

The European and International Currency Problem

It is often argued that the crisis of the international monetary order founded at Bretton Woods is acting as a catalyst in the process of European monetary unification. Equally frequently, the opinion is voiced that the mounting disorder into which the Bretton Woods order has drifted is hampering that process and, sooner or later, will finally wreck the whole E.C. construction. Since it is difficult to prove either of the two opinions wrong, it is likely that each contains a grain or two of truth, as we shall see.

1. - Internationally, just as domestically, a primary function of money is to be an allocator of resources, i.e. a regulator of the demand for the same with a view to securing equilibrium with supply, that already in existence, as well as that actually and potentially forthcoming. But if we have a scramble for resources, then money is malfunctioning.

Domestically, unsound money makes the resort to administrative controls a necessity: controls on prices, rationing, etc. In the end, a situation may emerge not much different from the wholly planned economy, in which decisions as to the things on which to spend income and how much of it should be saved or spent are no longer taken by income earners themselves, but by the planning authorities — at the limit by means of distributions of coupons.

A failure of money to discharge internationally its function of allocator of resources is apparent when the system is generating excess "liquid" assets, thus putting in the hands of residents of reserve-currency countries, and deficit countries generally, more claims on resources, both flows and stocks, than surplus countries are able or willing to depart with.

This also will lead, in the absence of policy changes and/or correctives applied through the price mechanism, i.e. through exchange rate changes, to a growing panoply of controls. As usual, the starting point will be controls on capital movements. Next, or even together, will come tourism and other "invisible" transactions. Finally, trade transactions and their conditions will be affected, the danger looming especially big now that disequilibrating capital movements take largely the form of leads and lags on commercial payments.

As it was, the sudden realisation that what used to be a true world currency, unconditionally accepted for short- and long-term capital transactions among third-country residents, for private settlements across the exchanges, for official intervention purposes and for settlements among central banks, might after all no longer be such, has produced a mixture of administrative controls and of exchange rate flexibility. That mixture is far from ideal, due to the element of surprise, and (formerly) to the basic distaste of the authorities for flexible exchange rates.

2. - The erosion of the status of the dollar as an international currency is more directly ascribable to the failure to regulate its supply in a fashion consistent with its international role. This, of course, is not meant to imply that the U.S. authorities in regulating money supply should give priority to the needs of the world economy over those of the American economy. But the conflict was and is there because the United States and that part of the world which adopted the dollar as its monetary link do not comprise an optimum currency area. Furthermore, the excess supply of dollar liquidity has not been in its entirety U.S. generated. The Euro-markets being unaffected by the regulations which apply to money creation denominated in local currencies, have grown into a large source of dollars located outside the United States. Because the dollar was the vehicle currency in international payments and loan transactions, non-American banks could get a share of the business, and thereby prevent a monopoly by the banks of the country issuing the vehicle currency, only by "adopting" the dollar. What is still more relevant to the argument of this paper is that the *Euro-market system gradually has also broken the monopoly of the reserve-currency country as far*

as the issue of the international currency is concerned; it has enabled a sort of extra-territorial monetary power to issue that currency. This has, of course, added to the difficulties of keeping the supply of international currency under control. All the more so, since the Euro-markets could, and would, create it in response to the needs of *any* deficit country.

Efforts to curb the extraterritorial money-creating power have fallen short of what was needed. Also, the attempts to impose a balance of payments constraint on the reserve-currency country, which were meant to lead to a fall in the U.S.-generated dollar supply to the rest of the world, have had a result different from what was expected by those who were most determined to impose it. For the U.S. reaction has been to escape that constraint by formally cutting the link between the dollar and gold — and, indeed between the dollar and any other "external" monetary asset. This has swept away any sort of actual or potential monetary obligations for the United States. The readiness in principle to sell gold at a fixed dollar price justified the technical asymmetry which, under the Bretton Woods system, exempted the United States from intervening on exchange markets in support of the dollar rate in terms of other currencies, and yet it conferred to the dollar the status of a fixed-rate currency. Once that link was cut, the dollar was put on a floating rate basis to the other currencies, even before floating actually started.

3. - Actual floating started at the initiative of European countries, which were left virtually with no choice by currency speculation. The latter was quick to realise that the situation had undergone a fundamental change. *A sound international currency is needed to make sense of the fixed exchange rate system*; the fact that in principle the dollar was no longer on a fixed rate basis was an unmistakable sign that its deterioration had gone beyond the point compatible with its international currency role. The "flight" from the dollar would be all the more precipitate since under floating rates an international currency is less needed.

