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TOWARD LIMITED EXCHANGE-RATE FLEXIBILITY

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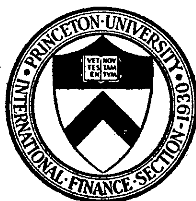

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

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INTRODUCTION

In its 1964 report on the balance of payments the Joint Economic Committee of the United States Congress recommended that "the United States, in consultation with other countries, should give consideration to broadening the limits of permissible exchange rate variations" and in its March 1965 *Report* it urged once more a study of this idea: "Broadening the limits of exchange rate variations could discourage short-term capital outflows through free market forces, on which we should continue to place our main reliance; permit greater freedom for monetary policy to promote domestic objectives; discourage speculation against currencies by increasing the risk; and to some extent promote equilibrating adjustment in the trade balance. . . ."

Noting again in August 1965 (*Guidelines for Improving the International Monetary System*) that it was unaware that any exploration of the advantages and disadvantages of widening the limits of exchange-rate variation had occurred since it had first recommended such study, the Joint Economic Committee expressed the opinion that "to ignore promising proposals for improvement would appear to us a luxury which the free world can ill afford. We do not insist that broader limits for exchange rate variations be adopted, for we have not fully explored their implications nor weighed any possible disadvantages against the benefits we recognize. But we do insist that the expertise of the administration be brought to bear on the idea and that it receive the serious consideration which it merits."

There is no published evidence to the effect that the administration has heeded the urgent appeal of the Joint Economic Committee, which was equally disregarded by other governments, the International Monetary Fund, and the Group of Ten.

Today, three years later, the situation is still unchanged. In September 1968 (*Next Steps in International Monetary Reform*) the Joint Economic Committee repeated its recommendation of a wider band "in view of the persistent international deficits on the part of the United States, the widespread imposition of autarchic restrictions on trade and capital flows in response to reserve losses, and an incipient rise in protectionist sentiment both in this country and the rest of the world" (p. 6). The International Monetary Fund and the Group of Ten, however, continue

to insist, at least publicly, that the present system of fixed, though not unalterably fixed, parities has worked well. Nevertheless, it is obvious that the present arrangements have not been working smoothly. They have led to repeated crises of confidence, to political tensions between Europe and the United States, and even to the introduction of quantitative controls that contradict our professed desire for increased freedom in international economic transactions. These difficulties have not been exclusively caused by exogenous forces; they are to a large extent the result of major defects inherent in a system that tries to join together incompatible elements.

One such defect concerns the use of dollar balances as the main source of additional international liquidity reserves. A constant growth of foreign-held dollar balances implies a continuous external deficit of the United States and, considering the gold convertibility of official foreign dollar balances, a deterioration of the United States' net reserve position. The present handling of the liquidity problem, therefore, decreases confidence in the system. The forthcoming creation of Special Drawing Rights may eventually end this dilemma. But the SDR scheme is to come into operation only after a drastic reduction in the deficit of the United States—a dangerous policy that, if adopted, would make the situation worse before it became better. Reforms of the international monetary system must pay careful attention to the problems of transition from old to new arrangements.

Another basic weakness of the present international monetary system comes from the fact that the system is based on fixed, though not unalterably fixed, exchange rates, together with free convertibility of the major currencies into one another—and of dollars into gold—at fixed parities. In spite of all assurances to the contrary, this so-called adjustable-peg system has shown itself to be a poor compromise between fixed and flexible exchange rates. The reason is obvious. A combination of fixed exchange rates, currency convertibility, and imperfect harmonization of the national economic policies of the member countries cannot work well. As soon as national economic policies diverge—as when, for example, different rates of inflation prevail—fixed exchange rates become disaligned rates, even if they had originally been correct or "equilibrium" rates. Disaligned rates give wrong signals to international trade, international capital flows, and domestic production in the various countries. External and internal tensions will then lead to growing insistence that these "fundamental disequilibria" be corrected through devaluations of deficit and upvaluations of surplus currencies; and these discrete peg adjustments, once they have become unavoidable, will cause severe

shocks in the market economies in which wrong price signals have been permitted to lead to misallocations.

