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To Board of Governors

Subject: Exchange Rate Study

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STRICTLY CONFIDENTIAL (FR)

The Division of International Finance has prepared and has circulated to other agencies the attached program for study of greater flexibility of exchange rates. Since study of this matter will doubtless go on, we felt it useful to try to set down, more or less systematically, the questions that require exploration.

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Attachment

STRICTLY CONFIDENTIAL (FR)

REC'D IN RECORDS SECTION
APR 2 1970

Proposed Program of Work on Greater Exchange-Rate Flexibility

Division of International Finance
Board of Governors of the Federal Reserve System

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Summary of Key Questions

The purpose of this summary is to identify, as closely as possible, the questions that seem to be crucial to a determination of whether exchange rates should be made more flexible, and, if so, which system or systems should be adopted. It is contemplated that study papers would not be written on questions as they are stated in the summary, but rather as they are stated more fully (with comments in most cases) in the Roman-numbered parts that follow. Each summary question is accompanied by page citations of the most relevant later passages.

1. Would greater exchange-rate flexibility change the world position of the dollar to the disadvantage of the United States? Would it require one or more changes in U.S. gold-price policy? (These two general questions are broken down later into seven specific questions. See part IV, pages 22 through 29.)

2. Would world trade growth be inhibited more by greater exchange-rate flexibility than by the other measures through which payments adjustment tends to be sought under the present exchange-rate system? (See page 20.)

3. Would greater exchange-rate flexibility lead to the formation of currency blocs and to a resulting decline in world multilateralism, with depressing effects upon aggregate world trade? (See page 20.)

4. Would greater exchange-rate flexibility conflict with or hamper realization of balance-of-payments aims? (See page 40.)

5. What are the main obstacles to greater rate flexibility under

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the present exchange-rate system, to what extent would systems of more flexible rates avoid such obstacles, and what are the main obstacles to establishment of a system of greater rate flexibility? (See pages 17-18.)

6. If a move to greater exchange-rate flexibility were to be made, should it be to one particular system (sliding parities, wider margins, or a combination of the two), or should the new regime be one in which any of these, plus adjustable-peg changes, might be used ad hoc? (See pages 40-41.)

7. Would a wider-margins system work well if parities were movable? (See pages 11-12, the paragraph numbered 2 and the following unnumbered paragraph.)

8. Regarding sliding-parity systems: (a) Are such systems workable if discrete changes in exchange-rates are also permitted? (b) Is there any way to avoid their constraint on monetary policy, is this constraint peculiar to the sliding parity, and is its presence in the case of the sliding parity a fatal weakness of such a system? (c) If a sliding-parity system were adopted, should it be the market-determined or the administratively-determined type? (See pages 5-6, 13-16.)

9. What agreed rules would be needed to control official intervention in exchange markets, both spot and forward? (See pages 34-36.)

10. If the move to greater exchange-rate flexibility were made at a time of significant international payments imbalance, could it be accomplished (a) without rewarding speculators, and (b) without introducing exchange-rate flexibility at an unduly slow pace? If so, how? (See pages 37-39.)

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I. The Proposed Exchange-Rate Systems

For each of the systems of exchange-rate flexibility under consideration, a separate paper should be prepared. Each paper should deal with the following topics (other topics would be optional with the author):

- A. Structural Characteristics
- B. Payments Adjustment
- C. Advantages of the System
- D. Disadvantages and Problems

Some papers now in existence deal with one or more of these topics, but the papers on different systems do not all deal with all four. When the topics are dealt with, moreover, they are not always considered under these headings, with the result that the relevant discussion is not always easy to find.

In discussing advantages and disadvantages, the study of each exchange-rate system should compare it not only with the existing system, but also, so far as possible, with each of the alternative systems under consideration, and with freely-fluctuating exchange rates.

Some of the following comments constitute suggestions as to the ground to be covered; others call attention to some major questions regarding the systems under discussion.

A. Structural Characteristics

1. Wider margins

a. Extent of widening? Widen margins to 2 or 3 per cent on each side of par? 4 or 5 per cent? More? Rationale for whatever figure

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is picked? (For a helpful discussion of this last question, in reference to margin-widening in different amounts up to 5 per cent, see IMF Departmental Memorandum DM/69/2, bottom of p. 22--top of p. 23.)

b. Same width for all IMF currencies? (See DM/69/2, p. 23, middle paragraph.)

c. Retention of parities? Meaning and usefulness of parity rates under wider margins? Advantages and disadvantages of retaining vs. eliminating parities?

d. A "one-time" change in margin width, or a change leaving open the possibility of additional widening later? The possibility would be open in any case--via further amendment of the IMF Articles of Agreement if necessary, i.e. one or more amendments following the one that provided for the first widening. The question has to do essentially with the ease with which margins could be widened further, and with the bearing of this on confidence in margins after they had been widened the first time.

e. Movable parities? If the parity concept is retained, should the possibility of changing parities be left open as an alternative (or adjunct) to the possibility of further widening of margins? (For an impressive statement of the impracticability of a permanent ruling-out of changes in parities, see DM/69/2, p. 20.)

f. Wider gold-price margins? Wider gold-price margins would not be technically necessary to the widening of exchange-rate margins. Would they be necessary for any other reason? (See IV-5 below.)

