

Widening the Band for Permissible Exchange Rate Fluctuations

GEORGE N. HALM

Our present international monetary system tries to combine three features: (1) fixed par values, (2) full convertibility, and (3) full employment plus stable prices. The member countries differ somewhat in their aims, their policy mixes and their rates of inflation. Moreover, these discrepancies are no longer ironed out over time by the international monetary mechanism itself. No country is willing to embark on inflationary or deflationary policies merely to maintain external balance.

L. Albert Hahn used to speak of the "magic triangle" to indicate that only a magician's wand could make such a system work. Repeated financial crises and growing quantitative restrictions have shown that the system does not work very well though opinions differ as to the reason why. A closer look at the three sides of the triangle can reveal the main weaknesses of the present international payments system.

Stable Prices

Domestic inflation is mainly the outgrowth of monopolistic pressures in the modern market economies which have greatly weakened the downward flexibility of wages and prices. Since the market economy rests on reactions to price changes, and prices are more ready to rise than to fall, the world trend is inflationary though not uniformly so in different countries. Furthermore, it has become increasingly difficult to induce individual countries to adjust their policies to the average rate of world inflation. Surplus countries with full employment are unwilling to increase inflationary pressures in order to balance their international accounts, and deficit countries in recession are most reluctant to use monetary contraction to protect their foreign exchange reserves. These are the dilemma cases in which

Mr. Halm is Professor of Economics, Fletcher School of Law and Diplomacy, Tufts University, Medford, Massachusetts.

policies for the achievement of domestic aims conflict with measures which would lead to external balance. For instance, high rates of interest to stop inflationary pressures in a surplus country attract funds from a deficit country which carries through expansionary monetary and fiscal policies. The balance-of-payments disequilibrium increases in both countries.

If exchange rates remain fixed, currency convertibility is maintained, and domestic policies are not used to achieve external balance, three possibilities are left: (1) liquidity reserves can be increased to permit temporary maintenance of a basically untenable position; (2) refinements of monetary and fiscal policies may accommodate simultaneously both domestic and international aims by carefully doctored policy mixes; and (3) incomes policies can try to achieve what monetary policies were not permitted to accomplish. None of these policies is promising. The first, liquidity creation as stop-gap, may make things worse by permitting postponement of urgent corrections in national economic policies or in par values. The second, the use at cross purposes of, say, contractionist monetary measures for external balance and of expansionist fiscal policy for domestic purposes, may never work owing to the extreme fungibility of money. And, even if such sophistication and fine-tuning were possible in the future, it is certainly not now available. The third, an incomes policy, may be used in emergencies but can never be a long-run substitute for adequate monetary and fiscal measures.

If none of these alternatives will work, either fixed exchange rates or convertibility will have to be sacrificed.

Currency Convertibility

A system of currency convertibility at fixed par values implies that the central banks maintain a perfectly elastic demand for, and supply of, foreign exchange. Liquidity reserves will continuously change. These international liquidity reserves give elasticity to an otherwise rigid payments system. Bretton Woods emphasized this aspect of elasticity by concentrating on the supply of liquidity reserves. Also, most of the more recent attempts to shore up, or to permanently improve, the Bretton-Woods system concerned themselves almost exclusively with liquidity creation. Throughout, not enough attention was paid to the adjustment problem, though it is obvious that the demand for international liquidity depends largely on the functioning or malfunctioning of the adjustment process.

Adjustment can be achieved either through domestic monetary policies which, in dilemma cases, are certain to be inadequate or it can be the result of exchange-rate variations which are excluded by definition as long as we stipulate a system of permanently fixed parities.

If exchange-rate variations are not permitted, if domestic monetary policies are not able to achieve external balance, and if liquidity reserves are inadequate, currency convertibility becomes impossible and quantitative restrictions will be introduced. To maintain fixed exchange rates by quantitative restrictions means to defend the use of a mere instrument by giving up the very aim for which the instrument was designed.

Fixed Exchange Rates

The absurdity of this situation in which controls are introduced to permit the maintenance of a fixed price is well known to the student of government interference with market processes. As a rule, such interferences are only tolerated in national emergencies. In normal times, they are rejected because they prevent the functioning of the market mechanism, the allocation process on which the private enterprise economy depends.

Why then the great reluctance to let flexible exchange rates perform the function of real market prices? The reason is probably to be found in the mistaken attempt to extend the official price stability of domestic money ("a dollar is always a dollar") to the international arena by tying all national currency units firmly to either gold or the dollar. However, the "joint" between national currencies and national price structures should not be rigid. It should be supple and vary with discrepancies of national inflationary trends (the so-called purchasing-power parities).