In failing to solve the adjustment problem, the adjustable-peg system intensifies the weaknesses of the reserve-currency system. A deficit country with an overvalued currency can maintain convertibility only so long as it possesses a sufficient supply of foreign exchange; and a financial crisis caused by peg adjustments leads to an additional emergency demand for liquidity reserves. This explains the present overemphasis on the liquidity problem. The dilemma becomes critical when doubts in the maintenance of the dollar-gold parity lead to attempts to eliminate the external deficit of the United States before a new system has been firmly established. The new system should not only provide for international liquidity reserves independent of a continued deficit of the United States, it should reduce the demand for liquidity reserves through a better adjustment mechanism.

We ought to find out whether greater exchange-rate flexibility can provide the presently lacking adjustment mechanism and, if so, how greater exchange-rate flexibility can be built into the international monetary system.

THE CASE FOR FIXED EXCHANGE RATES

Considering the obvious shortcomings of today's international monetary system, it is, at first, surprising that fixed exchange rates meet with the almost unanimous approval of bankers, businessmen, and government officials. If it concerned other prices of strategic importance (such as wages or interest rates), these same persons would oppose a policy of administrative price fixing as inconsistent with the basic principles of a market economy. They know that price fixing tends to lead to quantitative restrictions and eventually to bureaucratic administration of the economy from the center. Why, then, should exchange rates be an exception from this rule?

The main argument is that fixed exchange rates provide a firm and reliable basis for international trade and international financial transactions. If, however, fixed exchange rates can only be maintained by influencing demand and supply conditions on the foreign-exchange market through substantial changes in domestic economic policies or even through quantitative restrictions, the cost of a fixed-rate system can exceed its benefits.

As far as quantitative restrictions are concerned, the case for fixed exchange rates is difficult to uphold. In introducing exchange controls, we abandon the principles of the market economy. If we want currency

convertibility and multilateral trade, we cannot argue for fixed exchange rates once they are sustainable only via quantitative restrictions.

Whether and to what extent monetary and fiscal policies ought to be employed to maintain currency convertibility at fixed exchange rates is an open question. The answer will depend on such circumstances as the relative importance of foreign to domestic transactions, the existing price elasticities, and the relative emphasis on domestic or external balance. Where downward price and wage inflexibilities prevail, the maintenance of fixed exchange rates may imply undesirable results in terms of employment and growth. The cost of maintaining convertibility at fixed exchange rates may then exceed the benefits, and it can no longer be taken for granted that fixed rates are better than flexible rates. The fact that the U.S. Government found it advisable to introduce quantitative restrictions in lieu of monetary measures shows that the costs of contractionist policies were considered too high.

The following remarks on arguments for fixed exchange rates are incomplete; they merely try to show that the prevalent wholesale rejection of arguments for exchange-rate flexibility is not justified, particularly when we keep in mind that the present international payments system permits discrete peg adjustments in the case of fundamental disequilibrium.

The strong attachment of central bankers to fixed exchange rates is easy to understand. Only when the monetary authorities are duty-bound to convert the national currency freely into other currencies at fixed parities, will these authorities be induced to harmonize, as best they can, their national monetary policies with those of the other members of the international payments system. We are told that only the fear of running out of liquidity reserves will assure the necessary monetary discipline and the harmonization of national credit policies. Having received the mandate to defend the exchange value of the national currency and to maintain its free convertibility, the central banker is upheld in his political struggle inside the government (for example, against inflationary deficit spending) and outside (for example, against pressure groups with monopolistic market influence who press for "permissive" money creation).

While much can be said for this argument, it is not correct to assume that discipline is exclusively fostered by the fear of losing liquidity reserves and of endangering convertibility. Maintenance of convertibility can no longer be used as an argument in the defense of fixed exchange rates once exchange controls have been introduced and full convertibility has thereby been abandoned. Furthermore, the size of the liquidity reserves is not the only gauge by which the central bank can judge the

international position of the currency. "After all, exchange rate movements are very clear and loud warning signals. They are much more noticeable by the public than are reserve movements. It seems reasonable to expect that, in deficit countries of major importance as well as in surplus countries, clearer signals would gradually *increase* rather than reduce effective pressure toward responsible behavior."[1]

