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Anchoring the International Monetary System

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## Anchoring the International Monetary System

It is widely acknowledged that the performance of the current international monetary system has been less than satisfactory. As a result, there have been numerous calls for reform.

### The Need for Improving the Current System

President Reagan called for a conference on the international monetary system in his 1986 State of the Union address. Both the Group of Ten industrialized countries, and the Group of Twenty-Four, representing the developing countries, published reports concluding that the functioning of the present system needs improvement. Staff members of the IMF have also issued a report on Strengthening the International Monetary System that analyses the problems of the current system and explores various reform alternatives.

There is near unanimity among academicians, businessmen, and government officials on two broad propositions: One, stable prices are desirable and two, exchange rate stability is desirable.

Unfortunately, international monetary systems often focus on

one or the other policy objective and leave the other variable free to adjust. For instance, while the gold standard assures exchange rate stability, it forces national price levels to adjust to the imbalances that may impact not only on the domestic economy, but also on the world economy. In contrast, a flexible exchange rate system gives countries the freedom to attain domestic price stability while leaving the exchange rate as the key adjustment variable.

Neither situation is satisfactory to policymakers, businessmen, and consumers who would like to achieve both objectives. What is needed is an anchor or reference point that can serve as a guide for both domestic and international monetary policy purposes.

Today I would like to explore with you the possibility of improving the functioning of the international monetary system through reliance upon a set of commodity price indicators that may provide useful guidance for both domestic and international monetary purposes. Such a system may result in improved national and global price stability and bring about more stable exchange rates.

#### Alternative Exchange Rate Systems

Most observers will agree that stable exchange rates are a desirable policy objective. Stable exchange rates --

assuming they are at the right level -- will promote an expansion of international trade and capital flows, lead to more efficient global resource allocation, and promote price stability. But the various schools of economic thought differ on the best way to achieve exchange rate stability.

The various international monetary systems differ with respect to the degree of automaticity implied by the system and in their reliance upon alternative economic variables, such as exchange rates, prices, or income levels to bring about the desired adjustment.

Four broad approaches may be distinguished: one, the gold standard; two, a system of fixed, but adjustable, par-values of exchange rates as prevailed under the Bretton Woods system; three, a system of flexible exchange rates; and four, policy coordination with or without explicit target zones for exchange rates.

Each one of these systems has certain advantages and disadvantages, many of which have been catalogued in the IMF staff paper referred to previously. Thus, there is no need to repeat the advantages or disadvantages of the various systems. But in order to provide a backdrop for the use of international commodity price indicators that I wish to discuss today, it may be useful to enumerate briefly some of the key shortcomings of the four systems mentioned.

The gold standard relies totally on an automatic system that leaves no flexibility to national policy makers. Events in one part of the world may lead to international gold flows that will dictate an expansion or contraction in national money supplies that sovereign countries may be unwilling to accept.

Under a gold standard the two largest gold producers of the world, the Soviet Union and South Africa, might also gain an unacceptably large influence over the national monetary policies of the United States and the other Western democracies. For that national security reason alone the adoption of a strict gold standard may be less than desirable.

Second, the Bretton Woods system of fixed, but adjustable, par-values of currencies has much to commend itself as long as all countries pursue policies that are acceptable to all other countries. But as the experience of the 1960s showed, an excessive monetary expansion on behalf of one country -- in this case the United States -- resulted in unacceptable inflationary pressures in other countries. When the commitment of the United States to pursue non-inflationary policies was called into question, other countries were no longer willing to accept the policy consequences.

Furthermore, under the Bretton Woods system there was no orderly way to provide for increases in international liquidity, although that particular flaw of the system was remedied by the creation of additional reserve assets in the form of Special Drawing Rights.

Third, the system of floating exchange rates among the major currencies that prevails today relies upon appropriate monetary policies in the various countries to result in exchange rate stability. As the experience of the last decade and a half has shown, this system resulted in larger short-term fluctuations of exchange rates than prevailed under the Bretton Woods system and also did not prevent an apparent medium-term overshooting of equilibrium exchange rates.

It should be said in favor of the system that the last 15 years were not particularly tranquil as far as the global economic and financial environment is concerned.

