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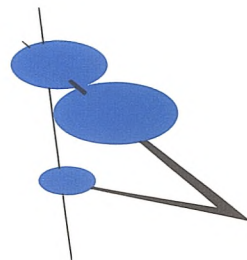
FEDERAL RESERVE BANK OF PHILADELPHIA

SAN FRANCISCO

# Monthly Review

*In this issue*

**Exchange Rate Reform?**



*January 1971*

## **Exchange Rate Reform?**

... International monetary reformers aim at achieving limited flexibility within a basic framework of fixed par values.

**Editor: William Burke**

## Exchange Rate Reform?

The financial system which presently governs international transactions is based upon fixed exchange rates for individual national currencies. The International Monetary Fund (IMF), which administers these arrangements, was established by treaty among its member nations shortly after the Second World War. Since its founding the IMF has presided over a number of changes in the details of the international-payments system, but the principle of fixed exchange rates has remained intact. Now reform of this basic element of the system is under consideration.

### The fixed exchange rate

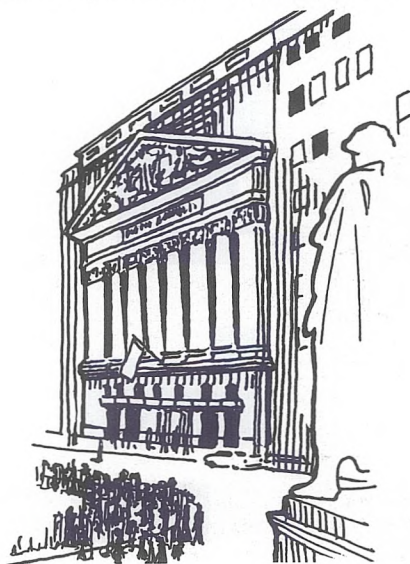
Under the Articles of Agreement of the IMF, the member nations of the Fund have pledged to maintain, for spot transactions, the external value of their currencies within one percent of a specific par value. (Thus, rates are not *rigidly* fixed.) Other pledges in the convention include such things as convertibility or freedom from restrictions on buying and selling of the currency. Although escape clauses in the Articles have permitted the currencies of some nations (mostly less-developed countries) to remain inconvertible, and some transactions to occur at other than official par value, the major trading nations generally adhere to the rules. As a result, the bulk of world trade today occurs within a network of fixed exchange rates.

In most countries which attempt to maintain the par values of their currencies, the central bank is responsible for controlling exchange rate fluctuations. The central bank keeps the market exchange rate within the one percent of par allowed by the IMF by trading its currency in

the international market. In this manner, it absorbs the fluctuations in market demand which otherwise could push the rate beyond the one-percent limits.

Purchases are made with a country's foreign-exchange reserves, which consist of U. S. dollars and other convertible currencies, Special Drawing Rights (SDR's), gold and/or borrowing rights at the IMF. Day-to-day exchanges are transacted in convertible currencies — usually U. S. dollars — and official transactions with other central banks or with the IMF itself are executed with SDR's, gold, IMF borrowing rights or convertible currencies.

The basic objective of this system is to facilitate world trade by establishing firm values for individual currencies relative to one another, and by reducing the risk of exchange-rate fluctuation. Another objective is to avoid competitive



devaluations, such as characterized the destructive trade policies of the 1930's.

The IMF provides a framework for avoiding competitive devaluations by requiring that countries consult with, and for major (and even some minor) adjustments, obtain approval from the IMF. At the same time, the Fund can use its lending power to help a country losing reserves on account of temporary disequilibrium in its external balance of payments to avoid unnecessary devaluations. Devaluations that do occur are theoretically limited to countries in "fundamental disequilibrium," such that their current exchange rate is inappropriate for their long-run balance-of-payments position.

Judged in terms of its objectives, the present fixed exchange-rate system has been quite successful. World trade has increased steadily, the major currencies have become convertible, and the number of major currency adjustments has been relatively small. It is difficult to say just how much fixed exchange rates have helped to attain these goals, because other economic conditions and policies also have influenced international payments, but the fixed exchange rate has been associated with the record, and many IMF members are reluctant to modify it. Nevertheless, discontent with the present rules is growing, and more and more authorities are advocating greater flexibility.

