

THE INTERNATIONAL MONETARY SYSTEM: DEVELOPMENTS AND PROSPECTS

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Introduction

This paper addresses several fundamental issues raised by recent developments in the world economy and considers their implications for the design and functioning of the international monetary system. We do not make any proposals. Our purpose instead is to identify factors that merit attention in any serious examination of the system.

First, some background. Over the past several years, the international economic landscape in the industrial world has been dominated by the following key developments. To begin with, there have been unprecedented current account imbalances for the three largest economies. In 1987, the United States recorded a current account deficit of \$154 billion, while Japan and the Federal Republic of Germany registered surpluses of \$87 billion and \$45 billion, respectively (see Table 1). A primary objective of policy has been to reduce these external imbalances while still maintaining satisfactory growth of the world economy. The contribution that fiscal policy should make to reducing absorption relative to output in the United States, and to increasing it in surplus countries, has become an integral—and often a contentious—element in the policy dialogue. Suffice it to say that the adjustment of fiscal positions has proven to be a difficult process, with firm evidence of a narrowing of earlier divergencies apparent only within the last year or so (see Table 2).

Heavy official intervention in exchange markets (especially during 1987) and episodes of coordinated adjustments in interest rates—

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TABLE 1
MAJOR INDUSTRIAL COUNTRIES: BALANCE OF PAYMENTS ON CURRENT ACCOUNT, 1980-87

	1980	1981	1982	1983	1984	1985	1986	1987
Balance on Current Account^a (In billions of U.S. dollars)								
United States	1.87	6.89	-8.68	-46.26	-107.08	-115.11	-138.83	-153.97
Japan	-10.75	4.77	6.85	20.80	35.00	49.17	85.84	87.02
Fed. Rep. of Germany	-13.85	-3.57	5.12	5.32	9.85	16.58	39.31	45.01
(In Percent of GNP)								
United States	0.07	0.23	-0.27	-1.36	-2.84	-2.87	-3.27	-3.40
Japan	-1.01	0.41	0.63	1.76	2.78	3.67	4.34	3.64
Fed. Rep. of Germany	-1.69	-0.52	0.78	0.81	1.58	2.62	4.37	4.00

^aIncluding official transfers.

TABLE 2
MAJOR INDUSTRIAL COUNTRIES: GENERAL GOVERNMENT FISCAL BALANCES AND IMPULSES, 1980-87

	1980	1981	1982	1983	1984	1985	1986	1987
Fiscal Balance^a								
(In billions of U.S. dollars)								
United States	-34.50	-29.60	-110.80	-128.60	-105.02	-131.80	-144.40	-104.87
Japan	-46.94	-44.86	-39.15	-43.23	-26.25	-11.02	-21.91	-8.74
Fed. Rep. of Germany	-23.68	-25.17	-21.65	-16.60	-11.87	-7.23	-10.87	-19.06
(In Percent of GNP)								
United States	-1.26	-0.97	-3.50	-3.78	-2.78	-3.28	-3.41	-2.32
Japan	-4.41	-3.84	-3.60	-3.66	-2.09	-0.82	-1.11	-0.37
Fed. Rep. of Germany	-2.89	-3.67	-3.29	-2.52	-1.90	-1.14	-1.21	-1.69
Fiscal Impulse^b								
(In percent of GNP)								
United States	0.65	-0.50	0.55	0.57	0.60	0.72	0.16	-0.84
Japan	-0.40	-0.78	-0.52	-0.19	-1.22	-0.94	-0.20	-0.70
Fed. Rep. of Germany	-0.19	-0.51	-1.87	-0.42	-0.55	-0.86	0.25	0.17

^aData are on a national income accounts basis; + surplus, - deficit.

^b+ expansionary, - contractionary.

both undertaken in an effort to foster more stability in key-currency exchange rates—have been a second prominent feature of the landscape (see Figure 1). These efforts, in combination with the monetary response to the global stock market crash of October 19, 1987, and with plans for a liberalization of capital controls in the European Monetary System (EMS) by 1992, have once again put the spotlight on an old question: How successful can monetary policy be when it is asked to wear two hats, one for internal and the other for external balance?

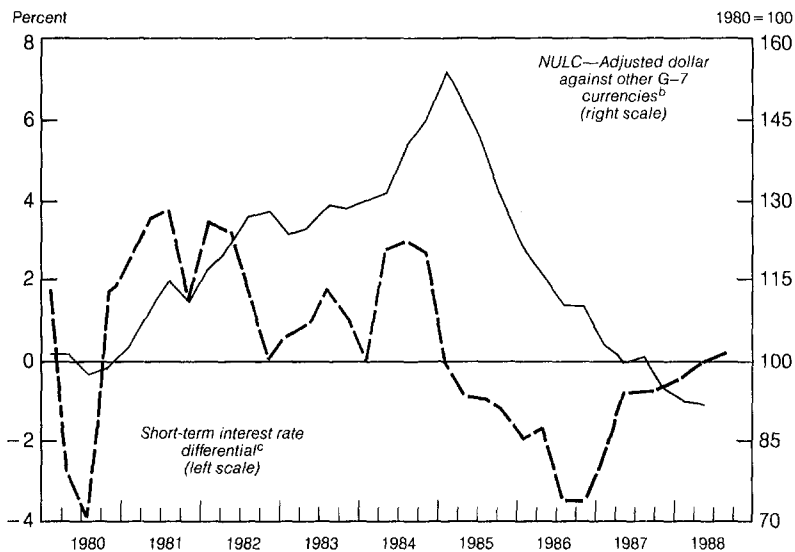
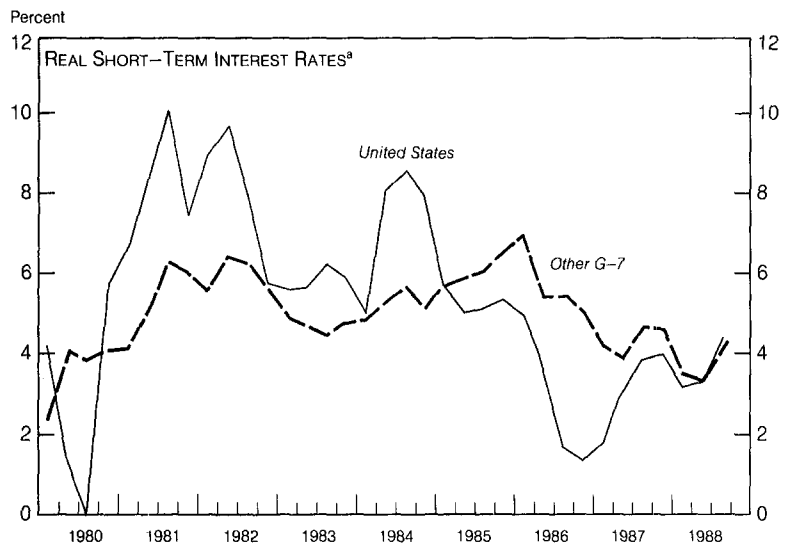
Another distinguishing characteristic of the last several years has been the sizable decline in both the nominal and real value of the U.S. dollar. By now, all of the 1980–85 real appreciation of the dollar (on an effective basis) has been reversed (see Figure 2). The central question has been “Do you think the dollar decline has gone far enough?” On a number of occasions (e.g., the Louvre Accord, February 22, 1987; the September 1987 meetings of the Interim Committee; and the G-7 statement of December 22, 1987), officials have supplied their own answer—by offering a concerted view on the consistency of the existing pattern of exchange rates with “fundamentals.” Moreover, interest continues to be expressed in some reform proposals—including a system of target zones—that hinge on knowledge of equilibrium exchange rates.

