

## PANEL

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Instead of discussing the international adjustment mechanism in general terms, I would like to summarize how it has seemed to me to have operated in practice over the two decades that I have been concerned with it.

I may preface my remarks with two general points. Firstly, automatic adjustment has not been the major factor in securing reasonable external balance; deliberate policy actions to manage both the domestic economic situation and the balance of payments itself have been constantly required to make the adjustment mechanism work over a sufficient range. Secondly, to opt rigidly for either flexible rates or fixed rates has seemed to me to overgeneralize. As any theoretical model must be a simplification of reality, it is easy to construct a variety of plausible models. The real problem in dealing with practical cases of imbalance is to decide upon what model and what policy instruments are appropriate to the case at hand.

One can divide the countries of the world roughly into two groups: countries that have a reasonable capacity for monetary discipline and those that seem to have limited capacity for it. I will concentrate on the first group, because I do not know what to do about the second. Their real failure is in the exercise of political authority, and until that is corrected most of them would probably be better off not pegging the rate of exchange.

#### *Adjustment Process in France, Germany, and Spain*

Among the countries of the first group a disequilibrium in the balance of payments has arisen rather frequently over the years. Once the realignment of currencies in 1949 was out of the way, however, most of the imbalances that arose were of the sort that could be corrected by appropriate monetary and fiscal policy, with maybe a few extra gadgets — like managing the rate of borrowing or lending abroad, or temporary use of direct controls. The adjustment

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process has sometimes been rather quick and sometimes slower, when there were political difficulties in the adopting of proper policy measures. The point to emphasize about all these cases of imbalance is that one had no impression at the time that the exchange rate was out of line and that, in fact, adequate adjustment was made without a change in the exchange rate. Analytically, at least, they were not difficult situations.

However, over these 20 years there were some imbalances that clearly required a change in the exchange rate; in other words, there was a fundamental disequilibrium. As a general proposition, I believe it is not wise to conclude too quickly that a given imbalance involves fundamental disequilibrium; it is desirable to wait until the evidence is rather conclusive. This is particularly so when there is excess domestic demand, because it may be difficult to judge the corrective impact on the balance of payments of suppressing the excess demand.

I recall, for example, that when Germany got into difficulties in 1950 and Italy in 1963, there was some opinion in favor of a devaluation of the currency. However, this was proven to be quite unnecessary once the overheated state of the economy was brought under control; both the German mark and the lira were strong currencies in the years which followed the respective crises. It would certainly have been a mistake to devalue the exchange rate in either case, as the likely consequence would have been a higher level of domestic prices.

There have been other cases where the signs that the exchange rate was out of line became overwhelming. Due to the substantial inflation in France during the war in Algeria, it became clear that the external deficit could not be corrected without a devaluation of the franc. I thought at the time that a change in the rate should have been incorporated in the stabilization program initiated at the end of 1957; however, the Government was not prepared to take this step at that time and it was not until the end of 1958 that the currency was devalued and the franc stabilized. In retrospect I am not sure now that waiting a year was a mistake, because by that time the fiscal and monetary restraints of the stabilization program had had a chance to cool off the domestic boom. Hence, when the devaluation came, it quickly yielded good adjustment results.

Similarly, in the case of the Spanish stabilization program of 1959, it was evident that a substantial change in the exchange rate would

be needed to make the balance of payments viable. This step was taken at the same time as fiscal and monetary restraints were imposed and, as the domestic restraints were rigidly held for a period of six months, the adjustment process implicit in the devaluation worked like a charm.

An interesting case of imbalance on the surplus side was the German mark in the 1950s. At that time the balance-of-payments deficit of the United States was rather small so that the German surplus was considered to be exerting significant pressure on other European countries. You will remember that, after the exchange rate had been fixed at the time of the currency reform, there was a further devaluation in 1949. Whether this was appropriate is an open question, but in any case it became quite clear that the German mark was undervalued as the productive potential of the economy was restored in subsequent years. The revaluation of the German mark was seriously considered in 1957, which caused some disturbance in exchange markets, but no action was taken. You will remember, however, that the currency was revalued in 1961. I believe it is generally agreed that earlier action would have been in the interests of monetary stability domestically and a contribution to the international adjustment process.

The point I have been trying to make in citing these cases is the following: most countries have experienced significant external imbalance at one time or another in the past 20 years; as an exercise in applied economics it has generally not been very difficult to analyze the situation and to decide on the corrective measures required to make the adjustment mechanism work — including a judgment about the appropriateness of the rate of exchange. The two exceptions have been the United Kingdom and the United States where there have been both analytical and operational difficulties.

### *Sterling Crises*

As you know, sterling was subject to a series of exchange crises over the years since the devaluation of 1949 and eventually it was devalued again in November 1967. This was a difficult case for two reasons: firstly, it was not easy to say at what point in time there was clear evidence of overvaluation; secondly, it was not easy to know what to do about it. So far as the exchange crises in the 1950s are concerned, there were special circumstances in each instance which made it doubtful that fundamental disequilibrium was involved. In

1952 the special factors were the excess demand generated by a heavy rearmament program and the high prices of raw material imports associated with the Korean war. In 1955, although the balance of payments was again in deficit to some degree, the exchange market was upset by discussions of a proposal for wider bands. In 1957 the balance of payments was actually in surplus when the market was upset mainly because of the rumors of a German mark revaluation. The exchange difficulties in all these instances were rather short-lived and there did not appear to be any necessity to protect the exchange rate by excessive unemployment. Indeed, there was rather some reason to say that the economy was generally under demand pressure.