### Objections to fixed rates

The arguments for and against reform of the fixed exchange-rate payments system are complex and involve political as well as economic issues. However, most of the current reform proposals concur in the judgment that present IMF rules are too rigid: one-percent fluctuation about par is not enough, and par values tend to be defended too long.

Under the present rules, policy choices open to a central bank are limited. It must intervene whenever the market price approaches the support prices on either side of par, which means that it must manage its currency within a total range of only two percent. A wider band would

give the central bank more choices in the degree and timing of its intervention. In addition, the extent of exchange-rate movements could give a clearer indication of the strength of current market trends and help guide policy decisions.

Another alleged shortcoming of the present system is its tendency to encourage currency speculation. When a country's exchange rate falls to its lower support price and its official reserves continue to fall, the probability of devaluation increases. To protect themselves, holders of the currency begin to look at the alternatives available for temporarily shifting their funds, and non-holders begin to sell the suspect currency short. If there is no devaluation, the currency's exchange rate cannot rise by more than two percent. On the other hand, if a devaluation occurs, the reduction is often as much as 10 or 15 percent. The relatively low penalty for incorrect speculation under the present system, compared to the possible gains from speculation, reinforces speculative pressures once a currency gets into trouble, and thus complicates the central bank's management task, even if devaluation ultimately is avoided.

Even greater problems can be caused by the reluctance to change par values. In principle, the IMF Articles permit a country to alter the official value of its currency whenever it is in fundamental disequilibrium, but in practice many factors may combine to delay such changes. Experts may differ as to whether an existing crisis is due to a speculative run on the currency, a temporary fluctuation in the external trade balance, or to the fact that domestic prices and costs are out of line with the country's longer-term trade position. In the latter case, devaluation (or revaluation upwards) is an appropriate action to restore balance. This conclusion may be obvious after the event, but in the midst of a balance-of-payments crisis, it is not always clear what the real problem is and whether a change in the par value is appropriate.

Unlike domestic monetary or fiscal policies, mistakes in changing the par value of a currency cannot be reversed easily. In a crisis, the adjust-



ment in par value must be large enough to convince the international financial community that the new level will hold, or else speculation will continue. Yet too large a change may have undesirable effects on the domestic economy.

In general, devaluations help export-oriented industries, but they also apply upward pressure on domestic prices. The cost of imported materials used by domestic firms increases automatically as a result of the devaluation, as does the cost of imported goods purchased by domestic consumers. From a payments standpoint, both effects are good because both discourage imports. However, if firms attempt to pass along their costs to consumers in the form of higher prices and consumers attempt to preserve their real income positions by extracting higher wages, the inflationary forces set in motion can wipe out the balance-of-payments gains from the devaluation.

To be successful, devaluation usually implies restrictive policies which a government may find difficult to implement. Instead of confronting these problems it may prefer to avoid, or at least postpone, devaluation with tariffs or administrative controls on goods imports and capital exports. Revaluation (the opposite of devaluation) also causes internal problems by shifting the burden onto export industries and import-competing domestic industries. But the point is the

same; a change in the par value of the currency creates difficulties that a government usually prefers to avoid.

Considerations such as these often have led governments to delay changes in the par values of their currencies, thereby impeding effective management of the domestic economy and distorting patterns of international trade. Major trading countries have been especially reluctant to change their exchange rates, and in many cases their efforts to defend unsuitable fixed exchange rates create problems for their trading partners as well as for themselves.

### Proposals for reform

Among the reforms that have been suggested, the ones now receiving serious consideration by the IMF would increase the degree of rate flexibility that is possible within the existing framework of "fixed" exchange rates. Proposals to modify the existing rules are discussed in the report, *The Role of Exchange Rates in the Adjustment of International Payments*, released by the IMF's Executive Directors in September 1970.

**Prompt adjustment of parities:** One set of proposals is designed to eliminate undue delays in changing currency par values. The object is to encourage more frequent, small changes in preference to infrequent major adjustments. It is hoped that small adjustments in par values would be more acceptable to individual governments, and would avoid some of the shocks to international financial markets which were associated with the large (10 percent plus) changes of the past. The IMF report suggests the possibility of amending its Articles of Agreement to permit adjustments of up to 3 percent in any twelve-month period without prior approval from the Fund.

