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THE "BAND" PROPOSAL: THE LIMITS OF PERMISSIBLE EXCHANGE RATE VARIATIONS

GEORGE N. HALM

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY · 1965

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PREFACE

The Joint Economic Committee recommended recently that "the United States, in consultation with other countries, should give consideration to broadening the limits of permissible exchange-rate variations."[1] In view of the fact that no official of the United States Government or of the Federal Reserve has been willing to discuss any form of greater exchange-rate flexibility, at least in public, and that such discussion was expressly excluded from the Ministerial Statement of the Group of Ten,[2] the Joint Economic Committee's suggestion constitutes a major breakthrough. It is to be hoped that the proposal to widen the band will be widely discussed in the near future, both in official and in academic circles, and that this discussion will contribute substantially to the solution of our international payments problem.

The band proposal is very old. Robert Torrens suggested as early as 1819 that the range between the so-called gold points should be widened. Since then the proposal has been repeated quite often, but it has only once been thoroughly discussed, in John Maynard Keynes' carefully reasoned recommendation "that the difference between a Central Bank's obligatory buying and selling prices should be made somewhat greater, say 2 per cent, so that there would be at least this difference between the gold points irrespective of actual costs of transporting gold."[3]

That the proposal has been neglected is not only due to the official lack of enthusiasm, noted above, but also to the fact that more extreme and more challenging plans have monopolized the theoretical discussion. Now, however, the time has come for a serious consideration of this recommendation, because it may offer possibilities for a constructive compromise between the more extreme theoretical positions ("fixed versus freely fluctuating exchange rates"), and also between the attitudes of economists and central bankers, who are still separated by an apparently unbridgeable gulf.

The present study seeks to contribute to the discussion of the band proposal in two ways: by a survey of the long but, in content, rather

[1] *The United States Balance of Payments*, 88th Congress, 2d Session, Senate Report No. 965, Washington, March 19, 1964.

[2] On the ground that "the Ministers and Governors agreed that the underlying structure of the present monetary system—based on fixed exchange rates and the established price of gold—has proven its value as the foundation for present and future arrangements." The Statement was issued August 10, 1964.

[3] John Maynard Keynes, *A Treatise on Money*, Vol. II (New York: Harcourt, Brace and Company, 1930), chapter 36.

brief history of its different versions, and by studying the pros and cons of one particular version in somewhat greater detail. Of the many possible recommendations to widen the margin for exchange-rate variations, the combination of a wider band with a *permanent* parity is selected for full discussion. The assumption here is that greater exchange-rate fluctuations around an unalterably fixed parity can be substituted for the present adjustable-peg system, which is considered to be a bad compromise between rigidity and flexibility.

Technical details will be kept to a minimum because it is assumed that they will be worked out through practical experience, as central banks cooperate in managing the system. Monetary authorities may develop greater interest in a widened band as they learn to regard their operations in the foreign-exchange markets as a powerful tool in maintaining balance between external and internal equilibrium.

It need hardly be stated that the band proposal is not a panacea. It aims at demarcating one promising area for constructive compromise. The proposal would be compatible with other reform plans, such as the various proposals for the creation of reserve assets, and other suggestions in connection with our efforts to overcome the difficulties and dangers of the present key-currency system.

G.N.H.

