

Cohen, Benjamin J.

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exchange rate system on the basis of PPP could however give an impetus to the snake countries to intensify their economic coordination. Snake and OPTICA scheme are by no means incompatible. Only if inflation rates are continually diverging among the snake partners tensions will arise.

In conclusion it should be emphasized again that not too much should be claimed for this scheme. The OPTICA proposal recognizes the unfortunate fact that inflationary propensities differ among member countries. It emphasizes the predominantly nominal character of divergent inflation rates and it allows exchange rates to offset (no more than) differences in inflation trends. It therefore underlines the importance of real factors for the processes of integration and economic growth in the Community. Contrary to earlier approaches to monetary integration the proposal is not trying

to fix and support nominal exchange rates. Rather it aims at stabilizing real exchange rates within certain margins. The approach may therefore be labelled as the model of a "real" snake — as distinguished from the traditional "nominal" snake mechanism.

Recognition of the fact that inflation rates differ is both the strength and the weakness of the scheme. It constitutes its weakness, because it means that the scheme by itself cannot contribute in a major way to the harmonization of inflation rates at a low level. The prerequisite for this is, in fact, a close coordination of the member countries' monetary (and incomes) policies. It constitutes its strength, because — contrary to the snake arrangement — the OPTICA scheme cannot be endangered by a persistent divergence between member countries' monetary and incomes policies and the resultant variation of inflation rates.

Managing Floating Exchange Rates

Benjamin J. Cohen, Medford/USA *

There is much to praise in the OPTICA proposal for a new exchange-rate agreement for the European Community. The authors are clearly well informed about the recent behavior of foreign-exchange markets, as well as about recent developments in exchange-rate theory, and their case for improving management of exchange markets is a strong one. I am in full accord with their general approach to the problem. But there is also much to which one might take exception in their proposal, at least as it is presently formulated. I am in less accord with some of its most crucial details. In my view, an effective system of exchange management must, first of all, be supple — capable of bending before the wind like a willow, not rigid and inflexible like an oak. The OPTICA proposal, I fear, is more an oak than a willow and could easily break if the winds in the exchange markets happen to blow strongly enough.

Anarchy Instead of the Rule of Law

What is the case for improving management of exchange markets? Essentially, it is the case for replacing anarchy with the rule of law. At the moment, no effective rule of law prevails with respect to exchange rates — neither within the European Community nor in the wider international context. Governments everywhere are pres-

ently free to follow virtually any exchange-rate policy they choose. No agreed principles exist to specify which instruments of national policy may be used to influence exchange rates or which targets of national policy may be regarded as legitimate. Consequently, no certainty exists that policy instruments will be employed, or targets established, in ways that are mutually consistent. If the policies of governments are mutually inconsistent, it is hardly likely that their exchange rates will remain stable for long.

Whatever its defects, the old Bretton Woods system of "adjustable pegs" had one outstanding virtue: it established the rule of law with respect to exchange rates. Governments accepted an obligation to maintain exchange rates within specified margins around a declared par value. After the struggle to preserve the old system ended in early 1973, and the rates of major currencies began to float without limit, nations technically were living in sin. The main accomplishment of the Second Amendment of the IMF Articles of Agreement, agreed at a special Fund meeting in Jamaica in January 1976, was to remove the stigma of sin, by legalizing floating.

Unfortunately, not much else was accomplished on exchange rates. The Second Amendment mentions nothing specific about norms or conventions to guide central-bank intervention in exchange markets, nor about what should be the respective

* Fletcher School of Law & Diplomacy, Tufts University.

adjustment obligations of surplus and deficit countries. It does suggest that governments should "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members". But it contains no effective mechanism to *ensure* that such "dirty floating" will in fact be avoided. Indeed, it does not even define what "manipulation" or "unfair competitive advantage" are supposed to mean, let alone suggest any rules by which they might be curbed or prevented. The leeway for discretionary behavior by governments remains very wide, as the OPTICA authors note. Consequently, the risk of inconsistency among national policies or of competitive exchange-rate manipulations by individual governments remains very high. That in turn tends to foster uncertainty and destabilizing expectations in exchange markets.

This does not mean, however, that we should go back to formal pegging of exchange rates. It is true that pegging offers the advantage of a relatively fixed point of reference for international economic transactions, while in principle the necessary flexibility can be assured by periodic adjustment of the peg. But in practice this flexibility is not likely to be used sufficiently because of the political overtones of such overt policy moves. Delays are inevitable in a policy context where a positive decision to change is required. Political pressures from domestic and foreign actors whose special interests are threatened by an exchange-rate change naturally favor procrastination on the part of decision-makers; and this tendency towards bureaucratic inertia is reinforced as well by delays as the necessary evidence for a change is accumulated. In a world of extensive capital mobility, this constitutes an open invitation to speculate against parities — a "one-way option" to bet against the ability of governments to maintain declared par values. With formal pegging, there is always a risk that governments will drift back toward defending fundamentally inappropriate currency prices. Under the Bretton Woods system, the emphasis was always on the "peg" rather than on the "adjustable".