In fact, it was not just private speculation to sense the danger, if the Deutsche Bundesbank in its latest annual report could venture the guess that between 1972 and 1973 the DM has come to occupy second place as a reserve currency. Several countries,

which under a generalised floating rate system would have to peg their currency to that of a leading industrial country (or group of countries), and/or happen to hold, and to be earning, large amounts of foreign exchange have switched from the dollar into the DM and other European currencies, thus shifting on to the countries issuing those currencies the risk of the dollar exchange rate, which their liquid external assets would otherwise have carried.

If that risk is as large as it is today, this has happened in part at Europe's doing. In their quest for notional symmetry, which reflects their aspiration to be on a footing of equality with the United States — an aspiration which only European unification can truly fulfil — the Europeans insisted in December 1971 that the structure of exchange rates should be adjusted by also having the U.S. authorities devalue the dollar in terms of the international numéraire. They carried the day, thus proving the point that all currencies can be weak and vulnerable. But, in a sense it was a Pyrrhic victory for it "forced" upon the United States notwithstanding its special position of reserve currency country, i.e. of large debtor country, the freedom to use exchange rate changes just as any other country. The United States took advantage of that freedom last February when they further devalued the dollar, unilaterally to all practical effects. Since the Germans, and the Europeans, had thought that the Smithsonian exchange rates suited them, and would produce equilibrium over the medium run, they might have wanted to hold out and buy the dollars offered. It cannot altogether be ruled out that their determination might have overcome speculation. But they learned that after December 1971 their determination to preserve a given rate structure, likely to bring about payments equilibrium, was not sufficient to avoid huge exchange losses on the dollars pouring in. The outcome has been that most European countries have been under a constraint to float upwards — or to declare outright revaluations — every time that the dollar inflow was, or threatened to become, large.

A reserve currency may with luck and ability survive the severance of the link to an ultimate monetary asset — be it gold, SDRs or whatever — but in can hardly continue to be spontaneously held in the very large amounts (often) posited by fixed exchange

rates if the reserve country, i.e. the debtor country, can at its own initiative, or unilaterally in any case, slash the value of those holdings in terms of third currencies. *The initiative of the reserve country in changing the exchange rate of its currency, the reserve currency, has magnified the risk of exchange losses, by putting that risk definitely beyond the control of creditor countries.*

4. - The outcome has been that, in addition to the dollar's official inconvertibility since August 1971, its market usability has been more and more restricted. European countries have had to erect one fence after the other against inflows of *dollar liquidity*. Had there not been a wide resort to exchange rate flexibility in some form, European countries might have found themselves in the necessity of accepting payments in dollars for current account transactions *only*.

Controls tend to beget controls. All the more so in our case, since the dollar in its Euro-market variant has become over the years so large an element of the intra-European monetary and financial scenario. Indeed, it is *through* the dollar that national money and capital markets in Europe have been linked to one another. Similarly, currency convertibility and multilateralism could be enjoyed to a very high degree because the multi-currency system found in the dollar the common medium of intervention and settlement.

A common monetary medium is essential to multilateralism and convertibility. Thus, the E.C. in its efforts to reduce dependence on the dollar in the sphere of official operations has had to find a substitute for it: namely the European monetary unit of account. But the E.M.U.A. is unfortunately a weak surrogate, since it cannot be used for intervention purposes. Having largely dislodged the dollar as intervention currency, interventions for maintaining intra-E.C. margins (and parities) are conducted in all national currencies. This means that debit and credit positions arise in the first place bilaterally, with respect to both the currencies and the banks issuing them. The intermediation of the European Fund for Monetary Cooperation by means of the E.M.U.A., such as it now stands, cannot wash away altogether that "original sin". Multilateralisation of settlements and debit/credit positions is not complete; an intricate complex of regulations and a watertight "cloisonnement" of the Fund's operations are needed.

5. - The retreat from the dollar as the intervention currency may have a decisive influence on the process of European monetary unification if in order to fully multilateralise intra-E.C. official monetary transactions the E.M.U.A. is transformed into a fully-fledged instrument for finally settling official balances and a common medium of intervention. But, to become an intervention medium, E.M.U.A. assets would have to be created and made available for negotiation in the markets. In other words, the E.M.U.A. would have to be transformed into a currency to be used also by the private sector. Unless an adequate *market* substitute for the dollar is found, efforts to shut out the dollar through administrative controls may in the end affect the integration of national money and credit markets in Europe. Controls are difficult to apply; even more so when discrimination is to be allowed for. To the extent that discrimination in favour of E.C. currencies proves feasible, the result is likely to be that one E.C. currency (a few, initially) will replace the dollar. If the dollar was really to be discarded, the choice would lie between "adoption" of one of the national currencies — and the creation of a truly European currency.

