



SPECIAL PAPERS IN INTERNATIONAL ECONOMICS

No. 6, JANUARY 1965

THE
"BAND" PROPOSAL:
THE LIMITS OF
PERMISSIBLE
EXCHANGE RATE
VARIATIONS

GEORGE N. HALM

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY • 1965

This is the sixth number in the series SPECIAL PAPERS IN INTERNATIONAL ECONOMICS.

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FRITZ MACHLUP, Director
International Finance Section

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PREFACE

The Joint Economic Committee recommended recently that "the United States, in consultation with other countries, should give consideration to broadening the limits of permissible exchange-rate variations."¹ In view of the fact that no official of the United States Government or of the Federal Reserve has been willing to discuss any form of greater exchange-rate flexibility, at least in public, and that such discussion was expressly excluded from the Ministerial Statement of the Group of Ten,² the Joint Economic Committee's suggestion constitutes a major breakthrough. It is to be hoped that the proposal to widen the band will be widely discussed in the near future, both in official and in academic circles, and that this discussion will contribute substantially to the solution of our international payments problem.

The band proposal is very old. Robert Torrens suggested as early as 1819 that the range between the so-called gold points should be widened. Since then the proposal has been repeated quite often, but it has only once been thoroughly discussed, in John Maynard Keynes' carefully reasoned recommendation "that the difference between a Central Bank's obligatory buying and selling prices should be made somewhat greater, say 2 per cent, so that there would be at least this difference between the gold points irrespective of actual costs of transporting gold."³

That the proposal has been neglected is not only due to the official lack of enthusiasm, noted above, but also to the fact that more extreme and more challenging plans have monopolized the theoretical discussion. Now, however, the time has come for a serious consideration of this recommendation, because it may offer possibilities for a constructive compromise between the more extreme theoretical positions ("fixed versus freely fluctuating exchange rates"), and also between the attitudes of economists and central bankers, who are still separated by an apparently unbridgeable gulf.

The present study seeks to contribute to the discussion of the band proposal in two ways: by a survey of the long but, in content, rather

¹ *The United States Balance of Payments*, 88th Congress, 2d Session, Senate Report No. 965, Washington, March 19, 1964.

² On the ground that "the Ministers and Governors agreed that the underlying structure of the present monetary system—based on fixed exchange rates and the established price of gold—has proven its value as the foundation for present and future arrangements." The Statement was issued August 10, 1964.

³ John Maynard Keynes, *A Treatise on Money*, Vol. II (New York: Harcourt, Brace and Company, 1930), chapter 36.

brief history of its different versions, and by studying the pros and cons of one particular version in somewhat greater detail. Of the many possible recommendations to widen the margin for exchange-rate variations, the combination of a wider band with a *permanent* parity is selected for full discussion. The assumption here is that greater exchange-rate fluctuations around an unalterably fixed parity can be substituted for the present adjustable-peg system, which is considered to be a bad compromise between rigidity and flexibility.

Technical details will be kept to a minimum because it is assumed that they will be worked out through practical experience, as central banks cooperate in managing the system. Monetary authorities may develop greater interest in a widened band as they learn to regard their operations in the foreign-exchange markets as a powerful tool in maintaining balance between external and internal equilibrium.

It need hardly be stated that the band proposal is not a panacea. It aims at demarcating one promising area for constructive compromise. The proposal would be compatible with other reform plans, such as the various proposals for the creation of reserve assets, and other suggestions in connection with our efforts to overcome the difficulties and dangers of the present key-currency system.

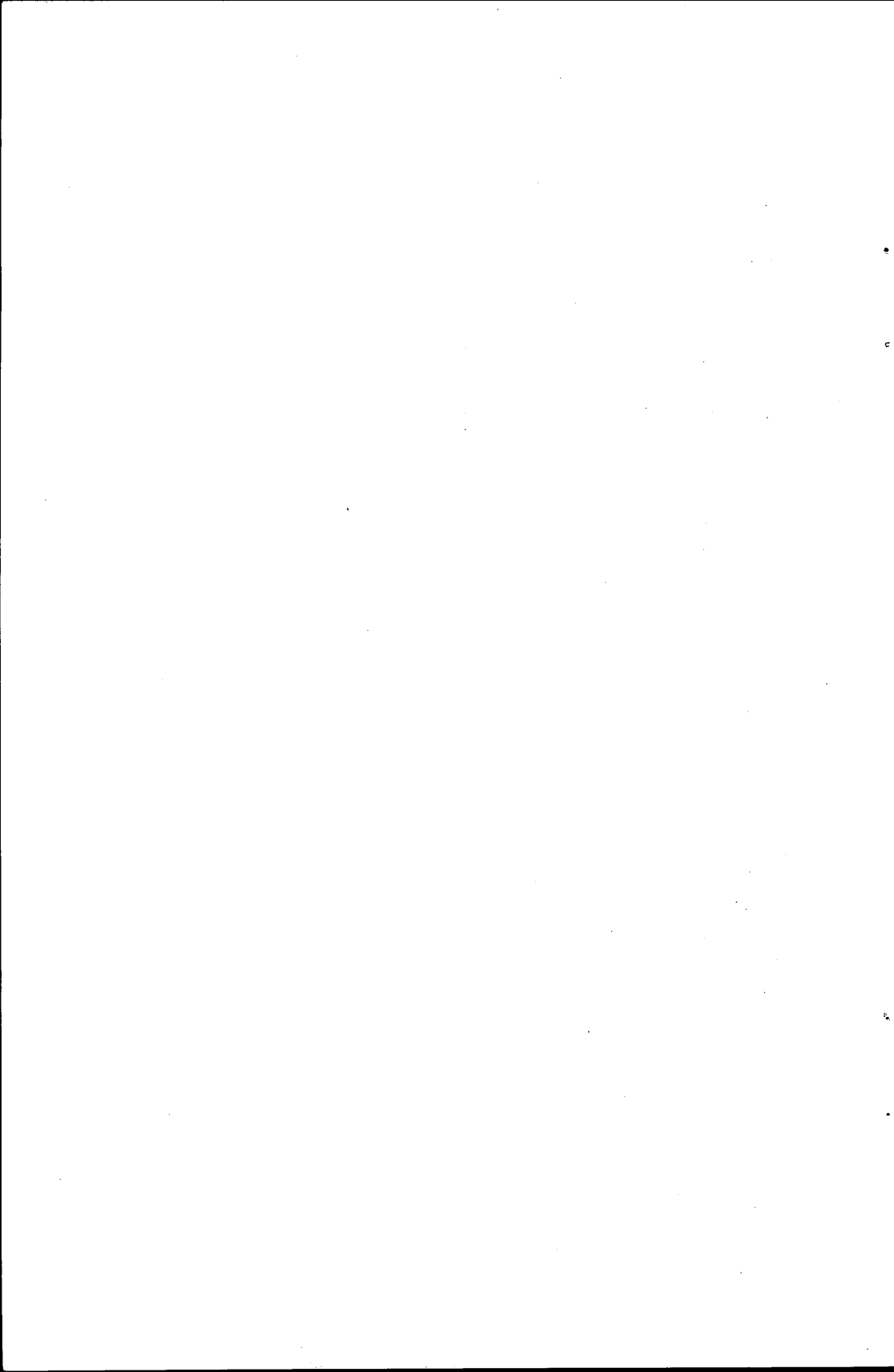
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I. Introduction

The Adjustable-Peg System

The monetary experts who participated in the great debate preceding the Bretton Woods Conference of 1944 were opposed to both permanently fixed and freely fluctuating exchange rates. The International Monetary Fund was a compromise which attempted to establish the principle of "managed flexibility" for the exchange rates of the member countries.

The argument against permanently fixed gold parities is well known. John Maynard Keynes objected to the gold standard on grounds that it confines the natural tendency of wages to rise beyond the limits set by the volume of money, and in doing so creates unemployment. The gold standard involves a financial policy which compels the *internal* value of the domestic currency to conform to an *external* value which is rigidly tied to a fixed quantity of gold.⁴ Keynes proposed that "instead of maintaining the principle that the internal value of a national currency should conform to a prescribed *de jure* external value," we should provide "that its external value should be altered if necessary so as to conform to whatever *de facto* internal value results from domestic policies."⁵ Since the International Monetary Fund has "to approve changes which will have this effect," Keynes felt that the Fund proposal was "the exact opposite of the gold standard."⁶

Those who reject a system with permanently fixed exchange rates still follow Keynes' argument that maintenance of exchange-rate rigidity may force a member country to abandon, or dangerously to curtail, its domestic employment and growth policies. A member country may, simultaneously, suffer from unemployment and inflation

⁴ Lord Keynes, "The Objective of International Price Stability," *Economic Journal* (June-September, 1943), pp. 185-187. He added that "this complaint may be just as valid against a new standard which aims at providing the quantity of money appropriate to stable prices."

⁵ Speech by Lord Keynes on the International Monetary Fund Debate, House of Lords, May 23, 1944. Reprinted in Seymour E. Harris (ed.), *The New Economics: Keynes' Influence on Theory and Public Policy* (New York: Alfred A. Knopf, 1948), pp. 369-379.

⁶ *Ibid.* It is interesting to note that John H. Williams, on the other hand, considered the new currency proposals from the very beginning as "essentially variants of the gold standard system." *Post-War Monetary Plans and Other Essays* (New York: Alfred A. Knopf, 1945), p. 11.

if monopolistic market forces forbid downward cost and price adjustments. If the inflation is greater than inflations in other countries, a balance-of-payments deficit will be created. Elimination of this deficit, at fixed exchange rates, will require contractionist domestic monetary policies and will lower the employment level still further.

A combination of permanently fixed exchange rates and satisfactory employment levels requires sufficiently competitive market conditions to permit the use of restraining monetary policies without creation of mass unemployment. But sufficient price elasticity downward may no longer exist in modern market economies.

In spite of the rejection of *permanently* fixed exchange rates, there existed, at the time, a general aversion to freely fluctuating exchange rates. The nearly complete silence of proponents of this form of flexibility excluded the system from discussion.⁷ Besides, freely fluctuating exchange rates would have been ruled out anyhow, as it was generally assumed that they would expose the system to competitive exchange depreciation, the much-feared evil of the 'thirties.

The International Monetary Fund Agreement of 1944 was a compromise between the longing for a free hand in domestic economic policies and an equally strong desire for exchange-rate stability. Therefore, it was decided that the currencies of the members would at all times be tied firmly to gold, but that the International Monetary Fund "should concur in a proposed change . . . if it is satisfied that the change is necessary to correct a fundamental disequilibrium."⁸

Twenty years of experience have shown that this compromise between rigidity and flexibility was not quite as successful as the experts had hoped. However, the adjustable-peg formula permitted at the time a compromise without which the creation of the International Monetary Fund would have been impossible.

⁷ The only exception, to the knowledge of the present writer, was Mr. Benson, who complained that the new plans did not propose relatively stable exchange rates nor reasonably stable exchange rates but fixed exchange rates which could only be altered by permission. He foresaw the main difficulty of the adjustable-peg system, viz., that a system of orderly devaluation and upvaluation would be exposed to disturbing speculative movements since nobody will want to buy the goods of a country for which a devaluation is impending until the devaluation has taken place. *Parliamentary Debates on an International Clearing Union*, House of Commons, May 12th, 1943, and House of Lords, May 18th, 1943. British Information Services, New York, July 1943, pp. 59-63.

⁸ *Articles of Agreement. International Monetary Fund and International Bank for Reconstruction and Development*. United Nations Monetary and Financial Conference, Bretton Woods, N.H., July 1 to 22 (Washington: United States Treasury, 1944), Art. IV, Sec. 5 (f).

Those who defended the Keynesian position that the new institution "should not wander from the international *terrain*" and "should be limited to recommendations, or, at the most, to imposing conditions for the more extended enjoyment of the facilities which the institution offers"⁹ made *permanently* fixed exchange rates impossible because they insisted on the elimination of that degree of harmonization of national economic policies without which a system of permanently fixed rates cannot work. Yet fixed rates which are not permanently fixed lose much of their alleged advantage as a firm foundation for the international flow of commodities, services, and loanable funds.

This structural weakness of the International Monetary Fund was not critical at first because of the prevalence of exchange controls. With the introduction of convertibility of the currencies of the more advanced industrial countries, however, overvaluations and undervaluations have become more dangerous for the international payments system. It is now rather generally agreed that the adjustable-peg system is exposed to disequilibrating speculation, unless the International Monetary Fund succeeds better than in the past in integrating the domestic economic policies of its members.

Assuming fixed rates of exchange and inadequate harmonization, the adjustable-peg system cannot work well. Maintenance of convertibility of "wrong" rates of exchange requires flows of international reserves from deficit to surplus countries. These flows advertise the deviation of the pegged rate from the equilibrium rate and may herald the approach of the day when the peg will be changed. This situation constitutes an invitation to sell overvalued currencies and precipitates the impending devaluation.

The adjustable-peg system, by delaying price variations in the foreign-exchange market, exposes the members' economies to sudden shocks which could have been avoided either by gradual changes of the exchange rates or by gradual cost and price adjustments.

These shocks, and the disequilibrating capital movements which are induced by impending peg adjustments, have led to an attitude on the part of the International Monetary Fund and many of its members which now makes exchange-rate adjustments very rare events. Thus we find ourselves back in a system with more or less permanently fixed exchange rates—the very system which we wanted to abolish at Bretton Woods.

⁹ *Proposals for an International Clearing Union* (London: H.M. Stationery Office, Cmd. 6437, April, 1943), Preface.