Last but not least, the period since the Plaza Agreement (September 22, 1985) has witnessed a strengthening of international economic policy coordination among the major countries. Coordination agreements have featured both country-specific policy commitments and official pronouncements on the pattern of exchange rates, but have not specified rules, anchors, or a center-country for the exchange rate system. Debate continues on whether the present coordination process is merely an intermediate stage on the way to a more far-reaching, rule-based reform of the system, or whether it is instead a durable, workable compromise between what some regard as the excesses of decentralized floating and the straitjacket of fixed rates.

So much for the landscape. How does it relate to prospects for the international monetary system? We would say “quite a lot.” Indeed, much of the controversy over reform of the system can be traced back to different views about the capabilities and limitations of more managed exchange rate regimes to deal with just the sort of policy problems outlined above. In our view, four central issues merit particular attention in the current climate:

- Can the exchange rate regime do much to help discipline fiscal policy?

FIGURE 1
THE DOLLAR AND REAL INTEREST RATES
(Q1 1980–Q3 1988)

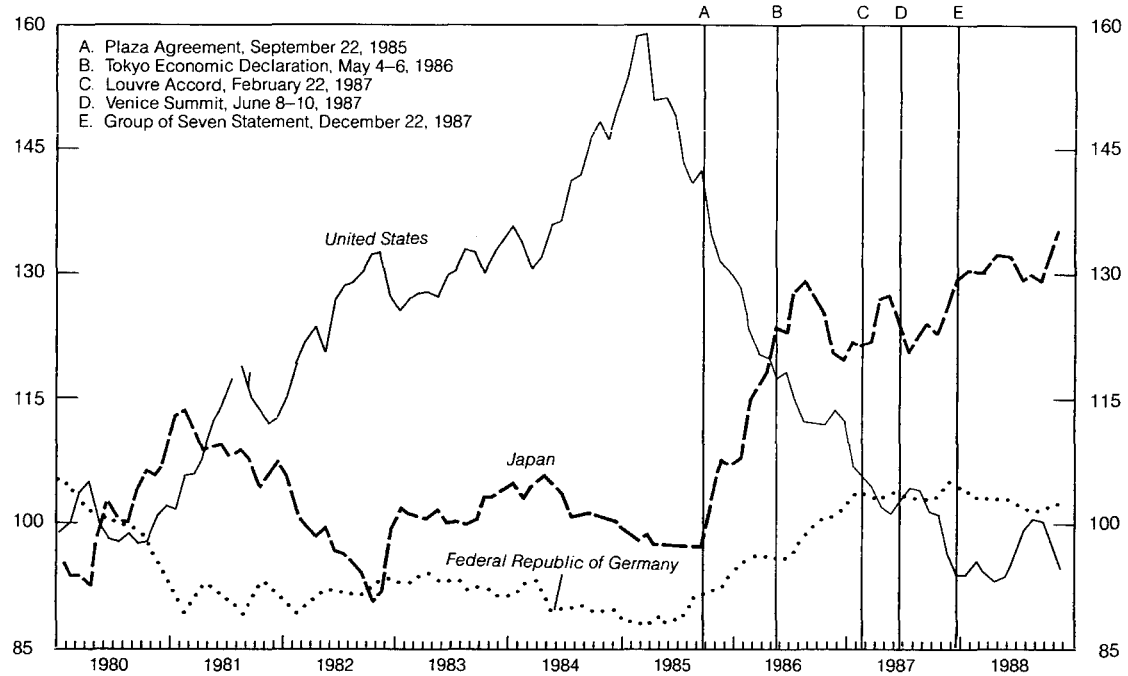


^aQuarterly average short-term money market instruments of about 90 days maturity deflated by the private domestic demand deflator. Other G-7 interest rate is a weighted average of individual rates. Weights are defined in note b.

^bThe NULC adjusted dollar is a weighted average index of the exchange value of the dollar against the currencies of the other G-7 countries, where nominal exchange rates are multiplied by the relative normalized unit labor costs in manufacturing. Weights are proportional to each country's share of world trade in manufactures during 1980.

^cU.S. real short-term interest rate minus other G-7 real short-term interest rate.

FIGURE 2
REAL EFFECTIVE EXCHANGE RATES, 1980-88^a



^aReal effective exchange rates based on normalized unit labor costs in manufacturing.

- What are the extent and costs of reduced monetary independence under greater fixity of exchange rates?
- How can the equilibrium exchange rate best be determined?
- Does a well-functioning international monetary system require a clearly defined set of rules, an acknowledged leader, and an explicit anchor?

We will examine each of these issues in turn.

Fiscal Policy and the Exchange Rate Regime

The proposition that the commitment to defend the parity provides economic agents with increased discipline to avoid inflationary policies is one of the oldest and most durable arguments for fixed rates. Yet close scrutiny of the typical focus of the discipline hypothesis suggests that it could be akin to Hamlet without the Prince of Denmark. In what follows, we elaborate on this point.

