

PRINCETON STUDIES IN INTERNATIONAL FINANCE NO. 31

Toward a New Basis for International Monetary Policy

The German Council of Economic Experts

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
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PRINCETON STUDIES
IN INTERNATIONAL FINANCE

This is the thirty-first number in the series PRINCETON STUDIES IN INTERNATIONAL FINANCE, published from time to time by the International Finance Section of the Department of Economics at Princeton University.

It is translated from the *Annual Report* of the German Council of Economic Experts, published in November 1971, and is introduced by Fritz Machlup, former Director of the International Finance Section, whose Foreword describes briefly the history and functions of the Council and the context from which this study is excerpted.

This series is intended to be restricted to meritorious research studies in the general field of international financial problems which are too technical, too specialized, or too long to qualify as ESSAYS. The Section welcomes the submission of manuscripts for this series.

While the Section sponsors the studies, the writers are free to develop their topics as they will. Their ideas and treatment may or may not be shared by the editorial committee of the Section or the members of the Department.

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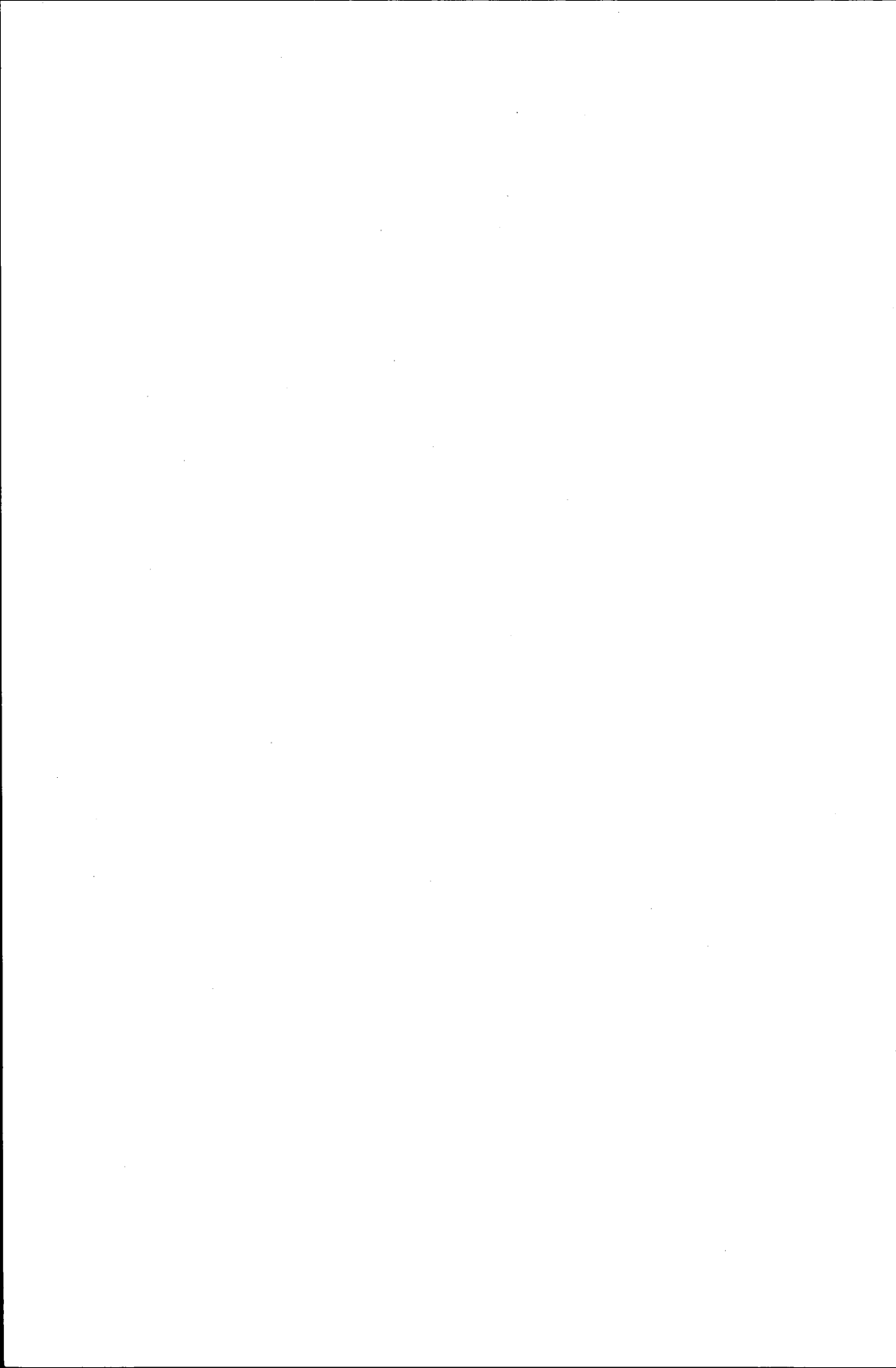
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FOREWORD

This is a rather unusual issue in the series of Princeton Studies in International Finance. It is unusual in at least three respects: it is an English translation of a study originally published in German; it is part of a chapter from an official document; and it was written by an appointed body of five economists with the aid of a small staff headed by a secretary general. An explanation of the nature of this document, of its multiple authorship, and of the significance of the views expressed seems to be called for.

The authors of the document are the members of the German Council of Economic Experts, which was established by a German Federal law of August 1963. This body, appointed by the President of the Federal Republic upon nominations by the Federal Government, is not to advise the Government but to aid it, as well as the legislature and the general public, in forming judgments on current economic problems and policies. The law stresses the complete independence of the Council. Its mandate is to present annual expert opinions on the current economic situation and on prospective developments, and also on appropriate ways to attain "within the framework of a market economy, stability of the price level, a high level of employment, and external balance, with steady and adequate economic growth." Alternative ways and means to secure these objectives are to be weighed and appraised, though no specific recommendations for policy measures should be made. The annual reports of the Council are submitted to the German Government in November of each year, and some special reports are made at other times.

The text published here as a Princeton Study is an English translation of Part III (sections 249 to 316) of the third chapter of the Council's Annual Report 1971-72, published on November 18, 1971. The first chapter of the Report gives a diagnosis of current economic conditions, the second discusses foreseeable developments, the third considers alternative options for economic policy, foreign and domestic, and the fourth focuses on special problems of governmental policies for the promotion of competition. Only the sections on international finance, contained in the third chapter, are presented here in an English version, under an arrangement with Professor Norbert Kloten, Chairman of the German Council of Economic Experts.

The Annual Reports of the Council carry individual titles emphasizing the themes of their major concerns. It is characteristic that "stability," which for German audiences means "price-level stability" or "stability of the value of money," is the theme that recurs most frequently. Thus, the first Report carried the title *Stable Money—Steady Growth* (November 1964); the second, *Stabilization without Stagnation* (November 1965); the third, *Expansion and Stability* (November 1966); the fourth, *Stability with Growth* (November 1967); and the eighth, *Monetary System, Value of Money, and Competition: Decisions for Tomorrow* (November 1971).

Although the composition of the Council has changed over the years—only one member of the present Council has been serving on it from its inception—the views on essential issues have been extraordinarily consistent. This is particularly noteworthy with regard to the controversy about fixed versus flexible exchange rates; the Council has been arguing in favor of greater flexibility, chiefly because it recognized from the very beginning that adherence to fixed exchange rates would make it impossible for Germany to avoid the creeping price inflation that has been tolerated by the major trading countries of the world. Thus, in its first Annual Report (November 1964, section 240) the Council discussed not only the advantages of a wider band for permissible fluctuations of exchange rates around parity, but also the possibilities of a system of freely flexible rates. In its third Annual Report (November 1966, sections 268–274) the Council advanced, among several alternatives, a plan for gliding revaluations of the German currency, with upward adjustments of the parity scheduled for several years in advance. These and other possibilities of safeguarding the stability of the purchasing power of the D-Mark against imported inflation were further analyzed in the fourth Annual Report (November 1967, sections 410–428), and again in the fifth Annual Report (November 1968, sections 217–229). The sixth Report (November 1969, sections 273–297) discussed the advantages of greater flexibility of exchange rates in a subdivision devoted to comparative merits of alternative reforms of the present international monetary system, after a Special Opinion (June 1969) had dealt with "Internal Stability and External Balance." In view of these consistent reminders, one may wonder how deaf the ears of the German Government and financial circles were, from 1964 to 1969, to the teachings of their appointed economic experts.

The reader of the translated extract from the eighth Annual Report of the Council may find several sections of particular interest. I wish to call his attention to the analysis of the minimum width of the band of exchange rates around parity relative to the frequency and size of change of parity: the band can be the narrower, the more frequent and smaller are the changes of parity (sections 265–272); to the views on the period of “dirty floating” (sections 249, 274); to the discussion of dual exchange rates for commercial and financial transactions and of other bureaucratic controls of capital movements (sections 275–278, 286, 298); to the defense, so rare in our time, of unrestricted freedom of international capital movements and unlimited convertibility for both residents and nonresidents (sections 251, 274, 287–288, 297, 311); and to the proposals to create an efficient market for forward exchange, where exporters and importers can obtain forward cover for exchange risks with extended maturities without resort to subsidized insurance schemes (sections 289–311).

In order to understand the references to the “present” period of floating exchange rates, the “current” attempts to come to an agreement on a realignment of exchange rates, the considerations to be observed in the “forthcoming” negotiations for revaluation and devaluation of several currencies, and similar pending or expected things that have actually come to pass, the reader must bear in mind that the Report was completed, submitted, and published one month before the Smithsonian Agreement was reached in Washington. The publication date of the Report was November 18, 1971. The printed copies of the edition published by W. Kohlhammer, Stuttgart and Mainz, became available in the same month.

The Report is signed by all five members of the Council of Experts. They are Wilhelm Bauer, Professor at the University of Cologne; Armin Gutowski, Professor at the University of Frankfurt; Norbert Klotten, Professor at the University of Tübingen; Claus Köhler, Professor at the Technical University of Hannover; and Olaf Sievert, Professor at the University of the Saarland. The dissenting opinion by Professor Köhler appears in the last five sections (312–316) of this extract.

The English translation was prepared in Germany, under contract from the Council, by Mrs. Grosse-Schwabe, then revised by the author of this Preface, and prepared for publication by the present Director and the Editor of the International Finance Section. It was approved

by the members of the Council. Any translation is either faithful to the original text or felicitous in idiom and style—it cannot be both, and a happy or unhappy medium has to be accepted. There are expressions in German for which very imperfect substitutes must be employed in English. And there are words that in literal translation would invite connotations not intended in the original, forcing the translator to look for different ways of expressing the meaning presumably intended in the original text. The reader will have to resign himself to the fact that a translation from a foreign language can never be satisfactory in every respect. The main purpose of this translation is to make available to our readers a useful analysis of important problems that would otherwise not be accessible to him.

Fritz Machlup

I. INTERNATIONAL ASPECTS

Reform of the International Monetary System

249. On August 15, 1971, the United States government put an end to the international monetary system and took measures to curb imports. There was danger that defensive reactions on the part of other countries would lead to a worldwide advance of protectionism and interference with the free flow of international trade. Such a turn of events was initially prevented by the general consensus that a trade war would harm everyone and benefit no one. But the provocation, which the U.S. action was widely felt to be, as well as uncertainty about the future of the international monetary system, weighed heavily on international economic relations, so that early reorganization was urged in many quarters. The transition to floating exchange rates provided some breathing space and room for experimentation. Yet several countries pursued monetary policies with a view to forthcoming negotiations for fixing new parities under the old system, not to test the effectiveness of a system of flexible exchange rates. This deprived the experimental phase, in which market forces ought to have brought about a new structure of equilibrium rates, of much of its significance. Nevertheless, previous misgivings about the alleged destabilizing effects of more flexible rates have been disproved by practical experience.

