Note on Fluctuating Exchange Rates

[Beyen]

1. There is no possible doubt that the Fund Agreement rejects fluctuating or flexible exchange rates as a system. The Fund Agreement does not even recognise fluctuating exchange rates as a temporary expedient, once a par value has been established in agreement with the Fund. There have been two cases so far where the Fund has accepted - or near to condoned - a situation where a member who had an established par value abandoned that par value without at once proposing a new one: Mexico and Peru. At the moment of the devaluation of sterling it seemed as if some of the West-European countries would find difficulties in proposing a new parity whilst being forced to abandon the old one. The Fund raised no objections in the case of Belgium, to a proposal to abandon its established par value without adopting a new one. But, finally, all West-European countries who had an established par value complied with the Articles of the Fund Agreement. Mexico has again an established par value, and at the moment the only case of a country living in violation of Article IV section 4 is Peru. The matter would therefore, be of no great practical importance if it were not for the fact that fluctuating exchange rates are part - and in the mind of some of the protagonists an essential part - of a plan to liberate Western Europe from restrictions on trade and exchange that is discussed with O.E.E.C. - the so-called Fritalux plan.

2. The idea to "defix" parities in Western Europe is considerably more disturbing from the Fund's point of view than the abandonment of a par value in the case of Mexico or the situation that might have arisen in Western Europe in connection with the devaluation of sterling. In all those cases it was justifiable to contend that the member, being forced by circumstances to abandon its established par value, was desirous to establish and maintain a new par value - but unable to declare at the moment for the maintenance of what par value it could accept responsibility. The Peruvian case is different in that there was not the same force of circumstances driving the member to abandon the established par value but (apart from the fact that the significance of an established par value is impaired where multiple currency practices exist) one might still construe the non-declaration of a new par value in Peru as due to a temporary inability of making the right choice. The West-European case is often presented as being similar to the other cases. If it will ever come before the Board of the Fund it will certainly be defended on the ground of such assumed similarity. There are, however, essential differences. Quite apart from the question whether fluctuating exchange rates are desirable or necessary for the liberation of trade and exchange in Western Europe, it is of great importance for the Fund that those differences should not be overlooked.

3. The violations of the strict rules of Article IV, accepted so far, could be considered as imposed on the member against its intention by "force majeure". The intention to comply with those rules, as soon as circumstances would permit,

-remained-

Min. Fin., Gen. Thes., A.B.B.
1260 (OEEC), doos 12

remained and continuous consultation between the member and the Fund was arranged with a view of assuring such compliance without unnecessary delay. In the case of the Fritalux plan, however, the violation of the rules would be intentional. The object of the plan is eventually to create, with the help of a temporary violation, a situation more in conformity with the purposes of the Fund than exists at present. But that does not make the violation any less intentional. The introduction of fluctuating rates, even in a restricted area and even if that introduction were considered propitious to the gradual establishment of convertibility of currencies, would constitute a method of fostering those purposes which is not recognised by the Fund Agreement. Introducing such a method in violation of the rules of the Fund Agreement poses quite other questions than condoning a violation in case of "force majeure". In the latter case a deviation from the system of the Fund Agreement is regretfully accepted: it is a recognised exception confirming the rule. In the former case, however, a new element is introduced into the system of the Fund Agreement and if this element would be incompatible with that system, it would change the system, not confirm it: a sin, when recognised as such, conforms the validity of religious doctrine, whilst a heresy undermines it. Even if one wants to be unorthodox and welcome the heresy it is necessary to realise that one does more than condoning a sin.

4. There is one more aspect to the matter. The proposal - in so far as known - does not go so far as to accept fluctuating exchange rates as a permanent trait of an international monetary system of convertible currencies. It intends to allow fluctuating exchange rates as a means to enable countries eventually to find the stable exchange rates at which they can afford to do away with exchange and trade restrictions. But it is fairly obvious that quite a number of those who are in favour of the proposal adhere to the philosophy of fluctuating rates as a permanent system. They do not see how in the present world stable exchange rates can ever be maintained without exchange control, or in other words how convertibility could be maintained without fluctuating rates. This philosophy - whether valid or not - is in direct conflict with the philosophy of the Fund Agreement. In accepting the proposal as a temporary expedient the Fund might unwillingly appear to submit to a philosophy opposite to the principles on which its very structure is based. Is there such a thing as temporary heresy?

