THE ECONOMIC BACKGROUND

THE INTERNATIONAL ENVIRONMENT

Proposals for the Reform of the International Monetary System

The recent slide in the external value of the US dollar, and the consequent volatility of exchange rates associated with this, has once again raised the appropriateness of the current, rather ad hoc, arrangements by which the key currencies of the world economy are linked together. As a result, proposals for the reform of the International Monetary System (IMS) are likely to become especially topical again. In this article, therefore, we take the current backdrop of currency volatility as a motivation for reexamining the case for the reform of the IMS and the current range of options available.

Ever since the breakdown of the Bretton Woods-Smithsonian system of fixed but adjustable exchange rates in 1973, the IMS has been characterised by some form of floating exchange rates. The degree of cleanness of the float has varied from period to period, with at times concerted and coordinated foreign exchange market intervention of central banks aimed at stabilising currencies. There is now a general consensus amongst international economists, regardless of their monetarist or Keynesian predilections, that the current version of the IMS has been one in which exchange rates have been excessively volatile. This excessitivity may be gauged in a variety of ways. For example, exchange rates have been excessively volatile relative to the fundamental determinants of exchange rates, such as the prices of goods and services, and also to the expected exchange rate change contained in forward exchange rates.[1]

The volatility of currencies is seen as having important implications for the informational efficiency with which financial markets operate and also, more generally, to the extent that exchange rates may remain over or undervalued for long periods of time, for the efficiency with which goods, services and capital are allocated in the world economy.

Although a large amount of empirical work has indeed verified that financial markets, and particularly the foreign exchange market, are informationally inefficient, empirical work on the effects of exchange rate volatility on trade and investment is less clear-cut; the body of academic work which has quantified an effect of exchange rate volatility on trade and investment, suggests that exchange rate volatility has only a very limited effect on these kinds of variables.

The main reason for the failure to find a significant relationship between exchange rate volatility and trade and investment is often attributed to the existence of financial derivative markets, such as forward and futures markets, with which international investors and traders can hedge their positions and effectively shift the exchange rate volatility onto others better able to internalise it (such as banks). This kind of argument is correct as far as it goes, but it misses two key points. First, such hedging is bought at a price, namely the foreign exchange risk premium, and this price is likely to be especially large when exchange rates are very volatile. The existence of this risk premium may of itself be a sufficient disincentive for traders not to consider entering international markets, or, if they do, taking very limited positions. This effect will be reinforced by the fact that markets for hedging risk are incomplete; they may be very good for periods of up to three months or even a year, but beyond that the ability to hedge is effectively non-existent. Hence an investor, say, considering undertaking new capital investment, the output from which would be geared to foreign markets for a number of years may consider the whole venture too risky in the presence of incomplete markets.

The other key empirical characteristic of exchange rate behaviour during the recent float has been that exchange rates have often been misaligned rates. That is to say, exchange rates have often taken long swings away from their values based on fundamentals, such as relative prices and money

[1]For a fuller discussion of these points, and of other points made in this article, see MacDonald, R. "International Financial Stability", in The New Palgrave Dictionary of Money and Finance, (eds) J. Eatwell, M. Milgate and P Newman, (1992), London: Macmillan.

supplies, and the consequent changes in competitiveness has had dramatic implications for competitiveness, trade flows and deviations of output and employment from their full employment levels. Perhaps one of the most dramatic examples of this was the large appreciation of the pound sterling in the period 1979-1981. On most estimates this misalignment resulted in 20 per cent of the UK industrial base being destroyed, with the consequences this had for trade flows, output and unemployment. The long swings of the US dollar in the 1980s (the dramatic appreciation in the first half of the 80's and the equally dramatic depreciation in the latter half) are another example of misalignment. A current example of misalignment is the value of the US dollar, which, most commentators would agree, is far from its purchasing power parity value.

The ability of an IMS, characterised by a system of floating exchange rates, to produce excessive exchange volatility and persistent misalignments has led many economists to advocate an alternative system of monetary arrangements. We now turn to a discussion of the more popular proposals.

Reform Proposals for the International Monetary System

One reform proposal for the IMS, and perhaps the most extreme, entails a return to the Classical gold standard system, which prevailed for the period 1870 to 1914. In this system, each participating country was committed to backing its paper money with gold at a fixed price per ounce and this, in turn, meant that each country's currency was pegged to the other participants at a fixed rate. A country was supposed to play by the 'rules of the game' and therefore a balance of payments deficit would result in a gold outflow, a decrease in the domestic money supply which would ultimately provide a self-correction to the balance of payments disequilibria. Further, the ability to ship gold at a fixed price put a very real discipline on inflation rates getting too far out of line between countries.

