

Stabilizing the Present International Payments System

SIR MAURICE H. PARSONS

In the general discussion of the international adjustment process at the present conference, it has fallen to me to discuss the ways and means of stabilising the present system. I shall have something to say later about various approaches which either already exist or have been proposed as innovations to help render the international monetary system more stable than it is. But before considering solutions to the alleged problem, it is, I think, worth spending a little time analysing the nature of the problem itself and forming a judgment as to how serious it in fact is. How deficient has the international adjustment mechanism actually been?

Test of a Successful Exchange System

We might perhaps begin by asking what would be the tests of an ideal or, at least, a generally successful adjustment process. I should like to suggest three.

First, no individual country's external surpluses or deficits should be too large or too prolonged. Secondly, the correction of such surpluses and deficits as do occur should be achieved in ways which do not impose either on individual countries or on the world as a whole, unacceptable inflation or deflation or physical restrictions on trade and payments. Thirdly, the maximum sustainable expansion of trade and activity in both individual economies and in the world as a whole should be facilitated.

Of course, as I have stated them these tests would need to be more explicit: one would have to define — or reach international agreement upon — what was the precise meaning of the expressions "too large," "too prolonged," and "unacceptable." There will always be room for argument and for legitimate differences of opinion on these matters, for what is involved is the achievement of a number of different aims many of which may conflict, and to which different

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people and different countries can attach varying degrees of importance. However, I think it is useful to bear these general criteria in mind, even if they cannot be turned into a precise yardstick, when discussing the alleged shortcomings of the international adjustment process or the possibilities of improving it.

Perhaps the most important characteristic of the existing international adjustment process is that it is in no way automatic or mechanical in its working. One can conceive, at least in theory, of systems which would involve an automatic mechanism. For example, under a fully rigorous classical gold standard system in which all currencies were immutably related to gold, and gold formed the basis of an immutable relationship to all credit creation, both domestic and international, there would presumably be no problem of prolonged external imbalances.

It could, however, produce violent domestic inflations and deflations in securing this external adjustment so that while my first criterion might be met, my second certainly would not. Another theoretical possibility might be to solve the problem of international adjustment by having either no foreign trade sector at all, or one which was totally regulated in all aspects — siege economies with some international barter. Such an arrangement might meet my first and second criteria but certainly not my third. The costs in wealth and welfare would obviously be large.

Few knowledgeable people in the western world would, I think, advocate either of these extreme approaches to the adjustment problem. But there is a third theoretical possibility — a regime of completely flexible exchange rates — which, though I believe it would be equally disastrous, does, I am afraid, command support in some quarters.

Theoretically, at least, totally flexible rates could eliminate surpluses and deficits altogether: but at enormous cost. We should have to expect large fluctuations in exchange rates as capital flows and speculative movements of all kinds would be superimposed on whatever misalignments might emerge on current account. There would be serious danger of cumulative movements: once a currency began to float downwards, the speculative pressures on the rate, the increase in costs — particularly in countries which are heavily dependent on imports for food and raw materials — and the inflationary expectations engendered would all tend to work through to export prices and to domestic consumer spending, continually

eroding whatever competitive edge had previously been attained and adding to the balance-of-payments problems.

Moreover, a general system of individually floating rates truly determined only by market forces is something of a pipe dream. Once the present system of fixed parities had been abandoned political pressures to manipulate the exchange rate, whether in the interests of such worthy causes as price stability or stable levels of employment or for less worthy motives, would become irresistible. Such a system would therefore tend to elevate the forces of economic nationalism and reduce the international co-operation which has been a major element in the growth of the world economy over the last two decades. We should see competitive depreciations, and the raising of tariff and other barriers by one country after another, just as happened in the 1930s.

I think we can also take it for granted that international trade would be adversely affected if traders were constantly faced by exchange rate risks which it would be quite impracticable to offset by cheap forward cover. The experience of Canada in the 1950s is sometimes quoted to suggest that fears of floating rates are exaggerated. But the reason for the Canadian float was basically unique in that it was introduced in order to offset the inflationary impact of the massive inflow of capital from the United States. It is one thing for a single country to float in a context of generally fixed rates, but it is quite another matter to contemplate all the large trading nations, including the reserve currency centres, floating against one another. Moreover, even in the Canadian case the floating rate raised serious problems which led to the resumption of a fixed rate.

The Bretton Woods System as a Compromise

The Bretton Woods system is a compromise arrangement between all these various theoretical extremes. It aims to provide a framework in which trade and payments can be very considerably liberalised, in which orderly economic relationships and a high measure of economic co-operation can flourish, at the same time allowing a good deal of internal sovereignty to each country in determining its domestic economic policies. In this system there is no *automatic* mechanism for adjustment. When, in the pursuit of domestic aims, a country runs into external imbalance — either surplus or deficit — a wide variety of responses are open to it. It can finance the deficit or surplus by drawing down or running up reserves, or by borrowing

from or lending abroad. It can act to depress or expand the level of internal activity, and it can impose or liberalise controls on various sectors of its balance of payments – particularly capital movements. Another alternative is for it to make a change down or up in its exchange rate parity.

