Flexing the International Monetary System: The Case for Gliding Parities

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Dissatisfaction with the present international monetary system mounted steadily from the mid to the late sixties. In the two years preceding October 1969 it permitted five major currency crises, involving gold and most of the major trading currencies. Calls for reform became legion. Defenders of the present monetary system have pointed out that the world economy has performed spectacularly well during the past two decades, probably better than during any corresponding period of history, and that while the crises were unsettling, they were largely superficial and were prevented from penetrating into domestic economies, as financial crises usually did in the past. A system that has done so well, they argue, should not be scrapped, but rather should be operated as it was intended to be when drawn up at Bretton Woods a quarter of a century ago.

I will argue that the success of the world economy during the past two decades occurred to some extent in spite of the Bretton Woods system rather than because of it, but that the system may be made to work without drastically overhauling it.

The Bretton Woods System on Paper

Let me first recall very briefly the main features of our international payments system. On the financial side, these are embodied principally in Articles of Agreement of the International Monetary Fund, laid down at Bretton Woods in 1944. On the side of merchandise trade, ground rules are embodied in the General Agreement on Tariffs and Trade (GATT), dating from 1947. In essence, these two documents call for freedom of international payments for goods and services exchanged among countries, for low tariffs, for fixed and stable exchange rates, for non-discrimination among countries, and for the avoidance of direct control over foreign trade. Drawn up against the background of the 1930s, they are designed to

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avoid beggar-thy-neighbor trade and exchange policies and at the same time to allow countries that degree of national autonomy in monetary and fiscal policies necessary to maintain full employment.

The rules did not extend to international capital movements. Against the background of the extremely disruptive movements of capital during the interwar period, British officials who co-authored the Bretton Woods Agreement were extremely doubtful about permitting private capital to move freely among countries. The IMF Articles of Agreement not only permit controls over capital movements, but actually require all participating countries to help enforce whatever capital controls other participating countries have imposed. At the same time, however, the dominant country of the postwar period, the United States, has always attached considerable importance to freedom of private capital movements, and other countries have increasingly accepted this objective as well. Moreover, it has become increasingly clear that in times of financial unrest no sharp distinction between trade and capital transactions is possible.

It was recognized that imbalances in international payments would develop under the Bretton Woods system. Temporary imbalances were to be financed, partly out of national reserves, partly by borrowing at a new institution, the International Monetary Fund. "Fundamental" imbalances – surpluses as well as deficits – were to be corrected through discrete adjustments in exchange rates, from one fixed level to another.

The difficulty in this distinction between temporary and fundamental imbalances is that by the time the need for a change in the exchange rate becomes known to those officials who must make the decision, it is also known to everyone else. Discrete changes in exchange rates offer windfall gains to those who can shift their assets from one currency to another in correct anticipation of a change. Currency speculation has grown markedly in total volume, to the point at which in May 1969 nearly four billion dollars flowed into Germany in the course of a week in anticipation of a revaluation of the German mark, and over one billion dollars on a single day. (Four billion dollars amounted to nearly one-quarter of the total German money supply.) Here the logic of proscription on capital movements comes clear. To the extent that capital movements may be *effectively* restrained, both the possibility for large private gain and the disruption of market tranquility generated by large speculative flows are greatly reduced.

Actual Performance of the Bretton Woods System

This, in brief, is the international payments system. If it is defective, why has the world economy fared so well? I believe there are two reasons. The first is that the Bretton Woods System did not come fully into force until around 1960. We did not *start* with this system right after the Second World War. It represented the objective, not the reality. International commerce was severely restricted in the late 1940s, and the Bretton Woods Agreement allowed for a five-year transition period. The transition lasted nearly three times that long, and during the transition a process of *differential* trade liberalization provided a de facto balance of payments adjustment mechanism that was absent in theory. Early in the period, European and other countries discriminated heavily against American and Canadian goods, and to a lesser extent against goods from one another. As the payments positions of various European countries improved, they accelerated their trade liberalization. Those in payments difficulty slowed down the rate of liberalization and occasionally even reversed it. So long as restrictions on trade and other transactions could be relaxed differentially in accordance with balance-of-payments requirements, sources of imbalance could be corrected without frequent adjustments in exchange rates.

This process of differential trade and payments liberalization had largely run its course by the early sixties, but here a second unanticipated development obscured the underlying weaknesses of the adjustment process in the Bretton Woods System. I refer to the large U.S. payments deficits after 1958, which (when put on a consistent accounting basis) had their counterpart in the balance-of-payments surpluses elsewhere in the world. The reasons for the large U.S. deficits are controversial and need not detain us here. But their presence made the need for adjustment by other countries rather less pressing. In the absence of U.S. deficits, tensions between the French franc and the German mark, for example, would have occurred long before 1968. It is noteworthy that in 1968 the United States ran a balance of payments surplus, in a sense relevant for this discussion, for the first time since 1957, and an even larger surplus was run in 1969. These surpluses throw into relief tensions among other currencies that were earlier obscured by U.S. payments deficits. With the help of differential trade liberalization in the fifties and large U.S. payments deficits in the sixties, the Bretton Woods adjustment process was spared frequent or severe testing.

