GOTTFRIED HABERLER

Speaking as the fourth member of this panel presents certain problems, not only of time but also of space. The two sides of the spectrum have been firmly occupied by Milton F. and Milton G., and Dick Caves has covered much of the middle ground in his speech. So I will have to find a few gaps, but I will also have to leave a little bit of space for the next speaker.

I shall follow Milton G. in discussing primarily the problem of the financially "disciplined" countries – that is, roughly speaking, the industrial world. As far as the undisciplined countries – most of the less developed countries – are concerned, I think the balance-of-payments problem is quite simple and intellectually (although not politically) much easier than for the developed countries. Milton G. said he didn't know what to do about them, but I think he did not really mean that. What these countries have got to do is to adjust their exchange rates – and the more quickly and frequently the better. The most inflationary countries – like Chile and Brazil – have found out that they must depreciate their currencies more or less automatically every two or three weeks. This surely is not an ideal situation, but if prices rise 30 percent a year or more, there is practically no other way out than to depreciate the currency at short intervals – that is, to introduce a sort of trotting peg. That is what Brazil, Colombia, Chile have been doing in recent years and expert observers, including foreign businessmen doing business in those countries, agree that the trotting peg is a great improvement over the system formerly in use under which rates were kept nominally stable by means of an intricate system of controls for half a year or longer and then changed with a bang by a large amount.

Turning now to the "disciplined" countries, the trouble is that they are not equally disciplined. And experience seems to show that small differences in financial discipline, resulting in comparatively slight differences in the rate of inflation, can have a profound influence on the balance of payments. This is the consequence of the

*The author has discussed the problems in greater detail in his pamphlet *Money in the International Economy*, 2nd edition, Harvard University Press, 1969.

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fact, emphasized by Dick Caves, that the economic interconnectedness and integration of the developed countries, especially but by no means exclusively of the members of EEC and EFTA, have made great progress; despite existing barriers and restrictions, trade and capital flows have grown by leaps and bounds and have become very responsive to price and interest differentials.

I shall follow Milton F.'s example and confine myself to the adjustment problem in the strict sense and not discuss what economists call the "confidence" and "liquidity" problem. The adjustment mechanism is clearly of paramount importance. If balance-of-payments disequilibria are not speedily eliminated either by the automatic forces of the market or by discretionary policy measures, huge amounts of international reserves (liquidity) may be needed and confidence crises are bound to occur from time to time. On the other hand, the more quickly and efficiently the adjustment mechanism works, the shorter the spells of imbalance, the less liquidity is needed to tide countries over periods of deficit.

Primacy of Adjustment Problems

The primacy of adjustment over liquidity has been officially recognized in the SDR agreement. According to Article XXIV of the amended IMF Charter, the SDR's are to be activated if there is "the likelihood of a better working of the adjustment process in the future."[1]

As you all know, the SDR scheme has actually been "activated" at the recent IMF annual meeting and the first allocations will be made in the near future. I am not sure that we really can assume that the mechanism will work better from now on. But at least the priority of the adjustment problem has been officially recognized.

Let me now briefly describe the adjustment mechanism and the principles of adjustment policies under fixed exchanges.

Adjustment Policies under Fixed Exchanges

I follow the example of previous speakers and distinguish between

[1]The language of the Charter is as follows: "The first decision to allocate special drawing rights shall take into account, as special considerations, a collective judgment that there is a global need to supplement reserves, and the attainment of a better balance of payments equilibrium, as well as the likelihood of a better working of the adjustment process in the future." Article XXIV, Section I(b) of the *Articles of Agreement of the International Monetary Fund* as modified in 1968.

monetary and real changes. Balance-of-payments disequilibria can be caused by real or monetary factors. A deficit – and the corresponding surplus – may be the consequence of autonomous inflation, more precisely one country autonomously inflating faster than others. (This is a quite general statement, if we regard deflation as negative inflation, keeping in mind that cases of real deflation have hardly occurred during the postwar years.) "Autonomous" means not induced by the state of the balance of payments, but by domestic forces or dictated by domestic considerations. But a deficit can also be the consequence of a "real" change, that is, by what economists call "a shift in international demand" for any reason whatever. In theory it is easy to make this distinction notwithstanding the possibility of mixed cases.

