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INTERNATIONAL MONETARY PROBLEMS AND THE FOREIGN EXCHANGES

EGON SOHMEN

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY · 1963

This is the fourth number in the series SPECIAL PAPERS IN INTERNATIONAL ECONOMICS.

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FRITZ MACHLUP, *Director*
International Finance Section

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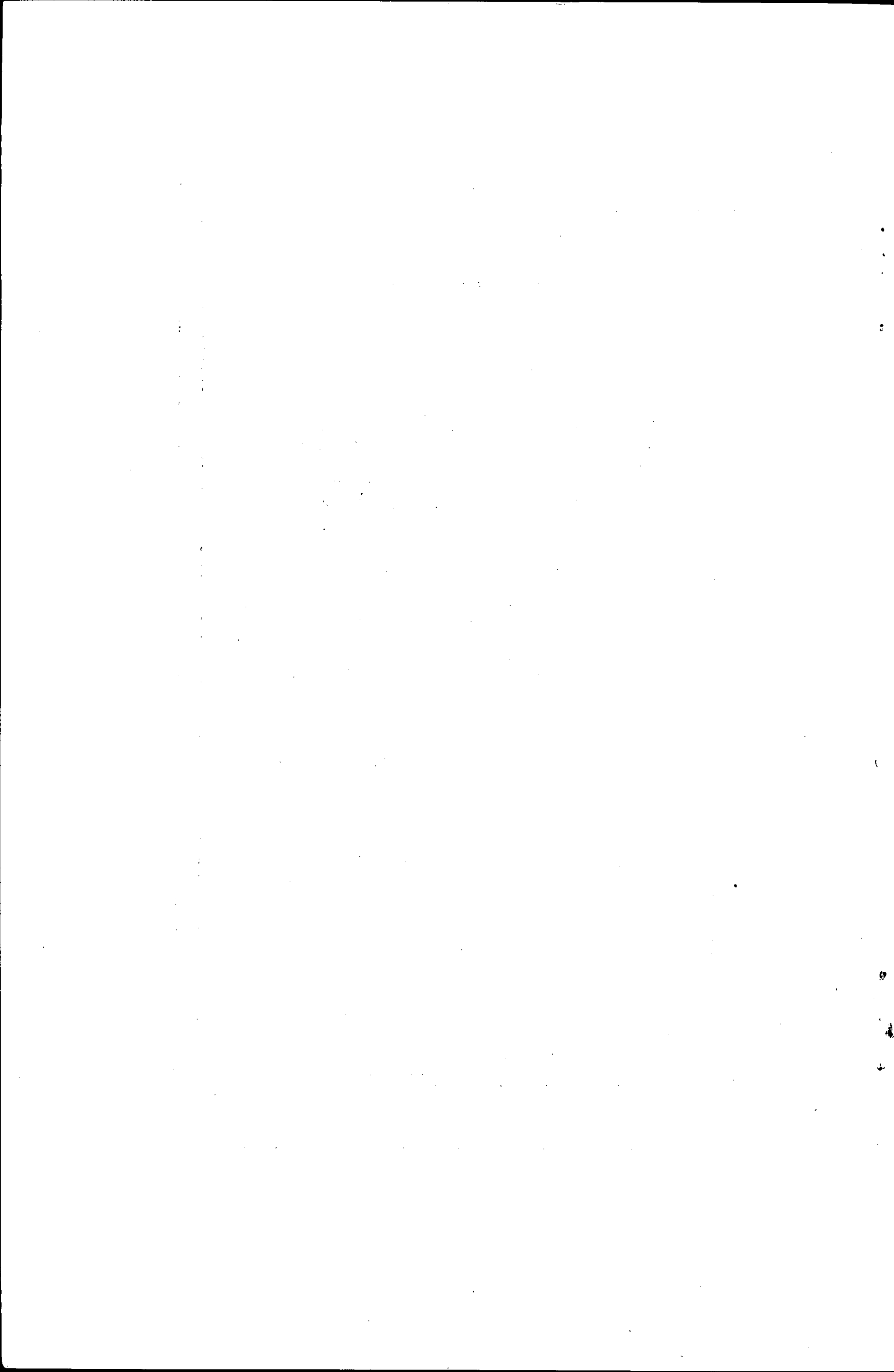


FOREWORD

Balance-of-payments crises and the distortions of world trade and payments they cause are but one of the many unresolved economic problems of our time. There are others—the bitter antagonism between two powerful blocs espousing radically different principles of economic organization, or the rather unsatisfactory progress of the less developed regions of the globe—that may well be even more important. I have the impression, however, that there is no other economic issue of comparable weight for which reasonable solutions can be put into effect as easily as for the problems of international finance.

