Alternative Exchange-Rate Systems: A Rejoinder

1. - *Introduction*

Professors Goldstein and Cohn have, in their paper, made a valuable addition to our earlier analysis. They have examined one of our three reasons for supporting a regime of sliding parities, namely, that a system of fixed exchanges is likely, under certain conditions, to insulate the rest of the world (ROW) from a disturbance originating in a given country.[1] Because of this *and* two other propositions, we had concluded that short-run fixity and long-run flexibility in exchanges had desirable properties. We argued that while these properties may not be sufficient to establish the superiority of sliding parities, they are very important in assessing the merits and shortcomings of alternative payment systems. In their paper, Goldstein and Cohn exhibit empirical evidence which does not favor either fixed or floating rates in dampening the effect of a domestic disturbance to the ROW. From this result, they argue for "reasonably clean floating rates".

2. - *The Modigliani-Askari Propositions*

Goldstein and Cohn state our three basic propositions, but choose *only* to embody the one regarding the propagation of disturbances to the ROW in their conclusion in favor of floating rates. Our three arguments were in summary as follows (Modigliani and Askari, 1973, pp. 296-297):

(i) The international transfer of capital is desirable in so far as it tends to equalize social yields via the movement of *real* resources. In a world of wage and price rigidities when countries insist on the ability to pursue domestic stabilization policies, this transfer cannot be achieved by having only high mobility of private capital but it must be accompanied by appropriate changes in the exchange rate. Thus gradual changes in exchange rates are desirable in order to equate social yields. On the other hand, short-run speculative capital movements can be reduced by short-run fixity of exchange rates. These arguments lead us to a system of sliding parities for achieving the transfer of capital indicated by differences in social yields.

[1] This result is opposite to the conventional view; the reason being that the traditional view assumes away the existence of capital flows.

(ii) Fixed exchange rates (as compared to floating rates) tend to dampen the international propagation of cyclical disturbance in domestic demand. This is because fixed rates impose on the disturbing country a behavior pattern which reduces its impact on the rest of the world.

(iii) Fixed exchange rates give the disturbing country the incentive to respond to the initial disturbance with policies which are both stabilizing for itself *and* for the ROW; but under floating rates, the disturbing country 'd benefit by following policies which further destabilize the ROW.

Goldstein and Cohn agree wholeheartedly with our first point. But they do not take its full implication into account in their recommendation of a given exchange system. Namely, they agree that to transfer real resources, in a world of widespread wage and price rigidities, a system with appropriate adjustment in exchange rates is required. However, real transfer of resources is *only* desirable *if* the surplus in question is of a long-term and permanent nature; in other words, if the changes that occur are of a significant structural kind. But if the surplus is cyclical in nature, then, as we concluded in our paper, it is best absorbed with *domestic* fiscal policies. That is, there is a cost associated with the cyclical transfer of real resources. Therefore, from this first proposition, our natural recommendation was a system of sliding parities which mitigates cyclical movements but facilitates the long-run transfer of real resources.

In our third proposition, which Goldstein and Cohn partially accept, we again favor a system of sliding parities: short-run fixity, a feature of sliding parities, would lead to domestic policies which are stabilizing for *both* the disturbing country *and* the rest of the world.

Goldstein and Cohn, on the other hand, empirically examine and utilize *only* our second proposition in reaching their recommendation. Furthermore, even *their* empirical result does not favor a floating over a fixed system in reducing the degree of propagation of domestic disturbances to the ROW. It is, therefore, curious that they, on the basis of an inconclusive empirical test and neglecting our third proposition, would propose a system of floating exchanges.

Finally, although it is true that our second proposition needs empirical verification, the empirical test carried out by Goldstein and Cohn is in many ways inadequate. First, it is difficult to understand the theoretical meaning of a "trend" in the exchange rate under a floating system; thus, its inclusion in their simple equation is open to question. Second, their equation is clearly subject to the possibility of two-way causation; as such, the estimates have little interpretative power and meaning. In short, a more complete system with other variables and proxies is needed to test the empirical validity of our second proposition.

3. - *Conclusion*

Professor Goldstein and Cohn make a valuable contribution in testing the empirical validity of our second proposition regarding the propagation of economic disturbance to the ROW. But the usefulness of the results is

somewhat limited by the simple model that they use. As such, further tests are warranted.

More importantly, they have not shown any reason why our other propositions would not lend some support to a system of sliding parities. Thus, given their limited and inconclusive empirical test coupled with their agreement on our other propositions, we cannot as yet share in their recommendation of floating exchanges.

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REFERENCES

FRANCO MODIGLIANI and HOSSEIN ASKARI, "The International Transfer of Capital and the Propagation of Domestic Disturbance under Alternative Payment Systems", in this *Review*, No. 107, December 1973.