Minimal "Code of Good Conduct"

The challenge, then, is not to abandon floating exchange rates but, rather, to manage them better — that is, to reduce the degree of uncertainty in exchange markets so as to promote stabilizing rather than destabilizing expectations. To accomplish this, it is necessary to reduce the risk of inconsistency among national policies or of competitive exchange-rate manipulations. And this means restricting the leeway for discretionary

behavior by governments, by instituting at least a minimal "code of good conduct" to influence national policy choices affecting exchange rates. Ideally, such a code should establish a "reference rate" within agreed margins for each country as a guide for central-bank intervention in exchange markets. This is precisely what the OPTICA proposal attempts to do for each member of the European Community. As formulated, however, the proposal would not necessarily provide the most effective basis for managing exchange rates in the Community. In this brief space, I shall focus my remarks on just two features of the proposal that are among the most crucial to its operation — the procedure for setting and revising reference rates and the intervention rule.

Greater Disequilibrium

The procedure for setting and revising reference rates is based on each participating country's relative price performance. A purchasing-power-parity (PPP) index would be calculated for each country by dividing its wholesale price index by a weighted average of the wholesale price indices of its competitors. Its reference rate would then be changed periodically in proportion to changes in the moving average of its PPP index.

The rationale for this procedure is that in the long term it is relative price performance that dominates in the determination of exchange rates. On this point I have no quarrel with the OPTICA authors. The validity of the PPP relationship as a secular phenomenon is well established empirically; elsewhere in their Report the authors themselves produce convincing evidence of the tendency for exchange rates, over longer periods of time, to move in conformity with national inflation differentials. Relative price performance can hardly be ignored in the procedure for setting and revising reference rates.

But is relative price performance on its own a *sufficient* basis for that procedure? I would argue that it is not — that, indeed, exclusive reliance on a PPP index might actually be destabilizing rather than stabilizing in its economic impacts. The PPP relationship is valid *only* as a secular phenomenon. The shorter the time period under consideration, the weaker are the links between exchange-rate movements and inflation differentials. Relative price performance counts for less; conditions of equilibrium in asset markets count for more. In the short term, the exchange rate is simply one of the prices that equilibrates international markets for financial assets (including money) and is determined simultaneously with yields on domestic and foreign assets so as to maintain overall balance in the portfolios of wealth holders. What might constitute genuine

market equilibrium for an exchange rate at certain points of time, therefore, may actually diverge quite considerably from a reference rate inflexibly established in terms of relative price trends alone. Intervention on the basis of such a reference rate, enforcing a rigid correspondence between exchange rates and price levels even when conditions in exchange markets dictate otherwise, may merely result in greater disequilibrium in other markets, for assets, for real goods and services, and for factors of production.

An Alternative

To avoid such an outcome, the procedure for setting and revising reference rates should be broadened to take account of developments in all of these markets — and not just of trends of national inflation rates alone. The OPTICA proposal, in effect, would impose a partial-equilibrium condition in a general-equilibrium setting. In the long term over which the PPP relationship tends to be valid, transitory deviations from secular equilibrium of other economic relationships (e.g., the velocity of circulation, the level of employment, the height of interest rates) may be safely ignored. But in the shorter term they cannot be. In the shorter term nothing is necessarily at its long-term "natural" level. To assume otherwise is to impose more rigidity on the system than is warranted — or may even be tolerable.

The principal advantage of the OPTICA proposal is its clarity. Because the PPP formula is unambiguous, delays in revising reference rates can be avoided. There would not be any of the bureaucratic inertia that characterized the Bretton Woods system. This advantage would be largely lost, it must be admitted, by my suggestion to broaden the procedure to take account of developments in all relevant markets, in effect substituting subjective judgment for a single objective rule. The more numerous and recondite are the criteria for revising reference rates, the more likely it is that the whole procedure could get bogged down in political procrastination and diplomatic haggling. But whatever a broadened procedure sacrifices in elegance, it more than makes up in viability. A certain degree of indeterminacy can be a real strength in organizing relations between governments, insofar as it ensures a sufficient degree of flexibility in arrangements to accommodate the full complexity and mutability of market conditions. The broadened alternative is much more the willow that is needed to withstand the force of winds in the exchange markets.

The intervention rule featured in the OPTICA proposal is an asymmetrical one, depending on the direction of recent change of each participating

country's reference rate. Countries whose reference rates have recently appreciated would be obliged to sell their own currency to prevent further appreciation, though not to buy in the event of depreciation. Conversely, countries with relatively depreciated currencies would be obliged to buy their own currency in the event of further depreciation, though not to sell to prevent possible appreciation.