Medford, Massachusetts
November 1964

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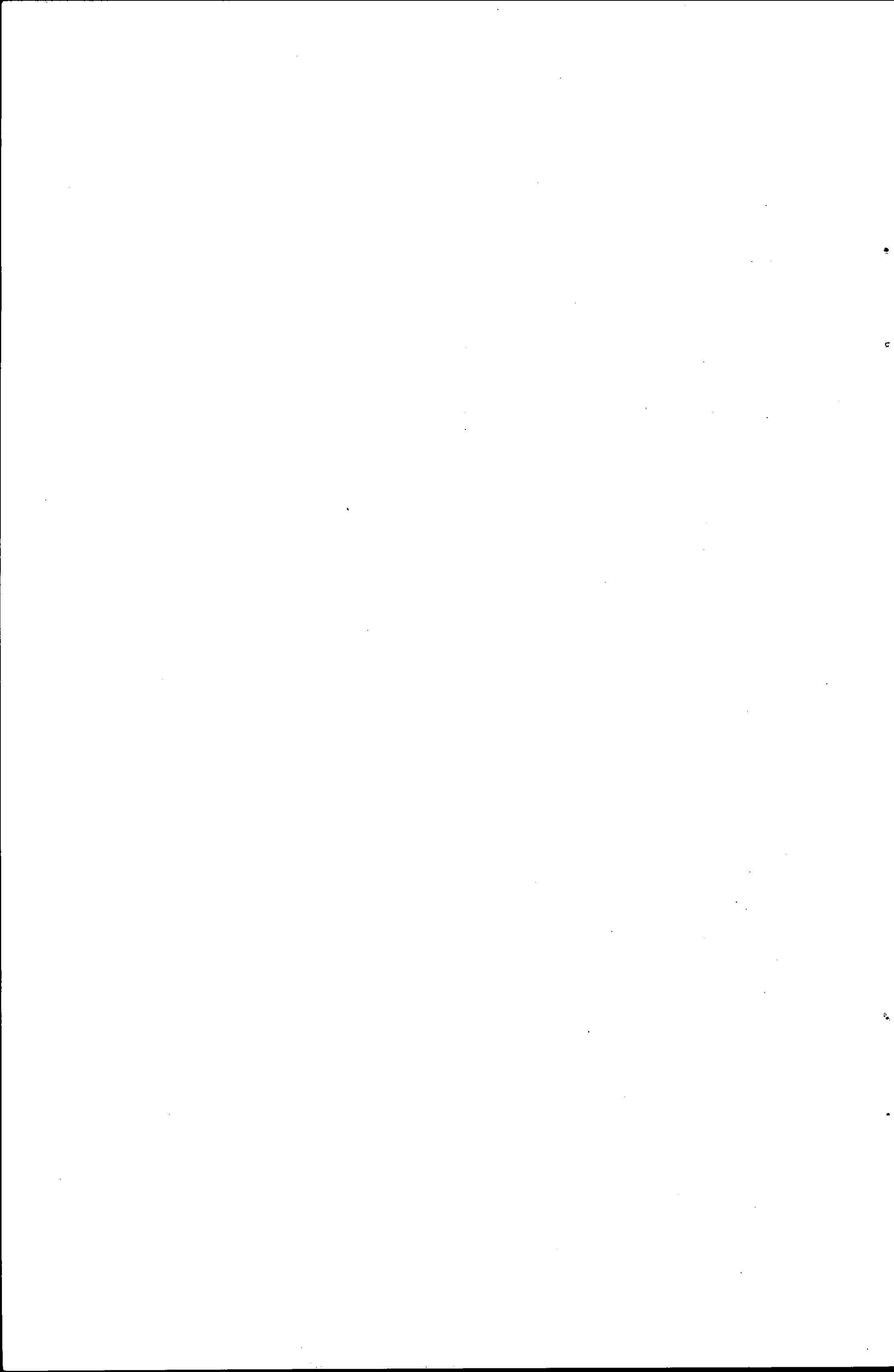

I. Introduction

The Adjustable-Peg System

The monetary experts who participated in the great debate preceding the Bretton Woods Conference of 1944 were opposed to both permanently fixed and freely fluctuating exchange rates. The International Monetary Fund was a compromise which attempted to establish the principle of "managed flexibility" for the exchange rates of the member countries.

The argument against permanently fixed gold parities is well known. John Maynard Keynes objected to the gold standard on grounds that it confines the natural tendency of wages to rise beyond the limits set by the volume of money, and in doing so creates unemployment. The gold standard involves a financial policy which compels the *internal* value of the domestic currency to conform to an *external* value which is rigidly tied to a fixed quantity of gold.[4] Keynes proposed 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."[5] Since the International Monetary Fund has "to approve changes which will have this effect," Keynes felt that the Fund proposal was "the exact opposite of the gold standard."[6]

Those who reject a system with permanently fixed exchange rates still follow Keynes' argument that maintenance of exchange-rate rigidity may force a member country to abandon, or dangerously to curtail, its domestic employment and growth policies. A member country may, simultaneously, suffer from unemployment and inflation

[4] Lord Keynes, "The Objective of International Price Stability," *Economic Journal* (June-September, 1943), pp. 185-187. He added that "this complaint may be just as valid against a new standard which aims at providing the quantity of money appropriate to stable prices."

