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THE LOGIC OF THE INTERNATIONAL MONETARY NON-SYSTEM

W.M. Corden
Discussion Paper No. 24
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Abstract

THE LOGIC OF THE INTERNATIONAL MONETARY NON-SYSTEM

by

W.M. Corden

This paper looks at the current international exchange rate system of managed floating and asks whether there is any coherence to it. In particular, what motivates the various decentralised exchange rate interventions of monetary authorities? It is noted that one motive is "exchange rate protection", taking the form mainly of "leaning-against-the-wind". The paper asks how world equilibrium is established - i.e. how various exchange rate or current account objectives are reconciled in the absence of explicit co-ordination. The main, and well-known, answer is "U.S. benign neglect" - i.e. the United States not intervening in the foreign exchange market.

The paper also explores the idea of world equilibrium in a symmetrical system, one where the U.S. does not follow a passive policy. Emphasis is given to market forces in equilibrating such a system. The willingness of countries to accumulate foreign exchange reserves, to run down reserves or to borrow will be influenced by world interest rates. Interest rate flexibility would tend to equilibrate a system in which there is no policy co-ordination among countries and the U.S. is not a residual transactor.

Finally, there is some discussion of whether this type of laissez-faire system, where various governments intervene in a decentralized way is optimal. It is suggested that the general principles of welfare economics could be applied to answering this question.
THE LOGIC OF THE INTERNATIONAL MONETARY NON-SYSTEM

Introduction

It has been said that the present international monetary system is really a "non-system". It emerged unplanned out of the chaos of the Great Inflation, the breakdown of the Bretton Woods system and the Oil Shock. It has no relationship to anything considered or proposed by the Committee of 20 that was supposed to produce an outline of a new system and that gave up the job at the end of 1973. It is neither a system of agreed fixed rates - even if fixed only for limited periods - nor a system of free floating. As a system of managed floating it is a system of many managers who appear to operate subject to no explicit rules, whether self-imposed or laid down by some central agreement. ¹

This rather negative characterisation can be developed further if one looks at this chaotic system with the eyes of a Soviet central planner. Who decides the prices - i.e. the exchange rates and the interest rates - in the system? Who ensures that when one price is changed by one manager the other prices change in a compatible way? Who decides the quantities? For example, when the OPEC countries decide to increase their current account surpluses, who allocates the inevitable total "oil deficit" of the rest of the world? How much of this deficit is to be borne by the United States, for example, and how much by the non-oil developing countries? When the corporations of a major country like Japan decide to reduce investment because of their pessimism about the future, who ensures that the resultant excess savings of the Japanese people are absorbed? And so on. Presumably the present non-system - like the chaotic decentralised capitalist system itself - would be the despair of such a central planner who
put his mind to understanding it. It is certainly a system which, in the minds of many, cries out for reorganisation, central direction and frequent reconsideration at summits of wise international statesmen. It is noteworthy that of the many plans for international monetary reform that were developed in the nineteen sixties and early seventies none emerged that can be said to describe the present system. It is indeed a miracle that it works at all. Perhaps there is some "hidden hand" that continuously guides it away from breakdown.

The purpose of the present paper is to seek out the logic of the system. This should help in understanding its points of friction and in finding ways of improving it. The paper does not attempt to deal with all aspects of the question since the study of the international monetary system is a complex subject and has spawned a vast literature. The purpose is really just to make a simple point, one which is implicit in much current discussion, but usually fails to be made explicit.

A System of International Laissez-Faire

The key feature of the present system is that it is a form of international *laissez-faire*. First of all, it allows free play to the private market, not just to trade in goods and non-financial services but, above all, to the private capital market. Secondly, it allows free play to governments and their central banks to operate in the market and - if they wish and where they can - to influence and even fix its prices or its quantities. Thus it is a fairly free market
where many governments, acting in their own presumed interests and not necessarily taking much account of the interests of other governments, are participants.

