The Future Exchange Rate Regime

Introduction

When the Bretton Woods system finally collapsed in March 1973, the explanation was not that the current structure of exchange rates was unrealistic: in fact it persisted largely unchanged for several months after the advent of widespread floating, and when it changed in the Summer of 1973 it was generally agreed that the changes were in large measure unjustified. Neither can the cause be found in the fact of a continuing payments deficit by the principal reserve-currency country: that deficit no doubt explained the abandonment of convertibility in August 1971, but it could hardly explain why the adjustable peg was found no longer acceptable some twenty months later. The explanation lies deeper than that, in the very nature of the exchange-rate regime itself.

The basic fact is that the mechanism for changing exchange rates that was legislated at Bretton Woods — the adjustable peg — is inherently incompatible with the degree of capital mobility that had developed by the late 1960s. The theory of portfolio equilibrium tells us that people who are free to do so will shift between assets on a massive scale when presented with the opportunity of a riskless gain from so doing, and this is precisely what the adjustable peg presents them with whenever the need for a significant exchange-rate change arises. Neither the exchange rate nor the interest rate can adjust immediately so as to neutralize the incentive to shift funds that is created by the expectation of a parity change. The exchange rate is in general not permitted to adjust immediately; and the interest rate cannot adjust sufficiently because anticipated discrete changes in the market exchange rate cannot be neutralized by finite

interest-rate differentials. Ergo, once capital mobility has developed, the system is bound to break down, as it finally did in March 1973.[1]

When the Committee of Twenty decided to rename the exchange-rate regime (calling it "stable but adjustable par values", instead of "the adjustable peg") rather than reform it, some two weeks after the system had collapsed, it immediately became clear that the ambitious attempt to write a new monetary constitution for the world had failed. It was of course conceivable that more might have been salvaged from the Committee's work than finally emerged, despite such bizarre incidents as the convening of a working group to study remedies for disequilibrating capital movements immediately after the Committee's affirmation of faith in the exchange-rate regime which is their necessary and sufficient condition, but a lasting reform incorporating an unworkable solution to a question as central as that of regulating exchange rates is an impossibility. If future attempts to reform world monetary relations are not to be equally doomed to failure, a primary requirement is a more realistic approach to this central issue. Accordingly, this paper is devoted to a consideration of the type of approach that would be required.

What Solutions are Feasible?

It has already been argued that, in conditions of capital mobility such as now exist, no system based on "stable but adjustable parities" can work. It is possible to dismiss equally briefly both of the textbook cases: completely fixed, and freely floating, exchange rates.

Completely fixed exchange rates are impractical because their maintenance demands that countries adopt the gold-standard "rules of the game" whereby the money supply is deflated in response to a payments deficit and inflated in response to a payments surplus, irrespective of the situation of the domestic economy. Governments are quite clearly unwilling to accept such an abandonment of monetary sovereignty, and in my view rightly so, at least in the absence

1 I cannot resist the temptation to quote what I wrote in 1965: "... the adjustable peg is unlikely to be viable indefinitely. Ever increasing destablilizing speculation will result if pegs are apt to jump; ...". J. Williamson, *The Crawling Peg*, Princeton Essays in International Finance, No. 50, 1965, p. 8.

of a high degree of fiscal integration incorporating an active regional policy.[2]

Governments show equally little sign of being willing to accept freely floating exchange rates, i.e. of agreeing to forego all intervention. Once again this attitude seems to me to be justified. It is now well established that speculative activity is essential to the dynamic stability of the foreign-exchange market,[3] but there is now rather dramatic evidence from recent experience that speculation is a dangerous activity to the private sector. This explains why, contrary to the hopes of many advocates of floating, exchange rates in the floating period have proved to be so volatile: an adequate volume of stabilizing speculation is brought forth only by large swings in exchange rates which take the rate beyond any reasonable estimate of its equilibrium zone.[4] In these circumstances it does not require particularly finely articulated management of the exchange rate to enable central bank intervention to improve on the unaided performance of the private market.