Consequently, the system of flexible exchange rates may have been put to a hard test. Nevertheless, in the judgment of the various official study groups cited previously the system needs to be improved.

Improved policy coordination and IMF surveillance is the main hope held out by the IMF staff study for a better functioning of the system in the future. Within that framework, some

observers, such as the Group of Twenty-Four, advocate the use of "target zones" to attain greater exchange rate stability. However, a majority of the industrialized countries represented in the Group of Ten considers target zones as undesirable and impractical because the obligation to intervene in foreign exchange markets might undermine efforts to pursue sound and stable domestic policies.

A simple agreement to stabilize exchange rates may not be sufficient to bring about lasting stability in the external accounts or an inflation-free environment. The experience of the 1960s and 1970s has shown that the opposite may well be true. During that period, the United States pursued excessively expansionist policies. These policies resulted in inflationary pressures in the United States. The attempt by other countries to maintain fixed exchange rates versus the dollar then resulted in a generalization of inflationary pressures on a global basis. In other words, exchange rate stability alone is no guarantee for an inflation-free, stable national or international monetary environment.

In addition, there is the thorny problem of defining an appropriate exchange rate in a multi-country world. For instance, if the U.S. authorities were to commit to hold the exchange rate against the German mark fixed, the dollar-yen rate may well vary widely. In a multi-polar world, it may be impossible to stabilize a significant number of crossrates.

Trying to stabilize a broadly based index of the foreign currency value of the dollar may not be desirable either. Stabilizing an index of the nominal exchange value of the dollar might be of little value if that index includes high-inflation countries. Again, national inflationary pressures would be globalized.

The attempt to stabilize real effective exchange rates may be associated with further problems. Clearly, exchange rates reflect commercial policies, such as tariffs and quotas, just as much as changes in competitive conditions and underlying inflation rates. It may be difficult to argue that the United States should adjust its monetary policy just because another nation chooses to impose a new tariff or quota. Furthermore, real effective exchange rates can be calculated only with a considerable time lag, rendering the procedure operationally troublesome.

Due to these difficulties, the imposition of a fixed exchange rate system may encounter serious problems. In particular, two thorny questions will have to be resolved: One, which exchange rate or exchange rate index should be stabilized and two, what country will have what intervention or policy-adjustment obligations.

These are the same questions that will have to be faced in a system that relies upon increased policy coordination or

policy surveillance to bring about the desired exchange rate stability. The key difference is whether rules or individual consultations will trigger the necessary actions. The policy actions that need to be implemented would be largely the same.

#### The Need for Domestic and International Policy Congruence

One basic reason for the failure of the various international monetary systems is their inability to guarantee both internal and external stability. The fixed exchange rate systems rely primarily upon domestic prices and income levels to do the adjusting, while the flexible rate system places more of the burden upon exchange rate adjustment.

Neither procedure is costless, as businessmen and politicians are quick to recognize. Whenever domestic and international objectives diverge, different interest groups will suffer unequal cost burdens, and hence there are strong pressures to avoid or delay the called-for adjustment.

Economists frequently fail to recognize the importance of these adjustment costs, because they tend to focus on the attainment of a new static "equilibrium", which will be efficient from a global resource allocation perspective. The costs associated with the shifting of these resources are often ignored.

For instance, there have been few, if any, rigorous attempts to estimate the resource reallocation costs associated with the rise in the value of the dollar between 1980 and 1985 and its subsequent decline. Yet, it is evident to even a casual observer that entire industries disappeared in the United States during the period of the dollar rise, while new ones were created in the countries with depreciating currencies. Due to the fall in the value of the dollar since early 1985, some of that process may now be reversed. Scrapping existing factories and building new ones in other countries is not costless. But there is nobody who has even a vague idea of the actual dollar costs involved.

If such episodes of resource misallocation and the associated costs are to be avoided, we need an international monetary system that assures both internal and external stability.

#### The Domestic Price Objective

There is probably a broad consensus in this country and in most other countries that the maintenance of price stability should be a key objective for monetary policy. By its very essence, monetary policy deals with money, and price stability is nothing but maintenance of a stable value of money.

If it is possible to define a price objective that has both domestic and international relevance, domestic and international monetary policy objectives can be unified and a consistent national and international monetary policy will emerge.