Governments are quite free to borrow and lend and to determine their own monetary policies. Above all, they are free to intervene as much or little as they wish in the foreign exchange market. From the point of view of the present discussion this is the most important way in which governments participate in the system. This latter freedom was clearly established in the Jamaica Agreement of January 1976 reached by the Interim Committee of the Board of Governors of the International Monetary Fund. The Jamaica Agreement in fact ratified the new system that had evolved since early 1973. It provided "principles for the guidance of members' exchange rate policies" and for "surveillance" of such policies by the International Monetary Fund. But, for all practical purposes, countries could do what they liked. The proposed guidance was rather general and no element of compulsion was intended.

In practice governments and central banks act subject to many constraints, whether constraints of credit-worthiness in the international capital market, ability to control their domestic monetary policies, or self-imposed constraints on their exchange rate policies. They may choose to fix their own rates relative to some other currency, relative to a currency basket, or to the SDR. But, like the constraints which the members of the European Monetary System have imposed on themselves, these are self-imposed and - above all - do not take into account the international system. The essential feature of the present system is thus decentralisation and absence of uniform, world-wide rules of any real significance.
In assessing this apparently chaotic "non-system" three questions arise. Firstly, what motivates the various decentralised interventions of governments? Secondly, how is a world equilibrium established; in other words, how are targets - whether exchange rate targets, current account targets or official reserve targets - reconciled? Thirdly, is there some element of optimality, some logic from a world welfare point of view, in the system?

The System of Free Floating Exchange Rates

Before pursuing these three issues it seems desirable to clarify the nature of the present system by describing an alternative model where governments and central banks are not actors in quite the same sense. This is the model of a free floating exchange rate system - with no management of exchange rates - which many of us envisaged until the early seventies as the alternative to the Breton Woods system. I assume that this is, broadly, the model that Milton Friedman and James Meade had in mind when they put their cases for flexible exchange rates in the nineteen-fifties.²

In this model each country chooses its fiscal and monetary policies with no concern for the exchange rate or current account outcomes. Let us assume for the moment a passive fiscal policy taking the form of exogenously-determined government expenditure combined with either constant tax rates and an endogenous bond-financed government deficit, or alternatively, with variable tax rates designed to maintain a constant deficit. Monetary policy could be determined in a number of simple ways: there may be a constant or pre-determined rate of growth of the money supply, the actual rate of growth being determined by
domestic considerations; alternatively, nominal wages may be assumed
given, and monetary policy may be aimed along Keynesian lines to achieve
a constant level of employment or a given unemployment rate; and
finally, monetary policy may be directed to maintain a constant domestic
nominal interest rate. With monetary policy decided on the basis of
any of a number of possible domestic considerations - and with fiscal
policy passive, with international capital mobility, and with the
exchange rate freely floating - there will then be unplanned exchange
rate and current account outcomes. There will be no need for official
reserves, and if they exist their levels will not change.

The world capital market will equilibrate through interest
rate changes. In any given period the algebraic sum of net capital
outflows of all the countries must add to zero for the world as a whole;
the converse is that the algebraic sum of current account surpluses must
add to zero. This would not just be a statistical result: interest
rate flexibility in the world capital market would make it a true
equilibrium. It might be noted that the existence of a world capital
market does not mean that interest rates throughout the world must be
uniform. Expectations of exchange rate changes will bring about
divergences between interest rates. In addition, since not all bonds
are traded, a country's monetary policy can still aim to fix or influence
the prices of its non-traded bonds even when the prices of traded bonds
are determined in a world market.

A change in a country's monetary policy will alter its exchange
rate and possibly its capital (and hence current) account. Thus
governments influence the foreign exchange and capital markets
even in a system where they do not directly intervene in the foreign exchange
market. As long as there is publicly supplied money, it cannot be
otherwise. But the "free floating" paradigm has an implicit view about motivation: monetary policy does not have exchange rate or current account objectives.

An active fiscal policy can easily be introduced. Again, it is necessary to assume that fiscal policy is not consciously directed to influencing the exchange rate or the current account. Given this assumption, it is not really necessary to set out the various possible motivations of fiscal policy changes, whether they are concerned with employment, with domestic interest rates, with the achievement of some budget balance target, or whether fiscal policy is the outcome of pressures from various interest groups.

