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## MONETARY POLICY

### Target Zones for the US Dollar?

by Wolfgang Filc, Trier\*

**The discussion of target zones for flexible exchange rates is evidence of the desire to experiment with new instruments for stabilising the international monetary system. What distinguishes target zones from systems of flexible and fixed exchange rates? What form should they take? How should one regard the various objections to target zones?**

Target zones for exchange rates define, for a given period of time, the limits within which the governments of participating countries regard exchange rate movements as appropriate in the prevailing and foreseeable economic conditions.<sup>1</sup> If currencies reach the limits of the target zones, there is reason to fear that exchange rate movements in the foreign exchange markets will impose strains on international trade relations and have undesirable economic repercussions.

Any reform of the international monetary system entails exchange rate management, which must go further than unenforceable declarations of intent. Binding forms of exchange rate policy require commitment and action on the part of governments and central banks. If no commitment is accepted, exchange rates will float freely. If they opt for "managed floating", governments and central banks can take action to affect exchange rates without in any way committing themselves to adhere to rules for stabilising them. A system of fixed exchange rates with fluctuation bands imposes strict rules on all participating countries; if the intervention points are reached, decisions on market intervention or central rate adjustments are unavoidable.

Target zones combine some of the features of the fixed exchange rate system with those of managed floating. Exchange rates outside the target zone are declared to be incompatible with economic policy goals, but there is no obligation to take precisely defined economic policy measures in accordance with objective indicators. By contrast with the "hard" margins of acceptable fluctuation in a system of fixed exchange

rates, the limits on movements within a system of target zones are "soft". If currencies move outside their target zones, all that is expected is that appropriate economic policy measures are taken to alleviate exchange rate distortions. A system of target zones is therefore more akin to floating exchange rates than to a fixed rate system.<sup>2</sup>

#### Features of Alternative Target Zone Systems

Exchange rate target zones may differ from one another in various ways:<sup>3</sup>

- ☐ One must first differentiate according to the degree of compulsion to take appropriate economic policy measures to keep exchange rates within their target zones.
- ☐ Secondly, target zones may be agreed in confidence between the governments and central banks of the countries concerned ("undisclosed" zones) or they may be made public ("disclosed" zones). Efforts to stabilise exchange rate expectations can succeed only if information on target zones is made public.
- ☐ Thirdly, target zones can differ in width. The range within which exchange rate movements are considered

<sup>1</sup> Cf. International Monetary Fund: Target Zones, prepared by the Research Department (in consultation with other departments), 9th January 1986, pp. 3 ff.; International Monetary Fund: The Exchange Rate System: Lessons of the Past and Options for the Future, a Study by the Research Department of the International Monetary Fund, Occasional Paper No. 30, Washington, D.C., July 1984, pp. 53 f.; J. H. Morsink: The European Monetary System: Rebirth of the Adjustable Peg? Dissertation, Princeton, New Jersey, 9th April 1986, pp. 113 ff.; H. Lehmert: Devisenmarktinterventionen bei flexiblen Wechselkursen: die Politik des Managed Floating, Tübingen 1980, pp. 128 ff.

<sup>2</sup> Cf. IMF: The Exchange Rate System, op. cit., p. 53.

<sup>3</sup> Cf. H. Lehmert, op. cit., pp. 148 ff.; IMF: Target Zones, op. cit., pp. 21 ff.

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compatible with the aim of stable currency relationships is determined by two requirements. First, limited changes in real exchange rates should make for easier adjustment of external imbalances, and secondly exchange rates should not diverge substantially or for long from the levels consistent with the economic fundamentals of the countries concerned. The smaller the degree of economic policy harmonisation among participating countries and the greater the disparities in the structure of their economies, the wider the target zones need to be.

□ Fourthly, a distinction has to be made between arrangements that prohibit certain measures and those that make action mandatory if exchange rates move outside their target zones. It is possible to forbid exchange market intervention that would accentuate divergence from the target zone.<sup>4</sup> Rules setting out mandatory action are a better way of stabilising the monetary system.

