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ARTICLES

INTERNATIONAL MONETARY POLICIES

World-economic Aspects of Exchange Rates

By Professor Dr Andreas Predöhl, The German Overseas Institute, Hamburg

There is scarcely a field in economic policy where the views relating to the factual problems are so diametrically opposed to each other as on monetary and currency policy. There are not only contrasts between theory and practice—preponderantly when it comes to the question of variable exchange rates—but also between practical men among each other and likewise between theoretical brains, when problems of international liquidity are discussed. Opposed standpoints are not acknowledged to be of only relative validity, through being based on different basic assumptions. On the contrary, they are being presented, with great passion, in the form of pleadings for an assumed absolute truth. This is a highly dangerous sign, suggestive of slovenliness in research, but on the other hand, the debates seem to keep a high level of scientific endeavour.

It would probably be best to let sleeping dogs lie but for the possibility of explaining the reasons for this paradoxical state of affairs, enabling us to resolve seeming contradictions. Such contradictions are caused by both camps omitting to see the problems as part and parcel of an indivisible world economy, both in its geographical structure and in its gradual evolution.

A Gold Currency?

To develop any consistent monetary policy, it is necessary to observe the close connection between rates of exchange and price levels. Currency policies which intend to keep the exchange rates stable must give up the idea of keeping prices in general stable, through autonomous intervention. Conversely, adepts of monetary policies who autonomously intend to keep the general price levels stable must necessarily give up the idea of stable exchange rates. Of course, mutual reactions between the different variables are different under different economic and currency systems, but the principle of the one desirability excluding the other and the alternative derived from it remains immutable, even under conditions of strict currency control. This absolute mutual exclusiveness can only be resolved by individual states adjusting their autonomous economic policies, either by co-ordinated price stabilisation or by parallel changes in the national price levels. Gold currencies are tied

to stable exchange rates—rates which will fluctuate only in the narrow confines between the so-called gold points. Under these conditions, the monetary policies of a given national economy are nothing but—and cannot be anything else—passively reacting to national and international gold movements. Provided we live under conditions of a genuine gold currency and a free enterprise economy, such reactions will merely consist in expanding and restricting credit in unison with the quantities of gold in the national bank's coffers. Of course, there is a whole gamut of less firmly-tied connections between credit and gold currency, but this does not detract from the basic principle.

The gold currency was an invention of British early capitalism. In fact, it was so much an indispensable condition for carrying on multilateral international trade without let or hindrance that liberal world trade is simply inconceivable but for an international gold currency. Wherever national economies were growing beyond their frontiers and narrow parochial ties into widely spaced international contexts, gold currency was bound to follow on their heels. On the other hand, when liberal world trade began to degenerate, especially when atomistic competition disappeared, the gold currency lost the foundations upon which it had been built. It is not true that its decay has been caused, as some advocates of a return to a gold currency assert, through a dilution of the gold currency, by substituting for it the system of gold foreign exchange standard. On the contrary, gold exchange currencies may be said to have prolonged the lifespan of pure gold currency relationships, because their operation was thereby facilitated under the deteriorating conditions of the years after the first world war.

Gold currency relations broke down as soon as an automatic, cyclical restoration of full employment could no longer be guaranteed. The traditional function of an economic depression, to reorganise the economy and to prepare it for a new boom, could be fulfilled only as long as prices and wages adapted themselves automatically. During the world slump, the economy remained stuck in a state of under-employment, and all great industrialised nations coun-

tered this peril by the systematic "creation of employment". During the big world slump of 1931, the business cycle has been replaced by an active policy of stimulating economic activity with the object of perpetual full employment. The theory of economic development shows us that this is an irreversible process. Should we try to return to gold currency relationships, we would only succeed in returning to the conditions which created the dreaded world-wide depression. This does not mean that gold should not be used for balancing out disequilibrium in international payments, in order to enforce a strict monetary discipline, but this has nothing to do with gold currencies.