The basic argument for fixed parities as policy instruments was that, combined with limited international liquidity reserves, fixed parities would help integrate national monetary policies. The deficit country would be forced into contraction, the surplus country prodded into expansion. The argument was reasonable as long as these reactions to changing reserves were considered desirable, possible, and probable. Even then, it was obvious, however, that the fixing of par values had to be accompanied by the artificial manipulation of another price of strategic importance — the discount rate.

Once the fixed-rate system is no longer permitted to produce these effects, once it is losing its power to bring about external balance and to maintain currency convertibility, fixed parities should no longer be maintained for their own sake.

The present international payments system does not rest on permanently fixed par values. The members of the International Monetary Fund are permitted to change the par values of their currencies if the Fund is satisfied "that the change is necessary to correct a fundamental disequilibrium."

Once parity adjustments are permissible, most arguments for fixed par values collapse: long-run transactions no longer rest on the safe foundation of a stable international value of the currency unit; monetary and fiscal policies are no longer forced to defend international liquidity reserves through inconvenient domestic policies; and harmonization of national policies can no longer be counted on, with the result that needed adjustments are brought about belatedly and abruptly through substantial devaluations and upvaluations. Emphasis in recent years on liquidity rather than adjustment indicates the increasing erosion of the very discipline on which the advocates of fixed exchange rates try to rest their case.

These ill-effects of the adjustable-peg system are now rather generally admitted, but have led some policy-makers to the wrong conclusion that par-value changes must be avoided at all cost — even at the cost of negating the real meaning of the whole system through the introduction of more and more stringent controls.

So much for an analysis of the magic triangle. Now to the question of how we can break out of this bad combination of interdependent limiting forces.

Flexible Exchange Rates

It should not be necessary to state the case for flexible exchange rates in market economies whose very logic depends on price reactions to changes in demand and supply. Nevertheless, this particular price, the rate of exchange, enjoys the unique distinction of being the only price that is kept artificially fixed with the approval of businessmen and bankers, and the support of many economists.

The main arguments against exchange-rate flexibility are well known: flexible rates, we are told, add new and additional risks to

international transactions, foster speculation, and are an invitation to disregard the balance-of-payments implications of national economic policies. Robert Triffin, for instance, accuses the advocates of flexible rates of making the exaggerated claim that "fluctuating exchange rates would automatically equalize cost disparities which derive from diverging national monetary policies, so that every country would be free to follow the most contradictory paths, without disturbing in the slightest the international payments equilibrium."¹ Exchange-rate flexibility seems, somehow, to convey the notion of self-aggravating depreciation, extremely wide fluctuations, or an irresistible urge to practice competitive depreciation. It is taken for granted that to stray from the virtuous path of fixed exchange rates would mean the end both of national monetary discipline and international cooperation.

This view is much too pessimistic. The exchange-rate variations needed for the achievement of external equilibrium may be quite modest. A system with flexible exchange rates does not, like the present system, postpone the adjustment process and is therefore likely to avoid the development of discrepancies which under fixed rates will eventually call for major adjustments of par values or for exchange controls. That countries would not pay attention to their external balances, as Triffin suggests, is as unlikely as complete neglect of domestic policy aims under fixed rates; nor would floating rates be an invitation to competitive exchange depreciation. When market forces are permitted to operate, competitive depreciation cannot exist. Sustained undervaluation can only occur under the present adjustable-peg system.

However, notwithstanding these arguments in favor of flexible exchange rates, most practitioners and some academic economists believe that complete freedom for exchange-rate variations would mean the end of monetary discipline, that exchange rates would fluctuate wildly and that, far from producing external balance, the system would be injurious to international trade relations and capital flows. Whether right or wrong, these beliefs are too firmly ingrained to permit serious practical consideration of a system of freely floating exchange rates. The question arises, therefore, whether, if not full, at least greater exchange-rate flexibility could be introduced.

¹Robert Triffin, "Die Währungsordnung des XX. Jahrhunderts" in *Inflation und Währungsordnung* (Erlenbach-Zürich und Stuttgart: Eugen Rentsch Verlag, 1963), p. 149.

A move to greater exchange-rate flexibility implies that the present system already contains some elements of flexibility. There are, indeed, two such elements. One is the permission of fluctuations of exchange rates around par values within a very narrow range; the other is the already mentioned adjustable-peg feature of the Bretton Woods arrangements.

