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International Trade and Monetary System

by Professor O. Issing, Nürnberg

At the end of World War II international economic transactions had reached a deplorable low volume. Thus international organisations had been created to restore a free exchange of goods and capital between countries.

The greatest hindrance to this aim were the controls in the exchange markets. Almost all important countries, the only remarkable exception being the United States, had not later than with the outbreak of war introduced a system of severe exchange restrictions. The predominant task of the International Monetary Fund (IMF) was to help and to urge its members to release these restrictions and to restore step by step full convertibility. After many failures, the one to begin with being the spectacular experience of the Anglo-American Loan Agreement, these efforts were of some success in December 1958 when fourteen Western European countries established non-resident convertibility, and fifteen other countries adjusted their exchange controls to the new conditions.

Battle against Controls and Duties

Striving for freedom in international transactions on the currency side was accompanied by the endeavours to abolish or at least lessen the constraints to international trade. This was the main task of the General Agreement on Tariffs and Trade (GATT). The battle against direct controls and duties reached its climax in world-wide campaigns, one of which is well known as Kennedy Round. More far-reaching effects were brought about by some regional Agreements as the European Economic Community (EEC) and the European Free Trade Association (EFTA).

Starting with Triffin's "Gold and the Dollar Crisis" in 1960 a growing number of the majority academic critics called for a revision of the international

monetary system. The motives for this charge differed widely: some deplored the low standing of international reserves (Harrod), others were highly aware of the special dangers accruing from the so-called Gold-Dollar-Standard and of the unsatisfactory way this system was producing exchange reserves (Triffin), another group of experts marched against the foe of the world-wide inflation and pleaded either for restoring a true international gold standard or for introducing flexible exchange rates.

Monetary System under Pressure

In view of so greatly differing opinions and of the volume of world trade still expanding enormously, international organisations and officials in all countries did not worry much about the warnings of sophisticated theorists. The development in the early sixties seemed to confirm the "official optimism". However, since 1967 the international monetary system has been under almost constant pressure. The immediate origin of these difficulties was the inability and unwillingness of the United States to restore its balance of payments and the persistent weakness of the British currency. The uninterrupted series of crises reached the peak at first in the devaluation of the Pound Sterling in November 1967. Permanent gold speculation resulted in raids on the gold reserves of the monetary authorities. In March 1968 the members of the Gold Pool decided to stop their interventions in the gold market. Since this date the private market for gold is isolated from the official market; the system of two separate gold markets manifests itself by two mutually independent prices of gold.

International trade was not directly affected by the events in the gold market. But the following exchange crises did great harm to the free inter-

national flow of goods and capital. In France the outburst of strikes gave way to excessive wage rate increases which were followed by a corresponding inflationary rise of prices. The continuing process of inflation and the immense outflow of speculative money ultimately made the French Government devalue the Franc in August 1969. The confusion was completed by the speculation in a revaluation of the Deutsche Mark, the former having lasted for more than a year, and bringing disorder to markets all over the world. Only the freeing of the exchange rate and the following revaluation of the Deutsche Mark restored normal conditions within the international monetary system.

Grave Interventions as a Result

These events on the international monetary scene have been accompanied by grave interventions into the free flow of goods and capital. Thus France introduced new exchange restrictions, quotas, and other import controls at a moment, when the six EEC-members were in the process of gradually building up a trade union. The United States restricted more and more the free export of capital, Great Britain imposed advance deposits on imports and restrictions in other fields of international transactions, because of its enduring balance-of-payments deficit, whilst Germany interfered with the free import of capital on just opposite reasons. So what in 1958 seemed to be only a temporary setback in the continuing process of liberalisation for international transactions today reveals itself as a turn towards protectionism.

The interrelations between the events in the exchange markets and those concerning directly the international transactions on current and capital account give occasion to study these connections more fundamentally. The experience of the thirties as well as the damage which was done by exchange controls after World War II compel one to see very clearly the most important condition for a continuing expansion of world trade: free convertibility of currencies. No weapon of trade policy does more harm to the exchange of goods than exchange controls.

But unrestricted convertibility (at fixed par-values) does not rank highest in the scale of goals the politicians responsible for national economic policy strive for. Full employment and "internal stability"—whatever content this latter concept might have—are of priority in all countries. Price trends vary from country to country, some authorities giving predominance to full employment even at the cost of inflation, others giving more weight to price stability. But as long as the "trade-off"

between full employment and price stability differs widely between countries, those differences in economic policy must result at times in crises in the exchange markets and finally lead to currency devaluation or controls. Most countries hesitate to sacrifice the par value of their currency, so that in almost any case of a prolonged deficit in the balance of payments the first measures of policy consist in an interference with the freedom in international transactions. Means of controls effect the reduction not only of the volume but also bring about distortions as to the direction and the composition of international trade.

Iron Law of Economic Controls

Restricting convertibility usually starts in the field of capital transactions. But a partial system of exchange controls will soon break down, because restrictions on capital exports alone cannot be made leak-proof without an overall exchange control system covering also other transactions as international trade, etc. Therefore the rapidly growing system of control on capital account in almost all countries during last year has to be interpreted as a serious threat also to the freedom of international trade. For there is an "Iron Law" of Economic Controls (Benjamin J. Cohen) meaning that a single interference with free market conditions tends to involve further controls in order to be effective.

