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EXCHANGE RATE POLICY

Is There an Alternative to Floating Exchange Rates?

by Olaf Sievert, Saarbrücken*

The discussion about the international monetary system has revived in recent months. Has the changeover to floating exchange rates in 1973 not fulfilled the expectations it aroused? How should the present proposals for the reform of exchange rate policy be assessed?

The floating exchange rates that replaced the Bretton Woods system of fixed parities held out the prospect that even a country that was highly integrated in the world economy could remain an island of stability in a sea of inflation. That promise has been fulfilled, even though it proved to be a more difficult and costly exercise than had been foreseen.

Nor was the prediction that world trade would learn to live with continually fluctuating exchange rates far from the truth. There have been complaints from that quarter, but they are surprisingly small if one considers the size of the exchange rate movements that have occurred. Futures markets, which offer a cost-effective means of exchange cover, are still not as highly developed as might have been expected, but firms have found other ways of limiting their open currency positions, either by ensuring that intra-company payments are in balance or by concluding financial transactions to hedge their trade deals.

The multiplying of the rate of world inflation in the period after the collapse of the Bretton Woods system was a far worse experience. It would be unfair and indeed objectively wrong to suggest that there was a strong link between these two events, but the system of floating exchange rates did not check the acceleration in inflation; rather, it gave greater scope to this development than the old system of fixed exchange rates would have done (if its operational requirements could have been restored). Without a doubt, the consequences for the world economy were disastrous. The two major worldwide recessions – 1974-75 and from 1980 onwards – were, not least, stability crises. Another proposition that assumes added importance in this

regard is that the inflation rate variance both over time and between countries increased as inflation accelerated. Changes in inflation differentials trigger exchange rate adjustments, however, and these have a marked tendency to overshoot. If floating exchange rates are partly to blame for the increased variance of international inflation differentials over time, exchange rate movements are not just a response to problems caused elsewhere, as they should be, but also a response to problems of their own making.

The effect of the switch from fixed to floating exchange rates on the pace of inflation in the world may still be a contentious issue, but there is no disputing the problems caused by the sheer scale of real exchange rate changes since 1973. The real exchange rate changes, that is to say those that are not justified by inflation differentials but which reflect or bring about changes in international competitiveness, were undoubtedly much greater than could occur under a system of fixed exchange rates, where they would take the form of differences in the rate of change of prices with nominal exchange rates remaining constant. Practically no-one had expected them to be so large, certainly no-one who had advocated the changeover to floating rates in the sixties. We had all assumed that exchange rates would gravitate towards purchasing power parities or thereabouts and confidently trusted that this would generate fairly stable medium-term exchange rate expectations, which would also have a steadying effect on volatile conditions in the spot market. It is the instability of real exchange relationships that is damaging for business, even if firms have found direct or indirect ways of forward exchange covering for the duration of normal trade contracts. For it upsets the investment calculations of all those who to any

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significant extent must base their investment decisions on the possibility of profitable sales in competitive international markets and who cannot therefore confidently predict worthwhile sales for the entire useful life of their production plant on the basis of futures contracts, let alone hedged futures contracts.

These microeconomic risks have become serious risks for the entire economy in countries with heavy foreign indebtedness. One must not gloss over the recklessness of many of the heavily indebted countries, but they would probably have been unable to cope with the multiplication of their real debt servicing burden caused by the sharp rise in real interest rates and the strength of the dollar in recent years even if less of their debts had been used to finance consumption and bad investments.

Dominance of Capital Transactions

These are not the only countries to complain, in fact. The massive real exchange rate changes of the past thirteen years illustrate the dominant influence that international capital flows have over the world economy. Such dominance should not be regarded as illegitimate per se – indeed, it has a welcome disciplining effect since it rewards efficiency, reliability and stability and punishes the absence of these qualities – but at the same time it can operate so arbitrarily (at times capital flows can be described as downright disorientated) that impatience with this domination is perfectly understandable. With all due respect to the rationale of free market forces, it must be conceded that international capital flows not only reflect a country's international competitiveness as determined by other factors but also determine it themselves, at least in those cases where they cause excessive real exchange rate changes.

