

In Search of an Exchange Rate Policy for the Dollar

In 1971, the Bretton Woods system of fixed exchange rates or par values collapsed. No agreement could be reached on the basic principles of an exchange rate system that would take its place. On the one hand, many monetary authorities hoped, and continue to hope even more strongly today, that it will ultimately be possible to reinstate a par value system. Other monetary authorities favored and continue to favor floating rates without any significant management. The preferences of still many others are somewhere in between. In these circumstances, a compromise was reached in 1975 that, with certain important safeguards for the international community, gives each country freedom to adopt the exchange rate arrangements of its choice.

It is against this background that — in the second half of 1977 and the first quarter of 1978 — a large movement occurred in the exchange rates of some major currencies, including the world's trading and reserve currency: the dollar. This movement has inevitably raised again fundamental questions about how the exchange rate system should operate. And the answers are particularly important, since the actions taken now will influence the evolution of the exchange rate regime in the years to come.

In what follows, therefore, I propose to examine (1) what has happened, (2) how the working of the exchange rate regime could be improved, and (3) what concrete measures commend themselves for the period ahead.¹

¹ The views expressed are strictly personal ones.

1. New Exchange Arrangements

Important as the change in the exchange rate field since 1971 has been, it has been limited to rather few countries, mainly the major industrial ones. Under the Bretton Woods system, these countries maintained stable exchange rates for their currencies against each other. Today, most of these currencies float against each other, with the exception of the currencies belonging to the European Exchange Rate Arrangement, or, colloquially the "snake". But this does not mean that floating has become general. On January 31, 1978, 44 currencies were pegged to the dollar, 14 to the French franc, 13 to the SDR, 6 to the D mark, and 5 to sterling; 22 maintained a peg to another currency, or to a basket of currencies other than the SDR. Indeed, only 24 currencies of the 132 members of the IMF were neither key currencies, nor pegged to a key currency or a basket of them.

Thus, what really happened in 1971-73 was simply that the major currencies, at the center of the system, started to float against one another. That this brought about a profound change in international monetary arrangements once more underlines the fact that the monetary regime continues to be dominated by the relationships among these few major currencies.

2. New Developments in 1977-78

In 1977-78 there have been two further developments. Up to the middle of 1977 the net effect of exchange rate fluctuations under the new regime of flexibility had mainly been to counterbalance differential rates of inflation; while this avoided the emergence of new disequilibria, it did little to reduce already existing external payments imbalances.² But in the second half of 1977 and so far in 1978, exchange rate movements occurred among the three main key currencies — the dollar, the mark and the yen — that went beyond such compensation. Thus the country with a substantial deficit saw the real value of its currency depreciate, while the currencies of the surplus countries appreciated. So far, so good.

² See, for instance, *Annual Report of the Executive Directors*, Washington: International Monetary Fund, 1977, p. 30.

What was worrying was that, once the movement had started, the dollar seemed to have embarked on an unstoppable self-propelling decline fed by speculative capital movements. This came about in part because of the constant profession of indifference as to the external value of the dollar on the part of officials of the U. S. Treasury during much of 1977. It is rumored that the U. S. attitude was finally modified only after King Khalid of Saudi Arabia had told President Carter during a state visit that Saudi Arabia could not hold the price of oil if the United States could not hold the price of the dollar.

However this may be, in January 1978 credit arrangements between the monetary authorities of Germany and the United States were put in place and activated in order to permit U. S. intervention on the exchange market to reinforce the quite sizable interventions of the German authorities. In March 1978, these arrangements were increased in size. More forceful action to counter disorderly conditions in exchange markets was announced, and it was pointed out that the United States possesses reserve assets such as SDRs and a reserve position in the Fund for this purpose. Then at the time of writing, in April 1978, the Treasury announced a series of auctions of U. S. gold, at first for dollars, later perhaps for marks. While the amount involved, roughly \$300 million, may be small, the psychological effect may well be large. For the action seems to confirm a change in U. S. attitudes.

