

**1. Recent Changes in the U.S. Balance of Payments and the International
Position of the Dollar**

Introduction

During the last three years, remarkable, and indeed somewhat paradoxical changes have taken place in the U.S. balance of payments and the international position of the dollar. It will be recalled that in 1958–60, after several years of small deficits, the U.S. balance of payments suddenly developed a deficit which was then generally regarded to be of alarming magnitude—\$3.4, \$3.9, and \$3.9 billion in 1958, 1959, and 1960, respectively (measured on the liquidity basis). The Eisenhower administration took drastic anti-inflationary measures which prepared the ground for a remarkable period of stable prices lasting until 1965. During these years of price stability the balance of payments improved greatly. The overall deficit (liquidity definition) fell from \$3.9 billion in 1959 to \$2.8 in 1964 and \$1.3 in 1965. Perhaps even more important, the surplus on goods and services rose from \$0.3 billion in 1959 to \$8.6 billion in 1964.

The new wave of inflation starting in 1965 led to a progressive deterioration of the balance of payments which again reached alarming proportions in the fourth quarter of 1967—annual rate of \$6.9 billion (liquidity definition). Huge speculation in gold, heavy pressure on the dollar, and rapid decline of the U.S. gold stock (from \$13.08 billion in the third quarter of 1967 to \$10.7 billion in the first quarter, 1968) prompted the Johnson administration to take drastic measures of control and to propose even more extreme steps. These proposals included an unprecedented tax on U.S. tourists abroad and generalized border taxes on imports, a program which, if carried out, would almost certainly have led to full-fledged exchange control. Fortunately, Congress refused to go along with these two measures, but severe restrictions on capital exports were imposed by executive order based on “the

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authority vested in the President" by Congress as part of the Trading with the Enemy Act of 1917.¹

Gold speculation continued throughout the first quarter of 1968. Then, in April 1968, the international gold pool through which the central banks of the leading industrial countries (except France which had withdrawn) had been feeding the speculators—with the U.S. contributing the major share—was abolished and the two-tier gold market established. Since then, there has existed an uncontrolled private gold market in which the price of gold is free to fluctuate under the influence of the changing pattern of demand and supply. National and international monetary authorities, on the other hand, have continued to trade gold among themselves at the official par of \$35 per ounce.

Later in 1968 the situation unexpectedly improved. Huge amounts of foreign capital flowed into the U.S. For the first time in ten years, the U.S. balance of payments showed a small surplus of \$0.2 billion on the liquidity basis and a much greater surplus on the "official reserve transaction" basis.² Foreign capital was attracted by high interest rates and the stock market boom. Moreover, the student-worker rebellion in France of May/June 1968, which almost toppled the de Gaulle regime and produced a veritable wage explosion, plus the occupation of Czechoslovakia by Russian troops, scared many investors and enhanced the comparative safety of the dollar. But while the overall balance improved, the traditional trade surplus—which had risen to almost \$7 billion in 1964—all but vanished. It was clear that the improvement in the overall balance could not last. For the richest country in the world to be importing capital on a large scale was clearly an unnatural and temporary phenomenon. The expected deterioration in the balance occurred with a vengeance in 1969. In that year the deficit reached a record level of \$7 billion (liquidity definition) and for 1970, according to preliminary figures, the deficit still was about \$4 billion—although the trade balance substantially improved because, as a consequence of the recession in the U.S., imports into the U.S. rose less than in former years.

It is surprising, indeed paradoxical, that the large deficits of 1969 and 1970 have caused not even a ripple in foreign exchange markets for the dollar and have not disturbed the calm of U.S. policymakers, while a much smaller deficit in 1967 produced a run on the dollar and propelled the administration into frantic activity. There were several exchange crises in 1968 and 1969 affecting, for example, sterling and the French franc, which were devalued, and the German mark, which was revalued. But confidence in the dollar remained unscathed. What is the explanation?

Reasons for the Strength of the Dollar

There are several reasons for the strength of the dollar. Through the termination of the gold pool in 1968 and the surprising success of the two-tier gold market, the U.S.

dollar has been effectively shielded from private gold speculation. Also the establishment of Special Drawing Rights (SDRs), by sharply reducing the chance of a change in the gold price, has greatly discouraged gold speculation. There has been, furthermore, a sharp decline in foreign *official* dollar balances held by foreign central banks as part of their international reserve—a decline from \$15.6 billion at the end of 1967 to \$10 billion at the end of 1969. When foreign capital flowed into the U.S. in 1968 and the first half of 1969, private individuals obtained the dollars for investment in the U.S. from their central banks whose dollar balances thus were drawn down. This was reflected in the fact that in contrast to the great deficit in the U.S. balance of payments according to the liquidity definition, the balance on the so-called official settlement basis showed a substantial surplus in 1969 (\$2.7 billion). The decline in their dollar balances mollified foreign central bankers although they must have realized all along that when the private capital flow to the U.S. receded from the high levels of 1968 and early 1969, as it would have to do, foreign official dollar holdings would go up again.

Indeed, in 1970, the official settlement balance developed a huge deficit (\$11.5 billion the first quarter, \$7 billion the second quarter) and official liquid dollar holdings abroad reached a record level (\$17.8 billion as of September 1970). This change has been noted with uneasiness among foreign central bankers, but it has not produced an atmosphere of crisis as did the large deficits of 1967/68.

Another technical matter might be mentioned at this point. Recent rapid and pronounced changes in the balance of payments, especially the often sharply contrasting movements in the deficit as measured on the so-called "liquidity basis" and "the official reserve transactions basis," have created fresh doubts concerning the proper definition and measure of deficit and surplus. In fact, it is now fairly generally agreed that the formerly widely-accepted liquidity measure of deficit is no longer applicable (if it ever was). We shall not discuss in detail the intricate problem of the proper definition of balance-of-payments surplus and deficit for a country whose currency is used all over the world as an official international reserve medium and as a vehicle for private transactions and investment.³ At this point it is enough to say that the liquidity definition of deficit has become obsolete and that the official reserve transactions definition, if not quite satisfactory, is certainly a much more significant measure.

Dollar Standard and De Facto Inconvertibility of the Dollar

The factors mentioned so far, important though they are, do not fully explain the surprising strength of the dollar in the face of a large deficit in the balance of payments (on either of the two official definitions). More important, we believe, are changes in the outlook and attitudes of policymakers, both in the U.S. and abroad.

which have taken place in recent years. To put it bluntly, it is now fairly generally realized that in a sense the world is on the dollar standard and that the dollar is de facto inconvertible into gold, at least for large sums. That is to say, foreign central banks cannot convert large sums of dollars into gold for the purpose of changing the composition of their reserves, as France did under de Gaulle in the 1960s.

The dollar remains, of course, fully convertible into foreign exchange for private holders at home and abroad, except that the capital export restrictions can be regarded as an infringement of the principle of unlimited convertibility as far as American residents are concerned. But these restrictions do not apply to foreigners. Despite its de facto inconvertibility into gold, the dollar remains fully usable as an international reserve medium and intervention currency. Foreign central banks can use their dollars to finance a deficit vis-à-vis the U.S. They can also use their dollars to buy other currencies, because the dollar is used by most foreign central banks as international reserves along with gold and by practically all central banks as "intervention currency." In other words, foreign central banks discharge their obligation under the International Monetary Fund charter to maintain the par value of their currency (within the allowable margin of 1 percent on each side of parity) by buying and selling dollars in the market in exchange for their own currency rather than by buying and selling gold. The U.S. alone has availed itself of the option offered by the IMF charter (Article IV, Section 4(b)) to maintain the par value of the dollar by buying and selling gold rather than by buying and selling foreign currencies.⁴ But this does not alter the de facto inconvertibility of the dollar into gold for large sums. No doubt, "small" amounts of gold are still available, especially for purposes other than to change a nation's reserve composition (à la de Gaulle).

What is "large" and what is "small"? Of course, no precise figure can be given. But if we look at the size of the U.S. gold stock in relation to U.S. liquid "liabilities to foreign official institutions," we find that since 1960 the gold stock has declined from \$17.8 billion to \$11.5 billion,⁵ while liabilities have increased from \$11 billion to \$16.6 billion. There simply is not enough gold to permit large-scale withdrawals because, once the process is started, it could easily snowball into unmanageable proportions. Large conversion of officially held dollars into gold would, in all probability, provoke massive switches of privately held dollars into official balances. These conclusions are strengthened if we add that total liquid liabilities, to official as well as nonofficial foreign financial institutions, have grown from \$21 billion in 1960 to \$44 billion in October 1970.⁶ Privately held dollar balances are, of course, not directly convertible into gold. But it is known that the figures for private dollar balances contain some official balances and, as recent experience has again shown, there can occur at any moment large switches from private to official holdings.

Alarming conclusions have been drawn from this apparent disproportion between the U.S. gold reserve and liquid liabilities: The gold exchange or dollar

exchange standard, as the postwar international monetary system has come to be called, is inherently unstable many claim. The growing discrepancy between the U.S. gold reserve and the superstructure of foreign held dollar balances, it is said, will inevitably undermine confidence in the dollar and lead to a crisis. Economists at opposite ends of the spectrum, Jacques Rueff and Robert Triffin, agree on the instability of the present system. Their prescriptions for remedy are, of course, different. Rueff wants to go back to the gold standard (after doubling or tripling the price of gold); Triffin wants to go forward by making the IMF a real world central bank, a lender of last resort with broad money-creating power.