Increased flexibility can be created by widening the margins of permissible exchange-rate variations from the present 1 percent on either side of parity to, say, 2-1/2 or 5 percent. This method of adding flexibility to a fixed par-value system was practiced even under the old gold standard² and was strongly recommended by J.M. Keynes in his *Treatise on Money*.³ It is now often referred to as the band proposal, the "band" marking the total range, up and down, over which the rates are permitted to fluctuate. Official sales and purchases of foreign exchange would become obligatory and automatic as soon as the intervention points are reached. Official purchases of foreign exchange would prevent the value of foreign currencies from dropping below the intervention point. Official sales out of reserves would prevent an appreciation of the foreign currencies beyond the upper limit.

In the eyes of advocates of exchange-rate flexibility, the widened band would offer a solution only if the permitted exchange-rate variations were able to handle the adjustment problems which are created by diverging national economic policies (or by excessively large unilateral payments) *within* the band. If the band is not wide enough and the adjustment effects are too weak, if national divergencies do not reverse themselves (or unilateral transfers remain excessive), the exchange rates will get stuck at the support points. This would indicate that the widened band did not offer enough flexibility and that a change of par-values would have to take place.

In this case, the system would seem to be once more exposed to all the weaknesses of the adjustable peg. However, par-value changes do not have to be of the type that became characteristic for the first quarter-century of Fund operations. Small and frequent parity changes (crawling, sliding, or gliding parities) can be substituted for the present practice of discrete and large adjustments of the peg.

²See Jacob Viner, *Studies in the Theory of International Trade* (New York: Harper and Brothers, 1937), pp. 206-207; Arthur I. Bloomfield, *Monetary Policy under the International Gold Standard: 1880-1914* (Federal Reserve Bank of New York, 1959), p. 52.

³John Maynard Keynes, *A Treatise on Money*, Vol. 2 (New York: Harcourt, Brace and Company, 1933), chapter 36.

The two moves toward greater exchange-rate flexibility do not conflict. A combination of the widened band and the gliding peg can be referred to as a movable band.

The Band Proposal

The band proposal is a compromise which can be interpreted either as a very limited system of floating rates or as a fixed par-value system with widened gold points. In the words of Robert V. Roosa, market forces are permitted to "demonstrate the basic strength or weakness of a currency", and price reactions give "sensitive signals of changes in fundamental forces." Nevertheless predetermined limitations for these price fluctuations maintain "fixed points of reference" and prevent the degeneration of foreign exchange markets into "disorderly chaos."⁴

Whether this compromise favors discipline or freedom depends on the chosen width of the band in conjunction with the supply of international liquidity reserves. Small reserves combined with a broad band can have about the same effect as a narrow band with very large reserves. It would not be correct, therefore, to say that a widening of the band will weaken discipline. Changes in international liquidity reserves, furthermore, would no longer be the only gauge by which to judge the international position of a currency. "After all, exchange-rate movements are very clear and loud warning signals. They are much more noticeable by the public than are reserve movements."⁵ Even a substantial widening of the band, therefore, need not be resisted on the grounds that this would be bad for monetary discipline.

If international liquidity reserves and widened bands are considered as trade-offs, the latter have the advantage that exchange-rate variations produce real adjustments while larger reserves only help postpone adjustments. The proper choice depends on the nature of the imbalances that are to be corrected. Temporary imbalances should be financed out of liquidity reserves; more deep-seated disequilibria should be eliminated.

⁴See Robert V. Roosa, "The Beginning of a Policy" and "Banking and the Balance of Payments" both in *Factors Affecting the United States Balance of Payments* (Joint Economic Committee, 1962), pp. 328 and 339; *Monetary Reform of the World Economy* (New York and Evanston: Harper and Row, 1965), p. 27.

⁵William Fellner in *Maintaining and Restoring Balance in International Payments*, ed. by William Fellner, Fritz Machlup, and Robert Triffin (Princeton, N.J.: Princeton University Press, 1966), p. 122.

The adjustment of the trade balance through exchange-rate variations takes time but its start is instant and automatic. The needed corrections are not postponed for years as under the fixed par-value system with a very narrow band. The time lag in the adjustment process will let exchange rates move beyond the long-run equilibrium point for the now existing market conditions. Lundberg⁶ and Meade⁷ have pointed out that these temporary deviations will induce private speculation to move funds from the surplus into the deficit currency in expectation of a rebound once the real adjustment has been accomplished. Private speculative capital will thus finance temporary imbalances and prevent an overreaction of trade adjustments where no serious disequilibrium is involved.

Experience has shown that fixed exchange rates produce disequilibrating capital movements in dilemma cases: the surplus country with the high employment level tries to check domestic inflation and thereby attracts funds from the deficit country that follows expansionist policies to combat recession.

