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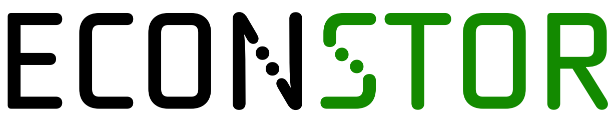

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EXCHANGE RATE POLICY

Proposal for an EC Exchange-Rate Scheme

by Hans-Eckart Scharrer, Hamburg *

Leaving foreign exchange markets to themselves may not lead to realistic and stable exchange rates. Thus appropriate criteria for interference must be defined. The OPTICA (Optimal Currency Area) Group which was appointed by the European Commission tried to work out appropriate rules for the EC. Dr Scharrer, member of the group, explains their proposal; Professor Cohen and EC Vice President Ortoli give their comments.

In the past years the European Community has not only made no progress in economic and monetary integration: persistent large discrepancies in inflation rates among member countries, high levels of unemployment and a succession of crises in the exchange markets demonstrate on the contrary that it has even drifted further away from the proclaimed goal. Of special significance in this context is the feedback of devaluations on the pace of inflation and vice versa which has become known as the "vicious circle". The policy makers' response to this process was largely confined to the reintroduction or tightening of exchange controls and of more or less overt restrictions to trade: measures which are clearly inconsistent with the goal of economic union.

It is against this background that the proposal of the OPTICA group [1] for a Community management of exchange rates should be seen. It was not the intention of the group to devise an "ideal", yet inoperable exchange-rate system for the Community. Our aim was rather, starting from the empirically observed medium and long-term correlation between exchange rates and inflation differences [2] to develop rules for exchange-rate policy conducive to stabilizing expectations of exchange-market participants and supporting the national monetary authorities in their endeavours to contain the upward movement of the price levels; rules which are acceptable to all member countries irrespective of their current rate of inflation. In this way the conditions for breaking the vicious circle could be improved and a convergence of inflation rates at a low level would be promoted. Exchange-rate policy is thus put at the service of internal monetary management and notably money-supply policy.

Other recent schemes do not seem to meet this guiding principle. This is true for the IMF guidelines for floating and the considerations of the Cromer-group [3] based upon them, as well as for the Oort scheme [4] (target zone coupled with crawling peg) and the Duisenberg proposal of the Dutch authorities. With the exception of the Oort scheme most of these proposals suffer also from the deficiency that national monetary authorities would be empowered with too much discretion in the setting and defending of the target rate: the rules are subject to wide margins of interpretation. Finally, none of the proposals is adequately taking care of the danger that transitory fluctuations of exchange rates, outside of their implied purchasing power parity (PPP) values, can initiate a process whereby the short-term deflections of the exchange rate are subsequently validated.

According to the OPTICA proposal the EC members should manage their exchange rates in relation to reference rates which crawl on the basis of countries' relative price performance (measured in terms of their wholesale price indices). The proposal can be summarized as follows:

a) The reference rate for each country participating in the arrangement is defined in terms of an effective exchange rate. The reference rate is subsequently expressed in European Units of Account (EUA) for purposes of standard measurement.

b) An effective PPP index is calculated for each participating country: its wholesale price index is divided by a weighted average of the wholesale price indices of its competitors, the weights being the same as those entering into the formula of its effective exchange rate.

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[1] OPTICA Report 1972: Inflation and Exchange Rates – Evidence and Policy Guidelines for the European Community, Brussels: Commission of the European Communities (Doc II/855/76 – E Final). Giorgio Basevi, Pascal Salin, Nils Thygesen and this author were members of the group, Paul De Grauwe was an associate member. Michele Fratianni and Horst Schulmann of the EC Commission greatly assisted the work of the group.

[2] Cf. the empirical evidence presented in Chapter I of the report.

[3] Three Steps towards European Monetary Harmonization, in: The Times, July 26, 1976.

[4] C. J. Oort, Exchange-rate policy in the European Communities, in: Common Market Law Review, Vol. 13 (1976), No. 3.

c) A country's reference rate is changed periodically (at least quarterly) in proportion to the change of a moving average of its effective PPP index. The length of the moving average and the weights to be attached to the individual time elements on an average would be the same for all countries in the arrangement.

d) The authorities set margins around the reference rate

e) At the beginning of each period (e. g. month, quarter) the authorities ascertain, on the basis of the computation described in b) and c), whether their country's reference rate has appreciated or depreciated relative to the preceding year. In the case of an appreciated currency the authorities intervene by selling their currency on the spot market if the market rate tends to extend the lower bound of the band. Conversely, in the case of a depreciated currency the authorities intervene by buying their currency if the spot market rate tends to exceed the upper bound of the band.

f) The authorities do not sterilize the monetary counterpart of their foreign exchange interventions.

g) The mechanism of intervention and reserve borrowing currently in use among members of the European Fund for Monetary Cooperation (FECOM) would have to be extended in order to make this scheme operational. Borrowing countries are to pay a positive real rate of interest on outstanding loans. Borrowing privileges are reduced or completely abolished in the case of a country contravening e) and f).

h) "Snake" countries can keep their present arrangement but at the same time would need to coordinate their economic policy so as to progressively align their exchange rates to their implied PPP value.