The traditional province of the discipline hypothesis is monetary policy. Under the well-known Mundell-Fleming model, monetary policy is completely ineffective for a small country with fixed exchange rates in a world of high capital mobility. This is merely one application of the dictum that policymakers who seek to achieve simultaneously fixed rates, open capital markets, and an independent monetary policy will be frustrated. The best they can do is to achieve any two of the three objectives. Thus, once the choice is made for fixed rates and open capital markets, monetary policy is effectively disciplined. The exchange rate could be devalued to give monetary policy a longer leash, but this approach is ruled out by the assumption that devaluation would bring with it heavy political costs.¹

More recently, the domain of the discipline argument has been extended to wage policy. The basic idea here is that if exchange rate adjustments do not completely offset inflation differentials, then the resultant real appreciation for high-inflation countries will deter exports, real output, and employment, thereby acting as a disincentive to excessive wage settlements.² An interesting and unresolved question is how long it will take to convince workers of the downward slope of the labor-demand schedule, especially if wage developments are dominated by insiders with jobs rather than by outsiders without them.

¹The issue of whether the consequences of a more expansionary monetary policy will be as visible under a fixed rate as under flexible rates is discussed in Frenkel and Goldstein (1986).

²See Giavazzi and Giovannini (1988).

Surprisingly enough, disciplinary effects on fiscal policy have been relatively neglected. And this neglect is despite the role often attributed to lax fiscal policy (particularly in the United States) in both the breakdown of Bretton Woods and the large—many would say “excessive”—real appreciation of the dollar during the 1980–85 period. It is, therefore, worth asking if and how alternative exchange rate regimes might influence fiscal policy.

First, consider fixed rates. With high capital mobility, a fiscal expansion will yield an incipient, positive, interest rate differential; a capital inflow; and a balance-of-payments surplus—not a deficit. Hence, exchange rate fixity helps to finance—and by no means to discipline—irresponsible fiscal policy. As suggested in the recent literature on “speculative attacks,”³ only if and when the markets expect fiscal deficits to be monetized will they force the authorities to choose between fiscal policy adjustment and devaluation. The better the reputation of the monetary authorities, the longer in coming will be the discipline of markets. In this connection, it is worth observing that whereas the EMS has produced significant convergence of monetary policy, convergence of fiscal policies has not taken place.⁴

Second, consider the outcome under target zones. Suppose the zones are to be defended by monetary policy. In that case, a fiscal expansion that puts appreciating pressure on the exchange rate will produce a loosening of monetary policy to keep the rate from leaving the zone. Again, the exchange rate regime will have exacerbated—not disciplined—the basic cause of the problem. Only if the threatened departure of the exchange rate from the zone initiates a review of the whole range of policies, and if that (multilateral) review tilts the balance of power in the domestic debate toward fiscal responsibility, will the target zones discipline fiscal policy. This missing link between exchange rate movements and fiscal policy under target zones is being increasingly recognized. We should note that whereas first-generation target zone proposals spoke mainly of monetary policy, second-generation proposals have added a specific rule to rein in fiscal policy (contrast Williamson [1985] with Williamson and Miller [1987]).

What about floating rates? With high capital mobility, one would again expect fiscal expansion to prompt appreciation of the real exchange rate. Pressures for reversal are then likely to come from the beleaguered traded goods sector, as it looks for ways to turn

³See Flood and Garber (1980) for a model of such speculative attacks.

⁴See Holtham et al. (1987).

around its decline in competitiveness. The trouble here is that there is also the protectionist alternative to fiscal discipline, which, if adopted, would again follow one inappropriate policy with another. The recent U.S. experience is suggestive of the difficulties associated with forging a dominant constituency for fiscal reform, and of the perseverance necessary to combat measures for quick-fix protectionist alternatives.

Finally, consider the influences operating on fiscal policy in a regime of managed floating with international economic policy coordination. One immediate advantage is that the potential for a perverse monetary policy response is reduced since specific fiscal policy commitments can be specified directly as part of a negotiated policy package. That is, one avoids the intermediate link between the exchange rate signal and the policy response. But this regime too is not entirely without pitfalls. For one thing, the kind of specific, quantitative policy commitments that lend themselves to reliable monitoring may be perceived as intruding too much on national sovereignty. For another, there is no explicit mechanism for sharing the fiscal adjustment across participants. Also, there is the problem of implementation of fiscal policy agreements when the responsibility for implementation lies with different branches of government in different countries.⁵

The bottom line of all this is that if proposals for modification or reform of the exchange rate system are truly to lead to more disciplined macroeconomic policies, more attention has to be given to how the exchange rate regime will have an impact on fiscal policy behavior. To some observers, the answer is that fiscal reform must precede reform of the exchange rate system. To others, the answer may be that better fiscal discipline requires mechanisms outside of the exchange rate system, such as Gramm-Rudman legislation. And to still others, the answer may be that the multilateral give-and-take encouraged by policy coordination or a system of target zones is a necessary, if not sufficient, tool for achieving greater fiscal responsibility. One thing is clear: It will be hard to know how to shape the evolution of the exchange rate system without knowing beforehand how to better discipline fiscal policy.

Monetary Policy Independence

As suggested earlier, a strong message from the theoretical literature is that a more fixed exchange rate regime requires keeping more of an "eye" on the exchange rate in the conduct of domestic monetary

⁵See Feldstein (1987).

policy. What is much more controversial is what such a reduced independence of monetary policy would cost.

Concern about reduced monetary independence is often strongest in countries with either relatively low or relatively high inflation rates. In the former, there is a worry about repetition of the latter days of Bretton Woods when disequilibrium exchange rates, heavy exchange market intervention, and massive capital flows combined to wrestle control of the money supply away from the authorities. In their view, a similar occurrence would jeopardize both their price-stability objectives and their hard-won, anti-inflationary reputations. For the high-inflation countries, there is a concern that less monetary independence could handicap the battle against the cyclical component of high unemployment. In addition, high-inflation countries often suffer from weak fiscal systems with relatively heavy reliance on the inflation tax.⁶ In this regard, they worry that a lower inflation rate will reduce their revenue from seignorage, run up against tax evasion in seeking to compensate for it by raising other taxes, and, hence, complicate what are already difficult fiscal problems.

More generally, there is a concern that greater stability of exchange rates would be purchased at the cost of both greater instability of other prices in the economy—including interest rates and prices of nontraded goods—and of a diminished capacity to use monetary policy to pursue other objectives of policy. For example, a large hike in interest rates taken to protect a weak currency could disrupt stock market prices. Similarly, a firm commitment to defend a given exchange rate pattern might limit the freedom of maneuver of monetary authorities in combating a weakness of certain financial institutions.