In any case, the most recent events in international monetary policy should not be judged primarily by the day-to-day difficulties encountered. The shortcomings of the Bretton Woods system have been evident for a long time. In another part of this opinion, the authors explain why the events of 1971 triggered the end of the system but were not the real causes of its demise. The compelling need for reorganization must therefore be regarded as an opportunity. It is an occasion to find and agree upon new rules and arrangements that will remain suitable for many years to come. Hence, we must resolve not to be influenced excessively by the understandable impatience of those who are troubled by the present uncertainty.

What the Monetary System Should Achieve

250. In discussions over the years about the reshaping of the international monetary system, numerous alternatives have been consid-

ered. The German Council of Economic Experts does not intend to present a complete comparison of these alternatives. To help the general public form an opinion, however, it is necessary to set forth the standards of performance by which a new international monetary system will have to be judged, and to assess proposed reforms according to those standards.

251. First, the main aim of the international monetary system is to promote free trade and the free flow of capital on a worldwide scale. The rapid expansion of world trade since World War II has been one of the most important sources of prosperity in many countries. The Bretton Woods system, which has helped to make this upswing possible, has in that respect far exceeded the hopes that accompanied its launching in 1944. Nevertheless, there has been an increase in the friction that accompanies the integration of countries participating in free international trade. Again and again, grave imbalances have emerged and, in connection with them, distortions in the flow of trade calling for painful processes of adjustment.

Freedom for the international flow of capital is one prerequisite of undistorted world trade. It also helps achieve a better international use of productive resources. A multitude of protectionist measures exist today in the guise of restrictions on convertibility, now that more obvious methods of protection are prohibited by GATT and other multilateral agreements aimed at the liberalization of trade and lowering of tariffs.

The fact that the Bretton Woods system was not able to achieve a completely free flow of capital, which the Articles of Agreement of the IMF encouraged but did not enforce, has had grave consequences for international attitudes toward the free flow of capital. When disturbing flows developed, as was unavoidable given the shortcomings of the system, it was not the system that was blamed but the free movement of funds. Speculative transfers, which perform the important function of clearing the market, came under the most vigorous criticism, so that, time and again, one country or another resorted temporarily to restrictions on foreign-exchange transactions. Indeed, the growth of restrictions tended to parallel the development of markets in which businessmen could take full practical advantage of the formal freedom that had been granted previously.

The developments leading to May 9 (the floating of the German Mark) and August 15 caused many countries to draw further *dirigiste*

conclusions, indicating the extent to which the Bretton Woods system, as actually conducted, served to discredit the free flow of capital, especially of short-term capital. A new international monetary system would have to safeguard freedom of capital movements against those who view it as a nuisance and fail to see that this freedom is useful to all countries concerned, provided it is allowed to function under appropriate conditions. The free flow of funds is properly understood as a sign of success on the road to a free world economy.

252. Second, if countries are to enter into the close relations required by free trade and the free flow of capital, the risks involved for each country, as defined or modified by the prevailing monetary system, will have to be cushioned by international cooperation. Concern for the interests of other nations is indispensable as a safety net for the system itself, because free trade and capital flows may make the solution of a country's domestic problems more difficult or may even aggravate them temporarily. In the absence of collective measures, countries may be tempted to fall back on restrictions on trade or curbs on foreign-exchange transactions in order to overcome their domestic difficulties or even to shift them onto their trading partners.

The Bretton Woods system, together with its supplementary standby arrangements, has met in full the requirement for international cooperation. The principle of cooperation was embodied from the outset in the system of fixed exchange rates; every country had to put up with the effects of cyclical movements in other countries without resorting to defensive changes in its exchange rate. A country in which full employment was jeopardized, for example, could rely on its partners to tolerate the additional export efforts made by its industries faced with a shortfall of home demand. A country caught in an inflationary process could count on additional imports to assist its efforts at stabilization, even though its additional import demand might endanger the price-level stability of partner countries. At the same time, the conditional financial assistance available from the IMF and complementary supporting operations furnished assurance that no country would be impelled by balance-of-payments crises to take measures restricting trade. Financial assistance also helped occasionally to forestall premature devaluations—devaluations that would have confirmed the failure of a stabilization policy when it was still possible to restore equilibrium by energetic efforts (as in Italy in 1964).

Under a system that allows fluctuations of exchange rates, these

risks may to some extent be neutralized by changes in the rate of exchange. Even then, however, some need for cooperation will remain.

253. Third, the more one relies on international cooperation to safeguard freedom of trade and capital movements, the less can the world dispense with the restraints which the monetary system implies as it forces countries to observe the discipline necessary to maintain price-level stability. This stability is essential to sound economic calculation in a market economy. Furthermore, it is essential to the preservation of free markets for the beneficial international exchange of goods and services. In its absence, these will be undermined by an economic power struggle in the form of competitive protectionism.

The Bretton Woods system failed to meet this challenge. Instead, it fostered cooperation in mutual tolerance of inflation. Numerous countries caught in a conflict of objectives brought about by excessive claims on Gross National Product decided against price-level stability. Being a majority economically and able to help each other out in liquidity shortages, they could impose their choice on the system as a whole. And, because a single country with a fixed exchange rate can safeguard stability of its price level only in favorable circumstances and, even then, only at a very high cost, the majority could force the more stability-minded countries to follow the worldwide trend of creeping inflation. Instances of successful resistance were rare and temporary. Only when a country was in danger of losing its economic equilibrium completely did the prevailing international pressures work in favor of greater stability. And, even in these cases, it was usually sufficient for a country to reduce its rate of inflation a little, since the international pressure for discipline was soon relaxed again by the continuing erosion of the value of money in other countries.

The inherent bias in the system may also be characterized as follows: Inflationary impulses were allowed to spread with less and less restraint, as the pressure for discipline that ought to have come from the countries bent on greater stability was to an increasing extent offset or even counteracted by the ample supply of international liquidity. Countries were able to escape the obligations that go with conditional assistance for adjustment as credit facilities were created that made an unrestrained monetary and credit policy less and less risky. This lack of discipline has strongly discredited the principle of international cooperation in monetary affairs. For this reason, an international monetary system that aims at price-level stability would have to

strengthen the constraints that work in the direction of discipline and reduce the excessive facilities for uncontrolled mutual financial assistance. At the very least, it would have to remove the danger that, as world economic integration progresses, individual countries' efforts at price-level stability will be increasingly frustrated by the inflationary world around them.

254. Fourth, the call for discipline for the sake of stability is unrealistic unless it is also acknowledged that a country in grave conflict between competing objectives must have leeway to decide for itself the order of priority of its economic aims. Full employment is an objective whose attainment no country can leave entirely to the interplay of international cyclical forces. The same can be said, more or less, for price-level stability, especially because the economic and social circumstances affecting its achievement are not equally propitious in all countries. This should be regarded not as a problem of international ethics but as a reason for flexibility of the monetary system. Countries with external surpluses must not be cast in the role of international troublemakers, nor should deficit countries be regarded as having their hands in other people's pockets. A monetary system is faulty if it gives rise to such attitudes by offering only stability for all or inflation for all.

The Bretton Woods system did not provide the necessary leeway. The agreed margin for the modification of exchange rates proved inadequate. Even with small differences among countries in their willingness to make sacrifices for the sake of stability, external imbalances developed from which countries were not able to extricate themselves quickly enough—or in a way that would have taken account of both their legitimate domestic interests and their commitment to external policies consistent with the rules of the system. The requirement that the international monetary system work in the direction of monetary discipline no doubt conflicts with the requirement that it permit each country to regulate the value of its own money. This intrinsic conflict, however, does not detract from the modest request that the international monetary system should not impair individual countries' efforts at stability.

255. Fifth, the international monetary system should enable countries to use monetary policy as a countercyclical instrument. For many reasons, fiscal policy cannot perform this task all by itself in either an upswing or a recession.

Under the conditions of the Bretton Woods system and as long as

the free flow of capital remained unimpaired, monetary policy could be applied effectively only as a tool of balance-of-payments policy. The resulting de facto limitation of national autonomy in counter-cyclical policy was the most obvious defect of the system (along with the constraints on the United States owing to its role as key-currency country), although probably not the most important one.

256. Sixth, insofar as the international economic system still needs to provide for an adequate supply of "international money," its reorganization should ensure that the supply to the world as a whole will no longer depend on the monetary policies that may be forced upon the government of the United States at any given time by its domestic economic situation.

The role of banker to the world has for a number of years and to an increasing degree overtaxed the capacity of the United States. In addition, that role has been regarded with growing concern in other countries, for noneconomic reasons as well. While the importance of the balance-of-payments policy of the United States for the stabilization problems of the Western industrial countries has in most cases been much exaggerated, there is no reason to prolong the reserve function of the dollar—unless it should prove impossible to limit the supply of a new reserve medium at least as effectively, and this would hardly be the case. Incidentally, giving up the dollar as a reserve currency would not necessarily impair its function as a transactions currency in international trade.

The Major Alternatives in a Reformed System

257. There is by now a consensus that the Bretton Woods system should be reformed and must in no event be restored in its old form, even if there is still disagreement concerning the causes of its failure. Nor is there much dissent on the several requirements of a new system, as set out above. Controversy centers on the order of priority to be given the various requirements. Moreover, negotiations and agreements are delayed because it has not yet been possible to propose generally convincing solutions to a number of important problems, despite prolonged worldwide discussion.

The various reforms that have been proposed can be described by comparing them with one of two extreme models:

- A system of fixed exchange rates without provision for any alterations and (in the limiting case) without a band of permissible fluctuations.
- A system of freely flexible exchange rates without any intervention by monetary authorities.

258. The pure model of fixed exchange rates permits no national autonomy in monetary policies to counter cyclical fluctuations or long-term trends. Hence, there is no freedom to influence the trend in the value of money. Emphasis is entirely on the need to harmonize policies of the different countries, on the basis of either common price stability or common price inflation. Cooperation is "built in" in the sense that countries support each other through a close interrelation of commodity prices and interest rates; they help each other through market forces to combat movements in either direction of, say, the level of employment. The system also implies that all countries must refrain from resorting to an aggressive exchange-rate policy designed to obtain a competitive advantage in international trade. Any additional reciprocal assistance, such as the provision of liquidity, would undermine the obligation to conform to the system, unless it were conditional and imposed very strict requirements on the countries aided. If countries were willing and able to put up with the consequences of such a system—to give their international commitments absolute priority over such national requirements as the elimination of unemployment at times of strong cost-push inflation—then, and only then, would the system be entirely compatible with freedom of international trade and capital flows.

259. The pure model of flexible exchange rates, on the other hand, permits nearly unlimited national autonomy for monetary policy to counter cyclical fluctuations and attain stability of the price level. There is an inherent systematic pressure for greater discipline with regard to price-level stability, as every country has to fear inflation even more than under conditions of fixed exchange rates. Flexible rates will immediately register a lack of monetary restraint. But the price of national autonomy is national responsibility. No international cooperation or collective responsibility is built into this system. No international links support the forces that press for discipline, no import surplus helps to close a temporary gap in the supply of commodities. If a country loses its internal monetary balance, it must work its way

back to stability on its own. Abstinance from aggressive exchange-rate policies (such as competitive depreciation) is implicit in the rules of the game (official interventions in the exchange market are forbidden) but would not be explicitly guaranteed. Credit arrangements to permit monetary authorities to intervene in support of given or desired exchange rates would be alien to the pure system. If these restrictions were accepted, a system of flexible rates could dispense with any measures that restrict free trade and the free flow of capital. Problems inherent in the use of an official intervention currency would also be eliminated.

260. The two pure models for a monetary system stem from different concepts of the organization of the world economy. The one regards the world economy as an entity, the other as a system of interacting sovereign parts. The one can be viewed as the logical corollary to the progressive dissolution of national states, as ever-larger economic areas are formed. The other can be viewed as the corollary to movement toward a federal system of responsible partners, as positions of economic predominance and dependence are dismantled. As neither model provides a monetary system fully equipped to deal with contemporary problems, they are important only as reference points for the discussion of intermediate forms. It should be added, however, that the widespread rejection of flexible exchange rates is due in part to misgivings that have often been refuted by theoretical arguments but can in the last analysis be confirmed or disproved only by prolonged experience. It is widely believed, for example, that it may be impossible to satisfy fully the businessman's legitimate demand for certainty about the value of his claims and liabilities (exchange-risk pessimism), and that destabilizing speculation may occasionally prevail over the "real" (long-term) forces of the market, distorting competitive price relations.

