Problems of the International Monetary System and Proposals for Reform – 1944-70

by CHRISTOPHER L. BACH

RECENT international economic events and government pronouncements have focused renewed attention on the future of the Bretton Woods international monetary system. What is the system now? What would we like it to be in the future? The debate is not a new one. Economists for years have recognized the system's actual and potential problems and have proposed a plethora of solutions to resolve questions about: (1) the distribution, size, and growth of international reserves; (2) the difficulty of international adjustment in a world of highly mobile capital when nations are committed to full employment; (3) the confidence problem, that is, shifts in preferences among national currencies and other kinds of reserve assets; and (4) the appropriate role for gold. Financial ministers and heads of central banks have also debated these questions.

Quite often, analyses of current problems and future needs of the international monetary system have arisen only out of monetary crises, and the adopted *ad hoc* solutions have shown no comprehensive plan for the future of the Bretton Woods system. Now, for perhaps the first time since 1944, there is general agreement that all aspects of the Bretton Woods system should be re-evaluated, and that certain characteristics of the system be altered to meet the requirements of international trade and exchange in the 1970s.

The critical economic problems which brought questions about restructuring the Bretton Woods system to the forefront of economic discussion at the conclusion of the 1960s were short-term capital flows and the failure of the system to promote international adjustment. These problems were natural developments from gradually changing economic conditions in the 1950s and 1960s. Lower international trade barriers, the establishment of general currency convertibility in 1958, improved capital markets, and the growth of multinational corporations contributed to increased capital mobility. Lack of harmonization of stabilization policies among nations, inappropriate alignment of parity rates, and political constraints on changing parity rates contributed to problems of international adjustment. Recent actions among major industrial countries have made a start toward restructuring the Bretton Woods system with new parity rates, widened margins, and the use of SDRs.

The following article summarizes the historical development from 1944-70 of the problems that arose in twenty-five years of operation of the system, and discusses some of the proposals offered toward the conclusion of the 1960s to remedy the major shortcomings of the system. The purpose of looking at the historical development of the problems and the proposed solutions is to provide a backdrop for current discussions of international monetary arrangements. While the events of 1971 and 1972 already indicate a movement toward correcting some of the problems, they have also revealed new problems, the discussion of which is beyond the scope of this article.

THE BRETTON WOODS SYSTEM AND THE INTERNATIONAL MONETARY FUND

Let us begin by examining the design of the International Monetary Fund (IMF). The Articles of Agreement state the purposes of the institution as follows:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the Fund's resources temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.[1]

Parity Values

The mechanism chosen to promote international cooperation while facilitating high levels of employment and real income was a regime of defined parity rates. From time to time, parity rates were to be redefined whenever necessary to correct fundamental disequilibria in balances of payments. In order to maintain consistency in the definition of parity rates, each nation effectively defined its currency in terms of gold. Thus, all currencies were tied to gold and indirectly to each other.

Within a group of nations whose currencies were fully convertible and in which the currency of one nation served as both domestic and international money, the number of exchange rates that could be *independently* defined was one less than the total number of nations. For example, in a group of three nations, country A can state the monetary value of its currency in terms of C's currency, and country B can state the monetary value of its currency in terms of C's currency. By virtue of this action the parity rate between country A and B is defined. If all three countries attempted to independently define their parity rates, a conflict would develop if one country sought to increase a parity that another country was trying to lower. Thus, at least one country had to observe a passive policy in defining its parity rate. By practice, that country in the Bretton Woods system has been the United States (country C in the above example).

Once a system of parity rates was defined, countries had to choose how to meet their exchange rate stability obligations. Individual member countries were originally required to limit exchange rate fluctuation to one percent on either side of parity. Most countries chose to limit exchange rate fluctuations by using the dollar as the intervention currency for spot transactions in the foreign exchange market.

The United States chose to meet its exchange stability obligations through purchases and sales of gold at $35 an ounce. It is important to note that the price of monetary gold is not a parity rate in the same sense as an exchange rate of one national currency for another. However, under the rules of the IMF, a change in the U.S. price of gold can alter parity rate relationships just as does a change in a parity rate, assuming the dollar rate for any currency is not devalued to the same extent as the dollar.