One solution that clearly cannot be rejected as either infeasible or unacceptable to governments is the system of managed floating that has emerged since March 1973. There are now some sixteen curriences that are floating independently (see Appendix), in the sense that the governments in question do not undertake to peg their exchange rates within specified or implied margins to any other single currency, group of currencies, or composite currency. All of these countries, with one exception, have continued to intervene heavily to manage their exchange rates since the advent of floating; paradoxically, indeed, intervention has if anything become more rather than less intense.[5] The exception is the United States, which has largely maintained its previous passive policy in the foreign-exchange market.

2 I have developed this argument most fully in "The Impact of European Monetary Integration on the Peripheral Areas", in J. Vaizey (ed.), *Regional Policy and Economic Sovereignty*, forthcoming.

3 The pioneering paper was A. J. C. Britton, "The Dynamic Stability of the Foreign Exchange Market", *Economic Journal*, March 1970.

4 It will no doubt be argued by some that the wide swings are in large part a reflection of the unpredictability of government policy. One can accept that assertion and still favour intervention: (a) because central banks are quite likely to have a comparative advantage in predicting government policy; and (b) because government policy may be made more predictable if the exchange rate is not treated as an unimportant residual.

5 J. Williamson, "Increased Flexibility and International Liquidity", a paper presented to the Williamsburg meeting of the Burgenstock Group, May 1974.

Another possible solution would be along the lines of the crawling peg. The essential feature of the crawling peg has nothing to do with the particular figures that were originally invented to illustrate how fast and frequently parities might be adjusted, nor with the formulae that, under some variants of the proposal, were supposed to determine when parities should be adjusted. The central insight is that, if the obligations to defend rigid margins that are inherent in a par value system are to be respected yet the par values themselves are to be changed without disrupting the system, it is necessary that expectations of future par value changes be able to adjust *interest rates* in such a way as to re-establish portfolio equilibrium. This in turn implies that parity changes be small enough to avoid a presumption that a changed parity will be followed by a sudden movement in the market exchange rate. Just how small this need be is not unambiguous, but one might guess that 2% parity changes could be absorbed without trouble in a regime of 2¼ per cent margines (i.e. 4½ per cent bands). One thing that is abundantly clear is that the adoption of crawling could not yield its anticipated benefits if it were grafted onto an adjustable-peg system as an optional extra: it would need to be accompanied by a proscription on larger par value changes, and also on temporary floating.

There are now five countries that utilize the crawling peg (Brazil, Chile, Colombia, Uruguay, and Vietnam), and there is rather general agreement that the system has succeeded in allowing them to neutralize the external effects of their high inflation rates efficiently. It has sometimes been asserted that the favourable experience of these countries is irrelevant to the decisions facing the major industrialized nations, but no analytical reason for this assertion seems to have been advanced, and none seems particularly evident. The crawling peg should therefore be considered as an alternative feasible exchange-rate regime. Its merits will be compared with those of a system of managed floating in the next section.

Managed Floating versus Crawling Par Values

The principal advantages of managed floating, as compared with the crawling peg, are that necessary changes in exchange rates can be implemented without delay, and without the necessity of tying interest-rate differentials to exchange-rate changes during a

lengthy adjustment period. These are powerful advantages. Not only are delayed adjustment and the subordination of monetary policy to external needs inherently onerous, but the fact that the benefits of abiding by the rules of the crawling-peg system largely accrue to the international community in general — in the form of confidence that the system will be perpetuated — while the costs in any particular instance fall on the specific countries in disequilibrium implies that countries would constantly be tempted to break the rules.