261. Predominant in the discussion of reform are intermediate or mixed solutions whose characteristics are

- fixed parities and obligatory intervention by central banks
- parities set in conformity with existing market conditions (realignment) as a new basis
- a new reserve medium
- wider bands around parities for market exchange rates, within which intervention is not obligatory
- easier shifting of these bands by subsequent changes in parities.

The last two elements, in particular, give rise to difficulties that have long-term implications.

262. Obligatory intervention by monetary authorities is likely to be restored, if only because of the widespread fear of hectic fluctuations in exchange rates, but it need not prevent the desired degree of flexibility. Among the short-term problems of reform, a realignment of parities is foremost.¹ This will serve to eliminate the imbalances of several small and medium-sized countries, but its main task is to do away with the overvaluation of the dollar. The United States cannot simply devalue like any other country; being a large country and the one with the intervention currency, it must expect many countries to follow any change in the par value of the dollar in terms of gold, and thereby prevent any change in the dollar price of their own currencies. Were it not for this problem, the imposition of the import surcharge by the United States would have been unnecessary. The achievement of an appropriate realignment is hampered by fears in some countries that a large revaluation of their currencies against the dollar (and, even more so, against other currencies) might excessively harm the competitiveness of their export industries. The risk of error in establishing new parities is thus accorded great weight, but it is probably overrated, given the ability of national economies to adjust. The decision, moreover, must be made by negotiation. Econometric estimates that try to recommend changes in parities by reference to prevailing imbalances in international payments will probably take inadequate account of the adjustment processes that will follow realignment and cannot, therefore, provide more than a starting point for negotiations.

It should not be too difficult to arrive at a negotiated solution if provisions are made to accommodate countries with different experiences and different policy objectives. Countries whose past experience causes them to be skeptical regarding their ability to combat inflation should be permitted to err on the side of revaluing too little; those which have been more successful in their efforts to maintain price-level stability should be expected to err, if at all, on the side of revaluing too much. In any case, the parities to be established initially will be the less significant, the more generous the new rules relating to subsequent flexibility of exchange rates—whether they institute a wider band for fluctuations around parities or make more liberal provision for parity

¹ The reader should be reminded that this was written some time before the Smithsonian Agreement of December 18, 1971.

readjustments. Finally, the method of realignment—whether it should be effected by causing some countries (say the United States) to devalue and others to revalue or by causing some countries to maintain their old parities and others to revalue by larger amounts—is without major economic significance, since what matters is the relative rate structure. This problem is one of political tactics, or possibly prestige.

263. The obvious way to relieve the dollar of its function as official intervention currency—a solution at the core of most reform proposals on this subject—is to establish Special Drawing Rights as the sole official reserve asset (perhaps under a more meaningful name). The main problem is to arrive without delay at rules that take account of the lesson of experience: A monetary system with fixed exchange rates is able to function only if international monetary reserves are kept in short supply. This matter will diminish in importance only if and when an appreciable degree of exchange-rate flexibility is introduced; in that event, the obligation for central banks to intervene would be invoked only rarely. A transitional problem, albeit serious, is the funding of monetary reserves held at present by monetary authorities, mostly in the form of dollar assets.

264. As Special Drawing Rights are not a medium of payment for private transactions, the authorities cannot use them when they intervene to stabilize exchange rates. They must buy or sell foreign currencies. It should not be taken for granted that the intervention currency of the future will be the U.S. dollar, especially if the dollar is subject, as intended, to the same rules governing parity adjustments against Special Drawing Rights as are all other currencies. If general confidence in the dollar returns, however, it is likely to remain the most important intervention currency, and, subject to the same assumption, it will continue to play an important role as an international transactions currency, especially for multinational enterprises.

The possibility cannot be precluded that governments and central banks may retain as reserves dollars or other foreign currencies obtained by intervention and may thus offset the disciplinary effect that obligatory intervention ordinarily has on deficit countries. Hence, many plans for reform propose an international agreement under which central banks would be obliged to exchange without delay the foreign currencies acquired in consequence of intervention—except perhaps for small working balances—for the Special Drawing Rights held by the countries whose currencies had been acquired.

It has also been suggested that the present gold guarantee for Special Drawing Rights be continued. This may at first have psychological advantages. It is widely understood by now, however, that what matters for the maintenance of a "Special Drawing Right Standard" is that this reserve asset be kept in short supply, and that a gold guarantee can be helpful only if it helps to ensure scarcity. Since a pure gold standard, for well-known reasons, will surely be out of the question, the rules that govern the creation of Special Drawing Rights will be decisive for the maintenance of the new standard—not a supplementary gold guarantee.

265. Inasmuch as the realignment of parities and the adoption of a new reserve asset may somewhat improve the old system of fixed exchange rates but cannot alter it essentially, the institution of wider bands for exchange-rate fluctuations around parity and of more frequent changes in parity may be regarded as the fundamental reforms.

These two changes in the system should not be viewed as being independent of each other. Both are meant to enable countries to determine for themselves the desired degree of price-level stability. A wider band for rate fluctuations also provides autonomy in countercyclical policy (to the extent that it relies on monetary and credit policies).

The minimal width of the band around parity should be made to depend on

- the extent to which monetary and credit policy is to be applied as a countercyclical instrument
- the maximum disparities in national rates of inflation that the international monetary system is prepared to tolerate
- the frequency with which revaluations and devaluations should occur (and their percentage rates).

266. If, for example, it is agreed that a country should be free to deviate from the international inflationary trend by as much as 4 per cent per annum (in either direction), and if the parity against Special Drawing Rights is to be changed no more than once a year,² this alone would require a 4 per cent margin for appreciation or depreciation within the exchange band. The rules should also ensure that any shift of the band by a change in parity will result in some overlapping of the old and the new bands, as this alone will reliably prevent specula-

² The margin for fluctuation against any single currency (cross-rate) would be twice as wide as the band around parity against the Special Drawing Rights.

tive transactions from pushing the rate prematurely to the limit of the old band in anticipation of a change in parity. For this additional reason, the band should be wider than required by the need for movements in rates between consecutive changes in parity.

267. Superimposed on the need for a margin wide enough for exchange rates to offset divergent price trends is the need for the flexibility of rates required by an effective countercyclical money and credit policy.

Money and credit policy cannot be independent of interest rates abroad if the authorities have reason to fear that capital movements set off by a change in domestic interest rates will affect domestic liquidity. This, in turn, can be prevented only if the central bank is free to refrain from buying or selling foreign exchange. With a margin for fluctuations in exchange rates, capital flows bring about changes in spot and forward rates and in the spread between them, but then, as a result of the changed rates, cease automatically. The change in the spread between spot and forward rates corresponds to the change in international differences between interest rates and is therefore desirable in itself; it ensures that the interest-rate policy has a direct effect on export and import transactions. (With fixed rates of exchange and a narrow band, it is not only difficult to change domestic interest rates by autonomous action, it is also impossible to ensure that a successful change in interest rates will have an immediate effect on the demand for exports and imports.) With unrestricted capital movements, international interest differentials can generate matching premiums and discounts in forward exchange rates having the same maturities. When this happens, the central bank will not be called upon to intervene in the exchange market (under its obligation to defend the exchange rates at the edges of the band). If, however, the interest differential calls for a forward rate outside the range of expected future spot rates, speculation against the central bank will set in and will be entirely riskless if the stipulated width of the band makes it impossible, not merely improbable, for the future spot rate to reach the level of today's forward rate. It follows that the width of the band, which governs the range of possible future spot rates, must be wide enough to permit changes in forward rates that correspond to changes in the interest differential. If interest-rate policy can bring about an interest differential between the domestic and foreign markets as large as 4

per cent, a band of 4 per cent would appear desirable on this account alone.

268. Movements in exchange rates required by trends in price levels are apt to coincide with international differentials in interest rates. A country whose exchange rate is appreciating (because its price level is rising more slowly than the international trend) will have a lower medium-term level of interest rates than its partners. With a free flow of capital, this is not merely probable but certain. The changes in interest rates that are needed for countercyclical reasons will therefore depart from a medium-term level lower than in other countries and will increase or reduce the interest-rate differences determined by trends in prices and exchange rates. The band for permissible fluctuations in exchange rates must be wide enough to permit fluctuations in the exchange rate that accommodate the interest differential resulting from divergent trends in prices plus the maximum interest differential implied by divergent countercyclical policies. Strictly speaking, the required width of the band will be determined by the sum of what is needed to give the monetary authorities autonomy in determining the trend in the price level and what is needed to let them pursue appropriate countercyclical monetary policies. If this double requirement is not met, the leeway for interest-rate policy in either direction may prove too narrow shortly after a change in parity; after a revaluation, for example, the exchange rate that would correspond to the price trend may come too close to the lower limit of the band, and the interest rates that may be desirable in a given cyclical situation cannot be shielded from external influences, because the exchange rate can fall no further. Still, as a rule, a country will not revalue its currency in a recession or devalue in a boom. Thus, in the event of a change in parity, it should not be necessary for the new band and the old to overlap as much as would be required to provide the full margin for monetary policy in either direction at any time. Given the policy aims assumed in the above example, it would suffice to have a band of 6 or 7 per cent (that is, 3 to 3.5 per cent on either side of parity), together with the possibility of changing the parity once a year by up to 4 per cent. If parity changes were permissible more often, a narrower band would be sufficient. In the limiting case, a system of continuous adjustment, the band would have to be no wider than required to accommodate the international interest-rate differentials needed to conduct a countercyclical monetary policy. Similarly, the

band would have to be wider than 6 or 7 per cent if parities were fixed for periods longer than a year.

269. The interdependence apparent from this exercise is important: If the frequency and size of parity changes are limited, the width of the band is no longer a matter of free choice. If there is any leeway left, it is merely because monetary policy may play a more or less important countercyclical role. If insufficient room is left within the band for exchange-rate movements to offset price-level movements between consecutive parity changes and for the additional interest differentials implied by the desired use of monetary policy, the spot rate may reach the upper or lower edge of the band and the central bank will have to intervene before the next parity adjustment, with corresponding effects on domestic liquidity. The policy makers of some countries seem to neglect this interrelationship and are therefore satisfied with an insufficient widening of the band. As a result, currencies will hit the limits of the band prematurely, and countries will be forced to give up autonomous liquidity and interest-rate policies or to invoke administrative controls to ward off capital movements. Both would be undesirable.

270. If the monetary authorities succeed in maintaining a sufficient scarcity of Special Drawing Rights and if it is understood that no country will act against the principles of free trade and capital movement, then the necessary changes in parities will take the form of devaluations by countries that run out of reserves. It is nevertheless desirable for countries whose rates of exchange approach the upper limit of the band to revalue rather than accumulate exchange reserves, and for adjustments to be carried out in an orderly way. Attention should therefore be given to the formulation of more or less strict rules to govern parity changes. The rules under consideration are not really new. The German Council of Economic Experts has repeatedly considered such rules.³ One possibility is to tie changes in parities and, hence, shifts in the bands to movements in monetary reserves. A much-discussed second possibility would have the shift in the band follow the moving average of past spot rates. Both possibilities may be developed into genuine automatic governing devices or into guidelines for discretionary decisions.

271. The ultimate choice is less likely to favor a mechanical formula

³ *Annual Report* 66, secs. 286ff.; *Special Report* 69, I, sec. 28; and *Annual Report* 69, secs. 287ff.

that dictates shifts in bands automatically; it is more likely to favor guidelines for discretionary shifts that must finally be made by national authorities. Even this would be quite a gain; modifications of par values would no longer be subject to international taboo. They would be regarded as a normal tool of economic policy to be applied within an agreed framework. Moreover, the conditions for granting international liquidity assistance and for allocating drawing rights from the IMF could require adherence to these guidelines instead of insisting, as before, on the maintenance of parities that are no longer realistic.