It is true that the U. S.-German Joint Statement of March 13, 1978 still speaks of the quite limited objective of "countering disorderly market conditions", which was first put forward as a guideline for exchange market action at Rambouillet in November 1975. One purpose presumably is to make clear that the new actions are not designed to begin a return to predetermined exchange rates, let alone par values. Yet the statement also speaks of broad policy coordination, in many areas, of a series of discussions devoted to that end, and of careful review whether additional resources are needed to deal with exchange market disorders. Despite the poor reception of the statement in market circles, it none the less seems likely that an important change in U. S. exchange rate policy is under way. In particular, the U. S. authorities seem to acknowledge some responsibility for the fortunes of the dollar in the world.

Indeed, we have learned that floating exchange rates do not provide a foolproof system against destabilizing, self-propelling, spec-

ulative movements, and that, left to themselves, these may take the exchange rate to levels unjustified by the underlying economic conditions. Thus at least two questions are raised, to which I will now address myself in turn: (1) what are the fundamental causes of instability, and (2) what is the proper exchange rate policy for the dollar under the actual circumstances prevailing today.

3. Instability

The fundamental cause of the instability of the present system can be quite easily identified as the use of different national currencies combined with the freedom of capital movements between them. At any given time, for any given reason, private financial institutions, multinational enterprises, or any other private entity may come to the conclusion that the actual rate of exchange between the national currencies differs from the prospective rate; financial assets are switched accordingly, with the result that the exchange rate moves in the expected direction. This self-fulfilling prophecy may lead to a cumulative movement resulting in monetary disturbance.

The phenomenon is by no means a recent one; on the contrary, it is tens of centuries old. When gold, silver, and copper coins circulated side by side in the national or city state, the same disturbances occurred. Economists know the phenomenon by the name of Gresham's Law, because Sir Thomas Gresham, a financial adviser to Queen Elizabeth I, formulated one of its consequences in a striking way in the year 1560. But the matter had already been analyzed by the astronomer Copernicus (1498-1543) and by the French ecclesiast Oresmius (1323-1382) in the Middle Ages, and had in Antiquity been mentioned by Aristophanes in his play "The Frogs".³ I note these historical antecedents to impress upon the reader the fundamental and persistent character of the difficulty. It would certainly be idle to hope that the problem will somehow go away in our century once markets "calm down".

There are in principle three solutions to the problem: (1) to forbid the disturbing transactions; (2) to have unalterable exchange rates; and (3) to replace the various currencies with a single one. The first solution formed part of the Bretton Woods system, which

³ Cf. ALFRED MARSHALL, *Money, Credit and Commerce*, London 1923, p. 60.

as a practical matter assumed strict and effective controls over international capital movements. It had to be dropped as effective capital controls and free multilateral trade proved incompatible. The second alternative was then tried from 1961-1967, as the major industrial countries refrained from adjusting their par values. But this approach had also to be dropped, since external shocks affect different nations in differing degrees, and since internal economic developments diverge. This is especially so for inflation rates. It was then hoped that floating exchange rates would solve the problem by making speculation riskier. But, while with proper management they may reduce the frequency with which the problem arises, we saw above that they have by no means automatically eliminated it.

A tentative exploration of the third approach, one single monetary asset, was made during the years 1971-74, when an attempt was made to arrive at a comprehensive negotiated reform of the international monetary system. Proposals to have only one asset, the SDR, in which at least official reserves would be held, were seriously considered. But the reform effort failed.⁴ The single monetary asset *was* the solution at long last adopted for their *domestic* financial arrangements by the national states in the course of the 19th Century or shortly after World War I. It finally and completely relieved the national monetary systems after many centuries from the disturbances under discussion. But it is not, of course, a practical solution to our international problems for a long time to come.

With tight capital controls, unalterable exchange rates and a single world currency all out of the question, there is at present *no* solution to the problem we are facing. For the time being we will have to make do with patchwork, searching for remedies that will only alleviate the problem or some of its symptoms. This means that even under the best of circumstances, we will have to live with disturbances on the exchange markets.

