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MANAGING THE MANAGED FLOAT

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

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PETER B. KENEN, *Director*
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Managing the Managed Float

The quadrupling of oil prices at the end of 1973, superimposed on an already accelerating worldwide inflation, a world commodity boom, recessionary tendencies in some leading industrial countries, and other uncertainties and unsettled conditions, made it inevitable that the widespread floating of exchange rates inaugurated in March 1973 would have to continue for an indefinite period. By the same token, it was clear that the plans under way for a comprehensive reform of the international monetary system based on "stable but adjustable par values" would have to be postponed.

The Committee of Twenty of the International Monetary Fund, which had been working on these plans for over a year, decided at its January 1974 meeting that reform would have to be a more evolutionary and step-by-step process and that attention should be focused on interim measures of a more immediately relevant but less comprehensive character. In its *Outline of Reform with Accompanying Annexes* (*IMF Survey*, June 17, 1974), approved by the IMF Board of Governors in September 1974, the Committee laid down the framework of a longer-run reform of the international monetary system, as well as a detailed program for immediate action. Included in the latter were guidelines it had drawn up for the management of floating exchange rates.

In a paper prepared in April 1974 (Ethier and Bloomfield, 1974), the authors of this essay investigated the general problem of managed floating, and in particular proposed a set of rules that we called the "Reference Rate Proposal." This essay will elaborate that discussion in the light of developments since that time, and will also briefly compare the Reference Rate Proposal with the guidelines of the Committee of Twenty and with those advanced by Mikesell and Goldstein in a recent *Essay* in this series.

The Managed Float to Date: Some Background

Since its inception in March 1973 during a period of economic and political turmoil throughout the world, the system of widespread floating has operated much more satisfactorily than many had expected. Despite substantial and perhaps at times exaggerated swings in exchange rates, foreign trade and investment do not appear, by and large, to have been seriously affected by the float. The business and banking commu-

nity seems to have adjusted itself to the new regime without undue inconvenience; many of its leaders have in fact expressed their preference for the new system over the old (see, e.g., *The Economist*, Supplement, Dec. 14, 1974, pp. 19, 29, 51). The spot and forward-exchange markets have generally functioned well, despite episodic aberrations, especially in the earlier part of the period. Exchange speculation has not proved predominantly destabilizing, as had been feared in some quarters. International monetary crises of the kind that plagued the Bretton Woods system have been avoided. To the extent that countries have allowed their currencies to float freely, they have acquired a greater degree of freedom to pursue macroeconomic policies aimed at domestic goals. The differential effects on individual industrial countries of the oil crisis, world inflation, and world recession have been cushioned. There has so far been comparatively little evidence of the aggressively competitive national behavior long regarded as a major threat posed by a floating-rate system.

The float has not, of course, been entirely free or unmanaged. Monetary authorities have intervened in the exchange market from time to time, and in some cases on a more continuing basis, in order to influence the movements and levels of exchange rates. The exchange-rate regime that has emerged has been a hybrid one. A number of continental European currencies combined in the "snake" scheme—the German mark, French franc, Dutch guilder, Belgian-Luxembourg francs, and Danish, Swedish, and Norwegian kroner—are floating jointly against the dollar and other outside currencies with occasional official intervention, while being kept by exchange operations within a narrow band vis-à-vis each other. Other leading currencies, including the U.S. and Canadian dollars, the pound sterling, the Swiss franc, the Japanese yen, and the Italian lira, have been floating independently, although subject to greatly differing degrees of exchange intervention. The majority of the remaining currencies have been pegged to the dollar, sterling, or the French franc, but these pegs have been altered with varying degrees of frequency. Since the currencies to which they are pegged are floating, these currencies also fluctuate against outside currencies even when the pegs are not altered. A number of Middle Eastern currencies are tied to Special Drawing Rights (SDRs), which are themselves now valued as a "market basket" of sixteen major currencies.

Some supporters of floating rates argue that rates must be completely unmanaged if the full benefits of the system are to be realized. They oppose all official exchange operations to influence exchange rates. Even if this view is valid in principle, it is unrealistic to envisage a perfectly

free float. Most central banks will continue to intervene in the exchange market to smooth out erratic swings in rates or to cope with emerging "disorderly" market conditions. They will be under strong pressure to intervene in order to offset or moderate market forces threatening to push their exchange rates to levels that interfere with the achievement of domestic economic goals. They may be tempted deliberately to depreciate their exchange rates or to keep them at unduly undervalued levels in order to gain competitive trade advantages in time of recession, or to maintain them at unduly overvalued levels or even deliberately to appreciate them in time of inflation. And, for a variety of reasons, some central banks may want their currencies to float jointly with others or be pegged to individual foreign currencies or a composite of currencies—all of which would require intervention. For these and other reasons, a perfectly unmanaged float would seem out of the question.