Although there is much debate in the academic literature about whether countries participating in the gold standard actually played by the rules of the game, research by the author suggests that despite this the system was nevertheless highly credible (indeed even the inter-war experience of the gold standard turns out to be a highly credible system). One of the main problems in reintroducing this kind of system at the present time is that there are currently very large stocks of gold held by various institutions and this, in addition to the rather capricious nature of the supply of gold, would probably make it impossible to implement a credible gold standard system. More generally, one can probably do no better than quoting Anna Schwartz, an acknowledged expert on the operation of the gold standard, who concluded after her exhaustive review of the operation of the standard that: "The objective factors that served to promote the international gold -standard in the past are no longer favourable to such an institution"

One alternative to returning to a formal gold standard is the 'gold standard without gold' proposal of Ronald McKinnon. Essentially this involves the three key currency blocks, represented by the mark, yen and US dollar locking their currencies together with rigidly fixed exchange rates; it is suggested that they should be locked together using the concept of purchasing power parity the idea that relative (wholesale or producer prices) determines the equilibrium exchange rate. A world monetary aggregate is then constructed (representing the weighted sum of the key industrialised countries money supplies) and this aggregate is targeted by the central banks of the three countries whose currencies are firmly locked, in order to achieve world price stability.

To McKinnon the key advantage of the lock in exchange rates is that it would do away with the unpleasant consequences of exchange rate volatility. However, in rigidly locking currencies together the benefits of exchange rate flexibility are being abandoned and these benefits are likely to be important for the three currencies which are the focus of the McKinnon plan. For example, we know that in the post war period there have been substantial productivity swings between Japan and the US and such swings, in the absence of downward flexibility of domestic prices, have required nominal exchange rate adjustment. Locking the nominal rates, in the presence of such productivity swings would put potentially unsustainable pressure on unemployment and, ultimately, the credibility of the exchange rate fix. It would seem perhaps that such a system would only be credible if it became the 'gold standard with gold' but even then, of course, there would still be the problem of reconciling the unemployment differences that would inevitably emerge across countries. Further, it seems unlikely, from a political economy perspective, that Germany would be prepared to subsume its

monetary policy for the greater good of the operation of the world economy.

As we have said one issue concerning the McKinnon plan is that by locking currencies together it throws away any potential benefits of exchange rate flexibility. An alternative plan, known as the Williamson-Miller (WM) plan, tries to achieve the best of both worlds in the sense that it offers a plan to rid the key currencies of volatility, while at the same time maintaining some flexibility between currencies. The WM plan is Keynesian, or neo-Keynesian, in orientation and involves a complete set of policy coordination rules to be followed by the main G-7 currencies.

In particular, each country participating in the WM plan would have the objectives of maintaining internal (full employment with low inflation) and external balance (a 'sustainable' current account balance) in the medium run. It is envisaged that each country's fiscal policy is used to maintain internal balance whilst monetary policy, in the form of interest rate adjustment, is used to ensure the effective exchange rate moves to achieve external balance.

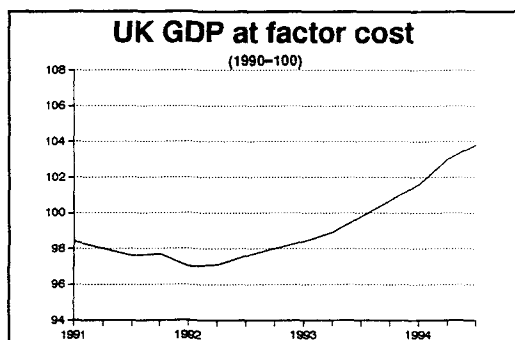
All of the above proposals for reform are interesting and have their separate merits. We believe that the central idea of these reform proposals, that exchange rate volatility should be attenuated, is correct and therefore the key currencies should be linked in such a way that this is achieved. In contrast to the above proposals, we would propose a return to a version of the Bretton Woods system that proved so successful in promoting international trade and investment in the post war period. In contrast to the historical Bretton Woods system, though, the specification and use of an effective adjustment mechanism would have to be a central feature of any new version of the Bretton Woods system.