With regard to the more technical properties of the proposal as mentioned in items a) – d) there are several alternative possibilities. The choice among them has however no direct bearing upon the essence of the proposal.

This applies to the definition of the effective exchange rate (country-specific as well as uniform weights may be used), the length of the moving average, the weights to be given to each element in the average, and the width of the band. As to the last point there was agreement in the group that given the current monetary and economic conditions a relatively wide band should be applied in the beginning and that a reduction should take place only gradually. This is in accordance with the general approach of the proposal: Its aim is not to stimulate market participants to test the authorities' determination of defending over-ambitious goals but rather to stabilize market expectations by setting creditable targets.

It is one of the main features of the proposal that interventions, if any, are made in only one direction for a given currency during any given period. Relatively depreciated currencies are not permitted to depreciate by more than the amount indicated by their purchasing power (plus the margin), but they are free to appreciate if the market so indicates. Conversely, relatively appreciated currencies are not permitted to appreciate more, during any period, than the amount implied by their purchasing power (plus the margin), but they can depreciate if the market so indicates. The rationale for this one-sided intervention scheme can easily be understood. On the one hand, the scheme aims at avoiding the building up of exchange-rate-wage-price spirals as possibly leading to hyper-inflation or exchange and trade restrictions in devaluing countries. It does not aim, however, at frustrating market forces where these enable a country to do better on the exchange-rate front than is indicated by its past performance on the inflation front. On the other hand, the scheme aims at avoiding too rapid appreciation of strong member currencies, but allows them to appreciate by as much as what seems granted by their past relative price performance, when market forces imply this result.

On the whole, the scheme puts the emphasis on stabilizing expectations in the exchange markets and on lessening the disparity of inflation rates among member countries. Such a goal, however, is not sought through the imposition of a strait-jacket in the form of shrinking margins of fluctuation. Inflation rates will continue to diverge so long as member countries do not harmonize their incomes and monetary policies. The proposal only aims at preventing inflation rates from diverging even more as the consequence of disturbances in the foreign exchange markets. The scheme in no way implies that low-inflation countries would be induced to raise their inflation rate.

Supplementing Monetary Policy

The mechanism is devised in such way that the exchange market interventions of the central banks supplement their internal monetary policies in their restrictive or expansionary path. This follows not only from the asymmetry of interventions but also from the postulate under f) according to which the monetary counterpart of interventions should not be sterilized. To clarify, consider the following example. Assume that a yearly money supply target is set at a 5% growth level. It may still happen that the target is temporarily overshot and that this or other exogenous factors push the exchange rate upward (a devaluation) during a quarter. Intervention to slow such a movement will

require destruction of base money at a rate that may restore the growth of money supply to the target rate. Over the whole year, however, if the exchange rate is smoothed on the PPP path implied by the yearly target for money supply, the foreign exchange intervention should be nil. Or, speaking in more general terms, the obligation of monetary authorities to prevent weak currencies from depreciating and strong currencies from appreciating too much implies that an abnormally high or low rate of money creation will be corrected.

On the other hand, if the smoothing rule on foreign exchange were not followed, the excessive departure of the exchange rate from the PPP trend implied by the money-supply target may feed back into prices and wages to such an extent that the authorities' capacity to stick to the target may lose credibility. In fact, abiding by the money-supply rule in the face of the unexpected inflationary push (implied by the unexpected devaluation) means a more stringent credit squeeze and/or a reduction of the central bank's willingness to finance the government deficit, either and both of which may be politically unacceptable.

Clearly, the stabilizing features of this scheme have also some drawbacks. While the scheme has the advantage of making it difficult for devaluing countries to accelerate their money supply too rapidly, revaluing countries are facing constraints in decelerating their money-supply growth too rapidly. In other words, as already pointed out, the scheme puts a premium on monetary convergence. However, the practical significance of this difficulty should not be exaggerated especially if allowance is made for the moderate length of the moving average (a year), the frequent periodicity in resetting the reference rates (every quarter or month) and the margins applied to the reference rate. Countries with a high propensity to monetary stability will therefore continue to be in the position to improve their performance. It is only the speed of improvement which is subject to limitations. On the other hand there is less danger that internal stabilization is pursued one-sidedly at the expense of industries exposed to international competition as could happen when exchange rates are deviating too much from purchasing power parity.

Conditions for Monetary Support

It follows from the features of the scheme and especially from the linking of exchange market interventions with internal monetary policies conducive to stability that the drawings upon FECOM will be modest. This will hold all the more once the exchange market has become familiar with the operation methods of the proposal and incorporates them in the formation of expectations. Yet, some initial scepticism of the countries who see themselves as likely creditors cannot be ruled out. To overcome this understandable attitude it would be expedient to begin with relatively wide margins around the parities thus limiting the need for interventions. Margins could be narrowed substantially after an initial period of, say, one year. When the system has reached normal operation, margins could be narrow enough to make effective the automatic corrective pressure which the scheme is designed to introduce on domestic monetary management.