Somewhat paradoxically, the possibility of relying on U.S. payments deficits has also run its course, for other countries have become apprehensive about permitting the United States to spend abroad unchecked, whether it be for military adventures or for private foreign investment. Under the influence of European pressure and (unnecessarily) alarmist pronouncements by the U.S. financial community, American officials themselves became committed to elimination of the payments deficit.

So these two mitigating circumstances cannot be expected to persist into the future. In addition, however, there is a third complicating development. That is the sharp increase in the international mobility of capital. Under the influence of the revolution in communications and the vastly increased flow of information about the rest of the world, banks, firms, and individuals distinguish far less between domestic and foreign assets than they once did, and the erosion of this distinction is continuing. With increased awareness of investment opportunities abroad comes also increased awareness of the possibility for speculative gains on currency changes. The potential movements of funds in response to anticipated changes in exchange rates has become quite phenomenal. Potential movements are increased further, and the possibility for distinguishing in practice between transactions on current and capital account is further diminished, by the substantial growth of the multinational firm. Such firms can readily shift not only working balances but also commercial credits among their operations in different countries in such a way as to speculate in favor or against particular currencies. They may even adjust the commodity prices at which intrafirm transactions take place for the purpose of developing a long or short position in a particular currency.

Under these circumstances, reliance on discrete changes in exchange rates as the principal weapon for adjustment to fundamental payments imbalances becomes impracticable, for anticipated currency revaluation results in a transfer of public and national wealth (in the form of foreign exchange reserves) into private and usually foreign hands, while currency devaluation results in an arbitrary redistribution of wealth among private individuals and to a lesser (but increasing) extent will also transfer national wealth to foreigners. An additional deterrent is the fact that currency devaluation usually involves questions of national prestige and even the political fate of

those with immediate responsibility.[1] Governments are reluctant to admit the failure implicit in a devaluation of the currency, and therefore procrastinate to the point at which devaluation cannot be avoided and currency speculation is correspondingly aggravated.

Not surprisingly, under these circumstances, countries have adopted a series of substitute measures, often violating the letter or the spirit of the postwar agreements, to keep their payments position under control but at the same time to avoid changes in currency parities. Most of the reversals in liberalization have involved capital movements, on which as noted above controls are technically permissible under the Bretton Woods Agreement. But countries have also engaged in extensive interference in foreign trade and services, resorting to a miscellany of ad hoc devices such as tying foreign aid, redirecting government procurement, selling arms, cutting embassy staffs, limiting foreign travel, et cetera. Canada (in 1962), Britain (in 1964), and France (in 1968) all imposed temporary measures directly interfering with private merchandise imports, in direct violation of their international commitments. Other countries have adjusted their tax systems in such a way as to encourage exports or to discourage imports. The Bretton Woods System also gives rise to considerable debate where the responsibility for certain imbalances lies, who should do what, who is not doing enough, and so on; it invites pretentious moralizing and contentious politicking, damaging to the international cooperation the system is supposed to foster.

The Bretton Woods payments system has become unworkable. We still do have exchange adjustments, such as the devaluation of sterling and other currencies in November 1967, but they almost always take place under *force majeure* rather than as an integral feature of a smoothly working adjustment mechanism.[2] To protect existing exchange parities, countries increasingly violate basic principles and purposes of the payments system. The absence of an

[1] In a sample of two dozen devaluing countries, mostly less developed countries, the probability that a Minister of Finance would lose his job within a year following a devaluation was increased three-fold over the corresponding experience of a control group. This illustrates the conflict between personal and national interest that may arise for the individuals responsible for framing national policy. See my "Currency Devaluation in Developing Countries: A Cross-Sectional Analysis," Gustav Ranis (ed.) *Government and Economic Development,* Yale Univ. Press (forthcoming).

[2] The French devaluation of August 1969 was an apparent exception, for the timing of the devaluation caught financial markets off guard; but most international firms and many individuals had already taken a short position in francs.

international adjustment mechanism will plague us increasingly in the seventies unless something is done about it. I see no escape from the choice between somewhat greater flexibility of exchange rates, on the one hand, or, on the other, more frequent resort to restrictions and other interferences with international transactions. Homilies about the need for countries to maintain tighter control over internal demand, even when they are to the point, are not likely to be received with grace or to be translated into action with the regularity and persistence required to avoid one or the other.

Compromise Solution: A "Gliding Parity" System

A possible compromise between the need for a long-term adjustment mechanism and a desire to preserve both a moderate degree of external "discipline" on domestic policies and pressures for international cooperation in framing economic policies resides in a scheme whereby exchange parities change slowly over time, but more or less automatically and in the direction required for payments adjustment. A system of "gliding parities" would provide a reasonable degree of certainty and stability in the short run, but would at the same time permit the gradual economic adjustments so necessary in the long run. In the remainder of this paper, I will argue for a particular version of the gliding parity proposal,[3] will indicate its merits and its limitations, and will compare it with alternative proposals for introducing greater exchange flexibility into the payments system.

