PANEL

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The title of this session on the international adjustment mechanism is a sign, in my opinion, of enormous progress in the discussion of problems of international monetary arrangements. The great defect in most of the discussions, over most of the nearly two decades that I have now followed them, is concentration on what are really peripheral issues of liquidity and confidence, rather than on the fundamental issue of what is the adjustment mechanism. So I want to congratulate the Federal Reserve Bank of Boston for starting our session with a discussion of the international adjustment mechanism.

Having gotten to that central problem, the next stage is to complicate it a little by being a little more sophisticated about it. Adjustment to what? Broadly speaking – and this is obviously an oversimplification as any such statements must be – there are two classes of things to which adjustment is required. There are adjustments to monetary disturbances and there are adjustments to real disturbances, and they raise rather different problems. For example, Dick Caves, in his discussion, spoke about sources of disturbances. He spoke about what he regarded as increasing elasticities in trade movements and in capital movements as meaning that the system was subject to greater sources of disturbances. One could take exactly the same evidence as meaning that the system has a more sensitive and an improved adjustment mechanism. Which it is depends on what kind of a disturbance you are thinking of. From the point of view of a government that would like to inflate or deflate, the greater sensitivity of flows of trade and of capital is a source of disturbance. But from the point of view of how the world monetary and economic systems can adapt to changes in real conditions – the changes in the comparative advantage of one place over another, or other similar real conditions – the factors that Caves cites represent an improved capacity to smooth the adjustment process. What I would like to do in my few minutes here is to discuss what the adjustment mechanism

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has in fact been up to date, and then make a few comments about where it is going, leaving almost entirely unsaid where it ought to go.

Disturbances from Differential Degrees of Inflation

What has the adjustment mechanism been? It is common to emphasize, as Dick Caves did, differential degrees of inflation; to say that, under a system of fixed exchange rates, the adjustment mechanism involves pressure on countries in surplus to inflate more than countries showing a deficit. That is true; that has been a part of the adjustment mechanism. But, it's worth emphasizing, that differential inflation has also been a major source of the need for an adjustment mechanism. We have to distinguish between differential inflation that has been a response to balance-of-payments problems, and that has been a source of balance-of-payments problems. Milton Gilbert distinguished between two categories of countries; he distinguished between those countries that did and those that did not have a capacity for monetary discipline. The Bretton Woods distinction was very different. It was between those countries that had a reasonable capacity for monetary discipline and those countries that had an unreasonable capacity for monetary discipline. Many of the problems of this era have been produced not by the lack of effectiveness of differential degrees of inflation as an adjustment mechanism, but by the disturbances arising out of differential degrees of inflation. So differential degrees of inflation have been both adjustment mechanism and also a major source of disturbance.

Variations in Direct Controls over Trade and Payments

A second adjustment mechanism has been variations in direct controls over trade and payments. I think it is easy to underestimate how important a role changes in the degree of control over trade and payments have played in the adjustment process. As we all know, we came out of the post-war period with a "dollar shortage" that it was said was going to last indefinitely. At that time countries other than the United States had extensive trade controls and payments restrictions. The United States was easing up sharply on its restrictions. In the course of the swing from the dollar shortage to the dollar surplus, you had a major swing in the character and location of restrictions on trade and payments. The United States moved toward greater restrictions on trade and payments; most of the rest of the world moved toward lesser restrictions on trade and payments. So that over this period of 20 or 30 years a great role was played in the adjustment process by variations in trade controls.

Exchange Rate Changes

Thirdly, and this is the point that I want to emphasize most, in my opinion the major adjustment mechanism in the post-war period has been exchange rate changes. Dick Caves talks about the adjustments with exchange rates fixed. But the fact of the matter is that exchange rates have *not* been fixed. In an article written by Margaret DeVries and published in the *IMF Staff Papers* in November 1968, she examines what has happened to exchange rates in developing countries, distinguishing between their experience and the experience of what she calls "the more developed" countries. If I take only her 21 more-developed countries, so that I leave out most of those countries Milton Gilbert was referring to as having no capacity for monetary discipline, only three of them had either no change or an appreciation in the par value. Only the United States and Japan had no change. Germany had an appreciation. Eighteen of the 21 countries had a depreciation in their exchange rates vis-à-vis the dollar. Of those 18, 6 had a depreciation of less than 30 percent, and 12 out of the 21 – or more than half – had a depreciation of more than 30 percent. Much of the discussion about the process of adjustment in the post-war period reminds me of the man who discovered at the age of 70 that he had been speaking prose all of his life. We keep on talking about what are the adjustment mechanisms with exchange rates fixed, when the basic fact of the matter is that exchange rates have not been fixed, that exchange rates varied a great deal, and that they probably have played the major role in the adjustment mechanism in the post-war period. If you consider these depreciations of 30 or more percent, I wonder if you can find any cases at all of differential degrees of inflation that have been part of an adjustment process and that have been of anything like that magnitude. The large differential degrees of inflation have been sources of disturbance, not adjustment. Those differential degrees of inflation that have contributed to adjustments have been at the most of the order of 3, 4 or 5 percent differential. There is the Japanese case. From time to time, Japan has unquestionably used differential degrees of inflation as an adjustment mechanism. But the differential is of far smaller magnitude than the kind of exchange rate changes that have occurred.