272. These new features of the international monetary system would not be inconsistent with an additional innovation. The leeway for revaluation might be made wider than for devaluation. In this manner, the system could still compel governments to maintain greater price-level stability—it could even impose more discipline than in the past by the manner in which it supplied international liquidity—without getting in the way of potential surplus countries that are willing, able, or forced to give higher priority to price-level stability than are the majority of world trading nations.

273. All efforts to achieve greater flexibility of exchange rates have been seriously set back by a misconception. The recent period of floating rates has been mistakenly regarded in many quarters as a test of what flexible rates can achieve. The results of that phase are taken as evidence of how easily the exchange rate, and with it the competitive position of any given country, may come to be dominated by speculative expectations unrelated to market conditions. In actual fact, the results were the outcome of expectations still conditioned by the system of fixed exchange rates, and should have been evaluated as such. Movements in exchange rates were bound to be determined, even without large-scale interventions, by expectations pertaining to the new parities that might be adopted, not by the underlying market conditions in each country. More specifically, the movements were determined by the expected outcome of an economic power struggle between the United States and its trading partners. Owing to this misinterpretation of events, and because misgivings about prolonged flexibility are widespread in any case, it is to be feared that reform of the international monetary system will not lead to bands for exchange-rate fluctuations and rules for parity changes that meet the need for national autonomy in countercyclical policies and in efforts to maintain

price-level stabilizing policies. Opponents of greater flexibility will probably be tempted to seek the autonomy needed for countercyclical policy by restricting international capital movements, especially short-term flows.

274. We have pointed out that a monetary order embodying elements of a system of fixed exchange rates invariably entails the risk that capital movements will be subjected to controls (section 251), and this may happen not only when the band around parity is too narrow to allow for an autonomous countercyclical policy, but also when attempts are made to maintain an exchange rate that is no longer justified by market conditions. This likelihood is not diminished by the experience of the last few months. While a number of countries set their exchange rates free to float in August 1971 after the United States measures, controls on capital movements were introduced. National authorities were not prepared to let exchange rates appreciate beyond a certain point, although the market called for a larger adjustment, or sought to limit the appreciation because they assumed that it would be exaggerated by rumors and comments on future parities and would push exchange rates beyond what they considered to be equilibrium levels. Attempts to curb the appreciation may also have been motivated by the desire to build up negotiating positions for the forthcoming negotiations on realignment. This so-called "dirty floating" (dirtied by interventions and controls) was tantamount to a temporary fixing of new exchange rates. If flexibility were introduced starting from equilibrium rates and without the expectation of a return to parities, there would be no reason for capital controls. And if flexible rates became customary, there might even be a gradual dismantling of existing controls.

275. The outcome of the worldwide dispute on "flexibility versus controls" will depend on how highly the advantages of free capital movements are valued. It should also depend, however, on the extent to which the authorities can expect to realize the advantages they hope to secure from controls.

Control of capital movements may be attempted in different ways. To discourage inflows of capital, for example, the Bundesbank imposes increased minimum reserve requirements on nonresidents' deposits with commercial banks. Measures authorized by Article 23 of the *Aussenwirtschaftsgesetz* (External Transactions Act) and put into effect on May 9, 1971, require prior approval for the payment of interest

on nonresidents' deposits, for the sale of domestic money-market paper to nonresidents, and for the conclusion of repurchase agreements with nonresidents. The full application of Article 23 would also permit an outright prohibition of all borrowing abroad, of all sales of securities to nonresidents, and even of purchases of ships and real estate by nonresidents. The External Transactions Act is to be supplemented by a clause under which a nonbank borrowing abroad may be obliged to deposit part of the loan proceeds in a blocked non-interest-bearing account with the Bundesbank.⁴ The External Transactions Act also provides an arsenal of measures to prevent capital outflows.

For quite some time, the United States has applied an interest equalization tax on loans to foreigners and purchases of foreign securities in order to curb the outflow of long-term capital. There have also been rules restricting short- and long-term direct investment, as well as the so-called "voluntary credit restriction" scheme administered by the Federal Reserve Board.

Other countries, including Italy, try to control capital movements by prohibiting banks from increasing or decreasing their net external asset positions after a given date.

A special method of controlling capital flows is the institution of a two-tier foreign-exchange market, one tier for transactions on current account (commercial foreign exchange) and the other for capital transactions (financial foreign exchange). While the rate for commercial foreign exchange is restricted to the narrow band around parity, the rate for financial foreign exchange is determined by the market forces of supply and demand. Belgium has used a two-tier exchange system for a long time. France introduced it in a modified form after the United States measures of August 1971.

276. Even if such controls were not technically difficult to apply, they would not solve the trend problem posed for fixed exchange rates by different rates of inflation. If, for example, the price level abroad rises faster than at home, the inflation abroad will spread to the home market through the direct international price link that is established by the fixed exchange rate. When this price link is imperfect, the process will be less direct but no less certain; surpluses on current account will emerge and stimulate a price rise in the home market via their effect on domestic liquidity. If a tighter credit policy is used in

⁴ This provision for "cash deposits" was promulgated early in 1972.

an attempt to combat inflation, and if, in consequence, the domestic interest rate rises above the level abroad, an influx of foreign capital will be induced, in the absence of controls, and will eventually compel revaluation of the national currency. This can be prevented by controls, to the extent they are effective. The problem, however, is merely postponed. The inflationary effects have to prevail either by way of the direct international price link or by way of surpluses on current account; if the price link is imperfect, the surpluses must grow continuously, until it becomes impossible to postpone revaluation. By that time, however, the resulting misallocation of resources may have caused considerable damage to the national economy. Controls on capital movements are doomed to fail if they are used in an effort to maintain fixed exchange rates when, over the long run, rates of price inflation differ among countries.

277. Let us assume that the problem of different price trends will be solved by more frequent adjustments of parities, but short-term fluctuations of exchange rates will be limited by keeping the band narrow. Controls may then be introduced to prevent interest-induced capital movements from nullifying an autonomous monetary policy. The problem then is how to limit the controls to short-term capital movements so as not to hamper autonomous long-term capital transactions.

278. This objective is probably impossible, if only for technical reasons, even with a two-tier system for foreign-exchange transactions or resort to the arsenal of measures authorized by Article 23 of the External Transactions Act. In order to avoid restrictions on long-term capital flows the foreign-exchange market would have to be split in such a way that all transactions making up the basic balance (current account plus long-term capital) could be effected at fixed rates and all short-term capital transactions would be effected at flexible rates. It is already nearly impossible to separate the partial markets for commercial and financial foreign exchange. If there is an incentive to import capital because of a higher level of interest rates at home, the free-market price of financial foreign exchange will fall. Any businessman seeking to import capital will then be tempted to declare the proceeds of his foreign borrowing as export earnings so as to exchange it at the fixed rate for commercial transactions. Similarly, importers of commodities will try to obtain foreign exchange in the free market. To prevent these evasions, anyone trying to sell foreign exchange in

the official market would have to present documents showing that an export transaction had in fact been contracted, and importers would have to show that they had obtained their foreign exchange in the official market. And this is not all. In order to prevent under- or over-invoicing and the cancellation of fictitious transactions, all imports and exports, incoming and outgoing payments, and even prices would have to be checked, audited, and verified. If, in addition, long-term capital transactions were to be effected at fixed exchange rates, it would be necessary to document the term for which each and every capital transfer had been contracted. It cannot therefore be seriously claimed that "only" short-term capital movements can be subject to controls, even if these are the only target.

The technical problems are by no means simplified if the provisions of Article 23 of the External Transactions Act or cash deposits to discourage short-term capital inflows are used instead of a two-tier exchange system. In these instances, too, it would not be sufficient to control short-term capital transfers, difficult though this alone would be. It would be necessary also to ensure that no short-term capital imports took place under the guise of commercial or long-term financial transactions. For this reason, Article 23 seeks to cover transactions with nonresidents as completely as possible. Yet the strictest enforcement, imposed at high cost to the public authorities and the business community, would not guarantee the successful technical application of the controls, even the most superficial technical aspects.

279. Repeated changes of parities in the past twenty-five years have destroyed any remaining illusion about the fixity of exchange rates. This illusion cannot return, especially since the reorganization of monetary institutions and policies will facilitate changes in parity rather than make them more difficult. This increased flexibility, however, will result in a much greater need for forward cover, which will to some extent express itself as a need for additional international credit facilities. This, too, should be taken into account in deciding on the degree of flexibility to be provided by the new international monetary system and thus also on the desirability of dispensing with controls and discriminatory policies against capital movements.

280. While the ultimate weighing of different schemes and models for reform must be left to the process of political decision-making, the authors believe that the opportunity provided by the need for reform will be missed unless a bold step is taken with regard to the

width of the band for rate variations around parity, the rules governing changes in parity, and the enforcement of these rules. The serious shortcomings of the Bretton Woods system will not be overcome if the monetary reformers overestimate the readiness of national governments to submit to monetary discipline for the maintenance of price-level stability and underestimate their inclination to resort to the regimentation of capital flows and even of trade. Anyone who shares this skeptical view will strongly advocate great caution in the creation of Special Drawing Rights, strict rules for the granting of standby credits, relatively frequent adjustments of parities, in small steps and according to stringent rules, bands wide enough to cover interest-rate policies designed to cope with pronounced differences in cyclical fluctuations, and the application of sanctions when the rules of the game are evaded. The limiting case would be a wide band with automatic parity adjustments and therefore with no substantial need for international reserves. That solution would come very close to a clean worldwide float, and it would combine many advantages of both basic models. It would afford countries the necessary autonomy in both countercyclical and price-stabilizing policies, without at the same time favoring inflationary excesses. The need for international cooperation would be relatively slight, especially for built-in cooperation, since there would be no compulsion to follow a common trend in the rate of increase of prices. Supplementary agreements on reciprocal assistance in the event of serious domestic crises could ensure that such requirements would be met as well.

II. EUROPEAN ASPECTS

The International Monetary System and a European Monetary Union

281. The monetary events of 1971 have delayed the first step toward a European Monetary Union originally planned for the middle of that year, namely, the narrowing of the band within which the exchange rates for Community currencies would be permitted to fluctuate against each other. But this has in no way changed the plan to create a European Monetary Union. Nor need that plan be affected by the eventual results of the efforts to reorganize the international monetary system.

What was said earlier about relations among the world's largest trading countries applies equally to the European Economic Community as a whole—in its relation to other countries and, subject to certain qualifications, with respect to the problems within the European Community. Some problems, however, will become less important if the transition period is disregarded and the success of the project is taken for granted.

282. The countries of the enlarged European Community, once they are welded together in a monetary union, will form a bloc whose economic power will not be much smaller than that of the United States. This will cause or even force many nonmember countries maintaining close trade and payments relations with the Community to orient their economic development and policies toward the Community even more than before, just as other countries have done or will do vis-à-vis the United States. Whether this tendency toward blocs is desired or discouraged, positions of relative dependence will in all probability be reshuffled. This will have its effect on monetary problems. Some of these are currently considered to be international problems but will become domestic problems of the Community—whether more or less acute than before. Others will become common external problems different in importance from what they are at present.

283. The European Monetary Union will have others dependent on it, rather than being dependent on others. This will particularly affect the problem of autonomy in matters of price-level stability. Just as the United States is quite independent of foreign countries in matters of price-level stability, compared with the Federal Republic of Germany,

so the future European Monetary Union will be largely independent too. Foreign trade will have much less weight for the Union as a whole than it has at present for each single country, and an increasing number of countries will orient their stabilization policies toward those of the Community.

The same holds true, more or less, for the problems of international monetary cooperation. Many of those problems will turn into problems of cooperation within blocs, just as cooperative arrangements used to follow situations of dependence.

