

Gutowski, Armin

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## The Changing Monetary System

Interview with Professor Armin Gutowski, Chief Economist to the Kreditanstalt für Wiederaufbau (Reconstruction Loan Corporation) and Member of the Council of Experts on Economic Development in the Federal Republic of Germany.

*Professor Gutowski, the most recent monetary crisis has been overcome temporarily by the devaluation of the dollar and the floating of the yen, early in February, followed in Mid-March by the joint floating of exchange rates of 6 EEC members and Austria, Sweden and Norway against the dollar. Are these steps sufficient to ensure a prolonged breathing space?*

In using the term "breathing space", you have been commendably cautious. For the question is not whether the measures taken will be sufficient to bring us permanent stability. If it were, the answer would be an emphatic "No". It would even be unwise to stick one's neck out and declare on oath that we shall be able to count on a prolonged breathing space because, our monetary system being what it is, another crisis is bound to occur.

In my opinion, all this speculation is nothing more or less than charlatanism. The system itself is in such a muddle that at the first deliberate cough by someone of influence or someone supposed to have some influence, speculative moneys may immediately start moving again with consequences we all know only too well. One only has to think back to the period

from the end of February to early March: Scarcely had the Japanese declared that they would not tolerate floating without manipulation if the Germans did not revalue, when the exchanges resumed their merry-go-round. The threat by the Americans to impose import restrictions also contributed to the unrest on the foreign exchange markets. In other words, we are at present enjoying a breathing space, but for how long, no one can say.

### **Basic Weaknesses of the System**

*What are the basic weaknesses of the system?*

The fundamental weakness is that we have a system of fixed exchange rates which may only move within relatively narrow margins — even though these margins have been widened to 4.5 p.c. Such an arrangement does not allow for the fact that the inflation progresses at a different pace in various countries. If this pace should continue to differ from country to country, then further changes in the relative values of the exchange rates will sooner or later become inevitable. Leaving aside for the moment the narrowing of the band within which EEC rates are allowed to fluctuate,

the wider margins undoubtedly give each country greater scope for autonomous action in the field of monetary policy. But in view of present trends, this greater freedom to pursue an independent monetary policy is purely temporary; it will cease to exist the moment interest differentials can no longer be neutralised by corresponding differences between spot and forward rates.

*And what about the fixing of one national currency — the dollar — as key and reserve currency of the entire system?*

The dollar problem is very closely connected with the system itself. A system of fixed exchange rates based on one key currency could quite well function — even if that currency is not linked to gold or convertible into gold —, provided the country with this currency orientates its domestic economic policy to the realities of the foreign trade situation. This, however, cannot be said of the USA, nor, when all is said and done, would it be fair to expect it of any country. This is the reason why the system does not work.

*What would be the main conditions you would expect a new workable monetary system to fulfil?*

In my opinion, the whole system would have to be so flexible that it would impose on the participating countries a certain discipline in matters concerning their domestic policies, taking into account that this discipline should be no stricter than what is politically feasible.

Generally speaking, I would personally prefer a system of flexible exchange rates. But, should it prove impossible to introduce such a scheme, the new system to be agreed upon would at least have to be flexible enough not to impose too great a strain on the economic policies of individual countries. First of all, currencies must be allowed to fluctuate freely within wider margins. Secondly, the scheme must provide for the possibility of making adjustments in the relations between various exchange rates at sufficiently brief intervals — i.e. when the rates are still inside the band and still allow adequate scope for international interest differentials. One of the main difficulties standing in the way of constructing such a system is that agreement would have to be reached on some indicators to define the point in time at which a rate should be changed. The question, which at present is the subject of a lively debate in the Group of Twenty, is whether one should — as is argued by some — use changes in the international currency reserves held as indicator or if one's cue should be taken — as others suggest — from the state of the country's basic balance.