The rationale for this procedure is that in the short term so-called "vicious" circles may develop in the relationship between exchange-rate changes and domestic price trends. I have no quarrel with the OPTICA authors on this point either, although it must be noted that among economists at large the vicious-circle thesis is still an issue of some controversy. In my own opinion, there is little question that such circles may emerge, given the right conditions. Suppose, for example, that domestic money supply is expanded in one country, causing the yield on financial assets there to fall relative to yields elsewhere. For overall portfolio balance to be maintained, an appreciation of the country's exchange rate must eventually be anticipated. This means that the initial depreciation of the home currency must "overshoot" its new long-term equilibrium (as implied by PPP) so that appreciation may in fact be anticipated. Such overshooting, which is inherent in the dynamic adjustment process, may easily lead to additional inflation at home, if the initial impact of depreciation on domestic prices tends to be quickly translated into inflationary income claims, and if these income claims tend to be "validated" by further increases of domestic money supply. In turn, the additional inflation may generate a further depreciation of the exchange rate, causing yet more domestic inflation, and so on, in a vicious circle or spiral. If this all sounds disturbingly reminiscent of recent events in such countries as Britain and Italy, it is no accident.

Shortcomings of the Proposal

Would the OPTICA intervention rule suffice to short-circuit the development of vicious circles? Obviously not, as the authors themselves admit. The real solution, they point out, is a non-inflationary incomes policy coupled with firm control of the domestic money supply. Their intervention rule is intended merely to supplement these other policies by helping to stabilize exchange-market conditions. But even in this limited role their rule could prove to be counter-productive, given the inherent tendency of exchange rates to overshoot in the dynamic adjustment process. Overshooting must be allowed to occur when conditions in exchange markets dictate. Otherwise (repeating my earlier argument) the result

only be greater disequilibrium in other markets. Intervention to prevent overshooting of a depreciating currency could slow the necessary adjustment in markets for real goods and services and in the current account of the balance of payments, resulting *inter alia* in a higher unemployment rate than would otherwise occur.

This is not a defect peculiar to the OPTICA proposal: any rule that *requires* governments to intervene in specified circumstances is likely, at times, to be counter-productive. But that does not mean that we should have no rules at all: that would simply condemn us to continued anarchy in exchange markets, which I have already argued is undesirable. Rather, it means that we must develop a *different kind* of rule — one that promotes a degree of certainty that policy instruments will be employed, and targets established, in ways that are mutually consistent, and yet which is not itself likely to become a source of market instability.

Rules for Governmental Behavior

Rules for governmental behavior may take two basic forms:

☐ those that specify circumstances in which certain policy actions are required (what may be called, using Biblical language, "thou-shalt" rules); and

☐ those that specify circumstances in which certain policy actions are prohibited ("thou-shalt-not" rules).

The Bretton Woods system and the OPTICA intervention rule are both examples of a "thou-shalt" type of rule. An example of an alternative "thou-shalt-not" type, which I would strongly advocate, is one that simply prohibits governments from selling (buying) their own currency at a price below (above) the lower (upper) margin around its reference rate. Such a rule gives a point of reference away from which an exchange rate cannot be forced by central-bank intervention (rather than a target which must be defended). It offers the advantage, therefore, of restricting the scope for "dirty floating", minimizing the risk of inconsistency among national policies or competitive exchange-rate manipulations, while nevertheless leaving governments free to play as active a stabilization role as they like when market conditions warrant. Assuming reference rates are set and revised by an appropriate procedure such as I have suggested above, this alternative would surely act to reduce uncertainty in exchange markets and to promote stabilizing expectations. It would also have the suppleness to bend like a willow before the force of winds in the exchange markets, which the OPTICA proposal does not. That is why I prefer it as the basis for managing exchange rates.

Uses and Limits of Monetary Mechanisms in the EC

by François-Xavier Ortoli, Brussels *

The efforts to establish a European Economic and Monetary Union have a rational basis. Our nations cannot achieve individual and social welfare if they do not command markets of the capacity demanded by present-day production technologies. This technological phenomenon has implications which manifest themselves in the progressive integration of the national economies. The task devolving on those bearing political responsibility in this context is clear: they must support the undeniable spontaneous tendency towards economic integration by pursuing appropriate policies.

* Vice President of the EC Commission.

Since 1970 the gradually coalescing European area has been exposed to various shocks from outside which pose highly diverse restructuring and readjustment tasks for the individual national economies. The responsible policy-makers have therefore to cope with another task as well: they must take concrete measures related to the contemporary scene in order to minimize the most adverse repercussions of these adjustment processes — high and divergent rates of inflation, a general weakening of the investment propensity, employment problems, and lack of stability in the foreign exchange markets.