In principle, with full knowledge of the facts and with a clear idea of relative priorities, the authorities in any given country should be able to choose a set of policies which adjusts the external position with least damage or most benefit to internal aims. A country with an excess level of domestic activity and an external deficit can deflate; although the impact of inflation on domestic costs may lead to the necessity to devalue and this will add to the problems of offsetting inflation. A country with too low a level of domestic activity combined with an external deficit may also be diagnosed to have an over-valued currency and can therefore devalue; a country merely suffering a temporary or seasonal deficit should be able to finance it.

In practice, of course, knowledge of the situation is far from perfect and judgment about trends and future possibilities highly uncertain, so that there can be much argument as to what is the appropriate policy in any country at any time. Because of this, the adjustment mechanism is far from automatic and the likelihood arises of incompatible objectives in different countries and harmful interactions between countries. It is quite possible that under the present system the adjustment process might in practice fail to meet one or more of the three criteria I listed earlier.

Let us look briefly at recent experience and see what our judgment on the system should be. We may take as the relevant period the decade since the major trading countries of the world achieved full external convertibility in 1958. Up to that date the world could probably be described as still in a state of prolonged post-war transition, and not fully operating the true Bretton Woods system.

For reasons which I shall come back to, I shall first leave the United Kingdom and the United States to one side. If we then examine the experience of the other major countries of the world, we have, I think, very striking evidence of an active and effective adjustment mechanism at work. First we have an unprecedented expansion in world trade and activity: 8½ percent per annum increase in trade and 6 percent increase in industrial production.

Associated with this, there has been a strong though not unbroken general trend towards tariff reduction and liberalisation of current and capital payments.

This was not achieved without producing external strains and imbalances. On the contrary, all major countries in the world experienced substantial movements into both surplus and deficit. All of them at different times during the 10 years had to undertake policies to correct their external position. A large variety of weapons was used, and in a number of cases there were short-term and unwelcome consequences on national activity or welfare. But these were generally short-lived, and the underlying trend continued for all of them to be satisfactory.

Perhaps a few examples are worth quoting. Germany, often considered to be an almost permanent structural creditor, experienced two substantial periods of deficit in the past decade: for seven quarters, in 1961/62, a total deficit of \$1.5 billion, and for nine quarters, in 1964/66, a deficit of \$2.7 billion. This latter deficit resulted primarily from domestic overheating: deflationary action was taken and the deficit was turned into a substantial surplus which continued until this year. In 1969, as is not always realised, the Germans have again been running a moderate deficit on current and long-term capital account combined, as a result of determined efforts to offset their large current account surplus with an even larger capital outflow.

The Italian economy became overheated in the early 1960s, causing a loss of confidence and a deficit of nearly \$2 billion over an 18-month period in 1962/64. This was cured by deflationary domestic action which led to fairly rapid correction of the position and was soon followed by an export boom and substantial surplus.

Japan experienced three external deficits amounting to \$1.3 billion in 1961/62, \$1 billion in 1963/64, and \$1.4 billion in 1967/68. Each of these was related to excessive domestic activity, each was tackled by domestic restraint and each was succeeded by a period of surplus. With the partial exception of Italy, where demand may be said to have remained somewhat deficient for rather too long after the deflationary action in 1964, all these countries experienced only relatively small and short-lived setbacks in the rate of increase of their domestic activity. Other similar, if less dramatic, examples of movements from surplus to deficit and back again could be quoted from many other countries in the world.

I would maintain, therefore, that the alleged difficulties of the present system have centred very much on our two countries, to a brief discussion of which I now turn.

The U.K. Experience

There is no question, I am afraid, but that the United Kingdom record has been unsatisfactory. In the 1950s our external position was broadly in balance, current account surpluses being normally roughly offset by capital account deficits, but because of the inadequate level of our external reserves in relation to our short-term liabilities, we should have been running surpluses. In the 1960s the position steadily deteriorated with current account surpluses being replaced by increasingly large deficits and the capital account deficits only being reduced by severe, and in the long run damaging, exchange controls. In the five years 1964/68 we had a cumulative deficit on long-term current and capital account of \$5.6 billion. At last, after many delays and disappointments, and following a long series of official actions — including of course the devaluation of sterling in November 1967 — the United Kingdom appears to have moved out of deficit; and I think there are grounds for cautious optimism that the position will continue to improve.

