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THE CASE FOR THE
PAR-VALUE SYSTEM, 1972

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

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The Case for the Par-Value System, 1972

The commitment of each member nation to maintain a par value for its currency and to consult the International Monetary Fund before changing it constitutes the heart of the international monetary system established at Bretton Woods. Economists have tended to be critical of this commitment. The professional literature has stressed the role of the exchange rate as a market price, and economists in general have preferred arrangements under which exchange values would fluctuate enough to clear exchange markets in an orderly fashion. The one-sided support economists have given to flexible exchange-rate arrangements has largely rested upon an overwhelming professional preference for shifting resources through market processes. The desire for more autonomy in national policy making has sometimes contributed to this preference. In any case, critics over the years have been convinced that the par-value system would inevitably lead, in a world of discordant national policies, to networks of governmental controls and to financial crises. There have been frequent enough financial disturbances in recent years to provide some justification for these misgivings.

And yet the par-value system established at Bretton Woods in 1944 survived these adversities, and this criticism, for a generation. During this period, to be sure, adjustment decisions by major trading countries were often avoided or postponed until conditions in financial markets reached crisis intensity. Nevertheless, needed changes in par values were eventually made and the Bretton Woods arrangements maintained because practical men were not prepared to abandon them. The one-sided, though not unanimous, preference within the academic community for flexible-rate arrangements was matched by an equally one-sided, though not unanimous, preference among government and banking officials and private entrepreneurs for a system of exchange rates fixed by international agreement and maintained through official intervention.

But developments in mid-1971 struck at the heart of the international commitments that had been the basis for world monetary cooperation since 1946. The key elements of that system were placed in jeopardy by the decisions of Germany and the Netherlands in May "not to maintain the exchange rates for its currency within the established margins" (IMF Press Release No. 839, May 9, 1971) and by the decision of the United

The analysis and conclusions of this paper represent the personal opinions of the author and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or of its staff.

States in August "no longer, for the settlement of international transactions, in fact, to freely buy and sell gold" (IMF Press Release No. 853, Aug. 20, 1971). Earlier, in June 1970, of course, the Canadian authorities had decided for the second time since 1946 to float the exchange rate.

The temporary suspension of par-value obligations by three Fund members, and of the gold-convertibility obligation by one, unquestionably marks a historic turning point in world monetary affairs. By December 18, however, after a series of international meetings under the auspices of the Group of Ten and of the International Monetary Fund, the industrial countries were able to announce agreement on a realignment of the world's major currencies and on several related measures affecting the international monetary situation: the introduction of a system of central exchange rates, a temporary widening of the margin of exchange-rate fluctuation to $2\frac{1}{4}$ per cent above and below the new exchange rates, and prompt discussions on reform of the international monetary system over the longer term.¹ The new central rates constitute the most widespread changes in the exchange-rate structure since the general devaluations in 1949. These changes, together with the continuing negotiations on questions of longer-term monetary reform in the interest of improved adjustment performance and liquidity arrangements, imply the most sweeping changes in the mechanics of international finance since the International Monetary Fund itself was agreed upon at Bretton Woods in 1944.

The intensity with which world financial arrangements are currently being scrutinized provides an appropriate occasion for a re-evaluation of the economic rationale of the par-value system. A review of the system's benefits and of some of its difficulties is also recommended by the conspicuous imbalance in the professional literature on the subject. There are a number of distinguished critiques of the par-value system, several excellent—and a few classic—pieces in defense of flexible-rate arrangements, but few attempts to defend the par value. This essay is an attempt to consider the case that can be made in favor of such an exchange-rate system.

The Par-Value System: Its Distinguishing Characteristics

An analysis of the economic case in favor of the par-value (or adjustable-peg) system requires, at the outset, an identification of its distinguishing characteristics. We must ask in particular in what respects such a sys-

¹ See "Agreement on International Monetary Arrangements," *International Financial News Survey*, IMF (Dec. 22-30, 1971), pp. 417-419.

tem differs from the systems of fixed, and of flexible, exchange rates described in the standard textbooks on international economics.