□ Fifthly, target zones can be shifted little by little, rather like a crawling peg, they can be formulated for a set period or they can be repositioned as the case demands, as in a system of fixed but adjustable exchange rates. A sliding adjustment of target zones requires an objective indicator of adjustment need acceptable to all participants. There is currently no prospect of devising a sufficiently accurate indicator to permit adjustments of the order of fractions of a percentage point, and in any case it would be dangerous to replace economic decision-making by an automatism controlled by indicators. It would be preferable to set target zones for a fairly long period, such as a year; this would be the surest way of stabilising exchange rate expectations and achieving an international coordination of economic policy.

□ Sixthly, target zones can be agreed between national currencies or in relation to a currency basket.<sup>5</sup> Those between national currencies are more effective in stabilising expectations. A further distinction may be drawn between target zones established vis-à-vis a single currency (the key currency solution) and those agreed between the currencies of all participating

countries (the consensus solution). The key currency solution would conflict with the aim of gradual economic policy convergence among the major industrialised countries.

□ Seventhly, there may or may not be provision for sanctions if the rules of the target zone system are violated.<sup>6</sup> Rules without sanctions are useless. Pressure must be brought to bear to achieve the aim of stabilising the monetary system, although this should not lead us into the naive belief that economic policy would bend to external forces.

### **Elements of a Workable Concept**

Exchange rate target zones designed to stabilise the monetary system and to pay regard to the international implications of economic policy measures should comprise the following features:

□ "Soft" target zones should be established and they should be made public ("disclosed" zones).

□ Target zones should be established on the basis of the consensus solution.

□ Target zones should be valid for a reasonably long period, say one year. Wide target zones are needed during the introductory stage, say 10 % on either side of a reference rate.

□ Rules on mandatory action should be laid down and sanctions established in case of non-observance. This should exert pressure on countries to co-operate more closely on economic policy matters without making domestic economic requirements subordinate to external exigencies.

The suggestion of using a target zone concept to intensify monetary and economic policy co-operation

<sup>4</sup> Such a provision accords with the prohibition of aggressive exchange market intervention as laid down in the IMF guidelines for flexible exchange rates.

<sup>5</sup> Cf. C. J. Oort: Exchange Rate Policy in the European Communities, in: Common Market Law Review, Vol. 13, 1976, pp. 301 ff.

<sup>6</sup> With regard to sanctions for a system of exchange rate target zones in the EC, see Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Zeit zum Investieren, Jahresgutachten 1976/77, Stuttgart and Mainz 1977, paragraphs 504 ff.

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among industrial countries with flexible exchange rates between their currencies has run up against numerous objections,<sup>7</sup> the most important of which are examined below.

### Objections to Target Zones

One objection to target zones is that limiting exchange rate movements in exchange markets would upset the allocative function of the price system. International currency problems during the final years of the Bretton Woods system were the result of insufficient flexibility in nominal exchange rates. The causes of the problems over the last decade have lain elsewhere. Overshooting exchange rates and substantial long-term shifts in real exchange rates demonstrated that the international monetary system was not up to the task of providing "a framework that facilitates the exchange of goods, services and capital among countries, and that sustains sound economic growth . . .".<sup>8</sup> Rather than being the consequence of changes in relative scarcity in goods and capital markets, exchange rate movements were the cause of the direction and scale of international current and capital transactions; rather than being the expression of allocative requirements, they determined the allocation of resources.

The exchange rate is a relative price forming the link between the prices of goods and services in the countries involved and between the income from financial and physical assets denominated in different currencies. Hence exchange rate changes influence resource allocation if the prices of goods and services and the yields on assets remain constant. The use of target zones to stabilise real exchange rates is designed to increase the significance of changes in relative scarcity, indicated by movements in price relationships, and of the distribution mechanisms they set in motion relative to the significance of exchange rate changes.