For some time the international monetary system appeared indeed to be moving in the direction of a crisis as foreseen by the Cassandras on the right and on the left. But since the near crisis late in 1967 and early in 1968, the system evidently has gained in stability.⁷

What is the reason? Paradoxically it has been the growing disproportion between the U.S. gold stock and liquid foreign liabilities that has strengthened the stability of the system by making it increasingly clear that the dollar is *de facto* inconvertible and that the world has to live with the dollar. Let us quote Dr. Edwin Stopper, president of the Swiss National Bank. In a speech in May 1970 he pointed out that "for the past months things have been astonishingly quiet in the monetary field." He listed a number of facts that contributed to the calm. The first and evidently the most important was "the progressing acceptance of a *de facto* dollar standard after the replacement of the Gold Pool by the Two-Tier-System and the voluntary restraint exercised by the central banks in respect of conversions into gold."⁸ True, Dr. Stopper speaks of "voluntary" restraint and hints that the posture of restraint could be changed at any time, for example, if inflation in the U.S. were not brought under control.

We shall return later to the problem of "balance-of-payments discipline." But the broad fact is that the "voluntary" restraint is really imposed by the logic of the situation. Nobody wants to rock the boat and provoke a serious crisis. Since the number of large dollar holders who could jeopardize the stability of the system is small, the resulting group equilibrium can be quite stable.

In the background is the ultimate, officially unmentioned, but undoubtedly well understood sanction of the equilibrium, namely, the fact that the U.S. could at any time make the dollar formally inconvertible into gold. Such a step would not even require an act of Congress.

A few academic experts have asked that this step be taken forthwith. And some have recommended that the existing gold stock should be offered for sale at the same time, thus turning the back on gold once and for all and probably bringing about its demonetization. Others would keep the gold stock intact for any future emergency.

There would be merit in these recommendations, if the only alternatives were either a painful contraction with a lot of unemployment or the imposition of severe controls on trade and payments. We shall show, however, that these are by no means inescapable alternatives, except perhaps if the U.S. inflation gets much worse than it is. It is therefore not necessary in our opinion to take the extreme step of declaring the dollar officially inconvertible into gold. *De facto* inconvertibility (for large sums) and the *de facto* dollar standard is probably sufficient. Realization that inconvertibility could be declared at any time, and that this step probably would be taken if there were large gold conversions, should be enough to ensure "voluntary restraint."

The situation was different at an earlier stage of the evolution of the dollar exchange standard. When the gold stock covered a large proportion of liquid liabilities, it was reasonable for foreign countries to assume that they would be free at any time to change the composition of their international reserve by converting dollars into gold. The growing disproportion between liquid liabilities and the gold stock has made it clear to everyone that large conversions of dollars into gold are no longer possible. The point of no return has been definitely passed.

2. Balance-of-Payments Policies: American Options and Foreign Response

General Principles

We distinguish between (a) policies and measures designed to provide means for the *financing* of deficits and (b) policies and measures for the purpose of *eliminating* deficits and surpluses (disequilibria). The former pertain to the *liquidity* problem, the latter to the *adjustment* problem. To the former group belong, on the national and bilateral level, the holding of uncovered dollars by foreign central banks as international reserves, the swap agreements with foreign central banks, the placing of "Roosa bonds" and bilateral standby credits with foreign central banks and the like. On the international level, there is the creation of SDRs and, earlier, the GAB (General Agreement to Borrow) between the central banks of the group of ten.

It is now generally recognized that the adjustment problem is more fundamental and more intractable than the liquidity problem. The smoother and quicker the adjustment, the less international liquidity is needed. If the mechanism of adjustment were to work very slowly or not at all, the need for liquidity would become unmanageably large.

If the world were formally and irrevocably on the dollar standard, there would be no liquidity problem for the U.S. Any need for liquidity that might arise would be automatically satisfied by the accumulation of dollar balances in foreign central

banks, if other countries were prepared routinely to accumulate dollar balances without limit.⁹ In that case the U.S. would not have any adjustment problem either, because any deficit would be automatically financed.

Clearly there are limits to the amount of dollars that foreign central banks will be prepared to add to their reserves. The limit has, however, not been reached and is not around the corner. That is why we could say (section 1) that the world is on the dollar standard and the U.S. has no acute or imminent liquidity problem. The U.S. has considerable leeway, but a limit exists somewhere ahead. Therefore, the adjustment of the balance of payments is a matter of great concern also for the U.S.

Balance-of-payments adjustment policies can be classified in three groups: (1) internal monetary and fiscal policies, which are often called "demand management"; (2) exchange rate changes, including par value changes under IMF procedures and the various types of exchange rate flexibility, for example, "wider band" or "crawling peg," that have been proposed in recent years; and (3) the method of "controls." Controls is a portmanteau expression covering a great variety of measures or a system of measures, designed to influence particular segments or individual items in the balance of payments. Controls can be mild or severe; they can apply to capital movements or current transactions; they range from full-fledged exchange control to the imposition of more or less uniform border taxes on imports plus similar tax refunds on exports, a system which comes close to being equivalent to a change in the exchange rate. Other types of controls are tying of foreign aid, "buy American" policies for government procurement, and similar measures.

Balance-of-payments adjustment through internal financial management (expansionist or inflationary, contractive or disinflationary monetary and fiscal policies) and through exchange rate changes in one form or another can be characterized as general types of policies working with and through the price mechanism. These are the methods of adjustment that conform to, and are suitable for, our free enterprise system; they minimize interference in the price and market mechanism. Controls, on the other hand, constitute more or less serious deviations from the market system. Depending on the concrete form and degree of severity, they introduce more or less severe distortions and inefficiencies into the economy and foster the growth of an expensive bureaucracy. They, thus, reduce output and growth and are inimical to the free enterprise system. We therefore take it for granted that controls should be avoided. Their cost, degree of wastefulness, and undesirability vary, of course, greatly from type to type.

American Options

With respect to the first type of balance-of-payments adjustment policies, that is, internal financial management, the task of American policy at the present time is, of

course, to curb inflation. We take it for granted and feel strongly that inflation should be brought to an end as soon as possible for purely domestic reasons, namely, to eliminate the distortions and inequities which inflation continuously inflicts on the social economy.

At the present time, clearly there exists *no* basic conflict for domestic macro-economic policies between the directions to be followed to achieve internal and external policy objectives. Both domestic policy objectives—price stability but also long-run stability of output and growth—and the balance of payments require that inflation be brought to an end as soon as possible. But a conflict between the magnitude of policy restraint necessary to achieve external and internal equilibrium may soon arise. Concretely, a situation may develop where it could be argued that for balance-of-payments reasons the anti-inflation policy should be intensified, although such an intensification would create much more unemployment and slack than can be justified on grounds of domestic policy objectives. Many experts feel that this point has already been reached in the U.S. They argue that it is time to relax the anti-inflationary policy because it creates too much unemployment.¹⁰ And they assume that even with the lowest rate on inflation—say 3 or 3.5 percent a year—that in their opinion could be achieved without creating too much unemployment, the balance of payments would be in large deficit. Professor Paul Samuelson and others seem to take this position when they assert that the dollar is definitely overvalued.

We doubt whether the dollar is really overvalued, at least to any substantial degree, in the sense that the deficit in the balance of payments would be uncomfortably large, even if the rate of inflation were reduced from its present level to a level that would be acceptable from the domestic standpoint. But the recent policy of more rapid re-expansion which seems to be gathering momentum may change the picture in the near future and bring about a dilemma situation in which requirements of internal and external equilibrium conflict.

Be that as it may, we feel strongly that whenever a serious dilemma or conflict between the requirements of external and internal equilibrium arises, domestic policy objectives should take precedence over balance-of-payments considerations. To be specific, in order to stop inflation, it is practically always necessary to accept a temporary rise in unemployment and a temporary slowdown of real growth. What we argue is that for balance-of-payments reasons, the U.S. should not accept more unemployment and more retardation of growth than may be necessary on domestic grounds to bring the price level under control. We are convinced that this rule, if fully thought through and correctly understood, is not only good for the U.S. but is also in the interest of other countries and of the rest of the world. There is, after all, general agreement that a serious depression or recession in the U.S. would not be in the interest of our trading partners, and the structure of the U.S. economy with a

relatively low GNP percentage of imports implies that a substantial dose of internal deflation and unemployment might be required to remove even a moderate external imbalance via domestic demand management.¹¹

To explain the reasons for these statements, we turn now to the *second* type of balance-of-payments adjustment policies, namely, changes of exchange rates, par value changes under the IMF rules, or some sort of exchange flexibility.

In discussing these policies, we start from the proposition now widely accepted that, because of the special position of the dollar as the world's foremost international reserve currency, the official intervention and private transactions currency and the large absolute size of U.S. exports and imports, it is extremely unlikely that the U.S. could successfully devalue the dollar vis-à-vis other currencies, by unilateral action, even if it wanted to; and, for the same reasons, it cannot unilaterally let the dollar float.¹² If the U.S. changed the par value of the dollar (in terms of gold), practically all countries of the world (with the exception of probably not more than two or three important ones) would also depreciate their currencies (in terms of gold), because only very few countries would be prepared to expose themselves to the intensified competition from American industries that would result from an appreciation of their currencies in terms of the dollar.¹³ Thus the exchange value of the dollar (in terms of other currencies, as distinguished from its gold value) would remain substantially unchanged. Similarly, if the U.S. tried to let the dollar float, most other countries, again with very few exceptions, would continue to peg their currencies to the dollar.¹⁴

The implications of this situation are far-reaching. Whenever there exists a conflict between domestic and external policy objectives, other countries can escape the dilemma by depreciating or appreciating their currency or by letting it float up or down, whatever the situation requires. To the U.S. this option is effectively denied. This is often regarded as a severe handicap for the U.S. which may, it is said, require and justify adoption of measures in the *third* category—controls, capital export restrictions, or even import quotas.