The absence of commitments to defend any rigid margins under a system of managed floating also gives countries greater freedom to use monetary policy for anti-cyclical purposes. In particular, it avoids the possibility of control of the domestic money supply being eroded by capital inflows when a tight monetary policy drives the exchange rate to the top of the band, and it similarly avoids the external constraint on pursuit of an easy money policy during a recession. This argument is not, however, as persuasive as those mentioned above, not only because of the widespread current doubts about the efficacy of fine tuning, and of the fact that a wide band provides considerable scope for pursuit of independent conjunctural policies, but fundamentally because it is by no means obvious that the absence of international constraints on the extent to which exchange rates can be pushed around by monetary policy for anti-cyclical reasons is wholly beneficial. The fact is that the business cycle tends to run in parallel in different countries: to the extent that it does so, one country's anti-cyclical depreciation is another country's competitive devaluation.

The latter point provides a particular example of a class of disadvantages of a system of managed floating. In the specific instance in hand, the problem is that of restraining possible predatory policies which would be transmitted through the exchange rate. The par value system provided a mechanism by which the international community could impose such restraint, by disallowing proposed par value changes; and a crawling par value system would have a similar sanction. Although the Guidelines for Floating adopted by the International Monetary Fund in June 1974[6] go some way toward providing the international community with similar powers to limit the freedom of action of individual countries, the absence of an agreed

6 IMF *Survey*, June 17, 1974, pp. 181-3.

structure of what exchange rates should be seems bound to limit their effectiveness in this role.

There are other disadvantages of managed floating that also stem from the difficulties of exercising any significant degree of international management of the world monetary system without a set of par values. In particular, there are thought to be difficulties in combining a system of managed floating with two of the reforms that were widely felt, during the C-20 negotiations, to be necessary in order to secure reasonable symmetry between the rights and obligations of the United States and of other countries. These two reforms are multicurrency intervention (MCI) and asset settlement. MCI is needed if the dollar is to enjoy the same margins as other currencies, if it is to have the same freedom to float as other currencies, and if its exchange rate is not to be passively determined — at least within the limits set by any margins — by the intervention of other countries. MCI is impractical under managed floating (as presently conceived) because the avoidance of conflict demands the existence of rules governing which currency may be used in intervention, and this requires a criterion as to whether a currency should be regarded as weak or strong. Asset settlement [7] is needed if reserve movements are to exert the same pressure to adjust on the United States as on other countries; it is also needed to secure international control of the volume of global liquidity. Yet asset settlement would seem precluded by floating, since a country that has not undertaken the obligation to defend a particular exchange rate can hardly be required to convert balances of its currency acquired in intervention by other countries into reserve assets, irrespective of its view of the appropriateness of other countries' intervention for its own exchange rate.

There is no reason to suppose that these disadvantages of managed floating are unimportant. The introduction of the SDR failed in its objective of achieving international control of the volume of global liquidity because there was no provision for controlling the growth of reserve currency holdings: i.e. because it was not accompanied by the introduction of asset settlement. Similarly, the problems of asymmetry were thought sufficiently important to be

7 Asset settlement is defined as a state of affairs in which an official settlements deficit is always financed by drawing down reserve assets (or borrowing negotiated credits), rather than by permitting a passive increase in reserve liabilities; and similarly, in which a surplus always yields an equivalent increase in reserve assets (or reduction in negotiated credits).

at the centre of much of the C-20's work, and it can be argued that these problems have been intensified by the advent of floating, insofar as the United States now has less defence than before against the possible adoption of predatory payments policies by other countries.[8] The question therefore arises as to whether it might be possible to conceive of a system of managed floating that would overcome the dangers of inadequate international control that are present in the system as it now functions. A proposal that could provide the basis for such a system is described in the next section.

The Reference Rate Proposal

One of the few attempts to discuss the question of the management of floating exchange rates is contained in a paper by Professors Ethier and Bloomfield.[9] They suggest that the following two rules be adopted to govern the international acceptability of national intervention policies.

(i) No central bank would ever be allowed to sell its own currency at a price below its reference rate by more than a certain fixed percentage (possibly zero) or to buy its own currency at a price exceeding its reference rate by more than the fixed percentage. This is the sole restriction imposed upon central bank intervention.

(ii) The structure of reference rates would be revised at periodic pre-specified intervals through some defined international procedure.