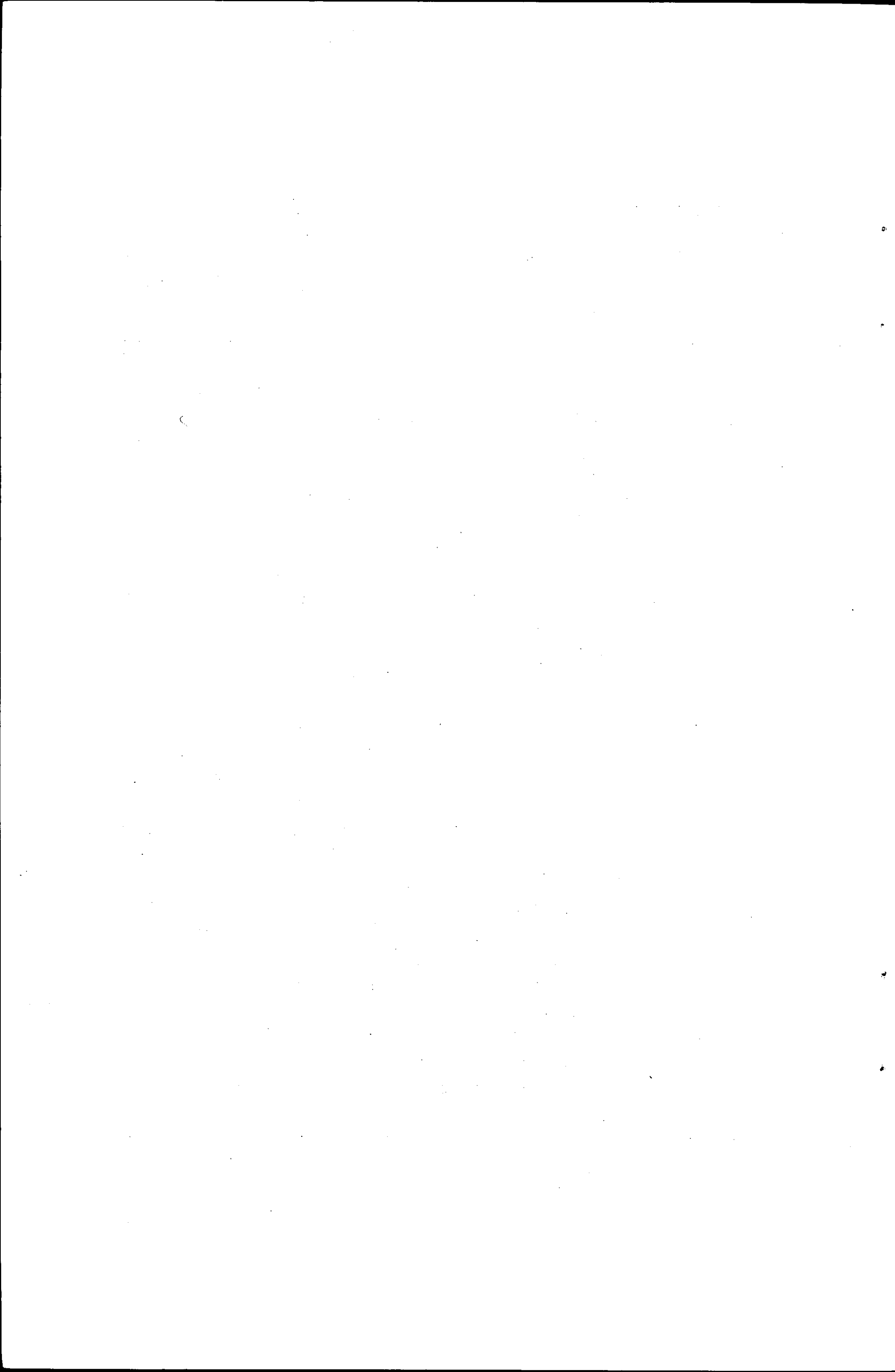
This booklet is addressed primarily to the economically sophisticated reader without special training in the area of international trade theory and policy. It may also serve as an introduction to my recent book, *Flexible Exchange Rates* (Chicago: University of Chicago Press, 1961) in which related topics are treated on a substantially more advanced theoretical plane. It was generally felt, I believe, that this latter publication was perhaps written in a somewhat too terse and difficult manner, given the fact that it also dealt with issues of rather topical interest to policymakers who do not always have the leisure to ponder abstract theoretical reasoning. I therefore welcome the opportunity to publish this companion volume.

