

Fixed Parities and International Order (*)

I

Stripped of technicalities and of short-run considerations the controversy over exchange rates: fixed or flexible, is essentially an aspect of the broader controversy over international economic integration (on the basis of the price mechanism and a common standard of value) as opposed to economic nationalism. The latter takes the form, in the area of monetary relations, of concern over a country's « monetary independence ». Flexible or floating exchange rates have, in the opinion of their advocates, the great virtue of allowing a country (*i.e.* a government) to adopt an internal monetary, financial and, indeed, economic policy without concern for balance-of-payments equilibrium. As Professor Friedrich A. Lutz wrote in the December 1954 issue of the « Banca Nazionale del Lavoro Quarterly Review »: « The main advantage that can be claimed for a policy of flexible exchange rates is that it allows a country both to avoid quantitative import controls and to follow... an « independent » monetary policy, *i.e.* a policy that is unaffected by deficits or surpluses in its balance of payments ».

Several years ago, writing in the same vein, Professor Alvin H. Hansen of Harvard University spoke of a *Revolution in monetary thinking* (1): « In the interwar decades a new standard of monetary policy increasingly won its way — emancipation from the adjustment process dictated by the gold standard; freedom to pursue a program of internal stability and full employment *without regard to the balance of payments* ». I have underlined the last

(*) Substance of a lecture delivered on May 16, 1955 at the Institute of Economics and Finance of the University of Rome.

(1) ALVIN H. HANSEN, *Monetary Theory and Fiscal Policy*, New York, 1949, page 201 and following.

words of the quotation; they express, as does the earlier quotation from Professor Lutz, one of the widespread and yet very fallacious aspirations of certain governments (their number has happily shown a substantial decline of late) and of altogether too many learned economists, aspiration to « do as one pleases » without suffering any adverse consequences. A very human aspiration indeed — but also one that has been proved time and again to be unattainable — and one in which it is rather unwise to persevere.

If Hansen speaks of the « emancipation from the adjustment process dictated by the gold standard », Lutz expresses the opinion that « the orthodox gold standard policy of dealing with a deficit in the balance of payments is at the present time outside the realm of practical possibilities ». And, rather prematurely, he adds: « No country is likely to subject itself to the discipline which the gold standard imposes » (2). These lines were published in December 1954 — two months later the British Treasury and the Bank of England were adopting a set of measures to deal with a balance-of-payments deficit judged excessive, which could not have been different were the United Kingdom still on the gold standard. One must never regard as impossible or undesirable what one judges, subjectively, to be « unlikely ». As a matter of fact, ever since 1949 or thereabouts, one government of Western Europe after another turned away from what Hansen called « a revolution in monetary thinking ». Internal monetary stability came to be regarded once again as a major objective of national policy and that means that balance-of-payments difficulties are no longer viewed with the complacency which prevailed in the immediate postwar

(2) « Banca Nazionale del Lavoro Quarterly Review », December 1954, p. 178.

years. An important landmark in this evolution is provided by the report: *The Internal Financial Situation*, prepared in the summer of 1952 for the OEEC by « a Group of independent Experts », including C. Bresciani-Turroni (Italy), E.R. Lindahl (Sweden), A.W. Marget (U.S.A.), M. Masoin (Belgium), L.C. Robbins (U.K.), J. Rueff (France), and E. Schneider (Germany).

« It is obvious » — wrote these distinguished experts — « that any country can get into serious external difficulties by a policy of excessive financial expansion. An upward movement of national expenditure, outstripping any increase of national output and exceeding upward movements which are taking place elsewhere, is bound to lead to trouble. At a fixed rate of exchange, it must lead to disequilibrium in the balance of payments, both through encouragement of imports and through its discouragement of exports. This is the classic case of disequilibrium caused by inflation ».

Nor is this all.

« In a world in which there is continual change in the markets in which a country earns its external income and makes its external expenditure » — the experts invited by OEEC went on to say — « there is a further possibility of trouble, whose neglect in the past has sometimes led to very inadequate conceptions of policy. If internal finance fails to take account of changes in the conditions of trade which are more than transitory, there is also the likelihood of external unbalance. Suppose that, for some reason or other, important sources of external earnings are restricted. If, in such circumstances, there are not appropriate adjustments of internal finance, the effect on the balance of payments may be similar to that produced by internal inflation. The initiating causes of disturbance are different: in the one case positive financial imprudence, in the other pure external misfortune. Yet, if there is no response to the misfortune and unbalance persists, the final result is the same: disequilibrium is ingendered in the balance of payments » (3).

