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JAMAICA AND THE PAR-VALUE SYSTEM

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Princeton, New Jersey

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Jamaica and the Par-Value System

At its meeting in Jamaica in January 1976, the Interim Committee of the International Monetary Fund proposed amendments to the Fund's Articles of Agreement. These amendments have met with a mixed reception. The critics' opinions depend to a large extent on how they interpret the original compromise of Bretton Woods—the so-called par-value system. To some, it seems that this system collapsed when major members of the Fund floated their exchange rates, and that Jamaica finally "buried" Bretton Woods by legalizing floating. Against this interpretation, others point out that the Interim Committee continues to favor a system of "stable but adjustable" exchange rates and that this is exactly what the Bretton Woods arrangements tried to accomplish.

According to the new Article IV, the Fund will legalize floating. But the Interim Committee does not really encourage adjustment through flexible exchange rates, or does so only in those rare cases of substantial disequilibrium where the old system, too, permitted changes in exchange rates by way of parity alterations. Therefore, the impression that Jamaica, with its tolerance of floating, seems to constitute a basic departure from the par-value system is perhaps not quite justified. The Committee acknowledged a *fait accompli* but tried to make managed floating "safe" by establishing guidelines that emphasize stability rather than flexibility of exchange rates. It must be admitted, however, that the new Article IV permits even free floating, since it tolerates "other exchange arrangements of a member's choice" (Sec. 2). This new article is a compromise between those who favor flexibility, like the Americans, and others who want to adhere as much as possible to stable par values, like the French. Nevertheless, whenever floating is mentioned one gets the distinct impression that what is meant is managed rather than free floating. And managed floating can be so managed that the system approaches a regime of par values, since par values were always understood to be adjustable.

While the following pages are mainly concerned with problems of managed floating, they will also consider international liquidity reserves, because the problems of adjustment and liquidity remain interconnected unless we adopt an international payments system of free floating, which by definition would have no use for official international reserves. It is my contention that acceptance of the proposed new Article IV would tend to maintain some of the main shortcomings of the old par-value system that floating tried to overcome—unless we change the philosophy on which the Interim Committee based its recommendations. Fortunately, there is no reason why this philosophy (and, accordingly, the interpretation of the new Article IV) should not be changed. Even the old Article IV could have been interpreted more liberally and the system operated more successfully if only better use had been made of Section 5, which even then permitted changes in the par value of a member's currency in case of an undefined "fundamental disequilibrium."

The Bretton Woods Agreement

The Bretton Woods Agreement was a compromise between the strict discipline of the old gold standard and the new freedom demanded for national economic policies. When the White Plan and the Keynes Plan were published, Williams (1943) suggested that they were "essentially gold standard plans," while Keynes (1944) declared that the new proposals were "the exact opposite of the gold standard."

Williams wanted to emphasize that, at fixed parities, transactions between members of an international monetary institution would affect their domestic monetary systems in the same way that gold movements did in the days of the gold standard. Parities would remain stable, and necessary adjustments would be accomplished through deflationary and inflationary developments in the deficit and surplus countries.

Keynes's attitude was just the reverse, although he did not argue for truly flexible exchange rates either. He wanted to establish "an orderly and agreed method of determining the relative exchange values of the international currency units" (Keynes, 1943 Ib) but recommended rather frequent parity adjustments. He called the permission to correct par values in cases of fundamental disequilibrium an epoch-making innovation. "For instead of maintaining that the internal value of the national currency should conform to a prescribed *de jure* value, it provides that its external value should be altered if necessary so as to conform to whatever *de facto* internal value results from domestic policies, which themselves shall be immune from the criticism of the Fund" (Keynes, 1944).

The Bretton Woods Agreement was possible because nobody insisted on a definition of the concept "fundamental disequilibrium." Today, the Jamaica Agreement rests on a similar vagueness concerning managed floating and par values. It is left open whether "orderly exchange arrangements" and the promotion of "a stable system of exchange rates" are to be approached via "reasonable price stability" or greater flexibility of exchange rates. Emphasized are "orderly underlying economic and financial conditions" (Art. IV, Sec. 1).

For the majority of experts in 1944, parity adjustments in fundamental disequilibrium meant a rare exception from the rule of fixed par values. The Keynesians, on the other hand, wanted par-value adjustments to occur frequently, as shown by the fact that in Keynes's (1943) Clearing Union such changes would have been required whenever deficit or credit balances of the members of the Union exceeded predetermined percentages of the members' quotas.

All parties at Bretton Woods, however, considered it essential that, during periods in which parities were not adjusted, the resources of the Fund would provide the members "with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity" (IMF, 1944, Art. I, Sec. V). Yet the Fund's resources were strictly limited. Their use had to trigger one or the other of the two available adjustment mechanisms: appropriate changes in domestic policies or reasonably frequent parity changes.