The arrangement of the material may require some explanation. The opening chapter is a rather extensive introduction to some of the current problems of the real world. The systematic exposition of the theoretical groundwork begins with Chapter II. This may appear as a reversal of the logical order of treatment. The reasons for adopting it were frankly psychological: it has been my experience that many readers outside a small circle of theoretically oriented economists want to see for what purposes theoretical analysis is to be used before they are willing to invest time in it. Readers who are not so inclined may just as well start with Chapter II and read the introductory first chapter at the very end. Literature references in the text are kept to a minimum; instead, I have appended an annotated bibliography.

Many economists appear to believe that members of our profession ought never to offer clear and unambiguous policy advice. Those who are thus inclined will not, I am afraid, be likely to derive comfort from the following pages.

For help and advice, I want to thank Professors Herbert Giersch and my assistant, Mr. Rolf Bollinger.

E.S.



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I. Problems, Policies and Panaceas

1. *Definitions*

An exchange rate is the price of one national currency in terms of another. The usual practice is to quote it as the price of one unit of foreign currency in terms of domestic currency. In the United States, e.g., an exchange rate of 2.80 for the pound sterling means that one pound can be purchased for $2.80. Only the United Kingdom deviates from this general practice and quotes exchange rates as the amounts of foreign currency obtainable for one pound.

For clarity, we shall avoid the ambiguous expressions "rise" and "fall" of an exchange rate. Instead, we shall always explicitly indicate whether an appreciation or a depreciation of a specific currency has occurred. By the former, we mean that its price in terms of other currencies has risen; by the latter, that it has fallen.

A closely related concept is that of "par value" or "parity" of a currency. Article IV of the *Articles of Agreement* of the International Monetary Fund stipulates that "the par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944" (the date on which the *Articles of Agreement* were decided upon at Bretton Woods, N.H.). The price of gold at that time was (and still is) $35 per ounce. Gold is thus made a universal value standard for the currencies of all member countries. For purely practical reasons, par values of currencies are usually stated in terms of their U.S. dollar equivalents.

By fixing their values in terms of a common denominator, the exchange ratio between any pair of currencies is also fixed. The actual exchange rates on any given day do not conform precisely to the ratios of the par values of the two currencies. These ratios serve only as pegs around which exchange rates fluctuate, as determined by the autonomous forces acting on the foreign-exchange markets. Rigid limits are set for such fluctuations, however: according to the *Articles of Agreement*, "rates of exchange . . . shall not differ from parity . . . by more than one per cent" (Art. IV, sec. 3). In practice, most member countries have fixed the limits at less than one per cent to either side of the par value (usually around 0.75 per cent). At these limits, the central banks or exchange-stabilization funds of the member countries have to intervene through purchases or sales of gold or foreign currencies to prevent wider swings. They often intervene, in fact, at a much earlier stage to keep even short-run oscillations within very narrow limits.

The movement of exchange rates is thus closely controlled today, although they are not rigidly pegged in the sense that foreign currencies could only be bought and sold at one single price. There are also substantial differences between countries in the extent to which central banks intervene on the exchange markets. The decisive characteristic of our present system is, nevertheless, that exchange rates are not allowed to move beyond the narrow bands fixed by the Bretton Woods agreement, *unless* the par value itself is adjusted.[1]

Such adjustments are foreseen in the *Articles of Agreement*. They are to be undertaken by administrative decision, after consultation with the International Monetary Fund and its formal approval, in the event of a "fundamental disequilibrium." The *Articles of Agreement* provide no explanation of the exact meaning of this term, and a little reflection will convince anybody that it is impossible to give one. The borderline between a temporary disturbance and an irreparable maladjustment is smooth, not abrupt. When par values were changed in the postwar era, this had necessarily to happen only after long and passionate controversy, after repeated public denials that such a measure was contemplated, and without the careful consideration of the pros and cons in the governing body of the IMF, as foreseen in its charter.