The adjustable-peg system, as proposed in Keynes' International Clearing Union, would have been even more objectionable than the Fund's. The *Keynes Plan* suggested that alterations of the exchange value of the member currencies be made part of the "internal stabilizing mechanism" of the system. For instance, if a member's "deficit balance has exceeded a *quarter* of its quota on the average of at least two years, it shall be entitled to reduce the value of its currency in terms of *bancor* provided that the reduction shall not exceed 5 percent without the consent of the Governing Board" and the Board, as a condition of allowing a member State to increase its debit balance in excess of *half* of its quota, may even *require* "a stated reduction in the value of the member's currency."¹⁰

The *Keynes Plan* would have made it easy for speculators to predict impending devaluations. For the International Monetary Fund's concept of "fundamental disequilibrium" we can at least say that it is very difficult to interpret while "a publicly recognized and recognizable criterion for exchange adjustment has . . . the disadvantage that it may act as a signal for speculative capital transfers in anticipation of changes in exchange rates."¹¹

Keynes' proposal cannot be defended on the ground that it implied more *frequent* adjustments of exchange rates and that frequent changes would be a good substitute for flexible exchange rates. His reference to a disequilibrium of two years' duration shows that he was suggesting a system that would have been made virtually unworkable through hot-money movements.

* * * *

The version of the proposal to broaden the limits of permissible exchange-rate variations, which is to be considered in the present study, can be regarded as a substitute for the adjustable-peg system. It seeks to do what the experts of Bretton Woods wanted to accomplish, viz., to find a compromise between fixed and flexible exchange rates. It suggests a permanent, built-in flexibility within a broadened band in order to avoid the need for an abrupt change of the peg. Should the permitted exchange-rate variations, however, fail to bring

¹⁰ *Proposals for an International Clearing Union* (London: H.M. Stationery Office, Cmd. 6437, April, 1943), II, 6 (8). Bancor was to be "international bank money . . . fixed (but not unalterably) in terms of gold and accepted by . . . members of the Union for purposes of settling international balances" (I, 4).

¹¹ Ragnar Nurkse, *Conditions of International Monetary Equilibrium*, Essays in International Finance, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1945), p. 8.

about the needed adjustments and should the monetary authorities be unable to keep their domestic policies within the range permitted by the broadened band, the band would have to be moved. Such a "movable band" system would, therefore, remain exposed to some of the shortcomings of the adjustable peg.

The Key-Currency System

Fixed exchange rates can be combined with deviations of national economic policies if the members of the international payments system have large reserves of gold or foreign exchange at their disposal. What amounts will be adequate will depend in the main on the degree of integration of the economic policies of the members of the system, i.e., on the efficacy of the adjustment mechanism. Furthermore, the need for the holding of official reserves will be partially determined by private capital movements that are characteristic of the payments system in question. If these private capital flows tend to be equilibrating, fewer official reserves need be held. If the system is prone to suffer from disequilibrating speculative movements, the demand for liquid balances or gold may become dangerously great. A system of freely fluctuating exchange rates, on the other hand, needs no official reserves whatever, since international payments equilibrium is established automatically, at all times, through instant exchange-rate variations.

We see that a system with a broadened margin of permissible exchange-rate variations would reduce the demand for international liquidity reserves if it succeeded in promoting external equilibrium and in harnessing equilibrating (and preventing disequilibrating) private capital movements. But it could not claim to get along without official reserves, as these would be needed at the upper support point and for any desired government selling activities within the band.

Proponents of a fixed-rate system differ widely as to the amount of official reserves that they consider adequate. Some suggest that only gold reserves should be held, while others would be extremely liberal in the degree of freedom which they would purchase through very large reserves.¹² This difference within the fixed-rate camp is often

¹² Egon Sohmen, an advocate of freely fluctuating but stable exchange rates, states correctly "that the call for ever bigger international funds, stand-by agreements and all the rest, for bridging balance-of-payments deficits is somewhat out of tune with the aim of achieving a maximum of monetary integration." Egon Sohmen, *International Monetary Problems and the Foreign Exchanges*, Special

much greater than the disagreement between some proponents of fixed and of flexible exchange rates.

Within the camp of the advocates of freely fluctuating exchange rates we find the same diversity of opinion. Some writers seem to come close to the extreme position that the very fact that no official reserves need be held frees the domestic authorities from any consideration of the balance-of-payments effects of their actions, while others are of the opinion that the exchange rates, though freely fluctuating, ought to be as stable as possible.

Already at Bretton Woods it was evident that astonishing differences of opinion existed as to the amounts of international reserves that would be adequate.¹³ Keynes' Clearing Union was unacceptable to the United States because up to 24 billion dollars of credit extension *on the initiative of the deficit countries* exceeded by far what she considered safe from the standpoint of domestic monetary stability.¹⁴ The resources of the International Monetary Fund, on the other hand, proved to be far too small. One main reason was that the Fund did not have the power to coerce its members into such monetary discipline and harmonization as would have enabled them to get along on the modest additional reserves that the new institution provided. However, on her own terms, the United States extended aid that exceeded

Papers in International Economics, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1963), p. 25.

¹³ The *Keynes Plan* suggested quotas of about 36 billion dollars for the world as a whole, while the corresponding figure for the International Monetary Fund was about 11 billion dollars. However, these two figures were not even comparable, owing to the different structures of the proposed institutions. In the International Monetary Fund the potential surplus countries were obliged to extend credit to the amount of their own quotas (which, for the United States, was 2.75 billion dollars). In the Clearing Union, on the other hand, a potential surplus country agreed to accept payment of balances from other members in the form of bancor credits with the Union, the amount being limited only by the sum of the debits of the deficit countries. Under the extreme conditions that prevailed after World War II, this could have meant a potential expansion of credits by the United States of up to 24 billion dollars, though correctives would have come into play before 8 billion dollars would have been reached. See Joan Robinson, "The International Currency Proposals," *Economic Journal*, Vol. LIII (June-September, 1943), p. 165. Reprinted in Seymour E. Harris (ed.), *The New Economics* (New York: Alfred A. Knopf, Inc., 1948).

¹⁴ Keynes defended the absence of a rigid maximum for credit balances by arguing that this absence would not impose on a potential surplus country an unlimited liability outside its own control, as it could always, by its own policies, reduce its surplus. *Proposals for an International Clearing Union* (London: H.M. Stationery Office, Cmd. 6437, April, 1943), III, 8. This is only partly true, because inflationist policies in deficit countries could exert stronger inflationary pressure on the surplus countries than the latter might care to accept for the sake of external equilibrium.

what she had not been willing to promise unconditionally under the *Keynes Plan*, and thus became the major key-currency country.

Many observers hold that the present key-currency system is dangerous and may lead to a collapse of the international payments system similar to, or worse than, the breakdown of the gold-exchange standard during the inter-war years.¹⁵ The argument is impressive. If gold stock and gold production are inadequate to supply the needed growth of international reserves; if the supply of dollar balances as international reserve must rest on a permanent balance-of-payments deficit of the United States; if a permanent deficit lowers the confidence in the dollar; and if the confidence in dollar convertibility, at a fixed gold parity, is further lowered by the decrease in United States gold holdings (in comparison with the permanent growth of gold-convertible foreign-held dollar balances)—then the system is bound to collapse unless it is speedily consolidated or liquidated.

Fortunately, the argument is not entirely convincing for three reasons. (1) It is wrong to assume that the demand for international reserves must continuously increase. Should we succeed in building greater flexibility into the international payments system, and in improving thereby the adjustment mechanism, the demand for reserves may be greatly decreased. (2) It is erroneous to conclude that confidence in the key currency is nothing but a function of the key currency's net reserve position. (3) The key-currency system has features which distinguish it favorably from the old gold-exchange standard.¹⁶

Another criticism of the key-currency system concerns its effect on the domestic economic policies of the key-currency country. Some observers point out that the key-currency country is put into the seemingly pleasant but actually rather demoralizing position of not having to pay for its deficits, as its debts are held as international reserves by other countries. Thus it is said that the United States has been prevented from carrying out sound monetary policies which would have been obligatory had the deficit been financed through a lowering of United States gold reserves.¹⁷

¹⁵ The most famous statement of this thesis is Robert Triffin's in his *Gold and the Dollar Crisis* (New Haven: Yale University Press, 1960), pp. 8-9.

¹⁶ These features concern, among others, the very existence of the International Monetary Fund as an international forum; the responsible leadership of the United States after World War II in contrast to her inconsistent behavior in the 'thirties; the general maintenance of higher levels of employment; the elimination of most beggar-my-neighbor policies; and the increase in international monetary cooperation.

¹⁷ See Jacques Rueff, "Gold Exchange Standard a Danger to the West," *The*

Against this argument can be held the opinion of those who feel that the key-currency country does not enjoy enough freedom in its internal policies. The United States is deprived of the safety valve which the Bretton Woods system offers to member countries in severe external disequilibrium, since as a key-currency country she cannot devalue the dollar. Neither can she force surplus countries to shoulder their share in the adjustment process if they should decide not to expand their domestic monetary circulation.¹⁸

Here we meet again with the fundamental question which characterizes the whole international-payments discussion: should there be more rather than less freedom for domestic economic policies? Agreement exists only to the extent that both schools of thought feel that the key-currency system should not continue in its present form.

* * * *

What contribution to the solution of the key-currency problem can we expect from a proposal that the margin of permissible exchange-rate variations should be widened? The present study will attempt to show that the following favorable effects could materialize: (1) the total of needed reserves could be decreased and the need for additional key-currency balances reduced; (2) greater variations of exchange rates could contribute to the adjustment mechanism without forcing deflationary policies on countries in deficit; and (3) if the system could successfully control private capital movements, it could eliminate the greatest and most dangerous source of disequilibrium in the United States balance of payments.

The band proposal is not put forward as a panacea. No international payments system can create external equilibrium if its members refuse to carry out necessary adjustment measures. Nor can it be expected that, for instance, transfers of huge unilateral payments can be made to materialize instantly in export surpluses. Nevertheless, as a workable compromise between international monetary discipline and some freedom for domestic economic policies, the proposal should contribute substantially to a solution of our problem.

Times (London), June 27-29, 1961; and Michael A. Heilperin, "The Case for Going Back to Gold," *Fortune Magazine*, Vol. 66 (September, 1962). Both articles are reprinted in Herbert G. Grubel (ed.), *World Monetary Reform* (Stanford, Cal.: Stanford University Press, 1963), pp. 320-342.

¹⁸ See George N. Halm, "Special Problems of a Key-Currency in Balance-of-Payments Deficit" in *Factors Affecting the United States Balance of Payments*, Compilation of Studies Prepared for the Subcommittee on International Exchange

It can be argued that the present situation is too precarious to permit the introduction of a system which would allow greater variations of the value of the key-currency unit. Our answer will depend on how broad the margin is to be, how closely the central banks cooperate, and how successful the new arrangement will be in controlling disequilibrating capital movements.

It must also be remembered that any major change of an established system involves some dangers. Take as an example the seemingly most conservative of the proposed plans, the introduction of a semi-automatic gold standard through a general upvaluation of gold. The plan seems to solve the key-currency problem through the liquidation of dollar and sterling balances out of gold profits. But is it not naive to assume that the holders of key-currency balances will quietly wait for a devaluation of these balances in terms of gold? Thus, if the introduction of a system of freely fluctuating exchange rates is at the moment out of the question, so is a general increase in the price of gold. It is at least arguable that the introduction of a broadened band around existing parities could be handled so carefully and gently that it would not upset the present international payments system. In fact, if flexibility through a broadened band could replace the pseudo-flexibility through peg adjustments, confidence would be strengthened rather than diminished.

Fixed vs. Flexible Exchange Rates

The proposal to broaden the band of permissible exchange-rate variations is intended as a compromise between fixed and flexible exchange rates, a better compromise than the existing adjustable-peg system.

Ideally, the proposed compromise should combine the strong features of both fixed and flexible rates and should avoid their weaknesses. To find out what these advantages and disadvantages are, we must briefly survey the case for and against fixed, as compared with flexible, exchange rates.

A system of fixed exchange rates is recommended on the following grounds.

(1) Only fixed rates, we are told, provide a firm foundation for international trade and for desirable international movements of

and Payments. Joint Economic Committee, 87th Congress, 2d Session (Washington, 1962), Part 7, pp. 541-561.

capital. Even though international transactions always concern at least two national currency units whose purchasing powers do not always change in the same degree or even in the same direction, there exists the almost universal desire to make the foreign-exchange rate resemble the domestic currency unit, by imparting to it absolute price stability in terms of *both* national currency units by fixing the rate of exchange, for instance, by tying both currencies to gold.

(2) It is considered an advantage rather than a disadvantage that these fixed rates can be maintained, in the long run, only under the condition that the countries' monetary policies are harmonized. When combined with convertibility and limited foreign-exchange reserves, fixed exchange rates *force* the national monetary authorities to integrate their policies. Inflation in any country, worse than inflation in the rest of the world, and maintenance of the inflation-country's exchange rate are mutually exclusive.

(3) Fixed exchange rates supposedly make it relatively easy to see which course the monetary authorities will follow. The central banks must adjust their bank rates so as to bring about balance-of-payments equilibrium. "Cheap-money" policies are ruled out and interest rates are determined objectively, we are told, and not through political pressure to accommodate price and wage increases. Monopolistic forces and inflationist trends, therefore, can best be stopped by a monetary policy which derives its authority from the fact that external equilibrium *must* be achieved at fixed exchange rates and without exchange control.

(4) Last but not least, fixed exchange rates supposedly eliminate the danger of competitive exchange depreciation. It was the rejection of competitive exchange depreciation that led to the unanimous approval of fixed, only conditionally alterable, exchange rates at Bretton Woods.

Much of the argument for fixed exchange rates loses force as soon as adjustments of these rates are permitted, even though these changes are supervised by an international organization and are supposed to occur only in cases of so-called fundamental disequilibrium. If those who make inflationary mistakes can be bailed out by subsequent devaluation, the argument for fixed exchange rates has lost its cogency.

The belief that the facts of economic and political life demand a system which is *less* rigid than a system of *permanently* fixed rates was expressed in the Bretton Woods compromise which created the

adjustable-peg system. Since we have already seen that this system has the shortcoming of depriving the international payments system of its tautness, of leading to disequilibrating speculation, and of administering the needed adjustments shockwise rather than smoothly, we must look for a better compromise between discipline and freedom.

