PRINCETON STUDIES IN INTERNATIONAL FINANCE NO. 31

Toward a New Basis for International Monetary Policy

The German Council of Economic Experts

INTERNATIONAL FINANCE SECTION
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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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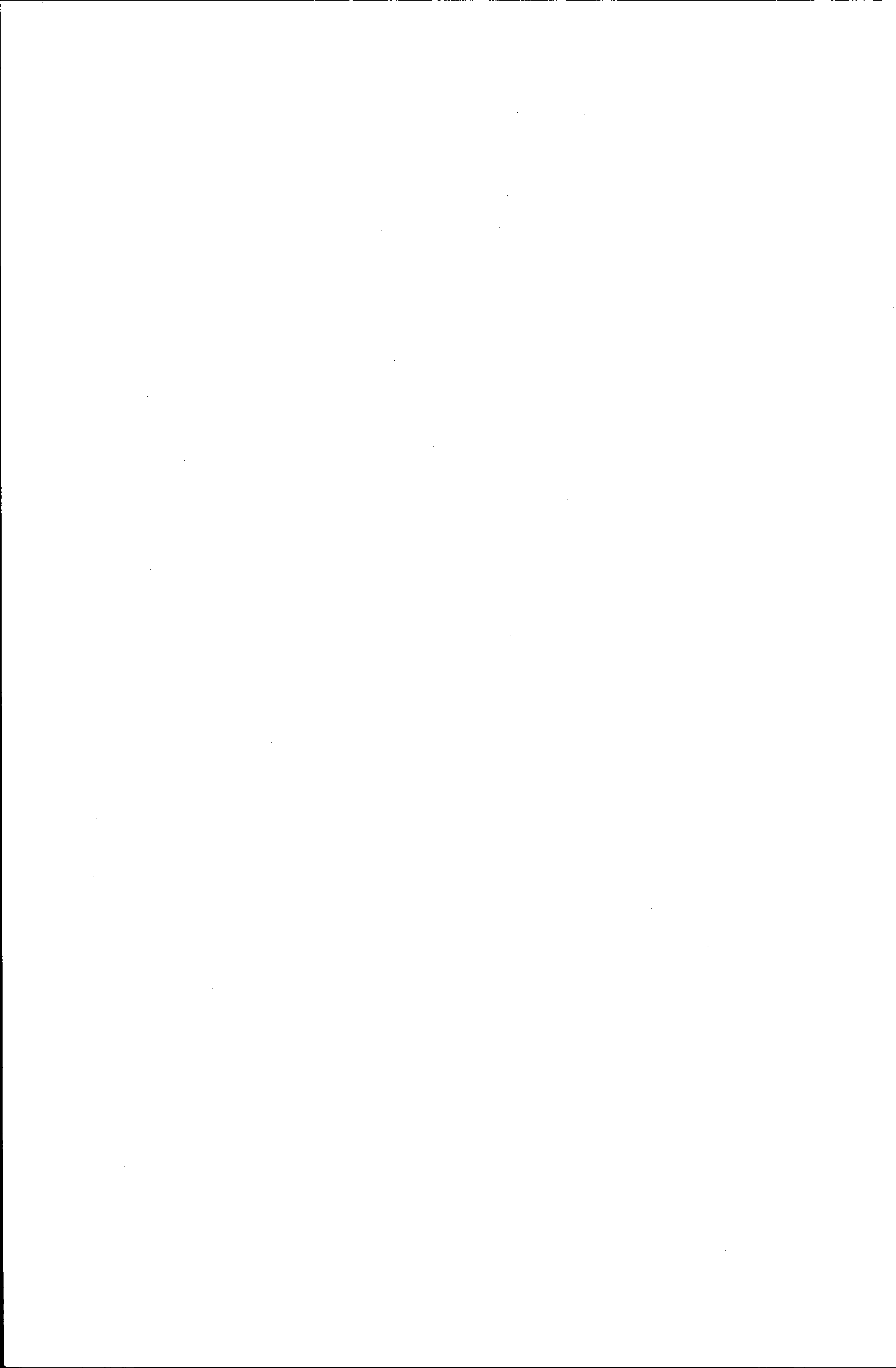

FOREWORD

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 Kloten, 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-Schware, 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 tolerence 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 countercylical 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 countercyclical 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