Since widespread floating will persist for a considerable period and the float will be managed in varying degrees by national authorities, internationally agreed rules of conduct are necessary to regulate the management of floating exchanges. In the absence of such rules or guidelines, individual countries could engage in official exchange operations that were detrimental to the interests, or inconsistent with the operations, of other countries. National or bloc conflicts of policy in exchange intervention could pose a serious threat to orderly trade and financial arrangements and to the interests of the international community at large. Moreover, rules regarding official exchange intervention by no means exhaust the kinds of rules that might be needed in a regime of widespread floating, as will be noted later. For example, exchange rates can be deliberately influenced not only by official exchange operations but also by capital controls, monetary policies, and trade or exchange restrictions.

As it happens, there appear to have been no major conflicts of policy in exchange-rate management since the inauguration of the float. To be sure, the exchange rates of the leading currencies have undergone substantial swings against each other—especially in the case of the dollar against continental European currencies—during the period since March 1973. And the central banks concerned have intervened from time to time, in some cases on a very substantial scale, to moderate these swings, to cope with large-scale, short-term capital movements induced by a variety of economic and political forces, and to support their currencies against strong downward or upward pressures. But far from working at cross-purposes, central banks have shown a high degree of cooperation in their exchange-market interventions. This has been

true not only of interventions internal to the "snake" but also of relations between the Federal Reserve System and the leading continental European central banks. Official exchange operations in the latter case have often been closely coordinated. Thus, the Federal Reserve has sometimes intervened to support the dollar in periods of sharp decline against European currencies by selling those currencies (acquired through swap drawings on the central banks concerned), while the European central banks have simultaneously bought dollars in the exchange market. When the dollar has strengthened, the Federal Reserve has characteristically bought European currencies in the market, in large part in order to liquidate the earlier swap drawings, while European central banks have occasionally lent further support to their currencies by selling dollars at the same time.

Nor has there been as yet any clear evidence of deliberate exchange depreciation by any of the leading industrial countries in order to gain competitive trade advantages. During a period of worldwide inflation, this has not been entirely surprising. But even the existence of substantial unemployment in nearly all these countries during the past year—to say nothing of the unequal impact of the oil crisis on national balance-of-payments positions—has not induced competitive exchange depreciation. European central banks have at times resisted, by exchange intervention or other measures, what they regarded as excessively sharp appreciations, but there is little evidence that any of them have thereby kept their exchange rates at unduly undervalued levels.

Indeed, if there has been any evidence so far of competitive exchange-rate policies, it has pointed rather in the opposite direction. Some of the major industrial countries, most notably Japan, the United Kingdom, and Italy, have sold foreign exchange on a large scale throughout much of the period to resist or moderate a depreciation of their currencies. A desire to reinforce domestic anti-inflationary policies (i.e., to export inflation) has undoubtedly played an important, though probably not dominant, role in these interventions. At various times in 1973 and 1974, moreover, the "snake" countries sold exchange on a significant scale to cushion a sharp decline of their currencies against the dollar. A desire to maintain orderly market conditions was probably more important in this case than anti-inflationary considerations. In any event, it is clear that the industrial countries have so far tended to lean against the wind more often when their currencies were under downward than upward pressure.

What emerges strongly from a survey of official exchange intervention since the float is that there have been no major national conflicts

of policy resulting from aggressively competitive or predatory behavior in the management of the float. In somewhat broader perspective, this lack of conflict may be viewed as part of a general coincidence of national interests that has more or less characterized the international monetary scene since 1971. There seems to have been a broad consensus among the main industrial countries as to the "appropriate" levels of, and "acceptable" range of fluctuations in, their exchange rates against each other. For example, there was general agreement at the start of this period that the dollar was overvalued, and on two separate occasions it proved possible to reach multinational agreements on new structures of par values or central rates. During most of this period, economic activity in the major nations has been more closely in phase than at any other time since World War II, and price trends have been broadly similar. Finally, there has been a natural desire to avoid common crises in the face of the disintegration of the old system.