But the circumstances are, in fact, far from good. Monetary policy might help to smooth markets. But in fact the national authorities are likely to continue to give pride of place to internal cyclical considerations. It is open to serious doubt whether, under floating rates, such a policy is justifiable, even from a national standpoint. For after the wage rate, the exchange rate is the second most important price for most countries. Following monetary policies which

⁴ I have described the failure of the reform effort in the September 1976 issue of this *Review*.

drive the exchange rate to an undesirable level is thus likely to cause greater harm to the domestic economy than any good that might be expected from the rather limited contribution it can make toward smoothing the cycle.

It is equally unlikely that a much needed guidance of long-term capital flows will come about. And the world is likely to stop short of taking adequate action to deal on a long-term basis with the disturbances caused by the surpluses of the OPEC countries.

As a result, it is to be expected that sudden emergencies will continue to erupt, moving exchange rates to undesirable levels, and leaving the authorities somewhat helpless given the handicaps they have created for themselves.

4. Is the Present Dollar Rate Right?

A most essential and intriguing question is, of course, whether the recent exchange rate movements will bring about a better equilibrium in international payments. Have they gone far enough, or have they overshot the equilibrium level? Have they left the dollar undervalued, overvalued or rightly valued? It is important to remember that exchange rate changes make their full effect felt only after a period of some three years. So let us put the question more precisely. Suppose we had a system of reference rates — that is, suppose we had a system whereby governments came to an agreed view about the exchange rates that would bring about something like payments equilibrium in the medium term, say 3 years, and strove to guide exchange rates to the reference rates — what, in that case, would these reference rates look like? The surprising answer is that the actual rates among the three main currencies — the dollar, the mark, and the yen — of early April 1978 would not differ much from those reference rates.

Before going any further it is essential to underline the many pitfalls that beset this field. One major reason why we do not have a system of reference rates is that it is almost, or perhaps even completely, impossible to estimate them with any accuracy. This is so because we do not know what effect recent exchange rate changes have already had on international payments, in part because the total effects of these changes on trade is not known accurately, but most importantly because the rate of growth in the economies concerned,

as well as the size of the OPEC surplus, have a major impact on the outcome. Moreover, capital movements are impossible to predict.

Yet, various studies seem to point in the same direction. The results of one such study was mentioned not long ago by Governor Wallich of the Federal Reserve System.⁵ The changes in real exchange rates (that is, after correction for differences in inflation rates) that have taken place will in time have an appreciable effect in reducing the U. S. current account deficit and in bringing better balance to Germany's and Japan's international payments. But this depends crucially on some decline in the OPEC surplus and on a pickup of growth in Europe and Japan. In particular, the effect of divergencies between actual growth and potential growth are truly striking. Full employment in the industrial world outside the United States, Governor Wallich estimates, would bring an improvement of \$10-20 billion in the U. S. payments position, compared with a U. S. current account deficit in 1977 of \$20 billion. Indeed, the effects on international payments of the exchange rate movements that occurred and those of eliminating economic slack in Europe and Japan would be roughly of equal magnitude.

The trouble is that Europe is unlikely to achieve full employment in the next few years. Given the strength of labor unions, inflation there has resulted in a massive redistribution of income away from profits and toward wages. This has led to low or negative real profits, that is after taxes and correction for inflation. Consequently, there is no propensity to invest, and unemployment results. Stimulating demand will not do the job; if, because of the relation between costs and prices, a given factory produces at a loss, doubling the demand for its product will not lead business to construct a second loss-producing factory. It will instead lead to more inflation and a further reduction in real profits, in part because inflationary "profits" are taxed as if they were actual profits. Besides, fundamental social questions are at stake, such as worker participation in business management, future government regulations regarding investment, and the type of society the European electorate wants.

