ECONSTOR
Make Your Publications Visible.

A Service of
ZBW
Leibniz-Informationszentrum Wirtschaft
Leibniz Information Centre for Economics

Arndt, Sven W.

Working Paper

The recent behavior of floating exchange rates: Erscheint in Kieler Vorträge, gehalten am Institut für Weltwirtschaft der Universität Kiel

Diskussionsbeiträge, No. 118

Provided in Cooperation with:
Department of Economics, University of Konstanz

Suggested Citation: Arndt, Sven W. (1978) : The recent behavior of floating exchange rates: Erscheint in Kieler Vorträge, gehalten am Institut für Weltwirtschaft der Universität Kiel, Diskussionsbeiträge, No. 118, Universität Konstanz, Fachbereich Wirtschaftswissenschaft und Statistik, Konstanz

This Version is available at:
https://hdl.handle.net/10419/68912

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

WWW.ECONSTOR.EU

Mitglied der Leibniz-Gemeinschaft

FACHBEREICH
WIRTSCHAFTSWISSENSCHAFT UND STATISTIK
UNIVERSITÄT KONSTANZ

The Recent Behavior of Floating Exchange Rates

Sven W. Arndt

Nr. 118

DISKUSSIONSBEITRÄGE

D-7750 Konstanz
Postfach 7733

The Recent Behavior of Floating Exchange Rates

Sven W. Arndt

Nr. 118

Erscheint in:
Forthcoming in:
"Kieler Vorträge". Gehalten am Institut für Weltwirtschaft der Universität Kiel (Hrsg.): Fritz Baade

Weltwirtschaft Kiel
A 9 913 79 Gr

Dezember 1978

Diskussionsbeiträge des
Fachbereichs Wirtschaftswissenschaft
und Statistik der Universität Konstanz

C 86205

A 913 79 Weltwirtschaft Kiel

The Recent Behavior of Floating Exchange Rates

by Sven W. Arndt*

Lecture at the Institut für Weltwirtschaft, Kiel

During the past decade the international monetary system has seen a great deal of instability and change. The Bretton-Woods system collapsed and was abandoned when it lost its ability to cope with the onrush of events. Driven more by desperation than conviction, countries turned to floating rates as an alternative. Five years have now passed since the adoption of floating rates; we have survived, though not solved, an energy crisis in the meantime and passed through the worst of a global recession.

We are not out of the woods by any means, however, for major policy problems await resolution. Unemployment, sluggish growth and inflation plague many countries, sometimes simultaneously in open defiance of Mr. Phillips and his curve. The distribution of current account positions has been altered drastically, to the satisfaction of almost no one. All of this appears to have given the foreign exchange

* The author is Professor of Economics at the University of California, Santa Cruz and Visiting Professor of Economics at the University of Konstanz, West Germany.

markets a severe case of indigestion and heartburn. And everywhere there is the threatening shadow of protectionism and economic warfare.

Taken together, energy, macroeconomic instability and exchange-rate volatility present a challenge formidable enough to tax to the limit the strength and resilience of the world economy and the skill and perseverance of policy makers. A happy ending to our travails is not at all inevitable, especially if we insist on repeating past mistakes. A proper understanding of our difficulties is an indispensable precondition for the design of a workable solution. I should like to examine several themes which bear critically on the problem.

THE VOLATILITY OF EXCHANGE RATES

My first theme deals with variability in exchange rates. We have, since the onset of floating in 1973, witnessed substantial fluctuations in exchange rates. This not inconsiderable volatility has led many to question the efficacy of floating rates and to ask whether we might not be better off with a much more strongly managed system, if not with rates that are fixed altogether. To some extent, this concern has been the natural reaction to unfulfilled expectations, for floating rates clearly have not worked in ways which most would have predicted. We have, I think, all been surprised by the roller coaster of exchange rate change.