We shall show that, in reality, the special position of the dollar and the impossibility of depreciating the dollar need not constitute any handicap and does not justify the imposition of controls, provided the U.S. does not allow balance-of-payments considerations to deflect it from the pursuit of internal macro-economic policies that are needed for the achievement of domestic policy objectives. Suppose a conflict between external and internal equilibrium arises: that is to say, suppose that restoration of equilibrium in the balance of payments requires a more energetic anti-inflation policy through monetary or fiscal measures than can be justified on domestic grounds in view of the fact that such measures would create an unacceptable volume of unemployment. How should the U.S. deal in that case with the external disequilibrium, the balance-of-payments deficit? The answer to that ques-

tion is that the U.S. should leave it to the countries whose balances of payments show the surpluses corresponding to its deficit—to the surplus countries—to choose one of several options. And, as we show below, all the options they have, assuming moderately rational behavior on their part, should be acceptable to the United States.

Options of Foreign Surplus Countries

Foreign surplus countries can choose any one, or any combination, of four possible responses: (1) they can finance the American deficit by accumulating more dollars; (2) they can appreciate their currencies (or let them float as Canada did again last May); (3) they can pursue a more expansionary internal monetary policy, thereby eliminating their surpluses and the U.S. deficit; or (4) they can reduce import tariffs or other import restrictions (or export subsidies, if they have them). Let us give an example of option (4): In November 1968, instead of appreciating the DM, Germany reduced border taxes on imports and tax refunds (subsidies) on exports by four percentage points. This constituted an implicit appreciation of the DM. Later, in October 1969, when the DM was explicitly appreciated by 9.4 percent, the border tax and export subsidy were raised again by four percentage points. Thus the effective appreciation of the DM (as of October 1969) was substantially less than 9.4 percent. But compared with October 1968 (before the border tax adjustment of November 1968), the appreciation of the DM was, of course, 9.4 percent.

We assert that each of these four responses on the part of foreign surplus countries should be perfectly acceptable from the American point of view. Clearly a policy of the surplus countries which tends to reduce their surpluses and the American deficit would be very welcome, be it a reduction of trade barriers, an appreciation of the surplus country's currency (although it constitutes a depreciation of the dollar in terms of the other currency), or an internal monetary expansion (inflation) in the surplus country. From the American as well as from the world standpoint, a reduction of trade barriers would be the best response; but for obvious reasons one cannot hope that this approach will be widely adopted.

We argue that the surplus countries' first option, further accumulation of dollar balances, is also acceptable from the American standpoint, provided U.S. domestic monetary and fiscal policies are guided solely by internal policy objectives—in other words provided the U.S. tolerates no more unemployment and slack than may be needed to curb inflation. The opinion is, however, widely held that an increase in U.S. liquid liabilities to foreigners may be dangerous and damaging for two reasons.

The first is that it may endanger the U.S. liquidity position. What would happen if, for any reason, there developed a run on the dollar and dollars were thrown on the market? The answer is simple and has already been given: Private individuals cannot

convert dollars into gold. They can only sell them to foreign central banks which are, under present arrangements, residual buyers for dollars. Since the dollar is de facto inconvertible into gold also for central banks, these banks could get rid of their dollars only by pursuing an expansionary monetary policy or by accepting an open or disguised appreciation of their currency. So we come back to the other three options, which clearly are acceptable for the U.S.

The second reason why an indefinite financing of a deficit by accumulation of dollar balances is said to be unacceptable can be formulated as follows: A balance-of-payments deficit implies that U.S. imports are larger and/or U.S. exports smaller than they otherwise would be. Other countries caught in such a squeeze could devalue their currency. The U.S. has to wait until the surplus countries act in any of these ways mentioned. Until they do—or if they do not—the U.S. suffers slack and unemployment. Therefore the U.S. should impose import restrictions or subsidize exports in one form or another.¹⁵

There would be some validity to this argument, if American domestic monetary and fiscal policy were *not* guided solely by domestic policy objectives—in other words, if the U.S. tolerated more unemployment and slack than might be needed to curb inflation, namely, the unemployment created by the shortfall of exports and increase of imports implied by the deficit. This formulation makes it clear that the argument does not hold, if internal monetary and fiscal policy (management of aggregate demand) is properly geared to domestic policy objectives.

Our analysis will perhaps be criticized on the ground that it is unreasonable to assume that monetary and fiscal policy can be so finely tuned that it irons out every dip in aggregate demand which is in excess of what must be tolerated to satisfy domestic policy objectives.

It is, of course, quite true that there are a hundred reasons—balance-of-payments changes being one of them—why there will often be slips in monetary and fiscal policies resulting in deviations of the actual level of unemployment from the target level, whatever the latter may be. But let us keep a sense of proportion. Those dips in aggregate demand that can be attributed to balance-of-payments changes are, in reality, quite small compared not only with GNP but with the annual changes in GNP, up or down, which occur as a result of the hundred other causes. Surely if there were a “gradual liquidation of American industrial potential” (to quote Professor Gottlieb) monetary and fiscal policy would cope with it.¹⁶

To summarize the results of our analysis in this section, surplus countries have four options: They can go on accumulating dollar balances, they can pursue an expansionary monetary policy, they can appreciate their currency or let it float, or they can reduce trade barriers. All of these options are acceptable from the American standpoint, including the first. A possible fifth option—namely, controls—is discussed in the next section of this chapter.

Reactions of Foreign Surplus Countries

Spokesmen for foreign surplus countries, both official and private, do not always take kindly to the advice that it is up to them to respond to an American deficit in any of the four ways mentioned. They often resent the suggestion that they should appreciate their currency if they do not want to accumulate more dollars or to inflate or reduce their trade barriers. A pet phrase has been that appreciation of the surplus countries' currencies instead of depreciation of the deficit country's currency (i.e., of the dollar) would be tantamount to imposing a painful cure on the healthy rather than on the sick. Why the cure should be painful is not clear. At any rate, the reaction seems to be based on the picture of a highly inflationary reserve currency country imposing inflation on the rest of the world.

If this were a true picture of the present world monetary scene, if the U.S. had much more inflation than many others and if, as a consequence, the U.S. deficit were very large and were matched by (unwanted) surpluses of a large number of other countries—in such a situation, it would indeed be possible to make a case for demanding that the dollar should be depreciated in one form or another rather than that scores of other currencies be appreciated.

Obviously, however, this is not the situation which we find today. In reality, there is only a very small number of countries that have less inflation than the U.S. and, as a consequence, have a large unwanted dollar accumulation. The great majority of countries spontaneously match or even surpass the U.S. rate of inflation.¹⁷ To put it in other words, if the dollar were devalued (in terms of gold), the vast majority of currencies would follow the dollar and only very few, two or three important currencies in the West (and presumably the Russian ruble), would keep their par value in gold unchanged and would appreciate in terms of the dollar. From the American standpoint, it really does not matter much how the change in exchange rates that may be needed is brought about—whether by depreciation of the dollar in terms of gold or by appreciation in terms of gold of two or three currencies of surplus countries. But given the fact that the dollar is the reserve currency of the world, the foremost private transactions and investment currency, that the dollar is used all over the world (including the Communist countries) as the unit of account in innumerable private and official transactions, contracts, and financial and commodity arrangements—given this fact, from the world standpoint, it would be easier and less disruptive, economically, administratively, and psychologically, to appreciate two or three surplus currencies than to depreciate the dollar along with its vast retinue of other currencies.

There is still another reason why a devaluation of the dollar in terms of gold would be very awkward: It would imply a general rise in the price of gold. A change

in the gold price by a few percent would surely give great encouragement to gold speculation, without making any contribution to the solution of the liquidity problem.¹⁸ It will be observed that the reason why the gold value of the dollar should not be changed is that such a change would violate the interests of the world as a whole. No specific or exclusive American interests are involved.

Irrespective of what spokesmen for the surplus countries say and how unhappy they may be or pretend to be, it is difficult to see what else they could do but adopt one, or a combination of some, of the four responses mentioned above—that is, accumulate dollars, appreciate their currency, inflate, or reduce trade barriers. It is sometimes suggested that they have still another, fifth option—namely, to impose controls—and that they are likely to do just that. But if the word “controls” is used in its usual meaning of import restrictions, this reaction would make no sense, because the use of such controls would make a bad situation worse; it would increase still more the foreign countries’ surpluses and the U.S. deficit. To be effective the controls would have to be negative, so to speak, restraining exports and stimulating imports. Countries usually do not like that kind of control. At any rate, that kind of control would amount to a messy, inefficient, and wasteful substitute for the appreciation¹⁹ of the surplus countries’ currencies and would constitute a violation of the letter and the spirit of the IMF charter.