The compromise of Bretton Woods, via a conveniently vague definition, became a practical possibility because of the enormous creation of liquidity outside the precincts of the Fund, that is, through the emergence of the dollar standard. In this connection, it is interesting to remember that, despite his advocacy of frequent parity changes, Keynes suggested resources for his Clearing Union that would in effect have been about five times as large as the original resources of the Fund. Furthermore, he was farsighted enough to urge that national currencies should not be used for official reserve purposes in excess of normal working balances (Keynes, 1943, V, 25). He wanted to prevent a limitless and unregulated growth of international liquidity. As it was, the emergence of the dollar standard and the tremendous growth of foreign-held dollar balances made it possible not only to give the Fund's members freedom to pursue their own domestic economic policies but simultaneously to maintain stable par values for long periods.

We shall see that the Jamaica Agreement has not succeeded in bringing the supply and distribution of international liquidity reserves under the Fund's control, but seems nevertheless to favor a high degree of stability of exchange rates and appropriate adjustments of the economic policies of the members. The Jamaica system rejects permanently fixed parities but does not recommend freely fluctuating exchange rates. Consequently, we must find out where the line between the different adjustment mechanisms is to be drawn—how much flexibility we want to provide by parity changes (and additional liquidity) and to what extent we are willing to forego cherished domestic objectives in favor of external balance.

The Bretton Woods system implied that the Fund had the power to influence the policies of its members by "repurchase" and "scarce currency" provisions and that fundamental disequilibria would be easily detectable. It was understood, however, that the adjective "fundamental" should not be limited to disequilibria in international payments (as it was in the White Plan). Since external balance could be gained by domestic policies that deterred economic growth and high employment, unemployment or lack of growth might entitle a country to devalue even if its international payments balanced. Thus it was impossible to use changes in a country's liquidity reserves as the only or primary indicator of "appropriate" changes in the par value of its currency.

The Jamaica Agreement and Earlier Statements by the Fund

The Jamaica Agreement does not resolve these difficult issues. While it permits floating and therefore seems to lean far more than Bretton Woods toward the side of exchange-rate flexibility, it still seeks to promote a stable system of exchange rates that emphasizes orderly underlying economic and fiscal conditions. It does not succeed in formulating guidelines for floating or in answering the crucial question as to *when* exchange rates should be changed or the management of floating altered in preference to pressures on domestic economic policies or, as an alternative, to the further creation of international liquidity. Nor does it suggest new ways to control international liquidity and its distribution.

The most important feature of the Jamaica amendment is its legalization of floating. As already mentioned, the new Article IV permits not only the adoption of par values and cooperative par-value arrangements but "other exchange arrangements of a member's choice" even including free floating. However, recent experiences with floating, as well as the text of the Jamaica amendment, suggest that in practice floating is to be managed.

The new Article IV says that "the Fund will exercise firm surveillance over the exchange rate policy of members, and shall adopt specific principles for the guidance of all members with respect to those policies" (Sec. 3b). Since free floating implies the absence of official intervention, we may assume that the Interim Committee did not think it at all likely that the Fund's members would choose free floating as the "other" exchange arrangement of their choice. Jamaica does not preclude free floating but would appear to regard it as unlikely of adoption, while managed floating turns out to be a special kind of par-value arrangement in which exchange rates are to be maintained over considerable periods.

There is little difference between a floating rate that has been pegged in practice for several years and a par value that has not been adjusted for an equal stretch of time. For semantic reasons, it may therefore be advisable to use the term "adjustable-peg system" when we want to refer both to par values and to rates pegged by extensive intervention under managed floating. The term "adjustable peg" is preferable to the term "par value" because it emphasizes the fact of adjustability, which mere reference to par values omits. The Fund has often used the expression "stable but adjustable," which is better but still favors stability over flexibility.

Jamaica has not buried Bretton Woods: it has merely legalized floating, which the Fund, as it turned out, did not have the power to prevent in the first place. Once the new Article IV is adopted, Fund members will no longer live in sin when they float their currencies. But they will be exhorted to manage their floating under the Fund's surveillance and in close simulation of the par-value system. The old par-value regime can come back only if the Fund's members determine by an 85 per cent majority of the total voting power that international economic conditions permit its re-introduction. Since an 85 per cent majority is extremely unlikely, the par-value system, in the strict sense of the word, seems to be a thing of the past. However, a careful study of the Jamaica Agreement suggests that members are expected to manage floating in the same way they maintained their par values and that they will, in the future as in the past, "unduly delay" adjustments of their pegged rates. Fundamental disequilibria may be recognized earlier and the peg shifted more frequently. But this is a matter of degree rather than of principle. We should remember that the possibility of more frequent par-value adjustments was available even under the old Bretton Woods system. It was the *operation* and not the *principle* of adjustable par values that was at fault.

The new Article IV deals mostly with the medium-term stability of exchange rates, a surprising fact in a document that supposedly legalizes the rejection of the par-value system. Section 1 says that "each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." This formulation is not too different from Section 4 of the old Article IV, which stated that "each member undertakes to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations."

