L.5.2

RFD 399

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

January 8, 1963

Professor Johnson on Equilibrium under Fixed Exchange Rates*

5 pages

J. Herbert Furth

*This paper was presented at the Annual Meeting of the American Economic Association, Pittsburgh, Pennsylvania, December 29, 1962.

January 8, 1963.

Professor Johnson on Equilibrium under Fixed Exchange Rates[1/]

J. Herbert Furth

Ever since I was first asked to participate in this meeting, I have been looking forward to discussing conditions of international monetary equilibrium under fixed exchanges. How can such equilibrium be preserved under domestic policies for maximum employment and maximum economic growth; under an international payments system based on reserve currencies rather than on gold; with huge transfers of government funds impervious to market forces?

Unfortunately, Professor Johnson's paper does not deal with any of these subjects, but merely compares the existing system of fixed exchanges with an ideal system of a uniform world currency.

Confronted with a choice between discussing my assigned subject and discussing Professor Johnson's presentation, I have decided to attack the live target. In order to keep within my allotted time, I shall deal only with five subjects: Professor Johnson's three concluding observations; his initial statement about the international monetary system; and his views of the central banking fraternity.

1. I agree with Professor Johnson's first concluding observation that the advantage of a system of fixed exchanges lies mainly in its unifying effect, and that this effect presupposes freedom of international competition. But I disagree with his contention that the existing payments system had not been conducive to such freedom. In recent years restrictions on the international movement of goods and capital have been eliminated at a pace and to an extent that all of us would have considered impossible a short time ago. And most recently, the Trade Expansion Act has taken an initial step toward solving the problem of relief for U.S. enterprises and individuals damaged by

1/ Discussion paper presented at the Annual Meeting of the American Economic Association, Pittsburgh, Pennsylvania, December 29, 1962.

international competition -- a relief Professor Johnson rightly considers an essential supplement to free competition. Incidentally, this step was suggested ten years ago by one of those wicked central bankers, Al Neal, than Vice President of the Federal Reserve Bank of Boston.

2. I also agree with Professor Johnson's second observation that a single international currency would be even more unifying than a system of national currencies with fixed exchanges. But such a currency will obviously remain out of the question for the foreseeable future -- and I have an uneasy feeling that this is the reason why Professor Johnson is so enthusiastic about it. More importantly, the difference in unifying effects between the present system and Professor Johnson's ideal is smaller than Professor Johnson believes. International commercial and financial transactions are not seriously hampered by intra-marginal exchange rate movements. And only on rare occasions are they seriously disturbed by fears of devaluation or revaluation of a major currency; and central banking cooperation can go a long way to curb disruptive effects of such fears. Moreover, such fears usually occur because a major country is in bad political trouble or because its policies are incompatible with its underlying economic situation; such trouble and such policies would have adverse effects under any system of international payments.

3. I disagree with Professor Johnson's third observation that the world needs a genuine international central bank, whose first responsibility would be to provide for an increase in international reserves.

It seems inconsistent for a paper that expresses such a poor opinion of central bankers in general to plead for a central bank that would be bigger and more powerful than any of the existing national institutions. And while it would be bigger, it would certainly not be better: at best, it would be controlled by the same forces that today control the central banks of the major countries.

More importantly, an increase in world liquidity is the last thing the present international payments system needs. This statement is not "ritualistic," as Professor Johnson believes, but follows from the fact that none of the urgent problems of our international financial situation can be attributed to a shortage of international liquidity. The first of these problems is the inability of many less developed nations to pay for all the imports they would need for maximum economic development. But the plight of these nations could no more be lightened by a general increase in international liquidity than the plight of a Southern sharecropper could be lightened by a general increase in bank liquidity in the United States.

The second major problem is the continuing deficit in the U.S. balance of payments. If the surplus countries were prepared to finance our deficit forever and ever, the difficulties caused by the deficit might indeed disappear. But their unwillingness to do so would hardly be eliminated by a further rise in their international reserves, which are already excessive rather than deficient.

4. One root of Professor Johnson's errors is found in his opening statement in which he deplores "forty-five years of chronic international monetary disorder." The present international payments system, with its mixture of national and international institutions, of gold and reserve currencies, of market forces and government intervention, is indeed about as disorderly as, say, the constitutional system

of the United States. But it seems to work about as well. Under this system, the world has experienced its most rapid economic growth, in the domestic economies of its major members as well as in international trade and finance, together with an unprecedented absence of cyclical disturbances and a remarkable improvement in income distribution. The burden of proof seems clearly to fall on those who claim that the world would have done as well or better under another system.

5. Another root of Professor Johnson's errors is his poor opinion of central bankers. The present system can indeed function only if central bankers show a modicum of competence. But is Professor Johnson right in stating that their performance has been poor and that they are inherently conservative and orthodox, lacking awareness of economic change?

I cannot go into the details of these indictments. For instance, I cannot defend myself against the accusation of having recently produced "the most solemn piece of primrose pathos": I have not the faintest idea what this means, and even whether it is a compliment or an insult. Also, I am not sure what economic attitudes are or are not conservative and orthodox: does Professor Johnson mean the orthodoxy of Cambridge, England, or of Cambridge, Massachusetts; of Chicago, Illinois, or of my native Vienna, Austria? But whatever he means, it is difficult for an economist who was introduced to central banking under the regime of Marriner Eccles to view central bankers as either incompetent or inherently conservative and orthodox.

Central bankers, like academic economists, have indeed sometimes failed to spot a cyclical turning point. But more often, they have recognized changes and shifted their policies accordingly long before our academic colleagues became aware of them. If central bankers had waited for academic economists, for instance, to tell them of the change in the international position of the dollar, they would have continued to pursue policies appropriate for a period of dollar shortage as late as in 1958 and 1959.

Although my comments may sound as critical of our academic colleagues as Professor Johnson's paper is of central bankers, I do not underrate the potential contribution of academic economics to central banking. Central bank economists have little time for fundamental research. But our academic colleagues can help us only if they are not content to deal with economic models of their own making, but, like us, face the world as it is.