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In their recently issued Report on *The Role of Exchange Rates in the Adjustment of International Payments*, the Executive Directors of the International Monetary Fund express the opinion that "the par value system, based on stable, but adjustable, par values at realistic levels, remains the most appropriate general regime to govern exchange rates in a world of managed national economies" (p. 67). However, the door is left open for changes, even if they should require an amendment of the Articles of Agreement, and there seems to be a consensus among the Executive Directors that the par-value system should be interpreted broadly so that somewhat greater flexibility of exchange rates could be achieved.

Critics of the par-value system prefer to call it the adjustable-peg system. They stress that (1) even a temporary fixity of par values leads to wrong rather than realistic exchange rates, because sufficiently close coordination of domestic policies cannot be achieved in a world of managed national economies; (2) wrong rates give faulty price signals to international trade and capital flows; (3) fixed parities can be sustained only by inordinately large amounts of international liquidity (often created *ad hoc*) or else by restrictions on international trade and payments; and (4) substantial parity adjustments tend to have serious political implications, nationally and internationally.

The basic disagreement concerning the system of par values or adjustable pegs goes back to the two plans which served as a basis for the discussions from which the Bretton Woods Agreement emerged as a compromise between the defenders of a system with fixed par values and the advocates of a system with more flexible exchange rates.

The Bretton Woods Compromise

Most of the experts who participated in the discussions which led to the creation of the International Monetary Fund supported the aim of stability of exchange rates. Harry Dexter White wanted to create an International Stabilization Fund whose resources "would be available under adequate safeguards to maintain currency stability, while giving member countries time to correct maladjustments in their balance of pay-

ments without resorting to extreme measures destructive of international prosperity." [*White Plan*, 1943, Preamble 3.] The chaos that existed in international monetary relations through much of the interwar period makes it understandable why currency stability and, in particular, avoidance of competitive exchange depreciation were considered of the utmost importance. Even J. M. Keynes in his *Proposals for an International Clearing Union* admitted the need for "an orderly and agreed method of determining the relative exchange values of national currency units, so that unilateral action and competitive exchange depreciations are prevented." [*Keynes Plan*, 1943, I, 1 (b).]

But while Keynes did not want to permit alterations of par values without the permission of the Clearing Union, he emphasized the importance of domestic employment policies much more than that of the stability of exchange rates and argued 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." [House of Lords, May 23, 1944.] Keynes suggested, therefore, that the Clearing Union might not only permit but even require "a stated reduction in the value of the member's currency, if it deems that to be the suitable remedy." [*Keynes Plan*, II, 6 (8).] These adjustments depended on the member's deficit balance with the Union. A member whose credit balance exceeded half of its quota would discuss with the Governing Board "the appreciation of its local currency in terms of bancor or, alternatively, the encouragement of an increase in money rates of earnings." [II, 6 (8) and (9).]

The White Plan permitted changes in the exchange value of the currency of a member country "only when essential to the correction of fundamental disequilibrium in its balance of payments" and only with the approval of three-fourths of the member votes. [IV, 5.] In the *Joint Statement on the Establishment of an International Monetary Fund* of April 21, 1944, the compromise between the British and American positions, White's International Stabilization Fund became an International Monetary Fund and the notion of a "situation of fundamental disequilibrium" was no longer limited to the state of the balance of payments. But the Joint Statement did not set up an adjustment mechanism geared to transactions between the members and the Fund. Keynes' acceptance of the compromise shows that he believed that the Joint Statement guaranteed the basic principle of managed flexibility of exchange rates. In fact, in the House of Lords he called it "the duty of the Fund to alter the gold value of any currency if it is shown that

this will be serviceable to equilibrium." Quite possibly White did not agree with Keynes. The vagueness of the concept "fundamental disequilibrium" blurred their differences enough to permit the great compromise.

A small number of economists and politicians expressed at the time the opinion that the Bretton Woods compromise would not work. Most outspoken was a participant in the British Parliamentary Debate, Mr. Benson, who argued on May 12, 1944 in the House of Commons that "even the Keynes Plan would introduce fixed exchange rates which could only be altered by permission, while the three prerequisites to the possibility of fixed exchange rates could not be met simultaneously, viz., (1) an unvarying ratio between international price levels, (2) an equation of imports and exports on current account, and (3) capital movements which represent and equate material movements." Benson believed that a system of frequent adjustments would be exposed "to disturbing speculative movements since nobody will buy the goods of a country for which a depreciation is impending until the depreciation has taken place." Frank D. Graham in his *Fundamentals of International Monetary Policy* [Princeton, 1954, p. 10] expressed the opinion that the new plans "would set up a (wobbly) system of fixed rates (maintained until collapse is imminent) without any provision for the adoption of the internationally unified price level policy under which, alone, fixed exchange rates can make sense." And R. G. Hawtrey commented in *Bretton Woods for Better or Worse* [London, 1946, p. 4] that "the limitation by the Bretton Woods Plan of the freedom of a member to release its currency from fixed rates of exchange is a serious danger."