[5] Speech by Lord Keynes on the International Monetary Fund Debate, House of Lords, May 23, 1944. Reprinted in Seymour E. Harris (ed.), *The New Economics: Keynes' Influence on Theory and Public Policy* (New York: Alfred A. Knopf, 1948), pp. 369-379.

[6] *Ibid.* It is interesting to note that John H. Williams, on the other hand, considered the new currency proposals from the very beginning as "essentially variants of the gold standard system." *Post-War Monetary Plans and Other Essays* (New York: Alfred A. Knopf, 1945), p. 11.

if monopolistic market forces forbid downward cost and price adjustments. If the inflation is greater than inflations in other countries, a balance-of-payments deficit will be created. Elimination of this deficit, at fixed exchange rates, will require contractionist domestic monetary policies and will lower the employment level still further.

A combination of permanently fixed exchange rates and satisfactory employment levels requires sufficiently competitive market conditions to permit the use of restraining monetary policies without creation of mass unemployment. But sufficient price elasticity downward may no longer exist in modern market economies.

In spite of the rejection of *permanently* fixed exchange rates, there existed, at the time, a general aversion to freely fluctuating exchange rates. The nearly complete silence of proponents of this form of flexibility excluded the system from discussion.[7] Besides, freely fluctuating exchange rates would have been ruled out anyhow, as it was generally assumed that they would expose the system to competitive exchange depreciation, the much-feared evil of the 'thirties.

The International Monetary Fund Agreement of 1944 was a compromise between the longing for a free hand in domestic economic policies and an equally strong desire for exchange-rate stability. Therefore, it was decided that the currencies of the members would at all times be tied firmly to gold, but that the International Monetary Fund "should concur in a proposed change . . . if it is satisfied that the change is necessary to correct a fundamental disequilibrium."[8]

Twenty years of experience have shown that this compromise between rigidity and flexibility was not quite as successful as the experts had hoped. However, the adjustable-peg formula permitted at the time a compromise without which the creation of the International Monetary Fund would have been impossible.

[7] The only exception, to the knowledge of the present writer, was Mr. Benson, who complained that the new plans did not propose relatively stable exchange rates nor reasonably stable exchange rates but fixed exchange rates which could only be altered by permission. He foresaw the main difficulty of the adjustable-peg system, viz., that a system of orderly devaluation and upvaluation would be exposed to disturbing speculative movements since nobody will want to buy the goods of a country for which a devaluation is impending until the devaluation has taken place. *Parliamentary Debates on an International Clearing Union*, House of Commons, May 12th, 1943, and House of Lords, May 18th, 1943. British Information Services, New York, July 1943, pp. 59-63.

[8] *Articles of Agreement. International Monetary Fund and International Bank for Reconstruction and Development*. United Nations Monetary and Financial Conference, Bretton Woods, N.H., July 1 to 22 (Washington: United States Treasury, 1944), Art. IV, Sec. 5 (f).

Those who defended the Keynesian position that the new institution "should not wander from the international *terrain*" and "should be limited to recommendations, or, at the most, to imposing conditions for the more extended enjoyment of the facilities which the institution offers"[9] made *permanently* fixed exchange rates impossible because they insisted on the elimination of that degree of harmonization of national economic policies without which a system of permanently fixed rates cannot work. Yet fixed rates which are not permanently fixed lose much of their alleged advantage as a firm foundation for the international flow of commodities, services, and loanable funds.