Fluctuating Exchange Rates?

On the other hand, the opposite extreme—the system of fluctuating exchange rates under conditions of autonomous national growth policies—does not prove helpful, in any of its many varieties. As a model of thought it appears bewitchingly simple and irrefutable, and that is why all theoretical brains fall in love with it. Fluctuating exchange rates cover the foreign trade flank of a so-called open national economy to such an extent that autonomous cyclical policies and, at the same time, the international division of labour will apparently survive unscathed under their rule—and this observation will not be refuted. However, if we disregard the undecided quarrel, admitting that a system of fluctuating exchange rates is critically invincible, no matter within which limits fluctuations are to be permitted, there still remains the objection on the general grounds of world economic aspects.

The idea that national economies are closed units which, if so desired, can also be opened towards the outside world, is completely unrealistic. The world economy is a network of individual economies, which are subdivided more or less arbitrarily into national compartments by the national frontiers. Foreign trade and trade in the home markets are in close connection, whose intimacy is different in degree from one national territory to the next, and this leads to exchange rates meaning completely different things as from one country to another, and from one sector of production against the next. There are a good many national economies that can be understood only if we look at them from the outside, from their relationship with world economy. To try to cover the foreign trade flank of such an economy can only mean to protect the members of a body against other members of the same body. Vestigia terrent! In the thirties, there has been in existence a system of autonomous cyclical policies, using fluctuating exchange rates as its instrument, and this has meant that even when business expanded, multilateral exchange was largely replaced by bilateral barter, and world trade was shrinking, thus crippling the international division of labour.

This can be seen most clearly when we compare the United States with Europe. In both cases, the structure of the continental economy is "concentric" in rings round an industrial focus. Most intensive exchanges are taking place in the interior of this focal area (internal trade in the centre), the exchanges are much less active between border areas with other border areas, and on the periphery the stream of trade is extremely thin. On the other hand, there is a very strong exchange of goods and services along the radii between various focal areas, and also between the foci and border areas, and even between foci and the periphery. However, whilst North American internal trade within the industrial heart area is genuine internal trade, expanding only across one national frontier into Canada's province of Ontario, European internal trade of the industrialised centre is largely foreign trade. Interference of national frontiers with world trade began when autonomous cyclical policies were adopted. The American "power field" was affected by this change only at its fringes, whilst the European one has been cut across jigsaw puzzle fashion. Exchanges that have been affected by this distortion were not only the most intensive but also the most sensitive ones, as these markets were handling largely commodities which can be substituted for each other, whilst the exchanges between the central industrial area and the border belts consist mainly of goods supplementing each other.

This state of affairs inevitably poses the task of European economic integration, intended to restore to the European power field the capacities which the American one never lost. This problem is by no means adequately described by saying that we have to pull down the obstacles to trade presented by national frontiers; a number of opposed national economic policies will have to be integrated and harmonised, so that market conditions will be the same in the individual national markets of Europe. Such politico-economical integration has to be achieved before any reorganisation of the world economy, as can be seen quite clearly now again in the concept of the Kennedy Round.

Fluctuating exchange rates, even in the moderate form of adjustments carried out as need arises, would place insurmountable obstacles in the path of economic integration. They would contest the objective of a common market also in the field of economic policy. As if it were possible to introduce fluctuating exchange rates as between Illinois and Indiana! It was no accident that the German revaluation of 1961 was immediately followed by the Dutch upvaluing their guilder. Changes in the exchange rates could, in any case, be only the last expedient, which has to be resorted to in extremis, lest we endanger twenty years of European reconstruction.

Theoretical deliberations of economic geography oppose fluctuating exchange rates beyond the area of European economic integration. This is not only true for trade between industrial "power fields", which

structurally correspond to internal trade round the economic centre, but also of exchanges with the periphery of the world economy. Not only do fluctuating exchange rates affect each individual country and every different product in a different way, but they are also not compatible with the structure of export trade carried on by highly developed industrialised countries, which by no means adjusts itself to exchange rates only. Exchange rates, in many cases, are almost without any important function, in any case they are only one of many factors influencing world trade.