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2. Sliding parities

a. Which sliding-parity system? Two main types of sliding-parity system have been distinguished. In one, parity movements would be determined by policy decisions by the authorities. In the other, parity movements would be governed by movements in market exchange rates. (By intervening in the exchange markets, if allowed, the authorities could of course influence parity movements even under the second method.) There is need for further study of the comparative advantages and disadvantages of each of these two types. A good starting-point for such a study would be DM/69/10, especially pp. 3-11, where the discussion also summarizes various views and proposals regarding the mechanics of the second of the two types.

b. Maximum per-annum rate of change in parity? The figure mentioned most frequently is 2 per cent. But see DM/69/10, pp. 4-5 and 8-11.

c. Periodicity of parity changes? Daily, weekly, monthly, quarterly? (See Williamson's The Crawling Peg, bottom of p. 3--top of p. 4; also DM/69/10, pp. 6-11.)

d. Criteria for parity changes under the policy-decision system? For a summary of views, see DM/69/10, pp. 3-4.

e. Retention of the possibility of discrete parity changes larger than the slide-amount for a given year (whether additional to the latter or in place of it)? If it would be unrealistic to assume that parities would become immovable under wider margins, it might be almost as unrealistic to assume that parities under a sliding-parity system would never be moved discretely by sizable amounts. But the possibility of

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such movements might jeopardize the workability of the system, since one of the main purposes of the sliding parity is to make speculation on large exchange-rate changes unprofitable. (For a brief round-up of relevant comments in the literature, see DM/69/10, p. 15.)

f. Adequacy of present margin width under the market-determined type of sliding parity? With a market-determined sliding parity, the maximum extent to which market rates could move in a given period of time would be influenced by margin width. As DM/69/10 points out (on p. 10), margin width is one of three variables that would determine the maximum amount of parity adjustment that could occur. So far as margin width is concerned, "the wider (narrower) the margins, the higher (lower) is the maximum rate of parity adjustment." Thus, as the same document points out (on p. 9), ". . . given the frequency of individual parity changes, the length of the reference period^{1/} and the width of the margins should be jointly chosen [in sliding-parity systems of the market-determined type] to accommodate whatever maximum scope is desired for exchange-rate adjustment over time."

The point is simply that even if there were no particular desire to add margin-widening to a sliding-parity system, a system in which parity movements were market-determined might require some margin-widening. The question is: would margin-widening in fact be required, and, if so, how much?

^{1/} The period over which market rates would be averaged to determine each new parity rate.

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3. Wider margins combined with sliding parities

Obviously the structural characteristics of this system would be some combination of wider-margin and sliding-parity characteristics. Whether any special questions of structure would arise regarding the combination itself would depend upon the precise characteristics chosen for its two constituent elements.

If the combination system selected was one in which parity slides would be of the market-determined type, the relationship with margins stressed in 2-f above would be particularly relevant. Under such a combination system, however, it might seem that use of the market-determined parity, in addition to possibly requiring some margin-widening, would severely limit the amount of widening which would be possible. Since the maximum annual rate of parity slide contemplated by most sliding-parity proposals is rather small (as noted in 2-b above, 2 per cent is the figure most often mentioned), it might seem that margins would also have to be kept small. It has been pointed out, however, that "if the rules stipulated the permitted range $\pm \frac{b}{100}$ [b being the spot-rate margin, comparable with the 1 per cent in the present IMF Articles of Agreement] as referring to the difference between the logarithms of the market and registered par exchange rates this would make the system consistent without the need to make b small, but would make it slightly harder to explain it to laymen. "^{2/}

^{2/} J. Black, "A Proposal for the Reform of Exchange Rates," Economic Journal, June 1966, p. 290.

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On the basis of careful study of combination systems, what structural specifications would be recommended for a system in which the parity slides would be market-determined? What specifications for a system in which the parity slides would be administratively determined?

B. Payments Adjustment

1. Balance-of-payments effects

Each paper should (a) attempt to deduce the types of current-account shifts, and the short-term and long-term capital movements, that could most reasonably be expected to take place in response to exchange-rate movements under the system, and (b) analyze the main problems (if any) that might be expected to arise because of these shifts. DM/69/2 (pages 2-10) makes an analysis of this kind for a system of wider margins (5 per cent on each side of par). The U.S. paper on wider margins should take that analysis into account, paying particular attention to its reasoning regarding short-term capital movements. (See 2 below.)

A point of particular importance in the study of balance-of-payments effects of exchange-rate changes under systems of greater exchange-rate flexibility has to do with the assumptions made regarding the use of other policies--whether general or selective or both--to help restore and maintain payments balance. The Fund paper on wider margins (DM/69/2) starts with the assumption that exchange-rate changes would not affect the use made of other policies. (See the bottom of p. 2 of that document.) Later it relaxes this assumption, and discusses possible changes in other

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policies, and the effects of such changes (pp. 11-14). One major conclusion drawn is that wider margins would tend to free up the general instruments of policy--particularly monetary policy--for greater use in the service of domestic objectives (but see certain qualifications, discussion of which begins at the bottom of p. 12 of DM/69/2). Another conclusion is that "the widening of exchange margins may be expected also to lessen recourse to payments restrictions on trade and payments and to take the place of other methods of manipulating capital flows, such as capital restrictions, interest equalization taxes, investment subsidies, and the like." (P. 13.) All the conclusions of the analysis need to be weighed, particularly regarding the extent to which they might have to be qualified if it turned out that parities could not, after all, be changed frequently if necessary, as DM/69/2 assumes.

Non-exchange policies under a sliding-parity system are discussed in DM/69/10, pp. 16-18. But this discussion is confined largely to the question of the sliding parity's constraint of monetary policy. Impacts on other non-exchange policies should also be considered.

2. Character of speculation

In connection with the analysis in B-1 above, each paper should consider specifically whether, under the system being examined, there would be more stabilizing and less destabilizing speculation than under the present exchange-rate system. The present system is said to encourage the wrong kind of speculation because it provides a "one-way option." It is also said that even a system of moderately-wider margins would make

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speculation more stabilizing, by increasing both the risk of loss from speculating against a currency, and the possibilities of gain from speculating in support of it. Would this be true even if parities and/or margin widths were changeable? What can be said about the probable character of exchange-rate speculation under the other systems of more flexible exchange rates?