6. - The awareness that administrative controls could not (and should not) be relied upon alone to stem the inflow of dollar liquidity is a main reason behind the decision of the European countries to float. Here, again, we find that as a result of the difficulties arising from the crises of the old international monetary order, E.C. countries tend to draw closer together in currency matters.

The German Federal Republic was first to experiment with currency floating, as early as May 1971. It soon found, however, that floating could be of limited use to a single country, even if that country was the largest E.C. partner in terms of foreign trade and gross national product. Whereas the *monetary* problem arose with the United States, the remedy in the form of an exchange rate appreciation would adversely affect its trade position. Being *monetarily* integrated with and through the dollar, but *commercially* integrated with one another, the E.C. countries have found it awkward to use *other than collectively* the exchange rate weapon, even when an appreciation of their currencies against *the dollar* was clearly overdue.

On the other hand, the defence of parities against capital

movements seeking to bring about revaluations or devaluations of single currencies has proved difficult, even when those parities were appropriate for purposes of medium-term equilibrium. Currency speculation has carried the day against the currencies which have appeared to be the strongest (or weakest) link in the exchange rate chain. By successfully attacking one currency after another, "footloose" funds have reaped several large bonuses in a short period of time. The appeal of swift, speculative raids has extended to sectors and people, who normally would not indulge in that sort of activity.

7. - These are some of the reasons, which made the majority of E.C. member countries to accept *joint* floating last March. Joint European exchange rate movements, identical in size and direction for all member currencies, would not upset the competitive position for most of an E.C. country's trade in goods and services. They would cut down the scope for currency speculation enticed by the self-fulfilling expectations of revaluation (or devaluation) of a single currency.

But the determination of European countries to act as one in exchange rate matters, could not elude the fact that the European economies are only semi-integrated; their national propensities to inflation differ; and so does their ability to reconcile fast economic growth with monetary stability. Therefore, European countries need to pursue somewhat different economic, monetary, budgetary policies, which do not leave unaffected the conditions that make a given exchange rate sustainable — and, for that matter, do affect those conditions in a way that will justify exchange rate changes different for some of them in size, and perhaps direction too.

In other words, Europe does not comprise yet an optimum currency area. I argued this point in a paper which I submitted to a meeting of the List Gesellschaft in Basle, in February 1972.¹ I pointed out, then, that in a very meaningful sense the E.C. comprises two, possibly three optimum currency areas, and that the problem of Europe's monetary unification could be described as

¹ "The Theory of optimum currency areas and European monetary unification", printed in *Floating - Realignment - Integration*, Proceedings and Papers, 9th Colloquium of the List Society, J.B.C. Mohr (Paul Siebeck) Tübingen, 1972, pp. 167-191.

one of defining and accepting a path which would allow the regrouping, exchange-rate-wise, of the present national monetary domains into two-three areas, and eventually the merging of those areas into one. I also suggested that the path might be found by issuing a new European currency which would steer a middle course between some appreciating E.C. national currencies, and those which would depreciate.

In the light of the foregoing, one might say that the decisions taken last March to let a group of E.C. currencies float jointly, the others individually, came as close to a rational arrangement as could be hoped for under the circumstances. This statement, however, needs a very important qualification; namely, that the approach is doubly lop-sided. Not only it emphasizes monetary union while unduly relegating into the background measures which belong to economic union; but within the monetarist approach itself, unification is made to hinge on a common exchange rate discipline —and little else.

The inconsistency is that exchange rate policy is elevated to the rank of a Community objective, but the results flowing (at least partly) from striving for that objective, i.e. the gains and losses of reserves following upon the acceptance of a common exchange rate policy, continue to be national gains and losses, not the Community's or the exchange-rate union's as a whole. This means that a Community objective is sought without the creation of a Community instrument. *The pooling of dollar reserves should indeed be seen as the indispensable, immediate instrument for implementing the Community's exchange rate policy.* Reserve pooling is immediately related to this latter.

In order to possess market credibility, the possibility of opting out should not be envisaged. Reserve pooling should be irreversible. Moreover the utilization of the pooled reserves, in support of a member currency, should not be related to the amount paid into the pool by the country in need of support. To make access to the pool automatic within the national quota, while virtually barring it for any amount in excess of that quota, would make reserve pooling almost meaningless. Access to the pool should instead be regulated by the European Fund appraising each case on its own merits, and having regard to the internal and external equilibrium of the Community as a whole.