A system permitting increased exchange-rate flexibility within a wider band would help restrain the disequilibrating capital flow certain to be generated under fixed parities. As in the case of fixed rates, the interest rate would be low in deficit country *D*, to increase employment, and high in surplus country *S*, to stop inflation. The interest-rate differential, therefore, would still tend to guide the international flow of private short-term capital in the wrong direction. But in a system with exchange-rate flexibility exchange-rate variations would tend to counterbalance the interest-rate differential. The exchange-rate of *S*-currency would appreciate, the rate of *D*-currency would depreciate, and these changes in exchange rates would reduce, compensate, or overcompensate the profit to be derived from the interest differential. Disequilibrating capital flows from low-interest country *D* to high-interest country *S* would be

⁶Erik Lundberg in *Skandinaviska Banken Quarterly Review*, October 1954.

⁷James E. Meade in "The Future of International Payments" in *Factors Affecting the United States Balance of Payments* (Joint Economic Committee, 1962).

⁸The case in which the deficit country enjoys full employment and the surplus country suffers from unemployment is regarded as a non-dilemma case, because economic policies aiming at external and internal balance need not conflict. The deficit country with full employment can be expected to have high interest rates because of its high level of economic activity, and it may raise these rates in an attempt to combat domestic inflation and to attract short-term foreign funds to eliminate the deficit. The surplus country, by contrast, tries to stimulate economic activity through low interest rates, thereby encouraging an outflow of short-term capital that, owing to the country's surplus position, would create no problems. In a system with fixed exchange rates, the changing differentials in

reduced, stopped, or even reversed by the exchange-rate differential that grows with each additional capital transfer. In other words, market forces would take care of the situation.⁸

Choices

The band proposal offers a number of choices, and it will be necessary to find out which arrangements will be best.

(1) It might be advisable to widen the band gradually as those engaged in foreign transactions gain confidence in the new system. However, this gradual approach would presuppose a general realignment of exchange rates since otherwise some rates would immediately get stuck at the support points.

(2) It has been argued that one and the same band cannot be equally well suited for trade transactions and capital movements and that, for instance, a band capable of adjusting exports and imports would be too wide for capital transactions in international financial centers. However, since it is impossible to charge different prices for different uses of a completely fungible market object, all that can be said is that the individual countries must make their choice in their own best interest.

(3) It must be decided whether central banks are to intervene inside the band or to limit their intervention to purchases or sales at the support points. Since these transactions are not likely to be delayed to the very last moment when the support points are actually reached, it could easily be that the band would be composed of an inner band of non-intervention plus outer rims in which interventions would normally take place.

(4) Since international capital movements are induced by interest-rate differentials and by exchange-rate variations, central banks may

interest rates between deficit and surplus countries are expected to help adjust national price levels and the trade balance, while the induced international flow of short-term capital helps finance the deficit until the adjustment is completed. Even under the old gold standard the interest-rate differentials were supported by the small exchange-rate variations between the gold points. The exchange rate of the deficit country *D* would depreciate temporarily and make it more attractive for speculators in surplus country *S* to purchase *D*-currency, enjoy temporarily the higher interest rate in *D*, and repurchase *S*-currency after equilibrium has been achieved and *D*-currency has returned to parity. A widening of the band would strengthen these equilibrating short-term capital movements. The capital flows induced by exchange-rate variations alone might even be strong enough to provide the needed foreign funds to finance the temporary external imbalance and give the monetary authorities the opportunity of handling interest-rate changes with greater consideration of the requirements of internal equilibrium.

want to add exchange-rate manipulation inside the band to their arsenal of monetary instruments.

(5) Several writers⁹ have suggested an asymmetrical band that would stress appreciations of surplus currencies more than depreciations of deficit currencies. For example, the upper margin would be 3 percent while the lower margin would stay at the present figure of one percent. This arrangement would force the surplus countries with undervalued currencies to make a greater contribution to international balance than the deficit countries with overvalued currencies and, thereby, build an anti-inflationist feature into the system.

(6) Many advocates of the widened band want to combine it with a gliding parity. This combination, the crawling or gliding band or band and crawl, can be recommended, unless we are afraid that the simultaneous use of band and crawl would seriously weaken the firm guidance for national monetary policies which may possibly be gained from a band with absolutely fixed support points.