5. Inherent to the philosophy of the Fund is the concept that as a general rule international division of labour should be based on a comparison of relative costs and should be brought about by competitive trading. To assure this, currencies must be freely convertible at stable exchange rates. As long as currencies are not freely convertible, government control is bound to interfere with competitive trading - and unless exchange rates are stable such trading cannot take place on the basis of comparative costs. Convertible currencies with fluctuating rates or unconvertible currencies with stable rates do not meet the requirements of the philosophy of the Fund. To say that convertibility cannot be maintained with stable exchange rates means that the Fund philosophy is not feasible in the present world

- - and -

- and the same meaning is implied in the contention that stable exchange rates cannot be maintained without exchange control. Such statements assume that there is no exchange rate - acceptable from the point of view of internal economic and social policy - at which, under conditions of convertibility, the balance of payments of the great majority of countries can continue to be in equilibrium for a reasonably prolonged period. Personally I consider this an unduly pessimistic point of view. It may be true that rigidity of costs - or rather the political impossibility to accept social hardships caused by necessary economic adjustments - have diminished the adaptability or local economies to the requirements of international stability of exchange rates, and that therefore the old gold standard could not work in the present world. But the Fund system is not the gold standard: orderly changes in exchange rates are part of the system if and when necessary to cure a fundamental disequilibrium. It goes much too far to say that under present conditions local economies have become completely unadaptable and that costs are entirely rigid. There is quite some room for adaptation and even quite some willingness to adapt costs in order to comply with the requirements of maintaining an established exchange rate. A change of exchange rate is generally felt to be an undesirable thing. This is only partly prejudice. Though sometimes unavoidable a change of exchange rate is, as such, not a desirable event for the serious producer or merchant, nor is it, as such, a good thing for labour. It is a gross overstatement that equilibrium in the balance of payments cannot be maintained except by continuous adaptation of relative costs or continuous change of exchange rates. It takes a considerable and persistent divergence of relative costs "fundamentally" to upset the equilibrium in the balance of payments. The first effect of cost discrepancies, as of newly introduced tariffs is more to restrict trade than to create fundamental unbalance. The adaptations necessary to prevent shrinking of trade - and unemployment - need not, therefore, take place over a very short period. Fundamental disequilibrium would be generated by continued lack of such adaptation combined with a full employment policy (which one might, with a less kind word, call inflation.) Although the Fund Agreement contains no undertaking to avoid such a development, the Fund keeps a certain control over it by the fact that it has to agree to changes in par value necessary to correct the fundamental disequilibrium. I fail to see anything in either the history of the twenties and thirties or in the present situation that leads to the conclusion that the system of the Fund is unworkable from a economic of from a sociopolitical point of view.

6. What we are faced with now is, however, a quite different problem, namely, how to redress the disequilibrium in the balance of payments caused by the war and how to find the exchange rates at which it can be reestablished. The core of that problem is the "dollar-gap" and everybody agrees that no exchange rate system, fluctuating or otherwise, could by itself do away with the "dollar-gap". It is also generally agreed that the balance of payments problem of the non-dollar countries inter se cannot finally be solved as long as the dollar gap exists. The question remains, however, in how far the balance of payment problem of non dollar countries inter se is aggravated by inappropriate rates; it is realised that

-such-

such aggravation might either increase the dollar gap or, at best, prevent its disappearance. And the next question is whether appropriate exchange rates can be found without a period of trial and error, in other words, without "defixing" parities for a period of time.

-7.-

7. Before trying to find an answer to these questions one (-may be superfluous -) remark may be made about the popular idea that currencies should be allowed to find their own natural level. It should be noted first that such a natural level does not exist. It is clear that the exchange rate at which offer and demand of a currency would strike a balance from day to day, if left alone by government or other interference, is not in any sense a natural but a purely accidental level. Not even under conditions of complete freedom from exchange control has that level in practice ever defined the exchange rate. Under the gold standard, as well as during its suspension or abolition, governments or central banks have always interfered and so have international credit and speculation But even in a broader sense a natural rate of exchange, to be defined in abstracto from genuine offer and demand, does not exist, because offer and demand themselves are dependant on the expectation of what the exchange rate is going to be in the future. No responsible government of whatever political creed can avoid to "direct" the establishing of an exchange rate, whether it likes it or not. All a government can do in directing the development is to try to find what is the exchange rate to which its domestic economy can adapt itself without politically unacceptable hardships. It is quite normal that after a crisis it will take some time to find that exchange rate. And it is not abnormal therefore that in certain cases no fixed parity can be established for some time. But to consider this process of tentative direction as "letting the exchange rate find its own natural level" is an - unfortunately very popular - misconception.