This structural weakness of the International Monetary Fund was not critical at first because of the prevalence of exchange controls. With the introduction of convertibility of the currencies of the more advanced industrial countries, however, overvaluations and undervaluations have become more dangerous for the international payments system. It is now rather generally agreed that the adjustable-peg system is exposed to disequilibrating speculation, unless the International Monetary Fund succeeds better than in the past in integrating the domestic economic policies of its members.

Assuming fixed rates of exchange and inadequate harmonization, the adjustable-peg system cannot work well. Maintenance of convertibility of "wrong" rates of exchange requires flows of international reserves from deficit to surplus countries. These flows advertise the deviation of the pegged rate from the equilibrium rate and may herald the approach of the day when the peg will be changed. This situation constitutes an invitation to sell overvalued currencies and precipitates the impending devaluation.

The adjustable-peg system, by delaying price variations in the foreign-exchange market, exposes the members' economies to sudden shocks which could have been avoided either by gradual changes of the exchange rates or by gradual cost and price adjustments.

These shocks, and the disequilibrating capital movements which are induced by impending peg adjustments, have led to an attitude on the part of the International Monetary Fund and many of its members which now makes exchange-rate adjustments very rare events. Thus we find ourselves back in a system with more or less permanently fixed exchange rates—the very system which we wanted to abolish at Bretton Woods.

9 *Proposals for an International Clearing Union* (London: H.M. Stationery Office, Cmd. 6437, April, 1943), Preface.

The adjustable-peg system, as proposed in Keynes' International Clearing Union, would have been even more objectionable than the Fund's. The *Keynes Plan* suggested that alterations of the exchange value of the member currencies be made part of the "internal stabilizing mechanism" of the system. For instance, if a member's "deficit balance has exceeded a *quarter* of its quota on the average of at least two years, it shall be entitled to reduce the value of its currency in terms of bancor provided that the reduction shall not exceed 5 percent without the consent of the Governing Board" and the Board, as a condition of allowing a member State to increase its debit balance in excess of *half* of its quota, may even *require* "a stated reduction in the value of the member's currency."[10]

The *Keynes Plan* would have made it easy for speculators to predict impending devaluations. For the International Monetary Fund's concept of "fundamental disequilibrium" we can at least say that it is very difficult to interpret while "a publicly recognized and recognizable criterion for exchange adjustment has . . . the disadvantage that it may act as a signal for speculative capital transfers in anticipation of changes in exchange rates."[11]

Keynes' proposal cannot be defended on the ground that it implied more *frequent* adjustments of exchange rates and that frequent changes would be a good substitute for flexible exchange rates. His reference to a disequilibrium of two years' duration shows that he was suggesting a system that would have been made virtually unworkable through hot-money movements.

* * * *

The version of the proposal to broaden the limits of permissible exchange-rate variations, which is to be considered in the present study, can be regarded as a substitute for the adjustable-peg system. It seeks to do what the experts of Bretton Woods wanted to accomplish, viz., to find a compromise between fixed and flexible exchange rates. It suggests a permanent, built-in flexibility within a broadened band in order to avoid the need for an abrupt change of the peg. Should the permitted exchange-rate variations, however, fail to bring

[10] *Proposals for an International Clearing Union* (London: H.M. Stationery Office, Cmd. 6437, April, 1943), II, 6 (8). Bancor was to be "international bank money . . . fixed (but not unalterably) in terms of gold and accepted by . . . members of the Union for purposes of settling international balances" (I, 4).

[11] Ragnar Nurkse, *Conditions of International Monetary Equilibrium*, Essays in International Finance, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1945), p. 8.

about the needed adjustments and should the monetary authorities be unable to keep their domestic policies within the range permitted by the broadened band, the band would have to be moved. Such a "movable band" system would, therefore, remain exposed to some of the shortcomings of the adjustable peg.

The Key-Currency System

Fixed exchange rates can be combined with deviations of national economic policies if the members of the international payments system have large reserves of gold or foreign exchange at their disposal. What amounts will be adequate will depend in the main on the degree of integration of the economic policies of the members of the system, i.e., on the efficacy of the adjustment mechanism. Furthermore, the need for the holding of official reserves will be partially determined by private capital movements that are characteristic of the payments system in question. If these private capital flows tend to be equilibrating, fewer official reserves need be held. If the system is prone to suffer from disequilibrating speculative movements, the demand for liquid balances or gold may become dangerously great. A system of freely fluctuating exchange rates, on the other hand, needs no official reserves whatever, since international payments equilibrium is established automatically, at all times, through instant exchange-rate variations.