For this purpose we must first investigate a system of freely fluctuating exchange rates, the system which the experts at Bretton Woods refused even to consider. Much can be said for such a system. But even if theoretical considerations should lead us to the conclusion that a system of freely fluctuating exchange rates would be preferable to a system of fixed or adjustable rates, we might still have to settle for a compromise if freely fluctuating exchange rates are flatly rejected by central bankers. If the present attitude in the International Monetary Fund is indicative, a system with freely fluctuating exchange rates still meets with the same entirely negative response as at the time of Bretton Woods, in spite of the interesting fact that an ever increasing number of economists now favors some form of exchange-rate flexibility.¹⁹

The proponents of exchange-rate flexibility consider it unnatural that currency units of different nations should be tied to one another at fixed rates, e.g., through gold parities. The exchange rate is a link between two national price systems and should be expected to vary roughly with the ratio of change of domestic purchasing powers of the national currencies.²⁰ The exchange rate should be a market price. To fix this price when market conditions change is a violation of one of the most basic working principles of the market economy. Exchange-rate variations would tend to bring about balance-of-payments equilibrium, while fixed rates lead to disequilibrium when they differ from what the market rates would be under given demand and supply conditions. To correct this disequilibrium, interest rates must be raised in the deficit countries and lowered in the surplus countries.

The advocates of flexible exchange rates contend that the adjustment

¹⁹ For a listing of economists favoring a system of exchange-rate flexibility, see Fritz Machlup, *Plans for Reform of the International Monetary System*. Special Papers in International Economics, No. 3 (Princeton, N.J.: International Finance Section, Princeton University, March 1964), pp. 79-81.

²⁰ The Bullion Report stated as early as 1810: "In the event of the prices of commodities being raised in one country by an augmentation of its circulating medium, while no similar augmentation in the circulating medium of the neighboring country has led to a similar rise in prices, the currencies of the two countries will no longer continue to bear the same relative value to each other as before. The exchange will be computed between these two countries to the disadvantage of the former."

mechanism under fixed rates is indirect, slow, roundabout, and artificial. Indirect and slow, because a change of the exchange rate would have directly and instantly changed the prices of all commodities in terms of the other country's currency unit. Roundabout and artificial, because the system first *fixes* one strategic price, the rate of exchange, only to have to *alter* another and even more strategic price, the rate of interest, and through the rate of interest the whole price level of the country.

The advocates of exchange-rate flexibility want to release the rate of interest from the task of having to be primarily responsible for the country's balance of payments. This task may conflict with the desire to maintain a relatively low bank rate in order to achieve a high level of employment, or a high bank rate in order to combat domestic inflation.

Thus it is argued that flexible exchange rates furnish the authorities with better tools to carry out the assignment of maintaining both external and internal equilibrium.²¹

When fixed exchange rates are maintained, the monetary authority may not be able to choose the rate of interest best designed to reach a high level of employment. Nor can fiscal policy solve the dilemma that fixed exchange rates create. If fiscal policy is to include deficit spending, it is not at all sure that we can make fiscal policy responsible for internal, and monetary policy for external equilibrium. Why not use flexible exchange rates for maintenance of the external balance and both monetary and fiscal policy predominantly for domestic stability and full employment? Then we would not have to make the often abortive attempt of using monetary and fiscal policies at cross purposes.²²

²¹ Ragnar Nurkse defined internal equilibrium as "a level of national income such that there is neither general unemployment nor an inflationary tendency for prices to rise" and external equilibrium as "a balance of payments that maintains itself without the persistent need for monetary stopgaps." Ragnar Nurkse, "Domestic and International Equilibrium," in Seymour E. Harris (ed.), *The New Economics* (New York: Alfred A. Knopf, 1948), p. 272. It is obvious that perfect internal equilibrium, as defined by Nurkse, cannot be achieved in the real world of today. Perfect monetary stability (whatever that may mean) might be achievable only at the cost of some unemployment. In other words, the level of income that avoids general unemployment may easily differ from the level that avoids an inflationary tendency of prices to rise.

²² Egon Sohmen, however, goes too far when he suggests that the introduction of flexible rates would strengthen domestic monetary policies to such an extent that we could then dispense with fiscal policies. Sohmen's argument rules out all fiscal-policy conclusions that had to be drawn from Keynes' *General Theory* and applied to a *closed* economy. Egon Sohmen, *International Monetary Problems and*

As far as the danger of competitive exchange depreciation is concerned, the advocates of exchange-rate flexibility argue that the monetary authorities would not misuse their power even if they should intervene in the foreign-exchange market. Besides, competitive undervaluation is more likely to exist under fixed exchange rates. Surplus countries can always compensate for the domestic monetary expansion which would otherwise be the automatic result of official purchases of foreign exchange at the lower support point. But if the surplus country prevents a domestic monetary expansion, its currency remains undervalued and the balance-of-payments surplus continues to grow to the detriment of the deficit country, which now has to shoulder a double adjustment burden. An uninterrupted loss of reserves forces it into contraction. Competitive undervaluation, therefore, can be just bad as competitive depreciation.

If the representatives of surplus countries claim that they are forced to protect themselves against "imported inflation," the proponents of flexible rates answer that the embarrassing inflationary pressures would not have arisen had the surplus currency been permitted to appreciate. Again we see that a system of fixed exchange rates may lead to results which are detrimental to both internal and external equilibrium.

The case for flexibility is dangerously overstated if we argue that the freely fluctuating exchange rates would maintain external equilibrium *no matter what domestic policies the trading countries follow*.²³ Continuous inflationary expansion in a member country would lead to capital flight, to a steadily rising demand for foreign exchange, and to exchange depreciation at an accelerated rate. However, this is not an argument against exchange-rate flexibility in normal times and assuming a normal degree of harmonization of the economic policies of the members. Besides, we have seen already that many advocates of fixed exchange rates ask for a very high degree of freedom for domestic policies and, accordingly, for enormous amounts of international reserves. There are extremists in both camps.

* * * *

The contrast between fixed and flexible rates of exchange is greatest when we compare *rigidly* and *permanently* fixed with *freely* fluctuating

the Foreign Exchanges. Special Papers in International Economics, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1963).

²³ "The single most potent objection to flexible rates is undoubtedly the argument that they might encourage undisciplined policies which could prove to be disruptive over the long run." Egon Sohmen, *op.cit.*, p. 8.

rates. In a compromise plan we can reduce the distance between these positions. Exchange rates need not be *rigidly* fixed; they can be permitted to vary within a certain range; and they need not be *permanently* fixed but can be subject to change under special circumstances. The exchange rates of the member currencies in the International Monetary Fund, for instance, are permitted to fluctuate moderately and can be changed under conditions of fundamental disequilibrium.²⁴ Similarly, exchange-rate flexibility need not mean freely fluctuating exchange rates. In a system with freely fluctuating exchange rates the national authorities would never intervene in the exchange markets and would never need, and never accumulate, any foreign-exchange reserves. If the monetary authorities are permitted to intervene in the foreign-exchange markets we would have a system of *managed flexibility*. The flexibility would be *limited* if the exchange rates were permitted to fluctuate only within a predetermined range, fluctuations beyond the limits of this range being prevented by compensating official sales and purchases of foreign exchange or gold. Within the limits the system could be managed or unmanaged.

We shall now turn to these compromise positions between rigidly and permanently fixed and freely fluctuating exchange rates. First, different possibilities will be listed; then, one version of the band proposal will be discussed in greater detail.

²⁴ *Articles of Agreement. International Monetary Fund* (Washington: United States Treasury, 1944), Art. IV, Sec. 3 and Sec. 5 (f).

II. The "Band" Proposal

Different Versions of the Proposal

We can arrange various proposals to deal with the international monetary system along a continuum of increasing flexibility (or diminishing rigidity), including different versions of the band proposal.

(1) One extreme is the setting of rigidly fixed parities which are not to be changed under any circumstances. No spread around the par value is permitted (the so-called gold points are abolished) and it is clearly understood and believed that the fixed parities will never need adjustment. This system would require either a maximum of international liquidity reserves or a maximum of international integration, or any viable combination of the two.

(2) The exchange rates can be rigidly fixed, but adjustments can be permitted. Again, the exchange rates may not move away from parity, but they may be adjusted once in a while when international cooperation or international liquidity reserves prove insufficient to permit maintenance of free convertibility at rigid rates. One could call this arrangement "step-ladder flexibility."

(3) The exchange rates are permitted to fluctuate within the so-called gold points; adjustments of parities, however, are ruled out. This was the case of the gold-standard mechanism. The spread between the gold points was equal to double the cost of transferring gold from one country to another.

(4) Small fluctuations around parity are combined with the possibility of parity or "peg" adjustments under special circumstances, as at present under the International Monetary Fund Agreement. The permitted spread is now the result of a prescribed maximum margin above and below par value for transactions in gold, and adjustments of the peg by more than 10 per cent are permitted only in cases of "fundamental disequilibrium."

(5) The band for permissible exchange-rate variations can be broadened by increasing the "prescribed margin," i.e., by raising the selling and lowering the purchase price of gold or foreign exchange. However, the parity itself is *not* to be changed and the monetary authorities must accordingly avoid fundamental disequilibria. The elasticity provided by the broadened band for exchange-rate variations replaces parity adjustments.

(6) The broadening of the band can be combined with parity adjustments. When exchange-rate variations within prescribed limits cannot achieve long-run equilibrium, i.e., when the exchange rates get "stuck" at the upper or lower support points, the parity, and with the parity the whole band, is moved. This is the system of the "movable band."²⁵

(7) Permissible exchange-rate variations within fixed support points, as in combinations (3) to (6), may be completely free in the sense that the monetary authorities do not buy or sell foreign exchange before the support points are reached, i.e., do not influence the exchange rates as long as they stay within the limits. The system implies, however, that the monetary authorities stand ready to maintain an "unlimited" supply at the upper support point and an "unlimited" demand at the lower support point.

(8) The monetary authorities do not only maintain perfectly elastic supply and demand conditions at the support points but feel free to influence the exchange rates at any time even within these limits through their buying and selling operations. The exchange market remains free from exchange control but not free in the sense of being exposed only to private market forces.

(9) The monetary authorities can either announce their support points or leave private speculation in the dark as to their intentions; they can announce official buying and selling prices closer to par within the official limits; or they can widen the band as earlier steps in this direction prove successful. Finally, they may influence the market in day-to-day transactions without the intention of maintaining predetermined limits.

(10) The opposite of the case of rigidly and permanently fixed exchange rates is the case of freely fluctuating rates without support points and without any attempt by monetary authorities to influence the rates. Since the authorities abstain completely from buying and selling operations in the foreign-exchange markets, they do not acquire or use foreign-exchange reserves. It would be wrong, however, to equate this system with one of excessively wide exchange-rate fluctuations. Close integration of national economic policies could lead to very stable exchange rates.

Our list could easily be lengthened, e.g., by applying certain com-

²⁵ It is better not to call it the system of the "adjustable band," because this term could as well, or better, refer to changes of the width of the band at stable parities—which would be a totally different proposition.

binations to the members of a group of countries in which close monetary integration is practiced and other combinations or versions to their relationships with other groups.

Since we can argue that the details of a system which operates with a broadened band should be worked out as we gain practical experience, there remains only one main choice concerning the various versions of the band proposal—we must decide whether we want to see in it a substitute for the adjustable-peg system or simply a new version of the latter, i.e., a “movable-band” system.

The present paper proposes that a broadened band should *replace* the adjustable peg.

Basic Principles and Operations

The proposal to broaden the band of permissible exchange-rate variations, but to maintain fixed parities, seeks to retain some of the discipline which can be expected of a system of permanently fixed exchange rates, and some of the greater freedom and the smoother adjustment process which can be secured by flexible exchange rates. Limited exchange-rate variations are to be substituted for discontinuous alterations of the peg, because the latter tend to soften the discipline of fixed rates and to replace smooth adjustments of market prices by long overdue and abrupt changes, which in turn are the breeding ground for the worst form of speculation.

The basic idea is old and simple. The gold or support points are pushed apart by raising the selling and by lowering the purchase price of gold (or of an international monetary unit such as *bancor*). At the support points demand and supply become perfectly elastic, because the monetary authority of each country stands ready to buy and sell gold, or foreign exchange, in unlimited amounts. The exchange rate cannot rise above or fall below these limits. When the limits are reached, foreign exchange or gold reserves are decreased or increased until external equilibrium is reestablished.

In the old gold-standard mechanism with rigid gold parities, the width of the band was determined by the cost of transporting gold from one country to another. Even at rigidly fixed parities, therefore, there existed a narrow ribbon within which exchange rates were permitted to move. Where buying and selling prices of gold differed, the double transportation cost, added to this margin, would determine the gold points.

In what follows we assume that the band is the same, irrespective of the cost of gold transportation. We agree with H. L. Puxley's statement that it would be "anomalous that a smaller fluctuation in Anglo-French exchange rates should cause gold to flow between the two countries than would be necessary to prompt a movement of gold between either of the countries and the United States" simply because the transportation cost of gold in one case is smaller than in the other. "If . . . the larger interval between the gold points of the sterling-dollar exchange at the same time affords useful protection to the gold reserves of both England and the United States, there is no logical reason why the gold reserves of France and England should be denied similar protection with respect to each other." Puxley proposed a broadened band in which the transportation charges have become uniform.²⁶ Technically this could be achieved easily, for instance, by the practical elimination of transportation charges as price-determining factors through the mutual holding of reserve deposits of gold (earmarking).

Whether central banks or other government agencies should influence exchange rates within the band is an open question. To leave exchange-rate variations entirely to free market forces would have the advantage of simplicity and automaticity. The monetary authorities would abstain from sales or purchases until the support points were reached. At these points, however, the transactions of the public would be met unflinchingly by compensating official transactions.

It is probable that exchange-rate variations without government intervention would exert an equilibrating influence and that the system would enjoy a built-in stabilizer. However, as long as we do not know whether the band should permit small or large exchange-rate variations, we cannot argue too convincingly that, say, a 5-per-cent margin would be just right, both for the encouragement of equilibrating (and the prevention of disequilibrating) capital movements and also for the speedy adjustment of the trade balance. In the latter case we know too little about price elasticities of demand and supply, and in the former we deal with psychological attitudes which are not always predictable. Even though we can show that exchange-rate variations within the band will work in the right direction, we cannot be sure that the dosage will always be best.