This brief description of a hypothetical "free floating" system where governments do not concern themselves with their countries' exchange rates nor with the magnitudes of the various components of their balances of payments, provides background for the subsequent discussion. We can now turn to the three questions listed earlier that arise in assessing the current "non-system" of managed floating.

The Motives for Intervention in the Foreign Exchange Market

What motivates the various decentralised interventions of monetary authorities in the foreign exchange market? There appear to be two main motivations.

(a) Smoothing Intervention

The first is to smooth out fluctuations, whether in the very short or the medium-term. Short-term intervention is usually described as avoiding "disorderly conditions" in the market. Such smoothing intervention, if it is successfully stabilising, should be profitable to central banks. It has been much discussed in the literature, and
raises the issue of whether public authorities have more resources or better information, or are more rationally motivated, than private operators in the market. In any case, governments widely intervene on these grounds not because they wish their central banks to make profits from foreign exchange speculation but because they believe that they can successfully smooth out exchange rate movements and because they regard this result as desirable for trade and capital flows.

In practice there is not much debate about the legitimacy of this type of intervention. It does not give rise to conflicts between governments because they usually welcome the smoothing activities of other countries' central banks. At the same time some academics doubt that such intervention is usually successful - i.e. that it smooths and is profitable - and even if it is, they query its necessity in the presence of private speculators.

(b) Exchange Rate Protection and Leaning-against-the-Wind

A second motivation for intervention in the foreign exchange market is by far the most important for the present discussion. This is "exchange rate protection", a special case of which is "leaning-against-the-wind". Governments intervene in the market in order to affect the domestic inter-sectoral or inter-factorial income distribution. Usually the aim is to prevent or moderate a redistribution that would otherwise have taken place as the result of changes in the real exchange rate. If the net effect is neither to bring about an actual redistribution relative to a recent period, nor to prevent completely one that would have taken place in the absence of intervention, but only to brake it or slow it up, then the policy can be described as "leaning-against-the-wind".
It may be observed that a country's exchange rate is appreciating in real terms, and at the same time foreign exchange reserves are being accumulated (which prevents even greater appreciation). Then we know that a leaning-against-the-wind policy is being followed. The same applies if the exchange rate is depreciating in real terms and reserves are being run down. There is evidence that, since generalised floating began in 1973, this has been the main type of medium-term intervention. For example, Japanese intervention in 1977 and 1978 slowed up the yen appreciation that was actually taking place, and this intervention appeared to be motivated by a concern for the adverse effects on export and import-competing industries that an even greater yen appreciation in real terms would have had. U.K. intervention in 1974 and 1975 was designed to prevent further depreciation of sterling that would have reduced real wages and so would have accelerated a wage-price spiral. In general, the governments of appreciating countries worry about the adverse effects on profits and employment in their export and import-competing industries and governments of depreciating countries worry about the effects on wage demands and hence inflation. In the era of the Bretton Woods par value regime these worries gave rise to reluctance to alter exchange rates while in the era of managed floating they gave rise to leaning-against-the-wind interventions.

Intervention of this kind can create problems and international conflicts, as Japanese intervention did in 1977 and 1978. A part of Japan's export industry was booming, capturing world markets and generating a current account surplus for Japan. Appreciation of the yen moderated the adverse effects on competing industries in other countries. At the same time it created adverse effects for other
Japanese export industries and for import-competing industries. Intervention designed to brake the appreciation then had a leaning-against-the-wind effect domestically in Japan, while preventing such an effect for industries in other countries that competed with Japan's boom industries.

In principle exchange rate protection could be more than leaning-against-the-wind. It could aim to prevent an exchange rate change altogether, or it might be directed to allowing some change, but then stabilising the rate at a new level other than the equilibrium rate which a free market would generate. Advocates of an exchange rate policy in Britain designed to prevent so-called "de-industrialisation" seem to have something like this in mind. It should also be stressed that intervention motivated by exchange rate protection assumes that nominal exchange rates and real exchange rates move together. It is assumed that domestic wage and price movements do not fully offset the effects of nominal exchange rate changes. There seems to be good evidence that, in general, for the short and medium-run this is actually so. Of course, there is usually partial offsetting, especially in the case of depreciation, so that the extent of a real depreciation is less than the nominal depreciation which gave rise to it.