We see that a system with a broadened margin of permissible exchange-rate variations would reduce the demand for international liquidity reserves if it succeeded in promoting external equilibrium and in harnessing equilibrating (and preventing disequilibrating) private capital movements. But it could not claim to get along without official reserves, as these would be needed at the upper support point and for any desired government selling activities within the band.

Proponents of a fixed-rate system differ widely as to the amount of official reserves that they consider adequate. Some suggest that only gold reserves should be held, while others would be extremely liberal in the degree of freedom which they would purchase through very large reserves.[12] This difference within the fixed-rate camp is often

[12] Egon Sohmen, an advocate of freely fluctuating but stable exchange rates, states correctly "that the call for ever bigger international funds, stand-by agreements and all the rest, for bridging balance-of-payments deficits is somewhat out of tune with the aim of achieving a maximum of monetary integration." Egon Sohmen, *International Monetary Problems and the Foreign Exchanges*, Special

much greater than the disagreement between some proponents of fixed and of flexible exchange rates.

Within the camp of the advocates of freely fluctuating exchange rates we find the same diversity of opinion. Some writers seem to come close to the extreme position that the very fact that no official reserves need be held frees the domestic authorities from any consideration of the balance-of-payments effects of their actions, while others are of the opinion that the exchange rates, though freely fluctuating, ought to be as stable as possible.

Already at Bretton Woods it was evident that astonishing differences of opinion existed as to the amounts of international reserves that would be adequate.[13] Keynes' Clearing Union was unacceptable to the United States because up to 24 billion dollars of credit extension *on the initiative of the deficit countries* exceeded by far what she considered safe from the standpoint of domestic monetary stability.[14] The resources of the International Monetary Fund, on the other hand, proved to be far too small. One main reason was that the Fund did not have the power to coerce its members into such monetary discipline and harmonization as would have enabled them to get along on the modest additional reserves that the new institution provided. However, on her own terms, the United States extended aid that exceeded

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Papers in International Economics, No. 4 (Princeton, N.J.: International Finance Section, Princeton University, 1963), p. 25.

[13] The *Keynes Plan* suggested quotas of about 36 billion dollars for the world as a whole, while the corresponding figure for the International Monetary Fund was about 11 billion dollars. However, these two figures were not even comparable, owing to the different structures of the proposed institutions. In the International Monetary Fund the potential surplus countries were obliged to extend credit to the amount of their own quotas (which, for the United States, was 2.75 billion dollars). In the Clearing Union, on the other hand, a potential surplus country agreed to accept payment of balances from other members in the form of bancor credits with the Union, the amount being limited only by the sum of the debits of the deficit countries. Under the extreme conditions that prevailed after World War II, this could have meant a potential expansion of credits by the United States of up to 24 billion dollars, though correctives would have come into play before 8 billion dollars would have been reached. See Joan Robinson, "The International Currency Proposals," *Economic Journal*, Vol. LIII (June-September, 1943), p. 165. Reprinted in Seymour E. Harris (ed.), *The New Economics* (New York: Alfred A. Knopf, Inc., 1948).

[14] Keynes defended the absence of a rigid maximum for credit balances by arguing that this absence would not impose on a potential surplus country an unlimited liability outside its own control, as it could always, by its own policies, reduce its surplus. *Proposals for an International Clearing Union* (London: H.M. Stationery Office, Cmd. 6437, April, 1943), III, 8. This is only partly true, because inflationist policies in deficit countries could exert stronger inflationary pressure on the surplus countries than the latter might care to accept for the sake of external equilibrium.

what she had not been willing to promise unconditionally under the *Keynes Plan*, and thus became the major key-currency country.