Some would say that exchange market intervention offers a solution to the “two-hat” problem by introducing an additional policy instrument to handle the exchange rate. We note that this line of argument should refer exclusively to sterilized intervention because nonsterilized intervention is best regarded as monetary policy by another name. Yet the available empirical evidence on sterilized intervention is not very encouraging to those who favor highly managed rates. In brief, the Jurgensen Report (1983) concluded that sterilized intervention is not likely to have a powerful effect on the level of the exchange rate over the medium to long run. Thus, while intervention may be helpful in smoothing short-run volatility and in providing the market with a “signal” about the future course of

⁶See Frenkel (1975) and Dornbusch (1988).

policies,⁷ it is not by itself likely to deliver monetary policy from having to serve two masters.

Another possible way out of the box would be controls on international capital flows. This is indeed the route sometimes taken in the past by some members of the EMS, as evidenced by the widening of interest differentials (adjusted for differences in tax treatment) between onshore and offshore financial instruments (denominated in the same currency) during periods of exchange rate crisis.⁸ No one asserts that capital controls are costless. The argument instead is that such controls are less costly to the real side of the economy than alternative policy options. In fact, James Tobin's (1980) "sand-in-the-wheels" proposal for an international round-tripping tax on all capital flows employs just this rationale.

In our view, the case for capital controls is a weak one on at least five counts.

First, the benefits from liberalization of capital controls appear to be substantial, including higher real returns to savers, smaller spreads between borrowing and lending rates, a lower cost of capital to firms, better hedging possibilities against a variety of risks, and a more efficient allocation of investment.⁹

Second, capital controls themselves induce changes in financial structure and rent-seeking activities that make it difficult to subsequently reverse them; yet the longer they stay in place, the more serious the distortions associated with them.

Third, there is no effective way to separate a priori productive from nonproductive capital flows. Also, the costs of an inappropriate classification could be large. In this connection, if some speculators are deterred from seeing through the "J-curve," exchange market stability could be adversely affected—a result directly opposite to the original rationale for controls.

Fourth, since controls are seldom negotiated on a multilateral basis, they can poison the atmosphere for advances in coordination and cooperation in other areas; in particular, controls on capital flows run counter to the development of an outward-looking policy strategy.

Fifth, round-tripping taxes are neither practical nor desirable. To work, such taxes need to be applied universally; yet an incentive always exists for some country not to impose the tax and thereby to capture much of other countries' business (i.e., their effectiveness

⁷See Mussa (1981).

⁸See Giavazzi and Giovannini (1988).

⁹See Folkerts-Landau and Mathieson (1987).

will be diminished by "regulatory arbitrage").¹⁰ Also, they would require a country that wishes to attract a capital inflow to raise interest rates even more, to offset the effect of the tax, thereby possibly increasing the variability of interest rates.

Yet another tack would be to assign fiscal policy to internal balance so that monetary policy can concentrate more on the exchange rate. Such an argument, however, faces two immediate problems. One is that fiscal policy is considerably less flexible than monetary policy in almost all industrial countries. We can contrast, for example, the frequency in the United States of meetings of the Federal Open Market Committee with the frequency of budget submissions to Congress. The other problem is that fiscal policy is not oriented to short-run stabilization goals in most industrial countries; it is instead guided by other considerations (e.g., reducing the share of government in Gross Domestic Product, reducing the burden of taxation, and so on) that often become objectives in themselves. For these reasons, it is hard to think of fiscal policy as a close substitute for monetary policy.

Thus far, we have outlined some of the costs and trade-offs that might be associated with less independent monetary policy. There is, however, another side of the issue that sees both the loss and consequences of monetary independence under greater exchange rate fixity as much less serious. Advocates of this position make the following points.

First, the independence of monetary policy disappears once the exchange rate is transformed from a policy instrument to a policy target. Experience suggests that few countries are able to treat the exchange rate with "benign neglect" once it moves by a large amount.¹¹

Second, increased independence of monetary policy is not synonymous with increased effectiveness. The true constraint on the latter is not the exchange rate regime but instead the openness of national economies, particularly high international capital mobility. With floating rates, exchange rates respond rapidly to perceived changes in monetary policy; nominal wages and prices adjust rapidly to changes in exchange rates; and the invariance of real wages to exchange rate changes limits the effects of monetary policy on real output and employment.¹² In the end, the real choice is between

¹⁰See Levich (1987).

¹¹See Goldstein (1980).

¹²For an elaboration of these considerations, see Frenkel and Mussa (1981) and Frenkel (1983).

accepting reasonable constraints beforehand or having them imposed at higher cost later by markets.¹³

Third, the inflexibility of fiscal policy is an asset—not a liability—in a world of inflation-prone authorities. Growth and price stability will be best served when fiscal policy is put on a steady, medium-term course. If there is an unusual situation that is widely recognized as calling for a shorter-term adjustment of fiscal policy, it can be accomplished (witness recent temporary departures from the medium-term path of fiscal consolidation in Japan and in the Federal Republic of Germany).

To sum up, the real issue is not whether monetary policy is capable of restoring more stability to exchange rates. Surely it can. It is instead what one has to give up in terms of other objectives to get it. To some observers, that shadow price is too high and they would, therefore, prefer to live with a “natural” degree of exchange rate stability—much in the way that one accepts a “natural” rate of unemployment. To others, the exchange rate regime cannot take away what is no longer there in any case, namely, the ability of monetary policy to influence real output and employment in the long run under conditions of high capital mobility. Again, the view that prevails in the end will have a lot to do with the structure of any modification or reform of the exchange rate system.

Identifying Equilibrium Exchange Rates

As highlighted in our earlier snapshot of key developments in the world economy, the 1980s have been marked by large swings in major currency exchange rates. One popular position has been that these currency swings have been subject to large and persistent misalignments, where by “misalignment” one means a departure of the actual (real) exchange rate from its equilibrium level. One implication of this view is that the exchange rate is too important a relative price to be left entirely to the market and, therefore, that officials should guide the market by supplying it with their own concerted view of the equilibrium rate. An opposing position is that the very concept of an equilibrium exchange rate different from the market rate is so riddled with conceptual and empirical problems as to render it operationally vacuous.¹⁴

The case that the equilibrium exchange rate may differ from the rate generated by the free operation of the marketplace rests on a number of arguments.

¹³See Duisenberg (1988).

