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Currency reform — a scenario of illusions

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INTERVIEW

Currency Reform – a Scenario of Illusions

Interview with Professor Dr Fritz Machlup, Princeton and New York University

IE: Professor Machlup, the oil policy of the oil producing Arab states will have monetary and balance-of-payments consequences. How might this affect considerations concerning the reform of the international monetary system?

MACHLUP: You are asking a question that would actually require hours to answer. Nevertheless, with my usual temerity, I will try to make do with a few minutes.

Arab States' Possibilities

Our point of departure must be to consider what the Arabs will do with their proceeds. And here we may of course indulge in an exhaustive casuistic. Let us begin:

Supposing the Arabs simply leave the currencies they get – Dollars, D-Mark or whatever – with the banks of the countries that pay for the oil. This would have consequences only for the liquidity balance but not for the official-settlements balance of payments, for the import of oil is linked up with a short-term capital import from the Arab countries. This is the simplest, but of course also the most improbable case, unless the interest rates are so high that the Arabs accept this as the most reasonable investment, at least for the time being.

A second possibility is that the Arabs convert their proceeds, i.e., their bank balances into something else. First there would be the possibility that they convert them into long-term capital assets. This raises the question whether these long-term investments will be made in the countries from which the payments originate. This would be another ideal solution, since there would be no balance-of-payments troubles. The oil would be paid for with the Arab purchases of securities or direct investments in the oil-importing countries.

A third possibility: the Arabs purchase assets in third countries. This would affect the foreign-exchange market: the exchange rate of the country paying for the oil would decline. You see I assume flexible exchange rates.

Fourth possibility: the Arabs use their proceeds for investments in their own countries. They intend, e.g., to industrialize and import machinery, equipment, etc., for these purposes. If the Arabs bought these goods from the countries, that bought the oil at higher prices, this again would not affect the foreign exchange market. In this case not only the balance of payments but even the trade balance of these countries would be balanced.

If, however, these goods were purchased in third countries, the foreign-exchange market would be affected: the exchange rates of the countries that pay for the oil would decline, and the exchange rates of the countries where the goods were bought would rise.

The next possibility: the Arabs establish plants and installations in their own countries to improve their infra-structure, e.g. they construct roads, port installations, etc., employing their own labour force. In this case money supply and wage incomes would be increased in the Arab countries. The con-

sumer demand would grow because of the higher wage incomes of the employed Arabs, and this consumer demand would lead to higher imports of consumer goods from various countries. Again the foreign-exchange markets would be affected only to the extent that the Arabs' purchases were made with a time lag and in countries other than those that bought the oil.

Manageable Problems

In all the instances mentioned, the associated foreign-exchange problems would still be manageable. Large fluctuations in exchange rates would not necessarily occur unless the supply and demand elasticities were particularly small in the countries concerned. This is generally so only in the short run. Upheavals in the foreign-exchange markets would thus only be short-term ones, not necessarily long-term ones.

But most people are not excessively concerned about these things; what they really fear is that the Arabs will become large-scale speculators and change their opinions on the most reasonable investments from day to day or week to week, i.e., that they suddenly wish to convert large amounts of money from one currency into another. This would of course create difficulties. But with our knowledge of the techniques of the foreign-exchange market we could manage even these difficulties.

IE: Would all these aspects – just with reference to the reform of the international monetary system – not advocate the necessity of very flexible exchange rates or, let us say, more flexible ones than the Committee of Twenty has provided for?

MACHLUP: Of course. The Committee of Twenty has been living in a world of illusions. The times of fixed exchange rates are gone. No matter whether the greater flexibility consists of more frequent changes or larger changes – there will have to be greater flexibility. Conditions are changing so fast that we cannot live any more with fixed exchange rates. Any fixed exchange rate, or allegedly fixed exchange rate, is a standing invitation to speculation, because large profits can be made if one guesses the right moment at which a currency is revalued or devalued. And when I say, the Group of Twenty has illusions, I refer to their prescription of "stable, but adjustable par values". This does not mean anything at all. We don't even know, what is meant by "stable". A definition of "stable" presupposes that we ask about the frequency of the changes and the amplitudes of the fluctuations of exchange rates. Without definition – what is stable and what is not? I would prefer to define stability over a long period and hold that an exchange rate that fluctuates from day to day and from week to week may in the long run be much more "stable" than an exchange rate that is fixed for years. If it is intended not to change parities for years – or even for one or two years – then situations will arise when very large parity changes will become necessary. And if stability means smallness of change over the long term, i.e., if the levels at the beginning and at the end are compared, then it will be seen that so-called fixed parities usually lead to less stability of exchange rates than flexible parities that are adjusted frequently by very small percentages.

IE: After this statement we must of course ask: what is your opinion on the block-floating of the EC?