However, it is clear that the United Kingdom has experienced a deficit that could be called too large and too prolonged on anybody's definitions. There have doubtless been many reasons for this. With her persistent trends of low productivity increase, high wage increases and low proportion of G.N.P. saved and invested, the United Kingdom undoubtedly has had, and continues to have, major structural deficiencies as a competitive productive economy. These deficiencies have considerably complicated the management of the U.K. balance of payments. However, I think there has been another factor operating in the case of the United Kingdom which does not arise from the other countries already discussed: the international status of sterling.

I do not want to be misunderstood. I do not believe that sterling's role as a reserve and trading currency has itself been a factor in producing our deficits. On the contrary, I believe that the trading role is highly profitable and beneficial to the United Kingdom. My point is rather that the ramifications of the widespread holding and use of sterling throughout the world are so far-reaching that an alteration in its value would have such dangers for liquidity, for

orderly trade, and for international confidence that there is a natural tendency for the rest of the world to give the United Kingdom the benefit of the doubt and provide financial support for the sterling exchange rate in greater quantities and for longer than would be the case for other currencies.

The chickens came home to roost at last. In the end it was impossible to avoid a devaluation of sterling, and this became widely recognised both at home and abroad. In the end we have, as I have indicated, finally moved out of deficit and are, I hope, on our way to a period of sustained and substantial external surplus such as will be necessary for us to repay our external debt. This process has taken too long. But the reason has been, I suggest, not because the means for adjustment which other countries have had to hand and have successfully used were not available to the U.K. authorities, but rather that there were special factors inhibiting their early use by the United Kingdom.

The U.S. Experience

The U.S. external deficit has certainly been large and prolonged on any definition. Indeed, running at an average of \$2.4 billion per year for 10 years it dwarfs any other imbalance in the system. The very fact, however, that it has been so long and so persistent suggests that it has differed in kind from the imbalances of other countries, including the United Kingdom. In the first place, for most of the period, though admittedly there has been a deterioration recently, the United States has run a massive surplus on current account which has been more than offset by capital transfers. Secondly, in earlier years, the deficit and the externally held dollars it generated were strongly welcomed by the rest of the world because they made a very useful contribution to the growth of international liquidity. Thirdly, under the Bretton Woods system the United States has a unique role which makes it almost impossible directly to change its exchange rate vis-à-vis other currencies. It has always been able to change the value of the dollar in relation to gold, of course, but such action, had it been taken, would not have constituted a devaluation or revaluation of the dollar in the normal sense because of the strong probability that all other currencies would change their gold values too to the same degree. Thus one of the major weapons at the disposal of other countries for the implementation of the adjustment process has not been available to the United States.

For most of the period the existence of the U.S. deficit has indeed played an important part in facilitating that relative ease of adjustment among other major countries of which I spoke earlier. It has to a large extent been a reflection of the rest of the world's liquidity needs.

Recently, however, matters have changed. Not merely has the willingness to accumulate further dollars deteriorated, but the nature of the U.S. deficit has altered. Inflationary pressures have developed in the United States, whose record until 1965 was very much better than the average, and the current account surplus has virtually disappeared. There is therefore at present a need for contractionary measures by the U.S. authorities on both internal and external grounds and such measures, both monetary and fiscal, are being taken. For some time it was difficult to discern much effect from the Administration's restrictive policies, but the rate of expansion of the U.S. economy is now being significantly moderated, and, in due course, though after a necessary time-lag, the rate of price inflation will also slow down. This together with the beneficial effects of the first issue of S.D.R.s on the rest of the world's demand for U.S. goods and services, should mean a considerable improvement in the U.S. current balance of payments. It is difficult, however, to predict how far the deficit will be reduced and indeed one is by no means enthusiastic that it should change to a surplus given the need of the rest of the world for dollars. Some degree of permanent U.S. deficit — much smaller than of late — could well be an element in a stable pattern of international payments.

Possible Improvements and Stabilisation for the System

It will be clear from my remarks so far that I regard many of the criticisms of the present international monetary system as ill-conceived. The problems and inadequacy of the international adjustment process are often exaggerated. Of course, the system is not perfect, and adjustment takes place less than ideally. Countries normally delay in introducing the appropriate measures. Many mistakes, both of diagnosis and prescription, are made, but I believe that some imperfections are bound to exist in any system. The question remains — can any modifications to the system be introduced which would usefully improve its working?