In DM/69/2 the analysis of short-term capital movements (pp. 2-6) seems to conclude that under margins of 5 per cent, speculation should be largely stabilizing. DM/69/2 assumes, however, that parities would continue to be movable (because the opposite assumption would be unrealistic), and it assumes that parities would in fact move, perhaps frequently. (The latter assumption is necessitated by the view set forth in DM/69/2 as to the main purposes that a wider-margins system could serve. See C-2 below.) It is essential to know whether the assumption that speculation under wider margins would tend to be largely stabilizing is consistent with an assumption that parities would be movable and would actually move. While it is true that wider margins would enlarge potential speculative gains and losses, to what extent does the effect of this fact upon market behavior depend upon confidence in parities and margins--i.e. upon belief that they will not be changed? If there is a lack of such confidence (as there may well be in certain circumstances if parities are movable), is it possible that speculation would become predominantly destabilizing? Or would the greater risk of loss than under present margins be a sufficient deterrent in all circumstances?

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C. Advantages of the System

1. Regarding the possible advantages of the system under analysis, each paper should explore: whether and to what extent the system would promote long-run adjustment (B-1 above); whether it would make for more stabilizing speculation (B-2 above); and whether and to what extent it would make possible dispensing with sectoral controls (on capital movements, etc.), and provide greater freedom to use the general instruments of policy primarily for domestic purposes. Assuming that this last question has been adequately explored under B-1 above, that analysis obviously need not be repeated here. As was suggested near the beginning of part I, however, in its discussion of advantages and disadvantages it would be helpful if each paper would make comparisons between different systems. So far as advantages are concerned, such comparisons should be made in connection with each of the aspects mentioned in the first sentence of this paragraph.

2. Regarding wider margins, it has been said that "the main potential advantage of the system is not that it reduces balance of payments disequilibria in the short run but that it facilitates prompt if partial adjustment of exchange rates to changes in their long-term equilibrium level" (DM/69/2, p. 22.) And: "If . . . the 'defusing' of par value adjustments of their traumatic character led to more frequent and smaller adjustments, the great bulk of the exchange rate adjustment to basic disequilibria might take place within the margins, with changes in par values tending to ratify adjustments that had already occurred rather than to initiate further adjustments." (Same document, p. 17.)

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Would there be general agreement with this conception of the purpose of margin-widening? Note its assumption that parities would remain movable, and that they would in fact be moved from time to time, perhaps fairly frequently. This relates back to the question raised above as to the nature of speculation under a wider-margins system with movable parities. If such a system promoted destabilizing speculation it seems unlikely that it would work well; in that case, it would probably be incapable of achieving the main potential advantage claimed for it in DM/69/2. This underlines the importance of a careful analysis in the wider-margins paper (section on payments adjustment) of the implications of par-movability.

3. A related question arises in connection with the sliding-parity system. One of the main advantages claimed for this system is that it would promote stabilizing speculation and discourage the other kind. Williamson has said that "The most immediate and important advantage that the proposal for a crawling peg offers concerns the elimination of . . . problems of confidence."^{3/} But whether the sliding-parity system would yield this advantage might depend upon whether exchange-rate changes would be held within the limits specified in the system. Failure to do so could raise essentially the same problem of confidence in parities and margins as would be raised by movable parities under wider margins. The difficulty, as noted under A-2-c above, is that it would probably be unrealistic to assume that parities would never be moved except under the sliding-parity formula. Note also that the

^{3/} Williamson, The Crawling Peg, p. 7.

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uncertainty might be particularly great if the world were to be following no single exchange-rate system, and if, instead, countries adopted different systems in different circumstances: sometimes a sliding parity, sometimes wider margins, sometimes discrete changes, etc.

D. Disadvantages and Problems

The only point requiring special mention here under this heading relates to the sliding parity. It is the important question whether this system would put a special constraint on monetary policy. For a useful summary of views on this problem, see DM/69/10, pp. 16-18. The following paragraphs indicate the nature of the problem, and develop various considerations relevant to it.

To the extent that parity changes under a sliding-parity system were predictable, and to the extent that spot exchange rates tended to move to the same extent (as well as in the same direction) as the parity rate, the system could provide widespread opportunities for profitable interest-arbitrage. Forward rates for a currency whose parity was sliding down would tend to go to a discount; and on the assumption that interest parity prevailed at the outset, this discount could create an incentive for interest-sensitive funds to move out from that country on a covered basis. They might even move out uncovered, given the expectation that the spot rate for the currency x months hence would actually be about where the forward rate is at present, i.e. when the interest-arbitrage outflow takes place.

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Actually, the problem extends beyond interest-arbitrage in the usual sense. The exchange-rate expectations referred to would also stimulate widespread leads and lags in payments: speeded-up payments in foreign currency, and lagged repatriation of earnings in foreign currency (via, for example, exporter extensions of credit to foreign buyers). A country whose currency was sliding down would be, by implication, a country with a payments deficit. Fund-flows of the foregoing kinds would obviously intensify current pressures on its reserves.

It has been suggested that this problem could be avoided through interest-rate policy (assuming no feedback effects on foreign interest rates which would wipe out the differentials that the monetary authorities at home were trying to establish). A country whose parity was sliding down would raise interest rates, and a country whose parity was sliding up would lower interest rates, by enough to offset the profit that could otherwise be made from interest arbitrage, leads and lags, etc.