Band and Crawl

Of course, the widened band will not achieve its purpose if the disequilibrating forces of diverging national monetary policies exceed the equilibrating power of exchange-rate variations inside the band. Once the exchange rates become stuck at the support points, the system has again turned rigid. Flexibility can then be maintained by moving the parity in very small and relatively frequent instalments and by not more than, say, 2 percent per year.

Harry G. Johnson argues, that for those persuaded of the case for flexible rates, the crawling peg is definitely to be preferred to the wider band because the latter would provide only a once-for-all increase in the degree of freedom of exchange rates to adjust to changing circumstances.¹⁰ However, the question need not be which of the two instruments for greater flexibility we *prefer*, the band or the crawl. There is no need to choose. In all probability both band and crawl will be used, and in this cooperation of band and crawl, the band is more important than Harry G. Johnson suggests.

⁹For instance George H. Chittenden, William Fellner, Fritz Machlup, and Robert V. Roosa in *Approaches to Greater Flexibility of Exchange Rates, The Bürgenstock Papers*, Arranged by C. Fred Bergsten, George N. Halm, Fritz Machlup, and Robert V. Roosa, Edited by George N. Halm (Princeton, N.J.: Princeton University Press, 1970)

¹⁰Harry G. Johnson, "The Case for Flexible Exchange Rates, 1969" in *Approaches to Greater Flexibility of Exchange Rates*, op. cit., pp. 107-108.

In overemphasizing the crawl we underestimate the equilibrating power of the widened band. We should not be unduly impressed by the divergencies of national monetary policies as they exist today. These divergencies were in part produced, and certainly exaggerated, by overvaluations and undervaluations as they are maintained under the adjustable-peg system. The postponement of adjustments has made things increasingly worse. We had, in fact, a system which led to *maladjustments*. The maintenance of wrong exchange rates pried the monetary policies of the member countries further apart by enhancing both inflationary and deflationary trends. Surplus countries with undervalued currencies exposed themselves to added inflationist pressure while deficit countries, not willing to interrupt national economic expansion for reasons of external balance, went deeper and deeper into deficit. These developments could not have happened to the degree in which they did occur, had flexible rates within a widened band been permitted to help balance the external accounts. It is wrong, therefore, to base estimates on the needed degree of exchange-rate variations or parity changes on the experiences of the more recent past.

If we want to be pessimistic about the future divergencies of national monetary policies and the integrating power of exchange-rate variations inside a widened band, we shall also have to ask whether even a crawl of not more than 2 percent per year will be enough and whether a faster crawl could solve the problem of disequilibrating speculation which will inevitably be connected with substantial parity changes.

Nothing argues against a combination of band and crawl. Both rest on the same criticism of the present system and both will provide more flexibility. It makes sense to add the crawl to the widened band when we assume that unidirectional deviations of national monetary policies may eventually exceed the adjustment capabilities of the band. For the same reason, it makes sense to consider the widened band the first step on the road to greater flexibility and the gliding peg the second step.

The crawl does not one-sidedly aid the band. The band may be able to aid the crawl. It can provide guidance for the practical operation of a gliding-peg system. For this operation, it will be essential to gauge the degree of the existing external imbalance which calls for the shifting of the parity. Variations of exchange rates within a widened band may offer the most reliable evidence. Furthermore, if the band is relatively wide in comparison with the

permitted yearly crawl (say, 6 percent against 2 percent), the parity adjustments can take place, as it were, *inside* the band and thus become invisible. This point is important in view of the difficulties that may be caused by private speculation.

In deciding on the relative importance of band and crawl, we should not forget that the widened band permits market forces to operate while the crawling-peg arrangement deals with a difficult question of price-setting. If we interpret the trend toward limited exchange-rate flexibility as a partial return to the operational procedures of a market economy, the band is more attractive than the crawl, and we may conclude that the crawl should not be stressed at the expense of the band.

*Band, Crawl, and the Dollar*¹¹

Playing the role of international money (transaction and intervention currency) and unit of account (common denominator or numéraire), the dollar also finds itself in a special position with respect to the band and crawl proposals. When we assume a band of a total width of 10 percent, currencies *A* and *B* can be as far as 10 percent apart. However, the dollar, as common denominator, can differ from any one of the other currencies by not more than 5 percent or one-half of the total band.

The widened band, therefore, would not apply to the United States in the same manner as to all the other members of the system and would continue the asymmetry of the payments system which is connected with the role of the dollar as intervention currency and numéraire. In today's adjustable-peg system all members of the International Monetary Fund except the United States enjoy the potential safety-valve of parity changes if they find themselves in fundamental disequilibrium. Under the wider band, the adjustment possibilities via exchange-rate variations would be limited to one-half of those open to other Fund members. As a matter of fact, the dollar rate would not be determined by the policy of the United States but by the sum of the decisions of all other countries concerning their position to the dollar.