The Bretton Woods system meant to combine the disciplining effect of fixed parities with the safety valve of parity changes if external equilibrium at fixed rates required either too much inflation or too much unemployment in the member countries. It did not contain an adjustment "mechanism" or even reasonably clear indicators as to when parity adjustments were in order.

When the Executive Directors say in their recent study "that the basic principles of the Bretton Woods system are sound and should be maintained and strengthened" (p. 67) they refer to principles not at all clear from the beginning and to a system whose main defect has been, all along, that it lacked an exchange-rate mechanism. That they did not fully trust the system of fixed rates is shown by their quoting the following passage from the Fund's 1969 Annual Report:

> If exchange rates that are no longer appropriate are nevertheless maintained, they contribute to the persistence of payments disequilibria, the encourage-

ment of speculation, and crises in the exchange markets. Moreover, undue rigidity of exchange rates may lead to the very developments that the par value system is intended to avoid, including restrictions on current transactions, the imposition or intensification of capital controls, and the sluggish growth of development aid.

This quotation implies an admission that an "undue rigidity" of exchange rates can develop under the par-value system, and this realization evidently induced the Directors to consider a somewhat broader interpretation not only of the definition of fundamental disequilibrium but also of the whole operation of the system.

The Par-Value System

The Executive Directors' Report sees the essence of the par-value system in the acceptance by the member countries of a limitation on their freedom of action over the exchange rate and in the acceptance by the international community of the right of individual countries "to adjust their exchange rates to fulfill legitimate domestic objectives, as well as agreed international objectives" (p. 5).

The aim of the par-value system as described in Article I(iii) of the Fund Agreement is "to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation." However, the newer proposals for greater flexibility of exchange rates also want to promote stability. If the expression "orderly exchange arrangements" refers to the absence of exchange controls, it is equally applicable to wider margins and gliding parities. Finally, the new proposals, too, want to avoid competitive exchange depreciation. Success in this direction in the post-World War II period cannot be credited exclusively to the maintenance of par values. As the Report admits, member countries are less likely to embark on competitive exchange depreciation because of the growing success of their employment policies. But the Report seems to claim a substantial part of this success for the elasticity of a system that permits adjustment of parities where permanently fixed exchange rates would prevent external equilibrium at high levels of employment. What the Report does not emphasize is the fact that, today, the main danger does not come from competitive exchange depreciation but from the maintenance of disaligned parities under a par-value system whose members have been all too slow in their adjustment to realistic par values.

"Undue delay" in the adjustment of par values may have occurred because fears of competitive exchange depreciation were stronger than objections to continued undervaluation. The concept "fundamental disequilibrium" was meant to be a protective fence against both "pre-

mature" and "unduly delayed" parity changes and it seems that in the operation of the system the general trend was to err in the direction of too much delay. With the Report's new interpretation of fundamental disequilibrium, this situation may improve.

Concerning the domestic aspects of the par-value system, the Report states that the exchange rate as the price of foreign exchange in terms of domestic money "performs certain basic functions of the price mechanism in influencing the allocation of resources and contributing to the balancing of supply and demand of the commodity in question—in this case foreign exchange" (p. 6). This statement would be correct if it referred to freely floating exchange rates; applied to fixed parities it is wrong, because artificially fixed prices do not perform their basic function in accordance with the principles of market economies. Indeed, they interfere with the market mechanism, maintain obsolete prices, and prevent the balancing of demand and supply via market forces, so that equilibrium must be achieved either through official sales and purchases in the foreign-exchange market or through direct controls.

The Report argues that the exchange rate in the par-value system should be looked upon "as a fixed point of reference which provides a useful discipline for the maintenance of financial stability domestically . . ." and states that fixed par values have "an important influence on basic financial magnitudes in a national economy," that is, "the flow of aggregate domestic output, incomes, and spending" (p. 6). Thus, while giving lip service to the exchange rate as a price and to its balancing effect on demand and supply, the Report concludes that this strategic price ought to be fixed so as to force responsible national monetary policies upon the member countries of the system and so as to create external balance *indirectly* through changes in domestic aggregates rather than in exchange rates. However, this disciplinary effect of the par-value system would be desirable only if the exchange rates could be maintained at "realistic" levels and this would be possible only if the national economic policies of the member countries could be adequately coordinated through pressures exerted by fixed par values.