Liquidity

Gold, convertible currencies, and general balances at the IMF were the major sources of international liquidity in the Bretton Woods system. The IMF had at its disposal two means for assuring international liquidity. A temporary means of increasing the supply of liquidity available to an individual nation was a procedure known as "drawing" on the general account of the Fund. Individual nations could borrow from the Fund's pool of currencies (which had been contributed on the basis of a pre-arranged quota system) in order to finance temporary balance-of-payments deficits. From time to time quotas could be increased to raise the amount of potential liquidity available to members.

After 1968, the Fund acquired the ability to consciously supplement the long-run growth of reserve assets permanently available to all member nations by creating Special Drawing Rights (SDRs). Participating countries were free to draw on the special account of the Fund without consultation or challenge of policies designed to restore balance-of-payments equilibrium (unlike drawing on the general account).

[1]International Monetary Fund, *Articles of Agreement* (Washington, D.C.: International Monetary Fund, 1944 and 1969), p. 2.

Countries which used SDRs might incur an obligation to "reconstitute" their position with the IMF to some extent, depending on the amount and duration of SDR use.

Balance-of-Payments Correction

Because countries were expected to experience balance-of-payments disequilibria from time to time, a method had to be devised to eliminate surpluses and deficits which would involve neither trade or payments restrictions nor undermine the essence of a par value system. Provision of ample liquidity (reserves) merely provided time for countries to take corrective balance-of-payments action, but did not in itself eliminate surpluses and deficits. Furthermore, it was only persistently large deficits and surpluses which the Fund viewed as detrimental to international monetary order.

Stabilization policies were expected to be the first line of defense in eliminating reserve gains and losses. It was presumed that countries would use monetary and fiscal policies to achieve high-employment objectives, and no country was expected to suffer severe unemployment to protect its balance-of-payments position. It was also felt that domestic stabilization policies could remedy many external payments problems with little loss of domestic real output.

If stabilization policies were insufficient to restore a country's competitive position with its major trading partners, the member country could propose to the Fund a change in its parity rate. The Fund was required to concur with the request when it was satisfied that the change was necessary to correct a fundamental disequilibrium in the balance of payments.

HISTORICAL EVOLUTION OF THE BRETTON WOODS SYSTEM AND ITS PROBLEMS

The Bretton Woods system never worked quite the way it was intended. As background for understanding the current problems of the system, let us briefly review the problems that arose in twenty-five years of operation. Many current problems of international finance can be traced, directly or indirectly, to three major changes in economic institutions and practices since 1944. The first major change was the expanded use of the dollar as an international currency and a widely accepted reserve asset; the second was the great increase in the degree of economic interdependence among nations, especially as reflected in movements of highly mobile capital; and the third was the comparative rigidity of parity rates that developed in actual practice.

The Dollar as an International Currency

The use of the dollar as an international reserve currency alleviated one problem of the Bretton Woods system but created two others. The problem that was remedied was the failure of gold, a key source of reserves in the Bretton Woods system, to provide a steady and sufficient increase in international liquidity over time. The newly created problems were (1) the gradual accumulation of dollars by foreigners, which were at first welcomed but later resented, and (2) the dilemma faced by a reserve currency center in seeking either to approximate external payments balance, or to provide an adequate growth of international reserves.

Gold Reserve Problems

The Bretton Woods system depended importantly on the efficient use and distribution of international reserves, especially at the conclusion of World War II and in the late 1940s. Because the United States held about 70 percent of the world's total gold stock and also had a substantial balance-of-payments surplus in this period, distribution of gold for use as international reserves proved difficult. Gold reserves available from other countries were insufficient to settle or "finance" their payments deficits with the United States. Even when gold reserves were supplemented with meager borrowings from the IMF and unilateral transfers from the United States, large payments imbalances would have occurred in the postwar period if there had not been tight regulation abroad of imports and capital movements.