Under this proposal, a country would be expected to change its exchange parity weekly whenever its payments position warranted a change. The weekly change in parity would be fixed at .05 percent, cumulating to about 2.6 percent a year if changes were made in the same direction every week. A change in parity would be triggered by a movement in the country's international reserve position. If reserves rose more than a stipulated amount during a given week, the country would announce at the end of the week an up-valuation in its parity for the following week, and vice versa for a decline in reserves. The movement in reserves would determine whether the parity changed or not, but not the amount of the change in parity, which

[3]This proposal is taken from my "Gliding Parities: A Proposal for Presumptive Rules," prepared for the Conference on Exchange Rates at Bürgenstock, Switzerland, in June 1969, and to be published in *Approaches to Greater Flexibility in Exchange Rates: The Bürgenstock Papers*, Princeton University Press, 1970.

would be fixed at .05 percent. Market exchange rates need not change by the full amount of the parity, however, for the country's central bank might adopt a strategy of supporting the market rates temporarily even after a change in parity.

Changes in parity would be presumptive rather than mandatory. Where special circumstances influenced reserve movements, a country might ignore the presumption that the parity should be changed. But a country that failed to alter its parity when an alteration was indicated would be required to explain and justify its decisions before other trading nations, which would meet on a regular basis several times each year to review international monetary developments. Any country that systematically ignored the presumptive rules and offered an unacceptable justification would be open to sanctions: for a country in deficit, no credit from the IMF and other international sources of balance-of-payments support; for a country in surplus, discriminatory "exchange equalization" duties against its products.

An arrangement such as this would provide relatively smooth accommodation to certain kinds of disturbance to balance-of-payments equilibrium. In particular, it would prevent or inhibit payments disequilibrium arising from:

1) gradual shifts in the patterns of demand, as incomes grow and tastes change, toward or away from the products of individual countries;
2) gradual changes in international competitiveness or other supply conditions, such as might arise from exhaustion of natural resources or from small differential rates of change in labor costs due in turn to different national choices regarding tolerable increases in money wages;
3) modest influences on trade positions due to alterations in national policies, such as changes in indirect tax rates and corresponding border tax adjustments.

This arrangement would not be well suited for coping with large disturbances to international payments, such as very large wage settlements or engagement in major overseas military adventures. For this reason large discrete changes in exchange parities, as called for under the Bretton Woods System, could not be ruled out. (The cumulative effects of small changes in parity might of course obviate some large parity changes that would otherwise be necessary.) The arrangement would offer somewhat greater scope, as compared with

the present, for independent national monetary policies, but monetary conditions would still be subject to strong international influences, as they are today.

Effect on Trade and Capital Movements

Gliding parities would affect both trade and capital movements. The effect on trade would arise from the gradual change – upward or downward – in exchange rates, making goods and services in a country whose currency was appreciating less competitive than they otherwise would be, and the reverse for a country in deficit. In some cases these changes in exchange rates would merely neutralize opposite changes in other elements affecting competitiveness, for example small changes in wage costs or in border taxes, and thus would be preventive of changes in price competitiveness rather than corrective. In other cases they would produce compensatory changes in trade flows to offset disturbing changes in trade or other international transactions. In the latter cases, trade flows would have to be sufficiently sensitive to relative price movements for the system to work well. Empirical evidence suggests that the required degree of price sensitivity exists for most countries.

Influence on International Investment

Gradual changes in exchange parities would also influence long-term international investment, but the influence would be limited and, on balance, would mark an improvement as compared with the Bretton Woods system. Under fixed parities, portfolio capital may inappropriately flow to countries with high nominal interest rates resulting from inflationary pressures – at least until a change in parity is regarded as imminent. Under gliding parities, exchange depreciation and/or appreciation will offset such yield differences, without however, inhibiting long-term capital movements inspired by real, as opposed to nominal, differences in interest rates. Similarly, gliding parities would help to neutralize inappropriate incentives or disincentives to foreign direct investment based on divergent trends in money wage costs or certain national tax changes under (temporarily) fixed exchange rates while leaving uninhibited capital flows based on differences in real rates of return.

The impact of a gliding parity on short-term capital movements, hence its implications for monetary policy, is somewhat more

complicated. The case in which gradual parity changes are widely expected must be distinguished from that in which the financial public is unsure whether parities will glide and, if so, in which direction. In the first case, monetary policy will have to be governed by balance-of-payments considerations if large outflows of interest-sensitive funds are to be avoided. In the second case, monetary policy will have somewhat greater scope than under the Bretton Woods system for devotion to domestic stabilization.

Strong and one-sided expectations about the direction in which the parity and actual exchange rates will move will be reflected in forward exchange rates. For example, a currency at its floor and expected to depreciate at the maximum rate would trade at a discount of at least 2-1/2 percent (annual rate) in the forward market vis-á-vis the intervention currency. Under these circumstances, strong interest arbitrage incentives would develop; and unless the country in question permitted its relevant interest rates to rise above those prevailing elsewhere by a corresponding amount, interest-sensitive capital outflows would ensue. In this respect, however, the gliding parity arrangement would not restrict the flexibility of monetary action any more than it is at present under similar circumstances.