Exchange rate protection - like other forms of protection - has a cost to the country practising it, even though there are presumably also perceived benefits. In the case of a deficit country this is the cost of running down reserves or official borrowing beyond levels that would otherwise be optimal, taking into account the world interest rate, political conditions attached to special loans, the domestic social rate of return on investment and the domestic rate of time-preference. In the case of a surplus country it is the cost of excess
lending on the world market, taking into account again the world interest rate as well as the potential social return if the funds were used domestically. The greater the borrowing or lending the greater not only the total cost but also the greater the marginal costs are likely to become, especially if the country is a large borrower or lender on the world capital market. Even in the case of a small borrower the market's perception of the country's creditworthiness is likely to deteriorate the more it is borrowed, and so the interest cost will rise.

Apart from smoothing intervention and leaning-against-the-wind there is a third possible category of motive for exchange rate interventions, namely to attain certain quantitative targets, whether of levels of official reserves or of current accounts. The implications of such motives will be discussed below. Nevertheless, it is difficult to explain a significant proportion of interventions in recent years — as measured by changes in official reserve levels — in these terms.

The objectives just discussed could also be achieved or influenced by domestic monetary and fiscal policies. For example, exchange rate protection can be brought about by a contractionary fiscal policy which lowers domestic interest rates, induces capital outflow and thus depreciates the exchange rate. Similarly, a monetary expansion can bring about this result. The net exchange rate and current account results can thus be achieved in a number of ways, though often intervention in the foreign exchange market seems the most direct for the purpose. In any case, the motivation and the final results, rather than the instrument, are crucial.
How is World Equilibrium Established?

With different monetary authorities intervening in the foreign exchange market as they choose and no centralised agreement about the exchange rate pattern (like the Smithsonian Agreement of December 1971) or about the pattern of current accounts (as was widely advocated in 1974), how does the system equilibrate?

(a) U.S. Benign Neglect

The simple and well-known answer is that - subject to some qualifications - the United States has acted as the residual net buyer or seller of financial claims in the world capital market. It has been passive in the foreign exchange market, following a policy of "benign neglect". Every other country can determine its own exchange rate relative to the dollar if it wishes, or alternatively can manipulate its exchange rate combined with monetary and fiscal policies to bring about a desired current account outcome. But the United States stands by and lets things happen. Essentially this was also the situation under the Bretton Woods regime, except that other countries were not quite as free as they are now. The world system is thus closed by the introduction of a major asymmetry. This does not mean that other countries can have the bilateral exchange rates they want - even though these may often be their main concerns. It obviously takes two to settle a bilateral rate. But the system does allow immense flexibility - coping for example with the OPEC surpluses by decentralized adjustments.

Two qualifications to this asymmetrical "benign neglect" model have to be noted. Firstly, in November 1978 the United States did intervene in the market in response to an apparently precipitous depreciation of the dollar. The intervention itself and - more important - the expectations generated by the intervention stabilised the dollar. This was a major departure of policy since floating began. It was an abandonment of
"benign neglect" and suggests the possibility of frequent or regular interventions in the future. Nevertheless this episode has not put the basic system to the test. The reason is that the objective of intervention was clearly not to establish an exchange rate pattern different from that desired by other major countries - especially Germany and Japan - but, rather, it was meant to put an end to what policy-makers regarded as "disorderly conditions" in the foreign exchange market. The intervention took place with the enthusiastic support of monetary authorities in the other major countries and was in the same direction as their own interventions. Thus there was no element of international conflict.

The second qualification is that there have been times when the U.S. authorities have had views about the medium-term value of the dollar - especially relative to the yen - these views having been much influenced by concern for U.S. industries that compete with Japanese exports. Thus an element of exchange rate protection thinking has existed in the U.S. For example, it influenced the U.S. advocacy of yen and D-mark appreciation in 1977. This type of thinking also played a part in the realignment of exchange rates forced by the U.S. in 1971. But at these times the U.S. authorities have not actually intervened in the market directly; rather they have sought by exhortation and political pressure to influence the intervention policies of other countries.