A type of control that the IMF charter permits is restrictions of capital movements. For example, surplus countries could forbid or restrict U.S. direct investments in their territories. We believe that it would not be in their well-considered interest to restrict American direct investment, at any rate, not on balance-of-payments grounds. But it is obviously up to them to make that decision. It has been suggested that surplus countries could try to separate the market for “current account dollars” from the market for “investment dollars.” This policy was pursued for a while by Switzerland in the years immediately following World War II. Dollars for current account purposes were kept at the official parity by pegging operations conducted by the Swiss National Bank. So-called “finance dollars” (resulting from and applicable to capital flows and certain services) were traded in an uncontrolled (or mildly controlled) market at a discount. After the war, when international trade and transactions were at an extremely low level, this system could be tolerated for a while despite its inefficiencies. At present, with the enormous volume of transactions on current and capital account and mass travel in all directions, it would require a formidable bureaucracy to administer such a system—to separate current from capital transactions, to prevent capital transactions from masquerading as current transactions. It would come very close to full-fledged exchange control, would not serve any useful purpose and would at any rate amount to a partial devaluation of the dollar and partial appreciation of the foreign currency in question.²⁰

Although the inflation in the U.S. in the last few years has created uneasiness and concern about the future of the dollar among the large foreign dollar holders, confidence in the dollar is substantially unimpaired. Unless inflation goes on unchecked or accelerates, confidence in the dollar will be preserved. But it may be useful to consider briefly what would happen, if a serious confidence crisis and a "run on the dollar" should develop.

First, private dollar holders abroad could get rid of their dollar holdings only by selling dollars directly or indirectly to foreign central banks. Second, in the absence of the possibility of conversion into gold, foreign central banks could reduce their dollar balances²¹ only by allowing their currency to appreciate, implying a depreciation of the dollar. This could be brought about either openly, by raising the par value of the foreign currency or by letting it float, or in a disguised form, by introducing "negative controls." None of these alternatives looks attractive from the point of view of foreign dollar holders. But there is no other way out.²²

Summary of Conclusions

We have argued that American balance-of-payments policy should be "passive." An "active" balance-of-payments policy would use either measures of control (in the broad sense defined earlier) or changes in the exchange value of the dollar. The first of these approaches is inefficient, wasteful, and undesirable; the second is, under present institutional arrangements which make the dollar the world's reserve and intervention currency, unavailable to the U.S. We have pointed out that this policy of "passivity" with respect to the balance of payments is no handicap for U.S. general economic management, provided that American monetary, financial, and other policies are exclusively guided by internal policy objectives (high level of employment, growth, price stability, or whatever they are).

A passive attitude towards the balance of payments can be described as a "policy of benign neglect." It should be observed, however, that neglect of the balance of payments does *not* imply neglect of either the interests of the U.S. or of those of our trading partners. Nor does it imply lack of interest in the organization and functioning of the international monetary system. To be more specific, under present arrangements and policies, the U.S. cannot unilaterally change the exchange value of the dollar or let the dollar float. However, this does not mean that the U.S. is not interested in reforms of the international monetary system that would permit greater flexibility of exchange rates—directly and explicitly for currencies other than the dollar, but indirectly and implicitly for the dollar.

The subject of such reforms of the international monetary system is taken up in the following section.

3. Reform of the International Monetary System

Creation of Special Drawing Rights

For many years, international monetary reform has been a topic of endless academic discussion, numerous official and unofficial conferences, and bursts of lengthy and intense negotiations on the highest level of governments. The major recent development has been the creation and "activation," by common consent of the member countries of the IMF, of a new form of international reserves, the Special Drawing Rights (SDRs). It was an unprecedented achievement of international cooperation—in fact the first peacetime example of an international agreement to change a major feature of the international monetary system. (The Bretton Woods Charter was negotiated during the war.) We do not wish to denigrate the historic importance of that event. Nor would we argue that the creation of SDRs was in itself a harmful act. If nothing else, this action appears to have had, as already mentioned, a very useful side effect in discouraging gold speculation by greatly reducing the speculators' estimate of the probability of an increase in the official gold price.

But the scheme also has its dangers and drawbacks. Our major quarrel with SDRs concerns the opportunity cost of their creation. Years of intensive international investigation and negotiation, employing a lot of the time of scores of highpowered experts and negotiators, went into working towards the solution of the liquidity problem and so diverted attention and scarce (intellectual) resources from the search for a solution of the much more basic and difficult problem of adjustment.

Maybe the sharp and widely accepted distinction between the three problems of confidence, liquidity, and adjustment, while very useful for analyzing the working of the international monetary system, has misled policymakers into thinking that the three problems were of roughly equal importance and could be successfully solved one at a time.

The liquidity problem was chosen first, perhaps largely because the chances of reaching international agreement in that area looked most promising.²³ To be sure, the connection between liquidity and adjustment has not gone unnoticed. In fact, the amended Articles of Agreement of the IMF which contain the provisions for SDRs state the connection explicitly: "The attainment of a better balance of payments equilibrium, as well as the likelihood of a better working of the adjustment mechanism" are mentioned as conditions to be taken "into account" when the first decision is made to allocate SDRs.²⁴ The first decision to allocate SDRs was taken in 1969. Although things were quiet on the dollar front in that year, it is not easy to understand what evidence justified the required "collective judgment" that the adjustment mechanism was likely to "work better" in the future. Nor do the events since that year give much ground for optimism.

But be that as it may, now we have the activated SDRs. The intellectual resources which went into their creation cannot be retrieved and diverted. Why cry over spilt milk?

Unfortunately there is a danger that some of the opportunity cost of SDRs creation will continue in the future. The management of the SDRs may not become routine for some time and may continue to absorb much expert work. Furthermore, the "link" between SDRs and development assistance which is being pushed energetically by less developed countries, by international organizations and by many influential academic and official spokesmen in the industrial countries is likely to complicate things further. Under the proposed "link" scheme, a fraction of the SDRs which are allocated to the developed countries would be ceded, via some of the international lending institutions (such as the International Development Association), to less developed countries and the industrial countries would have to "buy" them back from those countries in exchange for real resources. If such a plan were adopted, there would be continuous pressure exerted by the less developed countries and the various international institutions which specialize in development assistance to increase the portion of SDRs that is channelled through the "link." Pressure from one side will inevitably induce counter pressure from the other. An inkling of what may be in store was provided by the report²⁵ that a movement was under way to organize the less developed countries in the International Monetary Fund for the purpose of voting against any reform of the Fund's Articles of Agreement, such as the various proposals to introduce greater flexibility of exchange rates, unless such a reform is coupled with the "link." It should be kept in mind that certain changes in the Articles of Agreement can be effectively blocked by 16 percent of the voting power in the IMF.²⁶

The recently published IMF study, *The Role of Exchange Rates in the Adjustment of International Payments*,²⁷ is evidence that official attention has finally turned in the direction of adjustment—although belatedly and, as far as flexibility of exchange rates is concerned, grudgingly and hesitatingly.

A brief analysis of some implications of the present system, under a regime of rigidly fixed exchange rates, with or without further large SDR allocations, will show how important it is that progress is made soon in introducing some flexibility into the exchange rate structure.

Some Implications for the Present International Monetary System of Fixed Exchange Rates

A very important consequence of the present system of fixed exchanges with the dollar at its center is that the rate of inflation in all countries that peg their currency to the dollar is approximately determined by the rate of inflation in the U.S. Any

country that keeps its currency fully convertible into dollars at a fixed exchange rate will, in the medium and long run, be forced to have approximately the same degree of inflation as the U.S., whatever it is—positive, negative, or zero. This proposition is not generally understood and, if expressed bluntly, will be rejected by many. It is nevertheless a fairly obvious consequence of well-known facts, requiring only few qualifications which detract little from its importance.

Let us explain carefully what it means and what it does not mean. Any country is, of course, free to inflate more than the U.S. and many make use of this license. But any country inflating much more than the U.S. will be forced to devalue its currency. There are three qualifications: First, by accumulating and “sterilizing” dollar balances, a country can slightly postpone or slow down the required price adjustment. But, like any policy that goes against the grain of economic equilibrium, it is a costly struggle and likely to be progressively hampered by speculation. The second qualification is a spurious one: Up to a point a country can use controls (import restrictions, export subsidies, et cetera) to avoid depreciation. But, as is well known, such controls are just a devaluation in disguise, and a wasteful and inefficient disguise at that. The greater the price disparity and the resulting disequilibrium, the more stringent the required controls. Experience has shown a hundred times that the wastes and inefficiencies soon become intolerable, so that open devaluation has to be substituted for the disguise.

The third qualification is that if the degree of inflation is measured by the cost-of-living index (or some other broadly based index, such as the GNP deflator), there need not be perfect parallelism in the movement of these indices in different countries. As mentioned earlier, it sometimes happens that a country's export prices deviate significantly from its general price level, and these deviations may be in opposite direction in different countries. For example, in the U.S., export prices have often risen somewhat faster than the general price level while in Japan the opposite has been the case.²⁸ This has enabled Japan to have a little more inflation than the U.S. has and still enjoy a balance-of-payments surplus.

It is, however, true that large and persistent deviations in price levels are impossible with fixed exchanges and convertible currencies because, under modern conditions, there are innumerable actual and potential export and import commodities which serve to hold the discrepancies in price levels between countries to moderate proportions in the medium and long run.

Countries that wish to inflate less than the U.S. will develop a balance-of-payments surplus and will see their price levels rise unless they prefer to let their currencies appreciate. Again the three qualifications mentioned above apply, with the difference that the controls serving as a substitute for the appreciation of the currency will have to be negative, i.e., import-stimulating and export-restricting. And as we pointed out earlier, negative controls are not popular.