Most of the band proposals, therefore, advocate not only *limited*

²⁶ H. L. Puxley, *A Critique of the Gold Standard* (New York: Harper & Brothers, Publishers, 1935), pp. 200-201.

but also *managed* flexibility. The exchange-rate variations inside the band do not just become another price fluctuation, they may become a policy instrument in the hands of the monetary authority. Exchange-rate variations can be considered as strategic price changes just like bank-rate adjustments. Exchange-rate variations, for instance, can be used to compensate for existing interest-rate differentials and thus regulate the international flow of short-term private capital. "It is this distance," wrote Keynes, "which protects the money-market of one country from being upset by every puff of wind which blows in the money-markets of other countries."²⁷

An important practical reason for *managed* limited flexibility is obvious. Central bankers will accept the proposal more readily if it is viewed by them as opportunity to add an important policy instrument to the arsenal of the monetary authority. In this context it is very important to realize that the *influencing* of prices by government agencies is not open to the same criticism to which price *fixing* is exposed.

The Gradual Approach

The widening of the band could be carried out in successive stages as central bankers gain experience and confidence in their ability to cooperate successfully. Similarly, foreign traders, investors, and exchange dealers will learn to operate under more flexible conditions. It will become apparent that exchange-rate variations, within firm limits, will encourage equilibrating and discourage disequilibrating capital movements. Central bankers will appreciate the availability of a new monetary instrument, gain confidence in its use, and develop courage to apply it more boldly. Eventually they may even find that market fluctuations alone, uninfluenced by government transactions, can establish external equilibrium. In this case, the authorities may leave the market alone after having set the limits. Foreign traders will discover that hedging will offer the needed protection against exchange-rate fluctuations at relatively insignificant cost, and all concerned will see that exchange-rate variations do exert an equilibrating effect on the trade balance, an effect which will prevent them, in turn, from becoming excessive.

It would be presumptuous to determine in advance once and for all

²⁷ John Maynard Keynes, *A Treatise on Money*, Vol. II (New York: Harcourt, Brace and Company, 1930), p. 325.

the correct width of the band or the proper course of government actions within the band.²⁸ Only experience will show. A modest widening of the presently permitted span of 2 per cent to, say, 3 or 4 per cent, and then perhaps further as it is deemed desirable, recommends itself as a safe approach to greater exchange-rate flexibility. This approach could be combined with a *de facto* and, eventually, a *de jure* abolition of the adjustable-peg system, which would then no longer be needed.

We must be fully aware of the fact that the widening of the band by degrees but around a *fixed* parity has nothing in common with peg adjustments. The latter cause disequilibrating capital movements when they are anticipated, and shocks to the economy when they are carried out. A widening of the band, by contrast, need have no disturbing effects unless it were very badly timed and could be interpreted as a disguised peg adjustment. The two must be clearly kept apart.

It may happen, of course, that the flexibility provided by the broadened band will not suffice and that the parity, and with it the whole band, must be changed. If such cases were very rare exceptions, they need not ruin the system and the adjustment could possibly be handled by a temporary imposition of exchange controls. But frequent shifts of the whole band, i.e., a "movable-band" system would not be conducive to the gradual introduction of a genuine system of flexibility.

Once the system of limited exchange-rate variations has been operated successfully for some time, it might be possible to drop both the limits and the management within the limits, with the rates of exchange nevertheless staying reasonably stable. Here, as in other national payments systems, success will depend on the degree of integration of national economic policies and on the contribution which greater exchange-rate flexibility itself can make to the harmonization of the member countries' monetary policies.

Since all policies concerning exchange rates affect two currency units, it is logical to assume that the broadening of the band would

²⁸ Egon Sohmen, one of the most consistent advocates of a system of freely fluctuating exchange rates, writes: "Before a country embarks upon an experiment with fluctuating rates, it is of the utmost importance that its government and its central bankers appreciate both the increased power of the tool in their hands and the need to use it more often and more unhesitatingly." *International Monetary Problems and the Foreign Exchanges*. Special Papers in International Economics, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1963), p. 75. Would it not be wise then to introduce a system of freely fluctuating exchanges if and when a system with wider but still limited exchange-rate variations has succeeded?

be subject to international cooperation and control.²⁹ To avoid inconsistency between exchange rates and to prevent national authorities from working at cross purposes, a system with wider exchange-rate variations should be operated through some international arrangement inside or outside the International Monetary Fund.³⁰

This international cooperation might seem to pose grave problems and perhaps even revive the danger of competitive exchange depreciation. But if it is understood that the system serves to encourage equilibrating short-term capital movements, to eliminate disequilibrating flows from deficit to surplus countries (which are bad for *both*), and to give all participating countries greater freedom in the use of their monetary instruments, then different countries will be interested in the *same* exchange-rate variations. We underestimate the great progress that has already been made in international monetary cooperation if we fear that the "multilateral surveillance"³¹ that has already worked well in connection with bilateral financing and liquidity creation, could not undertake the coordination of national operations in the foreign-exchange markets.

It goes without saying that a cooperative system of the type proposed can work only between countries whose economies and economic policies are fairly similar. How much the national policies may be permitted to diverge would be determined by the width of the band and the availability of international liquidity reserves. If the national economic policies differ so much that the effect of interest differentials can no longer be neutralized by exchange-rate variations inside the band, the proposed system would deteriorate into a "movable-band" system.

²⁹ "Even moderate purchases and sales of foreign exchange by independently acting monetary authorities of different countries are apt to lead to mutually incompatible exchange rates between the same currencies. Unless the monetary authorities are in continuous accord with one another—agreeing on the supposedly free market rate, which they must act in concert to obtain or maintain—their interventions in the foreign-exchange markets will result in inconsistent rates, providing juicy profits to exchange arbitrageurs." Fritz Machlup, *Plans for Reform of the International Monetary System*. Special Papers in International Economics, No. 3 (Princeton, N.J.: International Finance Section, Princeton University, March 1964), p. 74.

³⁰ If the old gold mechanism were to serve as model, we might, for instance, want to manage the system through a gold pool.

³¹ This term is used in the Annex to the Ministerial Statement of the Group of Ten of August 10, 1964. One of the reasons for strengthening the review and appraisal process of multilateral surveillance "would be to give the monetary authorities of countries participating in the Arrangements a more comprehensive and up-to-date view of major trends and afford them a better basis for strengthening their policy cooperation in the international monetary sphere."

We cannot expect that *all* members of the international payments system will follow reasonably similar domestic policies, but within a group of countries the harmonization of economic policies may have advanced quite far. Such a group might maintain balance-of-payments equilibrium *within* the group by relatively small exchange-rate variations, while *between* groups a larger flexibility of rates may be needed. Again, it is desirable to test the system at first in the most promising environment. The introduction of the system, therefore, should not only be gradual over time but also gradual in a regional sense.

The Proposal and the Fund Agreement

Introduction of a widened band would not require any decisive change in the Articles of Agreement of the International Monetary Fund. Only Article IV would need some minor revision. Section 3 (1) would have to be changed, perhaps repeatedly, as we desired to broaden the band. Such repeated changes would not be exposed to the dangerous consequences of repeated parity changes under Article IV, Section 5 (f), which deals with parity changes in consequence of a fundamental disequilibrium. The crucial difference lies in the fact that successive decisions to broaden or to narrow the band around the *same* parity would be innocuous as far as destabilizing speculation is concerned, while successive changes of the parity itself would provoke capital-flight movements.

Ideally, a well-functioning system of flexible exchange rates should make it possible to abolish the adjustable-peg system, i.e., to delete Article IV, Section 5 (f) of the Fund Agreement altogether or at least to characterize changes in par values as events of a cataclysmic nature not to be found normally in a system with currency convertibility.³²

Since the proposal does not deal with changes in par values but only with the margin above and below par value, Article IV, Section 8 about the maintenance of the gold value of the Fund's assets would not apply.

³² As rare and disturbing events, changes of par values might be combined with a temporary imposition of exchange controls. Permission to use exchange controls could be granted similar to the permissions according to Articles VI-1, VII-3, and XIV-2.

III. History of the Proposal: Before World War II

Origin and Early Techniques

It will be noticed that the proposal seeks to *broaden* and not *create* limits for permissible exchange-rate variations. The possibility for minor variations existed under the old gold-standard mechanism in the form of those small deviations from gold parity which were determined by the cost of shipping gold from country to country. Buyers of foreign exchange were not willing to pay a price above the upper or gold-export point, because they could always procure foreign exchange by the shipment of gold, which they could buy at a fixed price and in unlimited amounts at home and sell at a fixed price and in unlimited amounts abroad. Similarly, the sellers of foreign exchange would not accept a price lower than the gold-import point, at which it was possible to transfer claims on foreign countries via gold shipments.

Restoration of balance-of-payments equilibrium depended under the gold mechanism on exchange-rate variations and on changes in interest rates. Exchange-rate changes would occur automatically with varying demand and supply conditions in the foreign-exchange market. These small variations, which could not exceed the spread between the gold points, would lead to equilibrating capital movements. The depreciation of a currency would stimulate foreign demand for the currency in expectation of the certainty of a rebound. Furthermore, even small variations of exchange rates would have a slight effect on international trade by stimulating the deficit country's exports and toning down its imports. In brief, *within* the gold points, a system of flexible exchange rates was at work.

Often, however, these reactions were not considered strong or fast enough to bring about the desired elimination of a balance-of-payments disequilibrium. Exchange-rate variations, therefore, were aided by changes in short-term rates of interest. The deficit country would raise, and the surplus country would lower, the bank rate. These interest-rate differentials would make equilibrating private capital movements even more attractive. An inflow of capital would lead to temporary relief in the external balance and would give the fundamental adjustment mechanism time to work: the domestic monetary contrac-

tion in the deficit country, and the domestic monetary expansion in the surplus country, would lead via price (and income) changes back to external equilibrium. Gold might never have to flow under this system if the monetary authorities were alert.

We see that the principles of fixity and flexibility were in practice always combined and that equilibrating capital movements took care of temporary disequilibria, and of the additional supply of foreign exchange that was needed for the period during which the more fundamental adjustments took effect.

Proposals and attempts to widen the distance between the gold points in order to increase the flexibility of the adjustment mechanism can be found rather early. Jacob Viner notes that Robert Torrens recommended in 1819 that "if a return were made to the gold standard, it would be desirable that the range between the gold points should not be too small." Torrens opposed Ricardo's plan of substituting bullion for coin because coin was "a less eligible article for export" and permitted a wider margin between gold points.³³

Viner lists quite a few devices that have been proposed and used to widen the distance between the gold points such as "seigniorage charges, premiums of gold for export, different buying and selling prices for gold at the Central Bank, generous tolerance for underweight in the internal specie circulation, differential buying and selling prices for the gold of the particular degrees of fineness most in supply or demand abroad and other similar devices."³⁴

For more recent times Arthur I. Bloomfield has shown how various central banks tried to manipulate the gold points to influence "the international movement of short-term funds and/or of gold in the desired directions. These devices were usually undertaken as short-run alternatives to discount rate changes or as supplement to them, and in some cases simply to offset the effect of similar measures being undertaken by other central banks."³⁵

In these attempts to broaden the limits of exchange-rate variations the techniques are of minor interest. Important is the fact that central bankers had the desire to widen the margin at a time when price systems were still flexible and rigidity of exchange rates much less problematic than it is today.

³³ Jacob Viner, *Studies in the Theory of International Trade* (New York: Harper and Brothers, Publishers, 1937), pp. 206-207.

³⁴ *Ibid.*, p. 378.

³⁵ Arthur I. Bloomfield, *Monetary Policy under the International Gold Standard: 1880-1914* (Federal Reserve Bank of New York, October 1959), p. 52.

Von Mises' Criticism of the Gold-Premium Policy

Ludwig von Mises criticized the use of the techniques indicated above as attempts to permit deficit countries to carry on "cheap-money" policies at a time when credit contraction would have been the proper policy to reestablish external equilibrium.³⁶ Von Mises felt that a gold-premium policy could delay the needed adjustment of domestic interest rates to increased foreign rates only for a very short time. Conceivably the gold-premium policy could be of some minor use when the situation promised to reverse itself very soon. He admitted that the policy "may sometimes have avoided raising the discount rate when it would otherwise have been necessary to do so for a short time."³⁷

He emphasized the interdependence of interest rates between different countries, pointing out that the mobility of capital goods is so great that it leads to the formation of a homogeneous capital market and that "the net rate of interest is no longer determined according to national, but according to international, considerations. Its level is settled, not by the natural rate of interest of the country, but by the natural rate of interest *anywhere*."³⁸ Adjustments to the world rate could not be stopped by a minor device such as the gold-premium policy. Nor would this be in the interests of those who propose to delay or hinder interest arbitrage. For the rate of interest could be kept down effectively "only by a suppression of the export of capital and complete exclusion of the country from international trade."³⁹

Von Mises did not care to distinguish between capital movements and commodity movements and considered it false to regard interest arbitrage as an "illegitimate" demand for gold in contrast with a demand resulting from the trade balance. "The idea on which this distinction is obviously based," he wrote, "is that trade in commodities and dealings in capital are two perfectly distinct and independent

³⁶ Ludwig von Mises, *The Theory of Money and Credit* (New York: Harcourt, Brace & Co. Inc., 1935), chapter VI. Von Mises discussed the gold-premium policy of the Bank of France but saw no essential difference between this policy and, e.g., the method of issuing, for export purposes, worn gold coin of inferior value, as practiced by Great Britain and Germany. The French policy rested on legal provisions which permitted the Bank of France to redeem its notes either in gold or in silver five-franc pieces. When gold was demanded for the "illegitimate" purpose of speculating on the difference between interest rates at home and abroad, gold was handed over only at an additional charge.

³⁷ *Ibid.*, p. 380.

³⁸ *Ibid.*, p. 374.

³⁹ *Ibid.*, p. 377.

branches of economic activity and that it would be possible to restrict the one without affecting the other."⁴⁰

We shall see presently that von Mises' attitude was diametrically opposed to John Maynard Keynes' ideas on the subject.