Section 3 of the new Article IV deals with "surveillance over exchange arrangements" and says that "the Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member under Section 1 of this Article." Unfortunately, "specific principles of guidance" were not spelled out in Jamaica and the problem of controlling a system of managed floating has been left unsolved. All possibilities, from very rare adjustments of the peg to a mere smoothing of daily fluctuations, are left open. Only the extremes seem to be ruled out, that is, deliberate delay in making changes and freely fluctuating rates. The latter are consistenly ignored, perhaps because they would eliminate policies that can be surveyed.

For answers not provided by the Interim Committee we must turn to other statements by the Fund, such as the *Outline of Reform* (IMF, 1974) and two reports by the Executive Directors: *Reform of the International Monetary System* (1972) and *The Role of Exchange Rates in the Adjustment of International Payments* (1970). There is no guarantee that these statements still apply. This previous work was done under the assumption that the par-value system still prevailed or that we would soon return to it, and the Jamaica amendment looks more permissive than the above-mentioned studies. We must nevertheless remember that legalization of floating was forced upon the Fund rather than being an expression of a newly desired emphasis on flexibility of exchange rates. The earlier documents still reflect underlying official preferences that will color the interpretation of the Jamaica amendment. As Kafka (1976) has pointed out, the Interim Committee "was practically identical in composition to the Committee of Twenty" (p. 19) and the par-value system "differs from managed floating only in degree" (p. 7). I therefore consider it legitimate and necessary to use the earlier documents for the interpretation of the Jamaica Agreement. Nowhere does the latter indicate a clear-cut break with past thinking.

The *Outline of Reform* by the Committee of Twenty is disappointing in its recommendations concerning parity adjustments. It insists on stable par values and rejects small but frequent parity changes. Adjustment is to be brought about by domestic economic policies of the members rather than through exchange-rate flexibility. When the *Outline of Reform* speaks of an exchange-rate "mechanism" (as in pars. 11-13), it suggests a gold-mechanism type of adjustment via changing national price levels rather than a mechanism for exchange-rate changes.

In their 1970 report, *The Role of Exchange Rates*, the Executive Directors made an attempt to explain the elusive concept, "fundamental disequilibrium." Such a state, they suggested, can exist even when a member enjoys external balance, since "attainment of payments balance through the use of measures destructive of national or international prosperity would clearly not comprise a durable payments equilibrium." Specifically, the Executive Directors refer to restrictions on trade and payments or an "unacceptably high rate of inflation or artificial measures encouraging the export of capital" (p. 48). Fundamental disequilibrium exists, we are told, when internal and external considerations "are pulling in opposite directions as regards domestic stabilization measures" (p. 49). Suppose, for example, that a country with a surplus in international payments and high employment insists on maintaining an undervalued parity. It will increase its external surplus when it tries to combat "imported inflation" by raising its interest rates and thereby attracts foreign capital. This country should revalue its currency. On the other hand, a deficit country suffering from unemployment can achieve more satisfactory domestic growth via monetary expansion (that is, by lowering its interest rates). But it will do so only at the price of worsening its external deficit as long as its parity remains overvalued, since capital will tend to leave the country. That country should devalue.

We may take it for granted that Fund surveillance under the new Article IV will consider exchange-rate adjustments obligatory in such cases of fundamental disequilibrium. However, the real problem is to find an adjustment mechanism that prevents fundamental disequilibria from developing in the first place. If such disequilibria arise, the adjustment of the peg has been unduly delayed. In other words, the concept "fundamental disequilibrium" is far too rough to serve as a guide for an adjustment mechanism that tries to induce speedy correction of imbalances. Reference to fundamental disequilibrium does not specify the "specific principles of guidance" on which the Fund's surveillance and the international cooperation of its members are to be based.

The Jamaica amendment is more permissive about floating than the *Outline of Reform*, since the *Outline* let members adopt floating only "in particular situations, subject to Fund authorization, surveillance and review" (par. 13). On the other hand, the *Outline* made an attempt to formulate guidelines for floating that are still worth considering.

The Guidelines for Floating

These guidelines begin with the revealing remark that "countries authorized to adopt floating rates would be guided by the same principles governing adjustment action as countries maintaining par values" (Annex 4B). We see that the problem of managed floating is approached from the fixed-rate end of a wide spectrum of possibilities rather than from the opposite end of flexibility, where exchange rates are permitted to act, more or less, as genuine market prices.

Countries with floating rates would (according to pars. 5-8) be examined "if either (a) there has been a disproportionate movement in their official reserves; or (b) . . . there is prima facie evidence that a country is facing significant imbalance, even though this is not indicated by a disproportionate movement of its reserves." A "sizable movement in the exchange rate for a floating currency" might be taken as such prima facie evidence (Annex 4B).