We could readily distinguish the par-value from the other two mechanisms if we could choose the full-fledged international gold standard as the representative fixed-rate system, and a freely flexible or purely market-determined arrangement as the representative flexible-rate system. But the pre-1914 gold standard is not a relevant model for a world that accords such importance to high employment in all countries. Similarly, it is hardly profitable to choose a model of freely fluctuating exchange rates in a world in which we know that governments are not prepared to permit their currencies to fluctuate in the exchange market without official intervention in any form.

Accordingly, we must accept the reality that contemporary exchange-rate systems will have elements both of government intervention and of rate flexibility; they will differ in the ways these elements are combined. The distinctions among the three alternative systems in terms of the technical characteristics of flexibility are summarized in Table 1. Flexible-

TABLE 1
RATE FLEXIBILITY UNDER THREE ALTERNATIVE EXCHANGE-RATE ARRANGEMENTS

<i>Characteristic</i>	<i>Exchange-Rate System</i>		
	<i>Market Flexibility</i>	<i>Fixed Rates</i>	<i>Par Value or Adjustable Peg</i>
Formal parity	None	Formal	Formal
Formal intervention limits	None ^a	Announced	Announced
Conditions for change in parity	None	"Last resort"	"Fundamental disequilibrium"
Exchange values in short run	Flexible	Fixed	Fixed
Desired exchange values in long run	Flexible	Fixed	"Internationally agreed" flexibility

^a Some advocates of flexible exchange rates recommend, and others oppose, formal intervention by the central bank in the foreign-exchange market.

rate systems are readily distinguishable from fixed-rate and par-value systems by the absence of a commitment to a formal parity, to specific intervention points, and to conditions that must be met before a change in parity can be made.

The fixed-rate and adjustable-peg systems have in common the commitment to a formal parity and to announced intervention points—that is, to the objective of rate stability in the short run. Both require international review before changes in par value can be made. They differ, however, in their long-run objectives. The conditions under which the par value could be altered become conspicuously more rigorous under a “last resort” fixed-rate system (which could be regarded as equivalent for our generation to the pre-1914 international gold standard) than they would be under the system of the adjustable peg. For the parity would be changed under a fixed-rate system only after available reserves and credits had been used up—that is, bankruptcy would be approaching. Under the par-value arrangement, by contrast, a change in parity could be justified in terms of an unwillingness to sacrifice domestic objectives. In other words, a change in parity under a fixed-rate system would reflect a failure of national policy, but under an adjustable peg it would reflect a change in policy mix.

In addition, the limitations on exchange-rate variations would be much more rigorous for a fixed-rate system than they would be under the adjustable peg. The Fund’s Executive Directors recently released a report (IMF, 1970, pp. 70–78), in fact, in which they found that, in certain specific forms, rate flexibility greater than that provided by the existing arrangements would be consistent with the Articles of Agreement. These forms included (1) proposals to achieve prompter and smaller adjustments in parities and (2) a slight widening in the margins around parity. The report also explored the role of temporary deviations from par-value obligations in a par-value system.

Flexibility in these forms would be contrary to fixed-rate concepts. Thus, in practical terms, many forms of greater flexibility—such as the crawling peg or gliding parity—could be accommodated under the par-value, but not under a fixed-rate, system. In the view of the Fund’s Executive Directors, in fact, the only forms of exchange-rate flexibility specifically regarded as “inconsistent with the par-value system” were (1) freely floating exchange rates, (2) substantially wider margins, and (3) automatic adjustment of parities (IMF, 1970, esp. pp. 42–46).

Perhaps the critical difference between the par-value and fixed-rate mechanisms lies in the different roles exchange-rate changes are expected to play in the adjustment of international payments. Under the fixed-rate variant, the par value would be considered to be as credibly fixed as it was under the former gold standard, that is, the authorities in each country would accord so high a priority to this intention that “for all practical purposes variations of exchange rates will in the future, as at present, be used only in exceptional cases as a method of balance-of-pay-

ments adjustment among the major industrial countries" (Emminger, 1967, p. 512). The national authorities would turn to exchange-rate policy as a tool of international adjustment only after other methods of adjustment had been tried and failed.