¹⁴See Haberler (1987).

The first is that the equilibrium rate should reflect the sustainability of policies.¹⁵ For example, if the market exchange rate reflects an unsustainable budget deficit, then this rate may not be considered as an equilibrium even though it clears demand and supply in the market.

A second rationale for rejecting the market rate as an equilibrium rate is that it may imply undesirable values for certain objectives of policy, such as unemployment, growth, or the degree of restriction in goods and capital markets. Ragnar Nurkse (1945), for example, defined the equilibrium rate as the rate that would produce equilibrium in the balance of payments, without wholesale unemployment, undue restrictions on trade, or special incentives to incoming or outcoming capital.

The existence of market imperfections represents another possible reason for eschewing the market's verdict, this time on second-best considerations. Specifically, the existence of imperfect labor mobility is sometimes put forward as a reason for concluding that the market rate is too "noisy,"¹⁶ and that exchange rate stability shares certain "public good" attributes.¹⁷ The recent literature on "speculative bubbles" can also be seen as antagonistic to the market-rate-is-the-right-rate position by demonstrating that models of profitable destabilizing speculation can exist.

On the empirical side, there is likewise by now a large body of empirical work that suggests there have been periods over the past 15 years when the market's evaluation of the equilibrium rate was considerably different from the sustainable rate (Krugman 1985), or when it was difficult *ex post* to explain actual rate movements in terms of "fundamentals" (Buiter and Miller 1983).

Finally, even if one did want to look to the market for the equilibrium rate, opponents of floating rates point out the market rate is distorted by a variety of official interventions that render it a far cry from a "clean float." Since there are many ways to skin a cat and since it is hard to envisage a prohibition on all such interventions, the market rate is, in their view, of limited use. Still, it takes an estimate to beat an estimate. That is, if the market's view is rejected, then authorities need to supply their own estimate of the equilibrium rate. What then are the leading approaches?¹⁸

¹⁵See Frenkel (1987).

¹⁶For an empirical attempt to judge whether actual exchange rates are too noisy in terms of departures from fundamentals generated by a monetary model of exchange rate determination, see West (1987).

¹⁷See Frenkel, Goldstein, and Masson (1988).

¹⁸See Goldstein (1984) and Frenkel and Goldstein (1986) for more comprehensive discussions of alternative methods for estimating the equilibrium exchange rate.

Perhaps the most long-lived is the purchasing power parity approach. This can be expected to generate reasonable estimates if one can identify an equilibrium base period and if all shocks between the base and current periods are monetary in origin. But when there are real shocks, one normally wants a departure from PPP. The following are just some of the real factors that call for a change in real exchange rates: trend intercountry differences in labor productivity (not just in tradables relative to nontradables à la Balassa [1964] but in tradables as well);¹⁹ permanent changes in the terms of trade; and shifts from net creditor to net debtor positions. In this sense, it can be hazardous to assume that the equilibrium exchange rate is constant over time.

A second approach is to resort to structural models of exchange rate determination to produce estimates of the exchange rate consistent with "fundamentals." The fly in the ointment here, aside from measurement problems for some of the right-hand side variables, is that these models—be they of the monetary or portfolio balance variety—have been shown to possess poor out-of-sample forecasting properties.²⁰ But why then should markets trust these models as reliable indicators of equilibrium rates?

Yet a third approach is to use an econometric trade model to solve for the level of the exchange rate that—given anticipated real output and inflation paths over the next 18 months or so, and given any relative price effects still "in the pipe"—will produce a current account equal to "normal capital flows." This way is often referred to as the underlying balance approach. The main sticking point with this approach, aside from the wide range of estimates of trade elasticities,²¹ is the need to estimate "normal capital flows." Given the instability of perceived investment opportunities across countries and over time, it is hard to say if, for example, the United States should be regarded as a net capital exporter or a net capital importer, and if the latter, whether normal inflows are \$10 billion or \$100 billion.

All of this suggests—at least to us—that estimates of equilibrium exchange rates could be subject to rather substantial margins of error, and that official estimates of equilibrium rates should be allowed to change over time in response to changes in real economic conditions.

¹⁹See Marston (1986) for an empirical analysis of trend differences in labor productivity in tradables as between the United States and Japan, and for evidence on the drawbacks of measures of competitiveness that rely on broad price indices such as the CPI. On the broader issues concerning the limitations of the PPP approach, see Frenkel and Mussa (1980) and Frenkel (1981).

²⁰See Meese and Rogoff (1983).

²¹See Goldstein and Khan (1985) for a survey of trade elasticities.

Those who favor a modification or reform of the exchange rate system, therefore, need to ponder two questions: Are official estimates of the equilibrium exchange rate likely to be better on average than the market's estimate, and would a moving official estimate of the equilibrium exchange rate with a relatively wide band be helpful as an anchor for medium-term expectations about exchange rates? If both these questions can be answered in the affirmative, then the recent evolution of the system toward more "management" and more "fixity" of exchange rates is likely to continue. If not, then strong reliance on the market to determine the right exchange rate, like democracy, may be the worst system—except for all the others.

Leaders, Rules, and Anchors

The strengthening of international economic policy coordination that began in earnest at the Plaza in September 1985 represents, as noted above, a move in the direction of more cooperative management of the system. Yet some might describe present arrangements as a "nonsystem" because relative to, say, Bretton Woods or the EMS, there is a less formal structure, no acknowledged leader, and no explicit anchor. It is, therefore, of interest to consider whether such factors are likely to influence the effectiveness of an exchange rate system.

A convenient way of characterizing the Bretton Woods system is as an "implicit contract" between the leading country, or hegemon, and the satellite countries.²² The leader accepted the obligation to conduct its macroeconomic policies in a prudent, stable way—perhaps best summarized by a steady, low rate of inflation. This obligation was also reinforced by the leader's commitment to peg some nominal price—in this case, the price of gold. Since there were only $N-1$ separate exchange rates among N currencies, the leader was passive about its exchange rate. The satellite countries were committed to peg their exchange rates within agreed margins to the leader. As a reaction to the competitive depreciations of the 1930s, all exchange rate adjustments were placed under international supervision and were to be undertaken under conditions of "fundamental disequilibrium." As a consequence of their exchange rate obligations, the satellites gave up independence in their monetary policies but received the assurance that they had hitched their wagons to an engine that would stay on the tracks. Under this implicit contract, both sides can be said to be "disciplined" by their obligations, and

²²See Frenkel and Goldstein (1988).

both share any efficiency gains associated with moving closer to an international money.