Gold-Exchange Currencies

The Bretton Woods agreement, forming the basis for to-day's currency policies, decreed free and stable exchange rates on current account but did not contain any rules for the signatories' behaviour. That Bretton Woods does not forbid changes in exchange rates under certain conditions does not justify us to call the Bretton Woods agreement a system of fluctuating exchange rates, although the principle of rigid stability of the exchange rates has been eroded in the course of time. The International Monetary Fund, which had been set up by the Bretton Woods agreement, would not have been able to operate under such conditions, unless the currency authorities of the participating countries had taken the initiative to work out rules of the game for regulating the equilibrium of the balances of payments by mutual agreement. Through this development, currency policies have strayed far from their starting point, so that the US dollar has become a true reserve currency, constituting a large part of most countries' currency reserves, in addition to bullion gold. This became possible only by the US showing willingness to exchange these foreign dollar reserves against gold, without setting any limit to such transactions. To a certain extent, the British pound fulfils a similar task.

There has been criticism of this gold exchange currency system because it depends on an adverse balance of payments of the US. The critics fear lest the US balance of payments attain equilibrium so that other countries might not get enough of the reserve currency for their requirements. They are also afraid that a lack of confidence in the dollar might lead to wholesale conversion of dollar holdings into gold, thus leading to the collapse of the entire system. And even if disaster could be evaded, shrinking reserves might bring about illiquidity in international payments, leading to deflation, the reverse of the steady rise in dollar holdings, which clearly favours inflation. Both the advocates of gold currency and the adherents of fluctuating exchange rates use this criticism for stating their cases. How to counter a scarcity of currency reserves has been elaborated by a wide variety of proposals ranging from raising the price of gold to the creation of additional international currency reserves.

Naturally, there is no gainsaying that the present dollar foreign exchange currency is but an expedient,

which in any case is fraught with dangers. But, as national banks have been cooperating closely, it has proved its worth, and at the same time it is the best approximation to overcoming the seemingly unbridgeable gulf between stable exchange rates and stable price levels, especially as the countries with the most important currencies have formed the so-called Club of the Ten. Increased international liquidity would only increase the lability of the system, as higher liquidity undermines strict discipline in keeping the national balances of payments in equilibrium.

However, this currency policy provides no solution to our problems, as it is unable to do away worldwide with the contradiction between stable exchange rates and stable price levels, even if we look only at the 27 countries joined together by subscribing to Article VIII of the Statutes of the International Monetary Fund. This Article precludes the signatories from introducing currency restrictions on current account transactions and currency discrimination, at the same time guaranteeing the convertibility of any foreign holdings of their currencies. One can say, the proposal to create some sort of world currency, in order to achieve a radical solution of our problem, is utopian, and it is all the more impossible to unify the economic autonomous policies of all the countries with convertible currencies. This would run counter to the geographical structure of the world economy, where each of these countries plays a completely different part. It is our task to take cognisance of the status quo of currency policies, without undermining it by advocating apparent nostrums leaning towards the one or the other extreme, but we must nevertheless explore the field for solutions which lead to genuine progress.

Integrated Currency Policies of the EEC

Again, European integration offers a way out of the dilemma. In world trade policies, neither the worldwide principle of GATT nor the Havana Charter can be used as an adequate basis for reorganising the economy of the world nor does the convention of Bretton Woods permit us to unify our currency policies. Reorganisation of world economy, in the fields of trade proper and in that of currency policies, can be achieved via European integration only. And European integration cannot be completed without a unified European currency policy. We must not forget that the International Monetary Fund would not have managed to grow from its completely unsuitable initial construction, which was based mainly on the victory of the White Plan over the Plan of Keynes, without the regional successes of the European Payments Union (EPU). As to European integration, the European Payments Union and the European Monetary Agreement (EMA) had a more profound concept than the EEC.