To reject target zones on the grounds that they reputedly impede the price system's allocative function is to overlook the fact that distortions are frequently found in relative prices in other areas and economic policy measures are taken to alleviate them. Examples of this are the finding that labour costs are too high in relation to capital costs, thereby causing unemployment, or that yields on real capital are too low by comparison with returns on financial assets. In the same way as economic policy is used in these fields to correct the result produced by the market in order to ease

misdevelopments in the domestic economy, target zones serve to reduce distortions in the world economy by containing real exchange rate changes within a wide margin of fluctuation. Hence, target zones do not impede the operation of the international price mechanism but promote it.

### Inclusion of the Dollar Unrealistic

A further argument put forward against target zones is that the permanent inclusion of the US dollar in an institutionalised framework for limiting exchange rate fluctuations is unrealistic. Decisions to opt for flexible or fixed exchange rates are often examined on the basis of theories of the optimum currency area<sup>9</sup> and the results obtained are applied in assessing the feasibility of target zones.<sup>10</sup> The analogy fails to recognise that "soft" target zones – the present debate is concerned solely with soft zones – are a form of managed floating, not a manifestation of a system of fixed exchange rates involving compulsory intervention.

Theories of the optimum currency area show that there is a tendency towards fixed exchange rates if

- ☐ the economic areas of the currency zones are relatively small and open,
- ☐ the production structures of member countries are strongly differentiated,
- ☐ there is a high degree of factor mobility within the economic areas, and
- ☐ countries hold similar views on threats to monetary stability.

These economic categories show that progress has been made towards achieving the requirements for more stable exchange rates between the currencies of the USA, Europe and Japan. For example, the openness of the US economy has increased, with exports and imports rising from 9.6 % of gross national product in 1960 to 18.2 % in 1982.<sup>11</sup>

Similarly, differences in the structure of production or in factor mobility among the three major economic areas of the western industrial world have not impeded fundamental agreement on lasting reductions in exchange rate fluctuations. Different attitudes towards threats to price stability between Europe, the USA and

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<sup>7</sup> Cf. IMF: Target Zones, op. cit., pp. 11 ff.

<sup>8</sup> Articles of Agreement of the International Monetary Fund (1st April 1978), Article IV, Section 1.

<sup>9</sup> Cf. F. Rühl: Optimale Abgrenzung von Währungsgebieten: Ein Überblick, in: Kredit und Kapital, Vol. 8, 1975, pp. 123 ff.

<sup>10</sup> Cf. IMF: Target Zones, op. cit.

<sup>11</sup> Cf. H. Hesse: Weltwirtschaftliche Entwicklung und Wirtschaftspolitik in wechselseitiger Abhängigkeit, in: J. Langkau, C. Köhler (eds.): Wirtschaftspolitik und wirtschaftliche Entwicklung, Bonn 1985, p. 117.

Japan should not be viewed differently than divergences between European countries. The monetary stabilisation policies pursued in all western industrialised countries in recent years prove that agreement on the social costs of inflation has increased. On the whole, objections based on theories of the optimum currency area fail to convince.

### **Equilibrium Exchange Rate Indeterminable**

The third objection to the establishment of target zones is that since equilibrium exchange rates cannot be determined it makes no sense to construct target zones around these unknown reference rates.

The quantifiable equilibrium price is a theoretical fiction. No-one can state the equilibrium price of any good, financial security or currency. If equilibrium is to be the objective, it must also be specified whether the goal is partial equilibrium, in the sense of zero excess demand in a single market, or whether links with other markets are also to be taken into consideration. In view of macro-economic relationships and problems, the objective of equilibrium solely in the foreign exchange market has as little meaning as the postulate of partial equilibrium in the money market or on the stock exchange. Equilibrium or the disturbance of equilibrium in financial or exchange markets only assume tangible dimensions if their effects on other markets, particularly goods markets, and on output and employment are taken into account. Although there is no satisfactory way of determining equilibrium exchange rates, there have been periods in the past when the dollar was clearly overvalued or undervalued.

The inability to determine equilibrium exchange rates satisfactorily also arises in the EMS. When the European Monetary System came into being it was based not on theoretical calculations of equilibrium exchange rates but on the rates prevailing on the day before its inception, because they were considered appropriate by the governments and monetary authorities of the member countries.