The argument that fixed exchange rates foster monetary discipline rests on the assumption of *limited* reserves. However, some advocates of fixed exchange rates want to soften the impact of an external imbalance on domestic policies through the supply of *very large* liquidity reserves. This, for example, is the attitude of Sir Roy Harrod, who considers fixed exchange rates advisable because a depreciation of the national currency would imply increasing import prices and interfere with an "incomes policy" that tries to keep wages and prices in line by moral suasion rather than by the use of monetary instruments. But, if an incomes policy is to be substituted for monetary and fiscal measures, we have to doubt the ability of the country to maintain a given fixed exchange rate in the long run. Peg adjustments will then become unavoidable and may prove more damaging than flexible exchange rates to the success of an incomes policy.

Most of the reasoning in favor of fixed exchange rates can be applied only to permanently fixed rates. In the adjustable-peg system the monetary authority can count on the International Monetary Fund's permission to alter the gold parity of the national currency in the case of "fundamental" disequilibrium. Once parity adjustments are permissible, most of the arguments for fixed exchange rates collapse: the long-run transactions no longer rest on the safe foundation of a stable international value of the currency unit; monetary and fiscal policies are no longer forced to defend international liquidity reserves through inconvenient domestic policies; and harmonization of national credit policies can no longer be counted on, with the result that needed adjustments are brought about belatedly and abruptly through devaluations and upvaluations. Emphasis in recent years on liquidity rather than adjustment indicates the increasing erosion of the very discipline and harmonization on which the advocates of fixed exchange rates try to rest their case.

THE CASE FOR FREELY FLEXIBLE EXCHANGE RATES

Consistent application of the principles of a market economy argues for exchange rates that would be free to adjust automatically to chang-

[1] William Fellner, Chapter 2, in *Maintaining and Restoring Balance in International Payments*, ed. by William Fellner, Fritz Machlup, and Robert Triffin (Princeton, N.J.: Princeton University Press, 1966), p. 122.

ing conditions of demand and supply in the foreign-exchange market. Automatic exchange-rate variations would bring about external equilibrium by changing directly and instantly the prices of all commodities in terms of other countries' monetary units. In a system with fixed exchange rates, on the other hand, balance-of-payments adjustments are the result of a long-delayed, roundabout, and painful process through alterations of aggregate spending that exert deflationary and inflationary pressures, often with undesirable consequences for the national economies.

It is easy to ridicule a system with freely fluctuating exchange rates by exaggerating the claims of the advocates of greater flexibility. It can be doubted that the latter really expect that exchange-rate variations would "automatically offset the impact of disparate national policies upon the international pattern of prices and costs . . . without any interference with each country's freedom to pursue whatever internal monetary and credit policy is chosen." (Robert Triffin, *Gold and the Dollar Crisis*, p. 82.) Overstatements like these prevent serious discussion. A system with freely fluctuating exchange rates could not work satisfactorily in a country with endemic inflation, but neither could other payments systems with free convertibility be successful under similar conditions. The very mention of exchange-rate flexibility seems somehow to convey the idea that one would have to expect either self-aggravating depreciations or extremely wide fluctuations or, finally, an irresistible urge to practice competitive exchange depreciation. It is evidently taken for granted that to stray from the virtuous path of exchange-rate rigidity would mean the end of both national monetary discipline and international cooperation.

This view is overly pessimistic. Easing constraints on domestic economic policies may, on the contrary, improve the internal equilibrium of an economy, with beneficial results for the other members of the international payments system. How widely the exchange rates fluctuate will depend on the degree of international economic harmonization that can be achieved under the realistic assumption that each member of the system tries to reach high employment and income levels. The exchange-rate variations needed for the achievement of both external and internal equilibrium may be modest. A system with flexible exchange rates does not postpone the adjustment process and is likely, therefore, to avoid the development of discrepancies that, under a system of fixed exchange rates, may eventually lead to adjustments of parities or the introduction of quantitative restrictions.

Nor does a system of exchange-rate flexibility have to apply equally to all members of the international payments system. Where blocs of

countries manage a high degree of internal harmonization, intra-bloc rates need not fluctuate at all, while between blocs exchange-rate variations may serve as an elastic link.