No-one envisaged this problem when the switch to floating exchange rates was made. The vision of many was that national economic policy would enjoy a new-found autonomy, for the sake of which they were even ready to forgo the international solidarity implicit in the intervention rules of the old Bretton Woods system. Autonomy did undoubtedly increase, but at the same time countries became dependent on the confidence of investors throughout the world to an unprecedented extent. This applies not only to economic policy in the narrow sense; many countries also became painfully aware of a change in the effectiveness of wages policy. Under the system of fixed exchange rates, wage restraint policy always meant restraint in real wages and hence had a positive effect on output and employment. With floating rates, it can be a way of inducing a real

appreciation of the currency via the strengthening of confidence in international capital markets; this has major advantages, but the downward pressure on prices may initially impede a significant adjustment of real wages. (Admittedly, the desired employment effect can still be expected to result from the increase in the real value of money and the reduction in interest rates brought about by the capital inflow.)

In short, leaving aside for the moment the undoubtedly important consideration that the dominance of international capital movements is perhaps nevertheless the least irksome of all possible forms of economic domination, we have learnt to set greater store by the stability of the external value of currencies once again. That does not mean that we attach greater importance to this than to the internal value of the currency, but that it is not a priori of little importance. The fact remains that the stability of the external value of the currency is meaningless if it ultimately entails instability in the internal value of money. However, given the international ramifications of economic activity, instability in the external value of the currency, and particularly instability in real terms, impairs its money functions in much the same way as instability in its internal value will do. The difference is at most one of degree, not one of principle.

Unfortunately, however, the justified lament about the unsatisfactory state of the world does not always contain the seeds of ideas on how matters can be improved.

Problems with Fixed Exchange Rates

In the quest for alternatives to floating, it is easiest to reject the diametrically opposed option, that is to say a return to fixed exchange rates. Nevertheless, it is worth carefully explaining why it is unacceptable, since this highlights fundamental problems that are also relevant to the hybrid arrangements to be examined subsequently.

It is beyond dispute that substantial international inflation differentials are incompatible with a system of fixed exchange rates, at least as far as internationally traded goods are concerned, and that a return to fixed exchange rates cannot be contemplated at present if only because an adequate convergence of stabilisation policy is (still) a long way off. Of course, this is not (or no longer) an argument against fixed exchange rates as such, but possibly only a temporary objection. Views on economic policy have changed since the sixties. When we argued for floating rates at that time we always had at the back of our minds (at least there) the notion that

each country had its own Phillips curve and differing views about the optimum point on that curve, and hence we thought that different combinations of inflation and unemployment were appropriate to each country, which was incompatible with fixed exchange rates. Ideas have now changed; there is now a new and fairly broad consensus that inflation or the toleration of inflation is no solution to any economic problem, and certainly not a permanent one. Stable Phillips curves are an illusion. Thus there is now a better prospect of economic policy convergence aiming at monetary stability or very low rates of price increase and the pressure for such policy harmonisation that is inherent in a system of fixed exchange rates can be considered to be more acceptable and hence more likely to succeed. However, it is still questionable whether such consensus goes far enough and would prove resilient enough in practice for the world to risk a new experiment with fixed exchange rates if inflation differentials appeared to be narrow enough in the near future.

This brings us to the second problem with fixed exchange rates. A workable system of fixed rates requires a key currency that can be relied upon to remain strong, unquestioning acceptance of this role by all concerned and subordination of the key currency country's economic policy to this role. There is no sign that the United States is yet ready to don this mantle again. The fact that the Bretton Woods system worked acceptably for a time was due partly to the link between the dollar and gold and partly to the Pax Americana during the first few decades after the Second World War. When during the Vietnam War the Pax Americana came to an end (partly but not solely for that reason), and the United States' gold horde began to melt away, the Americans closed the gold window rather than defend their gold reserves in accordance with the rules of the game; in these circumstances, the demise of the international monetary order established at Bretton Woods was inevitable. The United States used its new-found autonomy – like other countries – to pursue an inflationary policy, exhausted its credit in the same way as it had already consumed its gold reserves, was punished by the market with a massive depreciation of the dollar, accomplished an economic policy U-turn that restored its credit rating and is now in the process of again using up that credit, this time by indulging in excessive government borrowing. Will the next round be characterised by another bout of inflation and a further dollar decline? Be that as it may, in no way does this performance contain a base for restoring the dollar as a key currency in the foreseeable future, particularly as this would require not only a decision on the part of the