These guidelines for floating are ambitious. They do not suggest only that "a member with a floating rate should intervene . . . as necessary to prevent or moderate sharp and disruptive fluctuations from day to day and from week to week." They want to moderate movements from quarter to quarter "where factors recognized to be temporary are at work" (Annex 4B). The concept of "a medium-term norm" refers to an exchange rate "that would tend to bring about equilibrium in the underlying balance of payments, i.e., in the overall balance in the absence of cyclical and other short-term factors affecting the balance of payments, including government policies which are or, on internationally accepted principles, ought to be temporary." The authors of the *Outline of Reform* believe that "the 'medium-term' might be considered to refer to a period of about four years" (IMF, 1974, pp. 181-183).

Once we think in terms of four-year periods for managing stable exchange rates, we are virtually returning to the par-value system. Floating loses its significance if efforts to keep the rate pegged are extended over such formidable stretches of time—formidable, that is, in terms of a market mechanism. Far shorter periods should be considered if we want to create a system in which exchange-rate adjustments are activitated on the basis of market conditions.

The Committee of Twenty seems to have had some doubts about its guidelines for floating, for the latter are to take into account

(a) that national policies, including those relating to domestic stabilization, should not be subjected to greater constraints than are clearly necessary in the international interest;
(b) that a degree of uncertainty necessarily attaches to any estimate of a medium-term normal exchange rate, that this uncertainty is particularly great in present circumstances, and that on occasion the market view may be more realistic than any official view whether of the country primarily concerned or of an international body; and
(c) that in view of the strength of short-term market forces it may at times be unavoidable to forego or curtail official intervention that would be desirable from the standpoint of exchange stability, if such intervention should involve an excessive drain on reserves or an impact on the money supply which it is difficult to neutralize (IMF, 1974, pp. 181-182).

Here the guidelines for floating themselves make a very strong case against long-term pegging. Obviously, it is not worthwhile to abolish par values and then use managed floating to peg wrong exchange rates for years. It makes little difference whether we speak in this context of par values, pegged rates, or medium-term norms. What we are faced with in each case is interferences with a most strategic price and the grave economic consequences of wrong price signals. The greater the length of intended stability of the exchange rate, the greater the probability of deviations from realistic rates and the inducement of disequilibrating capital movements as the market participants anticipate unavoidable adjustments.

To these admitted difficulties, which derive from the complexity of market intervention, we can add the psychological danger that it will often be irresistibly tempting for monetary authorities to maintain wrong rates simply because they do not want to admit to having been wrong. As Friedman (1973) has pointed out:

> Having made a mistake, there will be a strong resistance to recognizing it, a strong tendency to hang on and hope that circumstances will change and show that it was not a mistake, a strong tendency to convert what might have been a minor exchange rate movement into a major disequilibrium and crisis.

The Interim Committee has ignored even some relatively modest suggestions in the direction of greater flexibility made in the 1970 report of the Executive Directors. These proposals included (apart from a "slight" widening of the margins for permissible exchange-rate variations) the interesting proposal 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, three per cent in any twelve-months period nor a cumulative amount of, say, ten per cent in any five-year period" (p. 73). Combined with widened margins, this proposal could have supported an attractive regime with a gliding "band," by which flexibility could have been approached in a manner quite similar to managed floating and without the risk of excessive fluctuations. This proposed amendment deserves to be reconsidered as a variant of managed floating. Machlup (1973) was correct in saying:

> In principle, it would be possible to operate a system of managed floating that is *de facto* equivalent to a system of gliding parities. . . . Instead of altering the official parities with strict limits regarding the size of each single change and the size of the cumulative change over each twelve-months period, one may manage the floating in precisely the same way, observing the

same limits for alterations of intervention rates. From a strictly economic point of view there need not be any difference between the two systems.

A gliding-band amendment would have the advantage of establishing exchange-rate variations as normal everyday events and of simplifying the guidelines for floating. On the other hand, if too narrowly construed it could prevent essential adjustments of larger dimensions.

The Managing Director of the Fund, H. Johannes Witteveen (1976), believes that the more flexible system of exchange rates we have at present will work better than the par-value system of the past. In the latter, "there was the need for complete confidentiality, and considerable diplomacy, in dealing with what were usually large, discrete changes in exchange rates. And such changes were typically accompanied by financial and political trauma." In a more flexible system, "with the removal of the taboos associated with par value changes," it will be possible for the Fund to engage in effective discussion with the members concerning their exchange-rate policies (pp. 181-182). When Witteveen speaks of the trauma of major parity changes, he implies that smaller changes would not cause problems of similar dimensions. This is the very reason why the Interim Committee should have argued openly for the desirability of smaller but more frequent peg adjustments instead of emphasizing medium-term stability of exchange rates.

In advocating a gliding band, Marris (1970) suggested correctly:

> With smaller and more frequent parity changes, the shift in demand management policies required at one time would be smaller and raise fewer technical and political difficulties. There would be less outcry from domestic pressure groups. Exchange rates would become less newsworthy, less likely to arouse irrational nationalistic reactions, and more easily subject to informed political debate.