But the problem of autonomous monetary policies will remain. If the Community maintains freedom for international capital movements, with fixed exchange rates and without controls, it will not be able to defend itself against an influx of mobile capital, despite its new position of power, whenever the domestic situation calls for higher interest rates than prevail abroad.

284. These considerations may help to resolve the present conflict concerning the degree of exchange-rate flexibility to be established by the new monetary system. The demand for a worldwide system of fixed exchange rates will lose urgency when most of the countries that prefer a closely knit system of fixed rates have detached themselves from other countries by forming a monetary union. Another argument in favor of flexible rates for Community currencies against those of the rest of the world is that flexibility will make it much easier to avoid the cumulation of interbloc imbalances among blocs than under conditions of fixed exchange rates—imbalances that may easily result in a power struggle if equilibrium must be restored and each party tries to pass the burden of adjustment on to its partner.

Of greater weight are the problems raised by a European Monetary Union. It is essential to a monetary union that autonomy be surrendered. In spite of their close economic ties, the economic aims of the member countries of the European Community are not yet sufficiently harmonized to facilitate the full surrender of national autonomy in countercyclical policy and price-level stabilization. The formal renunciation of sovereign rights by the national authorities, something that must happen gradually, is no longer the main issue. The actual stumbling block is the lack of consensus on the order of priority to be given the various economic policy objectives.

In the Federal Republic of Germany, a high level of employment, stability of the price level, balance-of-payments equilibrium, and

economic growth are regarded as equally important, and, despite numerous setbacks, the record of efforts to maintain stability shows that this equality actually determines economic policies. In other countries, there is more dispute as to whether price-level stability deserves the same priority as, say, full employment or economic growth. While it is not certain to what extent the Federal Republic will, by its economic weight, come to influence the price level in a European Monetary Union, it is now generally agreed that her partners cannot be expected to give this kind of stability the same priority—either in words or in deeds. It has therefore been said that the “European option” can be achieved only at the price of an erosion in the value of money that would heretofore have been regarded in the Federal Republic as a grave failure of economic policy. Whether this price should be paid is a political decision. Since the interacting circumstances are clear and no longer contested, the German Council of Economic Experts can do no more to facilitate a decision. There are, however, some basic problems on the way to a monetary union that have recently come to the fore.

285. It is the aim of the German Federal Government that the Community take the first step toward a monetary union, which is to narrow the band limiting exchange-rate fluctuations among Community currencies and, at the same time, to safeguard the external position of the Community by introducing more flexible rates against the outer world. The management of such a split system of obligatory intervention by central banks should not pose any grave problems for the central banks. Nevertheless, as a remedy for external economic problems, this combination seems occasionally to generate higher expectations than are actually justified. The external flexibility of rates within a wide band will provide a safeguard against excessive liquidity in third countries, especially the dollar area. Right from the beginning, however, this safeguard can be utilized only by joint action. If, for example, a single member of the Community seeks to raise its interest rates, capital will flow in from other Community countries and from third countries. If the inflow of funds from other Community countries should be insufficient to reduce the high interest rates, given the obligation to intervene at the edge of the narrow band—if, that is, the other Community countries permit the outflow of funds to tighten their money markets and increase their interest rates—then the narrow internal band will be pushed toward the upper edge of the wide

external band. The results could be a common level of interest rates near the original low level in the country that sought to raise them.

A single country can also impose a policy of low interest rates upon its partners, as their central banks will have to absorb any amount of liquidity emanating from it in the process of maintaining the exchange rates within the narrow band. If capital is also flowing out to non-Community countries, the narrow band will be shifted toward the lower limit of the wide band. The leeway for a Community country to pursue an autonomous interest-rate policy will thus ultimately be determined by the narrow band for Community currencies rather than the wide band for exchange rates vis-à-vis currencies of third countries. As a means to maintain price-level stability, then, the wide band can be of use only in joint action.

286. Member countries have long been eager to arrive at arrangements for common intervention in the market for currencies of third countries—arrangements governing not only the direction and extent of such operations but also the kinds of measure to be adopted. As a decision on greater flexibility against the outer world is still forthcoming,⁵ and it is not even desired by all countries of the European Community, the reconciliation of separate national policies is sought by way of restrictions on capital movements—following the unfortunate logic of the system of fixed exchange rates (see section 251). And because a complete reconciliation of such *dirigiste* policies has not been achieved—and it may not be achieved for quite some time—any interference with the flow of capital must also be applied to capital transfers among member countries of the Community.

287. It is necessary at this point to examine alternative conceptions of the process leading to a fully developed European economic and monetary union. One such conception may be set out as follows:

The monetary union is to be the end result of a gradual accommodation of the policy aims pursued in the Community and of a corresponding reconciliation of the policies themselves. Although continuing economic integration under present institutional conditions will not compel such a reconciliation, it will assist the process and will also call for the gradual convergence of economic and fiscal policies in all important sectors. To the extent that the countries of the Community succeed in this effort, monetary relations among them will be stabilized

⁵ The reader should again be reminded that this was written before December 1971.

and changes in parities will become unnecessary. The eventual proclamation of the monetary union will be no more than formal recognition of what has by then become a reality. In the interim, flexibility of exchange rates would permit intensified economic intercourse among the member countries, accelerating the process of functional integration on which everything depends in the last analysis. Functional integration will eliminate distortions affecting transactions among member countries because it will neutralize conflicts of objectives and prevent the periodic appearance of external imbalances and the instability that results; of particular importance, it will do away with any need for abrupt changes in parities. Instability and abrupt changes in parities cause grave disturbances in the exchange of goods, services, and capital among closely interlocking economies. All this could be achieved fairly soon, much earlier than would be possible if a monetary union of the institutional kind were forced upon the economy. A formal union could not really succeed until it had solved the difficult problem of harmonization, and this might compromise its chances of success because it would deprive member countries of an individuality that they wish to retain somewhat longer. Moreover, the much-desired "all-around harmonization" will prove to be unnecessary when it is recognized that, in many fields, the absence of harmonization is a problem only because rigid institutional arrangements, such as fixed exchange rates, fail to take account of the pluralism that exists among the European countries.

The other conception is this:

The achievement of a European economic and monetary union cannot be entrusted to a daily plebiscite on economic policy in ten member countries. If an economic and monetary union is desired, then irrevocable changes must be made in important conditions affecting the determination and execution of national economic policy—and the decisions of private economic agents. These changes must be made in such a way that self-interest impels everyone concerned to seek ways of establishing rapidly all the arrangements required for a monetary union to function. To achieve accommodation over a wide range of policies and give priority to the interests of the Community rather than to national interests will require extraordinary efforts. There will be deadlocks and setbacks; conflicts of interest will be uncovered that have thus far been hidden. This undertaking can succeed only if everyone knows that falling back on national selfishness offers no way out,

that only the desire to move ahead will help. The give and take of compromise, even the imperfections of interim solutions, will help to move things one step forward. One such economic policy decision is to fix finally and without reservation the parities among the currencies of the Community and to reduce forthwith the band for short-term fluctuations. By this act, countries would be deprived of autonomy in matters of countercyclical monetary policy, as well in matters relating to the purchasing power of money. So far, it is true, experience affords no evidence that such autonomy can be dispensed with, but it has been whittled down in any case. An open profession of willingness to give up this autonomy would clarify matters, free many from their fixation on the vestiges of national autonomy, and direct them toward the task of trying to achieve what is possible by working together. Once the impotence of national monetary policies has become manifest and is accepted not as a regrettable side effect but as a strategic principle of public policy, it will be seen that the reconciliation of policies in important fields is absolutely indispensable.

The German Council of Economic Experts is unanimous in the opinion that both conceptions can be presented with conviction. The choice between them is a decision on the goals and strategies of policy.

Under both conceptions, the monetary bases for the process of European integration must include the free flow of capital. With greater flexibility of exchange rates (within a band), the free movement of capital has among its functions the important task of clearing markets—not only the foreign-exchange markets of different countries but also the money markets and the exchange markets for transactions with different maturities (forward markets). The increased stability of medium-term expectations regarding exchange rates must be permitted, through free arbitrage transactions, to have decisive influence on spot rates and short-term forward rates.

Even if the exchange rates of Community currencies are fixed, the free flow of capital is an important part of the projected process of integration. Capital movements eliminate the independence of national monetary policies, reinforcing the inescapable dynamic compulsion toward harmonization described by the second view above. This must be intended and accepted. Otherwise, neither a definite fixing of rates nor a narrowing of exchange bands would make any real sense.

288. For this reason, it would be hard to understand any reaffirmation of the plan to create a European Monetary Union if it were to

coincide with the adoption by the European Community of external safeguards that would further restrict capital movements among member countries, even on an interim basis. In the eyes of individual citizens, a monetary union will be distinguishable from the present state of economic integration only by the absence of restrictions on convertibility in the widest sense (and by the certainty that there will be no such restrictions in the future). Any restriction of capital movements that applies also to transfers within the Community is a step away from monetary union.

To limit national monetary autonomy by narrowing the bands around parities and then increase national autonomy by restricting the flow of capital is to invite new protectionist acts by individual Community countries. As suggested in an earlier section, controls on capital movements—unlike flexible exchange rates—are the means of defending national autonomy most likely to hide protectionist practices, because of their *dirigiste* nature.

Forward Cover in Conformity with the Market

289. Complaints by exporters are becoming ever-more acute that the monetary events of 1971, especially the appreciation of the D-Mark, have made it increasingly difficult to conclude export contracts on a D-Mark basis, and that, in addition to the rise in the spot rate, exporters must bear the burden imposed by the increased cost of forward cover. It is also claimed that forward cover cannot always be obtained for the future proceeds of long-term contracts for the export of durable goods, although the need for facilities to cover exchange risks is most urgent in connection with that kind of business.

In the present monetary situation, the problem of forward cover is indeed a national problem of some weight. Solving it would simultaneously enhance the Government's leverage to conduct international monetary policy and give the business community greater independence from the outcome of the international reform effort.

In the past, the exchange-rate illusion has often tempted businessmen to dispense with forward cover, although this illusion has repeatedly been dispelled by abrupt changes of parities. Experience has even shown that an export transaction contracted in a foreign currency but covered by a forward contract provides greater security than a contract on a D-Mark basis, because the purchase price in D-Marks fre-

quently has to be renegotiated if a sudden modification in exchange rates causes the partner to demand that the exchange loss be split.

290. An inquiry by the *Deutscher Industrie- und Handelstag*⁶ has suggested that the majority of entrepreneurs no longer insist on the traditional system of fixed rates, with its sporadic and drastic parity changes, but would rather rely on a more flexible adjustment of parities in small steps and, not infrequently, even on flexible rates. It is widely appreciated that such a change would reduce the risk involved in sales calculations and decisions on production and investment and would improve the chances for a business strategy guided by genuine market data. It would also help to avoid structural distortions and the risk of wage explosions in the wake of imported inflation. There is, however, a general demand that, with greater flexibility of exchange rates, exporters and importers be offered adequate facilities for obtaining forward cover at a reasonable cost.

291. The problem of ensuring that arrangements for forward cover reflect real market forces coincides with the problem of creating efficient forward-exchange markets in which it would be possible to buy or sell, at a rate agreed upon today, any amount of foreign exchange for any future term.

It would be a mistake, however, to compare exchange risks with the types of risk that are usually covered by insurance contracts. For, clearly, the risk to one party of a loss through a change in the exchange rate is the chance of a gain for the other party. This explains why facilities for forward cover can exist at no cost to the world economy, apart from the small cost of the transactions themselves.

292. An exporter who combines a sale of commodities with the grant of a loan in foreign currency (or sale against deferred payment invoiced in a foreign currency), and who has no speculative intentions regarding his claim but wants to be sure of its value in D-Mark, may expect to find three kinds of partners for a forward contract: importers who seek forward cover in the opposite direction; speculators, that is, those who are ready to take up open (uncovered) forward positions; and interest arbitrageurs who seek forward cover in the opposite direction.