Before we heed the call for a return to fixed or greatly managed rates, however, we must make certain that we understand recent events correctly and that our analysis of those events is not leading us to inappropriate conclusions. We have, I would argue, allowed our perceptions and our beliefs in what should be the "common sense" of exchange rate dynamics to lead us astray. In evaluating the effectiveness of floating rates, many commentators have looked to volatility in the "fundamentals" of the system - variables like output, employment, wage rates, commodity prices and the like - as if it could be used as a standard. If, so the argument runs, exchange rates have varied more than all or some of the fundamentals, there must be something wrong with exchange rates. Experts everywhere are urging governments to intervene in foreign exchange markets whenever the short-term movement of the rate exceeds a specified limit (say 4% per period). This threshold value is usually based on what the advisor believes to be the outer limit of variability in the fundamentals.

Linking exchange rates and the fundamentals is intuitively appealing; but it is also fallacious in today's world. In a world in which all segments of an economy react equally rapidly to a disturbance, adjustment of exchange rates and other variables occurs simultaneously. This synchronization is absent in a world like ours in which some markets adjust faster than others and in which many price and quantity variables are controlled by governments or determined by slowly changing

contracts. In such an environment, the more flexible markets and variables absorb the initial impact of a disturbance, while the more sluggish segments show little reaction at first and adjust only with the passage of time. It is generally agreed, that asset and foreign exchange markets are more responsive in the short run than commodity and labor markets. We would thus expect prices in the former, and hence the exchange rate, to show relatively greater volatility in the short run.

The presence of significant rigidities - and who will deny their abundance in the modern economy - invalidates the rule that exchange rates should vary no more than the fundamentals. This does not mean that exchange markets are infallible or that volatility in exchange rates and the uncertainties associated with it don't complicate everyone's decision problem. It does mean, however, that we must avoid the use of inappropriat standards and criteria in evaluating the performance of an exchange rate system.

The proper approach toward reducing the volatility of exchange rates is not to arbitrarily restrict their movement, but to reduce the need for movement. This may be achieved by reducing the turbulance within the system and by improving its ability to adjust through removal of rigidities and obstructions. Governments can make important contributions here simply by conducting steadier policies. Recent history is replete with examples of public policy switching in short order from excessive expansion to excessive contraction and,

after having thoroughly destabilized prices, wages, interest rates and exchange rates, attacking these symptoms with incomes policies, exchange controls and other interventionist non-solutions. When public policy changes direction and signals too frequently, it loses its value as a guide to private decisions. The useful and reliable information it provides is diminished and the uncertainty in economic life increased. Steadiness in public policy, as distinct from its other qualities, has received insufficient attention in western democracies. Perhaps it is time to insist that governments pay attention to the impact of their policies on the general economic environment and assess the "uncertainty quotient" or "confusion index" of every contemplated policy.

In short, before we blame recent volatility on weaknesses and mysteries inherent in exchange markets, we must make certain that public policy is conducted with a steady hand; without such steadiness no system will work. Further, we must in evaluating floating rates employ standards which, unlike the "fundamentals" criterion, take proper account of the rigidities we have built into modern economies.

Conflicts Among Objectives

Apart from volatility, it has been the levels of exchange rates which have engaged peoples' concerns. We see this in the discussion on whether the dollar is over- or undervalued in relation to various currencies. The

Bretton-Woods system collapsed when governments attempted to maintain exchange rates at levels which failed to clear exchange markets. Under that system governments were always last to admit that a given exchange rate was the wrong one and needed to be changed. Still, we hear a growing chorus of voices urging governments to target and manage their currencies more aggressively.

On this matter the American position has been steady: intervention would be limited to smoothing disorderly exchange market conditions. Market forces rather than the government are to determine the path of exchange rates. This is, I believe, the correct approach especially in the contemporary setting in which countries would find it most difficult to establish currency values on which they could agree and under which they would conduct consistent domestic monetary and fiscal policies. It is unfortunate, in a sense, that an exchange rate always belongs to two countries. Wouldn't it be nice if each country had its own exchange rate to do with as it pleased. Even in that seemingly idyllic world, however, conflicts <u>within</u> each country between the incompatible claims of exporters and importers would have to be reconciled.