The Fund has been reluctant to accept the use of objective criteria for exchange-rate adjustments or guidelines for floating. In their 1972 report, the Executive Directors expressed the fear that

> objective indicators based on exchange rate or reserve movements may reflect short-term features of the balance of payments rather than the development of an underlying situation or its causes. The evidence they provide would, therefore, not necessarily be an appropriate basis for par-value adjustment if it remains an important objective that such adjustment be based on longer-term developments and prospects for the balance of payments (p. 15).

Obviously, the Fund authorities think they know better than the market, which may possibly reverse itself. The market lacks knowledge of the future, but the authorities think they possess it.

The Committee of Twenty was somewhat more liberal:

> The Fund will seek to gain further experience in the use of objective indicators, including reserve indicators, on an experimental basis, as an aid in assessing the need for adjustment, but will not use such indicators to establish any presumptive or automatic application of pressures (IMF, 1974, p. 179).

The Jamaica amendment says practically nothing about the *modus operandi* of either "surveillance" or "guidelines." The *Outline of Reform*, on the other hand, made interesting suggestions concerning the operation of an adjustment mechanism based on objective indicators. These suggestions have to do with definitions of reserves and liabilities, target reserve levels, and a point system for the activation of the adjustment process. The basic idea is that the official reserves of members should neither rise too high above, nor fall too far below, a proper reserve target. As the reserves move away from a member's target, they would pass, first, a "consultation point," then a point at which a country would become subject to "examination," and, finally, points at which it would be exposed to increasing "pressures" (Annexes 1 and 2).

The *Outline of Reform* makes several suggestions concerning pressures that could be applied to countries in surplus: (1) "a charge on reserve accumulations above a reserve norm . . . graduated with respect to the size of the reserve accumulation and the duration of the imbalance"; (2) the depositing "of reserves above a specified level with an Excess Reserve Account to be established in the Fund at zero interest"; (3) the withholding of future SDR allocations; (4) a report on the external position and policies of the country; and, finally, (5) the authorization for countries "to apply discriminatory trade and other current account restrictions against countries in persistent large surplus."

Countries in deficit could also be subjected to charges "graduated with respect to the size of the deficiency," interest rates on borrowing from the Fund could be raised, access to the resources of the Fund could be restricted, and future allocations of SDRs could be withheld. These proposals combine valuable older suggestions such as Keynes's (1943) negative rate of interest on credit balances in his International Clearing Union and Marsh's (1970) fixed reserve standard, in which floating rates would replace par values, with the proviso that official reserves be permitted to fluctuate only within a predetermined "reserve band."

Changes in official reserves are not the only sign that adjustment is needed. The *Outline of Reform* (par. 6) considers it possible that "there is prima facie evidence that a country is facing significant imbalance, even though it is not indicated by a disproportionate movement in reserves." I have already pointed out that the Bretton Woods experts tried to make clear that fundamental disequilibrium need not refer only to external imbalance, since balance-of-payments equilibrium can be achieved at the cost of unemployment, imported inflation, and payments or trade restrictions. The basic question is the extent to which domestic economic policies should be subjected to painful adjustments in order to maintain external equilibrium at stable exchange rates.

The Jamaica communiqué handles this crucial issue with the cryptic remark that the new Article IV establishes a system of exchange arrangements that recognizes "an objective of stability and relates it to the achievement of greater underlying stability in economic and financial factors" (IMF, 1976, p. 18, par. 7). How is this statement to be interpreted? Are both the exchange rates and the underlying factors to be kept stable or, if not, which is to be adjusted to give stability to the other? Certainly, this cannot be the old attitude that fixed parities create national monetary discipline. Not even Bretton Woods tried to enthrone permanently fixed parities. Furthermore, the Jamaica communiqué reaffirms the *Outline of Reform*'s decision to demonetize gold. It may seem absurd, therefore, to think even remotely of the old gold standard in connection with Jamaica. Nevertheless, any international monetary system that wants to maintain stable exchange rates over considerable periods must to some extent be patterned after the gold-flow mechanism, even though reserve movements *in general* would have to take over the role formerly played by gold movements.

In this context, we should remember that the most important feature of the gold standard was not the gold parity but the fact that gold reserves were supposedly more or less automatically connected with the money supply in the gold-standard countries. The Bretton Woods experts set up a system that seemed to be based on gold but was, in reality, based on the dollar as numeraire, major international reserve asset, and intervention currency: the Fund's own resources were far too small. To imitate the gold mechanism, the Fund would have to control the quantity of international liquidity reserves by being the lender of last resort for its members, and reserves would have to be connected to national money supplies. The fact that the Fund could never quite get off the ground because of its modest size and that the dollar had to take over explains most of the international monetary problems since 1944. Changes in dollar reserves did not trigger symmetrical changes in money supplies. Even the wrong operation of the par-value system, with its unduly delayed par-value changes, was closely related to the position of the dollar as numeraire. This position prevented the dollar's devaluation for too long and encouraged surplus countries to maintain undervalued parities through the purchase of dollars.

