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THE CHOICE OF A PIVOT FOR PARITIES



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INTERNATIONAL FINANCE SECTION

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THE CHOICE OF A PIVOT FOR PARITIES

During the recent discussions on exchange-rate reform it has generally been taken for granted that the dollar would not participate in any arrangements for increased flexibility that might ultimately emerge. The assumption has been that a widened band would merely involve other countries pushing their dollar intervention points further away from parity, while a crawling peg would be implemented by other countries making periodic modest changes in the dollar parities of their currencies; in either case, there would be no scope for an American policy regarding the exchange rate of the dollar. So far as a wider band is concerned, this presumption is unexceptionable; intervention by the United States on the exchange markets would raise the risk of inconsistent intervention and create ambiguity regarding the responsibility for maintaining rates within the band without achieving any significant objective. But if one is envisaging a change to the crawling peg, there is a real choice between a system in which the dollar remains passive, and thus acts as a pivot around which other currencies are adjusted, and a system in which some suitable international unit is adopted as the pivot and the dollar is treated like any other national currency in its ability to adjust actively relative to that pivot.

A "pivot" will be defined as the numeraire, or unit of account, in terms of which currency parities are expressed. It therefore corresponds to what Cohen has described as a "unit-of-account currency" (Benjamin J. Cohen, *The Future of Sterling as an International Currency*, London, 1971, p. 17). The use of the special term "pivot" to describe the unit in terms of which parities are expressed seems preferable to the use of a more general term (such as "numeraire" or "unit of account") in that it emphasizes that the use of gold as a pivot would in no way be inconsistent with the dollar remaining a widely used unit of account, or numeraire, for private transactions.

The present essay is devoted to exploring the economic issues raised by the choice of a pivot, under both the adjustable peg and the crawling peg. Most of the analysis compares the two principal contenders for the role of pivot—the dollar on the one hand, and the gold/SDR unit on the other. It is argued that the major issue involved in this choice is whether or not it is desirable for one country to pursue a balance-of-payments policy of "benign neglect" (since an active payments policy

requires the possibility of initiating an exchange-rate change), and it is concluded that passivity is not desirable. The objection that inconsistent payments objectives might lead to a scramble for reserves if all countries pursue active payments policies is shown to be surmountable by the adoption of an appropriate convention governing the rate of SDR creation. The essay concludes with a consideration of the feasibility of introducing the changes that the analysis has suggested to be desirable.

The Alternative Pivots

Under a dollar pivot, the United States would not have the opportunity of changing the parity of the dollar. All other countries would declare the parities of their currencies in terms of the dollar. Since it is widely believed that the option of an exchange-rate change is not open to the United States under the system as it has evolved in the postwar period, one can say that the present system is on a *de facto* dollar pivot.

Under a gold/Special Drawing Rights pivot, all countries—including the United States—would declare their parities in terms of gold (to which the value of SDRs is rigidly linked). It follows that the United States would have the same legal right to initiate a parity change as any other country. This is, in fact, the system that is enshrined in the existing Articles of Agreement of the International Monetary Fund. Article IV, Section 1(a) states:

Expression of par values. The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944.

In principle, therefore, the United States could request permission from the IMF to devalue the dollar (or act unilaterally for a devaluation of less than 10 per cent, since the initial leeway of a 10 per cent par change has never been utilized), and Congress could authorize the necessary increase in the dollar price of gold. It is not true, as is sometimes supposed, that such action would automatically result in a proportionate increase in the price of gold in terms of all currencies that have chosen to express their par values in terms of the dollar, because "the dollar" for the purpose of expressing parities is the 1944 gold dollar and not the current dollar. It would therefore be necessary for other countries to undertake a devaluation if they wished to avoid revaluing against the dollar. The present system is *de jure* on a gold pivot.

While remaining on the purely mechanical level of how a gold/SDR pivot would operate, it may be helpful to give a simple example of the repercussions of a decision by the United States to devalue the dollar

by (say) 1 per cent. Assuming that the dollar remained the intervention currency, other countries would have to alter their intervention limits. The intervention limits of the Bank of England, for example, would rise from \$2.38 and \$2.42 to \$2.404 and \$2.444. Calculation of the parities and intervention limits in terms of the intervention currency, the dollar, from the set of parities in terms of the pivot, gold, and the band widths is no more than a trivial arithmetical exercise.

There are other possible pivots besides the dollar and gold/SDRs. After all, there are over a hundred other members of the IMF, most of which have a currency: any of these could be chosen for the role of pivot if any advantage were seen in such a step. In practice, of course, the position of the dollar as the dominant form of international money makes it virtually inconceivable that any other national currency would be selected for this one (international) monetary role in preference to the dollar. And, in any event, the principles involved would be essentially the same if one were considering casting any other national currency in the role of pivot. There is therefore no serious loss in restricting discussion to the case of a dollar pivot.