USA but the ability to see it through – and to be credible in the eyes of the world. A key currency that does not inspire confidence is a ridiculous notion.

Real Exchange Rate Changes

We have now come to the third aspect, which concerns the real exchange rate changes that can or must occur and how a system of fixed exchange rates copes with them, compared with a system of floating rates. Let us leave aside real exchange rate changes caused purely by trade factors, in other words those associated with international differences in the development of real supply conditions (such as differences in the rate of productivity growth) or with shifts in international demand towards or away from the range of products offered by a particular country. In such cases, the balances on current accounts can be expected to remain unchanged only if real exchange rate adjustments occur. (The lack of offsetting capital movements forces an adjustment in real exchange rates. If the capital account mirrors the change in trading conditions, no change in real exchange rates is needed.) As a rule, these cases do not lead to insurmountable problems, under either fixed or floating exchange rates. Having narrowed the subject in this way, it can be said that the need for real exchange rate changes is linked to the need for real transfers of resources as the counterpart to international capital movements. (Note that an economy's balance on capital account, including the foreign exchange balance, is always identical to the current account balance. Put another way, an international monetary loan must always at the same time be an international loan of merchandise.) What this means is that capital transactions now call the tune and require an adjustment in trade.

We know from exchange rate theory that:

- ☐ Under a system of floating exchange rates it is possible in principle to achieve a balance between capital flows and real transfers of resources without there being any (major) change in the level of prices for the domestic product of the economy concerned. The shift in the exchange rate is such that the change it induces in exports and imports, together with the feedback effects of the exchange rate change (via exchange rate expectations) and any interest rate impact on the capital flow induced by the flow itself, fulfils the requirements for balance. (In the most simple case the necessary adjustment of relative prices between the domestic economy and the outside world – and of real incomes – would solely result from adjusting

export and import prices in the respective foreign currencies.)

□ Under fixed exchange rates, on the other hand, the necessary real transfer of resources can occur only if the necessary adjustment in relative prices is generated by changes in domestic product prices in the countries concerned, in other words by a rise in domestic product prices in the country to which capital is flowing and/or a fall in prices in the country experiencing an outflow. Furthermore, the dampening feedback effect that an exchange rate change produces if it generates contrary exchange rate expectations is also absent. It is this need for an inflationary or deflationary effect that can make massive changes in international capital flows in a fixed rate system intolerable. It should also be borne in mind that adjustment in the opposite direction becomes necessary as soon as the conditions for capital transactions are reversed. True, the intervention mechanism of the fixed rate system can greatly ease the pressure for a real transfer of resources, since the transfer need not be effected at the same time as the capital movements dictated by the market, but this cushioning effect is a decisive help only in certain specific cases, which will be outlined below. Apart from that, the only possibility that remains is to make government borrowing policy even more dependent on international capital movements and to give it a strictly compensatory role. For various reasons, this should be ruled out entirely.

Different Types of Capital Flow

However, in order to avoid exaggerating the fear of, and respect towards, international capital flows, we ought to attempt to differentiate between different types of capital flows. We can distinguish between:

- Capital flows that reflect structural international differences in the marginal efficiency of capital or in savings capital formation and which tend to iron out such differences (class 1);
- Capital movements that stem from differences in the economic cycle in different countries or are triggered by a well-founded stabilisation policy, including capital movements that iron out change irregularities in current payments (class 2);
- Capital movements triggered by a lax monetary policy or by government deficit spending apart from a well-founded stabilisation policy (class 3). Such policies may have productivity effects, which would make this class partly comparable with class 1;
- Capital movements that are originally set in motion by expectations of exchange rate changes (class 4);

□ Capital movements caused by a multitude of other political or economic factors that cannot be classified under classes 1 to 4, which for good reason or simply because of our own limitations we frequently term disorientated capital movements (class 5).