Some people have been calling lately for a widening of the margins around parity within which currencies must be maintained. Naturally

there is nothing sacrosanct about the particular margins of 1 percent either way laid down in the Bretton Woods rules. But I should be strongly opposed to a significant widening (for example to 5 percent either way, as is sometimes proposed) with the idea of trying to improve the adjustment process. Such a widening would immensely complicate international payments, and would appear to me to have the disadvantages of a flexible rate system while the exchange rate varied within the new wider margins, and all of the troubles that are alleged to exist in the present system would remain when the edges of the bands were reached. If a country attempted to achieve a small devaluation simply by letting the exchange rate go to its margin, it would thereupon generate speculative expectations that the parity itself would soon be moved to the point of the market exchange rate, with the possibility therefore of further downward movement. These disadvantages appear to be fairly widely recognised, for I notice that there has been some decline in interest in this particular type of proposed innovation. On the other hand, there continues to be considerable interest in the idea of a so-called "crawling peg" mechanism.

I am sure you are all familiar with the various forms under which this proposal has been put forward, and I understand that others will be analysing their advantages and disadvantages in some detail at this present conference. I shall therefore confine myself here to some rather broad, general remarks.

First, it does not seem to me conceivable that governments could or should sign away their sovereignty, as it were, in the field of the exchange rate by adhering to some form of automatic arrangement whereby, according to some formula, the parity at any one time is determined within narrow limits by developments in the markets or in the external position of the country concerned. Moreover, even if the nations of the world were to agree to let their parities be determined in this automatic way, the problems of regulating perverse intervention by the central banks would I believe be insuperable.

Doubts about the Crawling Peg

The alternative idea, under which countries could by prior announcement make small and gradual movements in their parities, is probably technically feasible, but I have yet to see a number of important questions which it raises satisfactorily answered. First,

considering how difficult it is to decide whether a currency is over-valued or under-valued when the degree of possible over- or under-valuation in question is usually 10 percent or more, I cannot see how it would be possible to diagnose a misalignment of 2 percent. But if one waits until the evidence for under- or over-valuation has become relatively strong, it is likely that changing the parity at the rate of, say, 2 percent a year will prove inadequate. This leads me to my second major doubt, which is whether the fact that a currency has begun to "crawl" will not in fact be as likely to increase as to lessen speculative pressure on it, because it would obviously be quite impossible completely to rule out major adjustments. Thirdly, I am doubtful whether a gradual change in the parity will produce the necessary adjustments internally to rectify the external imbalance. It seems to me only too likely, to take a downward crawling example again, that the stimulus given to increased costs and to inflationary expectations generally will, when they work through to exports, negate any competitive advantage originally produced by the downward crawl. Fourthly, I believe that the operation of monetary policy would be complicated by the need to take account externally of the announced steady changes in the value of a currency. More generally, much in the area of international trade and payments flows would be complicated by a system in which a number of important exchange rates were continually moving in one direction or another. Finally, I cannot conceive of how a reserve currency could become a potential crawler. It is my belief, based on some knowledge of the authorities in those countries which have traditionally held sterling as an external reserve, that the fact that the value of their reserve asset was continually liable to change would seriously reduce its attractions for them.

Differences Between Up and Down Flexibility

However, it would be wrong to set one's face against change simply for the sake of adhering to what exists. It may be that some of my doubt can be dispelled by argument and analysis and discussion. In particular, I can see that the possibility for countries to crawl upwards, if they so wished, might not involve all the disadvantages I see in downward crawling and might have some advantages. There seem to me two important differences between permitting more flexibility upwards and permitting more downwards. First, since a country cannot be forced to revalue in the same way as one

that is running out of reserves can be forced to devalue, it may be that the markets would accept an upward crawl as the maximum upward movement likely for the particular currency in a way that I have indicated they would very probably not do for a downward crawling currency.

The second difference between upward and downward movement takes us into a much wider area and, in my view, brings us to the heart of the problem. This is that, since in the nature of the Bretton Woods system the United States is virtually powerless to change the parity of the dollar vis-à-vis other currencies, it is important that in the long run the net result of all the various exchange rate alterations by other countries be not too large a movement in one direction or another. In practice, of course, devaluations against the dollar have enormously outweighed revaluations against it. Since there has also been a tendency for prices to rise faster in most of the other countries of the world than in the United States, at least until recently, the overall result of this "devaluation bias" in the system has not been too serious. But it is a potential threat to the system and therefore any device which encourages or makes easier upward changes is worth discussion. (It is, of course, still to be shown that a crawling peg arrangement *would* produce more appropriate revaluations than the present system.)

Problems of International Liquidity

These last considerations lead me back to my main thesis which is that the adjustment process has not always been as inefficient as is often claimed and that it is not at faults in adjustment in *general* that we must look in order to discover the major difficulties under which the international payments system has been labouring. It has been the problem of international liquidity which has been an important source of our difficulties. In the early years of the U.S. deficit, when increases in dollar holdings were desired by the rest of the world, the increased world liquidity produced by the United States facilitated a vigorous and active adjustment process between most countries. In recent years, however, this has no longer been the case, and it has become increasingly clear that we need to look for a new source for extra international liquidity. We have found this, of course, in S.D.R.s which are to come into operation in quite substantial amounts from the beginning of next year.