By contrast, under the adjustable peg, exchange-rate change would be regarded as an ordinary policy tool, and rate flexibility in the long run as desirable in itself. With the adjustable peg, exchange-rate action becomes a policy option open to the national authorities of each country, subject to specific and general international constraints. The principle was recognized—as the historic innovation at Bretton Woods—that a member country could, subject to international review, choose to employ exchange-rate policy to protect its domestic economic stability from international disturbance. In the words of the recent Fund report, the international community "accepts the right of individual countries, subject to the international obligations just mentioned, to adjust their exchange rates to fulfill legitimate domestic objectives, as well as agreed international objectives" (IMF, 1970, p. 5).

Thus, the distinctive characteristic of the par-value system is the acceptance of flexibility of exchange rates in various forms, but within specified limits and in accordance with internationally agreed-upon criteria and procedures. As we have seen, the definition could encompass some proposals for technical modification of exchange-rate practices currently being discussed, as well as the arrangements that have thus far been in effect under the Articles of Agreement. In contrast to a "last resort" view of the role of exchange rates in the adjustment process, the adjustable-peg system has essential elements of flexibility that would allow exchange values to be altered as needed—but only as needed—to promote orderly adjustment of international disequilibrium and orderly exchange-rate practices among member countries. There is, under the par-value system, "the preference for devaluation over deflation" (Yeager, 1966, pp. 101–102) in many situations in which advocates of fixed rates would choose deflation as the appropriate corrective.

There have been, and continue to be, widely differing notions among Fund members about how much rate flexibility is consistent with the intent and objectives of the Fund's Articles of Agreement. It is precisely these differences of interpretation that help to explain the current controversy over rate flexibility among the partners of the European Common Market. The high degree of exchange-rate rigidity among the industrial countries, especially between 1958 and 1967, made the Bretton Woods system of the adjustable peg—as it worked out in practice prior to the U.K. devaluation in November 1967—seem to be more nearly akin to a fixed-rate system of the pre-1914 type than to any recognizable form

of limited and internationally controlled flexibility. Recently, however, political leaders as well as government and financial economists have responded to international currency disorders by accepting a more active role for exchange-rate policy in international payments adjustment than they had been prepared to accept prior to 1967.

As a result of this change in view, much recent attention has been focused on the role of a limited increase in exchange-rate flexibility in a par-value system, and the ways it could be attained. The economist can find evidence of this alteration in viewpoint by comparing the 1966 report on *The Balance of Payments Adjustment Process* of Working Party No. 3 (OECD, 1966, esp. pp. 20-23, pars. 45-51) with the Fund report on *The Role of Exchange Rates in the Adjustment of International Payments* in 1970. Both reports concentrated on the possibilities of, and proposals for, improving the balance-of-payments adjustment process. But the 1966 report assumed a system of exchange rates within narrow limits around a fixed parity and with changes in the exchange rate "relatively rare among the OECD countries" (OECD, 1966, p. 8, par. 6); accordingly, it contains only infrequent and guarded references to changes in parity as an available instrument of national policy. By contrast, the title of the Fund report highlights the role of the exchange rate, and the discussion in it concentrates on the ways to make effective exchange-rate policy in the adjustment process. It is striking, in retrospect, that it was regarded as realistic in 1966 to explore the workings of the adjustment process without considering more fully than was the case the possible need for changes in parities, for changes in technical aspects in exchange-rate practices, and even for changes in rather fundamental aspects of the exchange-rate system itself. The changed climate of opinion is also indicated by a comparison of the suggestion in 1967 that it was "unlikely that in practice exchange-rate variations will be used in a more generalized and permanent way as an instrument of adjustment among industrial countries" (Emminger, 1967, p. 512) with the recent assertion in 1971 by the Managing Director that "the Fund has always been opposed to exchange rate rigidity. Indeed, it has favored a considerable degree of exchange rate flexibility in appropriate circumstances."²

The extent to which attitudes about rate flexibility have altered over the past few years makes it necessary to define the flexibility characteristics of the par-value system in broad terms, as in Table 1, and to recognize that there could be substantial modification of exchange-rate practices in the form of internationally controlled flexibility within the terms