Reserve pooling is not acceptable to (structural) surplus countries, and would not make much sense anyway, without a measure of harmonisation of economic and financial policies. But to oppose the pooling on the grounds that harmonisation has not gone far enough, nor does it promise to improve in the second stage of E.M.U., is tantamount to saying that policy harmonisation is not sufficient, in retrospect and in perspective as well, to warrant the present E.C. exchange rate agreement. On the other hand, the pooling of reserves should also give Community institutions the power to make policy harmonisation effective. Effective policy harmonisation is, or rather should be, the Community instrument for buttressing the exchange rate union over the longer run, as full economic integration with more uniform inflationary or anti-inflationary propensities is attained. Without policy harmonisation, joint floating which is now being resorted to for facing disturbances from without, would eventually break down under the tensions from within. But the results in terms of reserve losses and gains will still need to be, *then and now*, losses and gains of the Community as a whole. Reserve gains by some member countries, which are the result of joint floating, should accrue to the European Fund as such; the latter would finance reserve losses of other member countries, arising under that exchange arrangement. The exchange risk on *acquisitions* of reserves should be borne collectively, as a counterpart to the collective ownership and use of the same.

8. - The absence of a meaningful arrangement concerning reserves has been a main reason why joint floating has not withstood its first test satisfactorily. Joint floating is perhaps not a wholly self-explanatory locution. It obviously implies that a number of currencies are floating in terms of something external to them; but, no less important, it also means that participating currencies have locked their parities together. It is this latter element of the mechanism which is relied upon to defeat speculative assaults against one currency in isolation. When one currency alone devalues, or revalues as the DM did last June, intra-group parities are unlocked. The more you unlock them, the less credible and the less effective the joint floating agreement. A "floating snake" which under the impact of speculative attacks is unable to keep parities locked together is as useful as to front-seat car passengers would be inertia reel safety belts which did not lock under sharp braking.

If the foreign exchange that was pouring into the Federal Republic of Germany last June had been conferred to a Community pool, the inflow as well as the attendant exchange risk and liquidity creation² would have been diluted over the whole Community area; they would thus have weighed less on any single member country; the Community would have behaved as one entity. Had that not been sufficient to discourage speculation, it might have decided an equal appreciation for all currencies, thus safeguarding the joint float commitment; and it would have made this technically possible also for the weaker-currency countries because the foreign exchange, which initially had bought the strongest currency, would have been available for supporting the weaker currencies.

The decision to float jointly was important because participating countries might have represented an archipelago of stability in the rough seas of currency speculation. This might have been so, even though not all E.C. member countries participated in the arrangement; at any rate, speculation against two major world currencies would have been kept at bay. In fact, monetarists may be wondering why the arrangement could not be made to cover, under the present conditions of excessive external liquidity overall, the pound and the lira. They may have found it disconcerting that in a group of countries committed to monetary and economic union one had to put up the price of its currency, the DM, in order to stem an inflow of foreign funds, while another was borrowing the same on the Euromarket in order to prevent a further depreciation of its currency, the lira. Such happenings are not exactly indicative of progress towards union.

9. - The "economists' view" predictably will be different. As hinted above, it will be argued that as long as the economies are not fully integrated, the one hundred per cent locking of parities is premature. With different national propensities to inflation, one would have a case of uniformity in cost and price trends (which

² Concerning liquidity, I am assuming that the foreign exchange flowing into the strong-currency country would be presented for conversion to the European Monetary Cooperation Fund which would issue against it a common European currency. I am also assuming a Community-wide market for that currency and fairly free interconvertibility with, and of, national currencies. Finally, the rudiment of a European money supply policy, with the common European currency as an incipient component, would be required.

is required *in principle* by fixed parities), *versus* uniformly high employment trends. Last June, it perhaps would not have been sufficient to potentially turn over to Germany's "snake" partners the foreign exchange which was pouring into the country, in order to convince them to let the "snake" creep upwards. That would not have allayed their fear, though perhaps misplaced under the circumstances, that the creeping snake might depress levels of employment and economic activity at home (while helping to curb the flood of funds and inflation in Germany).

In the last analysis, the "economists' view" points to the drawbacks of a process of monetary unification, which is being pursued largely in response to challenges coming from outside.