There is also the hypothetical possibility of breaking the link between gold and SDRs and adopting the latter as pivot. This suggestion was aired by Stephen Marris (*The Bürgenstock Communiqué: A Critical Examination of the Case for Limited Flexibility of Exchange Rates*, Essays in International Finance No. 80, Princeton, 1970, pp. 47-50) in the course of the most thorough previous discussion of the issues involved in the choice of a pivot. The principal argument advanced in favor of this proposal is that it might circumvent any American objection to breaking the letter of their past commitment not to raise the dollar price of gold, since gold could remain rigidly tied to the dollar while the gold dollar crawled against SDRs. The proposal has the disadvantage of failing to use gold in the one monetary role—that of unit of account—which its long history makes it suitable to fulfill, as well as requiring an additional (and probably controversial) amendment to the IMF Articles to break the link between gold and SDRs. On economic grounds the SDR pivot would not differ significantly from the gold/SDR pivot, so that the former does not require separate discussion: the choice between the two is a matter of cosmetics, not economics.

It would be possible to use either a dollar pivot or a gold/SDR pivot with either the adjustable peg or most versions of the crawling peg. A decision-variant crawling peg (that is, one that involves parity changes which, though small, are a matter of deliberate government decision) could operate with either pivot. A formula-variant crawling peg is one where parities are determined according to some automatic formula

such as an average of past market rates of exchange or a relationship based on the level of, or change in, reserves. Formulae that utilize changes in reserves or the deviation of reserves from a target level could again employ a gold/SDR pivot (or, of course, a dollar pivot) without any problem, since the United States holds reserves much like any other country. The only problem would arise in the (highly improbable) event of a desire to introduce a formula-variant crawling peg based on past market rates of exchange: this would be inconsistent with a gold/SDR pivot unless the gold markets were reunified so as to provide a market from which to calculate gold-currency relationships. However, John Black ("A Proposal for the Reform of Exchange Rates," *Economic Journal*, June 1966) has argued that under such a system one does not need a pivot at all; each parity can be directly calculated in terms of all other parities.

The Grounds for Choice

It is natural to commence a comparison of the dollar pivot with the gold/SDR pivot by asking why the *de jure* gold pivot has evolved into the present *de facto* dollar pivot. The answer would seem to be that it has been believed, rightly or wrongly, that the United States did not have the ability to engineer a small devaluation of the dollar against the generality of other currencies by simply implementing a modest change in its parity. In part, this was because other countries were presumed to be reluctant to accept revaluation against the dollar, which would imply that they would choose to follow the dollar down—unless, at any rate, the dollar was devalued so much as to grossly inflate the purchasing power of gold reserves. The more cogent reason for doubting the practicality of a small unilateral change in the dollar exchange rate related to the effect on gold speculation. Any change in the dollar parity, which is expressed in terms of gold, would have been interpreted as a sign that the authorities were weakening in their resolve to prevent a large revaluation of gold and would therefore have precipitated a massive flight into gold. Prior to the abandonment of the gold pool, this would have threatened the existence of the gold-exchange standard—as in fact occurred in March 1968, when the system was abandoned in the face of unsustainable speculative pressure. Since the introduction of the two-tier gold market, the argument has been modified somewhat: it is now contended that an attempted flight into gold would drive the price up so much as to tempt some of the smaller central banks to sell official gold on the private market, thus jeopardizing the functioning of the two-tier system.

Although it is not clear that it has been influential in determining

policy in the past, one further consideration deserves mention. This is the possibility that American-initiated changes in the exchange rate of the dollar would be unsettling to foreign holders of dollars and thus undermine the usefulness of the dollar as international money. Like the danger of provoking gold speculation and the fear that an American depreciation would be nullified by widespread imitation, this is certainly not a frivolous point. My judgment is that a gold/SDR pivot would not be advantageous if it were introduced in circumstances that led to any of these three dangers materializing. It is therefore important to discover whether and how the dangers may be avoided; for this purpose, each of the topics is considered at greater length in a subsequent part of this essay.