Greater Scope for National Monetary Autonomy

On the other hand, if expectations about future exchange rate movements are diverse, a system of gliding parities would offer somewhat greater scope for national monetary autonomy than present arrangements. At present, a country whose exchange parity is not expected to change in the near future finds its flexibility to use monetary policy for domestic purposes increasingly circumscribed by a large and growing volume of interest-sensitive international capital.[4] While forward exchange rates are not technically pegged by official action, their movement is limited under these circumstances to a band hardly wider than the band officially allowable for spot exchange rates, for movements outside the spot floor and ceiling rates evoke speculative forward purchases or sales of the currency. The practical limits on forward exchange rate movements similarly limit deviations in domestic interest rates from those prevailing in major foreign financial markets, because deviations in excess of those permitted by the range of forward exchange rates would evoke

[4]Countries whose parities are expected to change also experience difficulty in preserving monetary autonomy, but for different reasons.

large-scale inward or outward movements of covered, interest-sensitive funds, thus weakening or even vitiating the intended effects of tight or easy monetary policy on the domestic economy.

Because under a gliding parity arrangement exchange rates could move in the course of a year by as much as 2.6 percent in either direction outside the band around parity, forward exchange rates could also range outside the initial band without evoking large, one-sided speculative forward purchases. To the extent that uncertainty prevailed about the direction and extent that the parity would glide, therefore, monetary policy would be given somewhat greater scope for pursuit of domestic objectives without being undercut by international capital movements.

A Case for Presumptive Rules for Parity Changes

It is tempting to make the rules governing changes in parity automatic and mandatory. Too often domestic politics and national prestige become involved in government decisions regarding exchange parities, and a fully discretionary system would very likely result in less frequent changes in parity than would be desirable. Even apart from the difficulty of devising automatic rules appropriate to all circumstances, however, governments as a practical matter are not likely to bind themselves to courses of action that they may not always conceive to be in their best interests. This difficulty can be resolved by laying down *presumptive rules,* of the type indicated in this proposal, which no country is obliged to follow, but which each country would be expected to follow in the absence of sound and persuasive reasons for not doing so. A procedure could be established in the International Monetary Fund or elsewhere for close and continuing examination by other member countries of those cases in which the presumptive rules were not followed.

Presumptive rules for parity changes must be based on some measure of balance-of-payments performance. Movements in reserves, spot exchange rates, and forward exchange rates all convey some information about a country's payments position. No single indicator will always be appropriate. However, simplicity is a virtue, and presumptive rules will be less seriously deficient if they are based on reserve movements tempered where necessary by other indicators on a discretionary basis, than if they are based on observed spot or forward rates. Forward rates may be held at a premium or discount by differences in national interest rates even when there is no net

movement of funds, and such a premium or discount signifies nothing about a country's balance-of-payments position. A currency trading at a forward discount is not necessarily or even normally an over-valued currency.

An alternative version of gliding parities, the one most frequently discussed, would make the parity at each moment in time depend on some average of the spot exchange rates prevailing in the recent past. If the spot rate were below the parity, this would generally induce a fall in the parity; spot rates above parity would raise the parity. Under this scheme, the spot exchange rate is used as the key indicator of a country's payments position.

Two Difficulties

There are two difficulties with this proposal, apart from its automaticity, which has been discussed above. First, it neglects entirely the great importance of non-market transactions, such as the purchase of German marks for U.S. forces under NATO. Even when by agreement these transactions take place at market rates, they exert no direct pressure on the spot market since they occur outside the market. Thus a country's currency may be technically weak even when the country has a strong payments position, and vice versa. While conceivably this problem could be solved by requiring all foreign exchange transactions to go through the market, the parties involved would frequently object to such a stipulation, not only because of the transactions costs involved but also because of the influence that large purchasers could exert on the market. (U.S. official purchases of marks for use in Germany amount to nearly one billion dollars a year, for instance.)

Second, the authorities of a country might influence the movement of its parity by intervening in the exchange market, for example, by selling home currency to prevent appreciation, thereby thwarting the purposes of the scheme. To prevent this, it has been suggested that official market intervention within the exchange rate band must be prohibited. Apart from the fact that few governments are likely to agree to such a proscription, it will not solve the problem, for countries can influence market rates by other means, such as monetary policy.

Under the arrangement proposed here, in contrast, monetary authorities would be free, as now, to intervene in the exchange markets at times of their choosing. But they would have an incentive

not to intervene within the band, since intervention (implying reserve movements) would presumptively require a change in parity in the direction which the authorities were resisting. Reserve sales to inhibit a fall in the market rate would call for a reduction of the parity, while purchases of foreign exchange to inhibit a rise in the rate would call for an increase in the parity. Any country that desires to maintain a constant exchange rate between its currency and some other currency can of course do so by following a monetary policy appropriate to that objective; its monetary policy then becomes fully dependent on conditions abroad, and monetary policy is truly (if one-sidedly) "coordinated," a necessary condition for a durable regime of fixed exchange rate without controls on international transactions.