With the benefit of hindsight, it is apparent that such implicit contracts can come under strain from a number of directions (in addition to Triffin's [1960] well-known "confidence problem"). One such strain is a breakdown of discipline by the leader so that the satellites come to see it as exporting inflation rather than stability. The satellites are then likely to sever their links with the leader and to seek stability through other mechanisms, including money-supply targeting and regional exchange rate arrangements with a more stable leader. A second strain is a change in underlying conditions that calls for a change in the real exchange rate between the leader and some of the satellites to restore external balance. If that equilibrating change in the real exchange rate is blocked by too much rigidity of nominal exchange rates (in surplus satellite countries), then the leader is apt to abandon its commitment to be passive about the exchange rate.

The EMS, like Bretton Woods, places exchange rate adjustments under common supervision. It also has clear rules about the intervention obligations of members. While there is no formal leader, many observers regard the Federal Republic of Germany (and its Bundesbank) as the *de facto* or acknowledged leader.²³ In this sense, it might be regarded as a system with informal hegemony. The implicit contract is similar in many ways to that under Bretton Woods. Germany follows macroeconomic policies that "export" price stability and anti-inflationary credibility to the others. It is noteworthy that while there have been 11 realignments within the EMS, none of them has resulted in a revaluation relative to the Deutsche mark, thus leaving Germany's reputation as an exporter of stability intact. Other EMS members are often described as "tying their hands" on domestic monetary policy. Exchange rate realignments may not always provide full compensation for past inflation differentials. In this way, the resulting real appreciation for high-inflation countries can act as a disincentive to inflation, while low-inflation countries receive a gain in competitiveness that provides some compensation for their export of anti-inflationary credibility. Monetary policy in Germany is typically regarded as the anchor.

While there clearly have been periods when large countries have exerted a stabilizing influence on the system, it would, in our view, be erroneous to conclude that hegemony is a necessary characteristic of a well-functioning international monetary system. For one thing, Eichengreen's (1987) careful study of alleged hegemonic systems,

²³See Giavazzi and Giovannini (1986).

including the gold standard, reveals that the amount of coordination needed for smooth functioning was substantial. A case in point is the coordinated action in the EMS when Germany and the Netherlands lowered their interest rates, while France raised its rate during the autumn of 1987. Also, the appearance of hegemony can sometimes result as much from common objectives as from asymmetries in economic size or reputation among countries. Again, the EMS serves as a fascinating laboratory. In the early 1980s, disinflation was the top priority in virtually all EMS countries. Since Germany had the best reputation for price stability, there was a commonality of interests in trying to converge to the German inflation rate. Now, however, some observers (for example, Dornbusch 1988) argue that given both the progress already made on the inflation front and the high unemployment rates prevailing in some EMS (and potential EMS) countries, it is time to give greater weight to objectives other than inflation. To some, such a decision would inevitably result in a more symmetric EMS. Indeed, these observers (e.g., Holtham et al. 1987) view the proposals on the EMS put forward to the EC Monetary Committee last fall by Minister Balladur of France as prefacing such a development of the EMS.

The system of floating rates that replaced Bretton Woods in 1973 could be said to have its own implicit contract. This contract suggested that each country should adopt sound and stable macroeconomic policies at the national level, with the expectation that stability of exchange markets would emerge as a useful by-product. In the event, some major countries did not adopt sound and stable policies at the national level, spillovers or externalities associated with these poor policies were significant (including protectionist pressures), and exchange rates displayed considerable volatility. In this decentralized system, there was no acknowledged leader. National macroeconomic policies served as anchors. The fact that intervention practices were sometimes different and uncoordinated led some (McKinnon 1984) to argue that an upward rise was imparted to the world money supply.

The perceived inadequacies of the decentralized floating rate system were, not surprisingly, the impetus for the move to stronger international economic policy coordination. The rationale behind the coordination process—and we think it can be regarded only as an evolving process—is that you need a mechanism to internalize the externalities of policy actions by the larger countries.²⁴ Specifically, multilateral surveillance is employed to see that the interna-

²⁴See Frenkel, Goldstein, and Masson (1988).

tional spillovers—both good and bad—of each country's policies—including the feedback of these spillovers to the country itself—are taken into account in the final, multilateral policy bargain. In some cases, countries may also be able to use "peer pressure" to help them take policy actions that are unpopular domestically but which are beneficial to them in the long run.²⁵

Although successive coordination agreements share several common elements (policy commitments, a concerted view on exchange rate developments, and pledges for closer cooperation on exchange market intervention), there are no explicit rules that apply across agreements. This flexibility carries both advantages and disadvantages. On the one hand, the agreements can cover a broad range of policies (including structural as well as macroeconomic policies), they can be quite country-specific and quantitative, and they can be custom-tailored to the most pressing problems of the day. On the other hand, without rules there are higher negotiation and recontracting costs.

Countries' monetary and fiscal policies serve as anchors in this system. Recently, however, U.S. Treasury Secretary Baker and U.K. Chancellor Lawson suggested the possible use of a commodity-price basket indicator as an early warning signal of future aggregate price developments. The use of this indicator might provide some assurance that stabilization of exchange markets does not come at the expense of either global inflation or deflation.

Another recent and noteworthy innovation in the coordination exercise is the consideration of aggregate indicators for the G-7 countries as a group. Their rationale is straightforward: Even when members of the coordination group reach agreements that are viewed as mutually beneficial, care still needs to be taken to ensure that such policy packages have satisfactory implications for those not at the table. This rationale is particularly relevant in the case of the G-7 countries since the spillover effects of their policies on the rest of the world are known to be large. Aggregate indicators, covering such variables as G-7 growth rates, G-7 interest rates, the G-7 current account, and the G-7 real exchange rate are simply an analytical vehicle for getting a better handle on these spillovers. In this connection, it is well to remember that there is a debt problem as well as a problem of improving the functioning of the international monetary system, and measures introduced to alleviate one will inevitably affect the other.

²⁵See Haberler (1987) for a different view on peer pressure.

Conclusion

It follows from the preceding remarks that we do not view reform of the international monetary system as an instrument of crisis management. Instead, we see it as akin to a constitutional change that should be governed by a long-term perspective. In keeping with that orientation, there is much to be gained by subjecting all proposals for modification of the system to careful scrutiny and study so that their full implications—both positive and negative—can be fully understood.