The Report reminds us that "in many countries the authorities have regarded a stable par value as a valuable aid in maintaining domestic economic stability" (p. 32). We are told that even in countries "which have not succeeded in dispensing with eventual exchange adjustment, the norm of fixity in the exchange rate has nonetheless been considered as an aid to equilibrium, both in the domestic economy and externally," because it promoted "political willingness to impose unpopular domestic restraints" (p. 32). This argument is not convincing: external equilibrium obviously was not reached, since eventually the parity had to be ad-

justed; and the domestic measures, though not achieving the external objective, may well have harmed the domestic economy, which was forced to accept the punishment of an unrealistic exchange rate for too long. Here the authors of the Report express sympathy with the very attitude which, in the past, has produced many undesirable delays in the adjustment of par values. They go even further when they argue that "where the attempt to defend the parity is ultimately unsuccessful, the psychological shock of a devaluation may promote broad support for the adoption of the necessary associated measures to curtail domestic demand" (p. 32). A more continuous adjustment of parities "without the trauma implicit in the act of exchange adjustment as a last resort, would exert less pressure for domestic corrective measures" (p. 32). Here the Report goes to the extreme position of actually defending "unduly delayed" parity changes by relatively large percentages.

The Report admits, however, that "in some countries that have been more successful than others in curbing inflation, maintenance of a fixed exchange rate has increased the difficulty of preserving domestic financial stability" (p. 32). Quite generally the Report agrees "that adjustments in par values have in a number of cases been unduly delayed," that "these delays have sometimes tended to aggravate problems of domestic economic management, and have sometimes also aggravated the external disequilibrium" (p. 34). The Report concedes, furthermore, that these delays have fostered the use of trade and payments restrictions and led to the building up of large speculative positions which played a disequilibrating role. Nevertheless, the Report suggests that these disadvantages may be weaknesses of the *operation* of the system rather than of the system itself and could be considered "as necessary costs that in the long run are outweighed by compensating advantages" (p. 34).

Achievements of the Par-Value System

The Report credits the par-value system with having contributed to the achievement "of unparalleled economic growth; albeit accompanied by continuing domestic inflation" (p. 29). But since this achievement was, admittedly, "the result of a complex of factors" (p. 29) it is not easy to identify the specific contribution of exchange-rate arrangements and policies. Concerning the par-value system, it remains an open question whether its main contribution came from the stabilizing effect of the "fixed point of reference" rather than from the freedom which the adjustability of the peg permitted in the national economic policies of the member countries. Historical references are not very helpful, particularly if we recall that the system was not free from international payments crises and restrictions on trade and capital movements.

The Report stresses the virtual absence of competitive exchange depreciation, evidently implying that this beggar-my-neighbor policy could not have been avoided with greater flexibility of exchange rates.

Another claim for the par-value system contends that "the arrangements under which countries other than the United States regulate their currency against the U.S. dollar . . . while the United States itself pursues a generally passive role in exchange markets, have provided a way of avoiding conflict between the actions of exchange authorities of different countries, without necessitating the elaboration of a set of rules or understandings on policies of exchange support" (p. 31). We have to ask, however, how this system has affected the competitive position of the key-currency country itself and we may have to agree with C. Fred Bergsten that the United States has suffered under a system in which (1) "payments pressures prompt or force devaluations, but seldom prompt or force revaluations," (2) revaluations tend to be smaller and devaluations larger than necessary, and (3) "any single devaluation generates pressures on other countries to devalue, both because of legitimate fears over loss of competitive position . . . and because devaluation is easier to justify politically if done in response to a like movement by another country." Bergsten concludes that "these biases toward devaluation against the dollar" explain American balance-of-payments deficits to a significant degree and, thus, that a system with greater exchange-rate flexibility "would be in the interest of the United States." [See *Approaches to Greater Flexibility of Exchange Rates, The Bürgenstock Papers*, ed., George N. Halm, Princeton 1970, pp. 68 and 75.] The Report does not mention the fact that serious conflicts have arisen between the United States and certain surplus countries under the par-value system.