The reader will note how far removed we are, in the passages quoted, from the nationalistic demands for « monetary independence ». The « independent experts » brought together by the OEEC recognised — and this is why their report must be regarded as a significant landmark along the arduous road to an integrated international economy — the

(3) O.E.E.C., *The Internal Financial Situation*, Paris, 1952, pp. 11-12.

dual requirement for national policy: to avoid getting out of step with the outside world through overindulgence in domestic inflation; and to make necessary domestic adjustments to external changes. These are, in a nutshell, the basic ingredients of a worldminded national economic policy.

II

But what of exchange rates? In cases where internal inflation has gone very far, or changes in external conditions have been of great scope, our experts expressly refrain from recommending « internal financial measures (that) would involve a severe positive contraction of money incomes or employment »; instead, they « should hold that a fundamental disequilibrium had developed in the sense of the Statutes of the International Monetary Fund and that some alteration of exchange rates was appropriate ». With this view I find myself in full agreement, albeit with one or two elaborations which will be submitted below. « Flexible » or « floating » rates have not attracted the attention of this group of economists. Instead, they caution against « an unnecessarily sensational conception of policy », when a country is faced with disequilibrium in its international position.

« Not all instances of external disequilibrium » — they emphasise — « are fundamental, especially if they are corrected at a sufficiently early stage; and we think that *there often occur cases where measures of internal finance can be effective in restoring equilibrium without resort either to alteration of rates of exchange or severe internal contraction* ».

I have italicised the last lines of this important quotation for they express an essential element of the « fixed parity » school of thought. What animates most of the advocates of « flexible exchanges », such as Lutz, Meade, Haberler (4), is the fear of strong deflationary

(4) E.g. F. A. LUTZ's article in « Banca Nazionale del Lavoro Quarterly Review », December, 1954; G. HABERLER's brochure *Currency Convertibility*, « American Enterprise Association », New York, 1954, and his article *Some Aspects of Convertibility* in « *Economia Internazionale* », vol. VIII, No. 1, Genoa, 1955; J. E. MEADE's book *Problems of Economic Union*, London, 1953, Chapter II, and his article *Bretton Woods, GATT, and the Balance of Payments — a Second Round?*, in the « *Three Banks Review* », London, December, 1952.

pressures in countries which, faced with an adverse balance-of-payments situation, want to maintain fixed parities. There is widespread misapprehension concerning the alleged deflationary character of the gold standard as it was known prior to 1914. These allegations have never, so far, been backed up by any careful survey of historic evidence. As I have shown elsewhere (5), the experience of the inter-war years, 1919-39, is far from conclusive. What is true, is that in academic circles there developed, during these two decades, a revolt against the discipline of the gold standard (as indicated by Alvin Hansen in the passage quoted above from one of his more recent books). This « revolt » had many forerunners; its most eloquent and most influential expression will be found in *A Tract on Monetary Reform*, published in 1923 by John Maynard Keynes. Since then, an abundant literature grew on both sides of the debate. After the end of the second World War, monetary nationalists seemed solidly entrenched. But events overtook them even while they were proclaiming victory. Inflation had to be checked — and wherever they were brought under control monetary « orthodoxy » came back with beneficial effects for the national economies concerned.

Belgium, Italy, Western Germany, the Netherlands, Austria, Portugal... such is the lengthening roster of countries which checked domestic inflations in recent years, contracted credit, got their external position into balance or close to it, countries which adopted, of free will and without commitment to anyone, the timetested rules of « orthodox » monetary and financial policy, and experienced economic expansion, not contraction, as result of the courage and determination of their monetary authorities.

The « independent experts », brought together by the OEEC, attached, in 1952, great importance to the part of their statement

(5) See my book, *International Monetary Economics*, London 1939; also my chapter entitled *Fixed Parities and Fluctuating Exchanges as Objectives of Monetary Policy*, in the volume « A Forum on Finance », ed. by George B. Roberts, New York, 1940. See further Chapter III of my more recent book, *The Trade of Nations*, New York, 1952.

which I italicised above. Their text goes on as follows:

It is just this possibility which we think has tended to escape notice in recent discussion. The requirements of international equilibrium relate to *relative* rather than to *absolute* movements of money incomes. In an expanding world system, small changes for the worse in the external conditions of one area can often be checked, not by positive contraction but rather by a slowing down or a temporary stopping of the local rate of advance. To ignore this possibility is apt to lead to an unnecessarily sensational conception of the requirements of policy — to the neglect of very practical and easily accessible methods.

Three years later, Messrs. Bresciani-Turroni, Robbins, Rueff *et al.* might still have formulated the same observations. Great progress has been achieved in recent years in the field of practical policy: Western Europe « rediscovered money » (6), *i.e.* the bank rate came back into its own as leading instrument of monetary policy — but the discussion, as distinct from action, still lags quite a way behind. In other words, although monetary nationalism is declining in the realm of practical policy, as far, at least, as Western Europe is concerned, its academic defenders are — as was noted above — full of zest, and so are numerous officials in the very countries which have re-adopted international criteria for their national monetary policy. Before attempting to explain what looks at first glance like a paradoxical situation, several observations must be made in order to make quite clear the present writer's own position in this complex and many-cornered controversy.