(b) **Equilibrium in a Symmetrical System**

The interesting question next arises whether it is possible to conceive of a completely symmetrical system where the U.S. does not follow a passive policy. In such a system all governments act in a decentralised way - with no role for exhortation, co-operation or centralised decision-making. Can such a system yield a world equilibrium? In such a system governments, like private firms, can be buyers and
sellers not only of goods but also of financial claims in the world market. They can be concerned with levels of real exchange rates and the interests of their export and import-competing industries to varying extents - varying between countries and at different times for any given country. In such a system the United States authorities must be allowed to have an exchange rate protection view - or a view about the desirable change in the level of net liabilities to foreigners in any given year.

In considering this hypothetical symmetrical international monetary world, the first point to make is simple. If all countries including the United States had fixed current account targets a problem of incompatibility of targets would be likely to arise. Some countries would end up not attaining what they wanted. Similarly if all housewives and shopkeepers went into the market on a particular day with a fixed view of how many apples they intended to buy or sell that day irrespective of the price of apples a problem of incompatibility of targets would arise. The essential feature of this supposed incompatibility problem is that it leaves out of account the possibility that targets can be influenced by prices.

Exactly the same problem would be generated if all countries wished to fix either their nominal or their real exchange rates. This point is so well-known that it need hardly be laboured. If all countries other than the United States fixed their nominal exchange rates relative to the dollar, the U.S. would be left with nothing to decide.

What then is the resolution to this apparent difficulty? The answer is that a role must be given to the usual forces of the market acting through prices. The relevant prices in this case are interest rates. The problem is to reconcile the desires of different countries to buy and sell financial claims on the world market, the potential
transactors including central banks that are intervening in the foreign exchange market. The system will equilibrate if the demands or supplies of financial claims of at least some of the transactors are responsive to interest rates. Given some elasticity, price changes in this market can reconcile targets that initially seem incompatible just as changes in the prices of apples can equilibrate the apple market.\(^4\)

Two stories out of many possible ones can be envisaged. In the first case governments (and central banks) have fixed targets, not responsive to the interest rate, but equilibrium is attained through the interest rate responsiveness of private-sector demands or supplies. In the second case governments have exchange rate targets, but these are interest-rate responsive.

In the first case we assume that the United States authorities do not wish to change the supply of bonds (financial claims) in the hands of the public, domestic and foreign combined, and use fiscal policy to ensure this. Foreign governments then intervene in the foreign exchange market to build up their foreign exchange reserves, which we can suppose to take the form of dollar financial claims of various kinds. They aim at a fixed target increase in reserves in a given period. The reason for this desired increase in reserves need not concern us here. The interest rate will fall (bond prices will rise) and this will induce private holders to part with bonds just sufficiently to satisfy the extra demands of the world’s governments. Governments thus have fixed targets, while market forces operate through the interest-rate responsiveness of the private sector in various countries.
The current account outcomes will be incidental. The U.S. current account will deteriorate as the U.S. private sector moves marginally out of bonds into goods. On balance the current account of any particular country other than the U.S. would move in either direction. On the one hand the accumulation of official reserves and the associated depreciations will improve the current account. On the other hand private capital inflow will result from the stimulus to borrowing (sale of bonds) brought about by the reduced world interest rate, and this will tend to appreciate the exchange rate and worsen the current account. For all non-U.S. countries together there must be a net improvement in the current account.

In the second case we assume that government targets are interest-rate-responsive. We assume that all non-U.S. governments have an exchange rate target relative to the dollar which they have initially attained, the U.S. having been passive. The result has been a particular pattern of current account imbalances, perhaps adding up to a net deficit for the United States. The non-U.S. public and private sectors combined are building up financial claims on the United States. The U.S. authorities then end their passivity. They may wish to reduce the accumulation of foreign claims on the U.S. More likely, they may wish to bring about depreciation of the dollar to assist U.S. export and import-competing industries, the motive thus being exchange rate protection.