Similarly, the reference rates for target zones including the dollar would have to be based not on conceivable equilibrium rates but on a common view of the appropriateness of exchange rates; "... an exchange rate is viewed as sustainable if it can be maintained over the medium term and is 'appropriate' from the standpoint of the country in question and the international community as a whole".<sup>12</sup>

In addition, the width of target zones accommodates possible errors of estimation in what is considered to be an appropriate exchange rate, allows temporary

disturbances to be absorbed without forcing the exchange rate out of the target zone, cushions differences in macro-economic developments and gives central banks scope for monetary measures without the danger of one-way speculation on exchange market intervention or other economic policy measures should the limits of the zone be reached.

The establishment of exchange rate target zones is similar to the central banks' practice of setting money supply targets. When the central banks began to announce money supply targets they did not attempt first to determine the "equilibrium money supply" but extrapolated the money stock they considered "appropriate" on the basis of the expected performance of the economy over the period of the projection; "soft" limits for monetary expansion were then drawn around the central value. This practice has frequently proved useful to central banks in setting monetary targets in order to stabilise financial systems; there is no obvious reason why a comparable procedure for setting exchange rate target zones should be bound to fail.

### **The Indicator Problem**

It is also argued that there is no consensus on the economic indicators that signal the appropriateness of an adjustment in target zones. Exchange rates reflect a host of actual or expected economic facts about the countries concerned. The relative weights of the various determinants change, and unforeseeable chance factors often mask the underlying economic trend, frequently dominating exchange rate developments.<sup>13</sup>

This inconvenience from the point of view of economic theory should not give cause to reject a target zone concept on the grounds that exchange rate predictions are of dubious value. The chances of obtaining a sufficiently accurate interest rate forecast are no better, and yet the Deutsche Bundesbank sets target ranges for call money rates in the money market, limited by the discount rate and the central bank rate on advances against securities. Shifts in target zones for call money rates by adjusting the reference rates are often made on the grounds of changed market conditions or because the central bank wishes to indicate the probable interest rate trend. Here too, it is a question of action to influence market expectations, namely expectations of future interest rate developments. The modification of

<sup>12</sup> IMF: *Issues in the Assessment of the Exchange Rates of Industrial Countries*, a Study by the Research Department of the International Monetary Fund, Occasional Paper No. 29, Washington, D.C., July 1984, p. 1.

<sup>13</sup> Cf. W. Filz, S. Bredemeier: *Bestimmungsgründe der Wechselkursentwicklung. Ein Überblick und einige Hinweise zur Einschätzung zukünftiger Wechselkursrends*, NORD/LB 1985.

exchange rate target zones serves a similar purpose, namely to stabilise exchange rate expectations. The multiplicity of exchange rate determinants and the fact that a number of imponderables impinge upon the exchange rate mean that target zones have to be wider for exchange rates than for call money interest rates. The main monetary problems of the last decade, apart from sharp exchange rate fluctuations, were substantial and enduring shifts in real exchange rates. Easing this problem in future means basing target zone adjustments on relative price developments in the countries concerned,<sup>14</sup> despite the many reservations about using a yardstick of this kind.<sup>15</sup>

Use of a reference variable such as this cannot be compared with an automatism based on purchasing power parities.<sup>16</sup> In setting exchange rate target zones for a period of one year, a country with low inflation by international standards should raise its reference exchange rate in accordance with the assumed inflation differential over the period in question.<sup>17</sup> This does not rule out considering macro-economic key data other than inflation rates, but inflation differentials should be the starting point in setting target zones. Any shift in target zones other than that indicated by this variable would have to be substantiated. Real exchange rate changes could not then grow increasingly large over time but would be restricted by the width of the target zone. This procedure broadly corresponds to the practice of adjusting central rates within the EMS.