10. - Another aspect of the international monetary problem which has put obstacles on the path to European monetary union has to do with gold. Had there not formed so huge a discrepancy between the official and market prices of gold, had not gold become frozen, the E.C., in trying to lessen its dependence on the dollar, and yet unable to create a common currency of its own, would have had a common monetary medium freely available for use in intra-E.C. settlements.

Recent experience has shown that the world is not quite ready to do without gold. Notwithstanding the latter's weakening potentiality as a monetary instrument, it is still felt by many (but perhaps not the majority) that a *deus ex machina* is needed to impose monetary and financial stability, just as in some countries the monarchic institution is thought to underpin the stability of the social fabric. But recent events have also made highly unlikely that gold be reinstated fully in its former position. Changes in the monetary and financial environment, as well as the growing industrial, technological and political influences on gold trends, have made it exceedingly difficult to fix an official price, and maintain it. Also the notion of an official price becomes less relevant under floating rates.

While gold's role as numéraire in the system has probably ended, it would be rash to conclude that gold cannot fulfil some useful role. Gold has not altogether lost its outstanding moneyness for central banks, nor for individuals; for some of them, it may represent under circumstances a *reserve of freedom* and a *brake on arbitrariness* and mismanagement. Since plans to endow the E.C.

with a money creating function of its own, have not as yet overcome the objection that they would fan inflation, whatever braking powers gold still possesses might be built into a E.C. monetary mechanism. More specifically, I am envisaging *a mechanism in which countries against the deposit of gold as collateral, would automatically be credited by the European Fund with amounts of European monetary units of account* (or common European currency), which would be determined on the basis of criteria taking into account, from time to time, factors such as the free market price of gold, the overall economic and monetary situation in the Community, its payments position vis-à-vis the rest of the world. Countries would be able to recover the possession and free availability of the gold deposited only by reimbursing the E.M.U.A.s. received; but they would be under no obligation to do so at any particular time. In order to avoid inflationary duplications, gold deposits would not be included in member countries reserves, which only would show freely available gold.

In the arrangement here suggested, gold is plugged back into the monetary circuit without running into the political difficulty of raising its official price, and the conceptual difficulty of *fixing* just any price under the conditions now obtaining. Indeed, there is no need of determining a "price" as such, because there is no transfer of ownership. There is, furthermore, no physical circulation *between* central banks signatories to existing international monetary agreements, but between a central bank and the European Fund, an institution *sui generis* trying to develop an autonomous monetary function in the E.C. by issuing its own, new monetary units in a variable ratio to gold deposits. This monetary function, coupled with the existing credit facilities as will be revised, following the decisions taken at the Paris summit meeting last October, are necessary to the E.C. exchange-rate union.

II. - The foregoing has perhaps shown that the monetary and exchange disturbances internationally have not been an unmixed blessing for the building of Europe's monetary and economic union. That being so, it follows that internal factors will play a decisive role in the failure or success of the enterprise, not least by turning against, or in favour of, it the unfolding international events.

We have thus a further, important reason for concentrating our attention on the internal aspects of monetary *and* economic union. In what follows I shall dwell on the link between the two, and on one or two important points which descend from it.

As I have already hinted, European monetary unification is being pursued largely as a means of regaining European control over monetary conditions in Europe. The recovery of monetary sovereignty *through union*, would again give Europe the power to pursue an autonomous monetary policy. But, which policy?

To answer this question, we need to recall the fact that monetary policy and instruments (including exchange rate changes) are available to monetary authorities in order to attain aims lying mainly in the sphere of stabilisation policy (but also in other fields). Stabilisation policy, in turn, is part of overall economic policy and strategy. Thus, monetary policy, which has held such a prominent place in the arsenal of weapons used in the postwar period for stabilisation purposes, is instrumental in achieving the objectives of governmental economic policies. *If the role of monetary policy, important though it is, is subordinate to overall economic policy objectives, monetary union cannot be regarded as an end in itself; nor can it be conceived of as feasible outside the wider context of economic union.*

Measures of *monetary* unification need to be appraised with reference to their implications for the union's broad *economic* policy objectives. I take it that, as far as those objectives are concerned, the union would behave in much the same way as individual member governments and countries. It has been a distinctive feature of the post World War II period that governments have clearly acknowledged their responsibility to secure full employment and economic growth in their respective countries.

In my opinion, looking at the order of priorities from the Community standpoint, the main qualification to be made is that more attention should be paid to the business cycle's changes *in space*. After all, the process of integrating the economies is largely one of re-arranging the allocation of resources and the location of productive activity throughout the union's territory as a whole. Hence, the bodies which are primarily entrusted with the task of promoting integration ought to recognise their special responsibility for growth balanced through space, while cooperat-

ing with national governments in order to stabilise the business cycle over time.