It is, after all, not the German importers who have been complaining about the rising international value of the mark. It is, rather, the export and import-competing sectors that are feeling the pinch in Germany and elsewhere,

and this especially after having enjoyed for decades the protection implicit in the general undervaluation of many European currencies under Bretton Woods. In these industries, adjustment to the new international monetary environment is causing distress and dislocation and cases may exist for public assistance and international coordination of adjustment. There is much scope here for the exercise of compassion, but enlightened public policy must never lose sight of the broader public interest. We shall have more to say on this matter.

What we have learned in recent years is that even under floating rates the worry over exchange rates will not go away. The naive expectation that exchange rates would become uninteresting under floating, permitting us to focus on more important variables and objectives, has certainly not been realized. We have learned, often the hard way, that "doing our thing" in the conduct, say, of monetary policy produced exchange rates with which we were not prepared to live. Thus, the discipline of the moving exchange rate has replaced the discipline of declining reserves. Though this is not the time to undertake a comparison of disciplines, it is worth noting that the discipline of the exchange rate is probably more symmetric as between strong and weak currency countries.

Even under floating rates ours is an interdependent world economy. Floating rates may have changed the details

in which this interdependence manifests itself, but not the fact of its existence. And that means that the need for international cooperation on monetary matters has not disappeared. But cooperation, if it is to be constructive, must first and foremost be concerned with maintaining and improving the ability of the international economy to adjust and to accommodate change.

MACROECONOMIC POLICIES AND EXCHANGE RATES

A second theme concerns the complaint that macroeconomic policies are becoming ineffective; that somehow the old medicine doesn't do the job any longer. Our economies, so the charge goes, are wobbly and unstable, poised between recession and double-digit inflation, seemingly permanently afflicted with stagflation and with no apparent cure for the malaise. In the good old days, inflation and recession had the decency to plague us one at a time; today we can't seem to get rid of either.

Two aspects of this issue are of particular importance. One is that the old medicine always partly depended for its effectiveness on some form of illusion, be it money or exchange rate illusion, or some other asymmetry in private perceptions and behavior. If workers had money illusion, monetary policy could be expected to change real output and employment; if the public had exchange rate illusion, adjustments in nominal currency values could be expected to effect changes in the real sector.

Much of that sort of simple illusion seems to have disappeared, gone with the age of innocence. There are in fact economists - those working within rational expectations frameworks - who argue that you can expect few real effects from most macroeconomic policies unless you conduct them in a totally unpredictable manner. I am personally neither entirely convinced of that argument nor disturbed by the loss of simple illusions, although I sometimes have the uneasy impression that our governments, having always known what "rational" economists are only now discovering, deliberately foment turbulance and uncertainty in the hopes of realizing their policy objectives.

Nevertheless, there does appear to be something to the complaint. In both cyclical and secular terms the system seems to have trouble adjusting to changes in signals. A change in macro policy is a change in the broad guidelines by which government indicates the direction in which it wishes the economy to move. If the government doesn't switch signals too frequently, its credibility will be good and the public will take the policy change seriously. But even where the new policy promises to enhance the overall social good, there will be groups whose well-being will be adversely affected and who will resist the change or demand compensation for injuries and losses incurred. Distributive justice doubtless would lead us to honor many of the claims for compensation, as in fact we have done over the years. We

have come to the aid of many an industry with microeconomic policies designed to ease the burdens imposed on some by the broad policies adopted for the benefit of all.

And we have with the passage of time and an important blurring of distinctions applied this assistance principle to groups and sectors affected adversely, not by changes in public policy, but by economic change regardless of origin. The difficulty is that the means of compensation which have been employed have all too frequently weakened or eliminated altogether the pressures to adjust; that is, the distributive goal has all too often been achieved at the expense of allocative efficiency. Now, while a healthy, dynamic economy can absorb some sacrifice in allocative efficiency, no economy can retain its resilience and vitality for very long when, of all the means available for the achievement of distributive justice, the choice consistently falls on those which interfere with the efficient allocation of resources and thus reduce the average productivity of all resources.