The Federal Reserve can bring the desired result about by engaging in open market operations designed to lower U.S. interest rates. This will lead to private capital outflow and - for given official net purchases in the foreign exchange market by foreign monetary authorities - will lead to the desired dollar depreciation.
But foreign official intervention cannot be taken as given since we are supposing that the foreign authorities have exchange rate targets. If the foreign exchange rate targets were absolutely fixed, foreign intervention would then be increased in order to restore the original exchange rate pattern.

It is at this point that the cost of exchange rate protection - to which reference was made earlier - must be recalled. In the case of a surplus country this is the cost a country incurs by lending abroad more than is justified by the usual optimal lending considerations. The lower the U.S. interest rate the greater the cost of excess lending and hence the greater the cost of exchange rate protection. It is reasonable to presume that exchange rate targets would be modified by this cost consideration. To take an extreme case, if a country like Japan found that it was obtaining negative real rates of interest on its dollar-denominated claims it would be likely in due course to moderate a policy of exchange rate protection that was leading to the official accumulation of such claims. If such a mechanism operates then market forces are at work through their influence on official policies. U.S. policies which lower U.S. interest rates will alter the exchange rate targets of foreign governments and so bring about the dollar depreciation desired by the U.S. It might be added that, as the interest rate falls, the concern of the U.S. with the growth of its indebtedness to foreigners might also be moderated, and the benefits to the U.S. from cheap borrowing might be set against the adverse effects on U.S. export and import-competing industries resulting from the exchange rate that goes with such borrowing.

The U.S. authorities could bring about a dollar depreciation not by open market operations that involve the purchase of U.S. bonds but by
intervening in the foreign exchange market directly - for example buying yen and hence pushing down yen interest rates. In both cases the U.S. money supply is increased. Given capital mobility, and with some substitutability between yen-denominated bonds and dollar-denominated bonds, the lower interest rates on yen-denominated bonds will also lead to lower interest rates on U.S. bonds and the question then is whether this will affect the Japanese exchange rate target. If the lower interest rates did not induce the Japanese to reconsider their exchange rate target there would be a clear case of incompatible exchange rate policies - with the Japanese buying dollars to keep the dollar up and the Americans buying yen to get the dollar down. On the other hand, a non-co-operative equilibrium would be established when these operations lead to a reconsideration of exchange rate targets and, in particular, when the lower interest rate induces the Japanese to moderate their accumulation of dollars.

Is the System Efficient?

In assessing the market economy as a method of economic organisation it is usual to assume that households and firms are the best judges of their own interests and then to consider the role of the market system as a co-ordinator or integrator of the various decentralised decisions of households and firms. The principal argument for the market is that
decentralised decision-making is more efficient and flexible than the alternative central planning approach. Theory does not suggest that the free market necessarily leads to an 'optimal' result, i.e. that it cannot be improved upon in various ways. In particular, monopolistic and oligopolistic elements may distort the outcome, externalities may generate effects which bypass the market, and finally, no firm judgement can be made about the income distribution effects which are a by-product of the market system.

It is also accepted that all firms do not necessarily know how to maximise profits or organise themselves efficiently. This gives rise to the study of business management, to consulting services, and also to conditions imposed by creditors upon firms that get into financial difficulties. In addition, households and individual persons may need information and guidelines to make wise decisions in their own interests. Furthermore, it is also thought appropriate in many countries to impose a few firm rules to protect citizens from themselves.

All these ideas which have been formalised in modern welfare economics can be, should be, but have not been applied to the assessment of the international monetary system. The parallel will no doubt appear obvious to the readers of this paper. The current laissez-faire international monetary system is simply a market system which co-ordinates the decentralised decisions reached by private and public actors and is likely to be as efficient in this as the market system is within the domestic economy. In formal terms one might make the assumption that when governments intervene in the foreign exchange market and when they practice their monetary and fiscal policies they are trying to maximise a national social welfare function in the same way as households are presumed to be maximizing a utility function and firms are presumed to be efficiently
maximizing profits. With regard to the international trade by private and public transactors in financial claims the crucial prices are interest rates, and the question has to be considered to what extent these prices are equated to relevant marginal costs and returns. Current account imbalances simply indicate the net trade by each country in financial claims in exchange for goods.