I regard this as easily the most important step which the inter-

national community could have taken towards stabilising the present system and facilitating the adjustment process. With the improved prospects for both the United States and the United Kingdom — the only important countries where the adjustment process has appeared to have been seriously deficient — I think we may see the system functioning much better than it has appeared to do in the past few years; and this may well occur without any of those reforms to the Bretton Woods system which some at the moment believe to be so necessary. Even if the failure of our two countries to achieve adjustment more efficiently may ultimately cause damage to the world economy, the new international liquidity system — if it is functioning effectively — should help to offset the damage.

DISCUSSION

ROBERT TRIFFIN

I will try for a change not to play the part of the prima donna so dear to all of us academics, but to limit myself to six very specific comments directed at the extremely interesting, stimulating, and thoughtful paper of Sir Maurice. I must, of course, by force stress the points of disagreement rather than agreement if I wish to bring any contribution of my own to this discussion and stimulate some exchange of views. But I would like to insist that these points are relatively minor, that Sir Maurice probably does not disagree with most of them, and that I certainly feel in full agreement with the main brunt of his arguments and conclusions.

What I disagree most with, I guess, is the title of his paper, "Stabilizing the Present International Payments System." I don't disagree with "stabilizing," but what I would like to see stabilized is certainly not the present international payments system but a vastly improved one. I suspect that this is also what Sir Maurice has in mind.

The Order of Priorities for an Ideal Adjustment Process

My second point of difference is about the order of priorities in the three tests which he suggests for an ideal adjustment process. I would just about reverse that order. That is to say, I would put first the third test — i.e. to facilitate the maximum sustainable expansion of trade and activity in the world as a whole — and put last, although not neglect, his first point — to avoid too large or too prolonged surpluses or deficits for individual countries. My main reason for reversing Sir Maurice's order of priorities is that large and prolonged surpluses or deficits for an individual country may well be beneficial at times for that country as well as for the world as a whole. He himself gave an example of this in his paper and repeated what Professor Cooper, my colleague at Yale, pointed out many years ago: that the deficits of the United States in the late 1940's and early 1950's were beneficial to all concerned and welcomed by them all. They were beneficial and welcomed, first, as a way to redistribute

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monetary reserves in a more satisfactory manner, from the excess reserves accumulated by the United States during the war and to replenish the depleted reserve levels of other countries at the end of the war. And they were welcomed also as a way to sustain desirable, feasible, and, on the whole during that period, noninflationary levels of world trade and production which could no longer be fed by adequate accretions to the world stock of monetary gold and could not yet be fed by SDR's, because they did not exist.

External Surplus or Deficit

My third point is a query rather than a disagreement. What is meant by the terms "external surplus" or "external deficit" to which he refers? I suspect from the rest of his paper that Sir Maurice refers very probably to what is called the "basic" deficit or surplus; that is to say, the surplus or deficit on current account and long-term capital account. Or possibly to the Bernstein deficit or surplus on reserve settlements accounts, which includes not only the current account and long-term capital account but also short-term capital movements other than the reserve assets of the domestic and foreign monetary authorities. I myself suggested this latter definition long before Bernstein succeeded in selling it to the U.S. Department of Commerce, and I still think it is a very useful one. Yet recent developments suggest to me that neither can be relied upon as meaningful by itself in isolation from the structure of the balance of payments, from the disaggregated accounts, current account and capital movements. Let me give you a very simple example. The U.S. basic balance or settlement balance could be in perfect equilibrium under two very different conditions. First, we might have a \$10 billion current account surplus financed by \$10 billion of capital exports. I would not be too dissatisfied with that ideal or that norm, but you could get the same basic equilibrium with a \$10 billion deficit on current account financed by a \$10 billion of capital imports into the richest and most capitalized country in the world. I would not take those two basic balances as equivalent to one another. I doubt that you would, Sr. Maurice. By the way, we hear a lot today about the fact that in this year the German balance was also in basic equilibrium or even in deficit. I don't take that very seriously either, and I have grave doubts, by the way, about the manner in which we distinguish, in our statistics, long-term and short-term capital movements. I would not be surprised if some

so-called short-term working balances were in fact far less volatile than "long-term" capital investments or flings in Wall Street.

No Really Automatic Adjustment Formula

That brings me to my fourth point which, fortunately, is one of agreement rather than disagreement. I share fully Sir Maurice's remark about the naivety of any automatic adjustment formula, whether it be, first, that of a mythical gold standard — à la Rueff — which never existed in history, or secondly, that of an equally utopian floating exchange rate system — à la Milton Friedman — under which central banks would be barred from any intervention whatsoever in the exchange market. There is a great deal of similarity, I think, between the two proposals. No responsible, or even irresponsible, government or monetary authorities will accept tying their hands behind their backs in this way and leaving a policy instrument as powerful as their currency's exchange-rate at the tender mercy of accidental forces and/or currency speculators.