Monetary unification should be pursued in a fashion consistent with a European policy of balanced growth. The Basle agreement, which foresaw the transfer of gold at a price that happened to be lower and lower vis-à-vis gold's market value, was not likely to work in the direction of balanced growth, because it would have inflicted windfall losses on the deficit (weaker) countries and given windfall profits to the surplus (stronger) countries. That is why the said regulation was a source of trouble and became obsolete so quickly.

12. - As long as the ability to sustain the process of economic growth in a context of monetary stability differs from country to country, a mechanism of monetary unification should be chosen which would not hinge on one hundred per cent freezing of parities. A rational approach would be to grant member countries an option of limited intra-E.C. flexibility of parities, while floating *erga extra*. That option would be regulated according to a presumptive "schedule of flexibility", so as to gradually reduce the size of the parity changes allowed during any given period. The progressive narrowing down of parity changes, hand in hand with progress towards economic integration, would eventually lead to completely fixed parities and exchange rates. This, together with the early introduction of a common European currency, would place progress towards monetary unification, in the transitional period already, on a less volatile basis than would a commitment not to change parities other than in accordance with some agreed procedures, as it has been suggested by some.

The need to retain internal flexibility will be less strongly felt inasmuch as sufficient progress is made towards a European policy of growth. The built-in link between monetary unification and the growth process is not only the result of the renunciation to use on a national basis such instruments as exchange rate policy, exchange controls, credit policy and ultimately demand management. The link also is there because the process of monetary unification, even before it leads to the use of one currency throughout the whole area, will tend to strengthen considerably the automatic factors which push *open* national economies towards economic integration.

Re-invigorated automatic mechanisms, such as the push towards pay parity throughout the Community's territory, will tend to weaken further the position as industrial location of regions and countries, where productivity is lower and grows slowly. Regional problems would be aggravated and monetary unification itself would be jeopardized, in the absence of a meaningful Community policy of balanced growth.

The implementation of such a policy would not necessarily mean that one would be ossifying a given territorial pattern and structure of production and investment activity. The process of economic integration would not have much meaning *if it did not bring about changes*. A development policy would have to be geared to the needs of fairly large areas in order to allow a meaningful choice between suitable and unsuitable industrial locations. On the other hand, one should not overlook the fact that geography has become less relevant as a determinant of industrial locations. As far as these are concerned, a weightier influence appears to be attributable to *ad hoc* policies pursued by governments and/or local authorities; and, at the other end of the spectrum, to a sort of inertia which preserves the power of attraction of old-established industrial centres long after the causes, which initially made industry settle there, have subsided.

To conclude on this point: monetary unification and monetary measures generally are not neutral *sub specie regionis*. They have an implicit regional effect connected with (a varying degree of) industrial and economic specialisation by the regions. Whenever that effect is not consistent with a European policy of balanced growth, differentiated policies should be pursued as far as practicable under the "schedule of flexibility" agreed upon for intra-E.C. parities, and/or offsetting Community policies should be enacted in fields which more properly belong to economic union.

13. - As Europe's monetary sovereignty will not be regained without *costs*, we should make sure that it is put to good use, by implementing a European policy of growth within the framework of monetary and economic union.

Those costs will be assessed to be high or low depending largely on the opinion different people hold as to the outcome of the current international monetary crisis. Those who believe

that, were it not for Europe's outburst of monetary assertiveness, it would be possible to restore the *status quo ante*, will tend to assess those costs rather high. Those who do not believe in the possibility of restoring the old order anyway, will argue that at most it is justified to speak of "costs of transition". What is paramount in their view is to make sure that the transition leads to a viable new system.

The former group of people seem to argue somewhat along the following lines. The appreciation of the yen, the DM and other European currencies since December 1971 has gone a long way towards restoring U.S. price competitiveness. The impact on trade flows is not quite apparent, due to the perverse effects of a protracted J curve. If the U.S. succeed in subduing inflation, at least the competitive edge implicit in present exchange rate relationships would be kept; it would again give the dollar the healthy look it needs in order to regain its former role. True, this would still not entirely dispose of that element of instability represented by existing dollar balances. Notwithstanding the loss in purchasing power due to world inflation and in foreign currency content due to exchange rate changes, dollar balances remain high. An arrangement is needed for dealing with them. And perhaps not so much a form of consolidation, which would mainly apply to the balances that are anyway firmly held. Rather, an arrangement which offered the more volatile dollar holdings a measure of security as to capital values, and/or some form of market incentive might — it is felt — do the trick. Moreover, consolidation should apply to the creditors as well as to the debtor; in other words, it should aim not only at protecting the latter from the risk of massive requests of conversion, but also at mopping up excess liquidity. Thus, it would be possible for the United States to restore the convertibility of the dollar. On a limited basis, at first; but, if agreement was reached on a substantial revaluation of gold or a dramatic turning point was passed in developing the SDRs, convertibility of the dollar might be unconditionally restored, at the outset already.