The question is whether, assuming that it would be possible to pinpoint monetary policy to produce the interest rates needed to offset such profit opportunities, this procedure would unduly constrain monetary policy in countries with sliding parities, during the period of the slide. Among the reasons for increased exchange-rate flexibility, one frequently advanced by theoreticians is the need to increase the number of policy instruments available for use. Under a sliding-parity system, would the instrument of exchange-rate flexibility be gained at the expense of the monetary-policy instrument? If so, in what sense would that be a special

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constraint on monetary policy? In countries experiencing payments imbalance, monetary policy already tends to be constrained by that imbalance.^{4/} If monetary policy is constrained both with and without the sliding parity, adoption of it might be the right course if this would definitely restore payments balance in time, and no other means at the disposition of a country would be certain to do so, or would be as acceptable as the sliding parity.

Would there be some means of solving the interest-rate problem, under the sliding-parity system, which would not put monetary policy under the constraint described above? It seems very unlikely that manipulation of forward exchange rates could provide a satisfactory answer.^{5/}

^{4/} Note, for example, the comment by Black, loc. cit., p. 294: "It is fairly certain that the present system involves the need for stricter monetary discipline than [the interest differential of about 2 per cent that the sliding parity might require] to counteract fears of sudden devaluation at times when fundamental disequilibrium is felt to be in the air." The implication is that monetary policy might, if anything, be somewhat less constrained under the sliding parity than it is now when payments imbalance exists. And A.F.W. Plumptre argued as much in his paper, "Flexible Parities--The Case for Smoother Exchange Rate Adjustment," given at an IMF seminar on November 13, 1968. See p. 12.

^{5/} There are at least two reasons for this. First, from the foregoing discussion of the problem it is obvious that the relevant transactions need not all go through the forward market (uncovered interest-arbitrage, leads and lags, etc.). Second, support of forward rates in the case of a currency whose parity was sliding down would make it profitable to sell the currency forward and to cover spot at the time of delivery under the forward contract, at the then-existing spot rate. If sterling, for example, were sliding down at 2 per cent per year, market operators could sell sterling one year forward at \$2.38 (if the U.K. authorities were pegging the forward rate at that level) and make their covering purchases spot one year hence at \$2.33. The difference would be a loss borne by the U.K. authorities. Such losses could be enormous if the rate slide were assured, since in that case the incentive to sell sterling forward would be limitless.

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Special taxes could perhaps be devised that would apply to interest-arbitrage profits arising from parity slides; but it is not clear that foreign-owned balances could be reached in this way. Moreover, would there be any way via taxation to prevent leads and lags of the kind referred to above?

Alternatively, would it be possible to ignore the whole problem (interest arbitrage, leads and lags, etc.), and let the reserves suffer the resulting drain? Or would such losses be too great? Could "recycling" arrangements be worked out to cover this case? (Conceivably this might be one/^{case}in which recycling would clearly be justified.) If not, does this mean that there is no way to avoid the monetary-policy constraint under the sliding-parity system?

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II. Main Obstacles to Greater Exchange-Rate Flexibility

1. What are the main obstacles to more frequent adjustment of exchange rates (via more frequent changes in parities) under the present IMF Articles of Agreement?

a. Fears of "excessive" or "sudden" changes in competitive positions? (Note that objections based on alleged competitive effects tend to be invalid in the case of devaluations that merely offset price-level increases in the devaluing country relative to price levels in other countries.)

b. Fears of destabilizing speculation before (and perhaps after) exchange-rate changes?

c. Prestige or domestic political considerations?

d. In the case of revaluation, reductions in the domestic-currency value of international reserve assets?

e. In the case of revaluations, a belief by surplus-country authorities that such rate actions would make life too easy for deficit countries?

f. Fears of injurious effects upon the world trade and payments system, similar to the effects that some believe would result from a move to wider margins or the sliding parity? (See III and IV.)

g. The special problems of the European Economic Community? More frequent adjustment of exchange rates would pose a problem for the EEC countries; and while the problem has recently been mentioned most often in connection with proposals for wider margins and/or sliding parities,

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it could also exist under the present adjustable-peg system if, under that system, parities were changed more frequently than they have been thus far. The EEC problem--which other groups of countries in the process of formal economic integration might also have to face at some stage--would be the need to choose between changes in exchange-rate relationships within the bloc, and having all members change their rates uniformly, i.e. in the same direction and to the same extent, whenever a change by one or more members became necessary. It has been claimed that either alternative would pose serious--perhaps insurmountable--internal difficulties for the Six.

We need to know more about these difficulties: just what they are, and how seriously they militate against making exchange rates more flexible in one way or another. Is there any one system of greater rate flexibility which would create substantially less difficulty for the EEC and its member countries than alternative systems? Does the theory of optimum currency areas throw any light on the answers to these questions?

- h. Other obstacles?
2. To what extent would the obstacles to exchange-rate changes under the present system be avoided or overcome by each of the alternative systems under consideration?
3. What are the special obstacles to the establishment of greater exchange-rate flexibility via one or another of the alternative systems?
 - a. Inertial resistance to a major change in the existing system?
 - b. Belief in the superiority of a system of essentially fixed rates?

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- c. Uncertainty about, or doubt of, the workability of any of the alternative systems?
- d. Other special obstacles?

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III. Main Issues for the World Trading System

1. Would world trade growth be inhibited more by exchange-rate changes, under a system of greater exchange-rate flexibility, than by alternative methods of seeking payments adjustment? If so, is that a decisive argument against adoption of such a system?

It is frequently alleged that greater exchange-rate flexibility would discourage international trade, reducing its rate of increase if not its absolute magnitude. On what reasoning is this view based, and what validity does it have? Would the magnitude of any impacts on trade differ materially under different systems of rate flexibility? Would more extensive forward-market facilities materially alleviate these impacts? (The question whether forward-market facilities would be more extensive under a system of greater exchange-rate flexibility is listed in V.) How important is the maximization of world trade, relative to other goals? Would more flexible exchange rates depress world trade (or its growth) more than would the adjustment techniques likely to be used, in some important cases, under the present exchange-rate system?