The difference between the obligations entailed in a par value system and those which would be involved by acceptance of Rule (i) can be illustrated by Figure 1. This assumes for simplicity that the country would have the same exchange rate as its norm whether that norm took the form of a par value or of a reference rate, and that the margins involved in a par value system would be the same as the "certain fixed percentage" in the reference rate proposal. If

8 See J. Marcus Fleming, "Floating Exchange Rates, Asymmetrical Intervention, and the Management of International Liquidity", as yet unpublished, to which the argument in this paper is in some respects closely related.

9 W. Ethier and A. I. Bloomfield, "The Management of Floating Exchange Rates", Discussion Paper No. 280, Wharton School, University of Pennsylvania, May 1974. The paper will be published in the forthcoming Proceedings of the Conference on World Monetary Disorder, sponsored by the Center for International Business and Management of Pepperdine University, held 23-25 May, 1974, at Pepperdine University.

the country was operating under a par value system, as during the period from time 0 to time t, it would be obliged to buy (sell) unlimited quantities of foreign exchange in return for domestic currency when the exchange rate appreciated (depreciated) as far as A (B), thus preventing the rate ever rising above A or following below B. Under the reference rate proposal, depicted from time t onwards, the country would *never* have an *obligation* to intervene: its only obligations would be to *avoid* intervening in such a way as to appreciate its rate (i.e. by selling foreign exchange) when its rate was above A, or depreciate its rate when this was below B. Between A and B it would be entitled to intervene in either direction, or, of course, not to intervene at all.

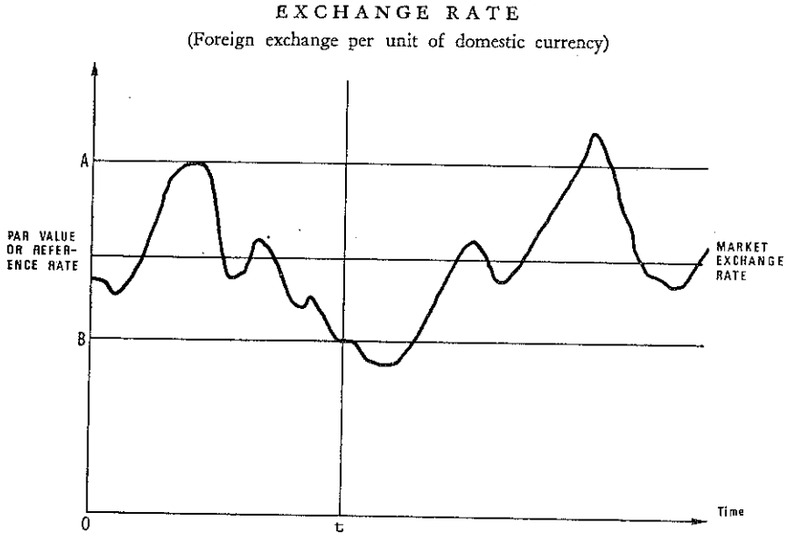

FIGURE 1

Because of the absence of any obligation to intervene to defend a particular exchange rate, there would be no question of the one-way options of the adjustable peg re-emerging. On the contrary, as the rate moved away from the reference rate, the market would know that future intervention could only be in the direction of pushing the rate back towards the official reference rate, thus adding to the risk entailed by further destabilizing behaviour by the private sector.

Rule (ii) would require countries to agree on a structure of reference rates, which would represent an official view on what exchange rates ought to be. There must be some question as to whether the international community is currently capable of the degree of co-operation needed to agree a structure of reference rates, despite the fact that the far more binding commitment to agree on a set of par values was accepted from 1946 to 1973, and that it included, on one occasion (the Smithsonian), a comprehensive re-negotiation of the set of par values. Moreover, some governments might at this time have a strong aversion to a proposal that would involve the resurrection of a structure of officially-endorsed exchange rates, even if these were reference rates which merely forbade governments to push market rates away from them, rather than par values which required governments to hold market rates close to them.