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SHOULD FLOATING CONTINUE?

Gottfried Haberler

Since I find myself in substantial agreement with the excellent paper by Jacob Frenkel and Morris Goldstein, I will not comment on their paper in any detail. Rather, I will use their paper as the basis for discussing the present international monetary system and whether floating should continue.

Critics of the Present System

In the last two or three years the present system, or nonsystem as its critics say, of loosely managed floating has again come under increasing criticism. The latest blast came from a totally unexpected source. His Holiness Pope John Paul II, in his Encyclical "The Social Concerns of the Church," says, "The world monetary and financial system is marked by an excessive fluctuation of exchange rates and interest rates, to the detriment of the balance of payments and the debt situation of the poorer countries."¹ Naturally, the Pope does not make concrete proposals for change. The Encyclical says, "The Church does not have technical solutions to offer for the problem of underdevelopment as such. . . . For the Church does not propose economic and political systems or programs." Still the statement has been widely interpreted as a rejection of the present system of floating exchange rates.

The French government also has expressed a distaste for floating rates. Both President Mitterrand's socialist government and Prime Minister Jacques Chirac's conservative government urged a return to some sort of fixed exchange system, and it is likely that the new center-left government will follow suit.

Cato Journal, Vol. 8, No. 2 (Fall 1988). Copyright © Cato Institute. All rights reserved.

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¹Cited in the *New York Times*, 20 February 1988, p. 4.

Naturally, the gold bugs at the *Wall Street Journal* have been delighted with the anti-float mentality of the Pope and the French. Indeed, they awarded a gold medal to French Minister of Finance Edouard Balladur and a silver medal to Pope John Paul II, citing them as among “the world’s notable economic thinkers.” The *Journal* then went on to criticize Beryl Sprinkel, a leading proponent of floating, awarding him a medal to “be fashioned in Styrofoam.”²

Mr. Balladur (1988) has spelled out the French position in considerable detail. Since his article has received widespread attention and reflects the general case against floating, his proposals should be carefully examined.³ He starts by mentioning several alleged failures of floating exchange rates to achieve expected results: Never have international balances been so large, nor fluctuations of these imbalances so wide as during the period of floating exchange rates. I could go through the list of alleged failures and show that what happened was not the consequence of floating. But I shall not take the time to do that, because his criticism of floating falls to the ground when we consider the nature of proposed alternatives to floating and what would have happened if any one of them had been in force in the 1980s.

Alternatives to Floating Rates

The suggested alternatives for floating rates are variants of the Bretton Woods system of “stable but adjustable exchange rates,” embellished by target zones and guided—or misguided—by commodity price indexes, including the price of gold. There is no reason to assume that in the 1980s a Bretton Woods type system would have functioned better than it did in the 1960s and 1970s. On the contrary, it is easy to see that it would have broken down just as it did in the early 1970s.

In 1982 the U.S. economy took off on a vigorous, non-inflationary expansion. Foreign capital from Europe and other countries poured into the United States, the dollar soared and a large trade deficit developed. Thus the U.S. economy pulled the world economy out of the recession.

Now consider what would have happened if in that situation the world economy had been in a straight jacket of fixed exchange rates. Europe would have come under severe deflationary pressure and any fixed rate system, with or without a target zone, would have

²*Wall Street Journal*, 23 February 1988, p. 30.

³See Solomon (1988) for a critical analysis of Balladur’s proposals.

collapsed. The response would have been imposition of controls and the world economy probably would have been plunged into a recession.

The Achilles' heel of the system of stable but adjustable exchange rates à la Bretton Woods is its vulnerability to destabilizing speculation. Very briefly, if under that system a currency weakens and the country loses reserves, the speculators (market participants) know that the currency can only go down; it cannot go up. Furthermore, they have learned from experience that a devaluation is bound to be large, because the authorities want to make sure that they will not have to go soon again through the painful operation. Therefore, if the speculators have guessed correctly and the currency is devalued, they make a large profit. If they have misguessed, they merely lose transactions costs.

Under floating the situation is different. A currency under pressure goes down immediately. Therefore, the speculators can never be sure whether the market has not already overshot and the currency will go up again. Thus the speculation becomes much more risky.

The existence of target zones does not change the situation, unless it is sufficiently wide and otherwise flexible so as to approach a free float. John Williamson, the chief and most persuasive proponent of the target zone system, has been fully aware of the vulnerabilities of Bretton Woods and of a rigid target zone to speculative capital flows. In a recent proposal for reforming the international monetary system, Williamson and Miller (1987) suggest five modifications of the target zone scheme to make it more flexible and less vulnerable to speculative capital flows. First, increase the width of the target zone. For example, a 20 percent band compared with a 2 percent band under Bretton Woods would sharply increase the risk for speculators. Second, give the zone "soft buffers," so that "the authorities would be entitled to cease defending the zone" if some unexpected disturbance threatened to push the exchange rate out of the zone. Third, apply the principle of the crawling peg to the target zone. Fourth, provide for regular reviews of the real exchange rate target. Fifth, adjust policy so as to preclude major interventions.⁴

To be sure, if the width of the zone is sufficiently large, the buffers sufficiently soft, the crawl sufficiently fast, the policy reviews sufficiently frequent, and policy adjustment sufficiently prompt, ample flexibility of the system would be assured. But in my opinion all this

⁴This fifth point was discussed in a letter by John Williamson to the author dated March 2, 1988.

is much too complicated to be put into a multilateral agreement such as the Group of Seven (G-7).

Jacob Frenkel and Morris Goldstein rightly say that the effectiveness of "a system of target zones" depends "on knowledge of equilibrium exchange rates."⁵ The fact is that we, economists as well as ministers of finance and central bankers, do not know what the equilibrium rates are. This was recently admitted by no one less than Japan's Prime Minister Noboru Takeshita. When asked whether in his judgment the dollar-yen rate was about right, he blurted out, "Only God knows!"

But many economists, Rudiger Dornbusch and Martin Feldstein among them, are convinced that the dollar has to fall a good deal more to sharply reduce the U.S. current account deficit. A few others, on the basis of some purchasing power parity calculations believe that the dollar is already undervalued. In my opinion PPP has some long-term uses, but is much too crude an instrument to be of any use for short- or medium-term problems.

