

PANEL

## *The International Adjustment Mechanism*

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In facing the topic assigned to me for this opening session, I was puzzled about how to strike out in the vast territory laid open for invasion, if not for conquest. On the one hand, I could take the utopian stance of announcing what would, in uncompromising terms, be a good, true, and proper international monetary mechanism. I have never been a very good utopian. I would be a better bank clerk. Furthermore, in noting the list of distinguished gentlemen who will be following me, I felt that sufficient utopian proposals might be forthcoming therefrom, and that I should perhaps take a somewhat more grey, gradualistic approach to the subject. So I shall devote my time to some remarks on the international adjustment mechanism, treating it as a question of whether or not a market mechanism of adjustment exists under fixed exchange rates, and raise a few issues about sources and sizes of disturbance to the system. We are all familiar with the underlying theoretical models. My concern is with the factual evidence which they designate as necessary to a choice among the major alternative ways of managing our international monetary affairs. The distinguished papers prepared for this conference will review the major proposals — float, crawl, band and the like. What do we know about the mechanism of adjustment that bears on the choice among these proposals?

### *Forces of Adjustment under a Fixed Exchange Rate*

As a useful starting point, consider the forces adjusting an industrial country's balance under a fixed exchange rate. The textbooks describe two of them to us. In a strict Keynesian model of income-flow adjustments, a decline in exports ultimately causes a fall in imports although in all probability not enough to eliminate the disequilibrium. This familiar mechanism of adjustment ought to work in the right direction, but not by exactly the right amount.

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Much interest in recent years has focused upon a more strictly monetary mechanism of adjustment. When a country has a balance of payments deficit, it will by definition be reducing its total privately-held asset stock, in the process of paying for the excess of purchases over sales. Its asset stock falls, its total financial assets relative to its level of current expenditure fall, and we may expect the level of expenditures to be reduced and the balance of payments pressed back toward equilibrium. The reduction in the stock of assets relative to the level of expenditure, and the fall in the price of internationally immobile relative to internationally mobile assets — as Professor Scitovsky has recently reminded us — ought to eliminate balance-of-payments disequilibria under fixed exchange rates, and without corrective government action.

The broad impression that one gets from discussions of these mechanisms of income and asset adjustment is that they are either weak or get short-circuited by government action. I would like to make some suggestions about the empirical status of these mechanisms of adjustment, on the view that their weaknesses in operation may tell us a lot about the case for reforming the system to give more play to the price mechanism of adjustment than does the Bretton Woods regime of the adjustable peg. Although my major argument will be that rapid growth in the sources and sizes of disturbances has been the principal enemy of these adjustment mechanisms, something should be said first about the role of government interferences to jam their operation. The role of government full-employment policy in short-circuiting the operation of these mechanisms is now commonplace knowledge. I am impressed, though, about the importance to one's preferences about the international monetary system of the answer to the following question: Do you or do you not believe in a relation of the Phillips Curve-type as dominating economic policy in the short run? If you feel that the rate of inflation and the level of employment cannot be disconnected from one another, then with a fixed exchange rate the number of policy instruments is inadequate to attain our objectives concerning employment, the price level, and the balance of payments. If you feel, however, that there is not a locked-in Phillips Curve relation and that the level of unemployment and the rate of increase of domestic prices can be separated with the armament of policy instruments now available, then the argument for flexible exchange rates to overcome a shortage of policy instruments is no longer necessarily compelling. Thus one's views on the need for greater exchange-rate

flexibility tend to depend heavily on its necessity as a means of securing an adequate number of policy instruments.

*Changing Patterns of International Transactions*

Be that as it may, I would now urge that the changing patterns of international transactions on current and capital accounts reveal a great increase in the size and the sources of disturbance that may impinge on an industrial country's *ex ante* balance-of-payments position. Let me remind you of just a few of them. On the current account side, over the last decade we have observed a great increase in trade among the industrial countries, involving an increasingly fine differentiation of the industrial goods that they trade with one another. This has inevitably increased the price elasticities governing the current account. The result, of course, is that a given change in a country's price level then causes a much larger disequilibrium in its current account than if this development had not occurred.

The international corporation has made the location of production increasingly sensitive to the level of factor cost at the going exchange rate, and this also tends to increase the elasticities and thus the size of disturbance to the foreign balance that can follow a disturbance to the domestic price level. I have been impressed by Richard Cooper's argument that the transformation possibilities of individual industrial countries are becoming increasingly similar to one another, and that capital tends to flatten out natural advantages based on labor or land, making countries more closely competitive with one another. This also portends larger disturbances to the current-account balance as a result of any given domestic development.

This is all *a priori* reasoning about price elasticities; what about the statistical evidence? What are the econometricians saying these days? My allotted time does not allow a comprehensive survey of this field, but my reading supports an increasing conviction that the elasticities are high, and that despite some lags they do come through in a reasonable period of time. The econometricians are, of course, better at thinking up reasons about why their estimates are biased downward than they are at producing unbiased estimates. But putting together these two sources of econometric evidence — the actual and *a prioristic* — I think that is where one comes out.

On the current-account side I suggested that sources of increased disturbance overwhelm the capacity of income or monetary mechanisms to adjust to them without exchange-rate changes. What about

the capital account? The same story can be told there. In the last 10 years it has seemed that every year — every month perhaps — some new category of international financial transactions has been devised or developed. Repeatedly the consciousness of the profitability of some international capital transaction has impinged on a new class of American or European lenders or borrowers. These innovations and discoveries are written in recent financial history — U.S. direct investment, the Euro-dollar market, long-term U.S. commercial bank loans, Euro-bonds, the discovery of the U.S. stock market by Europeans — one development after another that might be described as some set of asset holders recognizing a new possibility for profitable diversification of their portfolios. Where is this to end? How many more new forms can be invented?

### *Forecasting Innovation*

The forecasting of innovation is always a difficult matter, but the point is that these possibilities of increasing interpenetration in financial markets mean much higher elasticities of flows of capital in response to differentials among countries in yields on assets. Of course, it is not just a matter of increasing sensitivity of capital flows to what you might call ordinary commercial-yield considerations. It is also a question of the sensitivity of capital flows to exchange-rate expectations, a constant worry under the adjustable peg.

Here again, I think, a learning process can be clearly detected. Many of my British friends have said that the British man in the street has, as a result of recurrent sterling crises, become conscious of the possible profitability of converting his liquid assets into something that is not sterling. When the whole domestic money supply is ready to take flight at the thought of a devaluation, then one has, I think, an impressive potential for disturbances in the system.

What about the hard quantitative evidence on the capital accounts, comparable to the elasticity evidence about trade flows? What is available is very persuasive. My own research on Canada in the last few years has suggested that, during the period of the flexible exchange rate, both short- and long-term portfolio capital flows to Canada were extremely sensitive to yield differentials, and that this sensitivity increased substantially over the 1950's and early 1960's. They were, I might mention, also highly sensitive in a stabilizing way to movements of the Canadian exchange rate; that is, the tendency

of private capital flows to stabilize the fluctuating Canadian dollar was very strong.

My remarks have been aimed toward suggesting that, perhaps, the apparent inadequacies of income and monetary mechanisms of adjustment under fixed exchange rates may be traced to government policy decisions and to the constraints of domestic policy. There is a crucial question of whether we really are short of policy instruments. Secondly, the development of international transactions among the industrial nations has proceeded in a way that tends to enlarge disturbances to the balance of payments, and make them much more difficult to cope with under a fixed exchange rate.