Should the United States nevertheless welcome the widened band?

An affirmative answer would have to consider that the present

¹¹ See C. Fred Bergsten's paper "The United States and Greater Flexibility of Exchange Rates" in *Approaches to Greater Flexibility of Exchange Rates*, op. cit., pp. 61-75.

situation of the United States also implies certain advantages. The role of the dollar as reserve currency means that all surplus countries stand ready to buy dollars in unlimited amounts when an oversupply of dollars must be taken off the market to prevent an appreciation of surplus currencies. This means automatic financing of payments deficits of the United States. If the band for permissible exchange-rate variations is widened while the dollar is still used as reserve currency, the effect on the United States will be in the nature of a compromise. The regular advantage of the widened band, that is, its beneficial adjustment effects on trade and capital flows, would be limited to one-half of the potential maximum effect for other countries; but to the extent that surplus countries would have to buy dollars at the margin, they would still finance a remaining deficit of the United States. A quasi-automatic supply of liquidity for the reserve-currency country compensates for the more limited elbow-room for exchange-rate adjustments.

Technical difficulties could arise if the band were widened while the gold value of the dollar remained relatively fixed as at present. The dollar could depreciate and appreciate in terms of other currencies by as much as 5 percent, but in terms of gold by only 1 percent. Accordingly, it would seem that central bankers would prefer gold to the dollar as the safer reserve asset or that, in the case of an expected dollar depreciation, they would move into gold and, in the case of a dollar appreciation into dollars. However, we ought to be able to assume that considerations other than mere security and profitability would prevail at official levels.

Not a Panacea

The band-crawl proposals do not solve all problems of the world's monetary system. The problems of liquidity and confidence remain but will become less acute as soon as a real adjustment process via exchange-rate and parity changes will be permitted to work. The demand for international liquidity will not disappear as it would under freely floating rates, but it will become more manageable; and, as adjustment and liquidity are better handled than before, confidence in the system will improve.

In the end, however, all international monetary systems can be expected to work only if national monetary policies are reasonable. We cannot argue that a system composed of the elements of convertibility, limited flexibility, and widely diverging national inflationist

trends can be made to function. On the other hand, it is difficult to see why exchange-rate variations should not be as good a disciplinarian as changes in liquidity reserves and why international monetary cooperation and multilateral surveillance could not be applied to the administrative problems of band and crawl.

DISCUSSION

RICHARD E. CAVES

I am happy to be able to say at the start that I am in agreement with the great bulk of George Halm's paper. That is quite fortunate, since he is agreeable to so many alternative proposals to the present system that he becomes invulnerable to attack on any one in particular. He will accept both band and crawl; indeed, the limits of his band behave like the U.S. national debt ceiling, changing with only moderate inconvenience before they threaten to constrain the actual state of affairs. Furthermore, I gather that, if anyone gave him his preferences and made central bankers putty in his hands, he would have completely flexible exchange rates. In any case, always being an admirer of flexibility, I will not try to pick out any variant of this proposal and identify it as the Halm plan, but I shall comment rather on the relationship among several aspects of proposals that make use of the band device.

I would like first of all to reflect for a moment on the nature of the diagnoses that lead people either toward a crawling peg, as an alternative to the present adjustable peg, or toward a band proposal (which I'll define as a band with limits that do not change except perhaps in discrete steps). These two proposals stem from rather different diagnoses of what is allegedly wrong with the adjustable peg system employed under the Bretton Woods Agreement. The crawling peg is being supported by those who are concerned primarily with getting exchange rates changed in a more orderly fashion than they have been, and permitting these changes to proceed far enough to restore equilibrium. They are concerned simply with altering exchange rates and not with what one might call the policy system of the fixed exchange rate — its impact on the leverage of domestic policy instruments, speculative capital flows and the like.

Supporters of the band proposal, on the other hand, come to it from quite a different diagnosis of what is wrong with the adjustable peg system. They are worried primarily over the consequences of the policy system that results from fixing the exchange rate (or changing it by discrete jumps). They may fear the volume of speculative capital flows when people expect a rate change, or the government restrictions that may be imposed on commercial transactions in attempts to defend a fixed parity. Supporters of the band proposal

may also worry about the impact of the fixed exchange rate on the leverages of domestic economic policy or on the relative adequacy of the number of the policy instruments. Finally, they may fear that the adjustable peg will adjust by inappropriate amounts.