In a dynamic market economy relative prices play a crucial role in the allocation of resources. This role is all too often forgotten or ignored in the formulation of economic policy. Even in non-market economies something like relative price is needed in order to evaluate the extent to which a society is using its scarce resources effectively. When relative prices change in a fundamental way and thereby signal the need for society to reallocate its resources,

that society can consistently ignore those signals only at its own collective peril. To heed those signals, moreover, in no way means that society must abandon its distributive goals, although it may have to reformulate some of them. Society must simply eschew certain types of policies: instead of blunting or, worse, reversing the price signals calling for adjustment in a sector, an industry or a region which has become uncompetitive and unable to achieve minimum economic well-being by pursuing its traditional activities, public policy should strive to ease the transition to new pursuits.

It is in this matter more than any other that Western democracies are compromising the future viability of their economies. This development is the result of policies which are always believed to further human well-being and render our systems more humane; their long-term effect, however, is more likely to limit our ability to achieve those worthy objectives. To a growing extent market participants are learning that when their economic well-being is threatened by a more efficient competitor at home or abroad, or by an adverse development in their terms of trade, they can obtain more effective relief by using the political process than by meeting the economic challenge head-on. Indeed, Washington, Brussels and political capitals everywhere are abuzz with the activities of economic groups seeking to sell politically what they cannot sell in the market. The pleaders come from everywhere and have included New York City, the teachers, the sugar producers, the ship builders, the farmers, and lately

the steel producers. The principle being sold here is simple and powerful, and goes far beyond the maxim that the state has the obligation to provide gainful employment for its citizens. It requires the state to tax its productive citizens in order to sustain rather than eliminate the inefficiency of others. When the unproductive sector is relativ small, the burden is bearable; but in some of our democracies that principle has been applied to so large a part of the economic system, that its overall economic viability and productivity have been sharply compromised.

Shifting Comparative Advantage

In international trade, this principle has, of late, found expression in reference prices, minimum prices, crisis cartels, orderly marketing arrangements, and the like. These are the wrong medicines for what ails the industries involved; they may give relief to parts of the body economic but, being addictive, they ultimately destroy its overall health and vitality. The case of steel is instructive here. The steel industry in the developed countries is in trouble; it is plagued by excess capacity and low productivity. The behavior over the years of labor and management in the industry has not been designed to maintain its vitality; both sides are much to blame for the problems they now face. But a substantial part of the blame belongs to governments, which have encouraged and subsidized the creation of excess capacity, prevented the elimination of inefficient operations and

Bibliothek des Instituts
für Weltwirtschaft Kiel

obstructed the transfer of unproductive resources to other uses. What has finally forced the issue is the emergence of steel-making capacity in the poorer nations, a development which is the manifestion of a slow shifting of comparative advantage in many, though not all, types of steel. These shifts, it should be noted, are part of a continuing historical process and absolutely essential if poor nations are to realize their hopes of industrialization and growth. In a well-functioning world economy, the developed countries would slowly disengage and shift resources - labor, capital, etc. - from these activities into comparatively more productive ones. The role of public policy would be to ease the burden of adjustment borne by the workers and capitalists who are the owners of these resources.

That the workers and capitalists will resist the pressure to adjust is understandable and natural; that society in turn must resist the pressures to install policies preventing the reallocation of resources is essential for its long-term health and viability. Rather than crisis cartels and reference prices in steel or orderly marketing agreements in textiles and television, which are bad medicine even in the short run, measures must be devised which increase the productivity of resources. That these adjustments cannot take place overnight is only an argument in favor of starting the process rather than delaying it still further.

If western nations fail to provide for the timely reallocation of resources, they will find themselves drawn

increasingly into destructive responses to the inexorable shifting of comparative advantage. These responses will pit western industrialized nations against each other in a war in which everyone is the loser, and one which will set back the cause of economic development in the Third World as well.

With reference to the second theme, therefore, the conclusion is clear: the objectives of maintaining viable and responsive economies and of protecting everyone from the discomforts and inconvenience brought by economic change are incompatible. The proper focus of public policy is to further economic change in a framework which provides for sharing the burden of change.