A gold/SDR pivot enjoys a number of advantages. One may start by outlining a few of them that are straightforward, though perhaps of only modest importance. The first arises only under a crawling peg. Under a gold/SDR pivot the maximum rate of parity change between the dollar and any nondollar currency is the same as that between any two nondollar currencies, whereas under a dollar pivot any currency crawling up at the maximum rate would be appreciating relative to one crawling down at the maximum rate at twice the speed that either was changing relative to the dollar. So long as American price performance was modal this difference would be unimportant, because some countries would be wishing to appreciate relative to the dollar and others to depreciate, and no additional constraints would be imposed by the dollar's special status. If, however, American price performance were extreme—in *either* direction—then a dollar pivot would reduce the effective amount of flexibility conferred by any specified maximum rate of crawl. One could, of course, seek to compensate for this by increasing the permissible rate of crawl. But one of the attractions of crawling, as opposed to more extreme forms of flexibility, is the limitation it places on the uncertainty caused by exchange-rate variations; a faster permissible rate of crawl would tend to increase this uncertainty. Moreover, the ability of the crawling peg to eliminate hot-money flows without excessively large interest-rate differentials is dependent upon expectations that rates of parity change will be modest. Such expectations would be rather harder to maintain if it were necessary to increase the maximum rate of crawl in order to accommodate an atypical American price performance. It is true that the parity between any nondollar currency and the dollar could not change more rapidly under a dollar pivot than under a gold/SDR pivot unless the maximum rate of crawl was more than twice as great in the former case as in the latter, but the potential rate of change of cross-parities between nondollar currencies would increase *pari passu* with the

increase in the permitted rate of crawl, and these cross-rates are also major determinants of the extent of uncertainty and the necessary interest-rate differentials.

The second advantage applies under both the adjustable peg and the crawling peg but would be especially important under the former. It concerns the ease of rectifying a situation where the dollar has become inappropriately valued without corresponding misalignments among other currencies. The absence of an American exchange-rate policy that results from operating with a dollar pivot means that the restoration of an appropriate set of relationships would require the organization of a series of parallel parity changes by other countries, whereas under a gold/SDR pivot the United States could simply change the dollar parity. It is virtually impossible to arrange concerted parity changes under the adjustable peg, for the obvious reason that the inevitable rumors would spark hot-money movements: it is notable that the franc and deutsche-mark parity changes in 1969 were not in the end synchronized, despite the fact that everyone knew both changes were coming. Concerted parity changes should be rather easier under a crawling peg, but it would still be simpler to change a single parity than a large number.

Although the August crisis suggests that the second advantage would have been relevant to the circumstances of 1971, it is probably true that these considerations would be of dominant importance only if the United States ceased to be reasonably modal in its price behavior. One may not regard this as particularly probable, but one might still wish to insure against such an eventuality if one believes that history's most convincing lesson is the danger of naively extrapolating the recent past.

A third advantage of a gold/SDR pivot, which was in fact the major point advanced in its favor by Marris, is that it would prevent the competitive position of the United States from being undermined by any "devaluation bias" that the system may contain. Instead of the United States finding it necessary to pressure other countries into revaluation (a process that does not seem calculated to enhance friendly relations with its partners), it could exercise the option of itself devaluing. Although evidence that the system suffers from a devaluation bias has never been produced, there must be advantage in providing a way of countering any such effect that may exist.

Is Neglect Benign?

The preceding section identified three possible difficulties of a gold/SDR pivot and three ways in which it would be clearly superior to a dollar pivot. The present section takes up the central issue as to whether it is desirable for the United States to pursue an active payments policy

aimed at maintaining suitable balance in its external transactions. Or should it pursue a policy of "benign neglect"?

The issue is central because it is impossible to conceive of a dollar pivot working satisfactorily in conjunction with an active American payments policy. It is, of course, possible for a country without command of its exchange rate to ensure payments equilibrium by subjecting its internal demand-management policy to the needs of the balance of payments on gold-standard lines, but no one imagines that a large country with a small foreign-trade sector like the United States either would or should behave in that way. Neither is there any prospect that controls would provide an acceptable alternative method of payments adjustment. If the United States is required to seek payments equilibrium but is denied its own exchange-rate policy to accomplish this, one has a combination guaranteed to generate regular crises. Import surcharges and attempts to bully other countries into changing their parities in accordance with American interests are just the sort of event that one could expect from willing the payments end without the exchange-rate means. A dollar pivot makes sense only in conjunction with a passive American payments policy.

Some economists who have endorsed a passive payments strategy (e.g., William Branson, in Lawrence B. Krause, "A Passive Balance-of-Payments Strategy for the United States," *Brookings Papers on Economic Activity*, Washington, D.C., 1970, p. 361) have simply asserted that the United States "cannot do much about" any dollar overvaluation and that it is inappropriate for such a large country to devote its demand-management policy to external rather than domestic objectives. The question at issue is precisely whether it is *desirable* for the United States to be *able* to do something about an overvaluation of the dollar. The case for some exchange-rate flexibility is largely based on the proposition that it is undesirable for large countries to distort their internal policies so as to seek external balance, and the United States is a good example of a country that should not sacrifice either output and employment or price stability to defense of a rigid exchange rate. But the same is true of other countries. If the world wishes to maintain a fixed exchange-rate system, then it seems only equitable that the burden of doing so should be shared. If some countries do not, because they attach a high priority to the achievement of domestic goals, then it seems only natural for those countries to be the ones with the onus of changing their exchange rate. A passive payments policy represents a claim to have one's cake and eat it too, to enjoy the benefits of exchange-rate stability without making the sacrifices that system imposes.

