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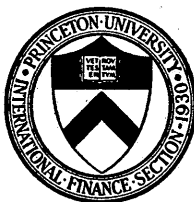

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Jamaica and the Par-Value System

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 over-

see 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." Specifical-

ly, 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