DEFICITS, ENERGY AND EXCHANGE RATES

A third theme revolves around the relationship between current account deficits, energy and exchange rates. I have been stressing the importance of relative prices, and nowhere are they more crucial than in relation to the energy problem. This is a problem which originated in a relative price change and one which we will solve only if relative prices are given a prominent role. More energy will be produced and conserved if prices are allowed to reflect the pressures of supply and demand and if private individuals are allowed to make their own adjustments in response to the changing price of energy. If, as a consequence of energy price increases, the real incomes of energy producers rise and those of (poor) energy

consumers fall to levels which are incompatible with our collective notion of distributive justice, taxes on the income of the former and subsidies to the income of the latter rather than government price fixing and allocation schemes are the appropriate remedy.

As far as the energy situation in America is concerned, much has been said and written and a great deal of it is off the mark. Europeans have been focusing too much on energy legislation and are expecting too much from the passage of an energy law in the U.S. These expectations, and especially those related to the U.S. current account deficit, are bound to be largely disappointed. This is not to say that an energy law, whatever its content, won't help; it will at least remove some of the uncertainty surrounding an important aspect of public policy. As I have already indicated, governments destabilize and add turbulance to the system with prolonged and frequent changes in policy signals. With few exceptions, nothing is more fundamental to private decisions than public policy on energy.

To the extent that the eventual energy law establishes the right signals, it will help point the economy in the right direction. But achievement of greater energy efficiency will occur only with the passage of time. Meanwhile, quite independent of legislative efforts, an important process has been under way since the beginning of the energy crisis: in response to increases in the relative price of oil, the

American economy has begun an adjustment process which is making it increasingly energy efficient. Let me illustrate by way of an example. We have always known in the United States that we could substantially reduce the energy used in heating and cooling our homes if only we built better houses. The price of energy relative to construction and insulation was such, however, that using lots of energy in poorly insulated houses was rational. That relative price situation has recently been changing in favor of conservation, and private decision makers - rational economic beings that they are - are adjusting their behavior. In other areas, such as the fuel efficiency of our automobiles, similar developments are taking place. The process is slow, of course; but it is moving us in the right direction and will, when completed, make a significant difference.

A word perhaps about the speed with which America is adjusting to the energy shock. There are those in Europe who have criticized the United States for not reducing the value of her imports or increasing the value of her exports in order to maintain rough balance between the two. Indeed, glaring spotlights have been focused on the American deficit and microscopic changes are examined and discussed with an utterly inappropriate intensity. This preoccupation has taken attention away from more important issues and has given exchange markets an unwarranted case of the jitters.

A country whose imports have become more expensive, that is, whose terms of trade have worsened, has several

avenues along which to adjust. It can cut the volume of imports in order to restore an appropriate balance between the values of imports and exports; it can raise the volume of exports until exports cover the increased cost of imports. In either case, the quantity of goods absorbed at home relative to a given national product must decline. In short, the energy shock is accommodated by a reduction in current real domestic absorption. On the other hand, the country can pay for more expensive imports by selling assets or borrowing abroad. In this case, the energy shock is accommodated through a reduction in future domestic absorption.

European nations have relied heavily on a combination of the first two alternatives, while America has opted for the third. There is nothing that makes one approach "better" than the other and to that extent the European criticism is inappropriate and unwarranted. The European solution is neither intrinsically more virtuous nor economically more sensible, because in its efforts to adjust current absorption to the new realities Europe has contributed to the global recession with all of its attendant human misery and loss of output.

In letting future absorption bear part of the burden of the shock, America is using its enormous wealth to soften the blow. This approach is good not only for the United States but for the world in general, for it has permitted America to maintain activity levels and growth rates which would otherwise not have been feasible and without which

the world recession would have been deeper and recovery substantially delayed. It is hence my contention that the American approach is entirely correct and in the global interest, which implies that the relevant portion of the U.S. current account deficit is appropriate to the given circumstances. Over time, as relative prices and a changing wealth position do their work, the necessary adjustment will come. Excessive preoccupation with the undulations of the current balance during the interim can only spread a quite unwarranted feeling of general malaise and disequilibrium when there really isn't one.