Another problem related to gold was that the supply of the existing gold stocks and newly mined gold was insufficient to satisfy the increase over time of both monetary and nonmonetary demands at a fixed and unvarying price. Throughout the 1950s and 1960s gold demand for nonmonetary purposes rose as world income rose, as well as demands for other metals substitutable for gold in some uses (silver, platinum, and palladium). Gold demand for monetary purposes also rose along with the expansion of income and trade. However, because the rate of growth of the gold supply was both erratic and inadequate to match the expansion in demand over time, and since the price of gold was not permitted to rise, monetary authorities were increasingly hard pressed to obtain monetary gold for addition to international and domestic reserves.

Dollar Reserve Problems

The gold reserve problems would have been far more severe if they had not been alleviated by the expanded use of the U.S. dollar as a reserve asset and world currency after World War II.

The economic size and dominance of the United States made its currency desirable as an international reserve currency, both before and after 1939. Much of the world's trade involved U. S. goods, services, or financial resources, and in addition, the value of the American currency proved far more stable over time than that of many other national currencies (at least until the late-1960s). Wider acceptability resulted from wider use and vice versa.

With the creation of the IMF and the obligation of countries to maintain exchange rate stability, most countries chose to keep their exchange rate within prescribed margins by buying and selling dollars against the local currency. By virtue of this arrangement, dollars became an intervention currency, and countries held additional working balances in dollars – a use for dollars that had not existed before World War II.

The use of the dollar as an international currency relieved the shortage of gold reserves and provided sufficient liquidity to finance payments imbalances at existing exchange rates. However, the continued accumulation of dollars by major nations throughout the 1950s and 1960s raised questions about how many dollars foreigners would willingly hold, especially official foreigners. The United States was looked upon to provide long-term financial aid and grants to the lesser developed countries in the 1950s, and, as an international financial center, to supply capital resources for the expansion of European business firms and multinational corporations throughout the 1950s and 1960s. When U.S. deficits persisted, problems of interpretation arose as to whether the dollar outflow represented a fundamental weakness in the U.S. economy and therefore required corrective action, or whether the rules for international reserve accumulation and depletion that applied to trading nations were inappropriate for the United States which was the banker for the world as well.

U.S. Balance-of-Payments Policy

Throughout much of the 1960s many people pointed out that the reserve currency country faced a dilemma. It could either seek to approximate external payments balance, or permit its deficits to continue in order to provide adequate growth of international reserves. Those who argued that approximate payments balance was the more appropriate objective of the two reasoned that a reserve currency country which ran persistent deficits could continuously finance its deficit simply by printing bank money which official foreigners were obliged to hold, and thereby avoid adjustment of domestic incomes, costs, prices, and exchange rates. Consequently, the United States improved its economic position by acquiring foreign goods and assets while foreigners were left as unwilling holders of dollar assets. Some foreigners claimed that this behavior served only to finance American enterprise and military adventures abroad.

Those who argued that provision of ample international reserves was the more appropriate objective of the two admitted that the preceding argument was not altogether unfounded, but pointed out that it was an incomplete description of the position in which the reserve currency center was placed. Major determinants of U.S. deficits were not just domestic economic conditions over which it had some control, but also exchange rate alignment and inflexibility, the role of the dollar as an international currency, and persistent surpluses by major industrial nations in the late 1960s, over which it had little direct control. Given the general shortage of international liquidity and the failure of the international monetary system to promote adjustment, continued U.S. deficits were not altogether undesirable. The only danger lay in the fact that a crisis might be precipitated if there was a sudden decline in the desire of foreigners to hold dollars.

Given this dilemma in the 1960s, U.S. balance-of-payments policy had to take account of the

> . . . haphazard linkage between the supply of additional reserves, provided by U.S. payments deficits, and the demand for them, combined with the great disruption that would result from applying the IMF prescription for fundamental disequilibrium to the United States. In dealing with its payments deficit, the United States has had to thread its way delicately between a desire to reduce the deficit and a desire to avoid measures for reducing the deficit that would be destructive of domestic objectives or international order.[2]

Many U.S. policy actions were directed toward reducing the deficit in the 1960s, although the efforts were not as active nor as effective as some would have liked.

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[2]Richard N. Cooper, "The Dollar and the World Economy," in *Agenda for the Nation,* ed. Kermit Gordon (Washington, D.C.: The Brookings Institution, 1968), pp. 485-6.