Offhand, I would say that monetary disturbances – differences in the rate of inflation – are a more important cause of imbalances than real disturbances, shifts in international demand. If prices in many less developed countries rise by 20 percent or more the case is clear. But in the "disciplined" countries it is perhaps not quite so clear that monetary causes account for most imbalances.

Let me give an example. Many of you have probably seen or read about an important recent paper by Professor Hendrik Houthakker. (H.S. Houthakker and S.P. Magee, "Income and Prices Elasticities in World Trade," *Review of Economics and Statistics,* May 1969.) The authors try to show that the income elasticities of demand for the exports of different industrial countries are substantially different. The two extremes are Japan and Great Britain with the United States in the middle. World demand for Japan's exports is supposed to be very elastic with respect to income, while world demand for British exports is inelastic. As a consequence, when world income grows, demand for British exports rises more slowly than demand for Japanese exports. This would be a non-monetary factor influencing the balance of payments of the two countries. I am not sure that Houthakker's statistical methods enable him to discriminate sharply between income elasticities and other factors influencing the balance of payments of different countries. I mentioned it only as an example of non-monetary, in this case a pervasive "structural," disturbance. It is easy to think of many other real changes that may put the payments balance of some countries in the red and that of others in the black.

In practice, it may often be very difficult to decide whether a particular imbalance has in the last resort been due primarily to monetary or to non-monetary factors, or a mixture of the two. But I submit that this is not a serious handicap for the policymaker. For it is not true, contrary to what is often said, that a different adjustment mechanism and policy is required according to whether the imbalance is due to differential inflation (monetary cause) or a shift in international demand (real cause).[2]

It is not difficult to show how the adjustment mechanism should work and what financial policies should be pursued under fixed exchanges to assure smooth adjustment, without imposing direct controls, irrespective of what the deeper causes of the existing fundamental disequilibrium are. ("Fundamental" we call an imbalance that is so large and persistent that mere financing is no longer possible.)

As Caves has pointed out, there are automatic forces of adjustment at work which tend to reduce an imbalance which has arisen for any reason whatever. I need not describe them again. Suffice it to say that they work today as they did in the past under the regime of the gold standard.

It is sometimes claimed that in order to bring about balance-of-payments adjustment monetary policy should simply refrain from counteracting or offsetting the automatic forces; these would, if left alone, restore equilibrium.

Conflict between Domestic and Balance-of-Payments Objectives

This advice is, however, not easy to translate into quantitative rules for monetary policy and difficult to carry out because monetary policy has important domestic objectives, maintenance of employment, growth, etc. which may be in conflict with the requirements of balance-of-payments adjustment.

[2]One finds frequently the following formulation: If an imbalance is due to "excessive demand" the proper corrective measure is elimination of the excess by monetary retrenchment (disinflation). But if the imbalance is due to a "cost disparity" a change in the exchange rate is indicated.

However, this theory overlooks that no sharp distinction can be made between the two types of causes, for the simple fact that "excessive demand" in the sense of "excessive inflation" (i.e. compared with abroad) will quickly bring about "cost disparities." It is entirely a matter of degree and the proposed rule amounts to saying that mild imbalances should be dealt with by disinflation while serious ones require a change in the exchange rate. This is sensible enough, but does not take us any farther than the familiar rule that only "fundamental" disequilibria justify exchange rate changes. The formula in question does *not* provide criteria for distinguishing fundamental from non-fundamental disequilibria.

But "letting free play for the automatic forces of adjustment" surely implies that monetary policy should assume a somewhat restrictionist stance. The following general rule would seem to cover the whole problem, letting automatic forces work as well as discretionary policies: In order to eliminate balance-of-payments disequilibria, deficit countries should restrict their monetary growth and surplus countries should stimulate it somewhat. If wages and prices were flexible, this prescription could be carried out without seriously endangering employment. Even if wages are quite rigid downward, as is actually the case in most countries, adjustment could still work without causing much unemployment, at least in progressive economies where labor productivity (output per man) rises. All that would be needed in deficit countries is that for a certain period, say a year or two, money wages be kept stable by sufficiently tight money, or at least be allowed to rise only a little less than average productivity rises. Then money costs and prices in the deficit countries would gradually fall and this would tend to restore international balance, provided the surplus countries do their part by letting wages rise a little faster than productivity so that their money costs and prices go up.