Keynes on Gold Points

The most elaborate proposal for establishing "a fair distance between the gold points" was made by John Maynard Keynes in 1930 in *A Treatise on Money* and in 1933 in *The Means to Prosperity*.⁴¹ Keynes argued that "the greater the distance between the gold points, the less sensitive to short-period external changes a country's rate of foreign lending will be."⁴² An increased margin would allow for a reasonable independence of bank-rate and credit policy to suit differing national circumstances "though there would be nothing to prevent a Central Bank from maintaining the gold equivalent of its national money within narrower limits in normal times."⁴³

In contradistinction to von Mises, Keynes argued against rigidly fixed exchange rates and a complete integration of credit markets because he wanted to protect national economic policies against too much exposure to outside forces. "Circumstances may arise," he wrote, "in which, if a country's rate of interest is fixed for it by outside circumstances, it is impracticable for it to reach investment equilibrium at home. This will happen if its foreign balance is inelastic, and if, at the same time, it is unable to absorb the whole of its savings in new investment at the world rate of interest. . . . There are, moreover, all sorts of other reasons why the day-to-day preservation of local investment equilibrium may require some departure of the local rate of interest from the international rate."⁴⁴

We have already seen that rigidly fixed exchange rates must lead to changes in the trading countries' interest rates. To argue for some freedom of domestic economic policy means to reject *rigidly* fixed exchange rates. Only under the unrealistic assumption that prices and wages are instantly adjustable could international payments equilibrium be combined with rigidly fixed exchange rates. A realistic appraisal of

⁴⁰ *Ibid.*, p. 385.

⁴¹ John Maynard Keynes, *A Treatise on Money*, Vol. II (New York: Harcourt, Brace and Company, 1930), chapter 36; *The Means to Prosperity* (New York: Harcourt, Brace and Company, 1933), pp. 32-33.

⁴² Keynes, *Treatise*, Vol. II, p. 320.

⁴³ Keynes, *Means to Prosperity*, p. 33.

⁴⁴ *Treatise*, Vol. II, pp. 303-304.

the slowness of the adjustments in prices, wages, production and trade is the crux of the matter.

Keynes pointed out that the main danger of a highly sensitive flow of capital under rigid exchange rates lies in "a high degree of short-period mobility of international lending, combined with a low degree of short-period mobility of international trade."⁴⁵ He considered it "impracticable to bring about a change in the foreign balance great enough to balance the change in foreign lending which even a small stimulus may provoke. . . . In this way adherence to an international standard tends to limit unduly the power of a Central Bank to deal with its own domestic situation so as to maintain internal stability and the optimum of employment."⁴⁶

To gain some independence for national economic policy, Keynes proposed two types of remedies: "(1) those whereby the authorities *offset* the action of the market, and (2) those whereby the authorities *influence* the action of the market."⁴⁷

To *offset* the action of the market a central bank needs command over large foreign-exchange or gold reserves. Letting the reserves fluctuate widely, it can prevent changes in foreign lending from having undesirable effects on domestic rates of interest. This proposal foreshadows the *Keynes Plan* of 1943. In 1930 Keynes suggested reduction of domestic gold-reserve requirements, holding of buffer reserves of gold, holding of large liquid balances in foreign centers, arranging of overdraft facilities between central banks and, finally, "borrowing and lending arrangements between Central Banks and a Supernational Bank."⁴⁸

The authorities can *influence* the market to regulate the rate of net foreign lending. They can, for instance, try to adapt the organization of a country's security markets to its normal capacity for foreign lending; they can use discriminatory taxation; control issues of foreign securities; and, finally, control the rate of short-term foreign lending.⁴⁹

Keynes considered large movements between long-term and short-term assets and between individual currencies (and currencies and gold) as dangerous. He argued that these movements—unless they

⁴⁵ *Ibid.*, p. 309. We note Keynes' complete rejection of von Mises' assumption of the practical identity of capital movements and commodity movements, and of money capital and capital goods.

⁴⁶ *Ibid.*, p. 309.

⁴⁷ *Ibid.*, p. 310.

⁴⁸ *Ibid.*, pp. 310-311. It should be noted how much of the gist of our present discussions and attempted solutions was already contained in Keynes' suggestions of 1930.

⁴⁹ *Ibid.*, p. 315.

can be offset—should be kept in check through appropriate changes in interest rates. The problem, however, was that the emerging rates of interest would not necessarily be the rates best suited to maintain both international and domestic equilibrium.

The problem could be resolved if it were possible to use two rates of interest, one of which would establish internal and the other external equilibrium. Keynes did not believe that such a policy could succeed in practice. He pointed out that

credit is like water;—whilst it may be used for a multiplicity of purposes, it is in itself undifferentiated, can drip through crannies, and will remorselessly seek its own level over the whole field unless the parts of the field are rendered uncompromisingly watertight,—which in the case of credit is scarcely possible.⁵⁰

At this crucial point in his argument Keynes made the proposal that the margin between the gold points should be widened. This arrangement would permit “a substantial inequality to exist between the rates of interest obtainable in two different currencies respectively if the rate of exchange existing at the moment cannot be relied on to last for more than a short period.”⁵¹

Accordingly, Keynes suggested

that the difference between a Central Bank's obligatory buying and selling prices of gold should be made somewhat greater than hitherto, say 2 per cent, so that there would be at least this difference between the gold points irrespective of the actual costs of transporting gold (double the amount of which would have to be added on to the 2 per cent to give the difference between the gold points). But the Central Bank would be free at any time, if it wished to encourage the movement of gold inwards or outwards, to quote closer prices within the legal limits. Further, a Central Bank should be in a position to control, when necessary, within the limits set by the gold points and the relative rates of interest at home and abroad, the premium or discount of the forward exchange on the spot exchange; whereby short-period interest-rates at home could stand *temporarily* in such relation (within limits) to similar rates abroad as the Central Bank might deem advisable.⁵²

⁵⁰ *Ibid.*, p. 319.

⁵¹ *Ibid.*, pp. 323-324.

⁵² *Ibid.*, pp. 325-326. See also *The Means to Prosperity*, p. 32, where Keynes proposed a difference of not more than 5 per cent between the buying and selling points for gold.

We must distinguish Keynes' proposal clearly from some older arguments for and against a widened band. In the standard picture of the working of the gold mechanism, fluctuations of exchange rates between the gold points fulfilled the important task of leading to *equilibrating* short-term capital movements. Exchange-rate variations *supported* interest-rate differentials in moving private capital to the country in need of an additional supply of foreign exchange. Short-term capital movements were considered advantageous because they would give time to carry through whatever domestic measures were needed to reestablish external equilibrium without detrimental effects for internal equilibrium or for the world economy. The flow of private capital, therefore, was to have the same cushioning effect for which Keynes demanded large reserves of foreign exchange. As a matter of fact, these capital movements were the gold mechanism's substitute for international reserves other than gold.

These capital movements have been attacked with the argument that a deficit country should not rely too much on foreign borrowing because the inflow of foreign short-term capital would tend to interfere with basic long-term adjustments.⁵³

To eliminate these "equilibrating" capital movements that are caused by exchange-rate variations we would have to establish rigid gold parities, i.e., abolish the gold points altogether. Keynes dealt with disequilibrating capital movements which are due to interest-rate differentials caused by an attempt to achieve domestic equilibrium. To illustrate his case he used the following example:

In the autumn of 1928 local conditions in the United States convinced the Federal Reserve Board that the short-period interest

⁵³ "If the automatic gold standard is supplemented by discount rate policy, a rise in the rate designed to curb internal expansion may attract short-time funds from abroad. Difficulties of this kind were fairly common in the twenties. With capital the most volatile item in the balance of payments, it is apt to dominate and to nullify any corrective effects which might otherwise result from the gold standard process of adjustment." John H. Williams, *Postwar Monetary Plans and Other Essays* (New York: Alfred A. Knopf, 1945), p. 205. Williams did not mean to criticize Keynes' argument. R. G. Hawtrey, however, misinterprets Keynes, when he believes that Keynes wanted to exclude foreign capital because it would delay the effect of credit measures designed to reestablish external equilibrium, and that "the progressive accumulation of short-term indebtedness becomes itself an independent threat to equilibrium." R. G. Hawtrey, *The Art of Central Banking* (London: Longmans, Green and Co., 1952), p. 413. Keynes was worried about capital movements which would interfere with internal (not external) equilibrium. He had no intention of establishing the gold mechanism at rigidly fixed rates, with all the harshness which an elimination of equilibrating capital movements would have implied.

rate should be raised in the interests of business stability; but local conditions in Great Britain were of a precisely opposite character, and the Bank of England was anxious to keep money as cheap as possible. The Federal Reserve Board did not desire that its high rates should attract gold from Great Britain; for this, if it occurred, would have tended to defeat its efforts. Nor did the Bank of England desire to impose high rates in Great Britain—to which it might be driven—in order to prevent its gold from flowing out. Such a situation could be handled by the above plan. The Federal Reserve Banks would reduce their buying price of gold to a figure nearer to their legal minimum, whilst the Bank of England would raise its selling price for gold nearer to its legal maximum.⁵⁴

Keynes' example makes no reference to the original balance-of-payments position of the two countries, though it does make some difference which of the two countries we assume to be in surplus or in deficit in its external balance. If the low-interest country (Great Britain) is not only having to cope with depression at home but is simultaneously suffering from a balance-of-payments deficit, an outflow of capital will accentuate its difficulties and, simultaneously, compound the inflationary pressures in the high-interest surplus country (the United States).

If a rise of the price of the surplus country's money unit (in terms of the deficit country's currency) can stop this destabilizing flow of private capital from the deficit to the surplus country, the effect will be advantageous in terms of both internal and external equilibrium. If a deficit country suffering from depression tries to boost its exports and to lower its imports through contractionist monetary policies, i.e., if it *raises* its bank rate, it accentuates the depression that already paralyzes its industries. Yet, if it *lowers* the bank rate, its balance-of-payments position is made worse through capital export. If the rate of exchange were permitted to fluctuate within certain limits, the price of the surplus country's money unit would rise in terms of the deficit country's currency. Interest-rate differentials and exchange-rate variations would *not* pull in the same direction. The inducement to gain from higher interest rates would be counterbalanced by a loss in the related foreign-exchange transactions.

Not so long ago many economists would have challenged the assumption that a country in depression would suffer from a balance-of-

⁵⁴ Keynes, *Treatise*, Vol. II, p. 326.

payments deficit. With falling employment and income a country was expected to enjoy a balance-of-payments surplus. In this situation, a capital flow from the low-interest depression country to the high-interest high-employment country would not create balance-of-payments problems. The export of capital might lead to expanding commodity exports and increasing employment. Besides, exchange rates would follow the classical pattern and would rather support than hinder the capital flow. And since the country in depression could *create* credit, the outflow of capital need not raise its interest rates.

Modern experience has shown, however, that international payments deficit and domestic depression can easily coincide. This combination is not unusual if we can assume that unemployment and falling national income may go together with price inflation and with falling exports.

Keynes pointed out that *moderate* fluctuations of exchange rates would not hinder foreign trade since anyone could cover himself satisfactorily in a free and reliable market in forward exchanges.⁵⁵ Nor would long-term lending suffer. Even a 10-per cent spread between gold points would not be very serious.⁵⁶ "But in the case of a short-period loan the exact cost of paying off the loan at maturity may have a decisive effect on the total net cost of the loan reckoned *per annum*. This leads us to the heart of our argument."⁵⁷

Keynes then repeats the argument for a widened band once more in these words:

It is, therefore, a serious question whether it is right to adopt an international standard, which will allow an extreme mobility and sensitiveness of foreign lending, whilst the remaining elements of the economic complex remain exceedingly rigid. If it were as easy to put wages up and down as it is to put bank-rate up and down, well and good. But this is not the actual situation. A change in the international financial conditions or in the wind and weather of speculative sentiment may alter the volume of foreign lending, if nothing is done to counteract it, by tens of millions in a few

⁵⁵ *Ibid.*, p. 333.

⁵⁶ "Suppose, for example, that the limits to the fluctuation of exchange has been fixed at 5 per cent on either side of par, then a 5 per cent loan in terms of the lender's money remitted at the par of exchange may cost in future years anything between 4% and 5¼ per cent interest, and when it is paid off the redemption may cost anything between 95 and 105, in terms of the borrower's money. In the case of a long-period loan these possibilities are not very serious. . . ." *Ibid.*, p. 334.

⁵⁷ *Ibid.*, p. 334.

weeks. Yet there is no possibility of rapidly altering the balance of imports and exports to correspond.⁵⁸

These conclusions could have led Keynes to advocate a system of freely fluctuating exchange rates and they did—at least in theory. He considered as ideal “the management of a national currency on progressive lines . . . freed from the inconvenient and sometimes dangerous obligation of being tied to an unmanaged international system; . . . the evolution of independent national systems with fluctuating exchange rates . . . (and) . . . the linking up of these again into a managed international system.”⁵⁹

But he accepted as a *fait accompli* an international standard and a quasi-fixed exchange rate and suggested that “the best practical objective might be the management of the value of gold by a Supernational Authority, with a number of national systems clustering around it, each with a discretion to vary the value of its local money in terms of gold within a range of (say) 2 per cent.”⁶⁰ Thus he took in 1930 roughly the position of those who today argue for unlimited exchange-rate flexibility but are willing to compromise and to accept as second-best solution a system of limited flexibility.

Keynes' proposal to widen the limits for exchange-rate variations was incorporated into the International Monetary Fund Agreement (Art. IV, Sec. 3) though it had not found a place in his own Clearing Union Plan. He discarded widened gold points in favor of the more drastic proposal of frequent peg adjustments. This proposal has already been criticized.⁶¹

Expert Opinions in 1936

A Joint Committee of the Carnegie Endowment and the International Chamber of Commerce, investigating the problem of monetary stabilization in 1936, asked a group of experts, among other questions, whether we “should accept the view that wider ‘gold-points’ will enable a restoration of the stability in exchange.”⁶² The concluding report

⁵⁸ *Ibid.*, p. 336.

⁵⁹ *Ibid.*, p. 338. In one passage in his *General Theory*, in which he made a fleeting remark about an “open system,” Keynes assumed “that equilibrium with the rest of the world can be secured by means of fluctuating exchange rates.” *The General Theory of Employment, Interest, and Money* (London: Macmillan and Co., 1936), p. 270.