Adjustment, Indicators, and the Control of Liquidity

An adjustment mechanism that calls into play both national monetary policies and exchange-rate adjustments must use reserve movements as an indicator. Furthermore, these movements must be reversible and not just inflationary expansions of the sum total of reserves. International liquidity must be subject to some kind of control by the Fund. This does not mean that the Fund need be the source of all international reserves. It implies, however, that the Fund's contribution to the sum total of reserves would be substantial enough to be able to compensate for haphazard changes in other reserve assets. This is what Witteveen (1976, p. 180) may mean when he says that SDR holdings "could well play a pivotal role in a system of international liquidity control, even though SDRs are not—in terms of quantity—the main reserve asset."

The Jamaica Agreement does not support this interpretation by the Managing Director, for the following reasons: (1) the new arrangements concerning gold make the price of gold more unstable and gold itself less suitable as a reserve asset than it has been in the past; (2) the use of national currencies for reserve purposes has not been sufficiently checked, and important suggestions as to how such restraint could be exerted via a Substitution Account in the Fund are barely mentioned; finally, (3) SDRs, instead of being raised to a strategic position, are too small a part of the sum total of all reserve assets to be able to play a pivotal role.

The Jamaica Agreement appears to have completed the process of demonetizing gold internationally. As far as the role of gold as numeraire is concerned, this impression may be correct, but when we look at gold in its role as major reserve asset, the picture is different. In the recent past, official gold reserves and the Fund's gold resources were frozen; after Jamaica, gold will again be an active and uncertain quantity. It is interesting to note that in the Interim Committee communiqué of August 31, 1975, members of the developing countries expressed concern that

> the proposed arrangements for gold would give rise to a highly arbitrary distribution of new liquidity with the bulk of gain accruing to developed countries. This would greatly reduce the chance of further allocations of SDRs, thereby detracting from the agreed objective of making the SDR the principal reserve asset and phasing out the monetary role of gold (IMF, 1976, p. 19).

Even the Managing Director, after having emphasized the demonetization of gold, admits that "nevertheless, with no pegged price, and with private and official stocks greatly exceeding annual production, gold remains a speculative asset" (Witteveen, 1976, p. 180). In short, Jamaica enhances rather than diminishes uncertainties with respect to gold.

Even more important, the Interim Committee has done nothing about national currency balances, the other major reserve asset over which the Fund has no control. In the aftermath of the dollar standard, the international monetary system is saddled with a dollar "overhang" and haphazard increases in the world's liquidity supply as a consequence of the deficits of countries whose currencies are used as reserve assets. For a time, it seemed as if we were on the way to a solution of this problem. In its paragraph 22, the *Outline of Reform* made "provision for the consolidation of reserve currency balances to protect the future convertibility system against net conversion of any overhang of such balances. . . ." To reduce the role of reserve currencies and to develop the SDR as the principal reserve asset, the Committee of Twenty suggested that the Fund be given the authority "to establish a Substitution Account through which SDRs may be issued in exchange for reserve currencies" (Annex 7).

The creation of such an account would have been a big step toward making the SDR the principal reserve asset. If the Fund is "to allocate and to cancel SDR so as to ensure that the volume of global reserves is adequate" (as par. 25 of the *Outline* demands), it must not only assess global liquidity needs properly—a difficult task for an international organization with both deficit and surplus members—but must also solve the problem of haphazard liquidity creation through growing key-currency balances and changing policies toward gold. But instead of taking the bold step of extending the idea of a Substitution Account to gold, the Jamaica amendment lets the attempt to consolidate the haphazard liquidity supply fall by the wayside while still claiming to have set up an SDR standard that will play a pivotal role. All the Interim Committee has to say about the vital issue of consolidation in its communiqué of January 8, 1976, is that "the Executive Directors should continue their consideration of the subject of a substitution account without delaying completion of the comprehensive draft amendment" (IMF, 1976, p. 19, par. 7f).

Witteveen is correct in saying that all the regular borrowing rights of Fund members should be added to the issues of SDRs if we want to ensure the Fund's ability to control liquidity. But, even added together, the reserve assets presently under the jurisdiction of the Fund are still far too small to play the role of regulator.