The key basic fact that I think ought to be in the forefront of every such discussion as this one is that there is in fact only one effective adjustment mechanism to disturbances of the kind that have been experienced – namely, to disturbances arising primarily out of differential monetary behavior. That adjustment mechanism, the one we have been using, and the one we are going to keep on using, is exchange rate changes. There isn't anything else. The real question of policy is not, "Should exchange rate changes be used as an adjustment mechanism?" The real question of policy is, "How do you use exchange rate changes?" Do you use them as we have been doing by permitting difficulties to accumulate until they are major and then have a big change so that there is a crisis every time there's a change involving a major country? Or do we try to adapt our protestations and our professions to what really is going on and have a mechanism of changing exchange rates which is smoother, more gradual, which will occur more nearly automatically, and will involve fewer crises?

Need for Smoother Adjustments

That is the real issue and it seems to me that any discussion of whether you ought to have a world with a single money, or a single set of rates of exchange, is, in Dick Caves' terms, "utopian." I am utopian. I would like to see a world with a single money. Unlike Mr. Kindleberger, I would like to see it *without* a central monetary authority. But if we are going to talk about what are the realistic and the important alternatives facing the world today, there is no possibility, as I see it, of an adjustment mechanism in the near future that does not involve exchange rate changes – just as any proper description of the past 20 years must assign to exchange rate changes a major role in the adjustment mechanism.

Having said this, we can go on and ask the question: Given that major reliance on discontinuous, occasionally large changes in exchange rates has been the adjustment mechanism, what is happening now? Let me put one thing aside – the creation of SDR's. In my opinion, that is not going to alter the adjustment mechanism in any important way. It is going to have negligible effects on the character of the adjustment process. Its major effect will be to make the world price level somewhat higher than it otherwise would be. The SDR's are a subject for another discussion, and I don't mean to digress by going to them. I only want to express, and you'll pardon me if limitations of time make me do it very dogmatically, my own personal opinion that, whatever their merits may be for other purposes, they have little relation to an improved adjustment mechanism, because the problem of an adjustment mechanism is not a problem of reserves. It's a problem of adapting prices, exchange rates, real flows, and so on to shifts in other countries' monetary policies and to shifts in real circumstances underlying international trade.

A more important change currently taking place is a wider recognition of the point I have been stressing – that exchange rates are in fact the only available major mechanism at the moment to counteract monetary sources of disturbances. This is taking the form of a much greater interest by a wide range of people – both official and unofficial – in mechanisms for smoother flexibility. I think the experience of the German mark in the past few weeks is a fascinating episode and an important episode. In the climate of opinion among governmental officials of 10 years ago, that kind of a development would not have occurred. Germany would not have floated the mark. From my jaundiced point of view, the best thing would be if the Germans, seeing how well the floating rate works for three weeks, decided that it might not be bad for another three weeks, another three weeks, and another three weeks. We might in that way slip into a Canadian flexible exchange rate. But I am not very optimistic that that will happen. The desire on the part of central banks to play an important part in the international monetary mechanism is too strong, I believe, to be frustrated by the mere fact that a floating rate works very well. And, consequently, I feel very confident in the prediction that Germany will establish a new par in the not too distant future. But I think the experience that Germany has had may set an example and may encourage a wider range of countries – hopefully not only countries whose rates will float up – to experiment with the possibility of using gradual changes in exchange rates instead of abrupt ones.

Personally, as a matter of prediction, I find it hard to believe that there will be any international agreement on a gliding parity or any other automatic mechanism. I see as more likely a gradual introduction by individual countries, on their own say-so, of devices such as the one the Germans have just adopted. I had rather supposed that Germany, for example, instead of doing what she just did – which I think is splendid – might experiment with the gliding parity by appreciating the German mark on an announced basis of 1 percent a month for 10 months, or something like that. I think gliding parities of that kind will be experimented with by individual countries because they offer to monetary authorities a kind of half-way house between the complete flexibility of a free market on the one hand — desirable as that might be from my point of view, it is not from theirs — and on the other this awful business of holding and holding and holding to the last gasp and then having to make a big change.