One implication of these remarks is clear: I consider most of the arguments calling for an "equitable" sharing of the oil deficit to be not only misguided but dangerous. If the United States had heeded these siren calls, a deep and lasting global recession would have been the consequence. The human suffering, loss of output and political and social turmoil which would have gone with it are too high a price to pay for an arbitrary and misguided definition of equity.

Deficits and the Future

In thinking about current account balances it is useful to keep in mind that they are nothing more than a reflection of a country's domestic saving-investment position. If a country's total domestic absorption of goods and services (through consumption, investment and the public sector) is exactly equal to its total current production, its current

account will be in balance. This does not mean that its exports or imports taken separately will be zero, for the country doesn't have to absorb goods and services exactly in the form in which it produced them. It can always trade domestic output (exports) for foreign output (imports).

It follows that a surplus country is one whose current production exceeds its current domestic absorption. This excess of current output is available for placement abroad. To state the matter somewhat differently, in such a country the sum of private and public saving exceeds the sum of private and public domestic investment, leaving the excess of saved resources free for investment abroad. By contrast, a deficit country is one whose current production falls short of its current domestic absorption, thus requiring net imports to make up the difference. Whereas the surplus country is a net saver and thus a foreign lender, the deficit country is a net foreign borrower.

Over the span of its history, each country will pass through phases during which it will be a net borrower or debtor, or alternatively a net lender or creditor. Generally, young and developing countries tend to be deficit or debtor countries, while mature and developed nations are the surplus or creditor nations. We should note in passing that it is by running surpluses vis-a-vis the Third World that the developed nations of the West provide development assistance to the former; such surpluses are crucial in the transfer of resources from rich to poor. It is hence proper for the

United States and other developed western nations to maintain on trend a collective surplus with the Third World.

Since at any moment, the various trading nations of the world are located at different points along the saver/investor spectrum, their current account positions will also differ. The factors determining the trend development of these positions are quite fundamental and include stage of economic development, industrial structure, resource endowment, national savings propensities and other preferences, etc. Variations around trend may occur from time to time especially in connection with business cycles. Consequently, a current account surplus or deficit is not necessarily an indication of disequilibrium or imbalance. Only in special cases will a zero current balance be required for macroeconomic equilibrium.

The close link between a nation's current balance and its saver/investor position implies that policy makers desiring to engineer lasting changes in the distribution of current account positions, will have to change the fundamentals determining domestic saving and investment. A surplus country must be made to save less or to invest more at home if its current balance is to be brought to zero, but care must be taken that these efforts do not inflict permanent damage on the structure of the economy.

Now, I argued earlier that the U.S. energy deficit was, under the circumstances, entirely appropriate and that "equitable" sharing of the oil deficit was a dangerous

notion. In an analogous fashion, the saver-investor classification suggests that so long as countries differ substantially in development stage, industrial structure and collective preferences, equitable distribution of current account positions is a bad idea in general. What politicians and opinion makers should worry about instead is that current world savings are invested around the world so as to maximize their returns and that these returns are appropriately distributed. Defining equity or fairness in this connection is not an easy task, but one which would absorb the creative energies of world leaders much more effectively than redistribution of current account deficits.

It is only through investment that global living standards can be raised. But to invest, the world must first save. Now, there is much evidence that the world pool of savings and thus the supply of investible resources has been rising along trend, partly because trend income growth has accrued more to the high-saver countries. The task before the world is to create the climate and the environment for the productive placement of these resources and for the appropriate sharing of its fruits. The obstacles to the creation of such an environment are formidable indeed; they are to be found as much in the LDCs who would be the recipients of funds as in the DCs who are the principal savers.

What is needed is an international code of standards for investment which would rationalize the placement of investible

resources around the globe while protecting the interests of all. A code, accompanied by appropriate sanctions and enforced by the coordinated efforts of governments is superior to internationally sponsored collusion, resource manipulation or price controls. Together with a more rational approach to economic policy within each country, such an international undertaking would go a long way toward stabilizing the world economy and improving its performance; a by-product would be reduced turbulance in exchange rates. In the long run such efforts would pay off handsomely in greater productivity and higher global living standards.