Instead of proposing increased issues of SDRs, the Interim Committee seeks to make better use of the original Bretton Woods arrangements by increasing quotas, temporarily enlarging existing credit tranches by 45 per cent, and improving the compensatory-finance facility. The reason seems to be that in all these cases the original "conditionality" of credit extension is maintained, while the creation of SDRs is unconditional or a free gift (at least, up to 70 per cent of the sums involved). When SDRs are allocated, the members do not incur a corresponding debt. From the standpoint of the adjustment mechanism, this is the great weakness of the SDR scheme. There are almost no obligations connected with the use of the SDR that are designed to engender disciplined behavior by the members of the Fund. It is therefore understandable that the Interim Committee wants to make more use of regular drawing rights than of SDRs. But then it is inconsistent to suggest that "the members of the Fund . . . undertake to collaborate with the Fund and with other members in . . . making the special drawing right the principal reserve asset in the international monetary system" (IMF, 1976, p. 19, par. 7a).

The Case for Freer Floating

The Fund authorities are obviously of the opinion that floating (which they shunned for so long) has worked quite well. In the Fund's *Annual Report for 1975* we can read:

> On the whole, exchange rate flexibility appears to have enabled the world economy to surmount a succession of disturbing events, and to accommodate divergent trends in costs and prices in national economies with less disruption of trade and payments than a system of par values would have been able to do (p. 33).

But if greater flexibility of exchange rates has been successful under difficult circumstances, why not assume that it would work in normal times, why the desire to stick as close as possible to the par-value system instead of emphasizing the advantage of an arrangement in which market forces are permitted to handle adjustment by frequent but small changes of the peg?

When we are told that exchange rates have fluctuated too widely in recent years, we can answer that substantial swings are to be expected in a transition from fixity to flexibility under crisis conditions. The system of floating rates inherited the pent-up disequilibria of the preceding par-value arrangement, in which wrong parities led to misallocations that must now be corrected. As Sohmen (1976) says:

> Artificial pegging of exchange rates obviously managed to hold the pendulum so far out of its equilibrium position that we should not be surprised if it were to swing around hectically for some time before market participants have a clear idea where the long-run equilibrium—or, more exactly, the equilibrium path of exchange rate movements—is located (p. 126).

The main danger does not lie in wide variations under the impact of major disturbances and after years of wrong pegging; it lies in the still predominant desire on the part of the monetary authorities and the Fund to approximate the par-value system by rules for floating that emphasize medium-term stability of exchange rates rather than flexibility.

We hear much about "cyclical" market behavior and what a mistake it would be to follow market indicators that may reverse themselves. Reference to cyclical swings made some sense in the framework of a gold-standard type of system as long as, under the pressure of reserve flows, monetary authorities were willing to maintain monetary discipline and to correct external imbalances by deflationary and inflationary policies. But in a world in which the members of the Fund follow independent paths, we must accept Keynes's advice and continuously adjust the external value of a currency to its internal value. In a world where full-employment and growth policies take first place, it no longer makes much sense to count on more or less cyclical behavior of the underlying market forces to stabilize exchange rates for years.

Two other important concerns have caused opposition to flexible exchange rates. One is the ingrained fear of competitive exchange depreciation, the godmother of the par-value system; the other is the fear that flexibility will lead to the abandonment of monetary discipline and contribute to worldwide inflation.

The Jamaica Agreement repeats the command found in Article I of the Bretton Woods Agreement that competitive exchange depreciation is to be avoided. Section 1 of the new Article IV calls upon each member to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The Interim Committee unjustifiably connects the danger of competitive depreciation with managed or "manipulated" rates rather than with par values. Where exchange rates are really flexible, competitive exchange depreciation is impossible, since it implies the willingness of other members to maintain overvalued rates. As a matter of fact, the real danger all along was not competitive exchange depreciation but competitive undervaluation within the framework of the par-value system. Again we must conclude that the danger of managed floating lies in unduly delayed rather than in premature adjustments, in the refusal of the surplus countries to revalue rather than in aggressive competitive depreciation.

Managed floating to maintain undervaluation will reveal itself in growing reserves. In order to maintain an artificially low value for the local currency in spite of increasing foreign demand, monetary authorities must purchase foreign currency with newly created domestic money. Such a policy of competitive undervaluation "imports" inflation and negates the very purpose of floating by maintaining wrong price signals.

These conclusions force us to reject the major argument for stable exchange values, that they help keep inflation in check by maintaining monetary discipline. Flexible exchange rates permit the less inflationary countries to protect themselves against inflation. Stable par values, on the other hand, must lead to money creation until the surplus country decides to revalue. For deficit countries, stable exchange rates imply the loss of reserves and pressure to follow more conservative policies through higher rates of interest. But higher interest rates will lead to increasing unemployment and are often politically unacceptable.

Thus artificially stabilized exchange rates force the members of the Fund to transfer the adjustment function from one strategic price to another, from exchange rates to interest rates. Flexible exchange rates would bring about external adjustment without influencing domestic policies, while stable exchange rates force market economies to transfer the adjustment function to interest rates and domestic monetary policies. Maintenance of exchange rates over extended periods means that the artificial stability of one price (the rate of exchange) is paid for by greater (and equally artificial) instability of another price, the rate of interest.

