'Floating currencies and free trade', from EFTA Bulletin" (April 1974)

Caption: In April 1974, James Lanner, Director of Economic Affairs at the Secretariat of the European Free Trade Association (EFTA), supports a system of floating exchange rates between the European currencies.

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Floating currencies and free trade

by James Lanner, Director of Economic Affairs, EFTA Secretariat

NOTE: In the last EFTA Bulletin appeared an article by Dr H. M. Mayerzedt, and Dr O. von Platen, which argued that currency floating was harmful to the freedom of trade and should not be adopted by members of a free trade area. The following article presents a somewhat different point of view.

The question of the form of a future international monetary system has been discussed and worried at length at all levels: academic, official, national, international, journalistic, informed and uninformed. The pros and cons of various schemes have been analysed and a large number of hybrids of completely fixed and freely fluctuating exchange rates have been devised and kicked around. As if this were not enough, the discussion has been further complicated by introducing the argument that successful regional free trade arrangements can function only under one particular monetary system, i.e. fixed exchange rates. Given the voluminous literature existing on the subject of the international monetary system, including the discussions on the question of the monetary and economic union in the EC, the only excuse for the present article is that confusion seems to remain worse confounded and that some “vulgarisation” of the basic arguments may help to clarify the issues.

Right at the beginning it should be pointed out that nobody proposes the use of *completely* fixed exchange rates. It is generally accepted that it would be absurd to expect separate political entities to promise to keep in all circumstances the exchange rates between their currencies unchanged. The existence of separate economic (and other) policies will almost inevitably lead to divergent developments of prices, wages and in economic structure, so that what is a “correct” exchange rate today will become a “wrong” rate tomorrow or the day after. Quite apart from the effects of different policies, social, economic and other developments will sooner or later create differences which require an adjustment of exchange rates. Would not, in fact, many regions, now for political reasons under one currency, be much happier and in a better economic condition if their currencies were not fixed to those of the “mother” countries?

An international monetary system coming close to fixed exchange rate was the (now defunct) Bretton Woods system, employing as its basis the “adjustable peg”. Under this system rates were fixed at parities declared to the IMF, but could be changed when an objective criterion, i.e. the appearance of a “fundamental disequilibrium”, showed that the parities were no longer appropriate; then the “peg” was “adjusted”. This system failed because it was difficult to see when a disequilibrium had become fundamental and, more important, because the maintenance of parities (misnamed the “defence of the currency”) became a question of politics. Parity changes were thus too long delayed with the result that a large field of operating was offered to currency speculators, who, it must be said, in general acted more rationally than governments.

The other extreme of the exchange policy spectrum, freely floating exchange rates, is probably another non-starter in the race for a new international monetary system. It implies a policy of official non-intervention in the foreign exchange markets and does away with the need for external reserves. In fact, “clean” floating can be recognised by the absence of changes in official gold and foreign exchange reserves (if we assume that the authorities do not cheat by using non-official agencies for their foreign exchange holdings). It is unlikely that the authorities will want to let the market operate completely freely and in some cases this may not be desirable, so that in general what exists is a system of “dirty” floating, or more politely “managed” floating.

Various new international arrangements to replace “Bretton Woods” are now being discussed, all of which would result in much more exchange rate flexibility than existed before and could even include floating as a solution in certain circumstances. It is clearly now generally recognised that completely fixed exchange rates do not provide the basis for a satisfactory, or even a workable international monetary system. This view takes full account of the fact that it is the function of such a system to permit the development of international trade so that the welfare of the world is raised by locating production where relative real costs are lowest. It is increasingly being recognised that greater flexibility of exchange rates favours a better international distribution of resources and that fixed exchange rates are a handicap. In countries which have allowed their currencies to float in recent years, industrialists are only afraid that some ill-advised

government will re-introduce something like the old exchange system.

At this point it may be appropriate to bring the argument from the international to the regional free trade level and it is as well to point out that there can be no difference in the way these two "levels" should be looked at. The aim of an international monetary system, be it "world wide" international or be it "free trade area" international, is to permit the development of international trade in line with the real comparative advantages of the countries concerned. It serves only to confuse the issue to argue that the need for fixed exchange rates is more pronounced for a regional free trade area than for the world as a whole. Economic integration can be considered to exist, even if only to a limited extent, as soon as there is any trade at all between countries, and given the relatively low trade restraints remaining on industrial commodities between the western countries, "integration" has already gone a long way. Free trade areas and customs unions have "integrated" somewhat further, but there is no reason why there should be a need for different exchange rate systems for these groups. If, as is sometimes argued, floating exchanges run counter to the aims of a free trade area, then they also run counter to the aims of trading relations between all countries in the world.

The evaluation of fixed exchange rates as against floating rates boils down simply to a comparison of the costs of the two systems. There is, of course, some specific cost involved in trading under a system of fluctuating exchange rates, in that forward cover must sometimes be obtained, but such cover is in most cases very cheap. So far as the existence of uncertainty under the two systems is concerned, this applies over the longer term and it is difficult to see why uncertainty is greater in the one system than in the other. Thus under the old Bretton Woods system a manufacturer or trader could never be sure when a parity would be changed and by how much. However if there is no change in parity it is quite possible that relative prices would change so that he would still not be able to forecast his real situation at the date when his transaction was completed. Under flexible exchange rates it is likely that price movements would be offset by exchange rate movements, so that the trader gains in security. Furthermore, inherent in the fixed rate system was the danger of the introduction of trade restrictions and other gimmicks to "protect the currency", adding a further dimension to uncertainty under fixed exchange rates. Movements of currency values under floating rates would be continuous and relatively small, thus reducing, rather than increasing, uncertainty.

The cost of a system of completely fixed exchange rates is very great indeed. It amounts to allowing the domestic economy to absorb directly, by changes in prices, wages, employment and social conditions, all influences coming from changing international trading relations. It represents the complete surrender of an important economic policy weapon, without any real gain. A brief glance at the development of prices, wages and employment in EFTA and EC countries in recent years shows that without a correction by exchange rate changes trade distortion would have been inevitable. And all this without taking account of the divergent structural developments in the member countries of EFTA and the EC. In fact, it is probably true to say that free trade will function better and have a better chance of survival under floating rates than under fixed rates.

It would appear that fixed exchange rates between the currencies of free trade area or custom union countries are not necessary and may be harmful. Reasonably managed floating rates would help to achieve all the aims of such groupings and, as long as the developments in the countries concerned were moving in parallel the rates would be virtually fixed. Fixed rates would therefore automatically result in a grouping of similar countries which had adopted not only free trade, but also common economic policies, including free movement of all productive resources, and were following very similar internal and external policies in general. From this reasoning it becomes evident what lies behind the pressure for the adoption of fixed exchange rates in regional groups. It is an attempt to force the countries concerned to adopt common economic and other policies and move towards greater political unity, since only if this is achieved can fixed rates be maintained. It may be questioned whether it is in fact reasonable to expect a baby to climb Mount Everest. This baby's difficulties are well illustrated by the fact that one of the founding members has deserted the European "snake" and that three "snake" countries have revalued!