#### Greater Flexibility

*You said you would prefer a general system of flexible exchange rates. The opponents of such a system argue that it would be fraught with too many practical difficulties.*

I am not so sure that we are in fact so very far away from a system of flexible exchanges as

some people believe. On the occasion of the currency realignment at the end of 1971, all countries agreed to all intents and purposes on the need for greater flexibility; they also agreed that they did not want a system of "freely flexible exchange rates". But since then quite a number of currencies have started to float — among them three of EEC member-states, although the existing rules do not allow floating.

More recently still, even France, as a result of last months' events, has declared itself prepared to allow the franc to float jointly with other European currencies in terms of the dollar. The Americans and Japanese have raised no objections against such a procedure so that I can easily imagine a future system under which the currencies of certain blocs of countries would be floating against each other — one bloc consisting of the USA and for instance Canada and some South American states which would be following the dollar, another bloc in the Far East with Japan as a nucleus, and yet another comprising all or some of the EEC members and other European states as well as a number of developing countries, and finally perhaps also a few individual countries which prefer to go it alone. Such a development would seem to me very reasonable indeed.

*But would this not lead of necessity to a trade regionalisation: USA — Latin America, Japan — Asia and EEC — Africa?*

Not necessarily. There would be no need for the relations between the exchange rates in these separate blocs to be rigid. It is conceivable for instance that some Latin American states, though linked to the dollar, may nevertheless from time to time make adjustments to their rates — adjustments which would take account of differences in the inflationary pace in North and

South America. In the EEC this would be a different matter, but, as far as trade with third countries is concerned, there is no reason why even here the system should not to a certain degree be flexible.

As forward markets would develop in the currencies of the various blocs, I see no reason why trade should be endangered by the flexibility of the rates. On the contrary, just think of the threats uttered in recent months by the USA that it would resort to import restrictions, if the EEC and Japan did not accede to its demands to dismantle their import barriers. Demands of this kind are partly the consequence of the system of fixed exchange rates; under a system of flexible exchange rates, such demands would become pointless because deficits and surpluses would disappear. However, a dismantlement of trade barriers would in any event be a good thing.

#### Dirty Floating

*What about the risk that even under a flexible system some governments may decide for whatever reasons to manipulate their exchange rate by open-market operations?*

I believe a little too much is made of this problem of "dirty floating". With the formation of larger currency blocs, the tendency to intervene against one another would soon disappear, for such interventions would quickly turn out to be harmful to both sides. On the other hand, whatever international monetary order is introduced, whether it be a system of fixed or any kind of flexible exchange rates, certain rules of conduct will have to be laid down so that competitive devaluations are avoided. This does not mean, however, that all interventions must be excluded, for in certain circumstances it is necessary and quite legitimate

for a central bank to intervene on the foreign exchange market for the purpose of ironing out some sudden exceptional movements of funds on any particular day. Care must be taken, however, to see that such interventions do not extend over too long periods. In my opinion, it is easier to lay down rules for a more flexible system than for the present system of fixed exchange rates.

#### Feasibility of the "Link"

*Another problem in connexion with a reform of the international monetary order arises from the demand of the less developed countries (LDCs) that a "link" be forged between special drawing rights (SDRs) and development aid. Is this demand really as unreasonable as it is made out to be by some industrial nations?*

I belong to the minority who do not reject the idea of such a link, for I do not regard a connexion between SDRs and development aid as wrong in itself. The question merely is how to construct such a link. To understand what is involved, it is perhaps useful to compare the system of SDRs with what happens under a properly conducted gold standard.

Under the gold standard, gold was produced, say for example by South Africa. The gold was then purchased by the central banks which in exchange for it transferred to the gold producing countries tangible assets, for the digging up of gold requires real resources for which the country had to be compensated. What resulted was a perfectly normal trade transaction in a commodity called gold. If one now placed every year additional SDRs at the disposal of the LDCs, the other countries would have to buy these SDRs from them in exactly the same way they used to acquire gold from the gold producing coun-

tries, i.e. by transferring real resources to the LDCs. There is however one difference between the two types of transaction, and I consider it to be a very important one indeed: in the case of the SDRs, the LDCs are not obliged to dig gold out of the ground which is subsequently put back into the ground elsewhere. The resources which under the gold standard used to be spent on the production of gold could now be employed more sensibly, say on the building of roads, schools or on other development projects. The industrial countries obtain their international liquidity in the form of SDRs which they acquire from the LDCs in payment for resources they have placed at their disposal for the realisation of development projects.