When Exchange Rate Changes Should Be Used

I hardly need to harbor that point in respect to the automatic gold standard — I doubt if there are any defenders of it here — but I might have a few remarks about fully floating exchange rates. I mean fully floating exchange rates without any kind of market intervention by central banks, assuming that this were thinkable. Exchange-rate adjustments, to my mind, cannot be regarded as the universal panacea for all of the major and radically different sources of balance-of-payments disequilibrium. That is to say: first, temporary, reversible disequilibria such as, for instance, due to bad crops or speculative capital movements; secondly, discrepancies in national demand policies, i.e. in relative rates of inflationary or deflationary fiscal or monetary policies. I think that those fiscal and monetary policies should ideally adjust GNP expenditures to the country's productive potential at reasonably full employment. If they don't, you will have continuing surpluses or deficits. And then there is the third source of disequilibrium to which I think the remedy of changes in the exchange rate is applicable and that is disparities in the international price and cost pattern.

Exchange readjustment will often prove the best, or even the only, feasible remedy for the third of these three major sources of

disequilibrium, but certainly not for the first two. Temporary disequilibria should be *financed* rather than prematurely and unwisely eliminated by exchange rate changes that would be not readjusting but maladjusting in the long run. Secondly, as far as overspending or underspending is concerned, this should obviously be corrected by appropriate fiscal and monetary action, but not by exchange-rate changes which merely rechannel the resulting disequilibria from the balance of payments to the domestic economy. I have estimated, for instance, that in 1968 the United States spent publicly and privately, for investment or consumption, about \$40 billion more than its maximum productive potential. This overflow of expenditures had to find its way both in domestic price increases of 4 percent a year or more and into a substantial shortage of the U.S. current account with relation to any reasonable surplus target that would finance desirable capital exports.¹ We might of course, if other countries allow us to do it, improve our current account by devaluation, but as long as the overspending continued, this would merely accelerate domestic inflationary forces. We would export more and import less, fewer goods would be available, and therefore the domestic absorption of the overspending would simply accelerate price rises that would, as a consequence, create the third type of disequilibrium — under-competitive levels of prices and costs — that would justify that devaluation *ex post*. But as long as overspending continued, inflationary forces would continue also and resurrect a balance-of-payments deficit.

Similarly, the underspending countries, if there are any, could eliminate their consequent surpluses through revaluation of their currency, but only by aggravating domestic deflationary forces. As different from the deficit countries, however, these deflationary forces would translate themselves today into unemployment rather than into wage decreases, and this asymmetry would introduce a devaluation bias in the world exchange-rate system through what my academic friends have dubbed a “ratchet” effect. I refer you again to my previous writing on the subject or shall let you raise questions about it if it is not perfectly clear to you.

Consequences of Floating Rates

In brief, an automatically floating exchange rate system would

¹See my booklet on *The Fate of the Pound* (Atlantic Institute, Paris, 1969) pp. 22 and 36-37.

bottle up internally the consequences of all mistakes in demand policy. But inflationary mistakes would result in permanent price and wage rises, while deflationary mistakes would result in temporary unemployment rather than in a downward movement of wages. Therefore, there would not be that nice balance that would be tenable in the long run. And, the former mistakes not being offset by the latter, floating currencies would tend over time to float uniformly downward in terms of other currencies or, if all countries were to adopt the system, at least in terms of goods.

These strictures of an automatically floating rate would be compounded under a less automatic system — which is the only one that is realistically conceivable — under which central banks did not abstain permanently from market intervention. First of all such interventions would be very likely to work at cross purposes. There is only one dollar-sterling exchange rate, not two. Who will manage it? The Bank of England or the Federal Reserve System, or both? We know that in the early 1930's the British authorities wanted to see sterling go down in terms of the dollar and the American authorities wanted the dollar to go down in terms of sterling. They could not both have their way, and when they finally realized it they concluded the Tripartite Agreement. I give to my students sometimes the simile with a set of contiguous shower baths, each of them equipped with a faucet that regulates the heat of the water for all of them. I think the bathers would come out and fight. And that is what would happen probably with managed exchange rates in which national authorities were free to manage their rates at cross purposes.