This may therefore be the place to make an important point about "Mr. Keynes and the Classics". During the depression of the thirties, the classical economists as well as the policy makers were

⁵ HENRY C. WALLICH, Member, Board of Governors of the Federal Reserve System, *Reflections on the U. S. Balance of Payments*, New York: mimeographed, December 28, 1977, pp. 5-12.

concerned about restoring appropriate relations between prices, costs, profits, etc. They ignored the fact that total aggregate demand fell short of the total production potential. The result of these one-sided policies was a failure to eliminate unemployment. During the serious and prolonged recession of the seventies, the opposite is the case. Attention remains focused on the management of aggregate demand, which Keynes indeed showed to be indispensable. But now the relationships among costs, prices, profits and the effects of uncertainty are ignored. Onesided policies once more prove incapable of eliminating unemployment.

Fortunately, this fact is being increasingly recognized. Two socialist ministers, one from a deficit and one from a surplus country, are among them. The following remark by Prime Minister Callaghan of Great Britain has attracted wide attention: "We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists."⁶ A similar remark was made at the 1977 Annual Fund Meeting by Mr. Duisenberg, then Minister of Finance of the Netherlands. The difficulty, as noted, is that the restoration of profit margins and of general incentives to invest runs counter to some basic desires for greater equality of power and wealth.

Apart from that there is the danger of Communist political successes, especially in Italy. While the voters may think differently, business management is likely to agree with former Secretary Kissinger's analysis that what the present Euro-communists say is in essence identical to what their predecessors said before taking over, say, Czechoslovakia and Hungary. This situation is not likely to promote investment and thus reduce unemployment.

With the prospect of sluggish growth in Europe, and with Japan staying below its growth potential and continuing through various methods and traditional habits to avoid significant imports of manufactured goods, refined econometric analysis — for what it is worth — would have one conclude that exchange rates, rather than having overshot their target, may not yet have moved quite far enough. Instead, medium-term equilibrium might be served by a further modest decline in the dollar rate from its early April levels. Moreover, even with full employment overseas, the reference rates

⁶ Speech at the Labour Party Congress of 1976.

would produce something like equilibrium only toward the end of 1980, not in 1978, so that a financing problem remains in any case.

But what about the intuitive feeling that the dollar is already vastly undervalued at present exchange rates? The point is that exchange rates are not determined by general price levels, but by the volume and price of those goods that actually move in international trade. The United States' imports of expensive oil are a much higher percentage of its trade than for most other industrial countries. Hence, the rise in the oil price has produced a vast relative increase in the U.S. deficit, and consequent pressure on the dollar. The likelihood that the United States will some day develop an alternative way of producing energy, which will produce a dramatic turn-around, is beyond the market's horizon. The same is true, at least at present, for a likely change in confidence that would occur if there were a communist take-over in an important European country. Those who have taken long positions in dollars on these grounds seem to have lost a great deal of money — at least so far, and, as Keynes observed, in the long run we are all dead.

5. Summing Up: Where Do We Stand Now?

Speaking broadly, the conclusion is that the movement in exchange rates in the twelve months up to early April 1978 for the dollar, the mark, and the yen has not only been about right, but necessary. The currency of a country in sizable deficit declined; those of countries in surplus rose. These movements will make an important contribution toward the correction of disequilibrium. If Europe manages to overcome its structural problems, if no political accidents happen, if the price of oil remains stable, if the financing of OPEC surpluses and the corresponding deficits takes place smoothly, and if inflation abates, then these exchange rates, or a slightly lower one for the dollar, may produce a sustainable pattern of international payments toward the end of 1980.

But the situation is obviously far from stable. If political accidents do after all occur in Europe, there might be a sudden and dramatic shift in sentiment and a sharp upward move in the exchange value of the dollar, which would not be justified on economic grounds. The economic system cannot be made foolproof against political upheavals.

With political calm, on the other hand, the prospect, without official action, is for some further decline of the dollar in the year ahead, because sizable U.S. deficits must be expected before equilibrium comes in sight, given the delay with which exchange rate changes do their work. Such a decline beyond a certain point would be too much of a good thing. One reason is that exchange fluctuations give pervasive but confusing signals to trade and production, and are therefore very costly. Even more important is the fact that an excessive decline in the dollar rate could easily degenerate in cumulative self-propelling processes.