That countries in a system with flexible rates would pay no attention whatever to their external balances is as unlikely as complete neglect of the national employment situation under fixed exchange rates; nor would floating rates be an invitation to competitive exchange depreciation. Indeed, why should central bankers who have made an excellent record of international monetary cooperation be expected to use beggar-my-neighbor policies as soon as rigid parities are abolished? Why should multilateral surveillance be incapable of solving problems of international monetary cooperation under exchange-rate flexibility? We should remember, furthermore, that the present system of adjustable pegs, with its undervaluation of pegged surplus currencies, comes closer in effect to competitive exchange depreciation than a system that would permit market forces to operate.

However, notwithstanding these arguments in favor of flexible exchange rates, most practitioners and some academic economists strongly believe that complete freedom for exchange-rate variations would mean the end of monetary discipline, that exchange rates would fluctuate wildly and that, far from producing external equilibrium, the system would be injurious to international trade relations and capital flows. Whether right or wrong, these beliefs are too firmly ingrained to permit serious practical consideration of a system of *unlimited* exchange-rate flexibility.

THE BAND PROPOSAL

Rejection of both the present system of adjustable pegs and the system of unlimited exchange-rate fluctuations leaves us with some form of *limited* exchange-rate variations as a compromise between rigidity and flexibility. According to the oldest and best-known version of limited flexibility, the so-called band proposal, exchange rates are to be allowed to fluctuate within a wider range or "band" than the very narrow margins around par values that are permitted under Article IV of the Fund Agreement.

The idea of widening the margins between the so-called gold points under the gold standard system is very old. Robert Torrens, for example, opposed David Ricardo's plan to substitute gold bullion for gold coin with the argument that coin was "a less eligible article for export," permitted wider margins between the gold points and, thereby, greater freedom for domestic monetary policy. (Jacob Viner, *Studies in the Theory of International Trade*, pp. 206-207.) This, we notice, happened

in 1819, when prices and wages were still flexible downward and national-income and employment policies virtually unknown.

Today's monetary authorities, though opposed even to moderately flexible rates of exchange, are not unwilling to make use of small exchange-rate variations permitted by the Fund. Robert V. Roosa, for example, points out that "within the relatively narrow band which is . . . 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." He also argues, convincingly, that "we want and need the sensitive signals of changes in fundamental forces that are reflected in price fluctuations in free markets." However, while Roosa reasons here implicitly for exchange-rate flexibility, he, nevertheless, expresses the fear that public authorities would come under pressure to manipulate the rates and that this could lead "to competitive devaluation, and on to trade and exchange restrictions." Free exchange markets, therefore, could "degenerate into disorderly chaos if they do not have some fixed point of reference." Since the widened band retains this fixed point of reference, Roosa admitted more recently that "the wider band might some day be of some use."[2]

The band proposal suggests three fixed points of reference by permitting exchange-rate variations around fixed par values and within predetermined support points. Assuming that a monetary authority maintains a given dollar parity and uses the dollar as "intervention currency," it will supply dollars without limit when the upper support point is reached, thus preventing a depreciation of its own currency unit; similarly, it will stand ready to buy dollars in unlimited amounts at the lower support point to prevent a further appreciation of its own currency unit. The rate of exchange is both fixed and free: attached to the parity as reference point, and free to rise and fall between the support points.

Whether this compromise between rigidity and flexibility favors discipline or freedom will depend on the width of the band, in conjunction with the supply of international liquidity reserves. Relatively small reserves combined with a relatively wide band can have about the same effect as a combination of larger reserves with a narrow band. It would not be correct to say, therefore, that a widening of the band will lower monetary discipline or that exchange-rate rigidity can be relied upon to

[2] The four quotations are from different sources. The first two are in articles reprinted in *Factors Affecting the United States Balance of Payments*, Joint Economic Committee 87th Congress, 2nd Session, 1962, pp. 328 and 339, respectively. The third is from Roosa's book, *Monetary Reform for the World Economy* (New York and Evanston: Harper and Row, 1965), p. 27. The fourth is from Milton Friedman and Robert V. Roosa, *The Balance of Payments: Free versus Fixed Exchange Rates* (Washington: American Enterprise Institute, 1967).

compel the adoption of policies leading to adjustment. Adjustment and liquidity are to a large extent substitutes. We must remember, though, that extended use of reserves is preferable to fast real adjustment only in the case of temporary and reversible imbalances of international payments; that more deepseated imbalances must be eliminated; and that more flexible exchange rates may be preferable to rigid rates in bringing about both external and internal balance.