THE UK ECONOMY

Macroeconomic Trends

In the fourth quarter of 1994, the provisional estimate of **GDP at market prices** - 'money' GDP - rose by 1.4%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.8% during the quarter, compared with the 0.8% increase recorded in the third quarter of 1994. Over the year to the fourth quarter, **'real' GDP** is estimated to have risen by 3.9%. When oil and gas extraction are excluded 'real' GDP is estimated to have risen by 0.7% in the fourth quarter and by 3.6% over the same period a year ago.

Output of the production industries in the three months to December 1994 is provisionally estimated to have risen by 0.5% over the previous three months, with output rising by 5% compared with the same period a year ago. Within production, **manufacturing** experienced an increase in output of 0.7% on the previous three months, output of the other energy and water supply industries fell by 3%, and production of oil and gas rose by 2.4%. Manufacturing output in the fourth quarter was 5.2% above the same period a year ago. The output of the **service sector** is provisionally estimated to have risen by 0.9% in the fourth quarter and by 3.6% over the fourth quarter 1993.

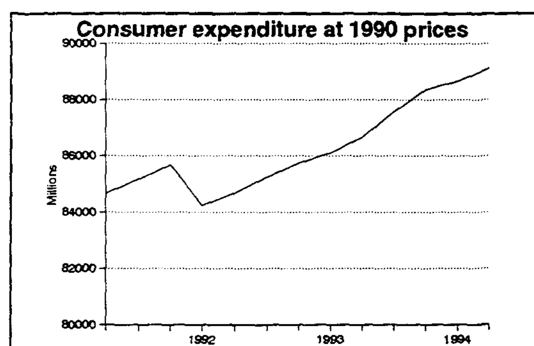


The CSO's **coincident cyclical indicator** for December 1994, which attempts to show current turning points around the long-term trend, continued to rise, although at a reduced rate. The index has been steadily rising since May 1992, suggesting an upturn in the spring of that year. The **shorter leading index**, which attempts to indicate turning points about six months in advance, fell in December 1994 as well as January this year and has been falling since September 1994. The **longer leading index**, which purports to indicate turning points about one year in advance, fell in the middle of last year, was relatively flat until April of this year, rose again in May and June but has fallen ever since including the latest data point in January.

In the fourth quarter of 1994, **real consumers' expenditure** rose by 0.6% after rising by 0.5% in both the third and second quarters. Spending during the fourth quarter 1994 rose by 2% on the same period a year earlier.

The provisional official **retail sales** volume figures seasonally adjusted for December 1994, were 0.5%

above the September figure. Over the year to December, the volume of sales rose by 3.8%. Taking the three months to December, the volume of retail sales rose by 0.5% and by 3.2% over the same period a year earlier. So, after a slight fall in the volume of retail sales in August, sales picked up in September, remained flat until November and then rose slightly in December. However, the latest **CBI distributive trades survey** for February suggests that retail demand is continuing to decline. A balance of 11% of retailers in the survey reported that sales were lower last month than in February 1994; this is to be compared with the balance of 2% in January reporting lower sales, and which was itself the weakest return since August 1992.



The underlying determinants of consumers' spending appear to have strengthened slightly in the middle of the year. The consumer credit figures for December show that **net lending to consumers** by finance houses and other credit grantors (excluding bank loans) rose to £583m in December from £504m in November. However, these figures represent a falling back from 1994's monthly peak of £632m in August, although the November and December figures were somewhat higher than the £479m and £451m recorded in September and October respectively. Net lending to consumers in the fourth quarter of 1994 rose to £1,588m compared with £1,460m in the third quarter. The **saving ratio** fell in the second quarter 1994 from 11% in the fourth quarter 1993 to 9.3%. The underlying increase in **average weekly earnings** in the year to December 1994 is provisionally estimated to have been 3.75%, unchanged from November and since June. **Real personal disposable income** is estimated to have fallen by 1.8% in the second quarter 1994 to a level 1.2% lower than in the same period in 1993.

General government final consumption rose by 0.4% in the fourth quarter 1994. Government consumption in the fourth quarter was 1.4% higher than in the corresponding quarter of 1993.

Real gross fixed investment or Gross domestic fixed capital formation rose by 1.4% in the fourth quarter to a level 1.4% higher than in the fourth quarter 1993. The provisional estimate of capital expenditure by manufacturing industry in the fourth quarter was 3% higher than in the third quarter and 5% higher than in the fourth quarter of 1993. For 1994 as a whole capital expenditure in manufacturing was 1% higher than in 1993. By particular categories of expenditure, there was an increase of 10% for new building work, little change for plant and machinery and a decrease of 8% for vehicles in 1994 over 1993.