2. Would greater exchange-rate flexibility lead to the formation of currency blocs, and, if it did, would this entail a decline in trade multilateralism and a rise of autarkic tendencies?

Some important officials in the EEC countries, especially among the Italians (notably Governor Carli of the Bank of Italy), seem to fear that adoption of a system of comparatively flexible exchange rates could break the world up into separate blocs--the EEC, a dollar bloc,

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and possibly a sterling bloc--and subsequent developments might necessitate efforts to achieve payments balance within as well as between these groups. The result could be growing restriction of trade and of capital flows, reduced trade between the blocs, and a tendency for each bloc to grow in upon itself. Economic groupings might also have important, and possibly undesirable, political implications.

What is at issue is whether fears of the kind indicated are justified, and, if so, whether the dangers involved would be less under some systems of greater exchange-rate flexibility than under others.

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IV. Main Issues for the Dollar and for Gold

1. Would greater exchange-rate flexibility inhibit use of the dollar in its role as the world's leading transactions currency?

Would greater rate flexibility reduce the secular rise in private foreign dollar holdings, or even lead to a secular decline in such holdings? Would the absolute or relative reduction in dollar holdings be paralleled by increased holdings of one or more other national currencies, or would banks, traders, etc., simply operate with smaller foreign-exchange balances? Would reduced transaction-currency use of the dollar be disadvantageous to the United States? In what ways, and to what extent? Would there be compensating advantages?

2. Would greater exchange-rate flexibility lead to a decline in the reserve-currency role of the dollar?

By assumption, exchange-rate flexibility would not be so great that reserves would no longer be needed; and unless a reserve-centralization scheme had been adopted, countries would still be concerned with the composition of their reserves. Would the possibility of frequent and perhaps substantial changes in exchange rates be a new incentive to curtail holdings of dollars and other reserve currencies, relative to total reserves? (Bear in mind that many countries already have incentives to limit or curtail such holdings, and the advent of SDR's may add to those incentives.) Is preservation of the reserve-currency role of the dollar important to the U.S. interest? If so, would greater exchange-rate flexibility require more extensive maintenance-

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of-value guarantees of foreign official dollar holdings? How would the implementation of such guarantees be financed? (With exchange-rate changes taking place, the guarantees would have to be made good from time to time.) Would the guarantee system be two-directional, i.e. when the dollar appreciated would some dollars be turned back to the United States (as, even under the present system, would happen in the case of IMF dollar holdings if the dollar were revalued)?

3. Should the dollar continue to serve as numeraire^{6/} for other currencies?

The dollar-as-numeraire system gives rise to the following questions:

a. Under the present system the exchange rate between the dollar and any other currency can vary less than the rate between any two other currencies. If margins were widened, the discrepancy in absolute terms would be still greater. Would this be significantly disadvantageous to the United States? If so, in what way? In pondering this question the following comment may be of interest.

"If this system [of the sliding parity of the market-determined type, with fixed margins around the parity] had been proposed in the early post-war period it might have been tempting to suggest that the exchange rates of all other currencies with the United States dollar should be fixed by the above rules, so that other currencies were allowed twice as much flexibility relative to each other as to the United States dollar. Given the present position of the United States balance of payments, this would

^{6/} For present purposes this term refers primarily to the intervention-currency role of the dollar.

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not appear to be acceptable, and I would suggest that the new system should apply the same rules to all pairs of convertible currencies. ^{7/}

In other words, he suggested the use of a non-currency numeraire, presumably in the belief that if the exchange-rate system were changed fundamentally while the United States is still in a difficult balance-of-payments situation, the United States, in its own interest, would refuse to agree to continuation of the feature of the present system which gives this country less exchange-rate flexibility, within whatever margins may exist, than other countries have.

b. To what extent do the constraints on U.S. ability to obtain changes in exchange rates for the dollar stem from its numeraire status, and to what extent do they stem from other factors, notably U.S. importance in world trade? It is sometimes said that the United States cannot take the initiative to change exchange rates for the dollar. The sense in which this is true is not the literal one; if the United States were to inform the IMF of a change in the U.S. price of gold, the parities of all other IMF currencies in relation to the dollar would not change unless other countries simultaneously changed the gold parities of their currencies (consulting IMF first and requesting its agreement if necessary).^{8/} What lies behind such statements is probably either the fact that the United States cannot take the initiative to change exchange rates unless it decides to change the price of gold (which has been ruled

^{7/} Black, loc. cit., pp. 291-292.

^{8/} The reason for this is the fact that however a member country may declare a parity change to the Fund, the Fund expresses the new parity in four different ways, including two that link the currency directly to gold (ounces of gold per unit of currency, units of currency per ounce of gold).

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out), or the belief that if the United States were to change its price of gold, all or most other countries would immediately consult IMF about corresponding changes in their own gold parities.

To the extent that this latter belief is correct, might such a response by other countries be due in part to the very fact that the dollar has the status of numeraire? Regardless of how other countries have declared their parities to IMF, many may think of them primarily in terms of relationships with the dollar, rather than with gold. Any views countries may have as to the validity of the dollar parities of their currencies are no doubt heavily influenced by the question of competitive relationships with the United States itself (as well as with other countries). But it is possible that their thinking is also influenced by an unanalyzed assumption that the numeraire is something that is fixed. Under such an assumption, the dollar parity of currency "y" should remain unchanged unless and until the authorities of country "y" find a change necessary. On the basis of such a view it would tend to follow that in the event of a change in the U.S. price of monetary gold, other countries would automatically contemplate a corresponding change in their own gold parities, in order to maintain the pre-existing dollar parities.