Secondly, and this is a very important point, I think, the market interventions of central banks would not be decided by God or his angels — that is to say, the economists. They would be managed by governments subject to all kinds of pressures from vested interests and lobbies. I refer you to the experience of Latin America, and particularly Argentina, in the 19th century. What happened there was that you had the *Cajas de Conversión* which would stabilize the exchange rate. When things went bad and the balance of payments was running into heavy deficit they closed the *Caja de Conversión* and as a result the exchange value of the Argentine peso went down, and the exporters were all very happy. But if later on there was a boom in Argentina as a result of good crops and so on, the exchange rate tended to move up, and immediately all the exporters shrieked that they were getting fewer pesos for their wheat or for their meat and all the economists joined in applauding the re-opening of the

Caja de Conversión. The rate could not be allowed to move up for very long and so you had a succession of downward movements very much like a staircase. This was true in most of the Latin American countries and I am afraid would be true again under such a system. Finally, a system of floating exchange rates would to my mind be bound to exhibit a strong devaluation bias since deficit countries would be forced by the depletion of their reserves to let their rates go down, while reserve accretions would never force the surplus countries to let their rates go up. They could always intervene in the market. This bias has been mentioned by several people this morning.

Surplus Countries

Let me now mention and expand on another major and crucial area of agreement between Sir Maurice and myself. I quote from the last paragraph in his paper, in which he says the United States and the United Kingdom are "the only important countries where the adjustment process has appeared to be seriously deficient." That is to say, the two reserve-centers of the ill-fated gold exchange standard. I have only two additional remarks to make in that respect. The first is that the adjustment process may be thwarted by, to use a phrase of De Gaulle's, "the exorbitant privilege" not only of the reserve centers but also of the surplus countries. The surplus countries indeed are free under the present system to do the following things:

First, they may accumulate enormous excess reserves as a result of what used to be called in the OEEC "bad creditor policies." That is to say, they may follow unnecessarily deflationary internal or restrictive external policies and maintain an overcompetitive exchange rate.

Second, having pursued bad creditor policies and accumulated large reserves, they are rewarded in consequence by their ability to pursue later "bad debtor policies," and run large deficits without ever having to go to the IMF to ask for assistance, at least for a long time.

Third, they can decide unilaterally to impose deflation upon the rest of the world by insisting on gold settlement of their surplus far in excess of current gold accretions. Or, on the contrary, they may decide freely to invest these surpluses in the financing of one country or another, through dollar *or* sterling accumulation for instance.

Fourth, they can later change their minds and suddenly decide to

put pressure on Britain by converting their accumulated sterling into dollars or, vice versa, on the United States by converting their dollars into sterling — which is maybe less likely at the moment — or from both currencies into gold metal at the risk of bringing down the whole international monetary system.

I don't say that they have done this in fact. On the contrary, Germany has probably followed better internal policies, on the whole, than its neighbors. It has financed very generously, maybe too generously, its surpluses through dollar and sterling accumulation. It has failed, however, until recently, to help correct these surpluses through price or exchange rate adjustments. Morally, the German authorities may possibly have been right; one sympathizes with them. Practically, they failed to recognize that they could not be right against everybody else, and that the revaluation of the mark was the only practicable policy and far more feasible and less damaging than the alternatives, i.e. persistent German surpluses entailing inflationary pressures for them and deflationary pressures for others; impossible reductions in wage levels abroad; unwanted price and wage increases in Germany; or a spiral of devaluations abroad, including a devaluation of the dollar. The devaluation of the dollar would be very difficult to endorse as long as the dollar remains the kingpin of the international monetary system and would, moreover, entail, under the present system, an appreciation of gold, whether desirable or not for its own sake.

Reserve-Center Countries

My second point is that the persistent failure of adjustment on the part of the reserve-center countries is not a mere accident, but is, in realistic terms, the predictable, nearly unavoidable, consequence of the reserve currency role assumed by them under the gold-exchange standard. Reserve-currency countries get more rope to hang themselves. They may escape for a long time the full pressure of their deficits, but at the cost of building up a precariously held indebtedness exposing them later to sudden discipline through crises.

I would like to quote here very briefly a few figures to conclude this paper. It is striking to think that in the last year before the First World War for instance, the United Kingdom, having been the first full-developed country in the world, had a current account surplus estimated by statisticians at about 10 percent of GNP. Today the two major financial markets of the world, the United States and the

United Kingdom, have a current account surplus not of 10 percent of their combined GNP — that would be about \$100 billion — not even 1 percent of their combined GNP, as hoped for by the United Nations — that would be \$10 billion — but a combined current account surplus of somewhere around \$1 billion.

I think that this drying up of the ability of the two major financial markets of the world to finance capital exports is something which is extremely worrisome. And yet, of course, their export of domestic capital continues. I think it is very unrealistic and difficult to believe that you can adjust your capital account to your current account by closing down the City or by closing down Wall Street, or by closing down the various programs of foreign assistance and intervention to which dollar and sterling diplomacy are condemned by their world-wide responsibilities. I would like to mention, for instance, that in spite of our huge deficits and the British deficits in 1968, we still exported more than \$10 billion of U.S. capital and the British themselves had long-term gross capital exports estimated at 1½ billion pounds — about \$3½ billion.

