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From Floating to Dirigisme

by Dr Heiko Körner, Hamburg *

The test case of "flexible versus fixed rates of exchange" has now been running for four months. Experience in this transitional and incipient phase has shown up a number of faults and impediments which are typical not only of the problems created by contemporary multicentric international economic policies but also of the kind of difficulties facing German economic policy in particular.

Since 1967 at the latest, throughout the years when monetary crises were a constant accompaniment of international economic policy even in the large industrialised countries, more and more professional observers of the economic scene have been demanding a turn-away from the gold exchange standard with—as a rule—fixed parities, as it was clearly no longer appropriate to modern conditions in the capital and financial markets or to national modes of conduct in the sphere of economic policy. Those concerned with the practice of monetary policy however stuck to their taboos, especially on the subject of "Transition to a system of flexible rates of exchange". It was only during the fourth D-mark crisis (since 1968) that the Federal Government made up its mind to act on its own. "Others talk of the weather — we make it" seemed to be its motto when on May 9, 1971, it decided on temporary de facto suspension of the D-mark's firm link with the US dollar (and thus with gold).

The Aims of the Decision

How did this West German Damascus come about? What converted the Federal Minister of Economics and Finance, Professor Schiller, in May 1971 "from a Saulus to a Paulus"? The objectives he had in mind when taking that decision may be described somewhat like this:

□ Since, despite (or because) of a formal assurance by Federal Chancellor Willy Brandt that the Federal Republic was not going to revalue the D-mark, exceedingly large sums of dollars had been placed with the Federal Bank in the winter of 1970/71, it was intended to "discourage speculation". A formal revaluation could have achieved this only with rates of revaluation more or less in line with those of October 1969 (8.5 and 9.3 p.c. respectively). Free market movements, it was hoped, would result in an insig-

nificant rise only, if the rate changed at all, or permit a return to the old parity in future.

□ The late boom, fed by persistent budget surpluses (of Länder and local authorities in particular) could not be countenanced by monetary policy unless the external component of money was brought under control. In the absence of a revaluation this would have been impossible without drastic interference with the freedom of the capital and financial markets under the foreign Economic Relations Law. This however was contrary to the market-economy concepts of the Federal Government. Hence floating of the D-mark was left as the only way of "screening" the economy from external economic influences.

Unfulfilled Expectations

Neither of these two expectations has been fulfilled, as can today be seen clearly:

□ The appreciation was not as "moderate" as expected. On September 24, 1971, the Deutschmark was nearly 11 p.c. up on the US dollar. There is really no end in sight of the bull speculation even though technical setbacks may interrupt the uptrend at times. A return to the old parity seems to be out of the question today, and so does even a minor revaluation.

□ The "screening" of monetary policy from external influences has met with indifferent success because the interest differential between West Germany and other industrialised countries is not compensated by any substantial exchange rate risks while boom expectations continue to be entertained, so that fresh foreign liquidity is constantly pressing in on the Federal Bank. Besides, since the Federal Government is describing the high revaluation rates pertaining at present as "unrealistic", these rates do not even have the disciplinary effects on incomes policy which might otherwise have been expected, with the consequence that in this field no alleviation is being felt either.

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□ Preliminaries of a disintegration of the economic world system have been noticed despite the accommodating German attitude: While the Federal Government still adheres to the principle of freedom in the markets, including the capital markets, a multitude of different exchange-rate systems has applied since mid-August beyond the West German frontiers: Great Britain, Switzerland, Belgium and the Netherlands are practising a regulated float (with excessive oscillations being prevented by intervention in or suspension of market dealings); France has introduced a two-tier system; the USA has officially severed the dollar from gold and imposed import taxes; and Japan is barring its doors to the inflow of more foreign monies, with the result that the quotation of the yen has had to be suspended in the German foreign exchange markets. Convertibility for non-resident funds has thus been substantially curtailed in all important industrialised countries. An escalation of political interference in foreign trade cannot be ruled out. There is thus a possibility that the final outcome will be precisely what the Federal Government set out to prevent.

Fragmentation of Monetary Policy

It would no doubt be unfair to hold the Federal Republic solely responsible for all these effects; the escalation of monetary intervention and the incipient threat of restrictive trade policies can undeniably be traced back to the measures taken by the US Administration on August 15, 1971. Whether these acts of intervention were reasonable in view of the domestic and external problems facing US economic policy need not be debated here. It must however be asked whether West German monetary policy did not help to prepare the ground for such a harvest. For the action which was taken on May 10, 1971, cannot simply be comprehended as a new variant of the "screening from external economic factors", which is the aim of the West German stabilisation policy. Besides, it marked the end of the Bretton Woods system which in spite of all its imperfections was still accepted in all countries as the foundation of good conduct in monetary policy. And this end came before a new system of rules and institutions recognised by the most important commercial countries of the world was available even in basic outline! Every one of the major industrial countries was from that moment at liberty (and indeed under an obligation) to cope with the manifest crisis according to preferences set by its own economic policy, and no country shrank from adding in its own way to the fragmentation of monetary policy.

Without the safety net of new international arrangements the West German monetary policy

was bound to be of limited effectiveness: For one thing, the limited floating to which some other European countries resorted and the refusal of France to revalue and the USA to devalue put a large part of the revaluation burden on the D-mark. For another, this very fact which resulted in relatively high rates of appreciation for the D-mark refuted the declared object of the Federal Government to tolerate a "moderate" revaluation only and supplied corroboration for the justification of expectations of a substantial revaluation which had been fostered by pointed indiscretions in the ensuing psychological warfare between the countries with important currencies.

Conclusions

What conclusions may be drawn from this state of affairs?

□ In matters of international economic and monetary policy no country is in a position to force its will, however good its intention, on the other main industrial countries. Existing international rules of procedure (though imperfect in practical operation) cannot be replaced by better ones until they have been sanctioned by agreement.

□ Patent solutions of economic theory—such as the balancing of international payments by flexible rates of exchange—cannot be translated into reality without adjustments. When reality, as measured by the heroic assumptions of theory, has become "dirty", the floating will perform also be "dirty", i.e., limited, partial or regulated. Besides, it should be borne in mind in this context that many of the economic experts who counsel greater exchange rate flexibility, including the members of the Council of Experts on Economic Development, advocated from the outset that a limited measure of flexibility (perhaps by widening the margins of fluctuation) should be introduced at least for an extended transitional period.

□ Absolute flexibility of exchange rates is thus not only impracticable but from the point of view of economic policy absurd. Taking a (somewhat Machiavellian) view of the external aspects of economic policy, a country which allows its currency to float upward to an undesirably high rate of appreciation is divesting itself of an important trump card in the game for the general realignment of parities. Under internal aspects there is a danger that abstinence from economic action on the ground that it would run counter to the rules of the market economy will weaken confidence in the consistency of economic policy later when it is abandoned because circumstances make intervention (which in that case will often be badly prepared and half-hearted) imperative.