In short, quite different diagnoses of the ills of the adjustable peg system are made by those who would opt for the crawl, and those who would opt for the band. Those who like the crawl implicitly like fixed exchange rates, but want to get them changed a little more neatly. Those who like the band implicitly like the floating exchange-rate system and the impact that it has on the operation of economic policy; but they are concerned about having some ultimate limits on the movement of speculative capital and its impact on actual exchange rates. In short, you might say the band proposal appeals to nervous floaters and the crawl to nervous supporters of the fixed exchange rate.

Effects of the Band on Domestic Economic Policy

Most of my comments about the band proposal will be related to its effect as an exchange-rate system on the use of domestic economic policy. This topic has received less attention in our discussions here than the other aspects of adjustment mechanisms, and I will argue that there is an important problem about the impact of the band proposal on the leverages of domestic economic policy instruments. Professor Halm mentions a familiar proposition from the theory of economic policy: given two policy objectives — domestic stability and foreign-exchange equilibrium under a fixed rate — and two policy instruments — monetary and fiscal policy (excluding exchange-rate variation) — then you may be able to set the two policies simultaneously so as to achieve both goals. He is quite skeptical about this, citing the fungibility of money as one reason why it won't work. I don't follow that objection, since the logic of the proposition requires only that the relative leverage of monetary policy on domestic equilibrium and the foreign balance be different from that of fiscal policy on the domestic and foreign balances. In principle, if the leverages are different, some combination can be found that will make it all work out. If one objects to this on the ground that it requires excessive finesse in quantification, timing, and the badgering of Congress, however, I would agree.

In any case, if concern arises over the number of policy instruments or their flexibility for dealing with the set of policy targets

arising with a fixed exchange-rate system — whether permanently fixed, adjustable, or a crawling-peg system — then one may very well be attracted either to a band or a totally flexible exchange-rate regime. I agree with Professor Halm that the flexible rate does save one policy instrument. This argument is not accepted by everyone, specifically not by Professor Kindleberger. It thus merits a closer look.

Two sorts of argument are made against this familiar proposition that the flexible exchange rate removes one policy target. The first is that central bankers in fact won't let the rate alone. I personally have never heard a central banker say that, only economists without obvious access to classified information. Even if central bankers did take this position, it might call not for fixed rates but rather for a treaty binding them to leave the flexible exchange rate alone. Sometimes the argument goes farther to insist that pressure groups will force governments to intervene in the exchange market for their benefit. To take a simple form of the argument, exporters expect that their activities will be more profitable if the exchange rate is depreciated and will hector the government to lower the rate for their benefit. Is this a major threat to the use of any kind of exchange flexibility — whether band or total? Professor Halm and I both doubt it, and I would like to suggest a reason or two.

Consider what would have to be done to favor the export interests. The government must incur a budgetary cost — that is, to lay out its own currency to buy up foreign exchange — to lower the value of its currency on the market. It can be shown that the cost of giving exporters a little thrill by this device is greater than would be the subsidy-equivalent value of the benefit to them. (The political processes admittedly do not always pick the most efficient means of helping out various interest groups.) Furthermore, outlays must be continued period after period if favoritism for exporters is to continue; a one-shot attack on the rate gives them only a one-shot benefit. The government must keep accumulating reserves, laying out its own currency, year after year in order to continue the game. In short, nobody can say that the political process will never force governments to meddle with ostensibly flexible exchange rates for purposes other than transitory stabilization, but such meddling is a costly and transitory way to achieve its assumed objectives.

The effect of adopting exchange-rate flexibility is not just to reduce the number of policy instruments needed. It also changes the

leverages of economic policy instruments on domestic policy. We owe principally to Marcus Fleming and Robert Mundell the proposition that with capital internationally mobile in response to interest-rate differentials, the exchange-rate regime affects the impact on aggregate demand or employment of fiscal relative to monetary policy. A flexible exchange rate with a high degree of international capital mobility tends to make monetary policy relatively more effective for altering domestic aggregate demand, and fiscal policy relatively less, than a regime of fixed rates. Unlike the effect of flexibility in reducing the needed number of instruments, however, this change in the leverage of monetary and fiscal policy on the domestic target may or may not argue for flexibility in a particular case.

The Canadian Experience

To illustrate this, let me refer to the Canadian experience under the flexible exchange rate. Professor Kindleberger suggested last night that the policy failures that occurred in Canada in the late 1950's and early 1960's somehow show that the flexible exchange rate failed to work properly. Instead, this case reveals an error in the use of policy instruments of a type that could have occurred with any exchange-rate system. In the late 1950's, in conditions of relatively high unemployment and with a flexible exchange rate and highly mobile international capital flows, the Bank of Canada chose — for good or bad reasons of its own — to raise, not lower, the interest rate. In these conditions, the maneuver tended not only to discourage investment and reduce aggregate demand at home; it also sucked capital into the country, drove up the exchange rate and, in turn, lowered the rate of employment and raised the rate of unemployment by worsening the current-account balance.