Greater Economic Interdependence

More significant in the long run than the problems associated with gold, the expanded use of the dollar as an international currency, or U.S. balance-of-payments policies were the problems associated with greater economic interdependence. Greater economic interdependence and integration brought increasingly intense clashes between domestic and international considerations in framing economic policies.

Evidence of increased economic integration was seen in the financial and technical innovations of the payments system. Convertibility of major currencies into dollars after 1958 and the growth of the multinational corporation with its improved methods of cash management both diminished risks and uncertainties in foreign commerce and increased the flow and efficient use of real and financial resources. The rapid growth of the Eurodollar market since the late 1950s and the Eurobond market since the mid-1960s meant that investors and borrowers could place and acquire funds in either national or international markets depending on relative yields, costs, and risks.

The most obvious, but probably not the most serious, threat to the success of the Bretton Woods system in a world of growing capital mobility and economic interdependence was its susceptibility to destabilizing speculation and other large-scale flows of short-term capital. In a monetary system of general convertibility among currencies and integrated money and capital markets, incorrectly aligned exchange rates became difficult to maintain. Hedgers and arbitragers were quick to take advantage of interest rate differentials, and leads and lags of corporate payments and receipts contributed to large capital flows. In order to try to preserve parity values, central banks sometimes paid high prices in the loss of foreign exchange reserves, and on occasion had to subjugate national priorities to international concerns. When a government failed to convince speculators that a parity value could be maintained, it had to accept the outcome associated with a change in the parity rate — namely, a change in a country's growth of income, output, and prices.

Rigidity of Parity Rates and International Adjustment

A greater threat to the future of the Bretton Woods system than increased economic interdependence and speculation was its failure to initiate and promote international economic adjustment promptly and to distribute equitably the costs of adjustment among trading partners. Excessive reluctance to change parity values eliminated an effective means of achieving international adjustment.

As price, output, and growth trends diverged, a country initially had to accept an increased or decreased outflow of foreign currency reserves at a given parity rate, and ultimately a change in internal prices, output, and income. Given the desire of most countries to achieve full employment of domestic resources, however, many were unwilling to permit the changes in internal economic conditions which the system required to remedy payments imbalances if parity rates remained unchanged. Because of the unwillingness of countries to alter their parity rates *or* permit changes in internal prices, outputs, and incomes, market pressures for adjustment were resisted and adjustment delayed as countries tried to shift at least part of the adjustment burden to other nations.

A corollary point was that in a moderately well integrated set of trading nations, a country which pursued domestic stabilization policies that resulted in a price and output performance *greatly* different from its trading partners experienced a higher rate of inflow or outflow of international reserves at a given parity rate than it did if domestic price and output performance was similar. The impact on reserves varied somewhat depending upon the size and relative efficiency of the nation. However, like the situation in the preceding paragraph, countries resisted the required changes in either parity rates or domestic economic conditions, and the Bretton Woods system failed to achieve adequate international adjustment.

Occasionally, stabilization policies were capable of achieving domestic and balance-of-payments objectives simultaneously and thereby permitted international adjustment. Nonetheless, in cases where conflicts arose in the 1960s, nations tended to choose to protect domestic employment and output. Tariffs, quotas, border taxes, and capital controls were often used (although at a reduced level from the 1950s) to insulate national markets from international repercussions. Such practices were disguised means of changing the parity rate and a second best solution to the adjustment problem.

The adjustment problem became particularly critical in the case of the United States. As its competitive position changed gradually over the years, the United States found itself unable to exert independent pressure on the exchange rates of dollars for other national currencies without disrupting international monetary arrangements (particularly in the 1960s). The difficulty of bringing general policy instruments to bear on payments and adjustment problems was even more severe than in the case of the European economies because of the smallness of the U.S. foreign sector relative to its domestic sector, and because the United States, like the Europeans, often incurred policy conflicts between full employment and balance-of-payments objectives.

ALTERNATIVE SOLUTIONS

Numerous solutions were proposed to remedy the problems of the Bretton Woods system. Let us now review the major alternative solutions to the liquidity problem, the adjustment problem, and the U.S. balance-of-payments problem, principally those that were suggested in the late 1960s.