There is unanimity that a European currency, desirable as it might be, cannot be achieved under present political conditions in Europe. There are far too

many national competences which would have to be handed over to a supranational solution. This would require a more far-reaching integration. We do not know whether this will ever be realised. But the big success of economic integration, which has been achieved within the EEC, makes it appear possible that a loose currency integration may take place in Europe. The Club of the Ten would then be reduced to cooperation between the three big industrial power fields outside the communist bloc, as we can add,

within the Club, Canada to the US. Currency policy vis-à-vis the countries on the periphery of world trade, mainly the so-called development countries, could be much simplified. And, what is more important, the currency system of the world would then correspond to its economic order. This order, as is well known, cannot be run without an adequate currency system, in the same way as an adequate currency can exist only on the basis of an adequate economic order.

THE DEVELOPMENT DECADE

The Widening Gap in the Wealth of Nations

By Professor Dr Alfred Michaelis, New York

An interim report prepared last year by the Secretary-General of the United Nations on the results of the first half of the Development Decade sounded a gloomy note: The age-old scourges of famine and epidemics, instead of receding into the past, have returned to haunt the minds of men; in some cases they have begun to assume critical proportions. Food production in the developing world is lagging behind the increase in population. Control of communicable diseases is not as effective as it could and should be. The rate of economic growth is slowing down instead of accelerating. The lack of foreign exchange is holding back the implementation of development plans and projects. The terms of trade failed to improve for the developing countries which are mainly exporters of raw materials; they rather show further deterioration. External financial assistance, extended by the industrially developed countries, shows signs of levelling off. A growing percentage of export earnings of developing countries is being absorbed by servicing a mounting foreign debt. All in all, the prospects for attaining the goals of the Development Decade have dimmed with passage of time.

The Targets of the Development Decade

The resolution designating the current decade as Development Decade which passed the General Assembly of the United Nations on December 19, 1961, set two specific targets: a minimum annual growth rate of the Gross National Product (GNP) of developing countries of 5 % by the end of the decade, and an annual transfer of development capital from the developed countries amounting to 1 % of their GNP. In view of the annual population increase of the developing countries, estimated at about 2.5 %, only half of the target growth rate would be left for a rise in the per capita income and funds available for the growing investment needs. This goal can hardly be considered as overambitious.

More complicated is the situation regarding the annual transfer of 1 % of the GNP of the industrialized

countries to the multitude of developing countries. This one percent includes government aid as well as private investments in developing areas over which governments do not exercise control. This one-percent target has not been reached; and the "rich" countries are being blamed for not having done their share. Last summer, on the occasion of the Geneva session of the United Nations Economic and Social Council, Secretary-General U Thant pointed at the "stark fact" that, while national income has considerably increased in the developed parts of the world in recent years, financial assistance to developing countries has levelled off with the result that "the transfer of resources from rich to poor countries has decreased in relation to the capacity of high income countries to provide such assistance". With these unmistakable remarks, the Secretary-General undoubtedly reflected the prevailing opinion in circles representing the developing countries.

\$ 90,000 million in Development Aid

Nevertheless, huge amounts of government and private long-term capital and donations have been made available to developing countries during the last 10 years. The total net outflow of resources from developed market economies (i. e. private enterprise countries) to developing countries during the years 1956-1964 is estimated by the UN Department of Economic and Social Affairs at \$ 62,600 million in public and private flows, either bilateral or through multi-lateral agencies. The 1965 total exceeds \$ 10,000 million, bringing the 10-year (1956-1965) total to approximately \$ 73,000 million. Although figures for 1966 are not yet available, it may be assumed that another \$ 10,000 million were added. According to UN compilations, commitments of bilateral economic assistance from centrally planned (i. e. socialist) economies to developing countries during 1955-1964 amounted to the equivalent of \$ 6,030 million, with the Soviet Union accounting for 62 % of the total. This brings the overall total of public and private