293. The provision of forward cover would become just a clearing problem if it were necessary merely to bring together exporters and

⁶ Head organization of all German Chambers of Commerce.

importers desiring forward cover for foreign-currency claims or liabilities of about the same amounts and maturities. For two reasons, however, it is unlikely that the need for forward cover can be fully met in this simple manner:

a. In a country like the Federal Republic of Germany, which exports capital goods on a large scale, the terms of payment that must be granted for export sales are on the average longer than the terms of payment stipulated in import contracts. Moreover, with net exports of capital funds, exports of merchandise will exceed imports.

b. As the D-Mark has not been suspected for many years of needing devaluation but has persistently been suspected of needing revaluation, exporters are more anxious to obtain forward cover than are importers. The latter may easily be tempted by expectations of a revaluation to act as speculators, that is, to dispense with forward cover for their liabilities as long as there is an extra cost, however slight, attached to the forward purchase of the foreign currency. Only when the D-Mark is sold at a forward premium—which few exporters are as yet prepared to accept—will importers be willing to cover their future needs for foreign exchange on the forward market.

It is also uncertain at what rate speculators may be willing to absorb a possible oversupply of foreign exchange on the forward market. A profit can be expected from speculative forward buying of foreign currencies only if their forward rates fall below the anticipated future spot rates.

294. It is therefore of the greatest importance that the gap left by importers and speculators be reliably filled by covered arbitrage on interest rates, as follows: The exporter will be promised (by his bank, for example) that his export earnings will, when due, be changed for D-Mark at a rate firmly agreed upon today. At the same time, the bank will take a foreign-currency loan with approximately the same maturity, sell the foreign currency in the spot market, and try to put the D-Mark proceeds out at interest. At the agreed date, the bank will repay its foreign-currency loan using the foreign-exchange earnings of the exporter, who will in turn receive from the bank the D-Mark it collects from its own loan. As the "cost" of the operation, the bank will charge the exporter the difference between the higher interest rate payable on the foreign-currency loan and the lower interest rate obtained on the D-Mark loan (plus the small expenses of the transaction). This charge will be expressed as a discount from the spot

price of the foreign currency it buys from the exporter. (It would grant the exporter a premium if the yield on its D-Mark loan was higher than the interest cost incurred on the foreign currency.) In this way, international interest differentials will determine the spread between spot and forward rates (swap rates) for all maturities, and can do so provided covered interest arbitrage is permitted to function unimpaired. Such arbitrage is profitable to banks even with small differences between swap rates and interest differentials.

There are, of course, several forces working to determine the forward-exchange rates:

Covered interest arbitrage will tend to make a forward discount or premium correspond to the international interest differentials.

Speculative forward purchases and sales will tend to make forward rates approach the expected future spot rates.

The more certain it is that a particular spot rate will prevail on a given future date, the greater the influence of expectations on the corresponding forward rate, and it is then the present spot rate (and the remaining forward rates) that must adjust to this particular forward rate, until they differ only by the discount or premium reflecting existing interest differentials.

The greater the uncertainty regarding future spot rates, the greater the influence of actual market conditions on today's spot rate, and it is then the forward rates that must adjust to the present spot rate, until again they differ by the discount or premium reflecting existing interest differentials.

295. The relationship between international interest differentials and swap rates shows this: It is the essence of forward covering in conformity with the market that exporters granting deferred terms of payment are able to base their calculations on the interest rates prevailing in the country in whose currency the delivery is invoiced. Similarly, for the importer, forward covering in conformity with the market means merely that he can resort to suppliers' credits at the rate of interest charged in the domestic market.

Interest rates abroad may at different times be higher or lower than at home. Exporters or importers will accordingly calculate a "cost" to be incurred or a "profit" to be derived from forward covering. They will, in any event, be able to operate under the same conditions as their competitors from other countries who do business in the same

currency and are equally in need of forward cover, unless they wish to assume a speculative position.

It may also happen that a national currency is subject to continual expectations of revaluation and is therefore at a permanent premium in the forward market. In the last analysis, this can only mean that the country concerned has been more successful than others in its price-stabilization policy. In that event, however, the country will also experience lower interest rates than those which prevail abroad. Hence, the "costs" of forward cover with which its exporters must invariably reckon would be no higher than their interest-rate advantage over foreign competitors. Arbitrage would equalize the interest-rate advantage and the forward premium on the home currency. Putting this point the other way round, the supposed burden of buying forward cover is precisely what is needed and desirable to achieve conformity with the market situation. It is identical with the requirement that exporters calculate future foreign-exchange proceeds in terms of D-Mark at a rate no higher than their probable value when falling due. Exchange-rate illusion misleads one into neglecting this principle.

296. Businessmen who engage in both export and import trade or have access to credit markets abroad may try to keep their open foreign-currency positions small by what may be called "internal forward covering." But the majority of businessmen engaged in foreign trade will not have that opportunity.

297. If there is a need for forward cover that cannot be satisfied by clearing (that is, by bringing together exporters and importers) and it is to be met by banks engaged in covered interest-arbitrage operations, then, ideally, there must be absolutely no restrictions on international capital movements. Otherwise, the desired alignment of interest differentials and swap rates cannot take place, nor even the emergence of forward markets for fairly long-term transactions. Even fears of future restrictions on (private) convertibility can prevent the development of efficient forward markets; they lead to uncertainty as to whether a forward commitment can in fact be discharged.

298. Numerous restrictions on convertibility⁷ and various discriminatory practices still hamper international capital movements. As mentioned above (section 259), such measures may prove increasingly unnecessary if floating rates are retained or, at least, a system is

⁷ Convertibility in the sense used here and elsewhere refers to the freedom of private transactors, not to any obligation of monetary authorities.

adopted that provides for greater flexibility of exchange rates. For the time being, however, efforts to expand controls on capital movements predominate in many countries.

The Federal Republic of Germany is no longer a strict exception to this rule. The ban on the payment of interest on nonresidents' deposits and the discriminatory minimum-reserve requirement make it difficult or even impossible for banks to engage in covered interest arbitrage and therefore to offer their clients forward cover in conformity with the market.

The planned Cash Deposit Act⁸ also interferes with efficient forward covering; it would permit the Bundesbank to make foreign credit so expensive at times of a high interest-rate policy that the incentive to borrow abroad would disappear. In such circumstances, it would not be possible for capital movements to align swap rates with international interest differentials. It is true that, under Article 1, foreign-currency credits "directly connected with the commercial settlement of commodity and service transactions" may be exempted from the borrower's obligation to make an interest-free cash deposit. But, without introducing arbitrary administrative decisions, it would be impossible to distinguish credit transactions based on the need for forward cover from financial loans. Hence, the Act in its entirety or its exemption must be regarded as ineffective.

299. The rising number of restrictions on convertibility in the exchange markets has obviously had a paralyzing effect on efforts to promote a system of forward covering that conforms to the market—hence the increase in urgent demands for solutions that will ultimately require the state to guarantee business against exchange losses. If the request for "cheaper" forward cover is met, losses on claims against nonresidents in the event of major changes in exchange rates will become nationalized. Yet these are losses that exporters ought to take into account in their calculations—and that they would be able to calculate if facilities for forward covering were provided on terms conforming to market conditions.

300. Nevertheless, the Federal Government intends—with a view to implementing the guidelines proposed by the Commission of the European Community—to offer exporters a foreign-exchange guarantee in the form of risk insurance. Public export-credit insurance is to

⁸ In effect since January 1972.

cover the exchange risk involved in foreign-currency contracts that cannot as a rule be covered in the exchange market, because of their long duration (more than two years).⁹ The insurance premium is estimated at between 0.8 and 1 per cent per annum and expected to cover costs over the long run. It is not yet clear to what extent insurance will cover the exchange risk in the first two years of the contract. Obviously, the intention is to create exchange insurance simultaneously with the authority to impose obligatory cash deposits, in order to avoid the problems that would otherwise be encountered in the application of the exemptions to the Cash Deposit Act (section 298).

301. If the potential cost to the Government of public insurance against losses is to be kept within limits while forward cover is to remain cheap for the exporter, the magnitude of the exchange risk will have to be foreseeable. This will not be possible over a long period. This much, however, seems certain: An exchange-insurance premium of 1 per cent per annum or less will mean high additional expenditure by the Government every year—unless the Government makes sure that the Federal Republic keeps in step with the worldwide pace of inflation, so that an annual appreciation of the D-Mark by more than 1 per cent will not be necessary.

With forward cover conforming to market conditions, by contrast, the parties to a contract need not have a clear idea of what the spot rate will be when the forward contract matures. It is necessary only to bring together two parties who seek forward cover in opposite directions, whether they be importer and exporter or importer and interest arbitrageur, and that they agree on a forward rate at which both are prepared to eliminate the risk of an open exchange position. As set forth above, if there are well-functioning forward markets, this rate will not differ from the spot rate by more or less than the difference in interest rates on loans of the same duration charged in the Federal Republic and the country in whose currency the contract is invoiced.

302. The idea of an exchange-rate guarantee at a fixed premium must be regarded as an offspring of the kind of *dirigisme* that tries to dominate the international capital markets, and it is to be feared that it will soon inspire a call for some other "necessary" interference with the free flow of capital. One interference spawns another. If insurance against exchange losses is cheaper than cover obtained in

⁹ It has since been created through the Federal Exchange-Rate Insurance Act and took effect on January 1, 1972.

the forward market, it will encourage longer-termed currency loans in connection with export sales; it is an invitation to nonresidents to obtain low-interest credit with the help of exporters. Only additional controls will prevent this from happening. And if it does not happen, the cheaper forward cover will be tantamount to a new kind of export subsidy.

Of greater weight is the argument that other countries promote their export trade by means of low-interest credit on a much larger scale than the Federal Republic. However, it has not thus far been a principle of German commercial policy to join in an international competition to subsidize exports, but rather to resist that trend—a resistance that has certainly done no harm to the German economy or to German export trade.

303. For these reasons, we recommend strongly as a solution to the problem of forward cover not a scheme of government subsidies but facilities that work in conformity with market conditions. This would require the establishment of properly functioning exchange markets. Hence the Federal Government would have to decide to remove all restrictions on the convertibility of the D-Mark in private foreign-exchange transactions and, as far as possible, rule out the use of restrictions in the future, even if the trend toward more controls should continue abroad for the time being.

304. The German Council of Economic Experts has satisfied itself in hearings that banks could quite soon provide adequate facilities for forward cover under market conditions—for export credits up to four years and in any of the important world currencies. To achieve this, it would be sufficient for the German authorities to abolish all restrictions on international capital movements. Facilities of this type would deal with the bulk of export contracts for which it is now difficult to obtain forward cover.

305. Less simple will be the provision of forward cover for exporters' longer-term contracts. Banks that are unable to find for their clients importers with whom to make forward contracts will not be able to rely on established interbank credit relations when trying to obtain matching forward cover by means of interest arbitrage. In such instances, an arrangement to cover the remaining net positions must be found on markets for internationally traded long-term securities. To this end, restrictions on convertibility, some of a grave kind, have to be removed. Nevertheless, the volume of long-term international

portfolio transactions is considerable even now. Much would depend on whether some part of the rapidly increasing flow of capital can be made to serve as the basis for forward cover in the longer-term forward market. Thus far, few such possibilities have been exploited. It would be premature to conclude that the business community is not interested, but the forward markets that ought to provide attractive facilities for forward cover are as yet undeveloped.

306. The authorities could do more than abolish existing restrictions on convertibility. To promote the establishment of smoothly functioning longer-term forward markets, they might, for example, consider establishing a public bank for forward operations. Initially, such a bank would have to institute a bourse-like clearing center for the whole Federal Republic. This would provide a complete picture of the market and thus the necessary information to all parties in need of forward cover. The main task of that bank, however, would be to engage in covered interest-arbitrage transactions. It would have to keep the difference between swap rates and international interest differentials small by taking advantage of the spread—by buying or selling in the forward markets when the swap rate deviated appreciably from international interest differentials, then buying or selling foreign exchange in the spot market. By taking or repaying foreign-currency loans, the bank could keep a balanced exchange position for every currency over the whole range of maturities, and it would expand or restrict D-Mark lending accordingly.

