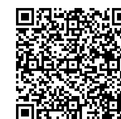
‘Why floating rates are now in fashion’ from The Financial Times (10 May 1971)

Caption: On 10 May 1971, the British daily economic and financial newspaper The Financial Times comments on Germany’s decision to let its national currency fluctuate and expresses concern at the consequences of a worsening of the international monetary crisis.

Source: The Financial Times. 10.05.1971. London: The Financial Times Ltd. "Why floating rates are now in fashion", auteur:Brittan, Samuel.
Archives familiales Pierre Werner, Luxembourg.

Copyright: (c) Financial Times

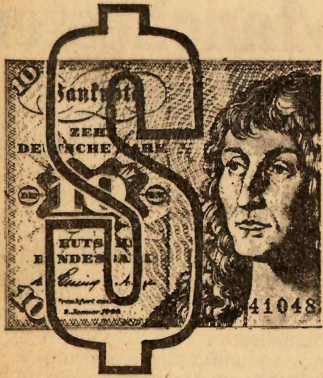
URL:
http://www.cvce.eu/obj/why_floating_rates_are_now_in_fashion_from_the_financia
l_times_10_may_1971-en-e3014101-4024-4862-b859-4f34c911b98f.html



Last updated: 05/09/2017

The Financial Times Monday May 10 1971

THE U.K. AND THE CURRENCY TURMOIL



Why floating rates are now in fashion

BY SAMUEL BRITTAN

A LEADING participant in international monetary gatherings remarked to me last year that it would take another major crisis to bring about a reform in the world exchange rate system. Never was a truer word spoken.

The present system—sometimes known as "Bretton Woods" after the conference which inaugurated it in 1944—has always contained within it the seeds of its own destruction. The system is based on exchange rates which are normally fixed, but can change in the last resort if a country faces an intractable deficit or surplus in its overseas payments.

Could not endure

This compromise has lasted a surprisingly long time; but it could never be expected to endure. One danger has always been that the system would fossilise into complete rigidity and that in order to prevent parity changes controls over trade and payments would proliferate, backdoor export subsidies and import restrictions grow up, and countries have to abandon either price stability or full employment for the sake of maintaining a parity. This was the main danger until the sterling devaluation of 1967.

Since then it has become accepted that exchange rate changes are occasionally necessary and are an essential part of international adjustment. But once people know that parities are liable to change, they do not wait for some Finance Minister to make the announcement, but move vast sums of money into currencies that are likely to appreciate and away from those that seem due for devaluation. These moves are not just due to private speculators out for a turn! International companies are anxious to protect their funds, and ordinary traders advance or retard their payments. The existence of the Euro-dollar market has magnified, but certainly not caused, the mass of funds that can be switched in this way. Thus the hands of governments are liable to be forced, and fixed parities become ever more difficult to maintain.

These difficulties were seen very clearly after the Nixon Administration took office in 1969 and particularly after the D-Mark crises of that year. The leaders of the reform movement were the U.S. Council of Economic Advisers, members of the IMF staff, and certain leading Continental central bankers including Dr. Emminger of Germany and Sr. Ossola of Italy. Japan and France were conspicuously hostile to the reform movement; the British Government remained very much in the background and successive Chancellors of different parties poured heavy doses of ritual cold water on the idea of floating rates at IMF meetings, while damning with faint expressions of interest the work on compromise forms of flexibility.

Nevertheless, by the Copenhagen meeting of 1969, the IMF managed to prepare a report on compromise ideas which aimed to secure the earlier and more gradual movement of rates before a crisis was allowed to build up. Earlier and more gradual adjustment would also have big advantages for domestic policy. For it would enable governments to avoid the large and sudden switches of resources of the kind that occurred after the British devaluation, when real incomes had to be held back for two years running—an experience which sowed the seeds of the present wage explosion.

There are various possible exchange rate regimes. Three of these were listed in the IMF report as possible compromise reforms; but member Governments did not commit themselves for or against. The first of these was a moderate widening of the margins around a fixed point. This would be useful against purely temporary disturbances; but would not impart true flexibility into the system. For it would not take long for the strong and weak currencies to become wedged against their upper and lower limits respectively, and the familiar troubles would then recur.

The second compromise idea was small and "timely" changes in parities. (This was a loose and informal version of the proposal, known as the "crawling peg" which would allow parities to move by up to, say, 2 or 3 per cent. per annum.) The third suggestion was for "temporary" floating. This could be adopted by countries whose currencies were under pressure, so that they could gain a breathing space to discover if, and by how much, their exchange rate needed to change. The first and third proposals required amendment of the IMF Articles although in practice the Fund can turn a blind eye and simply "note" a departure from established practice. The second suggestion could be implemented under the existing rules.

The international discussions have been treading water largely because the EEC countries agreed to act in concert but could not agree on what form that action should take. They disagreed both on the principles that any reform should embody, and also on the practical action required. They were due to narrow their margins against each other on June 15 as part of the attempt to build a monetary union. Thus any move against the dollar would have had to be a joint one—in terms of the original thinking; and as the last few weeks have dramatically demonstrated, such agreement does not exist.

Events, perhaps fortunately, do not wait for the slow processes of inter-Governmental discussions. As a result of the flood of dollars into Germany, that country, together with the Netherlands, has adopted the "temporary" floating proposal on its own initiative. Canada did the same a year ago and is floating still; for it has never since been clear to the Canadians what would be the correct level at which to peg the rate. (This indeed is one of the main arguments for a floating rate.) The Belgians appear to have adopted a floating rate for some capital transactions, while maintaining the present rate for current transactions. Switzerland, on the other hand, has made a stright 7 per cent. revaluation.