Classes 1 and 2 present no problems. One can and must live with them under both fixed and floating exchange rates and may actually have to regard them as welcome. Class 4 presents a powerful argument for fixed exchange rates. The very existence of class 5 is one of the most important arguments in favour of flexible exchange rates; the ability of a system of fixed exchange rates to absorb shocks of this kind is very limited, while that of a system of floating rates is greater, though still not satisfactory. One of the features of the Pax Americana era was that this problem remained limited owing to the absolute dominance of the dollar as the currency for official and private reserves and as an international investment currency. That probably cannot be repeated, however. It is difficult to decide whether class 5 appears to be so large merely because exchange rate changes occur and hence also generate expectations of such changes. Do not most of the capital movements in class 5 really belong in class 4? We do not know, and we are unlikely to discover the answer without further experiments in monetary policy.

That leaves class 3. The question of autonomy in the exercise of monetary policy has already been raised. However, forgoing monetary autonomy would not be a sufficient remedy, as fiscal policy is also subject to constraints under fixed exchange rates. Those who wish to maintain national economic autonomy at least in the fiscal field (beyond the confines of a well-founded stabilisation policy) must clearly advocate floating exchange rates. For example, a fiscal policy such as the Americans have been pursuing in recent years would have been possible under fixed exchange rates only at the cost of strong inflationary pressure at home or a corresponding deflationary impact on the rest of the world. This would probably have been a prohibitive price to pay, because the fight against inflation was also a high priority in the USA and because the initial inflationary surge would have had to be paid for sooner or later with deflationary pressure. Barring the exceptions described above, lasting international differences in the rate of price increase are not possible under fixed exchange rates.

Those who consider US fiscal policy of the last few years to have been fatal mismanagement both for the United States and for the world economy, as I do, and who believe that the fatal consequences have only been postponed would have been glad if the monetary

system had put a limit to such unbridled government borrowing from the very beginning under the threat of a rapid burst of inflation. On the other hand, those who believe in a “soft landing” sometime in the future possibly welcomed the fact that floating exchange rates permitted a real transfer of resources without fuelling inflation, since such transfers were unavoidable if the political aims behind the US deficit spending were to be attained. In the final analysis, the choice between fixed and floating exchange rates is not just a question of monetary policy autonomy; it is also a question of the autonomy of fiscal policy (beyond countercyclical policy). The internationalism of a system of fixed exchange rates demands that national macroeconomic policy submit fully to its conditions, not partially.

It is unnecessary to draw conclusions from the remarks made so far, since the possibility of changing over to a new fixed rate system is extremely remote at present. For the purposes of the sections that follow, we need only bear in mind the essential elements of the above analysis.

Exchange Rate Oriented Monetary Policy

We shall now examine hybrid forms, monetary policy rules that entail no strict obligation to intervene in defence of particular exchange rates but nevertheless do not allow complete freedom to pursue a money supply policy geared solely to national criteria.

The concept closest to the fixed rate system is one in which a country's monetary policy would be called upon to defend a given exchange rate vis-à-vis a given currency or currency basket, though without any obligation to intervene in the foreign exchange market (rigorously exchange rate oriented monetary policy, with or without voluntary exchange market intervention). Since under a genuine fixed rate system monetary policy could equally well follow a course in which the obligation to intervene generally did not come into effect, the most significant difference between this concept and the fixed rate system is that a monetary policy that is simply exchange rate oriented would leave considerably greater latitude to diverge from the intended objective in emergencies; no formal rules would be infringed if the objective were not attained.

This is a sound policy for smaller countries that are highly dependent on one dominant economy and have no serious reservations about the performance of that economy as regards stability. Some countries, such as Austria and probably the Netherlands as well, have followed this course more or less explicitly for years, though without formalising the concept. Where it is

adopted, no problems are to be encountered with the two first aspects of our analysis of the fixed exchange rate system, namely inflation differentials and the key currency role.