There is no hope that in the near future the above mentioned differences between countries as to the priority of economic goals will vanish or even diminish. Large disequilibria in the balance of payments and exchange crises with all damaging effects for exports and imports will be the consequence. Under such conditions the international monetary mechanism cannot fulfil its task of facilitating the international exchange of goods. The unwillingness of countries to devalue their currencies as soon as a permanent deficit in the balance of payments is obvious gives testimony to the experience that "the fixity of exchange rates or a particular rate become ends in themselves and then, instead of money smoothing and facilitating trade, the freedom of trade and even internal growth and employment are sacrificed to protect the particular form or aspect of the monetary mechanism. This danger is all the more acute because there are always strong forces at work, private interests supported by powerful nationalistic and interventionistic instincts and anti-liberal ideologies, which press for the curtailment of imports and the protection of inefficient domestic producers from foreign competition"¹.

¹ G. Haberler, *Money in the International Economy*, in: *Fundamentale Fragen künftiger Währungspolitik*, Publication of the List Gesellschaft, Basle, 1965, p. 144.

Many examples could be found which confirm Haberler's view to be highly realistic.

Expansion of International Liquidity

But could not a rigorous augmentation of "international liquidity" bring the solution to this conflict? For some people the start of producing Special Drawing Rights seems to be such a panacea. The argument for this runs as follows. Deficit countries are only forced to introduce all sorts of controls because their stock of international monetary reserves is dwindling rapidly. International credits, or better a steady addition to these reserves, would free these countries from being forced towards the use of means of restriction on imports and capital exports. Surplus countries would gain also from this policy because their exports are not hindered by policy measures of deficit countries.

Obviously international liquidity could fulfil this purpose without restraints, if deficit countries could dispose of unlimited amounts of reserves. So why not create this affluence of international liquidity, since "paper gold" in the form of Special Drawing Rights is believed to be costless? In the past, permanent surplus countries such as Western Germany opposed urgently such plans, and argued that every use of Special Drawing Rights or other forms of artificial international liquidity means a forced credit from surplus to deficit countries. Through this outflow of goods and inflow of money the ball of imported inflation begins to roll in the surplus countries.

Also the deficit countries are not on the safe side of the problem solely with the expansion of international liquidity. In the case of more fundamental disequilibria they sooner or later have to adjust internal prices and income to the conditions of the fixed exchange rate. Too great an amount of reserves and credits may delay unduly the process of adjustment, and the threat to freedom of international transactions comes back in a further deteriorated balance-of-payments position.

Flexible Exchange Rates

Traders, officials and many theorists believe that fixed parities cannot be abandoned, if the world is to enjoy all the benefits of international trade. Moreover, the international flow of capital wholly depends, in their opinion, on the pegged exchange rate system. They are convinced that only fixed parities will reduce the risks of international transactions to a minimum so that there are no principal differences between regional and international trade; risks in the exchange markets must hamper the international exchange of goods, reduce the volume of trade, and thereby do harm to the standard of living in all countries.

The advocates of flexible exchange rates do not deny the merits of stable conditions in the field of international money. They do, however, underline that such stability is by no means guaranteed in the present system of adjustable peg. Great waves of speculation, restrictions on international transactions on balance-of-payments grounds, abnormous costs in the markets of forward exchange for hedging operations of private traders in the case of crises, and sometimes abrupt changes of par values are altogether profound witnesses for the realistic attitude of the ones that uphold this opinion. As shown above these distortions result mainly from the different priorities to economic goals in the Western countries, and there is no hope that these differences will dwindle, not even in the EEC.

Under such conditions flexible exchange rates would not present the best of all worlds, but be least harmful to international trade. And as to the problem of trade liberalisation: flexible exchange rates would do away with the balance-of-payments argument for raising tariffs, introducing import deposits, quotas, and all sorts of exchange restrictions.

Friedman's View

The core of the problem has been clearly seen by Milton Friedman, one of the most renowned advocates of a system of flexible exchange rates: "The confusion between stable exchange rates and pegged exchange rates helps to explain the frequent comment that floating exchange rates would introduce an additional element of uncertainty into foreign trade and thereby discourage into expansion. They introduce no additional element of uncertainty. If a floating rate would, for example, decline, then a pegged rate would be subject to pressure that the authorities would have to meet by internal deflation or exchange control in some form. The uncertainty about the rate would simply be replaced by uncertainty about internal prices or about the availability of exchange; and the latter uncertainties, being subject to administrative rather than market controls, are likely to be the more erratic and unpredictable. Moreover, the trader can far more readily and cheaply protect himself against the danger of changes in exchange rates through hedging operations in a forward market, than he can against the danger of changes in internal prices or exchange availability. Floating rates are therefore far more favorable to private international trade than pegged rates²."

² Milton Friedman, *Free-Market Determination of Exchange Rates*, Statements by Private Economists submitted to the Subcommittee on International Exchange and Payments of the Joint Economic Committee, reprinted in: *The International Monetary System*, ed. by Officer, H. Lawrence, and Thomas D. Willett, Englewood Cliffs, 1969, pp. 198-199.