Financing Capital Exports

How could this be done? Those exports of capital were not financed by the current account surplus but were financed initially through the short-term private capital funds normally attracted to a major financial market. When those sources dried up, continuing capital exports were financed by central banks accumulating, taking the overflow of, sterling or dollars. And when this began to create great difficulties recently, they were financed by the Euro-currency and Euro-bond markets. This year they were financed in the Euro-currency market at a rate which I don't believe can be sustained. Our banks borrowed from their branches abroad about \$3 billion in two years in 1966-1967, about \$3 billion a year in 1968, and in the first six months of this year they were borrowing at an annual rate of about \$15 billion. Undoubtedly some of that was fed by American capital that was exported there, but still I think those figures are frightening. And therefore we have been led to all kinds of salvage operations. Mr. Schweitzer himself described the present world monetary system and reserve system as being financed only through these forms of negotiated credits. I have suggested that really we should not speak of reforming the gold-exchange standard — it has been dead for some time. In the last five years, the

traditional components of the gold exchange standard — that is to say gold and voluntarily accumulated foreign exchange — went down by about \$12 billion. There was no increase in world reserves from these two sources. But you had an increase of about \$18 billion from what I would call negotiated reserves through the Fund, through the Basle Agreements and so on.

There is a danger still, but I don't want to go outside the subject of adjustment, that the SDR system might preserve some part of this process by allocating automatically a large portion of the SDR's to the United States and the United Kingdom, and in general I would say that the system will have to be changed later on by deciding that the SDR lending potential should really be put to work to sustain *internationally agreed* purposes, rather than the automatic support of national policies, whatever they are at the moment.

The "Fork"

Finally, if I were to make a comment in relation to the crawling peg or wider band proposals, I would say that I would have neither crawl nor wider bands. I would prefer what I call the "fork." That is to say, I would like to apply the same discipline to surplus and to deficit countries. What I have in mind when I speak of the "fork" is this: each country would define a normal reserve level — I don't think this would be as difficult as it sounds — and a country could deplete its reserve level at a certain rate or increase it at a certain rate, but if this were prolonged and excessive, the country would have to discuss with the Fund what remedies would be applicable to the situation. This, of course, is something that already happens as far as the deficit countries are concerned. When they have lost too much of their reserves, they have to discuss internationally the conditions under which external assistance will be made available to them to defend their exchange rate, if this is appropriate. The surplus countries, however, are never forced into that position, and I think they should be. Therefore, beyond a certain rate or level of reserve accumulation, the surplus countries would also be forced into meaningful consultation with others; and if they cannot agree on appropriate remedies — changes in monetary and fiscal policies, for instance — they should be enjoined from further exchange market interventions. They would have to let their rate adjust if they refuse to adjust their internal policies. Compromises, such as the crawling peg, might have their place here.

The Need for De Facto Stabilization

From that point of view, I would also like to drop a purely academic idea which is probably utopian at this time, but someone else mentioned it this morning. I would very much wish that the Germans would not return as soon as possible to a new legal parity. I think it would be a mistake, nationally and internationally. I would far prefer to have a system in which the Bundesbank tries, of course, to have some kind of stabilization *de facto*, but would not legalize this for some time to come. Remember that was always the case in the past before the institution of the Monetary Fund. When a country felt compelled to change its exchange rate, it did not change it overnight. What it did was to suspend the old parity and then test the market. For example, Poincaré stabilized *de facto* in 1926, but stabilized *de jure* only in 1928. I think that if the Fund were to give members in such a situation a waiver from the obligation to declare immediately a new parity, and say that this waiver is conditional upon meaningful consultation continuing until parity is restored, this would be far more beneficial for all concerned, because under the present system it is very difficult to have meaningful consultations. When Mr. Emminger comes to the Monetary Committee in Paris and is asked to discuss what they will do with the mark, Mr. Emminger says: "Gosh! I don't know, and Mr. Kiesinger himself will not know until the cabinet meets." I think you could have much more meaningful consultations under a system of *de facto* stabilization of rates in consultation with the Fund.

A Lesson from Germany

Finally, I hope that any kind of people who still believe in the possibility of, not *legal*, but *effective* national monetary sovereignty will learn their lesson from what happened to the Germans. Germany finally did at the end of September 1969 what everyone had begged them to do in November 1968. They had to do what they refused to do then. If they had done it in November 1968, they would have saved the world and themselves nearly 12 months of distortions and agony, including possibly the break in the long-term stability which it had achieved in the area of wage levels. I hope that this lesson will not be lost on all of us.

The Fund should be empowered to initiate consultations on an exchange rate readjustment recognized as indispensable to correct a

“fundamental disequilibrium”, damaging to all its members, rather than be forced to wait — as is now the case — until the overvalued (or undervalued) currency country requests such a change.