A term we shall frequently use is that of "convertibility." Many years ago, it used to denote a state of affairs in which central banks were committed to redeem banknotes into gold at a fixed price. This type of convertibility no longer exists. In modern terminology, convertibility of a currency means that it can be freely exchanged into foreign currencies. This freedom, a natural by-product of gold-standard convertibility, is today limited in varying degrees in many countries. Restrictions on convertibility are summarized under the heading "exchange controls." They may take the very severe form of a general ban on currency conversion and the obligation to surrender all newly acquired foreign-exchange receipts to the central bank. Every single payment is then subject to the approval of the authorities. A milder form is a general permit for certain specified types of transactions, while others are strictly forbidden or subject to individual approval. All payments for imports of goods may be free (though their importation may itself be subject to import licenses), whereas "capital movements," that is, transfers of funds merely for the purpose of ac-

[1] A few countries no longer adhere to this rule, but have nevertheless not lost their membership in the IMF. The most important outsider used to be Canada, where exchange rates fluctuated freely from 1950 to 1962. It is generally acknowledged that this practice clearly violates the basic principles on which the Bretton Woods agreement is built.

quiring foreign assets (bank deposits, stocks or bonds, etc.), are closely supervised.

Apart from differentiation according to the purpose of payment, it is also possible to differentiate according to the type of person making a transfer. The most important distinction is that between "resident" and "non-resident" convertibility. Most West European countries introduced non-resident convertibility at the end of 1958. This change brought full freedom of disposition over all bank deposits held by non-residents while payments by residents of the country continue to be subject to controls of varying degrees of liberality.

Among other things, this booklet presents a plea for flexible exchange rates, that is, the removal of the rigid boundaries within which the movement of exchange rates is now confined. I suspect that most of the opposition to this proposal is due to semantics rather than to genuine differences of opinion. Superficially, the term "flexible" indeed appears to be the antithesis of "stable" and "durable." The advocacy of flexible rates is therefore often identified with the defeatist abandonment of a solid institution in favor of something weak and undependable.

In linguistics as well as in economics, "flexible" is not synonymous with "unstable." The antithesis of flexibility is not stability, but rigidity. This writer, for one, joins with enthusiasm all those who plead for a high degree of stability of exchange rates. It ought to be remembered throughout this study that there is no disagreement on that score. The dispute centers on the *means* by which the preservation of exchange-rate stability should be attempted. With this reminder, let us dispense at once with the most frequent objection to flexible rates, the contention that they would, as a consequence of greater insecurity of international commercial and financial transactions, lead to a reduction of world trade and payments. Disintegration of the world economy would indeed involve grievous losses, but it is precisely the promotion of *more* international trade that has led this author, among others, to reject the present system of (adjustably) pegged rates.

It is not enough to take a simple once-and-for-all policy decision to determine whether or not exchange rates are to be stable. The long-run equilibrium value of an exchange rate is the resultant of an immeasurably large number of actions by independent decision-makers. A country's monetary and fiscal policies, the variables directly under the control of its central bank and government, play an important part, but so do the price policies of all businesses and the collective-bargaining agreements between them and the trade unions.

In theory, governments also have the means of influencing these

latter factors. Antitrust action checking restraints on competition in the product markets as well as against monopoly power of unions may, among other things, serve to prevent too rapid an increase of prices. We are a considerable distance from a climate of public opinion where truly effective policies against the basic causes of sellers' inflation would be politically feasible. As long as these conditions are not satisfied in a number of leading economies—nobody can claim that they are fulfilled in the United States or the United Kingdom, for example—exchange rates are most unlikely to remain stable over the long run. If a government tries to enforce their stability through fiscal and monetary policies under these conditions, large-scale unemployment will be the consequence unless the authorities are willing to abandon the principle of free convertibility of the national currency into others and to impose restrictions on foreign trade.

Historical evidence shows that neither mass unemployment nor exchange controls and the associated impediments to international trade are popular enough to be feasible propositions over the long run. It is therefore always a safe bet that a country whose economy shows the symptoms of serious currency overvaluation, in particular business stagnation and balance-of-payments difficulties, will eventually devalue its currency. In all probability, to be sure, this will happen after years of solemn denials of any such intention by central bankers and government officials.

Even if a government is able to control all those variables in its home economy that influence domestic prices, and is willing to enforce reasonable stability of the price level, stability of exchange rates for its currency is by no means assured. An exchange rate is a ratio between *two* currencies. Stability of the par value of a given currency does not merely depend on the willingness and ability of its own authorities and citizens to satisfy an embarrassingly large number of conditions, but on an equal willingness and ability on the part of *other* governments.