⁶⁰ Keynes, *Treatise*, Vol. II, p. 338.

⁶¹ See above, p. 4.

⁶² Joint Committee: Carnegie Endowment and International Chamber of Commerce. Separate Memoranda on *The Improvements of Commercial Relations be-*

stated that the experts could not agree on "such a fundamental question" as "the artificial widening of the gold-points with a view to avoiding too frequent movements of specie and strengthening the independence of local money and capital markets."⁶³

All the experts rejected the proposal to widen the gold points if it was put forward as a sufficient means for the "restoration of stability in exchanges." This attitude was not surprising, for nobody has ever suggested the band proposal as a panacea. All the experts found something to say for the proposal, however, even including von Mises,⁶⁴ who saw in wider gold points a closer approach to stability—if one compares this system with a system of boundlessly fluctuating parities. But he thought that wider gold points would not make the restoration of stability easier to attain because the central bank would have to follow exactly the same policy as under the orthodox gold standard once the upper gold point was reached.

T. E. Gregory saw in the proposal to widen the gold points "a minor technical device intended to reconcile the technical exigencies of the exchange position with the desirability of not disturbing internal conditions for the sake of merely temporary external disturbances."⁶⁵ But he also held that "if the rates of exchange can swing through a wider arc, powerful reinforcing factors can enter into operation" so that "remedial measures can be postponed for a rather longer period of time" and "greater opportunity is given for 'self-correction' of the exchanges."⁶⁶ In other words, the tide may turn before the support points are reached and serious action is called for. Maintenance of larger reserves would have the same effect, however.

Gregory's attitude is somewhat inconsistent in relegating the band proposal to a minor technical position while admitting, at the same time, that larger exchange-rate variations may be a powerful factor.

Von Mises and Gregory approached the question coming, as it were, from the gold-standard side, while Henderson, Mlynarski, and Hammarskjöld answered it in the conviction that greater freedom of domestic policies for internal equilibrium was essential.

D. H. Henderson admitted that "if the margin were of the magnitude of 10 per cent, the fall of the exchanges of a country towards gold-export point would supply a powerful check on any adverse capital

tween Nations and The Problem of Monetary Stabilization (Paris, June 1936), p. 174.

⁶³ *Ibid.*, p. 414.

⁶⁵ *Ibid.*, p. 190.

⁶⁴ *Ibid.*, pp. 170-177.

⁶⁶ *Ibid.*, p. 188.

movements, since those withdrawing or exporting money from the country would incur thereby a substantial exchange loss."⁶⁷ Free variations between such wide limits, however, would be disturbing to trade. "With a much narrower limit," on the other hand, "it would become doubtful whether the prospect of a comparatively trifling exchange loss would provide a sufficient safeguard against the possibility of large-scale capital movements."⁶⁸ Instead, Henderson proposed what amounted to the adjustable-peg system, viz., the freedom to alter the parities previously established "without being exposed to any imputation of bad faith."⁶⁹

Feliks Mlynarski supported Keynes' suggestion that "the future gold standard should adopt a wider margin than heretofore between gold-points in order to check the disturbing influence of capital movements on gold movements."⁷⁰

Dag Hammarskjöld expressed the opinion that the main question was not whether exchange rates should be fixed or alterable but only whether alterations were to be the result of financial crises or were to be "effected according to fixed rules and acknowledged as the perfectly natural results of changes in economic conditions that they are."⁷¹

His proposals amounted to a combination of a widening of the gold points and peg adjustments; in other words, to what one can call the "movable-band" system. Foreshadowing the Brookings Institution Report of 1963, he suggested that we should distinguish between different groups of countries, and permit wider and more frequent variations of exchange rates (obviously meaning a wider band and more frequent parity adjustments) *between* rather than *within* groups. He urged international cooperation but doubted the wisdom of using universal agreements and single-formula solutions, and favored the slower and less formal methods of cooperation until the time was ripe for more definitive moves.

⁶⁷ *Ibid.*, p. 167.

⁷⁰ *Ibid.*, p. 337.

⁶⁸ *Ibid.*, p. 167.

⁷¹ *Ibid.*, p. 385.

⁶⁹ *Ibid.*, p. 167.

IV. History of the Proposal: Recent Suggestions

Recent Proposals and Discussions

The proposal to broaden the limits of permissible exchange-rate variations has found support in recent debates on the international payments system and the United States' balance-of-payments problem. These discussions have remained academic, however. Central bankers and government officials still shy away from the mere mention of greater exchange-rate flexibility;⁷² and those economists who favor flexible rates often ask for more freedom than a mere broadening of the band would permit. The discussions, therefore, still tended to contrast freely fluctuating with fixed or pegged exchange rates. Nevertheless, there are indications that an increasing number of economists are willing to compromise and to accept a wider band, at least as a second-best proposal.

The band proposal achieved a modest victory when the Report of the Joint Economic Committee on *The United States Balance of Payments*⁷³ listed it as one of nine recommendations. True, it did not recommend immediate acceptance, but only that "the United States, in consultation with other countries, should give consideration to broadening the limits of permissible exchange-rate variations." Pointing out that the present limits under the Fund Agreement are 1 per cent on either side of parity and that, in practice,⁷⁴ the spread is 1.5 per cent between the upper and lower support points

⁷² An example is the reaction of Frederick H. Klopstock to Representative Reuss' question as to what he thought of the suggestion "for vitiating the magnetic effect of interest rate differentials by widening the gold points." Klopstock's answer was: "Well, I have not studied this particular problem in great detail, but instinctively it does have very little appeal to me, I would say." *Outlook for United States Balance of Payments*. Hearings before the Subcommittee on International Exchange and Payments. Joint Economic Committee, 87th Congress, 2d Session, December 12, 13, and 14, 1962 (Washington, 1963), p. 142. The Ministerial Statement of the Group of Ten of August, 1964 says: "In reviewing the functioning of the international monetary system, the Ministers and Governors reaffirmed their conviction that a structure based, as the present is, on fixed exchange rates and the established price of gold, has proved its value as a foundation on which to build for the future."

⁷³ Report No. 965, Senate, 88th Congress, 2d Session, March 19, 1964, p. 18.

⁷⁴ The signatories of the European Monetary Agreement set the limits at 0.75 per cent on either side of parity.

The Committee concludes that a broadening of these limits would have several advantages.

(a) It would permit the monetary authorities greater freedom to pursue independent monetary policies without providing incentives for short-term capital movements; the authorities would have greater scope for short-term intervention in the forward exchange market to offset interest-rate differentials.

(b) It would permit exchange-rate variations to play a somewhat larger role in the adjustment process than is now possible.

(c) It would discourage speculation by increasing the risk of losses in relation to the possibilities for profit.⁷⁵

In the Studies and Hearings which preceded the Report several experts made the suggestion that the limits for exchange-rate variations should be broadened.⁷⁶ Since their statements are few in number and brief in content, they can be quoted at full length, thus indicating precisely the position of their authors—inevitably, of course, at the cost of some repetition.

Seymour E. Harris, referring in particular to the United States balance-of-payments problem, holds that there is

no sufficient reason why the gold points for the dollar should not be allowed to vary a few per cent in all up and down as allowed

⁷⁵ *Ibid.*, p. 18.

⁷⁶ *Factors Affecting the United States Balance of Payments*. Compilation of Studies Prepared for the Subcommittee on International Exchange and Payments. Joint Economic Committee, 87th Congress, 2d Session (Washington, 1962), quoted as *Factors*; *Outlook for United States Balance of Payments*. Hearings Before the Subcommittee on International Exchange and Payments. Joint Economic Committee, 87th Congress, 2d Session, December 12, 13, and 14, 1962 (Washington, 1963), quoted as *Outlook*; *The United States Balance of Payments*. Hearings Before the Joint Economic Committee, 88th Congress, 1st Session (Washington, 1963), quoted as *U.S. Balance of Payments*. Willingness among economists to consider the band proposal at least as a second-best solution of the exchange-rate problem is greater than a perusal of the Studies and Hearings might indicate. In recent deliberations of an international study group of economists the band proposal was discussed as a modified form of a system of freely fluctuating exchange rates. Though the economists of the study group had no intention whatever of advocating any special monetary system or reform plan and had come together merely to try to interpret reasons for their disagreements, there was found to exist substantial (though by no means unanimous) agreement on some propositions. Thus many participants felt that the "exchange rates should be allowed to change more frequently than currently contemplated by major governments" and "some previous advocates of unlimited flexibility in exchange rates tended, after consideration, to favor some form of limited flexibility." *International Monetary Arrangements: The Problem of Choice*. Report on the Deliberations of an International Study Group of 32 Economists (Princeton, N.J.: International Finance Section, Princeton University, 1964), pp. 102 and 105-106.

in the International Monetary Fund charter. The result would be a great discouragement of short-term capital movements, one of the most disturbing factors accounting for the gyrations in the balance of payments. A widening of the gold points would introduce an element of uncertainty which would greatly cut these capital movements.⁷⁷

To Philip W. Bell it seems to be utter folly to allow short-term capital flows, other than those which go to financing U.S. exports,

. . . to dictate monetary policy in this country. We can offset the adverse domestic effects of high interest rates by having a large budget deficit, thus achieving the same rate of expansion in income and employment here as we could have with lower interest rates. But why should we? There are alternatives.

The alternative which I suggest is an old one, but one which is, it seems to me, perfectly respectable. Indeed, it is the alternative which is presently practiced by the other great world financial center—London. There is no reason why we have to continue to buy and sell gold at absolutely fixed rates. If we were to widen our gold points so that fixed buying and selling rates were as much as 1 percent or so on either side of \$35 an ounce, as in the case of sterling, we would be in a position of offsetting the short-run effects of practically all of any widening of the London-New York differential or other European-U.S. differentials which is ever likely to occur.⁷⁸

Peter B. Kenen points out that

the narrow spread on the sterling-dollar exchange rate, for example, may make it difficult to manipulate or to operate on the foreign exchange rate so as to offset interest differentials. There is a limit to the forward premium or discount that one can induce, as long as the spot rate is confined within a very narrow range. . . . So I would surely support a recommendation that exchange rates be free to move over a slightly wider range than at present, and also that the free market price of gold be allowed to move more widely.⁷⁹

The present writer suggested that the members of the International Monetary Fund be permitted to widen the margin above and below

⁷⁷ *Factors*, p. 24.

⁷⁸ *Outlook*, p. 127.

⁷⁹ *Outlook*, p. 143.

parity, and that this should be done in conjunction with still closer cooperation of central banks and the greatest possible effort toward harmonization of national economic policies. However, even this mild move toward greater exchange-rate flexibility should wait until the United States balance-of-payments difficulties have been overcome.⁸⁰

Friedrich A. Lutz agrees that the spread between the selling and buying prices of foreign currencies should be still further widened, but considers it a minor point. Like the other advocates of the proposal, he wants to protect the domestic monetary policies against disequilibrating short-term capital movements.

The widening of the spread makes it possible in certain conditions to maintain, temporarily at least, substantial interest rate differentials between countries without causing shifts of short-term funds between those countries on such a large scale as could occur under the gold standard. For when there exists a fairly wide margin within which the exchange rates can fluctuate, the central bank in the country with the relatively high short-term interest rates can, by intervening in the spot and forward exchange markets, make the difference between spot and forward rates so high, and thus make hedging against the exchange risk so expensive, that the volume of funds actually attracted is reduced to small proportions.⁸¹

Robert Mundell is not predominantly interested in offsetting interest-rate differentials. He points to the need for an adjustment mechanism to replace the adjustable-peg system which the International Monetary Fund has failed to implement (through frequent changes of the exchange rates), a failure which "has led us back to the inflation-stagnation methods of the gold standard."

The solution I offer, which would simultaneously solve any potential liquidity problem, is not a very original one, but I am comforted by the thought that it is probably the right one. I recommend a widening of the buying and selling limits on gold, to not less than 7½ percent on either side of par. This would introduce an indispensable flexibility into the international price mechanism without imposing on countries the burdens of stagnation and domestic inflation. The additional exchange rate flexibility would at the same time provide guidelines for non-inflationary monetary

⁸⁰ *Factors*, p. 560; *Outlook*, p. 181.

⁸¹ *U.S. Balance of Payments*, p. 338.

policies. I would expect it to be followed by a dismantling of all those devices imposed for purely balance-of-payments reasons, including things like tied aid, equalization taxes, hidden export subsidies, quotas, and such things. I would further expect that central bank intervention in markets for foreign currencies could be dispensed with and that the outstanding short-term dollar liabilities to foreign central banks could be reduced.⁸²

Mundell proposes a system of limited but unmanaged flexibility to which he ascribes the ability to adjust the trade balance without much difficulty. His system comes very close to a system of freely fluctuating exchange rates.

Alternative Proposals

The Studies and Hearings produced three proposals which must be mentioned separately. Two cannot be classified as proposing clearly a system with broadened limits of exchange-rate variations, and one even suggests the opposite approach, viz., that we eliminate flexibility altogether.

Howard S. Piquet proposes that the United States Treasury should remove the presently existing floor for gold. With the price floor removed, "speculators in gold who are betting that the United States will raise the price of gold, would face the prospect of losses, as well as gains."⁸³

Piquet's argument implies a widening of the spread between the buying and selling prices of gold and the same criticism of the adjustable-peg system that has prompted the proposal for smoother exchange-rate variations within limits. But since Piquet's proposal is limited to speculation in gold and removes the price floor for gold, it would be unfair to claim his support for the band proposal.

A very interesting idea for changing the gold parities is James E. Meade's suggestion for yearly adjustments of up to 2 per cent up or down. Meade proposes

for earnest and immediate consideration a change in the rules of the International Monetary Fund on the following lines:

⁸² *U.S. Balance of Payments*, p. 547.

⁸³ *Factors*, p. 308. Fritz Machlup proposed in 1961 that the price of gold should be reduced by the leading monetary authorities of the free world over a period of several years by, say $\frac{1}{4}$ or 1 per cent every three months. He expects that several billion dollars worth of gold would be dishoarded and offered for sale to the monetary authorities. "Comments on the Balance of Payments and a Proposal to Reduce the Price of Gold," *The Journal of Finance*, Vol. XVI (1961), pp. 186-193.