At present the IMF's Guideline 3 (a) merely *permits* a country to name a target zone which, if found reasonable by the Fund, can act like a reference rate in justifying aggressive intervention to return the rate to that zone. Similarly, Guideline 3 (b) merely permits the Fund to encourage a country to take action to return its exchange rate toward a target zone if the rate has departed from " the range of reasonable estimates of the medium-term norm... to an extent the Fund considers likely to be harmful to the interests of members ". There are two reasons for regretting that the considerations mentioned in the preceding paragraph seem likely to prevent a strengthening of this Guideline such as would be involved in the Reference Rate Proposal. The first reason for regret is that, as Ethier and Bloomfield argue, it is not at all inconceivable that circumstances may arise in which there will be a need for defences against aggressive central bank behaviour, and these would be greatly strengthened if countries were expected to negotiate reference rates, as a precondition for intervening at all. The second reason is that regular public announcement of reference rates might help to reduce the very considerable volatility in market exchange rates that has been observed since March 1973.[10] This result could be anticipated to the extent that a reference rate succeeded in providing a focus for stabilizing speculation. The value of having such a focus is best demonstrated

10 F. HIRSCH and D. HIGHAM, " Floating Rates - Expectations and Experience ", *Three Banks Review*, June 1974.

by Canadian experience, where the $US 1 = $CAN 1 parity has long played this role, and resulted in capital movements being far more dependably stabilizing than appears to have been the case with other floating currencies. Whether reference rates could provide a similar focus is open to question, but the hope that they could is not implausible: they would provide the market with information as to what the authorities believed to be a realistic estimate of the appropriate rate, as well as providing a basis for informed public debate about exchange-rate prospects. This of course assumes that reference rates, like par values, would be a part of the public domain: this should certainly be so, since the only times when governments have an interest in concealing their views as to what they believe an appropriate exchange rate to be are when they are committed to a rigid defence of some other, unrealistic, rate. The major advantage of managed floating is that it avoids the need for governments ever to get themselves locked into such an absurd position.

The Reference Rate Proposal would therefore provide a worthwhile immediate way of strengthening the IMF's Guidelines for Floating. It would not, however, solve all the problems referred to earlier that arise from inadequate international management of the system. In particular, it would still be possible for intervention to have the effect of pushing the intervention currency *away* from *its* reference rate. This would occur if the dollar were above its reference rate, but the only countries that chose to exercise their intervention rights were those that were (perhaps temporarily) above their reference rates as well. This of course provides another example of the dangerous asymmetries that are present in systems of managed floating as hitherto conceived. The IMF Guidelines recognise, though they scarcely meet, this danger, by the injunction in Guideline 6 for members to bear in mind the interests of the issuers of intervention currencies.

In order to meet this problem, as well as to establish international control of the volume of global liquidity, it would be necessary to introduce a number of reforms that were discussed during the C-20 negotiations. It will be argued in the next section that these reforms do not require the restoration of a par value system, which — because of its fatal element of brittleness — would certainly break down rapidly, but could equally well be based on the Reference Rate Proposal.

Reference Rates as the Basis for a Reformed System

A reference rate, which we may assume for the moment would be expressed in terms of the SDR, would be the rate that was agreed by both the country in question and the IMF to represent a best official estimate of the appropriate figure for a currency's exchange rate at the current time. It would differ from a par value, not only with respect to the absence of an obligation to defend the rate, but also — on account of the regular revision of reference rates — as regards the rate that would or should be chosen. In the first place, reference rates would not become out-dated through inertia, as the par values of the DM, dollar and yen notoriously did in the late 1960s. A second difference concerns the treatment of cyclical factors. A par value system aims to prevent competitive depreciation or appreciation for purposes of cyclical management by prohibiting par value changes where these are not required by the needs of payments equilibrium over the cycle as a whole, thus limiting anti-cyclical exchange rate variations to those that can be accommodated within the band. A reference rate system would aim to prevent competitive policies by requiring that cyclically-motivated changes in reference rates be negotiated (rather than prohibited): a country with a stronger (weaker) pressure of internal demand than that in the world as a whole could appropriately seek a higher (lower) reference rate than otherwise. Third, the regular revision of reference rates would also facilitate the introduction of a reserve indicator system of the general character sought by the United States during the C-20 negotiations, if this were desired. Specifically, the deviation between a country's actual reserve stock and an internationally-agreed target reserve level would be a natural choice as one of the determinants of the reference rate. This would not involve the danger of provoking disequilibrating capital flows that was regarded in many quarters as one of the principal drawbacks of the reserve-indicator proposal, since governments would not be under an obligation to step in and defend a particular reference rate pending its revision.