Most people are satisfied that their own currency has not been devalued as long as the gold price in terms of that currency has not been changed. Unless one sees certain mythical properties in gold, it is clear that any change in the par value of another currency involves a certain measure of exchange-rate adjustment for the domestic currency in the opposite direction. The appreciation of the D-Mark and the Dutch guilder in March 1961, e.g., implied some degree of depreciation of the U.S. dollar. If for no other reason, the affirmation that the dollar will not be devalued is technically incorrect because this decision is not in the hands of the American authorities alone. This is less evident in the case just mentioned merely because the

U.S. economy is a more weighty object than the economies of the two other countries. It should be quite obvious to everybody that the Swiss franc, e.g., has appreciated if the U.S. dollar is devalued. The difference is only one of degree.

An economist easily acquires the reputation of a maverick by too outspoken advocacy of more forceful government policies to promote competition in both the commodity and labor markets. One of the principal reasons for this recommendation, with which the present writer wholeheartedly concurs, among most of its proponents is the role of price stability in preventing disturbances in a country's external accounts. The defense of price stability ought at least to be given credit for the strengthening of exchange-rate stability it implies. It is somewhat inconsistent for people who do not take the goal of price stability very seriously simultaneously to oppose flexibility of exchange rates on the grounds that their stability is too important an objective to be called in question.

The clear distinction between *stability* and *rigidity* on the one hand, *instability* and *flexibility* on the other, is of fundamental importance for all that follows. With the world as it is, long-run stability of exchange rates is, most unfortunately, not a feasible proposition. Wherever governments in countries with strong upward pressure of prices attempt for a few years to keep alive the fiction that it is, millions will have to suffer either from economic stagnation or, less visibly but as certainly, from stringent controls over foreign trade and payments. These surrogates for depreciation have, at least in peacetime, never lasted more than a few years. In view of the damage done by them, we may be grateful for that. The real issue under present conditions is not between stable and unstable exchange rates, but only between smooth and jerky instability over the long run. In more descriptive terms, the choice we have to make, given all the imperfections of the real world, is between (1) free exchange rates with a minimum of restraints on foreign trade and payments at reasonably full employment, on the one hand, and (2) artificially regimented exchange markets, with unemployment ruling in some countries, inflationary booms in others, and occasional hit-or-miss adjustments of currency parities, on the other.

2. *Monetary Policy and the Utility of Keynesian Economics*

The realization that today's world is not made for permanent stability of par values is usually the principal reason given for the endorsement of flexible exchange rates. Preference for the latter is expressed on the grounds that the smooth adjustment paths along which exchange rates will, under sufficiently alert monetary policies, be led

by the divergent movements of the myriads of monetary, political and technological factors in each country, are preferable to the unforeseeable large jumps characteristic of our present system, with years of maladjustment and stagnation in at least part of the world in between.

The case for flexible exchange rates does not, however, rest on this aspect alone. Its strength is much greater than what is already suggested by comparison with the "adjustable peg." Even *if* conditions in the world were such that the long-run stability of exchange rates would be a feasible proposition, their exposure to free market forces is an incomparably more promising arrangement than their stabilization within narrow margins by direct intervention on the foreign-exchange markets. It can stand repetition that the foremost bone of contention of liberal opponents to the Bretton Woods system is the principle of *artificial* pegging of par values through direct purchases and sales of gold and foreign exchange by central banks or other official bodies. By no means is it the attempt to hold freely fluctuating exchange rates as stable as possible through appropriate measures of fiscal, monetary and general economic policies. Since the subtle, yet fundamental differences between the two approaches to stabilization are so little recognized, the description of adjustment mechanisms under the latter system will be the principal topic of the following chapters. To anticipate the major result of our investigation: *flexibility of exchange rates opens up an entirely new dimension for monetary policy.*

If exchange rates have attained one of the points of intervention by the central bank or stabilization fund, and if currencies are convertible, monetary policy is for all practical purposes rendered impotent under the present system. If, on the other hand, the movement of exchange rates is not hemmed in by rigid limits and the authorities refrain from direct intervention in the foreign-exchange markets, the response of international trade and capital movements in a regime of convertibility will act as a powerful factor *reinforcing* monetary policy. It would undoubtedly prove to be the most important channel through which monetary policy can act as a countercyclical tool. These propositions will be developed in greater detail in later chapters.

