

REAL EXCHANGE RATES AND FREEDOM OF INTERNATIONAL TRADE AND CAPITAL FLOWS

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I would like to respond to rather than comment in detail on the paper by my former colleagues Michael Bordo and Anna Schwartz. While I agree with most and disagree with some of their presentation, I fear that there is real potential of a forest and trees problem if I attempt to distinguish which is which. Instead, I would like to present a different way of looking at economic transmission under alternative systems.

A Four-Way Classification

Bordo and Schwartz arrange their taxonomy around whether the economy is on a floating or fixed exchange rate system. I would argue that across this dichotomy lies a much more fundamental dichotomy of whether there is an open or closed trading system for goods and financial assets. Both dichotomies suggest black or white cases where there may be shades of grey in between, but I think they are useful because one or another philosophy or strategy predominates at a given place and time.

Open trading systems differ from closed systems in that changes in fundamentals have strong effects on the real exchange rate between two countries. The real exchange rate is the amount of goods in one country that trades for a given amount of goods in the other. An increase in taxes on capital or decrease in the international value of a dominant national product will tend to depreciate the real exchange rate. If the country has a floating exchange rate, its nominal exchange rate will depreciate as required by the assumed change in fundamentals. Alternatively, if there is a fixed exchange rate system, the depre-

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ciation will be achieved by a reduction in money supply and prices at home—a deflation—or increase in money supply and prices abroad—an inflation—according to which is the nonreserve country. The timing and sectors that are affected in the transition depend on whether a fixed or floating exchange rate system is followed but not the ultimate size of the real depreciation of the domestic currency or real appreciation of the foreign currency.

Under a closed trading system, capital and trade flows are restricted so that the assumed changes in fundamentals may cause smaller moves in the equilibrium real exchange rate. Indeed the controls—which are part of the fundamentals in this system—are likely to be adjusted to offset pressures on the nominal exchange rate if we are to judge from the historical precedent of the Bretton Woods system or other present-day examples.

The Evolution of Systems

Now, I have suggested a four-way classification—fixed open, floating open, fixed closed, and floating closed—but only the first three really seem to be observed much in the real world. If there is only one independent central bank with any other monetary authorities passively adjusting their money supplies as required to maintain the nominal exchange rate, then one has a fixed open system. The ultimate example would be the linkage of the other 11 Federal Reserve districts to that headquartered in New York, but some observers would characterize the European Monetary System this way as well as certain countries that independently have chosen to define their national currencies as a certain quantity of dollars or pounds.

When there are sovereign nations involved, each has the right to set up a central bank with the power to determine its own money supply so that inflation or deflation reflects national goals, not the choices of a foreign central bank or the implications for the real exchange rate of changing tax policies or other fundamentals. This is why sovereign nations rarely operate for long under fixed open systems.

There is a strong impulse for a nonreserve country to resist an unwanted inflation or deflation by imposing capital controls. At the same time a bit of protectionism is likely to be added. As time goes on these controls build up until the system can only be characterized as closed. This is the sad history of the Bretton Woods system. That system was broken both by the growing gap between the inflationary impulse in the reserve country and the lower inflation goals in many major nonreserve countries as well as by technological innovations that made capital controls increasingly difficult to enforce.

With the advent of floating rates, there is little to be gained to offset the costs of operating a closed system, so we should not be surprised that the controls were dismantled and that international trade boomed. The costs of dealing with fluctuating real exchange rates while real proved much less a burden on trade than the costs of the controls needed to prevent the fluctuations. As Bordo and Schwartz report, in work with James Lothian I have recently developed evidence that the floating open regime has indeed resulted in a much more integrated world real economy even as nations have pursued much more divergent inflation goals than were possible under the Bretton Woods system.

Conclusion

I believe that the basic distinction is between open trading systems in which real exchange rates fluctuate and closed trading systems in which the effects on the real exchange rate of changing fundamentals are attenuated or offset by variable controls on the flows of goods and capital. While both fixed and floating exchange rates are consistent with open trading systems, the fixed system requires acceptance of substantial fluctuations in the price level of the nonreserve countries. For this reason, we observe historically major sovereign nations linked primarily either by fixed closed or floating open systems. It seems preferable to me when analyzing transmission under fixed and floating exchange rates to account simultaneously for the differences in capital and goods controls that are associated with the two systems. There is little gain and much potential mischief in comparing real systems with imaginary alternatives: After all, even democracy and capitalism suffer by comparison to idealized utopias instead of real alternatives.

THE EUROPEAN MONETARY SYSTEM: HOW WELL HAS IT WORKED?

Michele Fratianni

Introduction

The Treaty of Rome makes no reference to monetary union or specific exchange rate arrangements. In 1968 Raymond Barre, then commissioner of the European Community (EC), wrote a proposal advocating tighter consultations of member governments concerning macroeconomic policy and in particular monetary policy. The celebrated Werner Report of 1970 was an outgrowth of Barre's ideas. Although this report set monetary union as the ultimate EC objective, it was careful to emphasize (1) preconditions in the form of coordinated policies and (2) the establishment of narrower margins of fluctuations around exchange rate par values. The so-called snake arrangement, instituted in 1972, was believed to be the Werner Report in action. In fact, from the Werner Report the "snake" system borrows only the idea of reducing currency fluctuations without setting a machinery to coordinate policies. The "snake" failed.

The decision taken in 1978 by Chancellor Helmut Schmidt and President Giscard d'Estaing to create a "zone of monetary stability" came as a surprise, not only to the general public but also to central banks. Samuel Brittan (1979) speculated that the birth of the European Monetary System (EMS) had less to do with a desire for monetary stability than a Franco-German reaction to the weakness of the dollar and the unreliability of the Carter Administration. Whatever the reasons, the EMS became a reality on March 13, 1979.

Several authors predicted failure or at least modest success. Benjamin Cohen (1981, p. 21) stated that "the potential for an inflationary

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