The importance of the third aspect – disturbances caused by capital movements – does make itself felt here too, however. Even Austria, which has gone furthest by adopting this principle of alignment for its entire economic policy right down to wages policy, has so far not risked forgoing the protection afforded by controls on capital movements. Hence even here it becomes clear that a system of fixed exchange rates or a monetary policy that is tantamount to a fixed rate system cannot ensure free capital movements and adequately cope with shocks from that quarter, or can do so only in very favourable circumstances. Tying the currency to that of a dominant economy is therefore quite out of the question even for countries such as Switzerland, which, though also small and intimately linked with a larger economy, are much more strongly affected by fluctuations in international capital flows than Austria and which are inclined to refrain from controls on capital movements (quite apart from other reasons).

Target Zones

The next variant, which appears to be in the forefront of international discussion at present, is the concept of a monetary and exchange rate policy that assumes the task of keeping the currency's exchange rate within internationally agreed target zones. This has been considered primarily for the major currencies. It should be stated immediately that it has nothing to offer.

The good idea of this concept is that it is designed chiefly to free exchange rates from the fatal influence of disorientated international capital movements. However,

- ☐ The possibility (not even the certainty) of avoiding pointless and even harmful exchange rate fluctuations has a price in that money supply policy may have to diverge from the path consistent with stability for longer than the short term.
- ☐ The harmful effects of such deviations cannot be reliably prevented by allowing the resultant exchange rates in turn to prevent free price determination via the international price link. The external price developments to which the country would be tied are much too uncertain.
- ☐ It would only provide an appropriate solution to the problem of capital movements induced by “wrong” exchange rate expectations or those that can easily be

influenced by expectation leadership. The problem of capital movements requiring real changes in exchange rates, a function that is often still best performed by means of a nominal exchange rate adjustment effected by the market, would remain. (If target zone exchange rates were taken seriously, they would have to be treated in accordance with the unnecessarily painful rules of the fixed exchange rate system; on this see above.)

□ Target zones would probably be set largely in accordance with political wishes and the participants' negotiating strength, rather than estimable market forces and planned and feasible economic policy. In the name of combatting wrong exchange rate expectations, the authorities would then be impeding the formation of correct ones. International interest rate differentials that should develop would not materialise.

A Theoretical Concoction

The value of a system of fixed exchange rates derives from the rigorous compulsion for all participants to submit to its rules, whereas the merits of a floating exchange rate regime stem from the self-discipline of each member. A system of target zones would be neither fish nor fowl. Gearing target zones to purchasing power parities – a typical theoretician's concoction – would only appear to lead to more rationality. It is a new ruse for managing without the rigours of rules and convergence or the pressure to exercise self-discipline. It is the pace of world inflation that would become the free variable of the system. We might end up primarily with everybody trying to take advantage of this degree of freedom at least cost.

The concept of target zones for exchange rates also generally includes the idea that exchange market intervention should be used to help attain the target zones. Many observers are fascinated by the central banks' "success" last autumn in their attempt to correct the most important dollar exchange rates by means of massive interventions. This too calls for critical scrutiny.

Let us continue with this example. The interventions were triggered by dissatisfaction with the strong dollar, which is blamed for the enormous US current account deficits, and by the universally feared pressure for greater protectionism in America that is the accompaniment to both these developments.

Our scrutiny must go deeper, however. Exchange rates and interest rates bind together, and balance out, a highly complex network of variables. Saving investment and government credit demand in the USA and elsewhere, exports and imports, capital inflows and outflows into and out of the USA and other countries – this entire set of variables must assume magnitudes that are mutually compatible, and it is the variable combination of interest rates and exchange rates that has to bring them into balance. The exchange rate must be at a level at which the trade flows it has helped determine show a balance consistent with the balance on capital account. However, this itself is not predetermined. Interest rates in the United States and elsewhere and once again exchange rates (as a contributory determinant of exchange rate expectations, which account for a part of the expected profit of foreign investment) must be such that the interaction of the demand for capital in the USA and elsewhere and the supply of capital in the USA and elsewhere produces a balance on capital account that matches the balance on current account; in our concrete case, this would mean a capital inflow into the USA equal to the US current account deficit. Rolled into one, this is the function that the markets must (and do) perform simultaneously.