This suggestion is one of a group of related plans discussed in academic and financial circles under the general name "crawling-peg." Another variant is to establish a link between exchange rates and certain economic indicators, say an average of past market-exchange rates, to

produce small automatic adjustments. However, the Fund's report specifically rejects any automatic formula on the grounds that economic indicators often respond to cyclical or temporary forces and could produce unnecessary adjustments in exchange rates. In any case, as a practical matter it is unlikely that governments would be willing to give up discretionary control over something as important as their currency's exchange rate. The report also regards very small par value adjustments as inappropriate, because in the Fund's view they are not consistent with the correction of fundamental disequilibrium. (Some writers have suggested weekly, fractional percentage adjustments.)

**Wider parity margins:** The second set of proposals involves increasing the parity margins from their current 1-percent range about par value in order to increase the risk associated with speculation and thereby discourage speculative runs on currencies. This proposal not only would increase the costs to speculators from guessing wrong, but also would give a central bank more leeway in managing its currency. The IMF's report suggests that members be allowed, at their option, to widen the intervention limits to 2 percent, or at the most to 3 percent, on each side of parity. Within this range, it is hoped the fluctuations in the exchange rate would not have a disturbing effect on trade. This proposal and the previous one are not mutually exclusive, and many international economists believe that the two should be combined.

**Temporary floating exchange rates:** The IMF report describes a third approach to payments adjustments as "temporary deviations from par-value obligations." This means having a "floating" exchange on a temporary basis. The IMF envisages the use of floating rates in cases when it is obvious that some change is needed, but the appropriate size of the change is unclear. The market would be used to test the strength of pressures on the currency, and in turn to indicate an appropriate new par value. This approach does not exclude central-bank intervention in the

market during the period when the rate is floating, but it does eliminate the need for a par-value objective to be announced officially.

The IMF takes the position that a new par value should be established as soon as possible, and that the usual IMF rules then should be reapplied. No general or regular use of floating exchange rates is implied.

In a sense, this plan is a variation of the first one, except that it involves continuous change in the exchange rate for a brief period until a single rate is formalized, rather than a series of discrete changes over a longer period. The aim is to encourage countries to avoid unnecessary delays in changing the par value of their currencies.

Another advantage claimed for the floating-rate adjustment is that it avoids giving speculators a quick, clear profit, since the exchange rate moves gradually to a new level. Market pressures help set the proper long-term par value and thus help reduce the possibility of another crisis in the near future. Finally, permitting the exchange rate to float for a brief period may help to avoid the build-up of a crisis atmosphere, which often is created by prospect of a major par-value change.

### The German case

A case study of the temporary floating rate is provided by the Federal Republic of Germany, which floated the deutschemark for about one month in late 1969. Foreign capital had poured into that country in anticipation of an upward revaluation of the deutschemark, and speculators had become convinced that the mark was significantly undervalued in terms of other major currencies and that it would be revalued. The flood of short-term foreign funds created serious problems for the Bundesbank (Central Bank), which already had permitted domestic interest rates to rise to record levels in an effort to control inflation in the booming German economy. On the one hand, the expansion of the domestic money supply caused by the inflow of foreign capital aggravated domestic inflation, but on the

other hand, efforts to offset this expansion would push interest rates still higher, attract still more foreign funds, and negate efforts to maintain the official price of the mark.

The conflict between domestic aims and defense of the external price of the mark presented a difficult policy dilemma. To make matters worse, a federal election was to be held on September 28, and a revaluation was expected soon afterwards. On September 29 the German government announced that it was abandoning its attempts to hold the mark at its official price, and would permit it to float temporarily.

The deutschemark fluctuated until October 27, when the new government announced a new par value, 9.3 percent above the previous par (measured against the dollar). By using the floating rate, the German authorities were able to get through a difficult period. The formation of a new government had taken two weeks, and during that time, no decision was possible on such an important matter. The flexible rate enabled the authorities to postpone announcing a new par value, while avoiding the strains of defending the old par value in the face of a massive capital inflow.

During the time the deutschemark floated, the foreign-exchange markets functioned without evidence of excessive or disruptive fluctuations — the major disruptive pressures occurred before the rate floated. The Bundesbank was a major influence in the market throughout the period, so that the exchange rate could hardly be called a market-determined rate. Moreover, at the outset, the government had made it clear that the floating rate was only a temporary expedient and that a fixed rate would be re-established. This experience thus provided a very successful test of the third proposal before the IMF, a temporary use of a floating rate.