307. The forward-exchange bank would thus engage in transactions that are in principle expected of private banks but cannot be conducted on a sufficiently large scale because of existing or anticipated restrictions on convertibility and capital movements. A public bank specializing in the provision of forward cover could take greater risks regarding the possibility of future restrictions on convertibility than could private banks. The Bundesbank, moreover, might try to obtain from foreign monetary authorities convertibility guarantees in favor of the bank for forward operations, but the ceiling, if any, on those guarantees would not have to set an upper limit on the possible volume of forward contracts with customers. The activity of such a public bank would have a stimulating effect on the willingness of private banks to take fuller advantage of the opportunities available even now for supplying forward cover through the international capital market.

It would not be the purpose of the public bank to supplant forward

cover supplied by private organizations. In fact, the bank will become superfluous once private activity on forward-exchange markets has become strong enough to work toward the alignment of interest differentials and swap rates for all maturities.

308. Forward cover supplied to exporters in accordance with market conditions is likely to be more expensive than subsidized insurance against exchange losses at the premiums now under consideration.¹⁰ There is no basis in general economic policy, however, for allowing exporters to refinance the credit they extend to foreign buyers on more favorable conditions than exist for loans in the contract currency. Nor should refinancing conditions be less favorable. It would be one task of the proposed public bank for forward exchange to prevent this from happening.

309. Occasionally, misgivings are voiced that forward cover conforming to market conditions not only may be too expensive but may also prove to be a general handicap to export trade, as the D-Mark would tend to appreciate in the spot market when foreign currency borrowed abroad for interest arbitrage comes onto the market. This apprehension misjudges the effects of covered interest arbitrage. A demand for forward exchange accompanied by a supply of spot exchange will modify primarily the term structure of exchange rates. More precisely, in counteracting the tendency for a forward premium or discount to deviate from the international interest differential, arbitrage ensures that exporters who must grant deferred payment will not be at a disadvantage compared with exporters who sell against cash, or vice versa. Interest arbitrage helps to bring about market equilibrium but does not change it.

In a country with export surpluses, foreign exchange will flow in, whether or not export contracts provide for deferred payment. If the spot rate is not to fall in consequence, the foreign exchange must be absorbed by capital exports in the same amount, whether covered by interest arbitrage or uncovered, as is the rule for direct investment. For the market to be in equilibrium, the export surplus—or rather the surplus on current account—must be equal to net capital exports. If capital exports are not sufficient, the price of foreign currencies will fall, and the export surplus will drop to the level of autonomous net capital exports.

310. Neutrality must also be required of any public participation in

¹⁰ They are now in effect.

the provision of forward cover. It might therefore pose problems if the Bundesbank itself were charged with the development of more efficient forward-exchange markets. Its monetary policy influences the exchange rate by affecting the level of interest rates. This is as it should be. Moreover, the Bundesbank will have to intervene occasionally to steady movements in exchange rates, in the forward as well as the spot market. Since a public institution engaged in the provision of forward cover is only a substitute for private participants in the exchange market, it would not be appropriate if that function were to be mixed up with the functions of the Bundesbank in the maintenance of currency stability.

311. The expansion of facilities for the provision of forward cover in conformity with market conditions would doubtless lead to a strong increase of credit relations in the most important international trading currencies. If the exporters and importers of many countries took advantage of those facilities, international capital markets would have to be further developed, especially the markets for longer-term securities. This would not impede the effectiveness of the central banks' monetary and credit policies as long as wide bands around parities ensured that capital movements led to movements in exchange rates rather than to interventions by the central banks (which would alter domestic liquidity).

III. DISSENTING OPINION ON EXCHANGE-RATE FLEXIBILITY

312. One member of the German Council of Economic Experts, Claus Köhler, presented a dissenting opinion on the question of exchange-rate flexibility; his views are set forth in sections 313 through 316. He argues that more flexibility for exchange rates is not the appropriate means to solve international monetary problems—as experience has shown in the past six months—and that a system of fixed rates within narrow bands would be more suitable.

313. After six months of flexible exchange rates, it has been found that administrative impediments to international economic exchange have increased, although flexibility was adopted in order to prevent just this from happening. Six months after rates were set free to float, it is apparent that the Bundesbank's interest-rate policy is being used for purposes of exchange-rate policy. This was not the intention of the majority of the Council of Economic Experts. Greater flexibility of exchange rates was meant to ensure the effectiveness of interest-rate policy in the home market. Moreover, the movement in exchange rates does not reflect differences in the pace of inflation at home and abroad. The *de facto* revaluation of the D-Mark after May 9, 1971, goes much farther than would be justified by the world inflationary trend and therefore has an undesirable restrictive effect on the domestic economy.

314. To regard these negative experiences as mere transitional difficulties attending the unpegging of rates is to miss the point. A system of flexible exchange rates can operate effectively only if international transfers of funds are free, if governments and central banks refrain from intervention in exchange markets, and if all administrative barriers to international flows of short-term and long-term funds are removed. A wholesome world in this sense does not exist and will not exist in the future. There will always be disparities from one country to another in the degree of liberalization of money and capital transfers. Furthermore, governments or central banks will intervene in the exchange markets whenever the trend of exchange rates does not suit the objectives of their economic policy at home, or their ideas of prestige. The extent of the *de facto* revaluation, largely attributable to expectations concerning the forthcoming realignment of parities, is only

one example—albeit a drastic one—of how political events influence exchange rates. The result of such influences is dirty floating, not pure floating, as the movement in exchange rates last autumn was described. Dirty floating is nothing but the expression of a discrepancy between reality and the conditions required for the effective operation of an ideal model.

315. The disadvantages attached to a system of flexible exchange rates¹¹ and the negative experience with flexible rates after May 9, 1971, are not exactly a recommendation for more flexibility in exchange rates, as, for example, within a wider band around parity. A reform of international monetary relations on the basis of fixed exchange rates must, however, provide a system with greater operating effectiveness than the Bretton Woods system. What matters is that the dollar should be relieved of its role as the reserve currency, and a newly created international money should be kept sufficiently scarce.¹² It will be equally important to lay down clear criteria for changes in par values by defining what constitutes a fundamental disequilibrium on current account. If it is understood that changes in parity are to be made only when a fundamental disequilibrium exists on current account—that speculative transfers of funds cannot compel a revaluation or devaluation as they did in the spring of 1971—then those transfers will not take place on so large a scale. Moreover, the authority of the International Monetary Fund must be extended to cover international movements of money and capital. It will then be possible to tie any liquidity assistance that may be needed in the case of a temporary imbalance on capital account to the use by the borrowing country of an appropriate countercyclical policy.

316. Within the framework of such a monetary system, credit-policy measures taken by central banks have a better chance of counteracting undesirable inflows of foreign exchange, such as those that may be induced by a high-interest-rate policy required in a given cyclical situation. The central bank may attempt to ward off such inflows right from the outset (as by fixing guarantee quotas), may channel incoming funds back to foreign markets (as by swap-policy measures), and may offset an increase in banking liquidity (as by open-market operations with nonbanks). External safeguards of an administrative nature (cash deposits for funds borrowed abroad by nonbanks or full applica-

¹¹ See "Dissenting Opinion," *Annual Report 1970*, secs. 302ff.

¹² See secs. 263, 264 above.

tion of Article 23 of the External Transactions Act) should be applied only in the interim period, pending the reorganization of the international monetary system or if no such reorganization is achieved. In this event, the uniform application against third countries of administrative safeguards by all member countries of the European Community, accompanied by the elimination of payments barriers within the Community, would have the advantage of advancing the European Monetary Union at the same time. Under a system of fixed exchange rates with only narrow bands, there will be no need for separate institutions, such as a specialized bank, to provide facilities for forward cover.

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8. Jagdish Bhagwati, *The Theory and Practice of Commercial Policy: Departures from Unified Exchange Rates*. (Jan. 1968)
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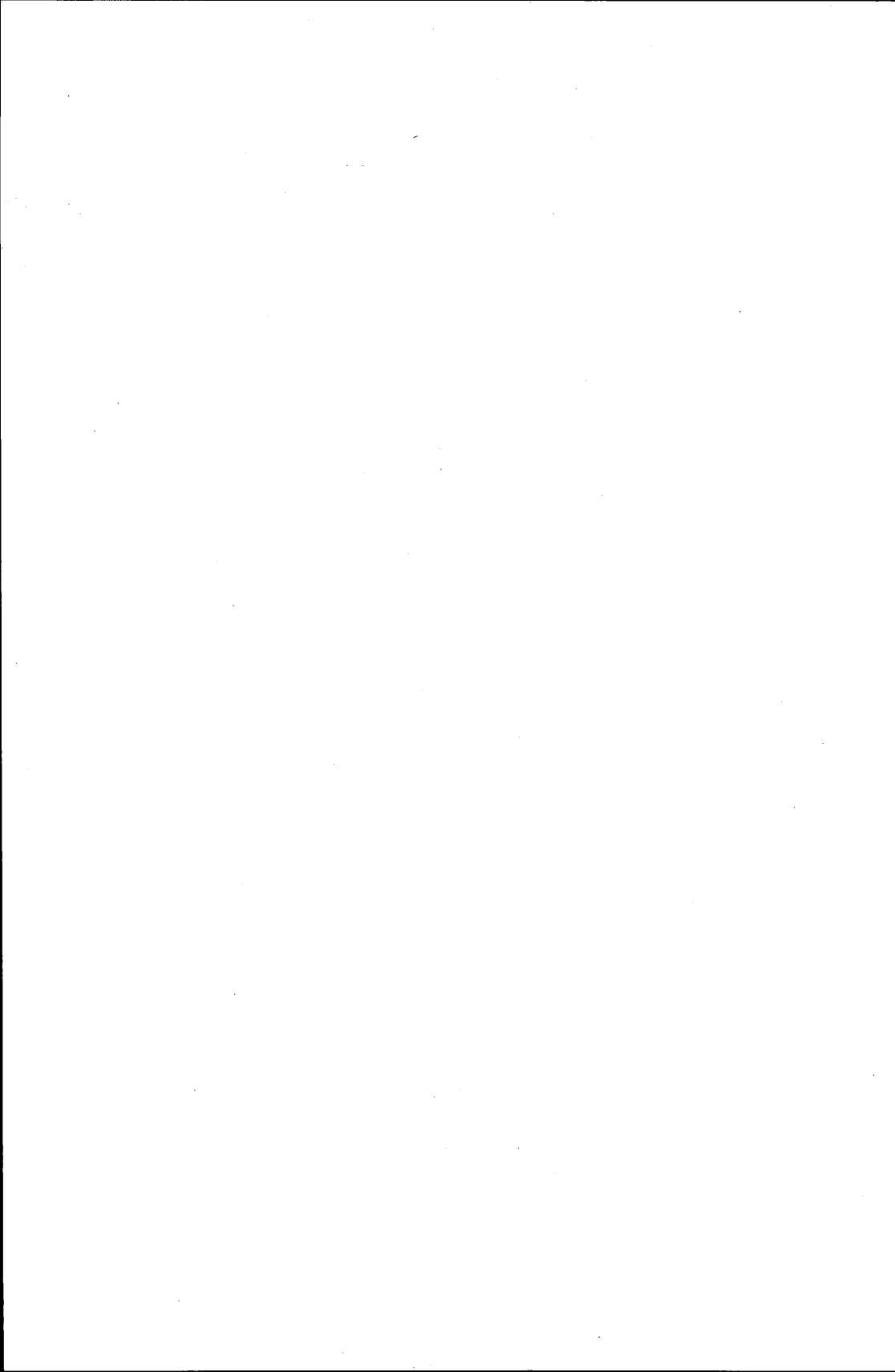
REPRINTS IN INTERNATIONAL FINANCE