The said group of people believe that the solution of the dollar problem holds the key to the solution of the international currency problem. The new health of the dollar would make it possible to restore fixed exchange rates all round. In other words, a return basically to the Bretton Woods system, with a less rigorous

application of the fixed parity principle than it has received in the past.

The recovery in the official status of the dollar would give a new boost to its market power. An unparalleled banking and financial infrastructure underpins it around the globe, including Europe. The E.C. would have a respite. After all, orderly exchange markets and credible parities all round, would also make the maintenance of fixed intra-group parities easier. The threat of a relapse into national controls on money and capital markets would finally recede. The process of institutional and operational integration of those markets would quietly go on. Europe would still not be able to dispense with the dollar; but one or two European currencies would see their role increase within the Community, and probably outside it, as junior partners in a sort of monetary crop-sharing with the dollar.

Official monetary unification would for the time being cease to be considered the catalyst of progress towards a united Europe. The emphasis would shift towards non-monetary matters. In a wide-ranging number of fields, from the protection of the environment against pollution to social policy, industrial relations, research and development, territorial planning, income and wealth distribution policy, there is ample scope for a common European approach.

Clearly, this is not a dramatic hypothesis; to many people it is a desirable and plausible one. In my view, however, its plausibility owes more to the difficulties of forming a European monetary union, due to wrong attitudes, than to the ease with which the old monetary order can be restored.

14. - In appraising the chances for the restoration of the old order, one should not overlook the *changes* which have taken place in the last quarter of a century both among countries and within them. *The international monetary upheaval technically is attributable to a failure to control money supply nationally and internationally; but it basically is a semi-controlled process of adjustment to those changes.*

Internationally, the main development has been the powerful economic and financial comeback of Europe, following a decline which had lasted nearly uninterrupted from the outbreak of the first World War till after the end of the second World War.

This, coupled with the meteoric industrial growth of Japan, has meant a decline of the U.S. economy from the position of undisputed dominance which it enjoyed when the Bretton Woods system was shaped. The more balanced distribution of world economic power was likely to affect anyway currency arrangements, fostering their evolution towards a polycentric monetary system.

The need to revise the international monetary system has been felt with compelling urgency also because of the difficulties which the United States have met with in their attempts to regulate the *domestic* cycle. Those difficulties are no smaller in the United States than elsewhere; and may make necessary a convergent use of all instruments. Exchange rate changes have entered the U.S. arsenal in order to enlarge, indeed, the number of available instruments, and as a result of a searching re-appraisal of costs and benefits connected with the reserve-currency function. The latter was distinctly beneficial to the reserve-currency country when other countries adjusted their economic and financial policies to the United States policies, because it suited them to do so.

In general, if the reserve-currency country predominates in the world economy in as paramount a way as the United States did during the forties and the fifties, or the United Kingdom up to 1914, the reserve-currency role will bring the reserve country *a)* profits from seigniorage and financial intermediation and *b)* very likely, macro-economic benefits. The chances are also that the system will on balance be beneficial to other countries.

But when the dominant position is shaken to the point where the business cycle gets out of phase and diverging trends develop in different countries, the monocentric reserve-currency system is likely to be damaging, and therefore unacceptable, to all concerned. Thus, European countries have found it increasingly difficult to adjust their policies to those pursued in the United States, as the latter's economy declined in relative terms and developed destabilising tendencies. For the reasons hinted at above, they also found it awkward, till recently, to adjust their exchange rates with the dollar.

15. - This set-up has had deflationary implications for the U.S. economy: automatic ones, as the U.S. trade balance tended to deteriorate; and policy ones, as other countries asked the United States to go back to the higher standards of monetary and financial discipline upheld in the past. The U.S. policy has been to try

to reform the international monetary system in a way that would eliminate those implications, and therefore the macro-economic costs of the reserve-currency function. If (a small number of) persistent surplus countries could be made to revalue promptly, when necessary, there would be no need on balance of payments grounds to deflate domestically and/or to devalue the dollar. The dollar would stay put in terms of the vast majority of currencies; its international currency role would again be both possible and profitable.