### Rejected: flexible exchange rates

The IMF report rejected the alternative which is the logical extension of arguments for more flexibility — a completely flexible floating exchange rate as a permanent policy. With a float-

ing exchange rate, no official par value is announced and no official intervention limits are established. The central bank may intervene to dampen particular fluctuations, but in general, shifts in market demand and supply determine the exchange rate.

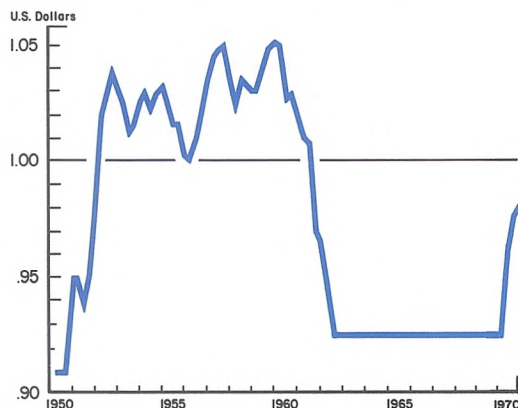
The arguments for and against the floating rate are numerous. Advocates claim that a floating rate removes the conflict between balance-of-payment objectives and internal policies that too often results in both inefficient domestic policies and restraints on international transactions. On the other hand, critics argue that freeing the exchange rate may result in excessive fluctuations, which can disrupt external trade and finance, and spill over into internal economic disturbances.

A case study of the floating-rate system is provided by Canada, which has permitted the Canadian dollar rate to float since June 1970. This experiment provides an isolated example of how floating rates can work in practice, and it underscores certain shortcomings of the current fixed-rate system.

### The Canadian case

Canada in 1970, like Germany in the previous year, was faced with a large trade surplus and a heavy capital inflow, which together resulted in

### Canada adopts flexible rate (for second time) in mid-1970



a rapid build-up of foreign-exchange reserves during May. Additional capital inflows seemed in prospect because of the usual seasonal upswing in tourist expenditures, and as a result of Canada's comparatively successful efforts to control the rise of domestic prices. On June 1st, the Canadian government elected to let the Canadian dollar float rather than attempt to fix a new exchange rate immediately.

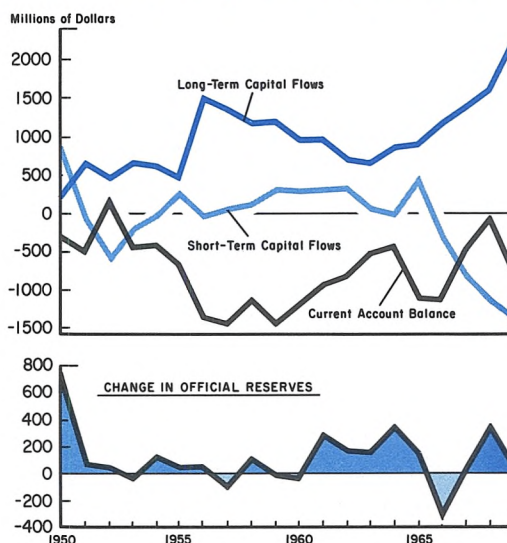
Unlike Germany, Canada has permitted her exchange rate to fluctuate for more than seven months in a range of U. S. \$.96 to U. S. \$.98. Supposedly the floating rate is a "temporary" deviation from the IMF Articles. It is understood that Canada intends to restore a fixed par value once conditions indicate an appropriate level. However, the last time Canada had a temporary rate, it was temporary for twelve years.

Canada is not under the equivalent pressures that Germany faced from its EEC partners to fix a par value, and it may well let the rate float for some time longer. Its external economic position continues strong, and the government may not wish to set a new parity under these conditions and be tied to a rate too high for longer-term trends.

In addition, Canada has already experienced a floating-rate system — an episode which left a background of experience dealing with floating rates and a considerable body of opinion favoring the system. In Canada, unlike most other countries, commercial bankers and academic economists are found on the same side of the argument advocating floating rates.