Thus, ideally, an adjustment is possible that does not impose undue deflation and unemployment on the deficit countries nor undue inflation on the surplus countries nor impart an inflationary bias on the world as a whole. (I do not call it deflation if prices fall slowly because *money* wages, on the average, rise less than labor productivity. Note that this would *not* imply a lag in *real* wages.) True, this process may take some time. But if it could be counted upon to work in the end, international reserves (liquidity) could be provided to finance the deficit during the interval.

Unfortunately, things often don't work out that way. Even the just mentioned modest minimum requirement of smooth adjustment seems to be impossible of achievement in many countries. There is a well-nigh irresistible wage push in some countries and demand-pull inflation of varying intensity is going on almost everywhere.

The Need for Guidance by Domestic Objectives

The basic difficulty, as I see it, is that everywhere monetary and fiscal policy is, and in the opinion of most economists should be, guided primarily by domestic objectives – full employment, growth, price stability, etc. This was different during the gold standard period when exchange stability and gold convertibility were the overriding considerations. Furthermore, priorities which different countries put on different policy objectives – especially on employment and growth as against price stability – are not the same. Some – the Germans for example – are more concerned with inflation, others, e.g. the British, with employment. Equally important, the intensity of the wage push is different in different countries – Germany and Great Britain offer an illuminating contrast.

The consequence is that the adjustment mechanism without changes in exchange rates and without controls could only work by means of differential inflation, the surplus countries always inflating more than the deficit countries, imparting a strong inflationary bias on the world economy. This is, however, not acceptable for the surplus countries. And in fact during the postwar period there have been a large number of exchange rate changes, a long string of currency depreciations and a few appreciations – three to be exact. The Bretton Woods agreement did not, in fact, provide the world with a system of fixed and stable exchanges.

Smoother Exchange Adjustment Needed

There is almost general agreement now that the current system of infrequent, large changes of exchange rates, the so-called "adjustable peg" system, is unsatisfactory, because it leads necessarily to large capital flows before and after each depreciation or appreciation. As time goes on, more and more people catch on to the pattern and the speculative flows tend to become larger from one crisis to the next.

Most experts, even many who only a few years ago were firm supporters of the system of fixed exchanges, have reached the conclusion that a smoother method of exchange rate adjustment must be found. I need not discuss in detail the different methods of exchange flexibility which have been proposed – unlimited and limited flexibility, crawling peg, upward crawling peg, wider band or a combination of the two, automatic adjustment of rates by formula or discretionary changes; this will be done in some of the other sessions of the conference.

I must confine myself to two final remarks: First, greater flexibility of rates does not mean that every currency in the world will fluctuate against every other. Many small countries will prefer to peg their currencies to that of a large country and groups of countries may well join in fixed currency blocs.

Second, the dollar is in a special position, because it is the world's foremost international reserve currency, intervention currency for foreign central banks, and private investment and transactions currency. It is now fairly generally recognized that as things are the United States could not unilaterally depreciate the dollar or let it float, even if it wanted to. The reason is that if the United States did declare a devaluation of the dollar in terms of gold of, say, 10 percent, practically all other countries, with the only exception of two or three hard currency countries,[3] would go along. Similarly, if the United States suspended gold payments and declared that it would let the dollar float, most other countries would continue to peg their currencies to the dollar.

But what about flexibility? How can it be attained under these circumstances? The answer is that the decision to introduce flexibility has to be left to other countries. If any country feels that pegging its currency to the dollar exposes it to undue inflationary (or deflationary) pressures, that the United States is "exporting inflation" (or deflation) as the phrase goes, it should let its currency float or crawl (up or down according to the circumstances). This does, of course, not mean that the United States should not discuss these problems with others in the IMF, OECD or in the Group of Ten. But the final decision to introduce flexibility will have to be made by others. This decision will, however, be influenced, in the long run probably decisively, by U.S. domestic monetary policy. If we check inflation and give the dollar again a stable purchasing power, we provide the world with a dependable and desirable reserve medium. If, on the other hand, the erosion of the dollar's purchasing power continues, we inflict losses on the holders of dollars, the usefulness of the dollar as an international reserve is impaired and the dollar's status as a reserve, intervention and transactions currency is undermined, although it seems to take a good deal of prolonged inflation to bring that about. It is impossible to foresee exactly what this course of events would eventually lead to. But we can be sure that it would spell troubles, recriminations and instability. Let us hope that inflation will be checked so that we need not find out.

[3]Now, after the large upvaluation of the German mark, there would probably be no exception at all, save perhaps the Russian ruble or the Swiss franc.