A Solution to the Liquidity Problem

The major solution proposed to resolve the liquidity problems of the Bretton Woods system was the rationalization of reserve creation by relying mainly on Special Drawing Rights – the supply of which was subject to conscious international control – rather than on gold or on U.S. dollars. This proposal was adopted in 1968 and implemented in 1970.[3]

Since their creation as an official reserve asset, SDRs have performed some of the functions of an international money. They have shared the role of a store of value with gold, and to a limited extent served as a medium of exchange among official institutions. However, it has been the dollar which has continued to perform *de facto,* if not *de jure,* each of the three classical functions of money for both private and official uses. As numeraire (common denominator or standard of value), medium of exchange, and store of value, the dollar has continued to serve as the dominant source of international money and liquidity.

It has been suggested that if all currencies were to be defined in terms of SDRs rather than gold or the dollar as at present, and all participating countries were to actively use SDRs in the purchase and sale of convertible currencies, some pressures on the dollar might be lessened. SDRs would then replace gold and dollars as the primary form of *official* reserve asset. Official reserve creation could be consciously controlled by international decisions, thereby removing the erratic and insufficient growth over time of official reserves in the Bretton Woods system. The dollar, because of its convenience and efficiency of use in foreign exchange markets, would probably remain the principal *private* monetary asset.

[3]For a thorough discussion of the mechanics and operation of SDRs, see Fritz Machlup, *Remaking the International Monetary System: The Rio Agreement and Beyond* (Baltimore: John Hopkins University Press, 1968).

Alternative Solutions to the Adjustment Problem

Solutions suggested over the last two decades for the adjustment problem centered around the choice of parities and how to change the parities when required, and how much exchange fluctuation to permit around parities.

Parity Rate Alignment

It was clear that if the adjustment process of the Bretton Woods system was to be improved, a way had to be found to promote orderly and periodic realignments of parity rates among major nations. Only when parity rates accurately reflected fundamental competitive positions and could be altered in the absence of anticipatory capital flows could a significant improvement in the adjustment process be expected.

By the late 1960s, no proposed solution had yet been agreed upon that could effectively deal with the problem. From the restoration of European convertibility in 1958 to the devaluation of the U.K. pound in late 1967, sluggishness of changing par values persisted and the balance-of-payments adjustment process proved more uncertain than the founding fathers of the system had anticipated. The series of shocks from mid-1967 to 1970 indicated that long-run stability of par values was being achieved at the expense of short-run stability in the world financial markets. Throughout the entire period, the United States as the key currency center could not effectively change dollar exchange rates for other currencies without fear of competitive rate changes or of disrupting international monetary arrangements. Theoretical suggestions were made in an attempt to define responsibilities of trading partners in initiating changes in parity rates, and in distributing the adjustment burden equitably among industrial nations, but none of the suggestions was practical enough to put into operation.

While little progress was made on the long-run adjustment problem, there was substantial sympathy toward the end of the 1960s for proposed solutions to short-run adjustment problems. Two alternatives were offered to increase the extent and speed of international adjustment in the Bretton Woods system once a system of "correct" parities had been determined — (1) a widening in the permissible margin of fluctuation around stable parities, and (2) frequent, small, discretionary or automatic changes in stable parities. Either of these alternatives, it was argued, would improve the short-run adjustment mechanism and initiate the balance-of-payments adjustment process more rapidly than in the past. However, it was also regarded as probable that neither alternative would substantially improve even the short-run adjustment process in the absence of an appropriately determined initial set of parity rates.

Stable Parity with Widened Margins

There was little doubt that widened margins about stable parities *could* increase the speed with which short-run adjustment was initiated and the extent to which demands for and supplies of currencies were either encouraged or discouraged. But there was also recognition that the expected improvement which would be promoted depended critically upon what people at any instant in time expected the *future* parity rate to be. If people widely believed that the future parity rate would be the same as the present parity, then wider margins would permit changes in foreign exchange prices to alter capital and trade flows to some extent without encouraging the massive one-sided speculation that sometimes occurred under a system of very narrow margins. Greater exchange rate flexibility would thereby partially insulate domestic money markets from international movements of short-term capital. Widened margins about stable parities might prove particularly desirable for countries in different cyclical positions. This type of short-run adjustment was not, however, to be regarded as a substitute for the long-run adjustment created by parity changes.

