thus far considered have been regarded merely as adaptations of, and not the supplanting of, the adjustable-peg variant of fixed rates.

The problem of short-term capital flows. Despite the recent attention focused on exchange-rate practices, events in 1971 demonstrated once

⁷ In his words, "As contrasted with the fund, whose charter was largely dictated by monetary experts and narrowly hedged about, the bank management could do anything it wanted to do" (1970, p. 83).

again the need for closer consultations on national economic policies—and not merely for agreements on international rules to achieve a greater, though limited and internationally controlled, exchange-rate flexibility. National stabilization programs aimed at a reconciliation of internal and external goals were threatened, both in the United States and in Germany, by unprecedented flows of volatile capital, provoked largely by cyclical disparities in interest rates, rather than by the disequilibrium in current or long-term capital transactions.

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

In fact, this process of financial integration now threatens the realization of what we have pointed to as the major *raison d'être* of the par-value system. For it must be recognized that international capital flows, even in response to minor interest-rate differentials, have become a most important source of disturbance in the world monetary system. The effects of gross disparities in the phasing of the business cycle, and hence in national monetary policies, are much intensified, because they can eventually set off doubts about the permanence of existing parities as well.

Three-pronged attempts to strengthen the par-value system. The authorities in the leading trading countries, accordingly, have been attempting to bring the Bretton Woods arrangements up to date in three critical areas:

1. Establishment of an appropriate structure of exchange rates that will remove the main sources of payments disequilibrium rampant in the 1960's.
2. Agreement upon improved, or at least additional, procedures for orderly changes in exchange rates as needed to improve adjustment performance in the current decade.
3. More effective control of the disruptive short-term private capital flows that have become so direct a threat to national autonomy in economic policy making in the recent past.

In addition to the efforts to achieve greater stability and more orderly processes of international adjustment, there are also likely to be decisions—made in an attempt to strengthen confidence and liquidity arrangements—that would affect the role of the dollar as an international

currency and of gold, and deliberations on proposals to stabilize reserve-asset holdings and to achieve a more orderly creation of reserve assets by the international community. The December 18, 1971, agreement on a general realignment of the parities of the major currencies represents an important first step in this process.

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

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

The case for the par-value system remains in theory, therefore, the same as it always has been. However, the experience in late 1971 points up some additional problems that are likely to occur under flexible exchange rates.

Continuing private capital movements, before and after the mid-1971 foreign-exchange disturbances, remind us that disruptive shifts of funds may also be a threat to orderly international monetary arrangements under conditions of systematic flexibility. To be sure, these capital movements have sometimes been closely associated with the "one-way" option that can occur under a system of pegged rates. But an emphasis upon this association would be misleading if it had the effect of obscuring the financial integration that has taken place among the major industrial countries over the past decade. These flows of funds reflect the development of banking facilities for the international transfer of funds of unprecedented efficiency and, in addition, the willingness of private entrepreneurs to make use of them in their own operations. These facilities have become so developed, in fact, as to raise a question about the possibility of maintaining orderly international monetary processes under contemporary conditions whether exchange rates are pegged or are allowed to float.

The controversies among the major trading countries in late 1971 over what has come to be called "dirty floating" are particularly im-

portant in revealing the wide range of measures governments have been prepared to introduce in order to hold down the rise in their currencies. Because of widespread concern to protect export sales abroad (and for negotiating reasons as well), the major countries intervened widely in exchange markets—both directly and through moral suasion, controls on market transactions, and multiple exchange-rate arrangements. In addition, there have been threats to introduce subsidies to exporters hurt by international developments and retaliatory restrictions on imports, both general and discriminatory in character.

In retrospect, it may be noted, Canada's experience with a floating rate since 1950—which is so often referred to by advocates of flexible rates—had not prepared us for our recent experience with “dirty floating.” It would appear, in fact, that systematic flexibility would create a wide range of problems related to international competitiveness and the maintenance of export markets that could be neglected when there was isolated flexibility in a single country like Canada. This recent experience will be particularly valuable if it leads economists to distinguish between the two cases and if it reminds them that competitive undervaluations, like the competitive depreciations of the 1930's, can be a major threat to orderly trade and financial arrangements under conditions of systematic flexibility.