Canada let its dollar float in October 1950 under similar circumstances to today's strong exports and capital inflows, and it was not until 1962 that it returned to a fixed rate. For most of this period, the floating dollar worked well, and without the problems of instability supposedly associated with this system. When the floating rate was finally abandoned, the primary cause was poor stabilization policies rather than any particular failure of the floating rate itself. The final blow was an ill-fated attempt to manipulate

## Canadian reserves benefit from heavy long-term capital flows



the flexible rate using official reserves, which produced a balance-of-payments crisis in 1962. The Canadian dollar was fixed again in the international rescue operation that followed.

The several experiments cited above—Canada 1950, Canada 1970, and Germany 1969—occurred in countries with undervalued currencies, in an environment of major capital inflows and expanding international reserves. In each case, the flexible rate — or in Germany's case, the transitional float — proved to be a successful device for revaluing the currency. (Less reassuring is Canada's attempt in 1961-62 to use a flexible rate to push down an *overvalued* currency.) Only the 1950-61 period provides a prolonged test of market-determined rates, and it can be argued that even this is not a sufficient test of a general system of flexible rates. Moreover, much of the Canadian success rests on Canada's favorable economic situation: a strong economy with easy access to U. S. financial markets. The balance of official and financial opinion still opposes the floating rate except for truly temporary circumstances, such as Germany's 1969 situation, and the floating rate has been rejected as a regular alternative by the IMF.



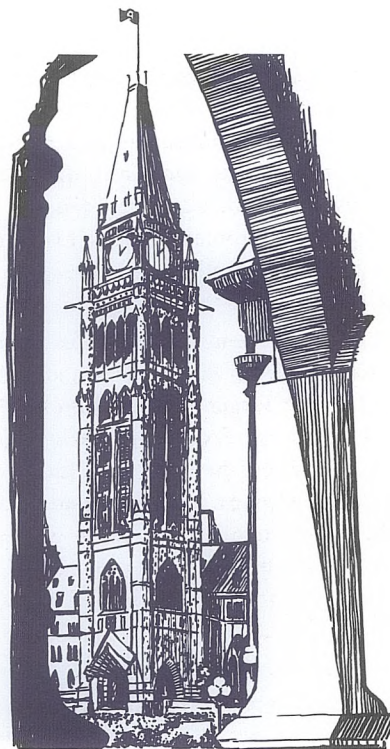
## Strengths of present rules

Despite the fact that the IMF actually is studying three specific proposals, there is considerable reluctance among the various central banks and in the financial community to modify the present rules. In brief, the principal arguments against any change is that the present system has worked well, judged both by the record of growth in international trade and by the basic stability of the world's major currencies under the IMF rules.

It is difficult to measure how much trade has been encouraged by the system of fixed exchange rates, but on the second point, the record is clear — only 14 changes in the par value of currencies in 16 developed countries have occurred since 1959. Furthermore, only ten countries moved independently; in the other cases, the countries were following moves by a principal trading partner. The network of fixed rates has held together over the past decade in the face of considerable strain in individual countries, and it can be argued, therefore, that the existing system shows considerable stability.

In the future, the prospect for the maintenance of par values is relatively favorable. The IMF has increased its ability to lend reserves to countries facing speculative and other temporary pressures. The quotas of its members have been increased to give it more lending capacity, and a new international reserve unit, Special Drawing Rights (SDR's), has been created on top of the previous reserve assets. In addition, the major industrial countries have negotiated reciprocal currency (or "swap") arrangements among their central banks, and between their central banks and the Bank of International Settlements, to provide bilateral credit lines.

There is also the so-called "discipline" argument. Many contend that the present system should be continued because greater flexibility could reduce incentives for countries to combat internal inflation as vigorously as they do now to avoid a forced devaluation. Supposedly, the discipline imposed by fixed rates is an important



bulwark against overly permissive domestic policies.

For many European countries, membership in the European Economic Community poses problems with regard to more flexible exchange rates. The EEC requires close coordination of national economic policies as part of the process of economic integration, and the general EEC view is that fixed rates are essential to its purpose, especially in such complicated areas as the agricultural agreements. Therefore, individual EEC countries could not make much use of greater flexibility, although a unified EEC currency, whenever it is created, could take advantage of flexible arrangements.