### Harmonisation Needs

Critics of the target zone concept also argue that target zones will founder unless there is increased harmonisation of economic policies among the countries concerned. One of the causes of exchange rate fluctuations and trend shifts in real exchange rates has been the inadequate co-ordination of national economic policies and the consequent differences in the development of economic fundamentals. Diffuse and uncertain expectations in the absence of firm indications of future exchange rates have been another. These two factors cannot both be eliminated by a single measure. Setting target zone limits to channel

expectations will attend to one issue; the level, width and frequency of adjustment of target zones as an expression of economic convergence will resolve the other.

Increased economic policy harmonisation therefore does not make exchange rate target zones dispensable, but neither are they a substitute for co-ordination of national economic policy concepts and measures; if that were the case, exchange rate movements would not frequently defy economic explanation. Nevertheless, a harmonisation of economic policies that went beyond the international co-ordination of interest rate measures by the central banks in March 1986 could reinforce a target zone concept. Adjustments in target zones against a background of increasing economic divergence hold the danger that countries will assess the direction and scale of the necessary changes differently and thus the risk that the target zone concept will fail. The less frequent and the smaller the required shifts in target zones, the more stable will the monetary system become. The international co-ordination of monetary policy in the context of half-yearly reviews of target zones could strengthen the system. Such co-ordination and the resulting impact on interest rates should not be confused with fixing interest rates or setting interest rate differentials between countries.<sup>18</sup> Real interest rate disparities also reflect different real economic conditions in the countries concerned, such as differences in the ratio of voluntary saving to investment or in assessments of returns on investment. Fixing interest rates or attempts to equalise real interest rates in all countries by means of monetary policy would impede the international adjustment between investment and saving. Neither international real interest rate differentials nor real exchange rate changes can be eliminated entirely; all that can be done is to limit the fluctuations if they threaten international co-operation in monetary and economic policy.

Experience with the EMS has shown that rules on the behaviour of market exchange rates generate pressure to harmonise economic policy in a context of greater monetary stability.<sup>19</sup> If these rules are not accepted, neither "hard" nor "soft" target zones can be maintained unchanged. Here too there is experience to go on, that with the European currency snake. The creation of a target zone system can therefore help limit exchange

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<sup>14</sup> Cf. C. Köhler: Bedingungen für mehr Stabilität im Weltwährungssystem, in: W. Filc, C. Köhler (eds.): Stabilisierung des Währungssystems, Berlin 1985, pp. 255 ff.

<sup>15</sup> Cf. IMF: Issues in the Assessment of the Exchange Rates of Industrial Countries, op. cit., pp. 14 ff.

<sup>16</sup> This view is expressed in: Commission of the European Communities: OPTICA Report 1976, Inflation and Exchange Rates: Evidence and Policy Guidelines for the European Communities, Brussels 1977.

<sup>17</sup> Cf. J. Williamson: The Future Exchange Rate Regime, in: Banca Nazionale del Lavoro, Quarterly Review, Vol. 28, 1975, pp. 127 ff.

<sup>18</sup> Köhler recommends linking the international interest rate differential to the international inflation differential. Cf. C. Köhler, op. cit.

<sup>19</sup> Cf. J. H. Morsink, op. cit.; G. Zis: European Monetary System: A Framework for International Monetary Reform? in: INTERECONOMICS, No. 2/1982, pp. 65 ff.

rate variations and speed up the harmonisation of economic policy.

### Need for Consensus

A further counterargument is that it is unrealistic to believe that consensus can be obtained to establish target zones between all currencies with floating exchange rates. A target zone concept would have to be based on agreed reference rates and limits for the currencies of all participating countries, not on a single key currency. Both monetary policy and the likely interest rate developments this would imply would have to be co-ordinated.<sup>20</sup> The problems of co-ordination increase exponentially with the number of countries involved, so that for the sake of administrative efficiency a target zone arrangement should be confined to the main reserve currencies – the US dollar, the yen and the Deutsche Mark.

The exchange rates of non-reserve currencies could be determined by arbitrage, or the governments and monetary authorities of these countries could decide to tie their currency to one of the reserve currencies. Exchange market intervention in reserve currencies that forced exchange rates between these currencies out of the target zones would have to be abstained from.