It will be asked why the price connection should be asymmetrical. We said inflation in the U.S. determines the pace of inflation abroad. Is there no causal force running in the opposite direction?

The answer is that the relationship is indeed asymmetrical. This follows from the special position of the dollar, from the fact that U.S. internal monetary and fiscal policies which determine the rate of inflation in the U.S. have become almost completely independent of the state of the balance of payments, and from the fact that the feedback from the deficit or surplus in the balance of payments to the U.S. economy is negligible because of the small size of U.S. exports and imports relative to the volume of GNP. As explained earlier, if there were an appreciable feedback—for example, if a balance-of-payments deficit becomes a serious drag on the economy—monetary and fiscal policy, geared as it is to domestic policy objectives, would counteract it.

Earlier we recommended that in case of a conflict in the requirements for monetary and fiscal policy between internal and external equilibrium, domestic policy objectives should take precedence over balance-of-payments requirements. In other words the U.S. should pursue a passive balance-of-payments policy, a policy of “benign neglect” of the balance of payments. (Let it be repeated that “neglect” of the balance of payments does in no way imply neglect to U.S. interests or of the interests of our trading partners.) Now we state it as a fact that such a passive policy is actually being pursued. We believe that this is a correct description of the present situation whereas it would not have described the situation ten years ago. Gradually during the 1960s, the grip of the balance of payments on monetary and fiscal policy has been loosened and by now it is practically gone. Concern with the balance of payments is still there but it expresses itself rather in terms of the policy of controls, primarily capital export controls. First controls were introduced and tightened, and now there is reluctance to loosen and abolish them although some clearly have become redundant.

Foreign Reactions

When we speak of foreign reactions we mean largely European reaction and reactions of only a very few countries. To repeat, there are only very few countries in the world that do not match or surpass U.S. inflation spontaneously—Germany, Switzerland, perhaps the Netherlands. France has, of course, been in the forefront of the complainers about the U.S. forcing inflation on others—in between her own frequent devaluations.²⁹

What the European critics have been complaining of is that the U.S. is not subject to balance-of-payments discipline. That is, of course, precisely correct. (As mentioned above, it was not quite true earlier.) It is a variation of the same theme when

they complain that the U.S. uses its de facto exemption from balance-of-payments constraint, or alternatively the special position of the dollar, to finance direct investments abroad ("take over European companies"), for direct investment flows are a component of the capital account of the balance of payments.

If foreign countries do not like U.S. direct investment, although it serves to close any "technological gap" (that may exist), they can restrict such investment without difficulty. In most countries foreign investment and takeovers are subject to government approval anyway. But the decision on this matter should not be made on balance-of-payments grounds. The U.S. would be well advised to leave this decision to the foreign countries. In fact, however, it has chosen to do much of the unpleasant work for them.

It is time for European as well as American policymakers to face up to the facts. Under fixed exchanges, foreign surplus countries have no choice but to share in the U.S. inflation (or to liberalize trade or impose negative controls unilaterally, both of which amount to a disguised appreciation of the currency). In the very short run they may avoid, or rather postpone, going along with U.S. inflation by accumulating dollars.

What else could they do? In the past they could signal their displeasure by converting dollars into gold. Except for small amounts this is now de facto barred.³⁰ Some proponents of fixed exchanges fully recognize these implications. Thus Professor Kindleberger has proposed to make them more palatable by placing European or other foreign representatives on the U.S. Federal Reserve Open Market Committee. In other words, he has proposed that U.S. monetary policy should be conducted jointly by all countries that have to share in its consequences. It is not necessary to add that this proposal is not likely to be accepted by U.S. policymakers.

Outlook for the Future

What is the outlook for the future of the dollar exchange standard, still assuming that the system of fixed exchanges is to be maintained? (Highly inflationary countries cannot, of course, maintain fixed exchanges.)

Until recently, inflation in the U.S. has been moderate compared to inflation in other industrial countries, and it surely will remain so by the standards of most less developed countries. If this is the case, the chances are that most surplus countries will grow accustomed to slightly more inflation without much fuss. (The Japanese seem to have made a more or less conscious choice to accept more inflation rather than to appreciate the yen or to sufficiently liberalize trade.) Of course, there will probably always be one or two countries which are really willing and able to have less inflation (or which, through some quirk in international demand, are able to develop a surplus while having more inflation than the U.S.). Such countries will

accumulate dollars and will have to make up their minds whether they should or should not let their currency appreciate.

If inflation in the U.S. is less moderate, there will be more dissatisfied surplus countries. There will be complaint and criticism about U.S. policy but the options of the surplus countries—inflation, appreciation (open or disguised), reduction of trade barriers—remain the same. The real danger is that either the surplus countries may adopt negative controls or the U.S. positive controls (tightening of the existing ones). But once the U.S. understands that nobody can force it either to adopt controls or to create more unemployment and slack than it thinks is necessary to achieve the domestic objective of curbing inflation, it will continue its passive balance-of-payments policy and leave it to the others to choose among their options.

But, some will ask, can the dollar not be dethroned from its special position, perhaps by the creation of an attractive substitute in the form of a European or Common Market currency? Would that not be a serious matter for the U.S.? Monetary integration with the declared ultimate goal of a common currency and a unified monetary management (a Federal Reserve System for Europe) has indeed been the subject of intense official investigation and negotiations in the European Economic Community (EEC). According to present plans, it will take ten years to approach the goal. And it may take even longer, especially if Great Britain joins EEC.³¹

Let us assume, however, that a common European currency in a meaningful sense comes into being. Can it replace the dollar as an official international reserve medium or private transactions currency? It will take a long time before we come to that bridge, but let us assume the goal of monetary unification is reached. A unified Europe, by pooling its members' international reserves, could certainly manage with a smaller dollar reserve, and third countries might want to hold part of their reserve in the European currency. But even if this should happen, Europe could not get rid of its dollars without letting the European currency appreciate. For reasons mentioned earlier, the chances are that European countries would think twice before taking that step. But even if they took it, perhaps because the U.S. had too much inflation in which they did not wish to participate, such a step would stimulate U.S. exports, reduce its imports. This would indeed be a burden (transfer of real resources) and would mean an increase in inflationary pressure. Repaying debt is always a burden. Quantitatively the burden would be negligible because the U.S. deficit, even at its worst, is a tiny fraction of GNP.³²

It is indeed mentioned as one of the advantages and purposes of a common European currency that it then would be easier to depreciate the dollar by appreciating a single European currency. This may be so, but it is also possible or perhaps probable that six governments acting in concert would be even more reluctant to change the status quo than any one of its constituents now is.³³

But these speculations and worries are largely idle and superfluous, especially from the American standpoint. They divert attention from more pressing dangers. The greatest danger in the area of international monetary relations is that deficit countries, the U.S. as well as others, will resort to controls and will restrict trade, payments, travel, and capital flows, instead of changing their exchange rate. The corresponding danger in the case of surplus countries is less acute, because countries are reluctant to use negative (i.e., import-stimulating and export-discouraging) controls. But appreciation of one's currency is even less popular than depreciation.

It is now almost universally accepted, even by those who are against any general limited or unlimited flexibility of exchange rates, that more frequent use should be made of the possibility under the IMF charter to change exchange rates in case of fundamental disequilibrium. This proposition will be examined more carefully in the following section. Here we only note that it implicitly acknowledges the acute danger of controls. Needless to add that deflation and unemployment would be equally or more destructive. There is, however, this difference: Practically no country would accept *serious* unemployment. The propensity to control is everywhere in the world much stronger than the propensity to deflate.

This brings us, finally, to the question of exchange rate flexibility.

U.S. Interest in Exchange Rate Flexibility

It is an implication of our analysis that the U.S. has less direct interest in exchange rate flexibility than other Western countries, because the U.S. cannot, under present arrangements, let the dollar float or change its exchange value, and because in the U.S., foreign trade is a much smaller fraction of GNP than that in any other Western country. The U.S. interest in flexibility is indirect and derives from the fact that greater flexibility is of great importance for our trading partners and for the international monetary system as a whole. U.S. interest in exchange flexibility is indirect and derived but real nonetheless.

This is not the place to review in detail the whole problem of fixed vs. flexible exchange rates in the abstract.¹⁴ The practical problem is not, of course, whether the existing par value system of fixed exchange rates subject to occasional adjustments, as set up by the Bretton Woods Charter, should be replaced by a system of general flexibility under which every currency in the world would fluctuate freely in terms of every other. No such radical change is feasible, nor is it necessary to achieve a better working of the adjustment mechanism. The elements of a much more modest, although in our opinion potentially quite effective, reform may be sketched as follows: Every country that feels aggrieved because the present system, based on the dollar, imposes on it too much inflation or the opposite should be allowed to let its currency float, or to widen its band of permissible deviations of the exchange rate

from the par value or to adopt a crawling peg. Persistent deficit countries should be encouraged to pursue a policy of exchange rate flexibility, rather than dissuaded from doing so. The problem of persistent surplus countries is easier to deal with. Probably no more is needed than to make it clear to them what their options are—accumulation of reserves, monetary expansion, appreciation³⁵ or floating of the currency, or reduction of trade barriers. There can hardly be a doubt that these are, in fact, the only practical choices and that any one of them, or any combination, should be acceptable to the U.S. and other countries.