This sort of unfortunate choice of policy could just as well have been made under a fixed-rate regime by a different but analogous mistake. If Canada had faced the same conditions except for having a fixed exchange rate, tightening rather than easing fiscal policy would have amounted to an analogous mistake. Not only would a tightening of fiscal policy obviously have an unfortunate direct impact on employment, it also would have tended to remove securities from domestic portfolios as the government's net deficit fell (or its net surplus rose), thus reducing the supply of assets in Canadian portfolios relative to the level of private expenditure. That ratio

would have been readjusted either through a contraction of expenditure or a recouplement purchase of securities abroad. These forces would have also created a two-edged tendency to reduce further the level of unemployment. In short, under either a fixed or a fluctuating exchange rate regime, there is always one way to make a spectacular blunder in economic policy. No one ever claimed, in my presence, that exchange flexibility guarantees against policy mistakes.

Speculative Capital Flows under the Band Proposal

One reason I wanted to introduce this discussion of the problem of policy leverages is it raises one question about the band proposal that has not generally been considered. Resting as it does on a presumption of a range of exchange-rate flexibility bounded by a floor and a ceiling, the band proposal obviously has important implications for speculative capital flows. In fact one can predict alternative effects of the band proposal on speculative flows, and I only want to lay out the possibilities rather than proclaim one of them as most likely. On the one hand, if people really believe that the government has adequate reserves and determination to defend the band limits, then the band might have the following effect on speculative capital flows: when the rate lies somewhere well within the limits, speculation might at times be destabilizing, tending to push it towards one limit or the other. But, as the rate approaches the limit, speculators may expect that the government will hold at the limit. As the rate approaches the lower limit, speculation would become entirely one-way and operate in a stabilizing direction with regard to the overall band.

Another interpretation is possible. If the rate has been floating well within the band, people might conjecture that it is going to stay somewhere in the middle, and exchange speculation might be stabilizing when the rate is near the middle of the band. On the other hand, as it approaches the edges of the band, especially the lower edge, people might conjecture that the floor cannot be held, and speculation might work adversely. In short, one can make opposite arguments about the effect of exchange-rate speculation at different points within the band or at the limits. The point that I want to make for further development is only that the behavior of exchange-rate speculation is presumptively not homogeneous within various parts of the band.

I shall argue next that the behavior of exchange speculation has an

important impact on those leverages of domestic policy instruments analyzed earlier. This is, I think, a rather important theoretical point that has not been developed in the published literature. Consider the example I gave you earlier. As a country moves from a pure fixed to a pure flexible exchange-rate regime, theory predicts that fiscal policy is replaced by monetary policy as an effective way of changing domestic aggregate demand or employment. What about the infusion of exchange-rate-sensitive — that is, speculative — capital flows into this model? Insofar as exchange speculation under a floating-rate regime stabilizes the exchange rate, the private speculators are behaving to some extent the same way the government does when it defends a fixed rate. Stabilizing speculation tends to shift the relative leverage of fiscal and monetary policy somewhere between what it would be with a pure fixed exchange rate regime and with a theoretical flexible exchange rate regime with no speculative capital flows — stabilizing or adverse. On the other hand, if destabilizing speculation does occur — although the case is uninteresting, because one is then off and away — it would push the relative policy leverage, as it were, beyond the point reached under the pure flexible exchange rate system with no speculative flows. This would involve a further augmentation of the relative effectiveness of monetary as against fiscal policy for maintaining domestic equilibrium.

I hope now I can bring together this rather complicated line of argument. I suggested, first, that exchange speculation is not homogeneous within the limits of the band and at these limits. It can vary with the rate's position within the band. Secondly, whether speculative behavior is stabilizing or destabilizing, and how much it is, will affect the leverage of domestic policy. My conclusion from those two propositions is that with the band proposal in force it would be difficult or impossible to predict what would be the leverage of domestic economic policy instruments. The responsiveness of capital flows to small changes in the exchange rate would be unpredictable or, at the very best, different depending on where you are within the band or at its limits. This I think is an important theoretical property of the band proposal. It certainly does not cause me to retreat to the adjustable-peg position, but rather confirms my leanings toward the flexible exchange rate.