To some extent, of course, something similar tends to happen when any important trading country changes the parity of its currency. When the United Kingdom devalued sterling in 1967, many countries followed

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suit with their currencies, and others considered doing so.^{9/} There is a serious question as to how free the United States would be, even under an international monetary system with a non-currency numeraire, to devalue the dollar without provoking competitive reactions by other countries: in particular, requests by them for IMF approval (where necessary) of devaluations of their currencies on the ground of "instant fundamental disequilibrium." But the numeraire status of the dollar may make a subtle difference, by blinding many people to the fact that circumstances can exist in which devaluation of the dollar relative to all (or at least to many) other currencies may be necessary to payments adjustment.

The numeraire status of the dollar should not matter in this connection if all desirable and appropriate changes in exchange rates between other currencies and the dollar take place through devaluations and revaluations of other currencies. But what if they do not? What if exchange rate changes are systematically biased in one direction? This line of thought leads to question 3-c.

c. Is there a tendency for the dollar to become progressively overvalued in relation to other currencies, and, if so, to what extent is this due to its intervention-currency status? Would this tendency continue, and perhaps become more pronounced, under a system of greater exchange-rate flexibility? These questions stem from the fact that since Bretton Woods there have been many more devaluations than revaluations of

^{9/} As an illustration of the point under discussion, the force of the U.K. example is reduced somewhat by the fact that sterling too is a reserve currency (and to some extent an intervention currency). Yet it does have some relevance as an illustration: the United Kingdom is an important trading country.

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currencies. Moreover, while some countries have devalued more than once, there has been something of a tendency for devaluations to be "passed around," as countries in effect take turns in falling into deficit. If this continues, eventually all currencies may have undergone a net devaluation in relation to the dollar--some by substantial amounts.

The answer to this might seem simple: the fact itself should entail no problem for the United States if all devaluations of other currencies merely correct for that much more inflation in those countries than in the United States. But it is improbable that the answer is really that simple. For one thing, what if the United States itself suffers in some periods from more inflation than other countries, but is debarred (for whatever reason) from ever using the exchange-rate corrective? This would be one more asymmetry in the international monetary system, and one that could over time, by its ratchet effect, mean a progressive overvaluation of the dollar.

If a problem of this kind is indeed possible, it is obviously one that can exist under the present exchange-rate system. The question is whether, if there is already such a problem, it would continue and perhaps become even more pronounced under a system of greater exchange-rate flexibility in which the dollar retained its numeraire status.

(With appropriate rules on official intervention--see part VI--and all-around observance of them, it might rather be ameliorated.)

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4. What could serve as a non-currency numeraire, and what consequences would be involved in shifting to it?

Does it make sense to believe that gold could be the numeraire, as in the gold-standard era, given what this would imply for private gold holdings and for the two-tier gold system? (For a discussion of how a gold-numeraire system might work in the present-day world, see DM/69/2, p. 22, first three paragraphs, and DM/69/10, pp. 18-20.) This question includes implicitly the question of the effect that shifting to gold as numeraire would have on monetary demand for gold.

If all reserves (including SDR's) were centralized, could Composite Reserve Units, à la Bernstein, be made marketable, and serve as numeraire?

In either case--a shift to gold, or a shift to CRU's, as numeraire--would such a development terminate the intervention-currency role of the dollar (eventually if not immediately)? Is there a significant U.S. interest in the preservation of this function of the dollar? To what extent, for example, is the reserve-currency function of the dollar dependent upon its intervention-currency role?

5. Could present U.S. gold-price margins be retained under a system of greater exchange-rate flexibility?

A widening of U.S. gold-price margins would not be needed in order to implement a widening of exchange-rate margins; it would not, in fact, have any necessary effect upon exchange-rate margins. It has been suggested that movements of the U.S. gold price within wider margins might have an equilibrating influence on the behavior of other monetary

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authorities with respect to international reserve-asset composition; but the author of the suggestion concludes that "This kind of offsetting could not be relied upon with any certainty, and would import an undesirable speculative element into the question of reserve composition." (DM/69/2, p. 21, last paragraph.) If this conclusion is valid, there would appear to be no need for exchange-rate margin widening to be accompanied by gold-price margin widening unless wider gold-price margins would be necessary in connection with problems of reserve-asset valuation. Whether they would be necessary in this connection is a question requiring some thought.

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V. Forward-Market Facilities, Cover Costs, and Official Policy

1. Would greater exchange-rate flexibility encourage or discourage expansion and elaboration of forward-cover facilities in foreign-exchange markets?

DM/69/2 (p. 16, note 1) gives two reasons in support of the view that the development of such facilities would be encouraged under greater exchange-rate flexibility. "The greater uncertainty as to future rates increases the desire of traders and others to cover and hedge exchange risks on the forward market; and the increased diverging of expectations as to future rates gives rise to apparent opportunities for profitable contracts on the forward markets." The claim is, in other words, that there would be an increased demand for forward cover, and an increased willingness to supply it. DM/69/2 also points out, it is relevant to add, that "It was in the period of fluctuating exchange rates of the early 1920's that the forward exchange markets first developed on a large scale."

It has sometimes been argued that forward markets would wither away under floating exchange rates. While it does not necessarily follow that those who hold this view would expect more limited systems of greater exchange-rate flexibility to have the same effect, the question should be explored, to determine whether the view that greater rate-flexibility would encourage the development of forward-exchange markets (or more precisely, the elaboration of forward-cover facilities in foreign-exchange markets--spot and forward markets are not separated)

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commands general support among knowledgeable people. The question is essentially whether an adequate supply of forward cover would be available in the absence of official support.