Furthermore, the recent episode of “dirty floating” can be offered as evidence that agreement on multilateral rules would be necessary for a system of floating rates as well as for one of pegged rates.⁸ Even in the Canadian case, which has been so widely studied as an example of a market-determined exchange-rate policy, evidence that the Canadian authorities have had an exchange-rate target and an exchange-rate policy is found in the recent emphasis by Deputy Governor Lawson of the Bank of Canada that “the most important question for a government in respect of exchange policy is not should the exchange rate be ‘fixed’ or should it float, but what should the exchange rate be?” He added: “I am aware that some people seem to believe that if the exchange rate is determined

⁸ See, for example, the recent remarks of Fund Managing Director Schweitzer: “The view has been expressed by some that the difficulties that have confronted the international monetary system could be largely overcome if the determination of exchange rates were left to the free play of market forces. However, the external value of a country's currency exerts an important influence on its aggregate output and expenditure, as well as on the allocation of its resources. For this reason, national governments will not find it possible to avoid intervening in the foreign exchange market. But such intervention will, in turn, affect the exchange rates of other currencies and thereby other national economies. Rules must therefore be retained bearing on the exchange rate policies of national governments in order to safeguard the interests of all countries” (speech before the Economic and Social Council of the United Nations, Nov. 27, 1971, in *International Financial News Survey*, IMF, Nov. 3, 1971, p. 355).

in a free market without direct official intervention it will inevitably be the right rate, but this view seems to me to be a considerable over-simplification. A floating rate may be influenced indirectly in a variety of ways to make it float freely at quite different levels. A decision to float does not therefore offer an escape from the fundamental question—“what should the exchange rate be?”⁹ However, “what exchange rate is appropriate for a particular country at a particular time . . . involves a balance of conflicting considerations, some pointing to a higher rate and some to a lower. . . . Good exchange rate policy is thus a blend of economics and politics; it requires analysis of the costs and benefits of the exchange rates that are possible in the circumstances, and then a choice between them” (p. 12).

The exchange-rate policy the authorities decide upon must also be acceptable to the country’s trading partners. For, in Lawson’s words, “there is no escape from the fact that exchange rates are genuinely international and must be dealt with as such” and not “to think that each country’s exchange rate is its own business” (p. 12). As a result of the commitments accepted by the participating countries at the Bretton Woods Conference in 1944, in fact, the exchange rate acquired a dual character, becoming at the same time both a *market* and a *negotiated* price (Katz, 1970, p. 1219). If there is need for arrangements that would permit exchange rates to fluctuate enough to clear the exchange market in a more or less orderly fashion, there is also the need for orderly procedures for international consultation about exchange-rate decisions.

Because of the recognized international character of exchange-rate policy, therefore, it could in practice prove to be about as difficult to establish—and then to keep continuously under international surveillance—multilateral rules among trading partners when exchange rates are flexible as it would be when they are pegged. The par-value system can be thought of as a means of achieving controlled flexibility on the basis of internationally agreed-upon criteria and procedures. As the Fund’s report has recognized, the par-value system can accommodate many, though not all, of the proposals for greater flexibility—however varied the technical differences among the various proposals may be. But the continued functioning of the Bretton Woods arrangements in the

⁹ R. W. Lawson, “World Currency Problems,” remarks to the Economics Society of Alberta, Calgary, Feb. 17, 1972, pp. 11–12, mimeographed. See also the speech by Senior Deputy Governor G. K. Bouey before the Canadian Conference Board at Toronto on Feb. 11, 1972: “The pursuit of [an expansionary monetary policy by the Bank of Canada for virtually two years now] has involved, among other things, concern that the appreciation of the Canadian dollar in the exchange market did not hamper unduly the development of our export industries and those domestic industries which must compete with imports” (p. 1, mimeographed).

years ahead requires, in the final analysis, a willingness on the part of trading partners to compromise among national goals and an agreement among them on the criteria and procedures for varying exchange rates.

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¹ A list of the titles of Essays Nos. 1 through 60 is available from the Section, or consult the complete publications list in earlier essays.

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- * (1) Klaus Knorr and Gardner Patterson, eds., *A Critique of the Randall Commission Report*. (1954)
- * (2) Gardner Patterson and Edgar S. Furniss Jr., eds., *NATO: A Critical Appraisal*. (1957)
- (3) Fritz Machlup and Burton G. Malkiel, eds., *International Monetary Arrangements: The Problem of Choice*. Report on the Deliberations of an International Study Group of 32 Economists. (Aug. 1964) [\$1.00]