It would, naturally, be desirable to minimize the number of occasions when reference rates became inappropriate. One way of doing this would be to allow reference rates to crawl so as to accommodate secular differences in inflation rates. The regular

international negotiations establishing reference rates would not merely determine a set of current ("spot") reference rates, but also a set of "forward" reference rates as of the date planned for the next negotiation, and the actual reference rate would then crawl from the one rate to the other over the intervening period. A country with an atypically low inflation rate would generally select a forward reference rate modestly above its current reference rate, and its actual reference rate would then appreciate continuously, until the next date for revising reference rates arrived. Naturally no well-run country would choose a forward reference rate so different from its current reference rate as to imply a rate of appreciation or depreciation greater than could be neutralized by an acceptable interest-rate differential, for reasons familiar from the theory of the crawling peg. But well-run countries would not be characterized by a refusal to show a forward rate different from the spot rate: on the contrary, financial officials would take a certain pride in their forward rate turning out to be an accurate forecast of the future spot reference rate, and — so long as the need for exchange rate changes persists — this will not in general be possible with forward rates set equal to spot rates.

Now that the SDR is defined in terms of a basket of currencies, a decision to express reference rates in terms of the SDR would not be an inconsequential one. It would in fact have the effect of preventing currencies being pegged to a single intervention currency, in the way that the majority of currencies (over 70) still are. Countries that wished to continue pegging would be obliged to adopt the growing practice (already followed by some ten countries) of pegging on a composite of currencies, where the composite would be that embodied in the construction of the SDR basket. There would be advantage in this, insofar as the trade of most countries is now sufficiently diversified to ensure that the maintenance of a constant rate against the SDR would come closer to stabilizing the effective rate than would a policy of pegging on any single currency. (Stabilization of the effective rate would, tautologically, be even better achieved by pegging on a composite that matched each country's individual trade pattern, which solution would also be excluded by a requirement that reference rates be expressed in SDRs; but the loss would probably be minor for most countries.) It is therefore assumed that reference rates would indeed be expressed in terms of the SDR.

This raises an unimportant but intriguing issue that was extensively discussed prior to adoption of the proposal to value the SDR in terms of a basket of currencies.[11] The problem arises when each currency has some officially-sanctioned value (a par value, or reference rate) in terms of the SDR, while the latter is in turn defined in terms of a basket of currencies. Suppose that initially these two sets of values are consistent, in the sense that, when all market exchange rates are at parity (defined as the ratio of two par values, or reference rates), the exchange rate between the SDR and any currency is the inverse of the par value (or reference rate). The problem is that, if the par value (or reference rate) of any currency contained in the basket is changed, while the composition of the basket remains unchanged, the above consistency will be destroyed. For example, if the dollar constituted one-third of the basket and was devalued by 10 per cent, the value of the SDR in terms of every other currency would decline by 3 1/3 per cent (when all market rates were at parity) while none of their par values (or reference rates) would have changed. There are various things one can think of doing about this unimportant, because purely cosmetic, inconsistency, including ignoring it. But the opportunity of an elegant solution, which formalises an important economic reality, arises in the context of the proposal to base intervention rights on a set of reference rates that would be systematically revised at regular intervals. This solution would involve those currencies included in the basket first having their reference rates simultaneously determined in terms of one another (thus recognising the economic fact that there are a limited number of currencies whose importance is sufficient to require simultaneous determination), and then having their absolute reference rates in terms of the SDR calculated mechanically by the requirement that the reference rates be consistent with the value of the SDR as determined by the basket on a pre-specified date. Meanwhile all other countries would negotiate directly about their absolute reference rate in terms of the SDR, thus recognizing that, while it is important that the reference rates of even the smaller currencies be chosen appropriately, the rate chosen for any individual currency would not have a sufficient feedback to justify changing the reference rates of other currencies. (The reference rates of both sets