Formidable coalition

The idea of secret limits on the movement of the rate should not be taken too seriously. The Germans are anxious to repel dollar inflows; and the supposed "limits" will be adjusted in the light of events. The abnormal element in the world monetary system has been the intervention of Governments to freeze the exchange rates of paper currencies against each other. One is tempted to say that, so far from crisis, it is now normality that is breaking out.

If one hesitates to make this statement it is because of the formidable coalition of interests which have built up in favour of "fixed" parities. The most formidable is the EEC commitment to monetary union. The comuniqué of the Six makes clear that tremendous efforts will be made by the Brussels Commission and the French to get the Germans to freeze their rate again. The Council of Ministers paid lip service to the idea that "parities" were to remain unchanged, even though rates are to be allowed to move in the market. The IMF, while interested in limited experiments under its own control, sees that any independent move to floating rates would undermine its power and role.

A floating mark will complicate the Common Agricultural policy; but unfortunately it is quite untrue that it will destroy it. Within Germany there will be pressures from business and perhaps trade unions lobbies who dislike the threat to profits in any effective anti-inflationary policy. Nevertheless, it will be far from easy to freeze the rate quickly; and the present float is very different from the 1969 one which lasted a few weeks and was intended simply to give the post-election government time to agree on a revaluation.

The problem of the dollar is moreover still with us and will remain so until either the Americans agree to change the dollar's own parity against gold, or a great many more countries float or revalue than have done so up to now. There remains the problem of what Dr. Emminger has called "living in the same boat as an elephant." Sudden and violent changes in U.S. monetary policy will be easier to live with if European countries can take the strain on the rate rather than on their reserve; but they will remain disturbing. Agreement will also be necessary on means of preventing the multiple expansion of the Eurodollar supply. The issue of special high interest rate securities for central banks to hold may be a useful palliative; but more fundamental is the need to prevent too many unwanted dollars ending up in central banks in the first place.

Where does the U.K. stand after all the turmoil? This country was scarcely involved in last week's events at all. If the Six had floated as a bloc, the issue might have appeared in political terms as a choice between "going with the EEC" and "going with the U.S." There was some political support in London for the idea of "going with the EEC"; but the Treasury was violently against the idea, as it would have involved an appreciation of sterling, which would have put British industry at an increasing competitive disadvantage at a time when British costs are in any case rising fast, and the U.K.'s share of world trade falling fairly rapidly.

Nor, to be fair, was there any indication that the EEC wanted this action at the present stage—before British membership and the parity decision that will have to accompany it. In any case with the failure of the Six to agree on joint action, the discussion died away—at least for the present.

One is tempted to say that so far from crisis, it is now normality that is breaking out. If one hesitates it is because of the formidable coalition of interests which have built up in favour of 'fixed' parities.

Dr. Emminger, vice-president of the Bundesbank.

Sterling strong

The British Government had the option this week-end of either announcing an independent float or of doing nothing. Predictably, it chose the latter. The result is that the pound remains fixed to the dollar and all the many other currencies, including the franc, which have made no move. The floating of the mark and guilder and revaluation of the Swiss franc will give British industry some competitive advantage. But it is likely to be limited. Only a fraction of either of our competitors or our customers are involved and the degree of upward movement seems likely to be small, with perhaps periods of reversal.

An independent British float would have its attractions. Sterling and the balance of payments have both been very strong recently; and there would be little danger of an alarming downward plunge. If anything, the rate against the dollar might rise a little for a short while. But over a longer period, there would be an automatic corrective to prevent a loss of competitive power arising from British inflationary trends. Under a floating rate, there could be no sudden crisis devaluation of the 1967 variety, as the rate would be moving gradually in the market in whatever direction required. Growth would be based on exports and not just on the home market; and by suitable intervention in the foreign exchange market, the authorities could build up a sufficient surplus to meet the impact effect of EEC membership.

Nevertheless, the authorities may not be able to put off considering the matter for very much longer. Now that the Mark is floating, speculators and holders of funds are likely to shift their resources into other countries with strong currencies. Now that Switzerland has revalued, the obvious candidate will be Japan. But it is quite on the cards that the U.K. and France will receive unwelcome amounts of "hot money" at sometime in the not too distant future. (Thursday's trade figures could be relevant here.)

The British authorities would then have three main options. One would be to tighten exchange controls on incoming funds. But this is easier said than done. The most obvious move—a ban on short-term Euro-dollar borrowing for domestic investment — was already imposed at the beginning of the year. The second alternative would be to accept a large drop in interest rates, including Bank Rate. Although politically attractive, this would be a dubious move when inflationary forces are still so strong and when, allowing for price rises, most interest rates are even now negative in real terms.

The third alternative would be to respond to any unwelcome inflow of funds by floating sterling. As there are in any case strong arguments for doing this, such a response would be the most suitable of the three. Recent international currency events and the changed situation inside the Common Market would enable British Ministers to escape from their previous commitments to a fixed rate. Even if there is no massive inflow of funds, a change of policy along these lines should not be too long delayed.

It is not often that history provides rulers with an opportunity for embarking on a new course with dignity and without embarrassing inconsistency. But alas it is one thing for a chance to be given and another for men to take it.

www.cvce.eu