The next sterling crisis was a rather different matter. After the economy had stagnated for four years, a strong stimulus to expansion was given by the budget of 1959 and several other measures. In not much more than a year a significant external deficit developed and a shift in policy to restraining measures became necessary. It was reasonably clear, therefore, that a situation had been reached in which economic growth comparable to other industrial countries could not be maintained without an external deficit — which is surely indicative of fundamental disequilibrium. Anyone not convinced of the overvaluation of sterling at that time had little reason to miss this judgment when the renewed expansionary policy reflected in the budget of 1963 led to a large external deficit by mid-1964 and then to the exchange crisis later in the year.

But what to do about it? It was highly probable that a simple devaluation exercise would not work. Devaluation could, of course, be made to secure a balanced external position on the flows of transactions arising currently. However, it was almost certain to lead to significant liquidation of foreign-held sterling balances, particularly those in the reserves of sterling-area countries. While such diversification of reserves in sterling might not come all in a rush, it would exert a constant pressure on sterling and make a new fixed exchange rate at least fragile and probably untenable. My own view on the matter was that allowing the rate to float for some time was the most realistic way out of the dilemma.

In the event, sterling was devalued to a new fixed rate in November 1967, and it was not long before the expected drain from the sterling balances was evident. The difficulty was resolved by the second group arrangement through the BIS to provide financial support to the UK authorities against adverse movements of the

sterling balances. The United Kingdom on its side gave guarantees on official sterling-area holdings of sterling, and the group of central banks and the BIS gave reasonable assurances of the liquidity at the guaranteed rate of the reserves held in sterling. This imaginative exercise in monetary cooperation has worked very successfully — aided by the fact that policy measures to support the devaluation have themselves been effective. It must be considered a good outcome to a quite difficult problem.

### *The Dollar Problem*

The other really complicated, and controversial, case has been the dollar. The United States has had a balance-of-payments deficit almost continuously since 1950. No economist has contended that the dollar has been continuously in fundamental disequilibrium over this period and there is little agreement on the root causes of the difficulty. To make matters worse, there is no consensus on how equilibrium for the US balance of payments should be defined, in view of the complications arising from the fact that the dollar is the intervention currency and the dynamic reserve currency of the international monetary system.

I have myself defined external equilibrium for the United States in a growing world economy as an upward trend in US gold reserves sufficient to maintain confidence in the convertibility of the dollar in the face of growing reserve holdings of dollars. According to this definition the balance of payments has been in disequilibrium for most of the past 20 years. I believe that several causes are involved in fully explaining this disequilibrium, that sometimes acted together and sometimes had much different quantitative importance.

Firstly, the US external position has at times been affected by adverse cyclical movements at home and abroad, as for example in the years 1958-59.

Secondly, there has been an adverse effect at times from domestic excess demand, particularly evident during the period of the Vietnam war.

Thirdly, it is fair to say that the United States did not take effective measures to correct the external deficit, apart from the imposition of direct controls on the outflow of capital. In particular, monetary policy was generally conducted as if the United States were a closed economy, and the differential between domestic and

foreign interest rates was sufficiently wide at times to induce large outflows of funds. It was argued in the early 1960s that a higher priority in monetary policy on the external situation would not be effective, but the case was never convincing and the opposite has since been demonstrated.

Fourthly, a basic factor in the losses of gold reserves over the entire period has been the shortage of new gold available to the monetary system. In effect, the demand for gold by foreign monetary authorities in a surplus position was larger than could be supplied by new gold availabilities. The tendency was for the shortage to be made up by net purchases from the United States. It seems to be more correct in these circumstances to say that gold and the system were in fundamental disequilibrium, rather than that the dollar itself was in fundamental disequilibrium. In any case, the remedy available to the United States was to negotiate a change in the gold parity of the dollar with the IMF. This seems to me to be the adjustment process called for in the Bretton Woods system. But, for what I believe to be political considerations, the United States has not chosen this course.

The adherence to the existing gold parity of the dollar in the face of the growing shortage of gold has been leading to fundamental changes in the Bretton Woods system — at times threatening its breakdown. There has been a growth of direct controls by both deficit and surplus countries. In addition, gold reserves have tended to freeze up due to the uncertainty surrounding the price of gold. Moreover, without an adequate inflow of new gold into the system, the free growth of dollar reserves has been inhibited so that the growth of reserves has depended largely upon special credit transactions among monetary authorities. Finally, in the absence of a semi-autonomous growth of gold and dollar reserves, pressures on exchange rates have become more and more frequent and several major changes in rates have taken place. I believe that a solution to the gold problem is required as a foundation for an effective adjustment mechanism, and I find it difficult to imagine that the introduction of SDRs alone will solve the problem.