Some people may ask—are countries not more or less free now to react in any of the ways described? Unfortunately this is not the case. They can inflate or liberalize trade but the sticking point is exchange flexibility.

It is true that as far as highly inflationary less developed countries are concerned, the IMF does not object to exchange rate flexibility. It probably encourages countries such as Brazil or Chile to make frequent changes in exchange rates. In recent years, some of them—Brazil, Chile, and others—have developed a system of flexibility which may be described as the system of “the trotting peg.” Under this arrangement, the currency is depreciated at short intervals by small steps. For example, in Brazil the value of the cruzeiro is reduced by something between 1.8 percent to 1.3 percent every four or five weeks. The trotting peg has been a great improvement over the earlier system of the adjustable peg under which these countries waited six months or longer and then devalued with a bang by a large amount.³⁶

The reason why the International Monetary Fund has acquiesced in those cases is, no doubt, that under rapid inflation the adjustable peg system, let alone fixed exchanges, soon leads to intolerable consequences.

In the case of the industrial countries where the disadvantages of the present system are not so pronounced, the attitude of the IMF has been much less tolerant. This was clearly revealed in the case of Canada in May 1970 when Canada returned to a floating exchange rate. The move has not hurt anybody and was a great help in Canada’s internal management (fight against inflation). Nevertheless, Canada was sternly rebuked for abandoning the adjustable peg and is under constant pressure to restabilize.

The above mentioned IMF report on *The Role of Exchange Rates in the Adjustment of International Payments* evidently reflects the thinking of the fund’s executive directors at the present time. The report offers a subtle, closely reasoned and well documented analysis of all aspects of exchange rate changes. It is technically of high caliber, as one would expect from a first-rate staff and a prestigious board of directors. But as policy statement which is supposed to show the way, if not to bold new ventures, then at least to new solutions of old problems which have not responded well to traditional treatment, the report has surprisingly academic flavor.

One tends to agree with the conclusion of a thoughtful and penetrating analysis³⁷ that the report "is on the whole a disappointing document. It suggests no real breakthrough in the direction of a genuine adjustment mechanism based on greater flexibility of exchange rates." The report is largely a defense of the existing par value system and of the adjustable peg, although it freely admits that damage is often done because countries unduly delay exchange rate adjustments beyond the time when it should be clear that a fundamental disequilibrium exists.

The report rejects outright three proposals for greater flexibility: a system of freely fluctuating exchange rates, a substantial widening of the band for permissible exchange rate fluctuations, and the various suggestions to effect parity changes frequently and automatically according to some objective indicators (the crawling peg proposals). Instead of these, it favors a slight widening of the margin of permissible fluctuations. As George Halm points out, it is somewhat surprising, in view of the rejections of any crawling peg, that the report seriously considers the seemingly more radical suggestion that "the Articles of Agreement might be amended to allow members to make changes in their parities without the concurrence of the Fund as long as such changes did not exceed say, 3 percent in any twelve month period nor a cumulation amount of say, 10 percent in any five-year period."³⁸

The main thrust of the report is that the par value system may well work quite satisfactorily if countries could be persuaded to make more frequent and prompt use of the provision of the original charter to change their exchange rate in case of "fundamental disequilibrium." But the report does not give much guidance and help to the governments which are admonished to make "prompt adjustment of parities in appropriate cases." Continuing the earlier practice of the IMF, the report refuses to give a clear-cut definition of what is a fundamental disequilibrium, and substitutes for it a long and involved description of various factors and circumstances that should be taken into consideration when a determination is made whether an existing disequilibrium, presumably a balance-of-payments deficit or surplus,³⁹ is to be considered fundamental or not.

We submit that the greatest weakness of the report is that it does not sufficiently consider the main drawback of the adjustable peg system—that is, comparatively large parity changes at fairly long intervals induce highly disturbing capital flows. Compared with a system of truly fixed rates, as under the old gold standard on the one side, and a crawling or trotting peg on the other side, the adjustable peg system maximizes destabilizing speculation.

To be sure, recent experience with the trotting peg and also with the brief period of managed flexibility of the German mark prior to its formal appreciation in October 1969 suggests that it is not necessary to go all the way to a system of completely unmanaged, freely floating rates in order to reduce or practically

eliminate speculation. This gives rise to an important problem. For anyone who rejects as the IMF report does both continuous flexibility, either of the unlimited or crawling variety, and complete rigidity, the crucial question is this: Where does the adjustable peg end and where does flexibility, sufficient to eliminate dangerous speculation, begin? Suppose we arrange alternative changes in exchange rates (depreciations and appreciations) in such an order that the size of the change becomes smaller and the interval between changes shorter. There will then be a threshold value (or threshold zone) somewhere on the scale beyond which speculation ceases to be a problem. It would be extremely important to have an idea approximately where this threshold lies. The report is silent on this central question. There is internal evidence, however, that the authors, when they speak of "prompt parity changes in appropriate circumstances" and warn of undue delays, were thinking of intervals of, let us say, substantially more than a year.

In our opinion, rather more frequent but still fairly large changes in exchange rates⁴⁰ would not offer any substantial relief from the problem of large speculative capital movements and might even exacerbate them because of the smaller likelihood of "fixity illusion" (analogous to "money illusion") which has at times been present under the adjustable peg. At just what point a more promptly adjusted adjustable peg would become in effect a discretionary crawling peg it is difficult to say. But in order to produce substantial reduction in speculative pressures resulting from the "one way option" of the adjustable peg, adjustments much more frequently than every couple of years would be needed.⁴¹

The point has been made many times that disregarding highly inflationary countries, over the years the structure of exchange rates under the Bretton Woods system has become much more rigid than the founding fathers had anticipated. In our opinion this is not due to faulty or negligent management of the system, but is the consequence of the fact or suspicion, well founded in our opinion, that too frequent changes reduce the stability of the adjustable peg system.

These remarks do not pretend to give the full answer to the question posed above of where the adjustable peg ends and managed flexibility begins. But they indicate the type of problem that faces those who reject anything approaching full flexibility but recommend more frequent and "prompt adjustments in appropriate cases" than there were in the past. To repeat, the report is silent on this crucial matter.

We can be confident, however, that the report will not remain the IMF's last word on exchange flexibility. It is a milestone in a continuing process of reappraisal of the basic assumptions of the Bretton Wood system. Let us hope that in due course the crucial issue mentioned above will be faced squarely. This would force a reconsideration of some of the positions taken in the present report. A good deal of new evidence from recent experience in various parts of the world has become available and it sheds light on the question we have emphasized. No organization is in a better position to assemble and interpret the relevant facts than the IMF.

Summary and Concluding Remarks

We have argued that of the three areas of international monetary reform—confidence, liquidity, adjustment—the last mentioned is by far the most important and pressing. Problems having to do with confidence are taken care of by the close cooperation of the world's major central banks that has developed and deepened in the postwar period. The problem of liquidity has probably been brought under definite control by the creation of the SDR scheme. The task of improving the balance-of-payments adjustment mechanism remains to be accomplished.

The SDR agreement recognized the paramount importance of the adjustment problem by stipulating that, before the first decision is made to allocate SDRs, "a collective judgment" be reached to the effect that there is a good chance of "a better working of the adjustment mechanism." The first decision to allocate SDRs was made in 1969 and allocations were made on January 1, 1970 and January 1, 1971. Whether adjustment mechanism will in fact work better in the future is still very much in doubt.

The attention of the policymakers in the international monetary area has shifted to the problems of adjustment. The comprehensive IMF report, *The Role of Exchange Rates in the Adjustment of International Payments*, testifies to that shift. In our opinion, the report does not go nearly far enough in the direction of proposing new methods of adjustment through greater flexibility of exchange rates. But at least it is a beginning and it will surely not remain the IMF's last word on that important subject.

The practical problem is not to replace the par value system with a system of generalized flexibility of all currencies. Such a radical change is not only not feasible but also unnecessary to assure a better working of the adjustment mechanism. We presented the elements of a modest scheme, which in our view would be a major step forward.

We have emphasized that the American interest in greater flexibility of exchange rates is indirect, because the U.S. cannot, under present arrangements, change the value of the dollar. But nevertheless it is quite real, because the U.S. shares fully in the world interest in the smooth working of the international monetary system. The U.S. should do all it can to promote changes in the rules that will make it easier for other countries to use exchange flexibility to solve their problems—deficit countries to avoid trade restricting controls and unnecessary unemployment, surplus countries to avoid unwanted inflation and "negative" controls. By solving their own balance-of-payments problems, our trading partners also solve ours.

The special position of the dollar and the small size of U.S. foreign trade in relation to GNP makes it possible for the U.S. to continue its "passive" balance-of-payments policy, even if it takes some time and perhaps another major exchange crisis before

anything decisive is done to improve the adjustment mechanism. If the U.S. is able to reduce the rate of inflation to an internally tolerable level, there will probably be very little trouble on the dollar front. But even if it is not so successful with the fight against inflation, the passive balance-of-payments policy should be continued, although in that case policymakers would have to brace themselves for continuing grumbling and criticism. But the basic strength of the dollar is such that, barring really bad inflation or any other unforeseen catastrophe, U.S. policymakers can afford to stand firm and not to change the passive stance of balance-of-payments policy in the face of foreign criticism. The U.S. should realize that nobody can force it either to impose controls or to suffer more unemployment than is needed, in its own judgment, to curb inflation.