Many observers hold that the present key-currency system is dangerous and may lead to a collapse of the international payments system similar to, or worse than, the breakdown of the gold-exchange standard during the inter-war years.[15] The argument is impressive. If gold stock and gold production are inadequate to supply the needed growth of international reserves; if the supply of dollar balances as international reserve must rest on a permanent balance-of-payments deficit of the United States; if a permanent deficit lowers the confidence in the dollar; and if the confidence in dollar convertibility, at a fixed gold parity, is further lowered by the decrease in United States gold holdings (in comparison with the permanent growth of gold-convertible foreign-held dollar balances)—then the system is bound to collapse unless it is speedily consolidated or liquidated.

Fortunately, the argument is not entirely convincing for three reasons. (1) It is wrong to assume that the demand for international reserves must continuously increase. Should we succeed in building greater flexibility into the international payments system, and in improving thereby the adjustment mechanism, the demand for reserves may be greatly decreased. (2) It is erroneous to conclude that confidence in the key currency is nothing but a function of the key currency's net reserve position. (3) The key-currency system has features which distinguish it favorably from the old gold-exchange standard.[16]

Another criticism of the key-currency system concerns its effect on the domestic economic policies of the key-currency country. Some observers point out that the key-currency country is put into the seemingly pleasant but actually rather demoralizing position of not having to pay for its deficits, as its debts are held as international reserves by other countries. Thus it is said that the United States has been prevented from carrying out sound monetary policies which would have been obligatory had the deficit been financed through a lowering of United States gold reserves.[17]

[15] The most famous statement of this thesis is Robert Triffin's in his *Gold and the Dollar Crisis* (New Haven: Yale University Press, 1960), pp. 8-9.

[16] These features concern, among others, the very existence of the International Monetary Fund as an international forum; the responsible leadership of the United States after World War II in contrast to her inconsistent behavior in the 'thirties; the general maintenance of higher levels of employment; the elimination of most beggar-my-neighbor policies; and the increase in international monetary cooperation.

[17] See Jacques Rueff, "Gold Exchange Standard a Danger to the West," *The*

Against this argument can be held the opinion of those who feel that the key-currency country does not enjoy enough freedom in its internal policies. The United States is deprived of the safety valve which the Bretton Woods system offers to member countries in severe external disequilibrium, since as a key-currency country she cannot devalue the dollar. Neither can she force surplus countries to shoulder their share in the adjustment process if they should decide not to expand their domestic monetary circulation.[18]

Here we meet again with the fundamental question which characterizes the whole international-payments discussion: should there be more rather than less freedom for domestic economic policies? Agreement exists only to the extent that both schools of thought feel that the key-currency system should not continue in its present form.

* * * *

What contribution to the solution of the key-currency problem can we expect from a proposal that the margin of permissible exchange-rate variations should be widened? The present study will attempt to show that the following favorable effects could materialize: (1) the total of needed reserves could be decreased and the need for additional key-currency balances reduced; (2) greater variations of exchange rates could contribute to the adjustment mechanism without forcing deflationary policies on countries in deficit; and (3) if the system could successfully control private capital movements, it could eliminate the greatest and most dangerous source of disequilibrium in the United States balance of payments.

The band proposal is not put forward as a panacea. No international payments system can create external equilibrium if its members refuse to carry out necessary adjustment measures. Nor can it be expected that, for instance, transfers of huge unilateral payments can be made to materialize instantly in export surpluses. Nevertheless, as a workable compromise between international monetary discipline and some freedom for domestic economic policies, the proposal should contribute substantially to a solution of our problem.

Times (London), June 27-29, 1961; and Michael A. Heilperin, "The Case for Going Back to Gold," *Fortune Magazine*, Vol. 66 (September, 1962). Both articles are reprinted in Herbert G. Grubel (ed.), *World Monetary Reform* (Stanford, Cal.: Stanford University Press, 1963), pp. 320-342.

[18] See George N. Halm, "Special Problems of a Key-Currency in Balance-of-Payments Deficit" in *Factors Affecting the United States Balance of Payments*, Compilation of Studies Prepared for the Subcommittee on International Exchange