2. Would the cost of forward cover be higher under more flexible rates?

In considering this question it is necessary to distinguish the transactions cost of forward cover from the forward discount or premium that to a trader may appear to be part of (in most cases probably the bulk of) the cost to him of forward cover. It would seem that this discount or premium cannot properly be regarded as part of forward-cover cost for any purpose which is relevant to the present inquiry. The reason is that while a given forward discount or premium is a cost to traders on one side of the market, it will constitute a windfall gain (i.e. a negative cost) to traders on the other side. This means that while it hampers trade in one direction it encourages trade in the other direction. The question under discussion obviously implies the view that if forward-cover cost would be higher under more flexible exchange rates, world trade might thereby be discouraged. Since higher forward premia or discounts will encourage some trade while depressing other trade, with no reason for thinking the net result of the two tendencies will always lie in one direction, such premia and discounts seem irrelevant for purposes of the question at hand.

It has been argued--see p. 16 of DM/69/2--that under wider margins "forward exchange premia and discounts would often be wider than at present." How often, and in what circumstances, would this be the case? Would this also be the case under a sliding-parity system?

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The transactions charge--the true "cost" of forward cover--is something that has to be paid even if forward cover is obtained at the spot rate. It reflects the ordinary costs of those who provide the forward cover (office space, phone calls, secretarial help, etc.) plus an allowance for profit. After referring to commissions on forward transactions as being of negligible importance as a barrier to international trade, DM/69/2 goes on to say (p. 16), in regard to such commissions under wider exchange-rate margins, that "Only to the extent that foreign exchange dealers themselves assume exchange risks in the course of their operations, e.g., through discrepancies in the respective time distributions of claims and of obligations in particular currencies, might there be a tendency to an increase in percentage commissions, and any such tendency might be outweighed by the substantial increase that is to be expected in the turnover of financial transactions." (The reasons mentioned above for expecting an increased turnover in transactions are then given.) Holding in mind the fact that commissions charged on forward-cover transactions were said to be negligible as a barrier to international trade can keep one from attaching excessive importance to the fact that the quoted passage says only that the tendency for commission percentages to rise under wider margins might be offset by increased volume.

It is suggested that further study is needed in order to decide whether the answer to question 2 implied by the foregoing--"perhaps, perhaps not, but in any case it would probably be of negligible importance as a deterrent to world trade"--is correct.

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3. What role for official policy?

a. It is widely believed that in certain situations, central banks actively discourage private banks from engaging in forward dealings. Should central banks refrain from restraint of such dealings? What would be the costs of such abstinence?

b. Under greater exchange-rate flexibility would central banks have any stronger incentives to intervene in forward markets than at present? Would such intervention be good or bad?

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VI. Rules Regarding Official Intervention^{10/}

The question of rules, as it arises in connection with proposals for greater exchange-rate flexibility, has to do mainly with the restrictions, if any, it would be desirable to place on the freedom of national monetary authorities to intervene in foreign-exchange markets. Proposals for the establishment of rules grow out of two opposing concerns: fears that through official intervention some national authorities might prevent desirable exchange-rate changes the effectuation of which would be the whole object of establishing a system of greater exchange-rate flexibility; and fears that some national authorities might intervene actively to bring about exchange-rate changes, notably in order to achieve competitive devaluation.

The question of rules has an obvious relevance to proposals for wider margins. In the case of the sliding parity, it is relevant mainly to proposals for parity slides of the market-determined type; since parity changes under such systems would be governed by movements of spot exchange rates, the authorities might be tempted to intervene for either of the reasons indicated above.

The following are among the more important questions that arise

^{10/} The questions listed under this heading do not include questions regarding the precise form that any rules agreed upon would take, i.e. whether they would be incorporated in the IMF Articles of Agreement explicitly, or be the subject of separate written understandings, or be effectuated in some other way. In some cases, notably under a sliding parity of the market-determined type, they might, to a considerable extent at least, be implicit in the mechanics of the system itself. Whatever their form they should be as clear as possible, be accompanied by sanctions for infringement, and be subject to amendment, on the basis of a suitable majority vote, in the light of experience.

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in considering operating rules for systems of greater exchange-rate flexibility:

1. The extreme positions are: no official intervention (or none except for smoothing operations) and no restrictions on official intervention.

Should either of these positions be seriously considered?

2. Under a system of greater exchange-rate flexibility, should "aggressive" intervention be prohibited completely?

DM/69/2 suggests two cases in which departure from such a rule might be justified: (a) countries belonging to groups such as the EEC which may wish to maintain fixed rates against each other while retaining some of the benefits of wider margins; (b) countries which have either very high or very low reserves and which, while experiencing reserve changes in the desired direction, wish to speed them by depreciating or appreciating their currencies (within wider margins).

How would the groups contemplated in (a) achieve the aims indicated? (DM/69/2 does not make this entirely clear.) Are there any situations, in addition to the two mentioned, where aggressive intervention might be justified? What rules would be needed to prevent or limit aggressive intervention, and how would they be policed?

3. In what situations should "defensive" intervention be permitted?

DM/69/2 suggests two possible approaches, which could be used separately or together: (a) a "margin within a margin," with no intervention being permitted in the "inside" margin (e.g. 3 per cent, if the normal margin was 5 per cent), and defensive intervention being

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permitted in the "outside" margin; (b) a system under which, in any calendar quarter, a country could practice defensive intervention only after the rate for its currency had moved by a specified amount (e.g. 1 per cent) in a given direction during that quarter.

What view should be taken of these proposals? Are there other situations in which defensive intervention should (or might have to) be permitted, or other principles under which it might reasonably be allowed? For example, what about a system in which defensive intervention would be permitted for as long as, during a specified period, reserve changes did not exceed a specified percentage figure?