U.S. policy should concentrate on promoting domestic economic stability, employment and growth, and should remove rather than continue to tighten barriers to international trade and capital flows. Since 1969 substantial progress has been made in the untying of foreign aid. Much less progress has been made, however, in the area of relaxing and gradually phasing out controls on capital exports. We do not wish to minimize the importance of having at least ended and even reversed a little, the trend which started early in the 1960s of ever increasing use of first voluntary and then mandatory controls and other selective measures designed to "improve" components of the U.S. balance of payments. This change in tendency is an important step forward. But residual fears concerning the U.S. balance of payments have substantially slowed the process of dismantling these measures of the 1960s. There must be considerable doubt about the continued effectiveness of capital controls in terms of improving the balance of payments. Experience has shown many times that controls, unless they become redundant, have a tendency to spring leaks as time goes on and have to be continuously tightened if their effectiveness is to be maintained. But even more important, balance-of-payments improvement via the use of controls is not an appropriate objective for a country occupying the United States' unique position in the world economy.

The removal of the remaining controls in the face of a measured U.S. deficit would be a courageous act, for it would cut against conventional wisdom that is still widespread both at home and abroad. But the benefits of final, full recognition of the United States' position in the international monetary system would be enormous.

Postscript

This paper was written late in 1970 and early 1971, eight months before the gold convertibility of the dollar was terminated (August 15, 1971), and long before floating exchange rates were reluctantly accepted by policy makers. For a brief account how floating originated, see "The International Monetary System in the

World Recession.” [Chapter 11 in this volume] The 1971 paper took it as a fact that floating had no chance to be accepted and it argued that the world was practically on a dollar standard. That implied that the United States could not unilaterally depreciate the dollar or let it float because most other countries would have followed suit. On the other hand, the equilibrium was precarious, because the U.S. gold stock had declined while U.S. liabilities to foreign central banks had sharply increased, and inflation in the United States was high by the standards of the time, although quite low by present standards.

Under these circumstances the paper recommended for the United States a “passive approach” to the balance of payments problem—a “policy of benign neglect.” This was defined to mean that U.S. macropolicy should be guided exclusively by domestic policy objectives—curbing inflation and preventing unemployment from going higher than was necessary to curb inflation. It should be left to other countries to bring about a change in the exchange value of the dollar or to introduce floating, by changing the dollar parity of *their* currencies, or be letting their currencies float in the market.

The policy of benign neglect received much attention and criticism in the United States and abroad; it was often misunderstood by critics and interpreted to mean that the dangers of inflation should be ignored, despite the fact that the authors emphatically stated that in their opinion U.S. inflation must be curbed.

Another criticism was that the U.S. policy of benign neglect was a selfish, nationalistic policy. This criticism overlooked the fact that our paper gives foreign countries a wide range of options. A country that developed a balance of payments surplus because its inflation rate was lower than the American rate had three options: internal expansion, appreciation of its currency, or letting its currency float. It was suggested that each of these courses should be acceptable to the United States.⁴² Thus they should not lead to any serious economic conflict. This appraisal has been confirmed, we believe, by the responses to the subsequent gold convertibility of the dollar. (August 15, 1971.)

Notes

1. Section 5 (b) of the act of October 6, 1917. For details of balance-of-payments developments and policies until 1968 see *U.S. Balance of Payments Policies and International Monetary Reforms: A Critical Analysis*, by Gottfried Haberler and Thomas D. Willett (Washington: American Enterprise Institute, 1968).

2. The official balance-of-payments statistics compiled by the Department of Commerce presents two alternative measures of deficit and surplus, the “liquidity” concept and the “official transactions” or “official settlement” concept. The liquidity concept is defined as “changes in liquid liabilities to foreign official holders, other foreign holders, and changes in official reserve assets consisting of gold, Special Drawing Rights, convertible currencies, and the U.S. gold tranche position in the IMF.” The official settlement concept is defined as

"changes in liquid and nonliquid liabilities to foreign official holders and changes in official reserve assets consisting of gold, Special Drawing Rights, convertible currencies, and the U.S. gold tranche position in the IMF." The official settlement definition was proposed in 1965 by a committee under the chairmanship of E. M. Bernstein. Figures for the official settlement balance are available from 1960. In earlier years, the liquidity measure was generally used.

The major difference between the two definitions is that the liquidity concept takes into account the change in U.S. liquid liabilities to all foreigners, while the official transactions or official settlement concept considers only changes in U.S. liquid liabilities to foreign official agencies.

In its recently published annual report for 1970, the Council of Economic Advisers adds two additional measures for gauging the position of the balance of payments: the "Balance on Current Accounts" and the "Balance on Current and Long-Term Capital Accounts." The latter is often called the "basic balance" and was used by the Department of Commerce until it was replaced by the liquidity definition.

3. For recent discussions, see Charles P. Kindleberger, "Measuring Equilibrium in the Balance of Payments," *Journal of Political Economy*, November-December 1969; Raymond F. Mikesell, *The U.S. Balance of Payments and the International Role of the Dollar* (Washington: American Enterprise Institute, 1970); and Thomas D. Willett, "Measuring the U.S. Balance of Payments Position," Harvard Institute of Economic Research, Discussion Paper, 1971.

4. In recent years the U.S. too has engaged in foreign exchange transactions and holds a fraction of its international reserves in the form of "convertible currencies" (\$0.8 billion compared with a gold stock of \$11.5 billion as of October 1970).

5. To the gold stock could be added U.S. holdings of convertible currencies, its reserve position in the IMF and its Special Drawing Rights. As of October 1970, "total reserve assets" were \$15.12 billion. Further adjustment in figures of liquid assets and liabilities could be made, but the overall position and conclusions would not be changed by such refinements.

6. All figures are taken from the *Federal Reserve Bulletin*. Stock figures relate to the end of the period mentioned.

7. For a theoretical analysis of the stability problem, see Lawrence H. Officer and Thomas D. Willett, "Reserve-Asset Preferences and the Confidence Problem," *The Quarterly Journal of Economics*, November 1969; and the same authors, "The Interaction of Adjustment and Gold Conversion Policies in a Reserve Currency System," *Western Economic Journal*, March 1970. They show that the system never was so unstable as the pessimists say.

8. "Elements of Stability and Instability in the Monetary Field," remarks made on May 18, 1970, at the Monetary Conference of the American Bankers Association, Hot Springs, Virginia (mimeographed).

9. Other countries would still have a liquidity problem unless the U.S. reciprocated and accepted foreign balances as part of its international reserve. U.S. officials have indicated they would be willing to follow such a practice, at least to some extent, in case the U.S. should run a persistent surplus.

10. It is not necessary for our purposes to discuss the controversial question of whether the adoption of an incomes policy would do any good. If it were possible by means of an incomes policy to improve the inflationary situation marginally—more than that is not expected, even by the policy's supporters—the effect on the balance of payments too would be only marginal.

11. How much unemployment constitutes a recession and how much price stability should be traded for how much unemployment, if there is such a trade-off, is a question on which views may differ, both inside the U.S. and between the U.S. and foreign countries.

12. It is not unimportant to observe that three or four years ago this situation was well understood by only a few.

13. Admittedly, many countries complain that they have to "import inflation" from the U.S. But when the chips are down, the foreign critics are extremely reluctant to accept the logical implication of their complaints, that is, to let their currency appreciate. There have been only three cases of currency appreciation in the whole postwar period (Germany in 1963 and 1969 and the Netherlands in 1963). But there were literally dozens of depreciations against the dollar.

Complaint about imported inflation combined with a refusal to appreciate amounts to wanting to have one's cake and eat it too. However, the situation would probably change if the inflation in the U.S. got out of hand. More on this later.

14. It could be argued that the outcome of a change in the gold value of the dollar would be different if it were the result of international negotiations rather than of a surprise decision by the U.S. government. In the former case, it might be said, more countries would be willing *not* to follow the American example and accept an appreciation of their currency.

This may be so, but it is extremely doubtful that an internationally agreed realignment of many exchange rates is feasible. Negotiations could not be kept entirely secret and would thus give rise to very disturbing speculation.

15. Arguments like this abound in the popular discussions, but it is not easy to find clear formulations. One of the rare, explicit and straightforward statements is contained in a letter to the *New York Times*, October 18, 1970, by Professor Manuel Gottlieb.

We quote: "Many economists . . . would agree that present exchange rates significantly overvalue the dollar, especially when allowance is made for American capital outflow and governmental transfers. . . . The proper remedy for an overvalued exchange rate is exchange-rate adjustment ('Devaluation') and not import restrictions. . . . Under present institutional arrangements, our exchange rates can only be changed by decisions of our trading competitors who choose to 'revalue' ('Appreciate') their currencies or to let their currencies 'float.' I cannot watch the gradual liquidation of American industrial potential on the vain hope that foreign monetary authorities will be sensitive to our needs and capacities and will establish exchange rates that would permit competitive terms of trade at full employment. . . . Rather than that, I go for the 'quota' bill with all of its imperfections."

16. Especially if it is "gradual." It goes without saying that not every fall in exports or rise in imports or change in the trade balance has something to do with the balance of payments. For example, from 1964 to 1969, the trade balance fell from \$6.8 billion to \$0.7 billion and unemployment did not go up but down—from 5.2 percent to 3.5 percent of the labor force.