There is, finally, some positive advantage in keying parity changes to reserve movements, since this would relate balance-of-payments adjustment explicitly to demands for reserves and would thereby highlight any national inconsistencies in the global demand for reserves. Under the Bretton Woods System, countries declare exchange parities but do not declare their demands for reserves, with the result that global demand may exceed global supply (or vice versa), and balance-of-payments adjustment policies may work at cross purposes as many countries attempt, unsuccessfully in the aggregate, to increase their reserves.[5] Under the presumptive rules proposed here, changes in parity would be keyed to national reserve changes relative to some normal, desired reserve increase. The declaration of desired reserve increases would, in turn, assure that the total demand for reserves matched the total supply — if necessary by adjusting the total supply (e.g. creation of SDRs).[6]

Transitional Problems

A difficulty with any new proposal is the transition during which it is put into effect, especially when the initial situation may be characterized, in this case, by large actual or suppressed imbalances in payments.

[5]Thanks to the reserve-currency role of the dollar and the relative indifference of the United States to its payments position, this problem was not acute during the fifties, since dollar outflows satisfied any residual demand for reserves in the rest of the world.

[6]Each country would thus have two reserve indicators under the scheme: (1) the target increase to allow for secular growth in reserves and (2) the amount by which reserve changes would have to exceed or fall short of this target increase before a change in parity was indicated.

It would be highly desirable with any innovation in the rules governing exchange rates to begin from a position of approximate payments equilibrium, at least among the major trading countries. As a practical matter, this may not be possible, even with some initial realignment of rates, since such changes may not be exactly right. Fortunately, however, transitional problems for a system of gliding parities are markedly less than for many other proposals regarding changes in the exchange rate regime. In particular, initial equilibrium, while desirable, is by no means a necessary precondition for the introduction of gliding parities.

Inaugurating the system from a position of disequilibrium would, for a time, assure the direction in which certain exchange parities would move; and this assurance, in turn, would provide incentive for speculating on currencies expected to rise in value and against those expected to fall. But this incentive would not necessarily be greater than that before the introduction of gliding parities in what is, by assumption, a position of widely recognized disequilibrium. The only new element is the certainty of parity change, but with that certainty also comes the certainty of small changes spread over a period of time (provided the new regime itself is credible) and the assurance of eventual correction (provided new sources of disequilibrium do not equal the corrective capacity of the parity changes). Moreover, the financial incentives of small changes in exchange rates can be compensated by corresponding differences in interest rates – lower on assets in an appreciating currency, higher on assets in a depreciating one. Thus, starting the arrangement in the presence of payments imbalances might require, at the outset, an adjustment in certain national interest rates to compensate for expected changes in parities. Since relative rather than absolute interest rates matter here, such an adjustment should be the subject of international discussion and agreement. Furthermore, where financial institutions maintain a rigid separation between capital and income on their accounts either by law or by accounting convention, some provision should be made for offsetting one against the other insofar as changes in capital valuation would result from changes in exchange parities.

Gliding Parities and Widened Band Proposals Compared

Before concluding, let me contrast this proposal for gliding parities with the proposal for introducing greater exchange flexibility by widening the band within which market exchange rates are free to

fluctuate without required intervention by the monetary authorities. In my view, these two proposals serve basically different functions, and thus are complementary rather than competitive in their effects. So long as the exchange rate is within the band, wider bands introduce greater uncertainty with respect to the movement of exchange rates in the near future. As a consequence, a wider band permits greater national autonomy in the pursuit of monetary policy, for forward exchange rates are similarly free to move more widely than is true with a narrow band. Gliding parities permit somewhat greater monetary autonomy, but not so much as a much wider band would.

Second, a wider band would reduce the need for reserves to cover seasonal, cyclical, and other reversible balance of payments disturbances. These disturbances would be compensated by movements in market exchange rates, aided by stabilizing private speculation. To the extent that the parities remained credible, the need for international liquidity would be reduced.

A wider band would not permit adjustment to secular, or cumulative, disturbances to international payments, such as might arise from persistent divergences in national price or demand-for-import trends. These are the kinds of disturbance that a system of gliding parities is designed to accommodate. Once the floor or ceiling of a widened band is reached, a country would find itself in just the same condition as it does today under similar circumstances. Since I believe that such long-run divergences in balance-of-payments trends are inevitable, I cannot regard a widening of the bands as a permanent solution to the adjustment problem. It leaves us with all of the same problems outlined earlier in the paper. I find unpersuasive the claim that wider bands would make discrete parity changes easier. A market rate at the floor or ceiling of the widened band would certainly make the need for parity changes more obvious than it sometimes is today, but that need would be as obvious to private parties as to government officials, and would stimulate massive speculative flows of funds.

A widening of the bands is often linked with a proposal to permit parities to glide. However, it is not true, as has sometimes been claimed, that there is an organic connection between the width of the band and the permissible rate at which parities may glide. Under the proposal described earlier whereby the parity is linked automatically to an average of historical market rates, the band width, hence

the possible deviation of actual market rates from the parity, obviously influences the rate at which the parity would glide. But when parity changes are keyed to reserve changes, a gliding parity is consistent with a variety of band widths; the two proposals are separable, and each can be considered on its merits.