CONCLUSION

Let me in concluding try to pull the various themes together and to relate them to the floating rate regime. The fact that monetary conditions have an important influence on exchange rates is well established, so I have not dwelled upon them here. If the United States continues to run more inflationary policies than its major trading partners, the dollar will continue to depreciate. Such exchange rate changes merely offset the effects of increasingly divergent national price levels. Thus, any gains in competitiveness which accrue to German exporters from an increase in the price of substitute American goods are eliminated by an appreciation of the mark relative to the dollar. So long as countries have different inflation tolerances, flexibility of exchange rates will be a necessary part of the international

monetary order. The American government has made the fight against inflation a top priority. If its efforts succeed, I expect the pressures on the dollar coming from differences in inflation rates to diminish.

We have also seen that market rigidities force the initial burden of adjustment to be absorbed by exchange rates and thus increase the short-term volatility in exchange rates. Monetary and other disturbances, including those originating in public policy, generate reverberations in the foreign exchange markets. The more pervasive the presence of rigidities, the more the need for public policy to be conducted with a steady hand. Rapid and frequent changes in the thrust of monetary, fiscal and regulatory policies are inappropriate in such an environment. You cannot navigate economies built like the Queen Elizabeth as if they were racing boats.

We have seen further the importance of not reacting to every current account imbalance as if it were an imbalance and to use proper standards in evaluating a given distribution of current account positions. I have argued that by forcing much of the oil shock to be accommodated by reductions in current absorption, Europeans have inhibited their domestic economic activities and reduced their growth rates. Given the importance of these variables in determining countries' imports, Europe's policies have contributed to the size of the overall U.S. current account deficit by reducing purchases of American goods. Europe's growth rates and activity levels are likely to increase in the near future, while those in the United States

are likely to slow somewhat. In combination, these developments should relieve some of the pressure on the dollar.

While destabilizing influences are likely to generate further turbulance in financial and exchange markets in the foreseeable future, the major threat to the system comes, in my view, from increasingly unprincipled and abusive official intervention at the micro level. The new protectionism in particular, with its reliance on price manipulation designed to neutralize the allocative mechanism, and crisis cartels, orderly marketing agreements, and the like which encourage the formation of private and semi-public monopolies, have the potential to wreak enormous damage. These measures should be abandoned in favor of policies less damaging to the health of the world economy.

I have few illusions about the likelihood of change taking the direction I have been urging. Such change will of necessity be opposed by those who are on grounds of principle against market-oriented solutions and to whom the failure of a program based on government intervention simply means that there wasn't enough intervention. It will also be questioned by those who fail to distinguish between the allocative and distributive functions of a price and who will thus be afraid of having to give up their distributive goals. Beyond these obstacles, the political problems of implementation are overwhelming. No single industry or economic interest group has the incentive to alter its behavior at home and no government to alter it internationally. The costs are too high if

everyone else continues to operate in unchanged ways.

If we are to stop abusing our economic system and to start using our scarce resources more effectively and to the greater benefit of all, the effort must be collective at home and coordinated internationally. Given the relative parliamentary weakness of many western governments and the domination over the legislative process of special interests, public attitudes must first be changed. Here, too, the picture is thoroughly bleak: economists have not been able to carry an effective message; most journalists writing about economic subjects do not understand them; and politicians whose tenure in office is often short have no incentive to talk about, let alone tackle, problems whose solutions lie - at best - in the distant future. So, a public bent on gratification and not at all eager to face unpleasant realities is left to the ministrations of economically illiterate gurus and snake-oil salesmen.

Still, there are isolated signs of the dawning of recognition. The public may be on the way to understanding the difference between the end of a just and humane society and the means used to achieve it. Reckless conduct of monetary, fiscal and regulatory policies and abusive intervention in the allocative mechanism - even if motivated by the noblest of intentions - lead to double-digit inflation and other diseases. The road to that just and humane society has to be paved with something more substantial than good intentions, or we shall all end up in the Other Place.