It must not be thought that one can manipulate one or two of these variables that one dislikes and yet expect everything else to remain as it is. If one wants to bring down the dollar exchange rate and the current account deficit, one must realise that this means reduced capital inflows and a reduced fulfilment of government or private credit demand in America. This result would be

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achieved via the market if investors throughout the world reduced their propensity to invest funds in America, in other words demanded higher interest rates from the USA (with the result that chiefly interest-rate sensitive private investment in that country would decline). The same effect could be achieved on the public sector side – without raising interest rates – if the US Administration voluntarily curbed its credit demand. However, it is either unwilling or unable to do so. Instead, interventions in the foreign exchange market take place. And what does that signify? Foreign borrowing is replaced by central-bank credit – an inflationary expansion of the money supply. Such action provides a brief respite but not a permanent solution. What is the alternative? Other countries could switch to a restrictive monetary policy (for example by engaging in non-sterilised exchange market intervention). This would indeed help the dollar exchange rate, but if one considers the cyclical repercussions on trade it would scarcely achieve its real objective, namely to improve the US current account, and it would unnecessarily impair output and employment abroad.

Treating the Symptoms

Is there another alternative? Other countries could (as a result perhaps of American pressure) adopt more expansionary fiscal policies to supplement and underpin exchange market intervention. This would mean the rest of the world copying the sins of the USA. It would benefit the dollar exchange rate and the US current account, but at the price of creating a worldwide shortage of capital, in other words curbing investment, in plain contradiction to all international agreements on what is required in view of the unresolved unemployment problems. By the way, the universally feared trade restrictions would of course be no solution to America's problems either. As long as government credit demand is not curbed, the USA needs foreign capital – and a corresponding current account deficit – or it must restrict domestic private credit demand.

Mischief at every turn. But the whole purpose of this digression was to demonstrate just that. It may appear sensible on paper, but a renewed invitation to intervene in the foreign exchange markets would primarily be an invitation to succumb to the ever-present temptation to treat the symptoms, and even to enlist joint international efforts to do so. This would divert attention from the real problems and spawn new ones. It is the US budget deficit that forms the hard core at the centre of the problems that the world has been trying to tackle by monetary means for some time. It is there too that the solution to the problems must lie; I know of no thorough analysis that reaches any other conclusion. That does

not mean that the problems caused by persistent overvaluation of the dollar should not have been taken seriously. On the contrary. It is precisely because they have to be taken seriously that the USA should frame its economic policy entirely in accordance with this perception. Every serious monetary policy commitment would be recognisable by the fact that it attacked the root of the problem, which in this case cannot mean exchange rates. In any case, target zones for exchange rates are not necessary for the USA to do what is required of it and for which there is no substitute.

This rather vehement judgement may have given the impression that all intervention in the foreign exchange markets is bad. That is certainly not true. Central banks are entirely free to try to influence the public's exchange rate expectations by exchange market intervention if they are confident in their ability to shape opinion in this respect while safeguarding their money supply objectives, in other words only by engaging in sterilised interventions if they have exhausted the scope for money supply policy. Exchange rate management by means of sterilised interventions and the guidance of exchange rate expectations – these are undoubtedly compatible with a monetary policy geared towards the money supply.

It should be realised, however, that in most cases intervention cannot achieve much. It is not a reliable means of steering exchange rates towards target zones, since sterilised interventions are merely an exchange of assets at the central banks, and moreover one that is only possible or acceptable within limits. Only where this is the sole problem, in other words where the public simply wishes to change the currency denomination of its assets, does such an exchange offer fully effective help. One instance is the case of mistaken exchange rate expectations, an important case, but due caution is needed in attempting to diagnose such occurrences, for they are difficult to identify. Hence a further warning not to seek objective target zone exchange rates (and certainly not to hope to find any with the help of the purchasing power parities theory).