If, in contrast to the preceding example, there was widespread belief that the future parity rate would be substantially different from the present parity, speculative activities associated with the former uncertainties about parity rate changes would recur. In this situation there would be little that widened margins could do to discourage destabilizing and other large-scale flows of short-term capital.

The nature of these conclusions for an individual country would be complicated further if all nations had widened margins around their parities. Nations are unlikely to attach equal weight to the various objectives of economic policies. Some nations prefer to tolerate more unemployment, and others more inflation, than their trading partners. In addition, governments differ in their ability to control domestic costs and prices. Thus, varying domestic economic conditions and policy actions might cause currencies to move to the floor or ceiling of the widened margin and stay there, causing sufficient concern to throw established parities into question. Even if the internal cost and price trends of all nations were identical, changes in the composition of internationally traded goods might necessitate changes in parity values. In these cases, widened margins might or might not be beneficial in promoting short-run international adjustment, depending upon the future exchange-rate expectations that would be generated.

Crawling Parity with Widened Margins

A crawling, or gliding, parity was offered as an alternative to the stable parity. It was often combined with suggestions for widened margins around parity. Under this system, the ability of widened margins to improve adjustment was subject to the same qualifications as in the preceding paragraphs.

The distinguishing feature about a crawling parity was that the parity value changed gradually over time up to an agreed upon maximum rate. Hence, in the short run the parity was essentially stable and could give a degree of certainty to international transactions, while in the long run the gradual change in parity could reflect small changes in relative costs and prices and initiate changes in balance-of-payments positions before disequilibria became massive. In a world of interdependent nations, frequent and small changes in parity values could compensate for differing effectiveness of internal stabilization policies and gradually changing international trade patterns.

Automatic vs. discretionary parity changes — The desirability of changing parities frequently and by small amounts (as illustrated by the crawling parity) depended in the minds of many observers on whether the small changes were discretionary and made by national governments, or whether they were automatic and made in the international market place. If the changes were discretionary, government officials still had to decide when and by how much to alter the parity rate, just as under the system of stable parities and very narrow bands. While frequent and small changes might reduce disruptive capital flows, government officials would still be pressured on occasion to make decisions that might have unpopular domestic economic effects. They would remain free to avoid international adjustment pressures if they were willing and able to sustain a loss or gain of reserves, and they could still be swayed by domestic concerns to postpone changing the parity rate until financial and political pressures made it imperative.

If the parity and the margins about the parity rate were free to change up to an agreed upon maximum rate per year in either direction, the market place would determine fluctuations within the margins while government officials would limit the range of parity and exchange rate fluctuation by establishing the margins. While many argued that fully automatic parity changes within agreed upon limits would greatly improve the adjustment mechanism, others contended that some countries might find the system unacceptable because countries often regard control over their exchange rate as an established prerogative of national sovereignty. Too much fluctuation in the parity, even when a "correct" initial parity had been determined, might represent diminished control over domestic resources.

A suggested compromise (which retained most of the benefits of a discretionary or automatic crawling parity with widened exchange rate margins, while respecting concerns over national sovereignty) was a set of mutually agreed upon rules with some degree of multilateral surveillance. Such rules would be designed to guide the countries in establishing the margins and limiting the amount of governmental intervention (if any) within the widened margins.

Possible restrictions on domestic stabilization decisions – It was generally argued that gliding parities with widened margins permitted increased freedom for domestic interest rate policy. Stabilization authorities would have more freedom than with stable parities and very narrow margins to direct policies at domestic interest rates and economic conditions without encouraging short-term capital flows. Changes in the parities would mitigate the incentive for shifting interest-sensitive funds that might accompany shifts in domestic stabilization policy.

However, under certain conditions, crawling parities might tie domestic stabilization decisions just as closely to international conditions as throughout the 1960s. If, for example, a country's parity was highly predictable and it was widely believed that it would move downward at a maximum permitted annual rate of two per cent per annum for an extended period of time and its spot exchange rate would move down accordingly, domestic stabilization decisions would have to submit to the conditions of international trade, and domestic interest rates would have to be two per cent higher than foreign rates if there was to be no capital outflow. As long as the direction of future parity and exchange rate movements was clear, expectations would give rise to the one-sided speculation which characterized most parity rate changes of major nations from 1967-70.