11 See J. J. Polak, *Valuation and Rate of Interest of the SDR*, IMF, Washington DC, 1974, p. 15.

of currencies would, of course, be determined in a joint negotiation where all countries participated.)

So much for the mechanics that would be involved in the negotiation of a structure of refecence rates. The more important question is that of whether there is any prospect of countries being able to agree regularly on a consistent structure of spot (and, preferably, forward) reference rates. I do not propose to offer an estimate of the probability that countries will actually accept a system that presupposes a willingness to reach regular agreements of this nature, but I would wish to argue that the required degree of international co-operation is not over-demanding by the standards that were commonplace prior to August 1971.

The first point to note is that a par value system did operate until March 1973, and at the Smithsonian a comprehensive renegotiation of the set of par values was successfully accomplished under the worst possible circumstances. It is therefore difficult to believe that the less binding commitment to a reference rate should be beyond the bounds of possibility. There are, admittedly, those who believe all countries to have a permanent national interest in an under-valued exchange rate, and who therefore explain away the past success in agreeing on par values as being a result of US willingness to acquiesce in an over-valued exchange rate. I have explained elsewhere why I reject the proposition that an under-valued exchange rate is in general nationally advantageous,[12] and the spate of voluntary revaluations during 1973 suggests that the authorities of many countries share my view; but those who differ in their assessment will obviously be less sanguine as to the feasibility of reaching agreement on reference rates. An interesting feature of the reference rate proposal is, however, that occasional failure to reach agreement need not be a disaster. Such failure would carry its own remedy and sanction: since intervention would be permitted only to push the rate toward the reference rate, or within a specified band around the reference rate, the lack of a reference rate would automatically serve to prohibit intervention. This would safeguard the international community from aggressive intervention by the uncooperative country, and — since the ability to intervene is in

12 J. Williamson, "Comment on Dr. Lamfalussy's Paper", presented to the Fourth World Congress of the IEA, Budapest, August 1974.

general advantageous — it would also penalise the recalcitrant country, but it would not threaten its vital interests, because free floating is an inconvenience rather than a disaster.

One may therefore doubt whether the difficulties of agreeing on reference rates are so acute as to rule out a system which is strongly desired because of the advantages it promises. The crucial question is: what are the advantages of a reformed system that are unavailable under the present system of internationally-unregulated, nationally-managed floating, but could be introduced in conjunction with reference rates? The answer to this question is straightforward. Apart from the provision of a focus for stabilizing speculation, the advantages of the Reference Rate Proposal are that it would permit attainment of the objectives of symmetry in the adjustment mechanism and control of the volume of global liquidity, which could be achieved by the introduction of multi-currency intervention and asset settlement. It was argued earlier that these issues are of very considerable significance. And it is surely conceivable that the increased vulnerability of the United States to the payments policies of other countries may at some stage give the United States a rather immediate interest in the construction of a more symmetrical system.

A minimum requirement for a system of multi-currency intervention is that there be a rule that specifies whether a currency is sufficiently strong to be sold by a country wishing to support its currency, or sufficiently weak to be bought by a country wishing to acquire reserves. The Reference Rate Proposal is easily able to satisfy this requirement. It would simply be necessary to stipulate that intervention should always take place in a currency that would be pushed towards *its* reference rate by the intervention being undertaken.