McKinnon's Proposal

An equally widely discussed proposal that is associated mainly with the name of Ronald F. McKinnon appears to be more satisfactory from the point of view of political incentives, if not monetary theory. It hinges on the idea that the participating central banks – initially those of the USA, Japan and the Federal Republic of Germany – should assume joint responsibility for a target magnitude for the "world money supply" (M1). Compatible national money supply targets would

therefore form part of the basis agreement. Target zones for exchange rates, and later fixed exchange rates, would give rise to intervention obligations. Foreign exchange purchased in interventions would be held exclusively with partner central banks in order to guarantee compliance with the target for the world money supply.

The laudable aspect here is the concern to contain worldwide inflation. However, the question of the adequate distribution of the world money supply does not seem to have been thought through in full. The problems caused by international capital movements are equated to the problem of shifts in currency preferences – currency substitution. It is assumed that capital movements that trigger interventions indicate currency substitution on a corresponding scale, for the rule is that the money supply of one country contracts by this amount and that of the other countries is increased accordingly. This is not necessarily the case, however. It may be appropriate to sterilise part of the interventions or to redistribute the world money supply on a scale larger than the interventions. And the crux of the matter is this – as the solution of the problem cannot be objectified, the idea of a world money supply managed by autonomous national central banks loses its fascination. A quasi world central bank with far-reaching regional competence in the monetary field would be needed.

Linking the Dollar to Merchandise Prices

The idea that the value of the dollar should again be linked to the value of merchandise, is still circulating on the edge of the international monetary debate. It would be linked if not to gold, to a basket of goods, such as an assortment of internationally traded staple goods, making the dollar a merchandise reserve currency. Of course, this would have repercussions on the possible future role of the dollar in the international monetary system.

Many American advocates of the idea are letting themselves be swayed by other considerations, however, particularly the notion that this may be a way of getting round the constraints of monetarist money supply management, that are ultimately in every single situation not sufficiently justifiable, and above all the practical shortcomings of this concept. It is true that money supply policy has proved more difficult than had been imagined, at least in the USA. However, it cannot be dismissed as a failure. The money supply would probably not have been managed very differently if the dollar had been tied to some yardstick, although the indicators available to monetary policy would have been

simpler and clearer. The admitted imperfections of the money supply concept are not necessarily greater than those of a merchandise reserve currency. The strict stabilisation of the price level of a basket of goods is not necessarily the ultimate solution. If the basket of goods is very small (in the extreme case containing only gold) there are problems with changes in the specific scarcity of the reserve products. If the basket is very large (producing an indexed currency in the extreme case – for Europe, see the proposal by Vaubel et al.) it must be borne in mind that there is also a need for (temporary) changes in monetary value and that this requirement is not met in this instance; and the relative cost of money should not be excluded entirely from the free market play of relative prices.

The truly specific characteristic of a tied currency lies in its objectification of the scarcity of money. That is undoubtedly a great advantage. Keeping a paper currency in short supply is always an artificial exercise. Even money supply rules are simply devices for keeping money artificially scarce. They have to rely on human behaviour, something that economic history shows never to have worked adequately for long. Admittedly, tied currencies are also subject to the reservation that humans can sever the link if they consider it more advantageous than keeping the promise it implies. Nevertheless, if one wishes to envisage a future world monetary system with a restored dollar again serving as the key currency, money supply rules, however seriously meant, are probably no substitute for a credible link between the value of the dollar and a yardstick of some kind, for the reasons described above.

The EMS

We now come to the European Monetary System. Would it – in a more advanced version – be suitable as a regionally limited international monetary order along the lines of the fixed exchange rate system? When the EMS was established, it seemed more appropriate to regard it as a concept for joint managed floating rather than as a kind of fixed rate system, since the rules contain rather far-reaching exception clauses for the realignment of intervention exchange rates. Nevertheless, it must be acknowledged that the EMS has met with considerable and largely unexpected success. An assessment without any reason for euphoria, of course. The system was born out of fascination with Germany's successful stabilisation policy in the second half of the seventies; but then the pressure to adjust that the EMS imposed on the constitutionally weaker members was reduced to a tolerable level by the long lasting weakness of the Deutsche Mark.