² Pierre-Paul Schweitzer, Managing Director of the IMF, before the Economic and Social Council of the United Nations on Oct. 27, 1971, in *International Financial News Survey*, IMF (Nov. 3, 1971), p. 355.

of the definition. In brief, the adjustable-peg model can be regarded as an attempt to combine fixed exchange rates in the short run with internationally agreed-upon variations in the long run. A wide variety of reform proposals would clearly be consistent with this model. Because it combines elements of rate flexibility and elements of rate fixity, the par-value system can be regarded as a halfway house between flexible and fixed rates (as defined in Table 1) or, if you prefer, as a defensive arrangement among the major trading countries designed to guarantee that the desired degree of flexibility occurs on an internationally agreed-upon basis.

In this paper, we shall first consider the arguments in favor of a par-value system (as defined in Table 1) and then review some of the difficulties with it that have emerged in the post-1945 world. These difficulties, as we shall see, have spurred attempts to encourage an acceptance of modifications of recent exchange-rate practices in order to realize a greater (though still internationally limited) degree of rate flexibility during the 1970's than had been achieved in the preceding decade. These innovations have been encouraged because the difficulties experienced in international financial markets since mid-1967 have raised questions about whether it would be possible to create, within the contemporary economic environment, orderly processes of international adjustment consistent with the Articles of Agreement accepted at Bretton Woods twenty-five years ago.

Domestic Priorities and the Exchange-Rate System

The case for the par-value system, as compared with either a system of credibly fixed or of market-flexible exchange rates as we have defined them, would be weaker if, in practice, particular policy instruments, other than the exchange rate, could be assigned to particular target variables in accordance with assignment-theory analysis. If the authorities had an instrument variable appropriate and effective for each policy target and if they were able to use each of them with precision, there would be no analytical basis for pessimism about the prospects for external economic balance under fixed rates, even in a world in which national policies are only partially harmonized.

But, in practice, policy instruments are imprecise and often not separable; it is seldom that they can be uniquely assigned to a specific target variable. Too often, national authorities are beset with more objectives than readily usable policy instruments or with goals that are contradictory; they are seldom free to allocate tools to goals so as to ensure the achievement of multiple goals simultaneously. As a result, they usually assign the instruments they have available to their priority targets and are

forced to neglect secondary objectives that, all too often, include the nation's international objectives.

For example, economists have often recommended that, with fixed exchange rates, monetary policy could be effectively employed for external balance and fiscal policy for internal balance. Between 1958 and 1967, however, European central bankers were not prepared to abdicate their primary responsibility for domestic stability, even where balance-of-payments factors threatened the central bank's control over the domestic credit situation. Instead they fashioned new tools of central banking, making credit restraint an effective tool of domestic stabilization by devices to insulate the domestic economy from external sources of liquidity. Even in this period, when balance-of-payments surpluses were excessive and local spending aggregates high, these countries made monetary policy the primary instrument of domestic stabilization, often with only limited support from fiscal policy (Katz, 1969, esp. pp. 1-10 and 32-45).

The overriding priority given to domestic policy goals in the industrial countries has dimmed the prospect that external balance could be expected from an instrument-target approach to economic stabilization. Because there is a relative scarcity of usable instruments available to them in the best of circumstances, government officials are apt to deploy the policy tools at hand for domestic purposes. To be sure, the national monetary authorities may have acquired a growing capability—based upon political consent—to direct government tools toward priority economic goals. But, as a general rule, considerations of external balance have been assigned only a modest priority in formulating stabilization objectives, except in the most unusual circumstances.

Because the industrial countries agree in this relative neglect of external factors, the problem arises: How can we hope for a tolerable balance in international transactions so that the reconstructed liberal international trade and payments structure can be maintained? In a world in which external payments balance (without controls) is accorded only a subsidiary priority, we cannot expect the industrial countries to follow policies for external balance that conflict with the goal of internal balance. Instead, the national authorities must be able to choose measures for domestic balance which, in all situations, can be consistent with the requirements for external balance.

The unique adaptability of the par-value system. In this environment, the par-value system has the unique adaptability to offer the authorities a policy option through which external balance can always be made consistent with measures of domestic balance. This adaptability is not shared

by the two main alternative exchange-rate systems identified in Table 1—credibly fixed and market-flexible rates. Neither of them can as readily accommodate policies for internal balance that will prove to be consistent with the requirements for external balance.