Such an exchange standard distributed over three currencies<sup>21</sup> would raise the Deutsche Mark to the status of a key currency within the EMS. The co-ordination of monetary, exchange rate and economic policies between the USA, Japan and the Federal Republic of Germany would determine the average value of the EMS currencies – in other words the value of the ECU – against the dollar and the yen. The other EMS countries would have to adopt appropriate economic policies to keep the exchange rates of their currencies against the DM within the fluctuation margin for the spot rate. Only a few years ago it seemed unrealistic to suppose that the Deutsche Mark could assume the function of a key currency within the EMS. However, tacit agreement and de facto actions have now made the DM the key EMS currency and the stance of the Deutsche Bundesbank decisive for monetary policy in EMS countries.<sup>22</sup>

Within the EMS there is the possibility of an arrangement based on consensus, rather than dividing

responsibilities in this way. This would require common economic policy action by all EMS countries if the dollar and the yen were quoted outside their target zones. If exchange market intervention were considered useful, it would have to be undertaken by all the countries participating in the EMS exchange rate mechanism. Their respective shares in interventions could be based on the currency weights within the ECU. The distribution could be simplified if responsibility for interventions against the dollar and the yen were assigned to a central EMS body, such as the European Monetary Co-operation Fund. However, such a consensus solution within the EMS would not be conducive to administrative efficiency.

If the EMS countries accepted neither a key currency solution nor a consensus solution within the EMS as part of a target zone arrangement for the exchange rates of the three major reserve currencies, target zones could hardly be implemented. The Deutsche Bundesbank cannot be made responsible for easing exchange rate tensions both within the EMS and vis-à-vis the dollar and the yen.

### The Role of International Capital Flows

International capital flows between reserve currency countries play a crucial role in short-term exchange rate movements. A further objection raised by critics of target zones is that the dollar exchange rate, in particular, could be forced out of its zone by changed currency preferences on the part of investors.<sup>23</sup>

Changed currency preferences and the consequent portfolio adjustments could be accommodated without affecting the foreign exchange market if central banks conducted open market operations in securities denominated in foreign currencies as well as their own. For example, if the demand for US financial assets rose in Germany, the Bundesbank could release US securities to the market. It would then have to decide whether to take up the equivalent in DM-denominated securities or to reduce the central-bank money supply. In this way, shifts in currency preferences would be diverted away from the foreign exchange market. For this purpose the central banks participating in the target zone system would have to open securities stabilisation accounts with one another, which would give them the mutual right to draw securities from the holding of the other central bank in exchange for securities from its own portfolio. Holders of foreign securities released to the domestic market by the central bank would be

<sup>20</sup> On the link between central banks' money supply and interest rate targets, see K. Hasenbach-Jaenisch: *Strategien der Geldpolitik – Eine Kritik der Geldmengensteuerung*, Hamburg 1985, pp. 32 ff.

<sup>21</sup> This concept is advocated by R. I. McKinnon: *An International Standard for Monetary Stabilization*, Cambridge and London 1984.

<sup>22</sup> Cf. W. Filc, J. Kuhlmann: *The European Monetary System as a Factor of Integration*, in: *INTERECONOMICS*, No. 6/1982, pp. 268 ff.

<sup>23</sup> Cf. O. Emminger: *Kann das internationale Währungssystem nach der Phase der Störungen zu neuen Ufern aufbrechen?* in: *Handelsblatt*, 26. 5. 1986, p. B. 23.

entitled to exchange them at any time for domestic paper at the central bank. The exchange and interest rate risks would be borne by the investor.<sup>24</sup>

Even without a mechanism of this kind, target zones could channel international capital flows if expectations of exchange rate changes and shifts in international interest rate differentials could be reduced.