4. In so far as reserve changes might be a factor in rules relating to official intervention (either on the permissive side or on the restricting side), what problems might arise in the definition or measurement of reserves appropriate for this purpose?

5. Should there be rules about official intervention in forward markets? About official restraint of forward dealings?

See V-3 (p. 33.)

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VII. Problems of Transition

The transition to a system of greater exchange-rate flexibility could involve many problems, including some not directly related to the mechanics of the new system itself. Some of these might emerge from the particular circumstances which gave rise to the decision to move to a new system. It is suggested that for present purposes it is not necessary to cover all the transitional problems that might develop. However, those that could directly affect the workings of the new system, as well as those involving legal and institutional implications for IMF and for the United States, might most conveniently be studied when the possible forms of that system are themselves being analyzed. Chief among such transitional problems are the following:

1. Should adoption of the new system be preceded (or be accompanied) by a general "one-time" realignment of exchange rates?

As DM/69/10 says (p. 14), referring to the changed attitude of the German Council of Economic Experts in 1968 toward the sliding-parity proposal it had put forward two years earlier, "The implication is that the introduction of the new system should coincide with an economic situation in which no disparities exist between domestic and foreign price-and-cost levels . . ." Such a requirement could be met in one of two alternative ways: (a) by waiting until the desired economic situation emerges (perhaps urged along by policy nudges in the various countries); (b) by a general realignment of exchange rates. On the assumption that the first of these solutions might take too long, and that in any case it is unnecessary to wait,

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many students of these matters have suggested or assumed the second solution.

Leaving aside possible objections to this solution on the ground that a general rate realignment is unnecessary--or that it may be so at the time the move takes place--there is still a problem: the fact that such a realignment may be expected by the general public. This could lead to widespread speculation during the period of active discussion and negotiation of the new system. This possibility gives rise to question 2.

2. Could the problem of a faulty alignment of exchange rates at the outset be met by introducing the new system gradually?

As has been pointed out,^{///} the introduction of sliding parities of the market-determined type at a time of significant payments imbalance could also give rise to speculation, because of the extent to which parities (hence also market rates) could drop immediately if market rates have been pressing for a long time on one of the limits of spot-rate fluctuation. No such problem need arise under sliding parities of the administratively-determined type, because under such systems parities would move only at a rate determined by the authorities. But under a wider-margins system, if margins were widened abruptly by a substantial amount the immediate market-rate movement could be sharp, just as under market-determined sliding parities.

For the latter type of system (market-determined sliding parities) it has been proposed that the problem of speculation be got around through use of a technique for gradual introduction which would slow down the pace at which the parity could move.^{///} Presumably a similar

^{///} Black, loc. cit., p. 292. See also DM/09/10, p. 14.

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device could be used in the case of wider margins if this system of greater exchange-rate flexibility were adopted.

The trouble with such a solution in either case (market-determined sliding-parity system or wider-margins system)---and this problem would also exist under the administratively-determined sliding parity--is that if the initial imbalance were substantial, the achievement of equilibrium could take a long time.

Thus the answer to question 2 would appear to be: yes, but perhaps only at the expense of slowing down unduly the process of readjustment from a starting position of pronounced disequilibrium.

The foregoing comments on questions 1 and 2 may serve to suggest that the two questions should perhaps be stated as one: how to introduce the system of greater exchange-rate flexibility (whatever it might be) in a way that would neither delay basic readjustment unduly nor induce excessive speculation?

3. Effects upon IMF?

What changes in the IMF Articles of Agreement would each exchange-rate system under consideration require? How would each new system affect Fund policies, operations, and standing?

4. Effects upon national legislation and institutions?

For the United States, what legislative and institutional changes might be required by a move to greater exchange-rate flexibility?

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VIII. Theoretical Questions

1. Is exchange-rate adjustment at an early stage of disequilibrium desirable? Does the answer to this question help in choosing among alternative systems of greater exchange-rate flexibility?

Regarding the first of these two questions, see DM/69/4, pp. 3-4, for a discussion of advantages and disadvantages of early rate adjustment. Regarding the second question, it has been suggested^{12/} that a disadvantage of administratively-determined sliding parity systems is that they imply a build-up of a significant amount of disequilibrium before rate-adjustment begins. Do such systems necessarily have this implication? If they do, whether this is deemed bad may depend upon how one answers the first of the two questions listed above.

2. Most countries have balance-of-payments aims of some kind. The member countries of Working Party 3, for example, have gone on record on this question, stating aims for both their over-all payments positions and for the major components of their payments balances. Would greater exchange-rate flexibility conflict with or hamper realization of balance-of-payments aims?

3. Instead of opting for just one system of greater exchange-rate flexibility, should different systems be used, according to the needs of each particular situation?

The appropriateness of the sliding parity, it has been argued,

^{12/} By Peter Oppenheimer, in a panel discussion reported in the London Times of December 22, 1968, p. 39.

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depends upon the type of payments disequilibrium which is involved.^{13/}
This view, and other considerations, suggest the possible desirability of permitting the use of different methods of achieving greater exchange-rate flexibility.

Note, however, that as pointed out on pp. 5-6 above, if the range of alternatives included discrete parity changes of any size, this might jeopardize the workability of sliding-parity systems in any cases where they were adopted.

4. What effects would greater exchange-rate flexibility have on the stability of demand and on production and employment, in general and in the foreign-trade industries in particular?

For a discussion of this question in reference to wider margins, see DM/69/2, pp. 10-11 and 15-16.

5. What internal conditions would be necessary to make greater exchange-rate flexibility work?

To put the question somewhat differently: what internal developments could undermine systems of greater exchange-rate flexibility?

For a relevant discussion see DM/69/2, pp. 14-15.

^{13/} DM/69/4, pp. 7-11.