It would be very difficult indeed to measure the amount of unemployment or slack (lost output) that is attributable to changes in the balance of payments or balance of trade. Fortunately, policymakers need no such measure to determine the thrust of monetary and fiscal policy that the situation requires.

17. If there are surplus countries that have *more* inflation than the U.S., it does not affect our argument. A country with more inflation than the U.S. may have a surplus either because it has recently devalued its currency or because its exports are low-priced (compared with its

general price level) or otherwise are in strong demand. France, after her devaluations in 1958 and 1969, illustrates the first possibility, Japan the second.

18. Those economists who recommend a rise in the gold price in order to increase international liquidity rightly speak of doubling or tripling the price of gold. A small rise of 10 percent or so would do no good.

19. It should be observed that what we call "negative" controls (export restrictions and import subsidies imposed by surplus countries) are just as inefficient, wasteful, and undesirable as the ordinary controls imposed by deficit countries. Removal of existing trade barriers is, of course, a different matter. It is desirable, although it too can be regarded as a currency appreciation in disguise.

20. Surplus countries, such as Germany and Switzerland, have tried tax measures and the prohibition of interest payments on bank deposits of foreigners to reduce short-term capital inflow without much success in the longer run.

21. An objection to our argument might be that they could simply refuse to add to their dollar holdings without trying to reduce their balances. But that does not change the situation. If they refuse to buy dollars which are offered for sale, their currency will appreciate in terms of dollars (and in terms of all currencies that still are pegged to the dollar).

22. It has been suggested that the first reaction of the surplus countries would be to block further allocations of SDRs, and French officials who were reluctant to go along with the SDR creation in the first place have already voiced their opposition to further SDR allocations so long as the U.S. deficit is large. This may be a disappointment for other countries. However, for the U.S., the threat is hollow. If our assessment of the general position of the dollar is correct, it would simply mean that official dollar balances abroad would accumulate faster. It would in no way change the four options available to the surplus countries—accumulate dollars, inflate, appreciate, or reduce trade barriers.

23. The "confidence problem" (i.e., the problems that arise when confidence in a currency is lost and a run on the currency develops) would seem to be of decidedly lesser importance in the future. Any such crisis has to be dealt with on an *ad hoc* basis. But experience has shown that the close cooperation that has developed between the monetary authorities of the major countries and that has deepened in the postwar period is capable of handling confidence crises even when they involve major currencies.

24. Article XXIV, Section 1 (b).

25. The *New York Times*, September 29, 1970, and *The Economist*, September 26, 1970.

26. See Gottfried Haberler, "The Case Against the Link," *Quarterly Review*, Banca Nazionale del Lavoro, Rome, March 1971.

27. A report by the executive directors of the International Monetary Fund, Washington, D.C., 1970.

28. It is not necessary here to go into the reasons for these deviations.

29. It should be observed that the mere fact that the actual rise in the cost of living in a given country is equal to or a little higher than the rise in the U.S. does not prove by itself that the country in question spontaneously matches or surpasses the U.S. rate of inflation. It could be a case of induced inflation.

However, if prices in a country rise persistently and much faster than in the U.S., one gets the strong suspicion that it is not a case of induced inflation but one of spontaneous inflation. If

a country is forced from time to time to devalue against the dollar or to maintain controls, the suspicion is confirmed beyond doubt.

30. Even if the gold policy were changed, if other countries asked for conversion into gold of large parts of their dollar holdings and the U.S. were prepared to accede to that request, it would be unrealistic to assume that internal monetary and fiscal policies in the U.S. would be changed thereby. It follows that such a change in the gold policy would not relieve other countries from the necessity to follow the U.S. inflation, so long as they maintained full convertibility of their currencies into dollars at a fixed exchange rate.

31. It is now better understood than it was a few years ago that monetary integration and the creation of a common currency presuppose far-reaching harmonization and coordination of not only monetary but also fiscal, wage, and incomes policies. The EEC countries are still far from that stage. See Gottfried Haberler. "Reflections on the Economics of International Monetary Integration" (forthcoming) [*Verstehen und Gestalten der Wirtschaft*, J. C. B. Mohr (Paul Siebeck), Tübingen, 1971, pp. 269–278] and the literature quoted there, especially Wolfgang Kasper and Michael Stahl. "Integration Through Monetary Union—A Skeptical View," *Kieler Diskussionsbeiträge*, Nr. 7, Kiel, September 1970.

32. It should be observed, assuming as we do that monetary, fiscal, and other macro-economic policies in the U.S. are solely determined by domestic policy objectives, that the relevant comparison is with GNP. If, on the contrary, the U.S. allowed the balance-of-payments deficit to influence overall economic policies, as was the case in the early sixties, the burden could become much larger than suggested by the GNP percentage.

33. It is sometimes said that, at present, it is difficult for any single European government to appreciate its currency vis-à-vis the dollar because it would at the same time have to appreciate also vis-à-vis the other European currencies. This is, however, hardly the case—as if, say, the DM were overvalued only in respect to the dollar, and not equally or perhaps more so vis-à-vis some European currencies!

34. The authors have expressed their views in Haberler and Willett, *op. cit.* See also Gottfried Haberler, *Money in the International Economy*, 2d edition (Cambridge: Harvard University Press, May 1969).

35. In the case of appreciation of a surplus country's currency, as in the case of depreciation of a deficit country's currency, a flexible approach to the change in the exchange rate is much to be preferred to the rigid, disruptive method of the adjustable peg. Instead of waiting until a huge surplus has been built up under the accompaniment of mounting speculation and then appreciating by a large amount with a bang, it is better to let the currency float up gradually. This was dramatically demonstrated by the German appreciation in September/October 1969. Let us recall the salient events. The appreciation had become an election issue. Before the election, billions of dollars had flowed into Germany. On September 24, four days before the election, the exchange market was closed. On Monday, September 29, the day after the election, the market was reopened with the exchange rate unchanged. In a few hours, huge sums poured into Germany. The market was closed again and the decision was reached to let the mark float. The next morning, Tuesday, September 30, when the market was reopened once again, the exchange value of the mark shot up and—lo and behold—the speculation had practically vanished. It simply became too risky to speculate. Even more interesting, the speculation was not revived, at least not on a substantial scale, a little later when a more or less open debate was conducted in the press on whether the mark should be restabilized at the level of 6, 8, or 10 percent above the former parity.

It is true, in many respects, that the German appreciation was a unique case. To make the appreciation of a currency an election issue is a helluva way to change an exchange rate. But the fact that some flexibility—although it was managed (with flexibility in the direction though not the magnitude of the impending change in the rate predetermined)—was sufficient to stop speculation in its track teaches a lesson of great general importance.

36. The Brazilian system is well described and analyzed in J. B. Donges, "Neue Wege in der Wechselkurspolitik der Entwicklungslaender?—Brasiliens 'Trotting Peg,'" *Kieler Diskussionsbeiträge*, Kiel, Nr. 8, Oktober 1970. An English translation of that pamphlet will be published by the American Enterprise Institute later in 1971 [*Brazil's Trotting Peg: A New Approach to Greater Exchange Rate Flexibility in Less Developed Countries*, AEI Special Analysis, No. 7].

Contrary to a widely held view, speculation has been no problem under the trotting peg, whereas it was a very disrupting feature of the earlier system of the adjustable peg. This teaches a lesson which is applicable also to the industrial countries: If speculative capital flows are no problem in the case of the trotting peg, it follows *a fortiori* that it would not be one under the more favorable conditions of the crawling peg or freely floating rates.

37. George N. Halm, *The International Monetary Fund and the Flexibility of Exchange Rates*, Princeton Essays in International Finance, 1971.

38. *Ibid.*, p. 73.

39. It is not quite clear whether the report regards an actual or anticipated balance-of-payments surplus or deficit as a necessary, though not sufficient, condition of fundamental disequilibrium. It certainly is not a sufficient condition. Maybe the report wishes to speak of fundamental disequilibrium only in dilemma cases when requirements of internal and external equilibrium conflict. If this is a correct interpretation, attention should be given to the strong possibility (a) that the diagnosis of whether a dilemma exists or not may not be easy at all and the views of the country and that of the IMF may well diverge and (b) that a dilemma case can change easily and without notice into a non-dilemma case, and vice-versa. (On these points, see Haberler, *Money in the International Economy*, *op. cit.*, pp. 14–18).

The balance-of-payments disequilibrium need not be "actual." Suppose a deficit is suppressed by controls or excessive unemployment. Then a policy of de-control or re-expansion would presumably bring about a deficit. Again the diagnosis and interpretation of a concrete situation is likely to be far from clear and unambiguous, especially in its quantitative aspects: How large a deficit is to be expected and how large a depreciation of the currency would be needed to take care of the deficit?

All this highlights the difficulties of operating a par value system with discrete changes in the par value in case of fundamental disequilibrium.

40. What is "large" has to be determined in reference to the possibility of forestalling speculation by high interest rates. For example, in Brazil it does not pay to speculate on an expected change in the exchange rate (precise date unknown) of 1 percent or 1.3 percent with interest rates running up to 40 percent.

41. For a detailed analysis of speculation under limited exchange rate flexibility, see Thomas D. Willett, Samuel Z. Katz, and William H. Branson, *Exchange-Rate System, Interest Rates, and Capital Flows*, Princeton Essays in International Finance, No. 78, January 1970.

42. For references to the literature, see Thomas D. Willett, *Floating Exchange Rates and Monetary Reform*, American Enterprise Institute, 1977.