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

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International Finance Section

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FOREWORD

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

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

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

INTRODUCTION

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

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

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

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

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

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

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

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

I. THE ROLE OF EXCHANGE RATES IN THE ADJUSTMENT PROCESS

Balance-of-Payments Equilibrium

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Current Transactions

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

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

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

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

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