

Reflections on the International Monetary Crisis

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THE INTERNATIONAL monetary system has experienced another crisis. It is clearly too early to know whether the measures adopted in the three countries most directly affected — Germany, France, and the United Kingdom — will be adequate to solve the current problems. But this crisis, which rounded out a year of turmoil following the devaluation of sterling, has led many observers to state that the international monetary system is in need of an overhaul that will prevent the recurrence of such acute difficulties. It may be worthwhile, therefore, to ask whether this latest crisis teaches us any lessons as to the need for international monetary reform.

The crisis arose as the result of market expectations that the German mark would soon have to be revalued. Germany's very large current account surplus seemed to be chronic. It had increased sharply during Germany's recession of 1966-67 and remained substantial during recovery, strengthened by declining unit labor costs and, incidentally, by an increase in import taxes and export rebates last January 1. Germany had succeeded in offsetting its large current account surplus with massive capital outflows, but observers were becoming increasingly doubtful that the Bundesbank would be willing or able to maintain its easy money policy, which is a necessary condition for the continuance of the capital outflow in a volume more or less equal to the current account surplus.

In these circumstances, there was widespread talk of a possible revaluation of the deutsche mark (DM) and an accompanying speculative flow of funds to Germany. The speculative flow naturally was at the expense primarily of the two currencies regarded as most vulnerable — the French franc and the British pound. But, in the absence of the speculation on an appreciation of the DM, there would not have been a crisis over either the franc or the pound. France seemed to be adjusting as well as could be expected to the disturbances of last spring, and reserve losses had subsided. Sterling, despite poor trade figures in October, was not under severe pressure; furthermore, it is likely that the British authorities would

have taken further steps to restrain consumer spending in any event. However, the United Kingdom and France could not go on for long losing reserves heavily as speculators continued to bet on a revaluation of the DM.

The crisis involved the danger that a devaluation forced on either France or the United Kingdom could set off a chain reaction in which other countries would also be forced to devalue. The crisis also had political aspects, which were symbolized in the question of which country, Germany or France, would have to act. Movement in the exchange rate of one would lessen if not eliminate the need for a move in the exchange rate of the other.

The first observation we can make about this crisis is that it was not in any direct way attributable to the nature of the present international monetary structure. The fact that the dollar is widely held as a reserve currency was in no way responsible for the difficulties. (It is notable that the market price of gold barely rose during the eventful week of November 18.) One could imagine a similar crisis — involving expectations of exchange rate changes and the danger of competitive depreciation — in a Jacques Rueff gold standard world or in a Robert Triffin conversion account world in which there is only one reserve asset. In other words, the so-called confidence problem — involving the interconvertibility of two or more reserve assets — had nothing to do with the cause or severity of this crisis. It is one of the many ironies of the events of the last two weeks of November that the international monetary crisis which embroiled France should not reflect the alleged weaknesses in the monetary system that French officials have been pointing to for years.

The positive lesson that many observers are drawing from the crisis is that there is a need for a more flexible means of correcting payments imbalances. It may be significant that the *Wall Street Journal* recently ran an editorial calling for greater flexibility of exchange rates.

While there is much to be said for studying ways of facilitating exchange rate adjustment when

needed, it would be a great oversimplification to believe that the recent crisis stems simply from a fetish regarding fixed exchange rates on the part of monetary authorities. In the case of Germany, for example, the major obstacle to revaluation appears to be the political fallout from a drop in farm prices that would result from an appreciation of the DM. It would be naive to think that Germany's political leaders would have been more ready to revalue the mark had there been in effect an approved technique involving greater flexibility of exchange rates.

My point here is not to strike a blow against consideration of techniques for limited flexibility of exchange rates but to call attention to the fact that resistance to use of such techniques is not easily overcome. If that resistance on the part of governments could be overcome, there is nothing in the present IMF system to prevent adjustments as and when needed.

The most powerful argument on the side of those who favor greater exchange rate flexibility is that it would prevent the build-up of very large imbalances whose correction requires drastic and disruptive action both externally and internally. If gradual adjustment of exchange rates could occur in a routine way without engaging the prestige of governments, the sort of crisis just experienced would be less likely.

Perhaps another lesson from the recent experience is that adjustments in border taxes and export rebates can at times be a useful and less disruptive substitute for adjustment of exchange rates. Germany has reduced by 4 percentage points both its import taxes and its export rebates (authorized under GATT to compensate for domestic indirect taxes). France has substituted a value-added tax for its 4¼% payroll tax. This will permit France to raise import taxes and export rebates. This technique of balance of payments adjustment is not a complete substitute for exchange rate changes — but that may be a virtue as well as a shortcoming. One

advantage of this technique is that it does not induce large anticipatory capital flows. To benefit speculatively from this type of adjustment one must buy or sell commodities. Another advantage is that changes in border taxes and rebates appear less permanent than exchange rate adjustments and may therefore be more readily undertaken. But this may also be a disadvantage, since temporary adjustments of border taxes may not be suitable to correct structural imbalances.

Clearly changes in border taxes and rebates influence only merchandise trade whereas exchange rate adjustment may affect the entire balance of payments. But the difference between the two techniques may be smaller than it appears. In fact, the impact of exchange rate changes on capital flows is unclear, and ordinarily capital account effects are not aimed at when exchange rates are changed. Thus it is mainly current account flows other than merchandise trade that are unaffected by border adjustments but are subject to exchange rate moves. How serious this shortcoming is will vary from country to country.

In any event, it seems worthwhile to examine this technique as possibly representing — not the optimal theoretical adjustment method but — one that might make up in acceptability and feasibility for what it lacks in elegance. Were this approach to be adopted more frequently and more widely, it can be envisioned that the GATT and the IMF would provide multilateral surveillance over the border actions of individual countries.

A final and hardly novel lesson from recent experience is that domestic policies are crucially important to the success of exchange rate adjustments. The response in Britain to last year's devaluation points up this lesson. Whatever the case for greater flexibility in the pattern of exchange rates, adoption of such techniques will not by itself eliminate balance of payments problems.