Ultimately, any restraint that might be placed on domestic economic policy decisions from the crawling parity had to be compared with the restraint that occurred when a parity was generally considered out of line, and when capital flows were consequently stimulated by the expectation of a large discrete adjustment in parities. Many observers believed at the end of the 1960s that once an appropriately aligned initial set of parities had been agreed upon, a system of crawling parities would help to maintain these relative currency values as international trade patterns shifted gradually over time, and thereby avoid substantial balance-of-payments disequilibria.

Alternative Solutions to the U.S. Balance-of-Payments Problem

There were three broad schools of thought on interpreting the meaning of U.S. balance-of-payments deficits in the late 1960s.[4] The first emphasized the total supply of dollars available. As long as the supply at some given price was greater than the private demand, dollars would flow abroad through one channel or another and end up being acquired by foreign central banks. The only sure way to stop the deficit was to reduce the total supply of dollars relative to the demand for them, and the way to do this under a fixed exchange rate system was to maintain tight money.

The second school of thought insisted that a change in the price of dollars was required. The numerous *ad hoc* and direct measures already taken to cure surpluses and deficits such as border taxes, tariffs, and interest equalization taxes were ineffective and highly discriminatory means of reducing the deficit. What was needed was to remove these impediments to free trade and have a depreciation of the dollar relative to the currencies of the surplus countries.

In between the two extremes were those who said that the demand management approach was irrelevant because it failed to take into account the conflict between balance-of-payments and high-employment

[4]These positions are outlined in Cooper, "The Dollar and the World Economy," pp. 495-7, and Robert A. Mundell, *Monetary Theory: Inflation, Interest, and Growth in the World Economy* (Pacific Palisades, California: Goodyear, 1971), pp. 166-9.

objectives which often characterized the U.S. balance-of-payments problem. There were also those who pointed to the limited relevance of both the demand and supply approaches because of the difficulty of bringing general policy instruments to bear on the payments problem without damaging the domestic economy.

Many, but by no means all, interpreters of U.S. balance-of-payments performance found some common ground for agreement. They argued that piecemeal measures which had characterized balance-of-payments policies in the past should be abandoned because they were ineffective and discriminatory. They suggested that a viable alternative to previous balance-of-payments policies and continuous U.S. deficits was to set parity rates among industrial nations in such a way as to substantially reduce, but not eliminate the U.S. deficit, and to reduce the surpluses of many industrial nations. The realigned parity and exchange rate structure should assure that U.S. surpluses on current account were sufficient to nearly offset normal levels of unrestricted net private and Government investment abroad.

This position recognized that foreigners should no longer be forced to be unwilling holders of dollars, and that it was of critical importance to the Bretton Woods system to maintain confidence in the key currency. A means of restoring confidence was to reduce the deficit by parity rate adjustments. This position also recognized that there was unlikely to be any fundamental change in the role of the dollar in private international transactions in the early 1970s. As deficits were reduced and adjustment improved in the Bretton Woods system, confidence in the dollar would be restored and the dollar would continue to be in wide demand as an international currency. Finally, supporters of this position recognized that a more flexible means of realigning parity rates in the future had to be coupled with other reforms, if there was to be a permanent and significant improvement in the U.S. balance-of-payments position and in international monetary arrangements.

EPILOGUE

This statement of the historical evolution of problems of the Bretton Woods system and some of the proposals offered for their resolution at the close of the 1960s is intended as background material for understanding negotiations about international monetary arrangements that have occurred in 1971 and 1972. There has already been some movement to achieve improved adjustment and liquidity performance of the Bretton Woods system, as is evidenced by a realignment of parities, a widening of margins around parities, and adoption and limited use of SDRs. The events of 1971 suggest, however, that the improvement came at the cost of disrupting international monetary order. Furthermore, the problem of the key currency country initiating changes in its own parity rate is likely to remain a critical one. It may well be that unless corrective action is taken in each of the problem areas of the Bretton Woods system, a "solution" to any individual problem may represent little permanent improvement.