Apart from fostering discipline and avoiding competitive exchange depreciation, the main advantage claimed for the par-value system is that it will not be subject to "premature" changes of exchange rates. Why it should be obvious that exchange rates must be fixed at all times, why "it would be clearly inappropriate to adjust parities in response to balance of payments disequilibria of a seasonal or short-term cyclical nature" (p. 48) is not explained in the Report. Whenever an explanation is attempted, it leads quickly into the discipline argument or the rejection of competitive exchange depreciation. The authors of the Report seem to assume that floating exchange rates would always fluctuate substantially and that these fluctuations would present an unbearable additional risk to all international transactions. This reasoning need not be discussed again, but a reminder may be in order that those who are afraid of what even relatively small fluctuations of exchange rates might do

to the allocation of domestic resources are not consistent when they reject proposals for greater flexibility of exchange rates with the argument that the equilibrating effect of relatively small movements of exchange rates within a broadened band would tend to be negligible.

Whatever the arguments for fixity of the exchange rates and against premature adjustments of parities, it is imperative that the par-value system should be provided with reasonably clear criteria by which the difference between "premature" and "unduly delayed" adjustments can be determined. Since adjustments are to be permitted in cases of "fundamental disequilibrium," the Report makes the attempt to explain this concept which the experts at Bretton Woods had left vague on purpose.

Fundamental Disequilibrium

The Report emphasizes that a state of fundamental disequilibrium can exist when a country enjoys external balance, so long as "attainment of payments balance through the use of measures destructive of national or international prosperity would clearly not comprise a durable payments equilibrium" (p. 48). For instance, the external balance is only maintained by restrictions on trade or payments or by "an unacceptably low rate of economic activity" (p. 48). Similarly, the external balance may only have been maintained at the price of "an unacceptably high rate of inflation" (p. 48) or artificial measures encouraging the export of capital. So far, so good. However, the Report makes the concept of fundamental disequilibrium a prop of the par-value system by insisting that *it implies* "that where other measures can be taken to restore payments balance without damage to national or international prosperity, these should be preferred to exchange adjustment" (p. 49).

A different situation exists, states the Report, "where the requirements of internal and external stabilization point in opposite directions for domestic policy (e.g., where an external surplus coincides with excessive strain on domestic resources). There is then no such presumption in favor of domestic measures directed to restoring external equilibrium, since such measures, at least if unaccompanied by exchange adjustment, will intensify the domestic disequilibrium" (p. 49). Fundamental disequilibrium, therefore, exists when internal and external considerations are "pulling in opposite directions as regards domestic stabilization measures" (p. 49) and if this conflict is of a persistent nature.

Persistent surpluses are more likely than persistent deficits, because surplus countries are in a position to avoid parity adjustments whereas deficit countries are often forced to devalue. The reason is that a country can always buy up an excess supply of foreign exchange with its own newly created money while a deficit country must, sooner or later,

exhaust its own or borrowed liquidity reserves. This asymmetrical situation, which the Report does not stress, suggests that special pressure ought to be exerted in the case of a surplus country which is unwilling to revalue because it wants to preserve its export advantage. Some interesting suggestions concerning an asymmetrical treatment of surplus and deficit countries have been made by George H. Chittenden, William Fellner, and Robert V. Roosa in *The Bürgenstock Papers*, but they have not been mentioned in the Report.

Mere reference to dilemma cases is not going to solve the practical problem of steering the right course between "premature" and "unduly delayed" par-value changes. To begin with, we cannot automatically support fixed par values merely because measures for external and internal equilibrium do not conflict. It is true that when a country that is suffering from underemployment finds itself in payments surplus it can employ expansionist policies without immediate need to worry about its balance of payments. However, in a system with freely flexible exchange rates the market rates would not begin to depreciate until a successful policy of domestic expansion reverses the demand and supply situation on the foreign-exchange market. Rejection of greater flexibility of exchange rates when applied to this case rests on the suspicion that competitive exchange depreciation would be used to achieve full employment—an unjustified assumption when we consider that much better employment policies are available today and remember that the spirit of international monetary cooperation is not exclusively the product of the par-value feature of the Bretton Woods system.

For countries that suffer from balance-of-payments deficits while they maintain full employment—another nondilemma case—the Report suggests once more the maintenance of fixed par values and the use of high rates of interest, since the latter would combat domestic inflation and attract foreign funds, thereby eliminating external imbalance. It is not a foregone conclusion, however, that maintenance of the par value is the best policy in this case. The monetary constraints required for removal of the deficit may cause an unacceptable degree of unemployment under modern conditions of cost-push and administrative price inflation. We can assume, therefore, that the Executive Directors would consider this situation a clear case of fundamental disequilibrium.

In dilemma cases, internal and external considerations pull in opposite directions and the Report suggests that this conflict "may indicate a fundamental disequilibrium" (p. 49). A surplus country with full employment, for instance, that insists on maintaining an undervalued currency, will increase its external surplus when it tries to combat inflationary pressures by conservative monetary and fiscal policies. It should