(1) Each member would as at present fix a gold parity for its national currency.

(2) Each member would be allowed in any year to raise (or lower) this par rate by 2 per cent above (or below) the parity fixed in the preceding year.

(3) Each member would undertake never to raise the price of gold in terms of its own currency by the permitted 2 per cent unless it was at the time incurring a substantial loss of monetary reserves.

(4) Each member would undertake never to lower the price of gold in terms of its own currency by the permitted 2 per cent unless it was at the time incurring a substantial accumulation of monetary reserves.⁸⁴

Meade's proposal must not be interpreted as supporting a widening of the margin above and below parity.⁸⁵ Indeed, it may seem at first sight as if a country's exchange rate were permitted to vary by 4 per cent within any one year. This interpretation is wrong, however, since one and the same country is most unlikely to produce both a "substantial loss of reserves" and a "substantial gain in reserves" in any given year. Furthermore, for the proposal to broaden the limits of permissible exchange-rate variations it is important that the limits should be considered as based on a *fixed* parity and not be themselves interpreted as sliding parities.

A combination of the band proposal with an adjustable parity, i.e., a "movable band" would lose the advantage that is offered by reliance on limited fluctuations around a permanently fixed parity. As it stands, Meade's proposal seems to be even more exposed to the dangers of disequilibrating speculation than the present adjustable-peg system, just as the *Keynes Plan* was more objectionable in this respect than the Bretton Woods solution.⁸⁶

It may seem that Meade's proposal would have the advantage of introducing an element of smoothness into what are now abrupt parity adjustments. But we could achieve this advantage better through a system of flexible but reasonably stable rates of exchange within the limits of a broadened band.

⁸⁴ *Outlook*, pp. 242-243.

⁸⁵ As, e.g., Ervin P. Hexner suggests in *The "Fixed vs. Flexible Exchange Rate" Controversy: Recent Policy Developments*. Bureau of Business Research. College of Business Administration. The Pennsylvania State University, Occasional Paper No. 3, June 1964, p. 7.

⁸⁶ See above, p. 4.

In contradistinction to the proposal to widen the limits of permissible exchange-rate variations, James C. Ingram proposes to bring about financial integration of the trading countries through equilibrating long-term capital movements and *rigidly and permanently* fixed exchange rates. For example

if a given nation expands government expenditures and runs a budget deficit, it must offer higher interest rates to persuade financial markets to take its bonds. An inflow of capital will be attracted to cover the increased imports of goods that may accompany the budget deficit. The capital movement is equilibrating.⁸⁷

Indeed, exchange rates which are rigidly and permanently fixed (i.e., "with *no* spread around the official par value and no provision for any change") plus financial integration (i.e., "freedom for individuals, firms, banks, and government agencies to trade in securities and other financial claims across international boundaries")⁸⁸ will create international payments equilibrium. In fact, if these extreme assumptions can be adhered to, the main international payments problem has been abolished by definition, just as it does not exist between the different regions of one and the same country. But with these assumptions we have excluded the facts of life.

In Ingram's example a budget deficit raises the rate of interest and thereby causes an equilibrating long-term capital flow. But if the budget deficit is the result of intentional deficit spending with the purpose of injecting newly created money into the economy, the rate of interest will be lowered and capital may tend to flow out.

The Brookings Institution Report

The Brookings Institution Report *The United States Balance of Payments in 1968* proposes

a widening of the limits around the par values within which the actual market rates are allowed to fluctuate. The limited fluctuations of exchange rates permitted by such a widening of the support points would have a number of advantages. First, they would give rise to capital movements which, under the conditions specified, would be stabilizing rather than destabilizing and would reduce the need for using official reserves and credit facilities.

⁸⁷ James C. Ingram, *Factors*, pp. 186-187.

⁸⁸ *Ibid.*, pp. 190 and 179.

Second, they would permit greater variability in short-term interest rates among countries than would be possible with absolutely fixed market exchange rates, thus permitting somewhat greater national autonomy in monetary policies. Finally, even the limited variation in exchange rates possible with support points of 2 percent to 3 percent on either side of parity would be helpful in promoting balance-of-payments adjustment. Among industrial countries producing similar products, price elasticities in international trade over periods of several years can be expected to be high, so that small changes in exchange rates would have considerable influence on trade balances.⁸⁹

This clear and comprehensive argument for a widened band unfortunately loses some of its value owing to its position in the context of the Report's policy recommendations.

The Report is correct in pointing out that the present problem is not primarily a balance-of-payments problem of the United States. The real problem is the inadequacy of the international monetary mechanism in relation to the requirements of the Free World. In fact, if the United States did achieve a trade balance or a trade surplus, world liquidity would become insufficient, forcing other countries to cut their imports.

The Report points out that increasing liquidity is needed to give countries time to correct payments disequilibria without compromising more important goals, such as high employment and growth. The present system of fixed rates, "operated with the existing or foreseeable level of reserves"⁹⁰ is dangerous, particularly since it is not a system of permanently fixed rates but an adjustable-peg system. The latter system has these disadvantages: "the efforts to defend an exchange rate are likely to be too long delayed; and devaluations are likely to be excessive when they are finally made."⁹¹

The Report suggests that we can enjoy the advantages of permanently fixed exchange rates and avoid the disadvantages of the adjustable peg provided we have greater liquidity "because it would gradually be recognized that enough time was available to restore

⁸⁹ Walter S. Salant and Associates, *The United States Balance of Payments in 1968* (Washington, D.C.: The Brookings Institution, 1963), p. 251. The associates were Emile Despres, Lawrence B. Krause, Alice M. Rivlin, William A. Salant, and Lorie Tarshis. The Foreword reveals that "Chapter IX on policy proposals was a genuinely joint effort. Although all members do not subscribe to all the points made in it, it reflects the consensus of the group."

⁹⁰ *Ibid.*, p. 246.

⁹¹ *Ibid.*, p. 247.

equilibrium in the payments of the major countries without revaluation of their currencies.”⁹²

The Report then proposes a “satisfactory international monetary mechanism” with the following characteristics: substantially increased liquidity in the form of drawing rights or other credit facilities extended either directly or through international institutions, available readily and promptly and for a period long enough to permit elimination of the deficit; and, since the possibility of shifting reserves from weak to strong currencies must be prevented, international agreements to prevent such shifts, agreements which probably “would have to be accompanied by guarantees of the values of the reserve currencies.”⁹³ This multiple-reserve-currency scheme would, through close cooperation, lead to a coordination of national policies.

The proposed system should make it possible to replace the adjustable-peg system with permanently fixed parities. But “it will take some years, of course, to demonstrate the effectiveness of the system and to build up confidence in the permanence of the parities” and only “when that confidence has been established, a further useful step would be the widening of the limits around the par values within which the actual market rates are allowed to fluctuate.”⁹⁴

Thus the timing of the band proposal is changed. Greater flexibility through exchange-rate variations becomes, as it were, a bonus for having worked for years with a system of very limited flexibility—at least as far as exchange rates are concerned. Yet during these years the adjustable-peg system would still have been in force potentially. Furthermore, it is possible that substantially increased reserves could be interpreted as an invitation to indulge in inflation or to continue misallocation of resources, two possibilities which the Report admits. Both these consequences might lead to peg adjustments.

The Report’s liquidity proposals do not suggest an adjustment mechanism. On the contrary, the Report argues against fixed repayment dates and against conditions under which increased liquidity would be made available. In this respect the Report is very similar to the *Keynes Plan*.

If it is doubtful (either in fact or at least in the eyes of central bankers) that the proposed liquidity system will maintain the discipline needed for a system with rather rigidly and permanently fixed exchange rates, why not substitute greater flexibility of exchange rates, to some

⁹² *Ibid.*, p. 247.

⁹³ *Ibid.*, p. 249.

⁹⁴ *Ibid.*, p. 251.

extent at least, for the requested substantial increase of reserves? The liquidity increase (via drawing rights, etc.) is supposed to be large "because imbalances arising both from persistent and stubborn shifts in basic transactions and short-term capital movements are potentially quite large and are likely to grow."⁹⁵ Increased reserves, however, do not provide a mechanism for dealing with these imbalances, while variations of exchange rates within a widened band admittedly⁹⁶ would provide such a mechanism. The partial substitution of moderate exchange-rate fluctuations for increased reserves, furthermore, would probably provide clearer guidelines for the coordination of national economic policies than increased credit facilities without strings.⁹⁷

The Practical Approach

We have already seen that the operation of an international payments system with broadened margins has to fulfill the precondition of a very close cooperation between central banks. This cooperation has greatly increased in recent years.⁹⁸ Particularly interesting is the entirely new attempt of the United States to operate in the foreign-exchange market to defend "in concert with others, the whole system of convertibility at stable exchange rates that has been so painstakingly reconstructed since the end of World War II."⁹⁹ Robert V. Roosa, Under Secretary of the U.S. Treasury for Monetary Affairs, points out that the United States "foreign exchange operations have so far been mainly designed to help in providing a breathing space during which . . . basic programs could have a chance to become effective. In our judgment, they have been most helpful in deterring unwarranted speculation and unwanted capital flows, and in reducing the drain on our gold stock, which stands as the bulwark of the whole international currency system."¹⁰⁰

⁹⁵ *Ibid.*, p. 249.

⁹⁶ *Ibid.*, p. 251.

⁹⁷ In case a system with fixed exchange rates could not be made to work, the Report proposes "a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc. There would be relatively fixed rates within each bloc and flexible rates between them." *Ibid.*, p. 259. This proposal, which has been repeatedly criticized (see *The United States Balance of Payments. Statements by Economists, Bankers and Others on the Brookings Institution Study, "The United States Balance of Payments in 1968,"* Joint Economic Committee, Washington, 1963), does not impair the basic argument for a broadened band or the general suggestion that in a future system exchange-rate variations may be smaller within than between blocs.

⁹⁸ Whoever doubts this statement should take the trouble of going back to the Tripartite Agreement of 1936 and compare the extent of international monetary cooperation then and now.

⁹⁹ *Factors*, p. 327.

¹⁰⁰ *Ibid.*, p. 328.

Until recently the United States was "content to leave all operations concerning the exchange relations between the dollar and other currencies to the officials of those other countries."¹⁰¹ In other words, the United States had not even made use of the modest possibilities for exchange-rate variations permitted under the rules of the International Monetary Fund. For making use of these permissible exchange-rate variations, Roosa gave reasons which are identical with some of those used by the proponents of a broadened band. While rejecting the idea that the new policy should be used for the rigging of markets or the pegging of prices, he points out that

Within the relatively narrow band which is, in any event, permitted under the rules of the International Monetary Fund, there must be room for market prices to demonstrate the basic strength or weakness of any currency.¹⁰²

And, in another context, he stresses once more "that it is no part of our intention to disguise the basic forces of supply and demand, or the various market evidences of changing needs and conditions in the international financial condition of the United States or any other country. We want and need the sensitive signals of changes in fundamental forces that are reflected in price fluctuations in free markets."¹⁰³

To be fair to Secretary Roosa, it must be emphasized that he does *not* argue for a widening of the band but only for making use of the "relatively narrow" band permitted by the Fund Agreement. However, it may be pointed out that a relatively narrow band can be too narrow to show "the basic strength or weakness of a currency" or to permit "sensitive market signals of changes in fundamental forces." Since Roosa also argues for a "breathing space" for fundamental adjustment and, at least indirectly, for leeway in case of unavoidable differences in national economic policies,¹⁰⁴ he should be open to the suggestion that a careful widening of the band would be desirable. Is it not exactly the rigid fixing of parities which prevents the basic forces of demand and supply from working in the foreign-exchange markets? And why criticize only the pegging of rates within the narrow band and not the pegging that is obligatory at the support points, if these points permit only variations of exchange rates which might be too small?

Central bankers and Treasury officials should remember, too, that,

¹⁰¹ *Ibid.*, p. 328.

¹⁰² *Ibid.*, p. 328.

¹⁰³ *Ibid.*, p. 339.

¹⁰⁴ Criticizing Robert Triffin, he points out that the Superbank cannot work properly "so long as major differences in economic policy arise among different countries." *Factors*, p. 347.

at present, they are not supporting permanently fixed but adjustable exchange rates. They should be attracted by a proposal to eliminate the adjustable-peg system which creates the most dangerous capital movements and to substitute for it smooth price variations within a broadened band.

V. Advantages of a Broadened Band

A Workable Compromise

The band proposal indicates an area of compromise between the principles of fixed and flexible exchange rates, between external and internal equilibrium, and between theory and practice.

Since the proposal aims at creating greater flexibility, it is criticized by the advocates of fixed exchange rates on grounds that it will allow too much freedom for domestic economic policies and lead to financial irresponsibility. But this charge is offset by the claims of others that flexibility within limits does not permit sufficient leeway for national policies aiming at optimum employment and growth.

Since neither external nor internal equilibrium can demand our attention to the exclusion of the other, a good case can be made for exchange-rate variations between limits as a workable compromise. And since the strong theoretical support of flexible exchange rates is met by an even stronger preference by central bankers for fixed rates, the band proposal may be our only chance to overcome the present stalemate in the international monetary debate.

Fully to appreciate the advantages of a compromise proposal, we have to keep all its features in mind and refrain from discussing its individual parts out of context. Rigidly fixed exchange rates are better than exchange rates which vary even within narrow limits—if we insist on complete financial integration of all the major trading countries; and freely fluctuating exchange rates are superior to the band proposal—if we reject all government intervention in the foreign-exchange markets. Advocates of pure systems reject the proposal because they are unwilling to leave their uncompromising positions. But since the claims of the purists are incompatible, an intermediate proposal may have the great advantages of balance and realism which are often lacking in pure, simple, and straightforward systems.