It would be a serious mistake to rely upon this unprecedented consensus for the indefinite future or, more specifically, over the period (of unknown length) of widespread managed floating, for the coincidence of interests upon which the consensus has rested is very fragile. Signs of its dissolution have already appeared. Large-scale unemployment and a cessation of growth have occurred in many countries, and governments vary in the relative importance they ascribe to anti-recession and anti-inflation measures. The oil crisis is having sharply different impacts on the balances of payments of individual countries. With the abatement of the commodity boom of 1973-74, agricultural issues are again becoming sources of potential conflict. Finally, the underlying uncertainty concerning basic economic interrelations in the world economy that led to widespread floating also mitigates against complacency regarding the continued absence of major conflicts in exchange-rate policy. International rules for the management of the float thus become increasingly important.

General Principles Regarding Rules

What kinds of rules should we have? How comprehensive and ambitious should the set of rules be, which specific areas should they cover, and what particular form should they take?

Consider the first of these questions, the very general one of how comprehensive the set of rules should be. Their scope could fall anywhere between the extremes of no rules at all and a complete, detailed specification of a new international monetary system. But the latter would require a degree of international agreement on the basic issues of

reform that has not been forthcoming, and rules pertaining to a regime of managed floating are needed as soon as possible. Thus we deem it necessary to consider minimal reform programs. The rules should be general enough and nonrestrictive enough to be acceptable to most nations and enforceable without prior agreement on such basic, long-run issues as asset convertibility or the role of the dollar. They should also be flexible enough to encourage progress toward agreement on a longer-run, permanent reform, and to be compatible not only with a broad range of such reforms but with interim arrangements between individual central banks. On the other hand, the rules must of course have enough teeth to offer some protection against the major dangers from managed floating.

The next question pertains to the scope of behavior to be covered. Rules appropriate to a system of extensive, managed, exchange-rate floating could conceivably encompass a large number of areas. These could include (1) permissible and nonpermissible (and/or mandatory and nonmandatory) official exchange intervention; (2) the medium of intervention and the methods to be used; (3) the coordination of official intervention so that countries will not work at cross-purposes when engaged in permissible intervention; (4) the settlement of currency balances acquired through intervention; (5) the use of existing currency balances acquired through past intervention (e.g., the "dollar overhang"); and (6) the use of policies other than exchange intervention to affect exchange rates, such as capital controls, exchange restrictions, and monetary policies.

International agreement on (1) is most important, since it deals with a matter on which lack of agreement could have the most serious consequences. This is the area most directly relevant to the possibility of competitive exchange behavior or exchange-rate policy conflicts generally—the primary reason for rules.

Thus the rules must certainly address themselves to (1), but what about the other areas? Area (3), and to some extent (2), have to do with the general subject of central-bank cooperation. Such cooperation has been rather prominent and important thus far in the float, as it has been throughout the post-war period—in sharp contrast to the experience of the 1930s. Indeed, it is possible that the steady development of central-bank cooperation over a quarter-century will be regarded in the future as the single most significant by-product of the Bretton Woods system. But these areas must be left for the most part to the flexible, ad hoc responses of central banks to particular circumstances; they need not, and indeed cannot, be provided for in advance by specific rules.

In addition, prescriptions calling for central-bank cooperation or for

prior consultation under specific circumstances cannot be relied upon to take the place of formal rules in other areas, notably (1), because such cooperation may be least reliable when the need is greatest—in the face of sharply divergent national interests. In such areas, there must be some formal code of behavior more concrete than a procedure of central-bank cooperation and consultation.

With regard to areas (4) and (5), we might also rely to some extent upon ad hoc arrangements between specific central banks. For example, there are the arrangements made by the "snake" countries for Italy's benefit in 1972, before that country dropped out of the scheme; another example is the 1973 agreement between the Federal Reserve and the Bundesbank to "split" the profits or losses resulting from coordinated exchange intervention. Nevertheless, a general agreement on specific rules would be necessary to deal with this area at all comprehensively, and this would obviously require at least a conditional accord on such contentious issues as asset convertibility. Thus areas (4) and (5) cannot really be dealt with in a minimal reform program, and the set of rules should not include, as an integral component, general rules dealing with the settlement of currency balances acquired through intervention, though arrangements between specific central banks can be expected from time to time. A central bank that unilaterally decided to buy foreign exchange would therefore have no assured means of disposing of the balances acquired except through subsequent (permissible) sales on the exchange market. The possibility of exchange losses consequent upon intervention would, of course, be one element in the bank's decision as to whether or not to intervene.

The rules should, nonetheless, at least be compatible with all methods of dealing with areas (4) and (5) that might eventually be agreed upon.[1] It would also be desirable for the rules to contain features that might aid in implementing such an agreement. We shall presently discuss our Reference Rate Proposal in this context.