III

The first set of observations relates to the very concepts of *fixed parities* and *fluctuating* (or *flexible* or *floating*) *exchange rates*. How fixed are to be the former, how « flexible » the latter?

To this, my answer is simple. Parities, if the international economy is to be endowed with something approaching a common measure of values, must be entirely fixed — but,

(6) M. A. HEILPERIN, *Western Europe Rediscovered Money*, « Fortune », New York, September 1952.

in a changing world, they cannot be *immovable*. Situations may arise — and the scholars referred to several times in the course of the preceding pages have noted the fact in the OEEC report of 1952 — when a change of parity is the lesser evil. The Bretton Woods system provided for that possibility in Article IV of the IMF Charter, albeit (and that is one of its serious weaknesses, about which a word will be said later) without outlining a proper method of establishing a new and better parity (7).

As to « flexibility », its advocates fall into two groups. The most academic and most extreme among them don't want any parities whatever between currencies but would depend on free foreign exchange markets to establish every day the rate which corresponds to the eachtime relation between national price levels etc. Mostly, they would allow exchange equalisation or stabilisation funds to be used by Central Banks or Treasuries to counter speculation and neutralize « accidental » causes of fluctuations. They fail, generally speaking, to admit the unsettling effects of speculation, and they place what I should regard as quite excessive reliance upon the stabilising effect of forward transactions. As regards the question of speculation, my space here is too short to do full justice to the arguments advanced on either side of the debate. May I pay my tribute, however, to the excellent discussion by Sir Donald MacDougall in the « Westminster Bank Review » for August, 1954. He refutes, by anticipation, Professor Lutz's thesis of December 1954 (8) minimizing the role of speculation, and fails to be convincingly refuted (as far as I am concerned, at least) by Professor Gottfried Haberler in a still more recent article (9).

The real trouble with the advocates of indefinitely flexible exchange rates is that they fail to take into sufficient consideration the

(7) On that and connected issues, see Professor LIONEL ROBBINS' article, *The International Economic Problem*, « Lloyds Bank Review », London, January 1953, and his book, *The Economist in the 20th Century*, London, 1954, especially Chapter V.

(8) His article, already quoted from « Banca Nazionale del Lavoro Quarterly Review ».

(9) In « *Economia Internazionale* », vol. VIII, No. 1, Genova 1955.

causes of balance of payments disequilibrium. Now these, unlike Pallas Athene from Zeus' head, never spring « full armed » from a particular economic situation. They have their causes, the most basic of which: internal inflations or major changes in world markets, have been duly stressed in the quoted passages of the 1952 report on « Internal Financial Stability ». « Fundamental disequilibria » as they are called (but not defined) in the Bretton Woods Agreements, can — and do — happen. Often, however, they can be avoided: if and when an incipient inflation is brought under control; if and when adjustments to external change are effectively and early made. Now nothing encourages the early adoption of internal correctives more than an outflow of reserves under conditions of fixed parities, always provided, of course, that the country's monetary authorities are « internationally minded » and do their best to keep external equilibrium by all internal means at their disposal, short of quantitative controls over trade and payments and of excessive domestic contraction.

Advocates of « flexibility » fall, I said, into two groups. The second would be satisfied with widening the range of admissible oscillations around a parity (which at present, for members of the International Monetary Fund, is set at one percent up and down the parity). This widening of the new « gold points » is mostly advocated by central banking circles of certain countries and their experts, rather than by the academic economists.

There is much internecine fight between the adherents of the two types of « flexibility ». It must be admitted that the last-named type may well lose the concrete advantages of exchange stability without acquiring the abstract ones of complete exchange freedom. It commends itself to the attention of the practitioners of the art only if certain conditions are satisfied:

1) corrective internal measures must be adopted as soon as the lower limit of the former narrower range has been crossed (in substitution for the loss of reserves that would have taken place under the more rigid conditions envisaged by the I.M.F. Charter);

2) the level of gold and dollar reserves must be initially so low as to justify the limited substitution of exchange depreciation for a loss of reserves. Even so, there can be little doubt that in this case speculation will tend to aggravate the disequilibrium. « Contrary to widely held views, wrote recently Professor Roy Harrod of Oxford, it is likely that, on the occasion of an adverse turn in the balances of payments, it would cost more gold to support sterling within wide margins than within narrower margins. In the latter case assistance could be rendered by a high Bank Rate, in the former not » (10).