But let us remain with the system's success for the moment! The EMS skilfully exerted the degree of pressure towards convergence and discipline that the participants found acceptable in the prevailing circumstances; at a time of monetary instability, it has made a significant contribution to keeping the intra-European scene largely free of the influence of disorientated international capital flows. That alone is quite an achievement.

Given this success, it is perhaps not surprising that there has been pressure to develop it further, nor that the idea of a European monetary union has again won a considerable number of new adherents. However, why can the EMS not be praised without at the same time wanting to change it? It has proved its worth as it is, not as many people now envisage it becoming.

As far as further developments are concerned, only the removal of all restrictions on the movement of money and capital within Europe is really urgent, a view that accords entirely with the official German position. Such action would also be a suitable test of the ability of member countries to cope with steadily increasing monetary integration, i.e. to lay the foundation for it by adopting an economic policy geared towards this aim. It is a question of gradually increasing the pressure for convergence, avoiding setbacks and above all reducing the likelihood of further digressions into fiscal excesses. This appears to be realistic. By contrast, the idea of creating a true system of fixed exchange rates, of establishing a central banking institution that will eventually issue a European currency and even of creating a monetary union seem to hold no real fascination at present. The three aspects of the fixed exchange rate issue should be recalled; they are:

- ☐ We still have some distance to go before inflation rates converge sufficiently, or at least before there is a convergence of economic policy that can be relied upon to narrow the inflation differentials permanently;
- ☐ There is no European key currency. The Deutsche Mark, which is the only one that would be suitable, is not accepted in this role by the other countries involved;
- ☐ Resistance to the possibility of massive capital movements has not been tested, and is not guaranteed.

The notion that a European central bank (or some such institution) can give the people a stable currency will be an illusion until the member countries have each permanently demonstrated that they are willing and able to take a stand for a truly stable currency. Successful one-off stabilisation is not sufficient proof. We do not need a European currency of average mediocrity that would not be viable without protectionist restrictions on

capital movements at the expense of stronger competitors. Let us repeat that the only country in which a stable European currency could be rooted in the present circumstances is the Federal Republic of Germany. This is not only because Germany has an autonomous central bank but also because the central bank and its stabilisation policy enjoy wide support among the population. The dictum attributed to Jacques Delors, that in the Federal Republic some people believed in God and everyone believed in the Bundesbank, is therefore more than just a witticism; his view on the fact may be different, but the Federal Republic's love of stability is one of the most precious economic assets that the nation possesses (and probably that Europe possesses too); there should be no question of sacrificing even part of it on the altar of premature integration.

Conclusion

The time is not ripe for major monetary reforms, either in Europe or in the USA. That does not mean that there is no cause for concern and hence no reason for continuously reflecting on possible reforms. It is not only the unsatisfactory experiences of the past that urge us to do so; the danger of further turbulence has not been eradicated, particularly if one considers the tremendous unsolved problems which the USA is putting off, let alone the unresolved problems of the heavily indebted countries. However, none of these concerns are of the kind that can be overcome solely by means of institutional innovations. To some extent, the opposite is the case. The system of floating exchange rates has certainly not coped with the difficulties of recent years in a brilliant way, but it has not been a complete failure either. Many countries must continue to toil along the arduous road to stabilization; even without institutional changes, this offers the possibility of holding future exchange rate unrest in check.

In a few years it may be possible to give a different answer to the question of alternative monetary systems, although at the world level there are grounds for continued scepticism for some time to come. Even if far greater stability is achieved than prevails today, the multitude of changing reasons for major capital shifts in the world make it doubtful whether we can forgo the greater capacity to absorb shocks that is the hallmark of the system of floating exchange rates. The same scepticism need not apply to Europe, however. Even those can entertain hopes of a further development of the EMS who today warn against overhasty reform and advise us to be prepared for the European monetary scene to change very slowly.