Flexibility of exchange rates can be more conducive to monetary discipline than long-term stability, as the Executive Directors of the Fund point out in their report, *The Role of Exchange Rates*:

> In cases where a continued deficit reflects the persistence of inflation, and where external resources to finance the deficit are readily available through the use of reserves or unconditional borrowing facilities, the pressure to correct the inflation lying at the root of the payments disequilibrium may for a time be smaller than if the real cost of the inflation were exposed and transmitted to the domestic public at large through a depreciated exchange rate. In other cases, where countries have been more successful in curbing inflation than the world economy at large, so that their currencies have become undervalued, domestic financial stability itself has been weakened by defense of an exchange parity (p. 35).

The Case for Reducing Liquidity

Neither competitive exchange depreciation nor an absence of monetary discipline can be used as arguments in favor of medium-term stability of exchange rates in the formulation of proper guidelines for floating.

When the Executive Directors refer to readily available "external resources to finance deficits" and to "unconditional borrowing facilities," they point to the crux of the problem. Excessive international liquidity reserves have created a situation in which it is often impossible to prevent national monetary authorities in deficit countries from supporting overvalued exchange rates. Enormous international liquidity has made it possible to dispense with the application of both adjustment mechanisms, domestic monetary discipline and exchange-rate variations. Instead of achieving external equilibrium, countries have financed the existing disequilibrium with owned and borrowed reserves. Indeed, huge reserves may induce monetary authorities in the deficit countries to maintain overvalued exchange rates; otherwise, these reserves have no function to fulfill.

The case of surplus countries is different, of course. If they want to prevent their currencies from appreciating, they need only buy foreign currencies with their own money. But, in this case too, excessive accumulation of foreign reserves must be used as an indicator for exchange-rate adjustments.

With increasing flexibility of exchange rates under a system of managed floating, we are entitled to assume that the need for international liquidity reserves should greatly decrease. The Fund's *Annual Report for 1975* comes to the conclusion that, "other things being equal, the use of reserves, and the volume of reserves needed to support it, is smaller in circumstances of widespread managed floating than under the par value system" (p. 38).

If we are serious about building more flexibility into the adjustment process, we have to argue for a substantial reduction in the world's liquidity reserves, that is, for their partial cancellation or transformation into real investment. The recent oil crisis has shown how difficult the latter task can be. Other things remaining equal, a sudden lowering of international liquidity preference would tend to kindle worldwide inflation through the transformation of hoarded reserves into active demand for real resources. The problem is made even more difficult by the unequal distribution of liquidity reserves. We can hardly assume that the rich owners of redundant liquidity will agree to a cancellation of a substantial part of this purchasing power. On the other hand, a general scheme of redistribution whereby, for instance, the World Bank would invest such funds in poor countries could aggravate world inflation.

However, as long as international liquidity remains at the level characteristic of the par-value system, its mere existence will foster adherence to the old arrangements and preclude managed floating of the kind that would support a speedy adjustment mechanism. The national monetary authorities (facing the politically difficult task of either hurting the export industry or imposing monetary restraints and creating unemployment) will be tempted to avoid such unattractive decisions by the simple device of intervention in the exchange market in the hope that the present difficulties will somehow go away.

In judging the present supply of, and demand for, international liquidity, we must remember that managed floating does not apply to all members of the Fund and that the new Article IV permits "cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members." Where such arrangements exist (as between smaller countries and their main markets or sources of supply, or in the European Monetary Union), there is still great need for liquidity reserves.

Experience has shown that most of the arguments against the par-value system apply equally to an arrangement such as the European Monetary Union. Monetary union implies that the member countries succeed in integrating their monetary, financial, and wage policies. If they do not succeed, the result will be (1) increasing rather than decreasing political friction; (2) counterproductive effects in the national economies of the members, such as increased inflation in some and increased unemployment in others; (3) growth rather than elimination of quantitative restrictions; and (4) excessive liquidity creation to maintain parities in fundamentally unbalanced situations.

The Jamaica amendment does not take issue with members who want to maintain the par value of their currencies in relation to the currency or currencies of other members. Since the arrangement points toward stability, it is considered good and not in need of guidelines or surveillance. The Fund authorities, who treat floating and flexibility with suspicion, have ignored the negative experiences of this regional application of the par-value system—another proof of their partiality.

Conclusion

Jamaica may turn out to have been a landmark in the development of the international payments system, if the legalization of floating eventually leads to a really flexible adjustment mechanism. Only an overly conservative attitude of the Fund and of national monetary authorities stands in the way. Now that floating has been forced on the Fund and has shown itself capable of coping with situations that the par-value regime could not have handled, we should muster the courage to emphasize flexibility rather than stability of exchange rates. Stable or even fixed parities made sense as long as it was possible to control international liquidity and as long as reserve movements tended to integrate the national monetary policies of the members. Jamaica has done little to repair or reinstate this equilibrating mechanism. For this reason, external equilibrium must be brought about predominantly by variations in exchange rates.

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