Since the famous Louvre Agreement of the G-7 in February 1987, the official view has been that exchange rates of the G-7 currencies, in particular the dollar-Deutsche mark and the dollar-yen rates, are "consistent with the underlying fundamentals." The dollar has in fact remained fairly stable since then. But it required very large interventions by central banks in the foreign exchange market to prevent the dollar from declining. Furthermore, in the last several years a number of such statements have been made both by groups of countries and by representatives of two countries, for example by the United States and Japan, which were soon contradicted by the facts. The Louvre Agreement is not likely to be an exception.

Treasury Secretary James Baker and others have suggested that the dollar be anchored on, or linked to, an index of commodity prices including the price of gold. Mr. Balladur has mentioned that the monetary system as a whole might be given such an anchor. But as far as I know, nobody has spelled out how such a system would work.

I mention a few questions that have not been thoroughly discussed, let alone satisfactorily answered. First, which commodities should be included in the index? Take oil, one of the most important internationally traded commodities. The price of oil is very volatile, because it fluctuates with the ups and downs of the OPEC cartel. Does that not disqualify the oil price for inclusion in the index? There are other prices, such as the prices of coffee and tin, that are manipulated, or

⁵See also Frenkel and Goldstein (1987) for a detailed discussion of target zones.

at least sharply influenced, by dominant producers. Moreover, large export subsidies influence the prices of many agricultural commodities.

Second, what is the rationale of including the gold price? If exchange rates between the major currencies are not fixed, in which currency should the price of gold be expressed?

Third, is the commodity price index a proper measure of world inflation and one that should guide monetary policy in all countries? Proponents of the indexing scheme seem to think so, but in most countries the consumer price index is regarded as the proper measure of inflation. The two price indexes often diverge sharply over extended periods. I do not think it would be reasonable to recommend that the national monetary authorities should pay more attention to commodity price indexes than to the consumer price index, and there surely is no chance that such an advice would be heeded.

Where does that leave the suggestion that the dollar or some other currency should be anchored on, or linked to, commodity prices? The answer seems to be that the commodity price index is just one of several economic "indicators" that should guide policymakers in their decisions.

The notion of "indicators," often called "objective indicators," has been playing a considerable role in the drive for international policy coordination. Thus at the Tokyo Summit (May 1986) the heads of state of the seven summit countries "requested" the ministers of finance of the Group of Seven "to review their economic objectives and forecasts at least once a year . . . to ensure their mutual compatibility . . . taking into account indicators such as GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, monetary growth rates, reserves and exchange rates."

The proposed use of "indicators" has been hailed as a new approach and a major advance of policymaking in general and of international coordination of policies in particular. In my opinion there is nothing new in this "approach," not even the term "indicators" is new. As early as 1973, a report for the Committee of Twenty on Reform of the International Monetary System and Related Issues by "The Technical Group on Indicators" (under the chairmanship of Robert Solomon) discussed the use of indicators in the adjustment process.⁶

Actually, hardly anything has been heard about a development and use of indicators by later meetings of the ministers of finance. True, in September 1986 the ministers of finance of the Group of Seven met "to conduct the first exercise of multilateral surveillance pur-

⁶See International Monetary Fund (1974, pp. 51-76).

suant to the Tokyo Economic Summit Declaration of the heads of state of May 6, 1986.” But the one-page official statement of the meeting is a collection of generalities, evidently a compromise which, according to press reports, was reached after spirited, even somewhat acrimonious discussions.⁷

Later meetings of the seven ministers like the one at the Louvre in Paris (February 1987) reached the conclusion that “the exchange rates were just about right, that they are consistent with the underlying fundamentals.” Whether “objective indicators” were used to reach this conclusion is not known. But three things are clear: (1) The collective statements about equilibrium exchange rates turned out to be wrong; (2) the main thrust for international policy coordination is not to be found in the statements of the G-7, but in the pressure on Japan and especially on Germany by the United States, joined sometimes by other countries, to stimulate their economy; and (3) it is utopian to assume that these questions can be settled by setting up an agreed system of “indicators” that will tell every country what it has to do.

Floating Should Continue

My conclusion from all this is that the present international monetary system does not require a radical change and that floating should continue, which I think it will. A Bretton Woods type conference to set up a new fixed rate system as has been suggested by French governments, both socialist and conservative, is out of the question.

The 1944 Bretton Woods conference was run by Britain and the United States (by John Maynard Keynes and Harry Dexter White). Today it would be the Group of Seven or the Group of Ten, and it would be hard to keep out representatives of the Third World. It is inconceivable that such a group could agree on something so ambitious as a new Bretton Woods scheme. In the present world the alternative to floating is in most cases direct controls, not fixed rates with free convertibility.

But I do not want to overstate the case for floating exchange rates; in a sense floating is merely a second best. Fixed exchange rates would be the best system. If two or more countries can agree to fix the exchange rates of their currencies, it would be the best arrangement—provided, *first*, that the currencies are fully and freely convertible into each other at the fixed rate (in other words, that there

⁷See Haberler (1987, pp. 86–87) for details.

are no exchange controls and no trade restrictions “to protect the balance of payments”) and, *second*, that the fixed rate does not impose excessive unemployment or inflation on any participating country.

Unfortunately, in the present-day world these conditions are rarely fulfilled among sovereign states. It would require, as a minimum, close harmonization of monetary policy. The European Monetary System (EMS) is no exception.⁸ In the EMS, exchange rates are subject to periodic realignment and there is still exchange control in some member countries, for example, in France. A few real exceptions can be found among the many countries that peg their currencies to the dollar, the Deutsche mark or the yen. Austria is a good example. The Austrian schilling is pegged to the German mark. For a small country to peg its currency to that of its largest trading partner is a sensible policy. It is true Austria still has some exchange controls, but the controls are mild, and if the schilling lacked the firm anchor on the prestigious German mark, confidence in the soundness of the schilling would suffer and the controls would be tightened.

I repeat, in most cases the only realistic alternative to floating is not a fixed rate with full and free convertibility, but a pseudo fixity propped up by a battery of exchange and trade restrictions—the worst system. This was, of course, different before 1914; under the gold standard, exchange control was unknown. But those who want to go back, beyond Bretton Woods to the gold standard, face still another stumbling block. The Soviet Union and South Africa are by far the largest gold producers. As such, their output of gold would determine the long-term course of the world price level. Who would want to take that chance?

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⁸See the excellent contribution by Michele Fratianni to the present volume and his article “Europe’s Non-Model for Stable World Money” (1988).

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