Finally, I should add one tentative reservation about widening the bands or indeed any other proposal that might lead to substantial fluctuations in actual market exchange rates. Our understanding of the considerations which lead people to hold money is still highly imperfect. Ronald McKinnon has suggested that stability in purchasing power is an important consideration in the willingness to hold money and that, where the exchange rate of a currency fluctuates substantially against other currencies, residents may be tempted to move their holdings of cash balances from the fluctuating currency into a more stable one – a tendency that would increase in proportion to the importance of foreign goods in their expenditures.[7] Thus, stable currencies might "drive out" unstable ones, and evoke in turn national attempts to preserve national currencies through the use of controls to prevent flight into other currencies. Of course, as is frequently pointed out by the advocates of greater exchange flexibility, flexibility need not lead to instability. It need not, but it might; and therein lies the risk. This objection is not a serious one, however, for relations among major currencies.

While a system of gliding parities would be highly novel institutionally and, in that sense, would represent a sharp departure from present arrangements, its impact on trade and payments and on the need for close cooperation among major countries would be limited and, in that (more relevant) sense, it would represent a modest but possibly significant step in the evolution of the present international monetary system. Relations among currencies would be relatively stable, movements in exchange rates would be severely limited, pressures for coordination of national monetary and other policies would remain high, and movements in foreign exchange reserves – augmented when necessary by official borrowing from the IMF and elsewhere – would continue to absorb the bulk of swings in payments positions.

Within limits, however, a system of gliding parities would prevent the cumulative imbalances that arise from disparate national rates of

[7] R. I. McKinnon, "Optimal Currency Areas," *American Economic Review*, 53 (September 1963), pp. 717-24.

growth or disparate national rates of wage inflation, and by so doing it would reduce the need to resort to the import surcharges, tax devices to improve foreign receipts, and direct controls over international transactions that have once again become a common feature of the international economic landscape.

DISCUSSION

MARCUS FLEMING

Dick Cooper prefaced his excellent paper by taking a few pot-shots at the existing par value system set up at Bretton Woods. This has become a favorite sport wherever two or three economists are gathered together. I hold no particular brief for that system – perhaps I ought to as a Fund official – but recently, to my surprise, I have discovered in myself an impulse to rush chivalrously to its defense against what seem to me to be rather intemperate attacks and prophecies of doom. Dick admits in his paper that the period in which the Bretton Woods agreement and the GATT agreements have at least nominally prevailed has coincided with the period of unexampled prosperity and expansion in the world economy. Dick, however, would attribute this to rather special factors which have prevented the system from having its noxious effects. The special factors are the existence of discriminatory payments restrictions in the 1950's and the United States deficits in the 1960's. I would agree that the relaxation of anti-dollar discrimination was one of the factors that made the 1950's the success that it was, though I would remind you that it is very doubtful whether this development would have been possible without the devaluations of 1949. As for the U.S. deficits in the 1960's, these doubtless kept up the supply of world reserves and made it easier for countries other than the United States. At the same time the United States is part of the world, a fact which both the United States and the non-United States sometimes forget. Many of the symptoms of malaise that are pointed to by critics of the system really are things done by the United States. So that I think that the U.S. deficit has been at least a very ambiguous factor which may have helped the system in some respects but also harmed it in others. After all it is no very favorable sign if the central currency of the whole system is weak and under attack.

Reasons for Success of the World Economy in the Bretton Woods Period

I think that the reason for the success of the world economy during the Bretton Woods period is really much simpler, namely, the fact that countries by and large got their priorities right. They gave

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first priority to the maintenance of fairly full employment and reasonable internal stability (so far as these two things could be reconciled) and to the liberalization of trade, and were prepared in the last resort to adjust their exchange rates rather than sacrifice these primary values. Exchange adjustments may have come too late to prevent the spectacular crises that are always referred to, but they came in time to prevent any significant damage being done to world real incomes, and these after all are the primary objectives for which the Bretton Woods agreement was made. I would maintain that despite all its faults, the system has, to some extent, worked as it was originally intended to do.

Shortage of World Reserves

If the system has in recent years run into increasing difficulty, that is in my opinion entirely due to the increasing shortage of world reserves and reserve growth, combined with the increasing international mobility of capital. And as we know, steps have been taken – at first they were very improvised steps and later more systematic steps – to remedy the threatening shortage of world reserves. I certainly don't want to argue that the system is perfect, but I say that it ought to be judged not by comparing it with some textbook ideal, some concept of a perfectly competitive world economy, or even a perfectly operating, freely-flexible exchange rates system, but rather with the concrete available alternatives. Professor Cooper's paper is of course taken up with the examination of one such alternative – which the ill-mannered people have been accustomed to call the "crawling peg," but which I shall endeavor to refer to as the "gliding parity." I might say, before I go on, that I thought that Dick's particular variant of it was one of the most sophisticated and attractive versions that I had seen. Nevertheless, I feel that the faults that he found in the par value system and which, I agree, exist, are not really faults which the gliding parity system is particularly designed to correct. I would refer back to what Professor Caves said this morning – that many of the weaknesses in the present system would find a remedy rather in floating rates or in very wide margins within which rates can float, than in the particular device which we are discussing now.