MACHLUP: The block-floating is also an illusion, more than that, it is a mere fiction. For, if you take into consideration that during the ten months of block-floating already three changes of central values have been undertaken for currencies inhabiting the "snake", the whole story is virtually a joke. The currencies remain in the snake only because parities are changed whenever the exchange rates are about to jump out of the snake [1].

IE: Thus your solution would be to construct the monetary system generally on the basis of completely flexible exchange rates?

Two Kinds of Flexibility

MACHLUP: No, "generally" may mean that every country is compelled to apply flexible rates vis-à-vis all other currencies. That is out of the question. It should be left to every country to decide how to shape its adjustment processes. I can easily imagine that a small country would like to peg its currency to the currency of that country with which it has the largest part of its trade. A currency can also be flexible by being firmly pegged to a flexible currency. If for instance a country pegs its currency to the D-Mark, its currency is then as flexible as the D-Mark is vis-à-vis other currencies. This is indirect flexibility. We thus have two kinds of flexibility: direct and indirect.

IE: You are describing a world regarding which the question might be justified, whether it is not an illusion too, since the Committee of Twenty and also most industrial and developing countries – for whatever reasons – seem not to be prepared to switch to flexible rates to this extent. With an incomplete mutual flexibility of the most important currencies the problem

[1] This interview took place several days before the French franc was taken out of the snake and allowed to float independently.

of the adjustment of the balances of payments arises in any case. The USA officially seems to be of the opinion that this adjustment should orientate itself on changes in reserves. What do you think about that?

MACHLUP: The Americans have never thought that reserve changes should be the only indicator. They were aware of the need that someone start with a proposal. And thus they put one on the table so that one would have something to discuss. But the Americans did not mean to say that changes in reserves ought to be the sole indicators for all countries to accept as guides for their adjustment policies. At any time other possible criteria of the need to adjust will be recognized.

IE: Are there significant indicators at all?

MACHLUP: There are a lot of indicators, all of which may sometimes prove to be misleading. This ist the same problem as in internal economic policy where you also are guided in your forecasts and measures by a set of indicators, as, e.g., the increase of the stock of money, government expenditures, saving ratios, inflation rates, etc., – indicators that sometimes turn out to be misleading.

IE: Even ignoring the problem of indicators the question arises how the national governments can be forced to act correspondingly. For standards of conduct alone do not suffice – as was shown by the Bretton-Woods-System.

MACHLUP: So-called pressures are being discussed, and in the "Outline of Reform" presented in Nairobi a number of such pressures are described. I think, however, that it is politically impossible or rather, highly improbable that agreement on effective pressures will be achieved.

IE: But then we are facing again the old problem of adherence to rules of conduct...

Best Solution – Disagreement

MACHLUP: ...yes, but that does not matter. Perhaps it would be the best that could happen to the world if the countries were never to agree. Without agreement floating will continue, and at the moment floating is the most harmless one of all systems which so far are under discussion.

IE: The Committee of Twenty is still endeavouring to reach an agreement. In addition to the question of flexibility of exchange rates and the adjustment problem it must also deal with the future role of gold. Time and again you are called an "enemy of gold". What do you hold against gold as a reserve medium?

MACHLUP: Let us define the meaning of "reserves". Reserves are assets one is prepared to liquidate when one is short of cash. Gold is not such an asset. Gold is an asset for speculation, an asset one holds in the hope to gain – and therefore it is not a genuine monetary reserve.

IE: Another problem in connection with reform efforts is the question of the control of short-term capital movements. One would like to control not only capital developments, but also in doing this to distinguish between "damaging" and "healthy" capital movements...

MACHLUP: ...an illusion, too. A complete illusion is the idea that a civil servant – or any one else – should have a good nose for that. That there are people, who earnestly believe that such controls could work at all in the long run is deplorable and difficult to understand. The same people – if they were employed and paid for knowing how to get around the foreign-exchange regulations – would probably always be able to advise on how to shift short-term funds from one country to another. I can explain the propensity to control only with a predilection for bureaucracy. There are people who, whenever they are confronted with any difficulties, immediately call for the government to intervene and control. If they are warned about the consequences of control measures, they keep insisting that the government must step in with prohibitions and restrictions because one should not allow speculators and profiteers to take advantage of the situation.

IE: We have touched on almost all problems connected with the currency reform except for the "link". But the developing countries are agreeing not to consent to any reform if this question is not solved. What is your opinion as a monetary expert on the "link"?

Acceptable Link

MACHLUP: I know that most of my colleagues who are to be taken seriously oppose the "link" as offending against the principles of "sound money". I think, however, that there are times when one may yield to pressure especially if it will not prove too expensive, if the pressures will not be repeated too often, and if one feels sympathy with the people concerned and is prepared to help them anyway. All three conditions are satisfied. Thus if a "link" is demanded that does not surpass a certain percentage of the allocations of Special Drawing Rights, this can be regarded as acceptable. However, I am afraid the developing countries will not profit from this scheme. I believe that the individual donor countries, if the developing countries receive something by way of the link, will give less in other forms.