In assessing the system one has to consider whether there are externalities - i.e. connections between the actors in the system that do not pass through the price system - and whether the outcome is significantly affected by monopolistic or oligopolistic elements - which in the present case must presumably refer to the dominant role of the United States monetary authorities. It should be noted that if a particular policy of one country - such as an intervention that brings about depreciation of its exchange rate - has an adverse effect on another this does not necessarily mean that there is an externality. After all, if a housewife goes into the market and buys a thousand kilos of apples, hence forcing up the price of apples, this has an adverse effect on other apple-buying housewives, and yet it is not an externality because all the adjustments operate through the market. Similarly, if Japan increases her exports of goods so that her government can import more bonds (i.e. build up foreign exchange reserves) this will have an adverse effect on competing foreign producers of these goods and on foreign buyers of bonds, but there need be no element of externality.

It is not possible here to carry out an analysis along these lines in any detail. But perhaps it can be suggested as an agenda for research. In particular, what are the external diseconomies in the international monetary system, if any? It seems to me that the proper approach is to start with the assumption that this particular form of international
market is reasonably efficient. It is likely to be more efficient and flexible than a system of co-ordinated or centralised decision-making of the type that was uniquely and unsuccessfully attempted in 1971 at the Smithsonian Agreement with regard to nominal exchange rates. The focus should be on improving the information and signalling process, on correcting for specific well-defined distortions and, in general, on "making the market work".

There is presumably a role for an international body like the International Monetary Fund to give guidance to countries as to how to pursue and assess their own interests more effectively. In addition, the Fund plays, of course, the usual role of creditors with respect to the countries that borrow from it on conditional terms.

In my view it cannot be automatically assumed that attempts to "manipulate" exchange rates because of concerns with domestic sectoral or factor incomes - that is, exchange rate protection - are never legitimate. Such a concern could be part of a reasonable national social welfare function. But perhaps this issue should be left as an open question, calling for more consideration. In any case, from the point of view of thinking clearly about the international monetary system it seems convenient to separate those issues that are concerned with the optimal or efficient policies for individual countries from their own points of view (maximising their social welfare functions) and those issues that are concerned with the efficiency of the international system as a whole. Many international monetary problems fall under the first category - for example the problem of a country that has engaged in excess borrowing owing to an inability or reluctance to bring about needed reductions in real incomes and that faces either bankruptcy or a need for drastic and domestically unpopular measures as a result. The focus of this paper is
on the second aspect. The suggestion here is that, with regard to
the system as a whole, the concept of the market and the methods of
modern welfare economics for assessing markets are highly relevant.

At the beginning of this paper I said that the aim is really
to make a single, simple point. This simple point is that the current
system of managed floating, with its large and changing current account
"imbalances" and its exchange rate "manipulations", should be seen and
assessed in terms of familiar market concepts, bearing in mind that
governments can be actors in such a market. In particular, the role
of the interest rate in the adjustment mechanism must not be neglected.
It is only a beginning for analysis, but suggests an appropriate
framework both for discovering "non-optimal" or inefficient aspects
of the current international monetary system and finding ways of
improving it.
Footnotes

1. The term "international monetary non-system" comes from Williamson (1976), who unlike the present author, viewed the absence of "system" with disapproval.

2. Friedman (1953) and Meade (1955).

3. On "exchange rate protection", see Corden (1980), and on "leaning against the wind", Quirk (1977) and Tosini (1977).

4. This is, perhaps, the main point of this paper. The idea seems to have been neglected in the literature on the international monetary system, the only exceptions of which I am aware being Lindbeck (1977) and Salop and Spitalier (1980).
References


P.J. Quirk, "Exchange Rate Policy in Japan: Leaning Against the Wind", International Monetary Fund Staff Papers. 24, November 1977, pp.642-64.