As I have emphasized elsewhere, this property of a system of freely fluctuating rates ought to be the principal reason for endorsing it. This property deserves the reader's most serious consideration, for it has so far hardly entered the debate on the pros and cons of alternative international monetary systems. Most opponents of pegged rates have made their case depend on the role of exchange-rate flexibility in ironing out divergent rates of inflation in different countries or on

the possibility of removing foreign-exchange markets from the shackles of authoritarian controls. Even if the present system were able to withstand an unprejudiced examination on these counts, the diametrically opposite effect of monetary policy under pegged and flexible rates alone would be ample reason for rejecting the former.

A deeper analysis of international trade and capital movements has a very important by-product: the revelation that most of what some of us are used to calling "Keynesian" economics is rather irrelevant for the world as we know it today. We cannot enter into a discussion of theoretical details, nor shall we attempt to settle the terminological dispute whether or not one is justified in applying the adjective "Keynesian" to all the ideas and policies that have been developed from Lord Keynes' *General Theory of Employment, Interest and Money* (1933), though their derivation from that work is universally recognized. What matters for our purposes is the fact that in a world of reasonably free trade and payments (1) monetary and fiscal policies are for all practical purposes rendered useless as means of assuring full employment if exchange rates are rigidly pegged, whereas (2) monetary policy alone is amply sufficient to achieve that objective if exchange rates are allowed to fluctuate freely.

During the twenty years following the publication of the *General Theory*, monetary policy was more and more downgraded by economists. Although it has enjoyed a certain recovery in popularity, most economists continue to regard fiscal policy as vastly more potent medicine. The most important reason for this state of affairs is undoubtedly that the role of exchange rates as catalysts for the employment effects of monetary policy has never been adequately recognized. During the era of the gold standard, exchange rates could never move beyond very narrow limits. Lack of familiarity with exchange-rate fluctuations prevented a deeper intellectual interest in them.

In the postwar environment of stringent controls over foreign payments that has persisted until very recently in most countries, the international repercussions of domestic policy were easily forgotten altogether. The currency of the only major country whose residents enjoyed complete freedom of foreign payments, the U.S. dollar, was sufficiently undervalued for so many years, and protected from large-scale capital inflows by exchange controls elsewhere, that its domestic policies were not frustrated by balance-of-payments effects. One consequence was that writers on monetary theory and policy have for the past few decades confined their attention almost exclusively to the domestic effects of central banking. When exchange controls and impediments to international trade can prevent capital flight as well as too serious a deterioration of the current account, the pursuit of

full employment through fiscal and monetary policies can indeed be carried on for some time even at rigid currency parities.

In the early 1960's, the world presents a very different picture. Trade and payments between the leading industrial countries of the Western world have been liberalized to a substantial degree. The U.S. dollar is no longer an undervalued currency; for several years, the United States has had to endure stagnation, with unemployment rising to 7 per cent, to prevent its external accounts from slipping into precarious imbalance. With these profound changes, monetary and fiscal tools of anticyclical policy are no longer effective, although this fact is not yet very widely realized.

3. *The Dilemma of Sellers' Inflation*

Liberation of exchange rates from the straitjacket of rigid pegging, though a badly needed condition for the normal functioning of the world economy, should not be misunderstood to be a panacea that would by itself suffice to solve all the major economic troubles that confront us today. The single most potent objection to flexible rates is undoubtedly the argument that they might encourage undisciplined policies which could prove to be disruptive over the long run. If greater flexibility of exchange rates is seen merely as a means of making an economy immune against the balance-of-payments effects of domestic inflation, this danger is indeed a very real one. It is unfortunate that this interpretation predominates in today's discussion, and that flexibility may eventually be introduced for this reason alone.

Among the two manifestations of currency overvaluation, balance-of-payments disequilibrium and economic stagnation, the latter is undoubtedly much more painfully felt by most people. When sales and employment pick up after an exchange-rate adjustment, it is only natural that the upward pressure of prices (which presumably was the main reason why the currency became overvalued in the first place) becomes even more pronounced. Especially if the rise of prices is not due to excessive demand, but to the exploitation of market power by union and business monopolies (commonly known as "cost-push" or "sellers' inflation"), the movement of exchange rates is likely to be only in one direction. The general realization of this state of affairs may, as long as currencies are freely convertible, lead to capital flight and an even faster rate of depreciation. Such a snowballing crisis may bring the reintroduction of exchange controls and perhaps a general impression that the move toward exchange-rate flexibility alone is to be blamed for the calamity. The progressive rise of domestic prices will perhaps be widely attributed to the depreciation of the currency rather than to the irresponsibility of domestic policies and pressure groups.