Turning to the **balance of payments**, the **current account** for the third quarter 1994 was, after seasonal adjustment, in *surplus* to the tune of £0.8bn, compared to revised estimates of *deficits* of £1.1bn, and £1.5bn in the second and first quarters, respectively. The surplus on **invisible trade** stood at £2.4bn, an increase over the £1.3bn recorded in the second quarter and the £1.5bn surplus in the first quarter. On **visible trade**, the third quarter deficit stood at £1.5bn compared with £2.4bn in the second quarter and £3bn in the first quarter. The surplus on the **oil account** fell from £1276m in the second quarter to £1029m in the third quarter.

UK LABOUR MARKET

Employment and Unemployment

UK unemployment fell by 41,400 in the quarter to January 1995, so that the overall UK unemployment rate now stands at 8.5%, with a male and female rate of 11.4% and 4.6% respectively. However, the reduction in unemployment has not been accompanied by a rise in unfilled vacancies. Rather, vacancies, after having increased for over a year, fell slightly in the quarter to January. In the last month there has been a radical adjustment to the employment estimates. It is now believed that the previous data underestimated the employment level in the last two years by around 100,000 jobs, the revisions mainly occuring in construction. However, even with these additions, only the most recent figures for total UK employment reflect the strengthening in the labour market suggested by the declining unemployment rate. The figure for total employment for the quarter to December 1994 is 25,626,000, an increase of 115,000 (0.5%) in the quarter from September and an increase of 266,000

(1.0%) from June. This employment total is the highest for over two years.

Earnings and Productivity

Wage inflation continued at an annual rate of 3.75% to the end of 1994, but with the differential rates between manufacturing and service sectors increasing. In the quarter to December 1994 the underlying year-on-year increase in wages in services was 3%, whilst the same figure for manufacturing was 5%. The rate of growth of labour productivity in the whole economy continues to be high at 4% for the third quarter of 1994 and is particularly high in manufacturing which registered an increase of 5.9% over the previous year. The result is that manufacturing experienced a fall in unit labour costs, compared to the previous year, of 1.5% in the third quarter and 0.6% in the fourth quarter of 1994. For the whole economy, the most up to date figures are for the third quarter where unit labour costs were unchanged from the previous year.

UK OUTLOOK

Growth in the UK economy still appears to be primarily driven by net export demand. GDP was growing at an annual rate of just below 4% at the end of last year and the CSO now estimate that growth for 1994 will stand at 3.8%. Since growth rates of 3.5% to 3% are some way above trend growth it must be presumed that such rates are unsustainable without an acceleration of inflation and a deteriorating balance of payments and/or exchange rate position. Growth should continue at around 3.5% this year falling to about 2.5% next year.

Domestic demand still appears to be relatively weak, a perception which has been further reinforced by the latest CBI distributive trades survey (for February) which revealed that retail demand is continuing to fall with retailers taking the view that demand in the high-street is at its weakest since August 1992. Nevertheless, the CSO, in commenting on the latest GDP data, noted that while net trade accounted for most of the growth in the middle of 1994, increases in domestic demand accounted for all the growth between the third and fourth quarters. The CSO pointed to the upturn in investment which has been long awaited and which appears to have arrived in the final quarter of last year as investment increased by 1.4% after falling earlier in the year. Plant and machinery investment rose by 2.5% and investment in dwellings rose by 5%. Such investment is clearly necessary if the economy is to reduce potential capacity constraints and sustain growth rates above the 2.25% long-term trend. Moreover, the data show that the growth of consumer spending rose slightly from 0.5% to 0.6% in the fourth quarter. However, the recent survey data cast doubt on whether such growth will be sustained. And a slow growth of consumer demand may still offer the best hope that the recovery will not too soon run into inflation and balance of payments problems. An upturn in domestic demand may prove necessary to sustain the recovery but it is much more preferable if the source of rising domestic demand is principally investment rather than consumption.

The recent fall in sterling has given some cause for concern, since a falling exchange rate is, if left unchecked by an interest rate rise, a harbinger of a future rise in inflation. However, the fall in the trade-weighted index (over 2%) is much less than the fall against the DM and it is this index which is most relevant for domestic monetary policy decisions. The weakening of sterling appears to be a particular outcome of the general strength of the DM against all currencies, and would not appear to be sufficient justification in itself for a further rise in base rates.