The practical success of the widened band will depend on whether or not the permitted exchange-rate variations can perform their market functions while maintaining confidence in the stability of the situation. Only practical experience will tell. It may prove desirable to widen the band gradually as the parties engaging in foreign-exchange transactions gain confidence in the new mechanism. On the other hand, too timid an approach might prevent foreign-exchange variations of the size needed to produce equilibrium, particularly if the new system were not started on the basis of true equilibrium rates for convertible currencies. A general realignment of the member countries' parities might greatly help the transition from the present system to one with a wider band.

HOW THE WIDENED BAND WORKS

The present system of the adjustable peg achieves a pseudo flexibility by permitting large discrete revaluations. The system, in fact, is rigid and brittle. The widened band, on the other hand, would combine smooth adjustments through continuous exchange-rate variations with guaranteed limits to these fluctuations at the support points. The latter would be guideposts, clear signals for the monetary authority to support the adjustment process through domestic monetary policies. But these "interferences" with domestic economic policies would be rare because external adjustment would no longer be delayed as under the adjustable-peg system.

Adjustment of the trade balance through exchange-rate variations would still take time, but its start would be immediate and automatic instead of being postponed for years. Exchange depreciation inside the band will lead to increasing exports and decreasing imports, though, of course, not without a time lag. The exchange rate, therefore, may first tend to depreciate below the long-run equilibrium point for the new market conditions. As Erik Lundberg (*Skandinaviska Banken Quarterly Review*, October 1954) and James E. Meade (in *Factors Affecting the United States Balance of Payments*, pp. 241-253) have pointed out, this temporary excess depreciation will induce private speculation to move funds from the surplus into the deficit currency in expectation of a rebound when real adjustment has taken place. The short-run flow of

private speculative capital will help finance the temporary deficit and thereby prevent an overreaction in the process of trade adjustment when no serious fundamental disequilibrium is involved.

The mechanism of trade adjustment through varying exchange rates needs no elaboration, and postwar experiences suggest that a band of a total width of 10 per cent would in most cases have sufficed to maintain external equilibrium without parity changes or excessive supplies of international liquidity reserves, since the process of adjustment would have been set in motion without delay.

The additional risk in foreign transactions could be taken care of by the forward exchange market. The cost of hedging cannot be a serious consideration in a competitive market economy. This cost, in any case, is less serious than the private and social costs of delays in the adjustment process under a fixed-rate system.

There is no reason to expect that exchange-rate variations within a band of 5 per cent on each side of parity would lead to competitive exchange depreciation or exchange restrictions. On the contrary, it is the present fixed-rate system which, by permitting long periods of over- and undervaluation of currencies, has led to unfair advantages and the introduction of restrictive policies.

BAND PROPOSAL AND CAPITAL MOVEMENTS

The advocates of fixed exchange rates take it for granted that exchange-rate flexibility would be detrimental to desirable international capital movements. They are wrong, at least with regard to short-term movements. The introduction of a widened band would favor equilibrating capital flows and discourage disequilibrating speculation, whereas a system of abrupt adjustments of parities will always be exposed to speculative disturbances.

To understand the connection between exchange-rate variations and short-term capital movements we must first distinguish between non-dilemma and dilemma cases.

Let us assume that a country has reached its state of full employment through the application of expansionist monetary and fiscal policies that have raised prices and made the country less competitive at fixed exchange rates. Full employment has exerted an upward pressure on wages, and a high level of economic activity and national income has stimulated imports further, that is, over and above the increased propensity to import owing to relatively more attractive foreign prices. The full-employment country therefore, will have acquired a deficit in its balance of payments. For similar but opposite reasons, an underemployed