Advantages of the "Gliding Parity" System

This doesn't mean that I am entirely unsusceptible to the general idea of the gliding parity. I am attracted by the general principle as a remedy for certain types of disequilibria, crawling disequilibria, that affect the current account balance of payments, whether these are due to differences of Phillips curves, differences in demand policies between countries, or structural factors. It is surely better that real adjustments should be avoided if they are unnecessary, and that necessary ones should be carried out gradually. And I agree that it would be very pleasant to be able to avoid the speculative consequences of delayed adjustment of the rates of exchange, and it would be nice to be able to avoid the excessive adjustment of rates of exchange which may sometimes take place when adjustment is too long delayed. A further advantage of the system of gliding parities, as compared to wider margins, is that it could conceivably apply to the United States. I don't think that Professor Cooper made this point, and I don't belong myself to the school of thought which believes that the par value of the dollar can never be changed, but I certainly think that the difficulties in changing it might be minimized if it were done by the gliding principle, rather than by discrete amounts.

Difficulties of Estimating Equilibrium Rates

On the other hand, any system of gliding parities is liable to run into difficulties because the factors affecting the balance of payments don't divide themselves conveniently into those that are clearly of a short-term character – and should therefore be financed – and those that are of a long-term character, gradually changing character, and should therefore be dealt with by means of a gliding parity. As regards the substantial abrupt changes of long-term equilibrium, such as have arisen from exceptional wage increases, Professor Cooper would admit that they necessitate the retention of possible discrete parity changes. Now that is a very important admission, because I think it has an influence on the way in which the whole system will operate. There are also changes of a cyclical or medium-term character, of the type that frequently affect capital flows. The capital flows in question may not be speculative; they are possibly quite normal capital flows; but they are essentially of a one-shot character. I have the impression that such flows are of increasing importance. If one thinks that such temporary shifts in the

flows of funds should not be allowed to lead to flows of real resources and that exchange rates should not be affected by them, then the current behavior of market exchange rates provides very little guidance to the adjustment, gliding or otherwise, of exchange rates. Indeed, when such factors are important, it becomes very difficult to arrive at any firm estimate of the long-term equilibrium rate. I think that is the present case with respect to the dollar. The United States is presently in overall payments surplus and is nevertheless presumably in underlying deficit in the sense that over the long period it should have a more favorable current balance. In one sense it is in deficit and in another sense in surplus. One asks oneself, what over the long run would be the balance of payments of the United States if relative international price and cost levels remained unchanged? It is very difficult to say. It is very difficult in the case of Germany to say just how much the German mark is undervalued. So there is difficulty in determining what the correct rate is. On the other hand, if you think that such temporary flows of funds should lead to transfers of real resources, then gliding parities are surely inferior to floating rates or to wider margins as a means of achieving this.

This leads me on to what I think is the basic difficulty about implementing any system of gliding parities. The gliding parity has to move either in response to objective criteria, such as market rates of exchange or balance-of-payments deficits or surpluses, or at the discretion of national authorities (influenced, perhaps, to some extent by international authorities), or in response to some combination of these. Professor Cooper has devised a very interesting compromise formulation which combines the three. His device is one of presumptive rules that the country could persistently neglect only at the risk of some sort of international sanction.

Where the Gliding Is Done in Response to Automatic Criteria

I think it is easier to analyze the problem if one takes first the case where the gliding is done in response to automatic criteria, and then the case where it is purely discretionary, and finally the compromise solution. To the extent that the movement of the parity is automatically governed by statistical criteria, it may easily move in the wrong direction from the standpoint of long-term equilibrium, although admittedly by the very definition of long-term equilibrium, it must

be moving in the right direction most of the time. Nevertheless, some of the time it will be moving in the wrong direction, or it may fail to move at all. For example, if a deficit is suppressed by restrictions on imports or capital exports, then the automatic indicator will fail to indicate and no move in the rate would take place.

From the standpoint of medium-term equilibrium, if you think the object is to keep countries in equilibrium in the medium term, the parity will usually move in the right direction, but the rate will attain appropriate levels only with a considerable time lag. If one adds the lag required for exchange rate changes to take effect on trade to the lag of the actual rate behind the balance-of-payments situation which gave rise to that rate, the ultimate effect on the current account will often be perverse even from a medium-term standpoint. I grant Professor Cooper that the automatic criterion on his scheme – the change in reserves – leads to a better reflection of the tendencies in the balance of payments, other than those generated by the government itself, than would a criterion based upon market exchange rates. However, even his criterion is not exempt from the faults mentioned above.