First, there is the danger that excessive appreciation of the mark and the yen would give rise to a vicious cumulative appreciation/deflation cycle in Germany and Japan. Appreciation would lead to a fall in exports and profits, and hence in investment. The result would be stagnation. The fact that appreciation would hit prices and profits first, would aggravate Europe's structural difficulties and make it very difficult for the authorities to counteract the resulting reduction in total demand. Thus, appreciation and a fall in profits would be followed by a further appreciation and a further reduction in profits and economic activity. This vicious appreciation/deflation cycle would be the mirror image of the vicious inflation/depreciation cycle — depreciation, wage increases, further depreciation — with which we have become familiar. It would have a depressing effect on the world economy. It would also, as we shall presently see, bring about a sizable increase in the U.S. deficit. And the movement might be hard to stop, for it might trigger a self-propelling speculative movement of funds out of the dollar.

For a similar self-propelling mechanism might be at work on U.S. international payments. If one is to believe certain statements in OPEC countries, a further important decline in the dollar rate might increase pressure for an increase in the dollar price of oil, perhaps by setting the price in SDRs. This would further increase the U.S. current account deficit and further undermine the confidence in the dollar. At best, there would be new difficulties for financing the U.S. current account deficit. At worst, holders all over the world — of dollar balances amounting to hundreds of billions of dollars — might come to consider the dollar an unreliable currency, and might try to get rid of it. The disturbances that such a development might create in the world's finances might easily surpass in seriousness those caused by the sudden quadrupling of the oil price in 1973,

disturbances which are still with us today. This is what is at issue when the President and the U.S. Secretary of the Treasury speak about defending the integrity of the dollar.

Thus, a point has been reached at which a further large or rapid decline in the dollar rate might trigger important policy changes in other countries. It might sour U.S. relations with the oil producers, on the improvement of which much energy has been expended. And it might lead Europe — faced with increased unemployment and prolonged stagnation as a result of appreciation — to protectionist policies and inward looking currency blocks. For unemployment is the most powerful force pressing for protectionism. Finally, such a decline might seriously lessen the confidence in the dollar and, most important, in U.S. purpose and leadership.

6. The Action Required

The conclusion is that, even without the support of econometric models, it is clear that some period of near-stability in the external value of the dollar vis-a-vis the major European currencies and the yen is now desirable.

Insofar as pure financial speculation has contributed to the difficulties, consideration could be given to discouraging such speculation by the imposition in all countries of a tax of, say, 2 per cent on all foreign exchange transactions. This would make speculative transactions more costly, along with all other international transactions. The problem is to weigh the cost imposed by currency speculation on the national economies against the cost of the tax on productive international transactions. A second problem is to obtain cooperation from all potential financial centers, so as to avoid a re-routing of international transactions to the one center that did not collaborate. Although this does not require acceptance by every far-away island in the Pacific, this is likely to be an unsurmountable stumbling block.

Returning to more conventional measures, a first point to make is that up to now U.S. policy has yielded some important results. In the first place, an important and much needed adjustment in the exchange rate relationships among some major currencies has come about. Second, using its political power, the United States has ob-

tained two important concessions from Japan, namely, (1) measures to stimulate economic activity, and (2) a softening of Japan's pervasive and considerable *de facto* defenses against the import of foreign manufactured goods. Finally, a reduction has come about in the *real* oil price (that is the price in terms of other goods).

But when the process reached certain dangerous limits, a shift took place in the United States from a position in which there had been a profession of indifference to one in which arrangements for exchange market intervention were put into place and into action. Moreover, monetary policy was shifted to support those actions. It was the fifth time since World War II that the discount rate was changed for external reasons. The series of gold auctions, announced by the Treasury at the time of writing, seem further evidence of the fact, of great importance, that the U. S. authorities now seem to take a more active interest in the fortunes of the dollar, even though some public pronouncements are still lagging behind.