While it is easy to argue for domestic price stability, it is not easy to operationalize that concept. There will always be changes in relative prices, and in a modern economy there are various alternative ways to define the price level. Some observers prefer a GNP deflator, others a GDP deflator, a consumer price index, or a producer price index. All of these indicators have various pros and cons associated with them. For some, such as the GNP and GDP deflators, the data are available only quarterly. Other indicators have to be revised frequently because spending patterns change. There are difficult problems associated with the changing quality of certain products, and problems of measuring appropriate quantities of output persist especially in the service sector.

#### The Advantages of a Commodity Price Index

Given these difficulties, the use of a broadly-based commodity price index may be worth exploring.

One, commodities are traded daily in auction markets, and a commodity price index can therefore be calculated on a virtually continuous basis.

Two, most commodities are produced, consumed, and traded on a world-wide basis, so that the index has relevance for the entire world.

Three, internationally traded commodities are standardized, so that few quality measurement problems are likely to emerge.

Four, commodities are at the beginning of the production chain and serve as an input into virtually all production processes. Changes in commodity prices therefore often provide "early warning" signs of future changes at the wholesale and retail level. However, the correlation is less than perfect and special circumstances, such as bad harvests or oligopolistic pricing practices may have to be taken into account.

Focusing on commodity prices as an early and sensitive indicator of current and perhaps also future price pressures, the monetary authorities may take such an index into account in making their monetary policy decisions. In times of rising commodity prices, monetary policy might be tightened and in times of falling commodity prices, monetary policy

might be eased. Other indicators may be factored into the decision as well.

There is no need to react to every small fluctuation in commodity prices or to do so on a daily basis. But if commodity prices exhibit a broad trend, a policy action might be considered.

#### Commodity Prices and Exchange Rate Stability

Using a broadly based commodity price index as an indicator for monetary policy purposes may also be useful for exchange rate stabilization. As I pointed out before, commodity prices are rather uniform around the world and the same prices may be observed in a large number of countries. Because most commodities are traded internationally, the law of one price will hold with greater strength and consistency than among non-traded goods.

Because world production, world trade, and domestic U.S. consumption patterns of commodities are rather similar, various commodity price indices using alternative weighting patterns yield rather similar results. Consequently, it makes little difference whether we use global or domestic commodity price indicators for domestic monetary policy purposes.

If other central banks would use the same global commodity price index as a consideration in their monetary policy decisions, there would tend to be a congruence of domestic monetary policy actions across countries. As a result, exchange rate stability might be enhanced.

A few additional considerations may be taken into account. First of all, the developing countries have argued for a long time for the stabilization of their export commodity prices. The proposed stabilization of a world price index would accomplish that objective. That objective would not be attained through intervention purchases or sales of commodities and an international commodity stockpile, but by using the commodity basket as a guidepost for monetary policy. Of course, the determination of the base period may be somewhat contentious.

Second, one may also consider a redefinition of the Special Drawing Rights of the IMF in terms of the new global commodity basket. By that the SDR would be stable in terms of the world commodity basket and constitute a truly stable international standard of value and a unit of account that should be acceptable for international transactions, especially among governments.

Third, one may allow for an "escape hatch" to avoid the automatic ratification of a commodity price increase brought

about by the oligopolistic actions of a few key countries or sharp commodity price fluctuations due to natural disasters and other exogenous events. Under such circumstances, countries may agree through the IMF to redefine the commodity basket to sterilize the extraordinary and hopefully temporary aberration.

#### Conclusion

The use of a global commodity price index as an indicator for monetary policy might help stabilize primary commodity prices in the United States. Due to the significance of commodity prices as an input and as an early warning indicator, such an action might also contribute to overall price stability in the United States.

If other nations were to follow a similar procedure, greater global stability of primary commodity prices probably might result, and greater exchange rate stability might be achieved as well. In essence, paying more attention to commodity prices might help to anchor not only the domestic price level, but result in greater exchange rate stability as well.

Of course, changing the international monetary system requires much thought and careful deliberation, but I believe that it would be worthwhile to subject this proposal

to further study and scrutiny as it may well help us to achieve greater domestic and international monetary stability.