A Substitute for the Adjustable Peg

A system of freely fluctuating exchange rates has no chance whatever of being accepted in the foreseeable future in spite of the strong support which it enjoys among economists. Central bankers support the present system as if it were a system of permanently fixed exchange

rates. They often ignore the important fact that it is not a system of permanently fixed exchange rates but rather an adjustable-peg arrangement in which members have the right to change their parities in case of fundamental disequilibrium, be it internal, external, or both. Accordingly, the present payments system cannot claim the advantages on which the supporters of fixed exchange rates rest their case. The adjustable-peg system, instead of ensuring equilibrium, nationally and internationally, permits *ex post facto* corrections of exchange rates to compensate for external consequences of mistaken internal policies, is detrimental to discipline, creates the disadvantages of prolonged overvaluation and undervaluation, and is bad for external and internal stability. Furthermore, it tends to foster disequilibrating speculation, demands large reserves, and is particularly dangerous in connection with a key-currency arrangement.

The band proposal is to be understood as a substitute for the adjustable-peg system in that it seeks to replace delayed and abrupt parity changes with limited but continuous exchange-rate variations around a permanently fixed parity. Today's problem is not a choice between permanently fixed and flexible rates but between peg adjustments and flexibility.

At present there exists a tendency to make parity changes very rare events because of the unsettling effect of even modest upvaluations. But this trend does not eliminate potential peg adjustments which, under certain conditions, are a right of the members of the International Monetary Fund. Besides, the more rarely the parities are changed the more the member countries are forced into domestic policies which are not conducive to optimum employment and economic growth. In other words, the present system is a bad compromise. It must accept the hardships of a fixed-rate system (which the experts of Bretton Woods wanted to avoid) and is not able to enjoy the advantages which might result from permanently fixed parities.

The band proposal, on the other hand, tries to maintain stable exchange rates while avoiding rigidity. "In linguistics as well as in economics, 'flexible' is not synonymous with 'unstable.' The antithesis of flexibility is not stability but rigidity."¹⁰⁵ The band proposal would permit greater exchange-rate variations around a parity which would stay fixed after the abolition of the adjustable-peg system. The mone-

¹⁰⁵ Egon Sohmen, *International Monetary Problems and the Foreign Exchanges*. Special Papers in International Economics, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1963), p. 3.

tary authorities, through intervention within the band, might attempt to iron out the effects of disruptive capital flows. International monetary cooperation of central banks would exclude competitive exchange depreciation and inconsistent cross rates. The system could be said to enjoy flexible or floating exchange rates. Since "to float" suggests to move gently on the surface of a liquid, the term is well suited to describe continuous, modest, and orderly exchange-rate variations.

Limits as Guidelines

It is essential to the band proposal that exchange-rate variations cannot exceed predetermined limits. This feature, which causes some advocates of freely fluctuating exchange rates to reject the proposal or to consider it only a second-best arrangement, has the function of providing guideposts for monetary integration. The support points serve as a constant reminder that the central bank may be called upon to maintain a perfectly elastic supply of foreign exchange (or gold) at the upper limit. The domestic policies of the members of the system must be harmonized to the extent that any remaining deviations can be handled through the equilibrating effect of exchange-rate variations on trade, through equilibrating private capital flows, or through the use of official foreign-exchange (or gold) reserves.

The inescapable need for harmonizing national policies will strengthen the central banks of the member countries in their difficult stand against the inflationary consequences of monopolistic wage and price policies. To this extent, the band proposal can claim for itself the advantage of promoting monetary discipline. It may well be conducive to greater monetary self-control than the adjustable-peg system, which stands ready to correct the external effects of domestic inflation.

In promising to maintain the exchange rates at predetermined limits, the national authorities must remain aware of the limitations which the international payments position imposes on their internal policies. Some supporters of a system with freely flexible exchange rates will reject the band proposal for this very reason: they do not want to have their pursuit of domestic expansion hindered by balance-of-payments considerations and believe that freely fluctuating exchange rates will free them from this necessity. They are wrong in that they dangerously exaggerate the capacity of their proposed system. Therefore, it is one of the virtues of the band proposal that it divides the camp of the advocates of flexible rates into two distinct groups: those who want

freedom for domestic policies at all costs and would accept whatever exchange-rate fluctuations might be the consequence; and those who want stable but not rigidly fixed exchange rates. Since these two groups differ in their basic economic philosophy, they should be more clearly distinguished than they are at present. Advocates of freely flexible but stable exchange rates are likely to accept the band proposal as a second-best choice; proponents of the primacy of domestic expansion are bound to reject it.

The Adjustment Process

Exchange-rate variations within a broadened band will induce instant and automatic adjustments in the balance of trade. When the exchange rates are permitted to react as real market prices to changes of demand and supply in the foreign-exchange markets, the following advantages are gained:

(1) All domestic prices are instantly changed for foreign buyers and all foreign prices for domestic buyers since the national price structures are now connected by an elastic link of variable exchange rates. A depreciation of the currency of a deficit country, for instance, will tend to increase exports and reduce imports.

(2) To the extent that exchange-rate variations help produce balance-of-payments equilibrium, we can avoid the difficult, painful, and dangerous attempt to lower (or raise) the whole national price structure through contractionist (or expansionist) monetary policies.

(3) Interest rates and domestic monetary policies would be influenced to a lesser degree by the balance-of-payments situation than under a system with fixed exchange rates. It must be understood, however, that these policies and interest rates can never be entirely independent of balance-of-payments considerations.

(4) Real market forces would take care of immediate trade adjustments, while the support points and the variations of the exchange rates within the band would provide guidelines for the harmonization of national economic policies.

When demand and supply change in the foreign-exchange market it is normally quite natural for the rate of exchange to react and, in reacting, to help bring about a new equilibrium. Only when we believe that these exchange-rate variations are caused by disequilibrating speculation or that they will soon reverse themselves will it be wise to iron them out by official sales or purchases of foreign exchange or gold.

Rigidly fixed parities mean that we prevent the forces of demand and supply from working in the foreign-exchange market and that we violate thereby the basic principle on which the organization of a market economy rests. For no sufficient reason we deprive ourselves of the services of a built-in stabilizer (which we trust in all other markets), delay adjustments, let the external disequilibrium get worse through under- or over-valuation of currencies, and force ourselves to substitute an *artificial* change in bank rates for the *natural* exchange-rate variations which we eliminate when we fix rigid parities. And eventually we may even have to give up these parities through peg adjustments.

Exchange-rate variations free interest rates from unnecessary interference. The bank rate can now be determined primarily according to the requirements of internal economic policies of the member countries, i.e., interest rates would normally not be changed under foreign pressure to produce changes in price levels and in the balance of payments.

Regulation of bank rates is one of the most important instruments of economic policy in market economies, where we try to limit government policies to indirect controls. Through bank-rate changes the monetary authorities attempt to achieve price stability and optimum employment, two aims of internal policy whose achievement fosters rather than hinders external equilibrium. It is most desirable, therefore, that monetary policy should not be deflected from these important tasks by rigid exchange rates and their consequences. If exchange-rate variations can take care of the maintenance of external equilibrium, bank-rate policy is greatly strengthened and it becomes unnecessary to operate monetary and fiscal policies at cross purposes. A broadened band will permit exchange-rate and bank-rate changes to divide the task between them: exchange-rate variations would automatically and instantly work for external equilibrium, and interest-rate changes would be oriented toward the achievement of internal equilibrium. And both equilibria would support each other.

Of course, where excessive deviations of a country's behavior from the behavior of the rest of the international community were the reason for severe external disequilibrium, the domestic policies would have to be changed. But this is not an argument for instant changes in interest rates upon the slightest external imbalance, as in the case of rigid parities.

Internal and external equilibrium are not always in conflict. On the contrary, if the members of an international payments system can maintain satisfactory employment levels and reasonably stable prices, they contribute thereby to external equilibrium. Balance-of-payments trouble often originates with countries which are either unable to maintain a reasonably high level of economic activity, or do so at the expense of permitting themselves a price inflation which exceeds the inflation average of the rest. If monetary policy can be made more successful in maintaining internal equilibrium, exchange-rate variations can be said to help achieve external equilibrium in two ways: directly through their equilibrating influence on the trade balance, and indirectly through the fact that they free domestic monetary policies from unnecessary constraints and enhance their power to achieve domestic stability which, in turn, is conducive to international equilibrium.

A third important contribution lies in the effect that limited exchange-rate variations have on capital movements.

The Band Proposal and Capital Movements

Exchange-rate variations within a broadened band help bring about external balance through their favorable effect on private short-term capital movements. Private funds are attracted when they finance temporary and reversible disequilibria or when they are desirable because they permit more time for necessary basic adjustments; but disequilibrating capital movements from deficit to surplus countries can easily be prevented.

Where gains from exchange-rate variations are added to profits from interest-rate differentials, the widening of the band encourages equilibrating capital movements. This is the case, known from the gold-standard mechanism, where the deficit country has high and the surplus country low interest rates and where capital flows from the surplus to the deficit country, not only because of this differential but also because speculators buy the depreciated deficit currency in expectation of a rebound.

Against the argument that these equilibrating capital movements would undermine monetary discipline in the deficit country, we can say: (1) that adjustments in trade and production always take time, even if flexible exchange rates *start* the adjustment process automatically and instantly, and that in the meantime equilibrating capital

movements are just as desirable as are foreign-exchange reserves; (2) that it is always better that adjustments be gentle rather than harsh and exchange-rate variations smooth rather than abrupt; and (3) that capital imports may remove the need for basic adjustments when disequilibria are only temporary and reversible.

A broadened band could insulate the member countries against undesirable influences from abroad. At rigid parities, interest-rate differentials between countries will cause capital movements from the low-interest to the high-interest country. These capital movements may interfere with the domestic economic policies of the countries concerned, which use bank-rate changes for either anti-inflation or anti-depression purposes.

A high interest rate in *S*, the surplus country, which is supposed to dampen an inflationary expansion will attract funds from deficit country *D*. In country *S* the capital inflow increases the supply of foreign exchange. By acquiring *D*-currency to maintain the fixed parity, country *S* increases its monetary circulation and violates its own anti-inflation policy. If, on the other hand, the rate of exchange were permitted to vary, the price of *S*-currency would rise in terms of *D*-money and act as counterweight to the interest-rate differential. The dis-equilibrating capital flow would not take place.

If deficit country *D* has low interest rates to stimulate domestic investment, the flow of capital to country *S* will be undesirable because it will increase the balance-of-payments disequilibrium and may force country *D* either to stop its expansionist policies, to devalue, or to give up convertibility. Again, if the rate of exchange were permitted to vary, the price of *S*-currency would rise in terms of *D*-money. This would prevent capital from leaving country *D* even though *D* continues its low-interest policy to stimulate investment and employment.

If we reverse the example and let the surplus country maintain low rates of interest owing to domestic depression and the desire to expand, the capital flow need not be disturbing, because the surplus country can afford a reduction in its surplus and can consider investment in the deficit country a work-creating measure from the standpoint of its domestic economy. We need not argue that the capital outflow would be detrimental because it would increase the rate of interest. Owing to its expansionist policies the depression country pursues a policy of credit creation which can easily compensate for the effect of the capital movement on the domestic rate of interest.

We note that in this case, where the capital flow would be desirable from the standpoint of both external and internal equilibrium, interest-rate differentials and exchange-rate variations would, once more, pull in the same direction, because the flow of capital to the deficit country would be fostered by both high rates of interest and a temporarily low price of its currency.

It cannot be expected that the forces which are at work in the credit and foreign-exchange markets will always support equilibrating and discourage disequilibrating capital movements in amounts which are best suited for the situation at hand. The national monetary authorities, therefore, may want to intervene in the foreign-exchange market just as they intervene in the credit market. They could, for instance, determine the exact size of exchange-rate variations needed to offset a given interest-rate differential, which, in turn, is determined by the requirements of the internal policies of the different countries.

Exchange-rate variations within a broadened band are not only an important instrument of the monetary authority which can influence these variations, they are also a sensitive index for ascertaining the growing strength or weakness of a currency. This index, which is a clear price signal, is more straightforward than the gauge which we have to use in a system with fixed exchange rates. That gauge consists of changes in international reserves which are difficult to measure. The determination of the amount of available international reserves, which is a prior step in determining a change in reserves, is initially very hard since reserves do not consist only of officially held foreign balances and gold, but also of habitual credit relations and customary borrowing rights. If we add private foreign-exchange reserves, the picture becomes even more opaque. It is difficult to understand, therefore, why a system of limited exchange-rate variations should be criticized for lowering monetary discipline, when it can gauge the situation (as far as external disequilibrium is concerned) better than a system deprived of an effective market signal.

The Width of the Band

The most important strategic question in connection with the band proposal concerns the width of the band.

For those who have not yet made use of the possibilities which even the Fund Agreement provides, it may be a new and satisfactory experience to let the exchange rate move within the permitted modest range.

The United States monetary authorities found this to be true. Since the range set by the Fund is only 2 per cent, we may assume that double that range would amplify the benefits of these limited exchange-rate variations without danger to external or internal monetary stability.

The range we choose depends on whether we want to stress the regulation of private capital movements or the direct effect of exchange-rate fluctuations on imports and exports. The advocates of the proposal who are interested mainly in counteracting undesirable capital movements need not argue for exchange-rate variations much wider than those presently permitted. A doubling of the present range would probably prove quite sufficient. But a width of the band of only 4 per cent may not permit exchange-rate variations which would influence trade transactions decisively. Some experts believe that for this purpose spreads up to 10 or 15 per cent may be needed.

It is a great practical advantage of the band proposal that it can be introduced gradually as we gain experience and courage. But it is also possible that the full advantages of the proposal can only be had when the variations are large enough to shoulder a substantial part of the adjustment burden. If we are too timid we may never know what we are missing.

We must remember, furthermore, that the monetary authorities are in constant command of the situation, whatever the width of the band may be. The rate may never have to reach the set limits because a careful operation of the system keeps the rate close to parity. If the system should not work well, the rates would tend to get stuck at the support points and the whole arrangement would prove no better, but also no worse, than the present adjustable-peg system.

Should the new arrangement reach such perfection that exchange-rate variations would always stay comfortably within the band, we could remove the support points because they would serve no purpose. Thus a boy may remove the training wheels from his bicycle after he has learned to balance. Whether we had the limits on the books or not would become a matter of indifference. We should have reached the ideal system of simultaneously flexible and stable exchange rates.

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