It is now desirable to build on these actions by putting into place a more comprehensive set of policies designed in close cooperation between the United States and the main industrial countries. The restoration of confidence will be a vital object of such a set of measures, in the interest of both domestic expansion and orderliness in international exchange relations. Hence, international agreement on a coordinated set of measures seems indispensable. The measures should deal with the structural, cyclical, and short-run financial problems that beset us at the moment. The policies should take into account the need and desirability for continued further steady expansion of the U. S. economy and for restructuring and enhancing the growth of the economies of Europe and Japan, as well as for more effective action to control inflation.

Within such a framework of simultaneous coordinated action, there should be a further easing of monetary policy in Europe, both for internal and external reasons. There should also be a tax reduction in Europe designed to stimulate investment and to restore incentives. And Europe should pass from talk to action in overcoming its structural obstacles and moving toward full employment and growth. Some reduction in the manifold European systems of indexation would be a contribution in the fight against inflation, which seems to be the root cause of a number of the structural problems. It is equally important to put a resolute stop to the ever continuing growth in the share of the government take in the national income.

Indeed a reduction in that share, such as is now the policy of the British Government, may in the end turn out to be inevitable.

The most important long-term contribution the United States could make to the achievement of international payments equilibrium would be an effective energy policy, with special emphasis on new techniques of harnessing energy in ways that would not be inimical to the environment. In the short run, however, any conceivable energy policy will have only psychological effects. But since the difficulties on the financial markets are caused in part by a lack of confidence and sense of direction, such psychological effects would be of importance.

In the financial field, there should be an increased U. S. willingness to manage exchange markets, without in any way trying to freeze exchange rates or to keep them within predetermined "target zones". Intervention on the exchange markets should be part of such a policy, even though experience has shown that market intervention alone, in the absence of confidence and a comprehensive policy, has only a limited effect. In 1977, market intervention by European Central Banks and the Bank of Japan amounted to tens of billions of dollars, yet it could not stop the dollar's slide.

In addition, the U. S. capital account needs strengthening. Thus reinstatement of some restrictions on foreign lending by U. S. banks might be useful. Another method of obtaining medium-term finance would be a sizable U. S. drawing on the Fund. As such a drawing would carry with it international approval of U. S. policies, confidence would be strengthened by such evidence of international cooperation. A most powerful additional weapon would be the floating by the U. S. authorities of medium-term bonds denominated in foreign currencies in order to finance part of the U. S. Treasury deficit. Certain other important industrial countries have at periods in the past very efficiently arranged the financing of temporary international deficits. There is no reason why the United States should not do the same now.

It is hard to understand the objection that such borrowing would merely result in a switch of assets. Even such a switch would, in itself, relieve the pressure on the dollar rate. Moreover, if claims on the U. S. Government denominated in foreign currencies would indeed turn out to be so highly desired, they could be floated at a high price, and hence carry only a very low nominal interest. It is also said that U. S. prestige would be affected. But U. S. prestige is likely

to suffer less from preventing a crisis, than from letting one develop as the result of inaction. The United States is the banker of the world. If the bank is in need of some limited long-term finance at this juncture, it is hard to see how it could suffer from making the appropriate arrangements.

More generally, if the former profession of indifference as to what happens on the exchange markets is now to be replaced by a willingness to manage the system in cooperation with the other main countries, and within the framework of a comprehensive program, confidence may well return, and one important cause of the recent nervousness on the exchange markets will be removed. As noted above, the signs are that such a change in policy is underway.

The objective of such a comprehensive program, in which a number of industrial countries would participate, would be to make a start to deal with debilitating structural maladjustments, and to bring an end to the serious prolonged recession of the seventies. While it would also aim — as a means of obtaining these objectives — at greater exchange stability following the important adjustments that have taken place, and at avoiding cumulative “bandwagon effects”, firm stabilization targets or a freezing of exchange rates would be clearly ruled out. At least as long as governments have as little effective control over inflation and many other economic developments at home, as in the case at present, a stabilization of exchange rates could not be a realistic or indeed a desirable objective.

But it would be equally unrealistic to foreswear all management of exchange rate relationships. In the heyday of the 19th Century British *laissez-faire* Walter Bagehot concluded: “Money does not manage itself”. Neither do exchange markets.

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