As for the widening of the margins about parity, there is concern that the greater exposure to losses through exchange variations could be excessive and, therefore, disruptive for trade. In particular, forward exchange markets may not be able to absorb the greater demand for "covering" trade transactions at the wider margins that have been suggested. A 3-percent margin against a par

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value set relative to the U. S. dollar actually could mean a 6-percent swing against a third currency, if the first is at its upper limit and the other is at its lower limit. Therefore, an apparent minor widening of the intervention limits about par might have serious destabilizing consequences.

Finally, some traditionalists doubt that the gain in flexibility from the proposed reforms would be sufficient to help in major exchange-rate crises, such as the British devaluation of 1967 or the French devaluation of 1969. These adjustments were caused by a combination of factors, many of which were domestic, and they probably could not have been avoided even with greater exchange-rate flexibility.

In their 1970 annual meeting, the Governors of the International Monetary Fund considered the proposals discussed in the Executive Directors' report, but took no formal actions on the suggested reforms. Most probably, they realized that the arguments on this question cannot be easily resolved. The proposed reforms could have important effects on the international payments system, and therefore must be examined carefully. But unlikely as it may be that any or all of the proposed changes will be adopted in the immediate future, the important fact remains that, for the first time, the International Monetary Fund has formally considered the question of introducing greater flexibility in the fixed exchange-rate system.

*Robert Johnston*

### Publications Available

**Wall Street: Before the Fall** — (36 pp. 1970). A description of basic stock-market developments of the past 15 years. The booklet analyzes the industry's operational problems, the expanded role of institutions, and the supply-and-demand considerations underlying general price trends.

**Silver: End of an Era** — (32 pp. 1969). Series of articles on silver coinage, industrial developments, and silver mining in the West. Discusses the demonetization of silver and the recent price upsurge in the silver market.

**Copper — Red Metal in Flux** — (60 pp. 1968). Historical study of copper mining with emphasis on the growth of the Western industry. Explores copper markets and the outlook for the future of the red metal.

**Credit — and Credit Cards** — (16 pp. 1969). Report on bank credit-card plans and check-credit plans in use throughout the United States. Explores the role of Western banks as leaders in this rapidly growing field.

Publication Staff: Ray Mansfield, Artist; Karen Rusk, Editorial Assistant.

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# Western Digest

## Rates Continue to Fall

Interest rates continued to decline in January, headed by reductions in both the Federal Reserve discount rate and the prime business-loan rate. Federal Reserve Banks cut their discount rate to  $5\frac{1}{4}$  and then 5 percent — the third and fourth quarter-point reductions of the last two months. Major commercial banks meanwhile cut the rate charged their most credit-worthy customers to 6 percent. (The prime rate is now down  $2\frac{1}{2}$  percentage points from the peak of a year ago.) Recent declines in these rates and in domestic money-market rates generally have created pressures on money markets overseas. So far in January, the French, Italian and Japanese central banks have reduced their rates, and central banks elsewhere are under pressure to follow suit.

## Business-loan Demand Holds Up

In December, large Twelfth District banks posted a \$2-billion (4-percent) increase in total loans and securities. The \$764-million increase in business loans, which was concentrated over the tax date, represented a gain of more than 5 percent, double the rate of expansion nationally. However, Western banks added relatively less to their securities holdings than other banks did during December. On the deposit side, total time deposits grew at more than a 3-percent rate for an increase of over \$1 billion. This rapid rise was mostly due to a substantial inflow of public time deposits, which more than offset a run-off in large negotiable CD's. Demand deposits adjusted, although increasing  $4\frac{1}{2}$  percent, trailed the expansion rate at other large banks.

## California's Jobless Rate Rises

California's unemployment rate remained a full percentage point higher than the nation's during December, edging up to 7.1 percent while the national rate was rising slightly to 6.0 percent. Most major California industries posted declines in payroll employment during the month. Construction, trade, transportation and the Federal government all suffered employment declines, while the manufacturing and state-local government sectors registered increases.

## Congress Approves Eisenhower Dollar

Congress passed a bill in December to mint 150 million Eisenhower dollars with a 40-percent silver content. The 46 million ounces of silver required for this operation have already been set aside, mainly from U. S. stockpile supplies. The silver market meanwhile continued to weaken in December, despite the general expectation of a price rise following the termination of the Treasury's silver sales in early November. Between that point and year-end, the price of silver actually fell about 10 percent.