The essential condition for asset settlement to be a sensible proposal for an issuing country to consider is that the balances it is required to convert should be only those acquired in accordance with a set of rules that safeguard its interests. Balances acquired under MCI conducted according to the above rule would certainly satisfy this criterion.

Suppose, therefore, that the reference rate proposal was accompanied by MCI and asset settlement. The operation of the system may be illustrated by the following examples. A country wishing to intervene to support its currency would be obliged to buy its own

currency by selling a currency that was standing above its reference rate, which it could obtain by virtue of the obligation that each issuing country would have to sell its currency in exchange for reserves so long as its rate was above its reference rate. Conversely, a country that wished to limit the appreciation of its currency would do so by using it to buy a currency that was standing below its reference rate; the currency balances so acquired would then be converted into reserves, which the country whose currency had been bought would be obliged to sell so long as its currency was below the reference rate. In order to ensure asset settlement the rules would, of course, have to be written in such a way as to ensure that conversion actually occurred (in both directions) as assumed in the above examples.

No matter how much care was taken in determining forward reference rates, occasions would no doubt periodically arise when it would become apparent that a particular reference rate was no longer appropriate. If this happened to a currency within the MCI group, there would be a danger that the right of other countries to limit the deviation of the market rate from the reference rate would reintroduce the rigidities of the par value system. For example, if it became clear that the lira was under-valued, deficit countries that wished to support their rates would be entitled to sell lire for their currencies, thus preventing an appreciation of the lira which the Italian authorities might urgently desire in order to stem an unwanted capital inflow at bargain rates. No doubt most cases of this nature could be dealt with by informal inter-central bank co-operation: there would be no great cost to a country in acceding to another's request not to use its currency in intervention for the time being, since there would always be other currencies available for intervention (unlike the present situation). And the position of countries with intervention currencies could be further safeguarded by providing for the temporary suspension of convertibility obligations pending the settlement of a request for a changed reference rate. This would mean that, in the above example, the Italian authorities would be relieved of their obligation to buy reserves from other countries; in the converse case, the issuing country would be obliged to redeem its currency only when the new reference rate had gone into effect, which would be liable to impose a capital loss on a country that insisted on intervening in the over-valued currency.

Conclusion

I have long been an advocate of the crawling peg. I still believe that the crawling peg is one of the few viable exchange-rate regimes — and, indeed, the only one that would permit the restoration of a par value system with rigid margins. For reasons given in this paper I have, however, come to the conclusion that a regime of managed floating which was internationally supervised by the restriction of intervention to those occasions when it was within a band around, or in the direction of, an internationally-sanctioned reference rate would be a superior alternative. Such a system would seem to offer both the opportunity of an escape from the rigidity of the constraints imposed by any par value system, and the opportunities of symmetry between countries and of international management that have hitherto seemed to require the framework of some sort of par value system. If the need for a reformed international monetary system ever becomes widely felt, a regime of this general character could provide a realistic basis for its construction.

Coventry

JOHN WILLIAMSON

APPENDIX:
CURRENT EXCHANGE-RATE PRACTICES

In the course of the paper a number of references were made to the current exchange-rate regime. It may be of interest to some readers to see the following table, which provides a summary of the exchange rate practices of the 126 members of the IMF, plus Switzerland, in September 1974, as classified by the author. The entries in the table refer to the number of *countries*: where these do not have separate currencies, as well as where nominally independent currencies appear permanently fixed to others, the fact is recognized by an entry in column (1).

How peg is changed / Currency pegged to	(1) Not changed	(2) Adjustable peg	(3) Crawling peg	(4) Market forces	(5) Total
US dollar	2	56	5	1 (+?)	64
Pound sterling	1	9	—	—	10
French franc	11	3	—	—	14
Spanish peseta	—	1	—	—	1
South African rand	—	3	—	—	3
Several currencies	—	2	—	—	2
Mutual pegging (snake)	1	6	—	—	7
Composite currency	—	10	—	—	10
No peg	—	—	—	16	16
Total	15	90	5	17	127

J. W.