### Jeopardising Monetary Stability

The Deutsche Bundesbank points to possible jeopardy to monetary stability: "From the standpoint of monetary policy, even relatively wide target zones . . . should be regarded in the final analysis as nothing more than fixed exchange rate systems . . .".<sup>25</sup>

Target zones are a variant of managed floating, not a monetary system preoccupied with indicators triggering automatic intervention obligations. Target zones for exchange rates may therefore be compared with the targets central banks set for monetary expansion. If the rate of growth of monetary aggregates deviates from the projection, there is no automatic compulsion to bring it back within the target range. Expectations in financial markets can also be stabilised by explaining why divergences are being tolerated or by adjusting monetary growth targets.

Such "soft" target zones can also stabilise exchange rates in the foreign exchange markets. If exchange rates move outside their target zones, there is a need for either action or explanation. An automatism exists only to the extent that consultation between participating countries becomes necessary. This rule takes the place of earlier ad hoc arrangements, such as those made within the Group of Five. However, which measures are suitable for achieving exchange rate targets or whether target zones should be modified is another question.

A system of target zones may be an appropriate means of improving compliance with the objective of monetary stability. When setting target zones, the central banks should also explain and co-ordinate their monetary policy projections. If a country's monetary expansion exceeded the projected target and if this were accompanied by devaluation of the currency, the central bank could be obliged, when the exchange rate reached the limits of the target zone, to support its currency by means of unilateral intervention, the

liquidity effects of which must not be neutralised.<sup>26</sup> If the central bank did not fulfil these obligations, the governments of the other participating countries should be free to dissolve the target zone system. Stabilisation of the monetary system by means of exchange rate target zones is therefore possible without endangering the value of money.

### Conclusions

The debate about target zones for exchange rates is coloured by the experiences during the final years of the Bretton Woods system. Configured appropriately, a target zone arrangement could stabilise the monetary system and strengthen international economic and monetary co-operation without repeating the errors of the past. This requires general rules that enjoy more than passing acceptance, otherwise the present consensus among countries on the need for orderly exchange rate relationships may rapidly evaporate.

More than a decade ago, the following statement was made on the need for orderly exchange rate relationships:

"We seek an international monetary system which discourages nations from maintaining exchange rates that are 'wrong' – in the sense of being contrary to what is needed for sustainable international payments relationships. The possibility of having the 'wrong' exchange rate and the 'wrong' exchange rate policies can occur whether a country is technically floating or technically maintaining a par value. Thus, it is not meaningful or theoretically sound to proceed as though there were two separate 'systems' of par values and floating, each of which should be subject to its own rules, conventions, and procedures, and one of which should be regarded as morally superior."<sup>27</sup>

This perceptive pronouncement was followed by currency unrest that placed a strain on international economic relationships because there were no rules for adhering to these principles. There is as little to be gained from repeating the mistakes of unregulated floating as from repeating the errors of the fixed exchange rate system established at Bretton Woods. A target zone arrangement affords an opportunity to avoid these dangers.

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<sup>24</sup> Cf. W. Filz: Devisenmarkt und Geldpolitik, Berlin 1981, p. 305; Friedrich Ebert-Stiftung, Forschungsinstitut, Abteilung Entwicklungsländerforschung, Gruppe Information und Dokumentation, No. 18: Das Dollarkursproblem: Dimensionen, Ursachen, Lösungsansätze, 20th June 1984, pp. 16 f.

<sup>25</sup> Geschäftsbericht der Deutschen Bundesbank für das Jahr 1985, p. 89.

<sup>26</sup> Cf. P. Bofinger: Stabilitätsgerechte Festkurssysteme, in: Kredit und Kapital, Vol. 18, 1985, pp. 173 ff.; H.-J. Jarchow: Devisenmarkt-interventionen und Liquiditätswirkungen, in: Außenwirtschaft, Vol. 39, 1984, pp. 299 ff.

<sup>27</sup> Commentary on Alternative Approach to Article IV on Exchange Rate Arrangements by the Executive Director for the United States, Sam Y. Cross (1st May 1975), in: M. G. de Vries (ed.): The International Monetary Fund 1972-1978, Cooperation on Trial, Vol. III: Documents, International Monetary Fund, Washington, D.C., 1985, p. 300.