#### Danger of Inflationary Pressure

*Another essential difference would seem to stem from the growing scarcity of gold in proportion to international liquidity. It was after all this aspect that led to the creation of SDRs. In the case of SDRs, the scarcity factor does not operate with the result that, if the majority has its way, we may end up with too many additional SDRs.*

It is not my intention to appear in the role of a defender of the gold standard. On the contrary, considering present conditions I would demonetise gold at once, for as currency reserve it has become useless. The central banks are not prepared to pay in gold, and that for two entirely different reasons: either they believe that ultimately gold will after all be demonetised, in which case they will be able to sell their holdings in the open market, or they think that, if monetary gold is to be retained, the official gold price is bound to be raised. My advice would therefore be: let us get away from gold as quickly as possible.

The gold standard had yet other disadvantages in that the production of gold depended on the chance of finding new gold deposits, the costs involved in producing it, etc., and that the growing scarcity of gold coupled with the ever increasing demand for it to maintain international liquidity generated a world-wide deflationary pressure. This factor must be carefully weighed against the potentially inflationary effect of SDRs. This potential danger may become a real one, if for instance an unholy alliance between the LDCs and some industrial countries requiring additional reserves to improve their balance-of-payments situation succeeded in pushing through a decision in favour of issuing additional SDRs. This is why I said earlier on that all depends on the kind of rules that will be established for the issue of new SDRs.

The arrangement which in my view would have the best chance of success is the following: Only the industrial countries decide how many SDRs are to be issued each year, and only the LDCs receive them. The conflict of interests created in this manner would make it relatively easy to prevent any inflationary pressure from developing. For the industrial countries would know that they would have to earn the SDRs so that those countries among them which because of their domestic economic policy had got into balance-of-payments difficulties would have relatively little chance of earning these SDRs in competition with other countries. They would thus be obliged either to be more energetic in putting their domestic economy in order or to devalue their currency. Under my proposal which would restrict the issue of additional SDRs to LDCs, the improvident countries would not even be able to count on SDRs for a temporary solu-

tion of their problem. In such circumstances, it is hardly likely that more SDRs will be created than are really needed to provide the liquidity to finance the growing world trade without, however, causing inflation. These SDRs would be distributed in the first instance among the LDCs either direct or via an international organisation like the World Bank. This procedure would have a favourable effect on development in that the industrial countries, needing the SDRs for liquidity reasons, would have to earn them subsequently by transferring some of their real resources in exchange for these rights.

*And how do you see the SDRs fulfil their function as reserve unit?*

Only in the first stage of their existence – i.e. when they are

newly issued – would they not serve as international reserve medium. As soon, however, as they have passed into the possession of other central banks, they would become international reserve.

#### **The Problem of Distribution**

*One problem would certainly be the distribution of the SDRs among the various LDCs.*

Quite right; it is in fact the old problem of how to apportion development aid in a new guise. I personally would not divide the available funds according to some key or other, but would leave the distribution to some international organisation – the World Bank for example. I would further allocate them in the form of credits in order to avoid establishing through the issue of SDRs any contractual

creditor-debtor relationship between the industrial and developing countries. The LDCs should be credited with the SDRs – in the same way as other development aid credits – in order to make sure that they will in fact be used for the realisation of projects which will prove sufficiently profitable from the point of the particular country's economy as a whole. In order to avoid that the recipient countries do not suffer under the debt burden which may accrue, it may be advisable to introduce some kind of a revolving system. Once paid back, the funds could always be re-invested in fresh development projects – so could interest payments – for under my scheme no contractual creditor-debtor relation would exist between industrial and developing nations.

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