However, the underlying economic conditions have changed, the U.S. economy no longer weighs in a dominant fashion, countries find it more difficult anyway to master economic trends at home, and the technical conditions for running a dollar system are not as favourable as they used to be. These and other circumstances tip the balance in favour of the regionalisation of the international payments system.

Of course, regionalisation is being slowly achieved, partly as a "spontaneous" process. Some purposeful action may be however required on the part not only of the E.C., but also of the United States. A number of countries would foster their process of development and growth through increased integration with the American money and capital markets. For those countries the dollar would still be a suitable vehicle of financial intermediation. To the United States would accrue the rewards of the financial intermediation services; but they would be in no need to sacrifice the autonomy of their monetary policy.

In sum, more thought should now be given to the problems of organising regional monetary areas. The E.C. is addressing itself to that sort of problems and the experience it is making shows how complex they can be; each potential monetary area would have to solve problems of its own. Once progress is made towards solving the *internal* problems of regional monetary areas, the task of regulating monetary relations *among* areas with floating exchange rates in an auxiliary role will be greatly simplified.

16. - The acceleration of inflation, and the fact that markets have in the past few months tended to "overcorrect" exchange rate disequilibria have elicited rash judgments against floating. But, of course, to explain the inflationary explosion would help (rather than floating rates) the previous twenty years or so of

creeping inflation, the lagging supply of raw materials and foodstuffs, which is partly the result of long-term policies aimed at fighting a supposed structural excess in supply, as well as the failure to regulate the supply of the international currency and of the local ones.

Floating exchange rates are indeed performing the role of "defusing" the potential of disturbance represented by the dollar and other liquidity created through official and market mechanisms, under the old monetary set-up. *If monetary disorder prevails domestically in the reserve-currency country and in other leading industrial countries, it does not stand to reason to expect fully stable exchange rates, whether the system chosen is (nominally) fixed rates, or flexibility, or floating.*

Of course, international monetary arrangements can themselves be biased towards stability or instability, both externally and domestically. But, then, the experience made so far by countries which have been floating, seems to show that the authorities and the public react more promptly to a depreciation of the exchange rate, than under the former system they used to react to a fall in reserves, often made good by international financial assistance. Reaction to depreciation, and to policies leading to it, has come also from trade unions, concerned at the fact that following the increase in import prices, the whole system of domestic prices tends to rise, thus stultifying their efforts to increase real wages through money-wage rises.

Furthermore, floating has generally been approached with some half-baked principles in mind: for instance, the "principle" that, for floating to be clean, no official intervention on exchange markets should take place. It is surprising that such a "principle" should have remained unquestioned for so long. For, clearly, *a pledge not to intervene on exchange markets amounts to forgoing the use of the exchange rate instrument.* The use of that instrument is forgone, of course, under a fixed rate system. But fixed rates have not been repudiated in order to put that instrument squarely in the hands of the market, and its occasional whims; through more or less wide gyrations, the market would possibly secure equilibrium over the longer run. But, if governments are concerned with the stabilisation of the price of bread, or of the hamburger, how can they stand aloof when it comes to influencing the price of their currency, i.e. of all that they buy

and sell abroad, in view of the far-reaching implications for their economy and society?

"Clean floating" had better be defined as one in which governments implement that mix of general economic policies and of technical measures, including interventions on exchange markets when necessary, best suited to make the exchange rate move in the direction which will help to attain the sort of balance of payments equilibrium *agreed upon internationally.*

Another half-baked "principle", which has been a nuisance during the initial phase of floating, has been the assumption that with floating rates there is less need and scope for international cooperation and concertation in this field. Now, oligopolists know from experience that it is easier to agree on a common price that is fixed, rather than on a price that keeps changing at short intervals. Fixed exchange rates are fixed common prices for the world's currencies; floating rates, "administered" moving prices; hence, the latter require a more continuous exercise in international cooperation.

17. - The frictions unavoidably produced by the process of reform of the system towards a polycentric structure, have put a strain on international economic and monetary cooperation just when cooperation needed to be strengthened, in order to meet successfully the new challenges. But, international cooperation must not be misdirected; if it is to be successful and beneficial, it should address itself to the real problems and the new solutions they need. The repeated attempts to restore the monocentric reserve-currency system and the all round obligation to maintain fixed exchange rates are reminiscent of the efforts which were made in the twenties to lower the level of world prices in order to restore the pre-World War I currency parities with gold.

Now, as then, misdirected endeavours would be sterile, and damaging.

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