While it is essential, that the scale of lending facilities be adequate to strengthen the credibility of the reference rate structure, automatic drawings should be repayable over a short period, as is presently the case in FECOM. Access to medium and long-term credit facilities should be conditional on the borrower's compliance with collectively agreed standards of behaviour – in the proposed scheme points e) and f) on intervention rules and absence of sterilization respectively. Also, credits should carry a positive real rate of interest (g).

Tensions in the Snake

The OPTICA proposal for exchange-rate management has been inspired by recent experiences for the individually floating currencies. It is obvious, however, that adoption of the scheme would have some consequences for the snake currencies, too. If one accepts the proposition that exchange-rate management in accordance with PPP is indeed economically sound then the question arises why this relationship should not hold also among snake currencies. If one tried to exclude the snake from the scheme, changes in relative prices among snake countries are likely to invite speculation in the exchange markets and may lead to heavy (and unnecessary) strains for the snake.

In addition, suspension of rules for the snake currencies would create a number of technical problems. Should the snake as a whole follow a PPP rule based on the average performance of the members' inflation and exchange rates? Or, alternatively, should the rule hold only for the D-Mark with the other snake currencies continuing to observe fixed D-Mark intervention limits? It is obvious that the technical problems would be less if each snake currency were managed individually according to the PPP rule.

Nevertheless, the group is not proposing an abandonment of the present snake. In fact, this would be inconsistent with the underlying aim of breaking the vicious circle of depreciation and inflation so as ultimately to stabilize nominal exchange rates and harmonize national inflation rates at a low level. The creation of a Community

exchange rate system on the basis of PPP could however give an impetus to the snake countries to intensify their economic coordination. Snake and OPTICA scheme are by no means incompatible. Only if inflation rates are continually diverging among the snake partners tensions will arise.

In conclusion it should be emphasized again that not too much should be claimed for this scheme. The OPTICA proposal recognizes the unfortunate fact that inflationary propensities differ among member countries. It emphasizes the predominantly nominal character of divergent inflation rates and it allows exchange rates to offset (no more than) differences in inflation trends. It therefore underlines the importance of real factors for the processes of integration and economic growth in the Community. Contrary to earlier approaches to monetary integration the proposal is not trying to fix and support nominal exchange rates. Rather it aims at stabilizing real exchange rates within certain margins. The approach may therefore be labelled as the model of a "real" snake – as distinguished from the traditional "nominal" snake mechanism.

Recognition of the fact that inflation rates differ is both the strength and the weakness of the scheme. It constitutes its weakness, because it means that the scheme by itself cannot contribute in a major way to the harmonization of inflation rates at a low level. The prerequisite for this is, in fact, a close coordination of the member countries' monetary (and incomes) policies. It constitutes its strength, because – contrary to the snake arrangement – the OPTICA scheme cannot be endangered by a persistent divergence between member countries' monetary and incomes policies and the resultant variation of inflation rates.

Managing Floating Exchange Rates

Benjamin J. Cohen, Medford/USA *

There is much to praise in the OPTICA proposal for a new exchange-rate agreement for the European Community. The authors are clearly well informed about the recent behavior of foreign-exchange markets, as well as about recent developments in exchange-rate theory, and their case for improving management of exchange markets is a strong one. I am in full accord with their general approach to the problem. But there is also much to which one might take exception in their proposal, at least as it is presently formulated. I am in less accord with some of its most crucial details. In my view, an effective system of exchange management must, first of all, be supple – capable of bending before the wind like a willow, not rigid and inflexible like an oak. The OPTICA proposal, I fear, is more an oak than a willow and could easily break if the winds in the exchange markets happen to blow strongly enough.

Anarchy Instead of the Rule of Law

What is the case for improving management of exchange markets? Essentially, it is the case for replacing anarchy with the rule of law. At the moment, no effective rule of law prevails with respect to exchange rates – neither within the European Community nor in the wider international context. Governments everywhere are presently free to follow virtually any exchange-rate policy they choose. No agreed principles exist to specify which instruments of national policy may be used to influence exchange rates or which targets of national policy may be regarded as legitimate. Consequently, no certainty exists that policy instruments will be employed, or targets established, in ways that are mutually consistent. If the policies of governments are mutually inconsistent, it is hardly likely that their exchange rates will remain stable for long.

Whatever its defects, the old Bretton Woods system of "adjustable pegs" had one outstanding virtue: it established the rule of law with respect to exchange rates. Governments accepted an obligation to maintain exchange rates within specified margins around a declared par value. After the struggle to preserve the old system ended in early 1973, and the rates of major currencies began to float without limit, nations technically were living in sin. The main accomplishment of the Second Amendment of the IMF Articles of Agreement, agreed at a special Fund meeting in Jamaica in January 1976, was to remove the stigma of sin, by legalizing floating.

Unfortunately, not much else was accomplished on exchange rates. The Second Amendment mentions nothing specific about norms or conventions to guide central-bank intervention in exchange markets, nor about what should be the respective

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