8. There is no relevance therefore in the statement that in a given case all exchange restrictions could be lifted provided the rate of exchange would be left to find its own level. Such a statement is really no more than a truism. It leaves unanswered the question whether equilibrium at such an exchange rate would be economically and socially desirable (not only from the point of view of the countries involved but also from that of all other countries) and whether an exchange rate established that way would show any durability. No equilibrium can be durable unless the appropriate domestic monetary policies are adhered to and no decision on the appropriate exchange rate can be arrived at purely by trial and error: it must always depend on the choice made with regard to domestic policies. The reasons why European countries cannot afford to lift exchange and trade restrictions is not primarily a matter of their rates of exchange. It is primarily a matter of their domestic policies. It may be that no domestic policy is feasible that would permit the adjustment necessary to establish equilibrium at the existing exchange rate. But even then no considered decision on another exchange rate could be taken without first choosing the domestic policy that can and will be followed.

9. The danger of the use of fluctuating exchange rates even as a temporary expedient is that it lessens the cogency of choosing a clearcut domestic policy: it takes away the penalty of drifting in policy by allowing drifting

-in-

in the exchange rate. If there were no inflationary tendencies left in the countries involved, no problem of choosing the right level of investment and finding the right way of financing import surpluses caused by such investment, there might be little danger in letting the exchange rate matter in suspence for some time so as to avoid unpalatable adjustments that any advance choice of an exchange rate would involve. But all the countries concerned are faced with a problem of adjustment the solution of which is impossible without weighing the desirability of investment against the danger of inflation, a solution, therefore, that in their case cannot be solved by exchange rate adjustment alone. Nothing would be more dangerous to ultimate stability, then to create the illusion that fluctuating exchange rates would free those countries from the burden of finding a solution to their adjustment problem by choosing and applying the right policy.

10. That does not mean, of course, that all governments will be so intelligent in their choice and so consistent in their policy that they may not miss hitting the target set a chosen exchange rate. They may therefore have to make an ulterior change in that rate. For political reasons it could be undesirable if that change would have to be an "official change". One of the arguments for a fluctuating exchange rate is that it enables changes without all the publicity of a change in the par value established with the Fund. I do not deny that in certain countries there is some strength in this reasoning. But it is more an argument for France and Italy not to declare a new par value than for Holland and Belgium to abandon the present one without declaring a new one. Considering that two of the countries where changes in the exchange rate would have the greatest repercussions are in fact free to change their effective rate, it seems hardly worthwhile to open the door to the dangers involved in a fluctuating rate system by "defixing" the rates in two countries where an ulterior official change, if necessary, might be awkward but would not create unmanageable conditions and where, on the other hand, a fluctuating rate might generate speculative and political tendencies endangering the maintenance of a desirable policy.

11. Now, the last and maybe most impressive argument used in favor of fluctuating rates as a temporary expedient is that otherwise it will not be possible for quite some time to lift exchange restrictions and free trade. If that would be true, it would simply mean that the disequilibrium in the balance of payments is still so fundamental that no system of free and stable exchange rates is yet feasible. The countries in question are still in the midst - or maybe even at the beginning - of their adjustment process. Therefore, in the absence of reserves and exchange control, they could not maintain the exchange rate at which their adjustment policy is striving to establish equilibrium. Any other exchange rate, however, would entail an adjustment different in character from the one they are aiming at. There is no choice therefore but to allow them to maintain exchange restrictions or to provide them with reserves. Otherwise their whole

-adjustment-

adjustment policy would go awry. If therefore a speedy lifting of exchange restrictions is considered of primary importance, the only intelligent solution would be some form of additional reserves, not fluctuating exchange rates.

12. The conclusion that offers itself is that what should be done is:
    1) fixing the appropriate domestic policy in the countries concerned for achieving equilibrium in the balance of payments either at the established exchange rate or - if the September choice is considered to have been mistaken -- at another rate, without any immediate change unless the present rate is considered to be completely out of range.

    2) providing appropriate long term financing (loans or grants) for such part of the deficit in the balance of payments of those countries as is directly or indirectly connected with the investment program included in the policy investment under 1.

    3) creating, in concordance and cooperation with the Fund, additional reserves for those countries who are considered to be successful in this policy, in order to enable them gradually to lift exchange restrictions.

Washington D.C.
November 29, 1949