The policy conflicts the authorities would have to face in their attempts to achieve both internal and external balance under alternative exchange arrangements can be analyzed in terms of the “dilemma” and “nondilemma” situations outlined in Table 2. In a world in which the authorities

TABLE 2
SUMMARY OF INTERNAL-EXTERNAL BALANCE IN
NONDILEMMA AND DILEMMA CASES

	Internal Position (1)	External Position (2)	How Domestic Spending (<i>E</i>) Would Be Affected with Only	
			Demand- Management Measures ^a (3)	Exchange- Policy Measures ^b (4)
<i>Nondilemma cases:</i>				
1. Surplus-deflation	$Y^* > E$	$R > P$	+	-
2. Deficit-inflation	$Y^* < E$	$R < P$	-	+
<i>Dilemma cases:</i>				
3. Deficit-deflation	$Y^* > E$	$R < P$	-	+
4. Surplus-inflation	$Y^* < E$	$R > P$	+	-

^a (Fixed-rate adjustment measures.)

^b (Flexible-rate adjustment measures.)

NOTE: Y^* is the level of domestic output consistent with domestic employment and price goals, E is actual domestic expenditures (including trade balance), R is foreign receipts, and P is foreign payments.

are not to be allowed to depend either upon freely flexible exchange rates or upon controls to preserve external balance, they would encounter policy conflicts as they pursued either demand-management measures in accordance with the fixed-rate adjustment process or, alternatively, exchange-rate policy in accordance with the flexible-rate adjustment process. The nature of the policy dilemma would depend upon the type of exchange-rate system and upon the nature of the disturbance. If the authorities had a preference for fixed-rate adjustment measures, they would find an external-internal policy conflict in the dilemma situations, that is, when the surplus country had excess, and the deficit country inade-

quate, internal demand. By contrast, they would find a policy conflict if they had a preference for flexible-rate adjustment processes in the non-dilemma situations, that is, when the surplus country had inadequate, and the deficit country excess, internal demand.

Economists who have recently been exploring these conflicts in terms of dilemma and nondilemma situations have largely been covering ground that was pretty fully sketched out in Meade's (1951, esp. Chaps. VIII–XI, pp. 99–162) monumental treatise twenty years ago. It was Meade who approached external-internal balance as a policy problem in international economics in which target variables were specified and the corresponding values of the policy tools were then to be determined.

The four dilemma and nondilemma situations under existing fixed-rate arrangements are summarized in Table 2. There, actual domestic expenditures (E) are compared in column 1 with the level of domestic output that is consistent with domestic employment and price goals (which is designated as Y^*). The assumed levels of foreign receipts (R) are then compared in column 2 with foreign payments (P). Finally, the fact that the effects on domestic income of demand-adjustment measures (of the fixed-rate adjustment process) and of exchange-rate variations are complementary in both the surplus and the deficit country is brought out in columns 3 and 4.

This policy-oriented schema is intended to distinguish the effects of domestic policy actions on internal spending aggregates from the effects on external balance. It is assumed that the national authorities can, and almost always will, be primarily concerned to alter domestic spending aggregates in an endeavor to attain their Y^* target priority. The analysis will consider the ways the policies to achieve domestic balance will affect the external balance in the four situations first explored by Meade. Our concern will be to observe how policy measures designed to bring E closer to Y^* will alter the difference between R and P .

The analysis will be following Meade, it will be noted, in concentrating on a trade-only model of the international adjustment process. This choice in part follows logically from the emphasis upon high employment as the overriding economic goal in all industrial countries: after all, exports have a direct, and capital flows only an indirect, impact on domestic employment. The concentration on current flows of goods and services also follows logically from the distinction in the Fund's Articles of Agreement: members are permitted "such controls as are necessary to regulate international capital movements" but not in ways which would restrict payments for current transactions (Art. VI, Sec. 3). This distinction was reaffirmed in the Working Party No. 3's report that controls on current transactions "can only be regarded as a temporary expedient" but that