The Discretionary Form of the Gliding Parity

Now these faults are perhaps less important in themselves than in the excuse they give to national authorities to limit the scope of the automatic elements in the system. "You see," they will say, "how absurd it is to pay much attention to the weekly balance of payments, which may go in quite the wrong direction." In many cases that have been pointed to in the course of this conference, the contemporary balance of payments would have been a very poor guide to the direction in which long-term equilibrium lies. I would consider this result unfortunate because I happen to believe that the discretionary form of the gliding parity, however politically inevitable it is, is likely to work out even less well than the more automatic forms. To the extent that the gliding parity operates on the basis of government decree or the decisions of the monetary authorities, I believe that owing to its effect on capital flows it will normally increase the overall deficits of countries of overvalued currencies and the overall surpluses of countries of undervalued currencies. In the special case in which the country's temporary balance of payments is the contrary of its underlying positions this may be equilibrating but in the general case the effects will be disequilibrating.

My reasons for arriving at this conclusion are the following. If a government makes a decision, or if it consents to a small change in its parity, this is likely to be taken by the market as evidence that the authorities consider the rate to be significantly out of line. Governments are quite unable to detect, and even if they could detect, are unable to admit to, divergencies from equilibrium until these are significantly large. There will therefore be a high probability of continued small rate changes in the same direction and some remaining possibility of a large discrete change; the market will know that countries have not given up the right to make a big change. They will know that the authorities think there is something wrong with the rate or they wouldn't agree to the small changes. They know, therefore, that if speculation develops sufficiently, the government may be forced into the larger change.

I think this combination of circumstances is one which would lead to even greater disequilibrating speculation than under the present system. I think the combination of high probability of moderate profit and a chance of a big profit is just the kind of probability distribution of potential capital gains which is calculated to attract into the foreign exchange market a whole new stratum of speculative investors. I would expect exchange speculation effects to begin earlier in relation to any underlying disequilibrium and to be larger in cumulative amount than at present. But I would grant that the extreme crises might be less extreme since one would expect any discrete changes in rates to be smaller than under the present system. And there is a reasonable hope that under the gliding parity the average divergence from the equilibrium exchange rates over time would be less than under the present movable peg. Whether or not, on balance, disequilibrating capital flows would be greater or less than under the present system therefore, I find it very difficult to say.

Refusal to Glide

I carry the argument one stage further. It would be my feeling that governments, fearing precisely the effect on speculation that I have described, fearing in other words that if they allow a small change it will be taken as evidence of their view as to the necessity for a larger one, will exercise their discretion by refusing to glide, thus frustrating the whole system. Now the counter argument generally put forward, the one which Dick also mentioned, namely, that any effect that the glide may have on capital flows can be offset by an

appropriate interest rate policy, seems to me to be decidedly oversimplified. It is not so easy, I would submit, to gauge the interest difference that would be required to offset any given speculative capital flow. Nor would it be easy to gauge the additional interest difference required to offset the effects on exchange in anticipation of a decision to crawl at a given rate for a longer period of time. Countries in deficit usually have high interest rates anyhow, and it may be politically difficult to raise them further. If, as I have argued, resort to the glide intensified the capital flow, monetary policy, as we all well know, cannot be so easily pre-empted to meet needs of the balance of payments, if only because fiscal policies are not sufficiently under government control that one can rely on them to offset the domestic effects of the changes in monetary policy which are adopted for balance-of-payments reasons.

I have been speaking, of course, about the effects of the gliding parity in its discretionary form. I have said the Cooper form of the gliding parity is not the pure discretionary system. Countries unable to justify to other trading nations their persistent refusal to glide, when reserve movements indicate that they should, would in his scheme expose themselves to international sanctions. But if a country were to state its considered judgment that it could make a required exchange rate adjustment with less disturbance by discrete jumps than by a glide, I seriously doubt whether any international body would presume to override it, much less to apply sanctions. At the most it might use admonitions or recommendations. To find a middle way between automatism and discretion is something that appeals to the compromiser in all of us, but it is as difficult as it is desirable. I fear that the Cooper compromise would in practice end up closer to the discretionary end than to the automatic end of the spectrum of possibilities. If I am right, that the gliding peg to the extent that it is used, to the extent that the authorities allow it to be used, is as likely to intensify as to mitigate payments disequlibria, then it would be rash to expect from it any great improvements as far as abstention from payments restrictions is concerned. By the same token, however, I would not expect this to have the relaxing effect on monetary discipline that some people are afraid of.

Personally, I think exchange rate flexibility will in the end have to be sought in a much more market-determined system than the international financial community is as yet willing to contemplate. And the best to be hoped for in the present juncture is increased tolerance of experimentation in this direction by developed countries

as well as underdeveloped countries on an individual basis. However, I don't want to end my comments on Cooper's version of the gliding parity on too negative a note. If his presumptive rules are followed, and if sufficient international liquidity were made available to counteract the increase in speculation that I would anticipate from the crawling peg in its discretionary form, then I would agree that it might be possible to neutralize the disadvantages of the scheme while retaining its advantages. These advantages, to repeat, are that countries should be able most of the time to keep their exchange rates closer to their long-term equilibrium level, and should also be able to adjust their economies more smoothly to changes in that level than under the present system.