IV

There is one set of circumstances where a « floating rate » is not merely acceptable but, indeed, necessary. It is when a currency got out of line with other currencies, due to major internal inflation, to external world market circumstances (including a severe depression in one of the major economic centers of the world), or to war, and a new parity for it must be found. In the twenties there were theories, most prominently the so-called « purchasing power parities » theory, which allowed an *a priori* statistical determination of a new parity. These theories are now discredited (11) and the need for an empirical determination of new parities is generally recognised. The following enlightening passage might be quoted from Professor Robbins' latest book, *The Economist in the Twentieth Century* (London, 1954):

Once internal finances have been stabilized, the next step is the correction of overvalued exchange rates. This prescription wears an air of simplicity which does scant justice to the difficulty and the delicacy of the operations here involved. ... The exact

(10) « The Financial Times », London, July 19, 1955. The paper adds, editorially, the following comment: « In general, it seems that much of the argument in favour of a floating rate is based on the pursuit of a number of incompatible objectives ». « The Economist », though its editors favor — for reasons about which a word will be said later, a « floating pound » — admits, in the leading article of the July 23, 1955 issue, that: « No imagination at all is required to realise the disadvantages of fluctuating rates... » (page 287).

(11) Cf. M. A. HEILPERIN, *International Monetary Economics*, London, 1939, Chapter VII.

technique of such operations is doubtless a matter which will vary with circumstances. ... I can see strong arguments in this context for some *temporary* resort to a floating rate in order to test the market. I can imagine that if such resort were accompanied by some assurance to the outside world of the limits within which such fluctuation would be allowed, this might be taken as evidence that what was being done was a genuine attempt at equilibration rather than an arbitrary upset in the exchange markets. I should like to see the statutes of the International Monetary Fund modified, or at least « clarified », to make such a procedure definitely permissible. But I am far from arguing that this is the only method to be adopted; it is easy to conceive of cases where immediate adjustment of an otherwise fixed rate is preferable, any failure to hit the mark the first time being corrected by another operation (pages 150-51, italics added).

I have myself advocated in recent years the technique of « temporary flexibility » for France (12); I should be most reluctant, however, to accept it for the pound sterling.

V

This takes me to the final group of considerations I wish to dwell upon in the present article. A few of my academic brethren excepted, nobody really wants international monetary instability. This has been demonstrated time and again, in the past twenty-five years, by the frequency with which exchange control has been used to straight-jacket an unstable foreign-exchange rate. More positively, from the international point of view, it has been demonstrated by the « Tripartite Agreement » which, in the late thirties, introduced a modicum of stability into a disrupted international economy. Professor Robbins calls this a « craving for fixity » (13) and concludes from the experiences to which I have just alluded (and which seem to have impressed him quite as much as they have impressed the writer of the present lines):

The idea of a world in which the exchange rates of every sovereign state are perpetually free to fluctuate in terms of the exchange rates of every other, is purely fanciful. It is perfectly realistic to conceive of floating rates between large *blocs*, the sterling area and the dollar area, for instance. It is not realistic to

(12) In « Fortune », New York, February 1954.

(13) ROBBINS, *op. cit.*, page 101.

think of floating rates all round. But if it is so, I suspect, that we have not succeeded in banishing from the world the necessity for maintaining equilibrium at fixed rates somewhere. ... I am left asking whether, if policy has to be directed to maintaining fixed rates in some directions, it may not in the end be thought expedient still to direct it to maintaining fixed rates all round.

To ask the question, as far at least as I am concerned, is to answer it in the affirmative.

If the entire controversy over fixed parities or flexible rates has bounced up again, with such vigor, in recent years, the interwar discussions and experiences notwithstanding, it is clearly because of the debate over *sterling* convertibility. Advocates of « floating sterling » are impressed either by the relatively low level of the Sterling Area's gold and dollar reserves or by the precarious balance of the United Kingdom's external accounts and the extent of its domestic price inflation contrasted with that prevailing elsewhere (14).

The proper answer to be given to these two, highly legitimate, considerations, would appear to be the following:

(14) The latter concern is voiced and documented in the article: *Fixed or Floating*, appearing in the July 23, 1955 issue of « The Economist ».

1) it is better to *postpone* convertibility, at fixed rates of exchange (and not limited, as is currently proposed, to non-residents alone), until such day as the problem of international liquidity will have been solved (15), than to settle for a solution known in advance to be inadequate;

2) it is a great mistake to adopt even « non-resident convertibility » at a « floating rate » before setting the financial and monetary house in order: if adopted under such conditions it may readily become an « *amiable euphemism* » (to use Charles Rist's expression) for progressive devaluation of the pound in relation to the dollar. Nor can one reasonably doubt that stern and unpopular measures of monetary discipline, such as were applied by the British authorities during the current year, will prove even less acceptable, should the easier course of « downward flexibility » become readily available. The fate not only of the pound sterling as a world currency, but of international economic order itself are at stake as these lines are being written.

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(15) See my article: *Liquidità internazionale e convertibilità monetaria (1928 e 1955)*, « Rivista di Politica Economica », June 1955.