Gottfried Haberler and Thomas D. Willett (*A Strategy for U.S.*

Balance of Payments Policy, American Enterprise Institute, Washington, D.C., 1971) make a point of showing that any option open to surplus countries to counteract an unwanted influx of dollars (financing the deficit by accumulating dollars, appreciation, monetary expansion, or reduced controls) would be acceptable to the United States, provided that she is able to direct fiscal and monetary policies solely to domestic objectives. There is no ground to doubt that this is true, other than the quaint belief that balance-of-payments discipline is the main protection of American citizens against the inflationary impulses of their political masters. Personally, I have always found it difficult to believe that inflation is electorally popular (as this theory presupposes) and impossible to understand how economists and bankers can convince themselves that they have a duty to thwart the wishes of the electorate if the latter do, in fact, want inflation. This implies that payments discipline is in the first place unnecessary and, even if not redundant, improper. Hence benign neglect is a luxury for the United States that others can only envy.

But the proponents of a passive American payments policy do not admit that this would amount to sacrificing the rest of the world's welfare to that of the United States: they contend that such a policy would also be advantageous to other countries. The principal argument deployed to support this contention is what has been termed the "redundancy problem":

In a world of N countries, if $N-1$ have targets for their balances of payments which they successfully achieve, this automatically determines the payments position of the N th. . . . Unless at least one of the N countries reacts passively or sponge-like to the policies of the others, a high probability of conflict arises. (Ronald I. McKinnon, *Private and Official International Money: The Case for the Dollar*, Essays in International Finance No. 74, Princeton, 1969, p. 29.)

Ironically, only two paragraphs before this quotation McKinnon (then discussing a different topic) wrote:

It is true that official portfolio adjustment is a very haphazard affair, impeded by a variety of commitments . . . in domestic policies. Nevertheless, most countries have vague long-run targets in reserve holding. . . ." (*Ibid.*, pp. 28-29.)

To the extent that reserve targets are vague and that reserve adjustment is haphazard, the redundancy problem is not a serious one—because nothing very terrifying will result from the failure of some countries to achieve their targets. Despite this, it is probably reasonable to contend that the system needs to have sufficient elasticity in the long run to pre-

vent a self-defeating scramble for reserves from developing. (The note of doubt is occasioned by an analogy with domestic monetary theory. The argument presented by the dollar-standard proponents for a supply of reserves that is sufficiently elastic to respond to changes in the demand for them bears a distinct resemblance to the real bills doctrine, which is a contender for the title of the most thoroughly discredited economic theory of all time. Yet it is difficult to see how any good could emerge from a struggle among countries with inconsistent payments targets occasioned by a fixed stock of reserves. The difference between the domestic and international cases would seem to stem from the fact that individual nations, unlike individual firms, can be presumed to pursue stabilization policies and therefore do not need to be tempted into acting in the general interest by variations in the availability of credit.)

What this suggests is that the attractiveness of a passive American policy to other countries will depend very much on the alternative system with which it is compared. If one compares it with a system in which the stock of reserves is either fixed or changing at a rate that cannot vary in response to the desire for reserves, such as General de Gaulle would have wished upon us, then the dollar standard backed by a passive American payments policy has a great advantage. But if one compares it with a system that contains a reserve asset whose supply is amenable to conscious international control and where that control is exercised to ensure consistency among reserve targets, the dollar solution has no advantage at all. The question that needs asking is, therefore, whether one could determine the rate of SDR creation that would be needed to ensure consistency of objectives. It is argued in the next section that this would indeed be feasible under a gold/SDR pivot. This being so, the appropriate state to compare with the passive payments policy of the United States is an active policy in a world where targets are consistent.

If reserve targets are consistent but are not being met, there is a need for adjustment. The extent to which any one country needs to introduce adjustment measures depends upon the extent to which others do so. In the extreme case, if all countries except one adjust successfully, then the *n*th country can remain passive. Typically, if one country does more, then others need do less. In particular, if one country contracts out of participation in the adjustment process, then the others will be obliged to take more extreme actions than would otherwise have been necessary. This will impose a burden on them to the extent that the burden of adjustment tends to fall on the country that initiates adjustment. In popular discussion it is often taken as axiomatic that the burden of adjustment is associated with the initiation of adjustment—perhaps the best example