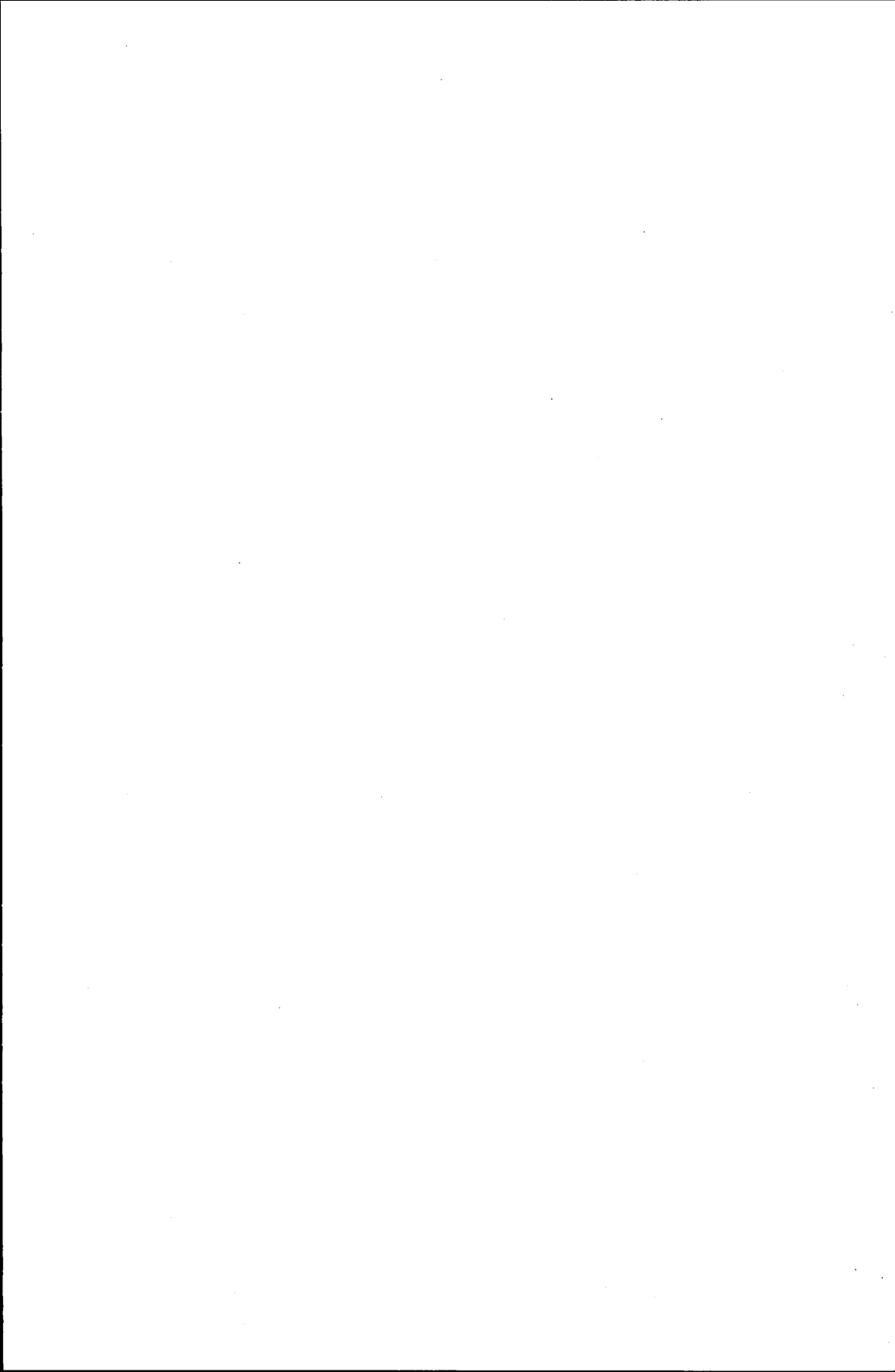
- *No. 1. Fritz Machlup, *The Cloakroom Rule of International Reserves: Reserve Creation and Resources Transfer*. [Reprinted from *Quarterly Journal of Economics*, Vol. 79 (Aug. 1965)]
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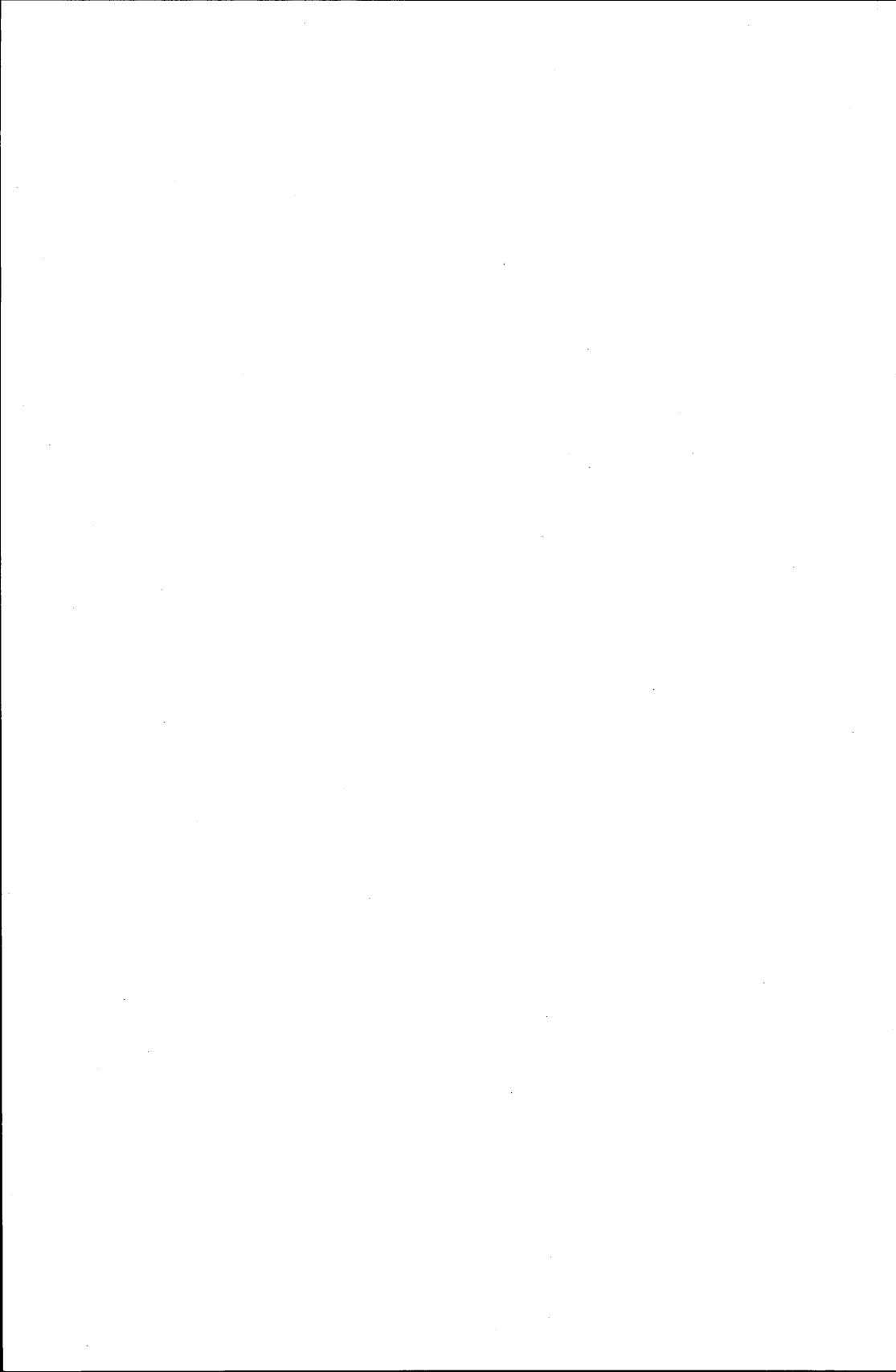
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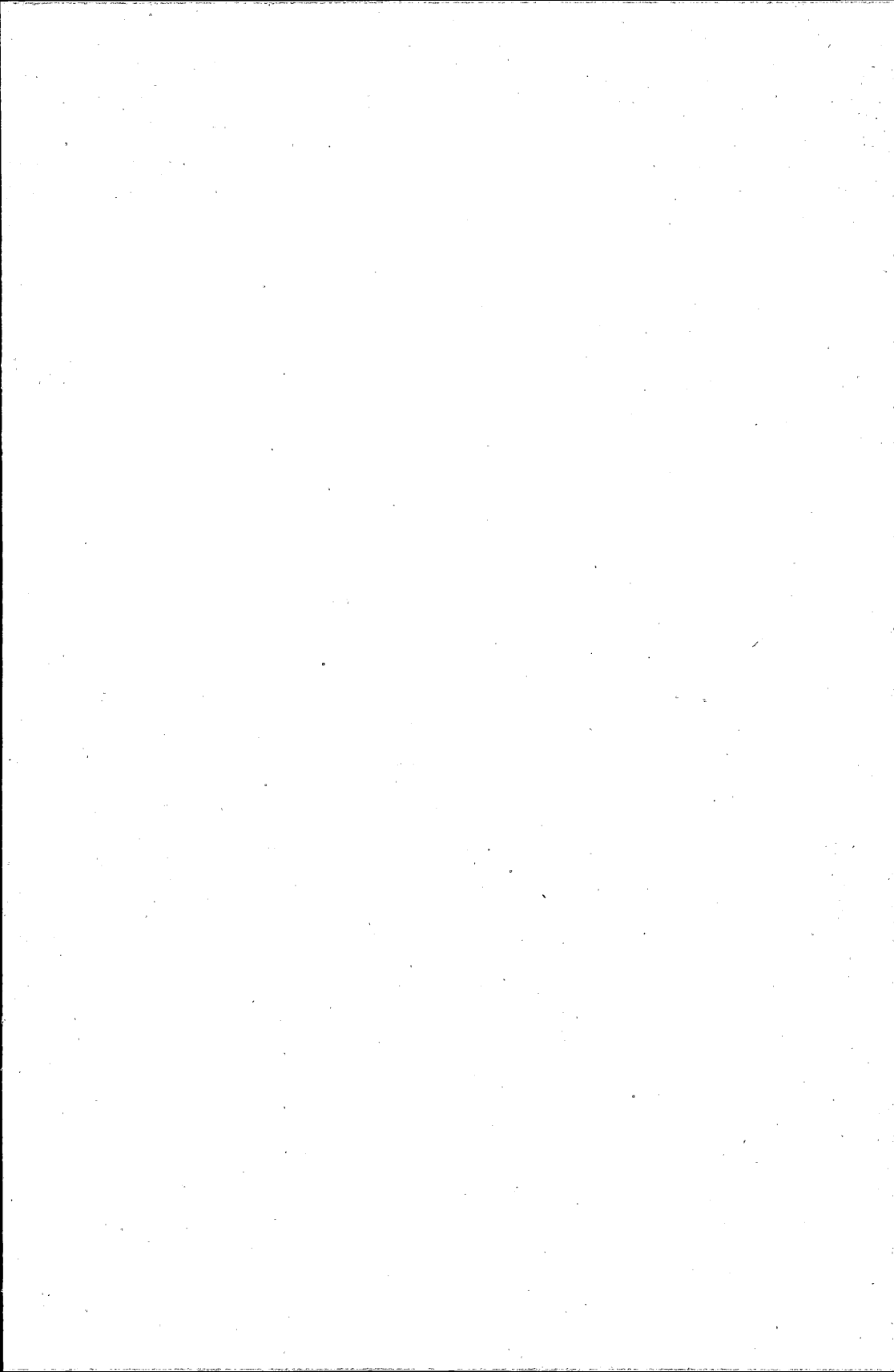
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- * (1) Klaus Knorr and Gardner Patterson, eds., *A Critique of the Randall Commission Report*. (1954)
- * (2) Gardner Patterson and Edgar S. Furniss Jr., eds., *NATO: A Critical Appraisal*. (1957)
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