Item (6) clearly constitutes an area for potential rules because of the marked interdependence between the exchange markets and other economic policies. For example, exchange-rate movements during the current float have been influenced in the great majority of countries by changes in controls over capital movements. These controls were tightened in the first half of 1973. Early in 1974, however, the United States lifted its controls over capital exports and many European countries relaxed their controls over capital imports—in both cases at least partly to check the rise in the dollar against the "snake" currencies. There

[1] Some of the longer-run possibilities in these areas are examined in the *Outline of Reform* of the Committee of Twenty.

was a renewed tightening of some European controls late in 1974 and in 1975. A number of countries have also periodically adjusted their monetary policies with an eye to influencing movements in their exchange rates. Trade policies have occasionally been altered with the same end in mind, the Italian import controls being a good example. Success in eliminating overt policy conflicts in the exchange markets might indeed simply shift the scene of such conflicts. But this is really a quite separate issue. It is clearly desirable to coordinate national economic policies and to remove conflicts to as great an extent as possible, regardless of what is happening in the exchange markets or what rules have been adopted regarding intervention. Thus problems relating to capital controls, trade measures, monetary policies, etc., are beyond the scope of this essay, it being understood that cooperation in these areas is of great importance in its own right and that any set of rules should facilitate such cooperation as much as possible.

We are left, then, with area (1), the nature of the rules to be adopted regarding official exchange intervention. Three broad types of rules (not necessarily mutually exclusive) are possible here: (a) The rules could specify circumstances under which official intervention by a central bank was mandatory. The Bretton Woods system was of this type, as were most of the suggested reforms of that system, such as wider bands or the crawling peg; any rules of this type would have to be much more flexible to be considered now. (b) The rules could instead be of the opposite sort and specify circumstances under which certain types of intervention were prohibited. (c) Instead of pertaining directly to intervention, the rules could specify circumstances under which prior consultation or international cooperation of some sort would take place.

A scheme based upon rules of type (a) or (c) would, in our judgment, be impractical and/or inadequate. The latter, for example, is realistic only in the sense that such a rule is likely to be adopted by default, and the former is precluded by the very impossibility of establishing a fixed equilibrium exchange-rate structure that, we have argued, makes floating inevitable. Any sort of prespecified mandatory intervention, no matter how flexible, would potentially lead to the sort of crises that repeatedly occurred under, and ultimately toppled, the Bretton Woods system. We opt, therefore, for rules of type (b).

What kind of intervention should be prohibited? We wish to prevent competitive exchange-rate policies by central banks, but which concrete acts are of this kind? *Any* official intervention designed to influence the exchanges is by its very nature an attempt to interfere with market forces. But completely clean floating, as suggested earlier, is just not in the cards. We should like to rule out attempts to export inflation or un-

employment through deliberately induced exchange-rate movements. But any exchange-rate movement, regardless of its cause, will to some extent influence domestic and foreign economic performance, and who is to judge what evil lurks in the hearts of central bankers? Not that motive need be all that important in any case; the attitude and response of the rest of the world to one central bank's actions will clearly depend upon economic conditions in the rest of the world. Furthermore, our concern should not be only with official intervention to push exchange rates away from prevailing levels. Intervention to maintain palpably overvalued or undervalued exchange rates could equally be regarded as unneighborly behavior. The Bretton Woods system in the 1960s offers a number of clear examples of such behavior. It is simply not possible to give an operational definition of central-bank activity that constitutes "competitive exchange-rate behavior." Indeed, this is one more potent reason why we need a highly flexible set of rules. Our rules should be confined to attempting to prevent both those visible, overtly aggressive acts most likely to induce retaliation and the prolonged maintenance of outdated exchange rates.

To summarize, rules pertaining to the managed float should embody the following general principles: (1) They should constitute a minimal reform program, at once broadly acceptable and highly flexible, that avoids the unresolved long-run issues. (2) They should contain formal regulations regarding official exchange intervention and not rely solely on central-bank cooperation and consultation. (3) They should be designed to prevent the most egregious sort of central-bank conflict in the exchange market rather than any difficulty that could conceivably arise. (4) They should specify when intervention is *not* permissible, rather than when it is mandatory. (5) This specification should be in terms of concrete acts of intervention rather than in terms of the presumed motives for such acts. (6) They should be compatible with simultaneous efforts to foster central-bank cooperation and to deal with the possibility of conflicts arising from policies other than intervention that are designed to influence exchange rates. (7) They should not impede the evolution of a long-run reform of the international monetary system, whatever shape that might take.

The Reference Rate Proposal

These general principles have been embodied in a specific program, the Reference Rate Proposal, to which we now turn.[2] The scheme requires

[2] See Ethier and Bloomfield (1974), and, for a subsequent discussion of the idea, see also Williamson (1975).