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International Currency Regimes, Capital Mobility,
and
Macroeconomic Policy

by

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INTERNATIONAL CURRENCY REGIMES, CAPITAL MOBILITY, AND MACROECONOMIC POLICY

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International monetary regimes.

The structure of the international monetary system is once again a topic of great interest and controversy, -- among economists, business managers, financiers, and government leaders. Many members of all these groups are acutely dissatisfied with the floating-exchange-rate regime that succeeded the Bretton Woods system two decades ago. Within the European Community (EC) the Exchange Rate Mechanism (ERM) has re-established a regime of "adjustable pegs." After 1992 financial markets and institutions will cover the entire Community. The further step of issuing a common European currency is under serious consideration, and beyond that the more drastic step of replacing national currencies with a single European currency. These measures would still leave exchange rates among Japan, America, and the EC free to float in currency markets.

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They would leave many other countries with choices among floating and fixing parities to one of the major currencies or to a basket of them. These are especially difficult choices for Eastern European countries and for the Soviet Union and its newly autonomous republics. They also face the question how rapidly to relax restrictions on external financial transactions.

I shall distinguish two dimensions of the international monetary system. The first is the spectrum of exchange rate regimes, from single currencies to adjustable parities to freely floating market-determined rates. The second dimension is the degree of capital mobility across regions and political jurisdictions, from completely free movement of funds at one extreme to strict exchange controls at the other.

I begin by considering one extreme, permanent commitment to a single common currency by the people of one or several political jurisdictions. That has been true in the United States of America for two hundred years; the commitment was solidified when the Civil War was settled in 1865. It is inconceivable that the dollar will not always be the same in California as it is in New York State. The 1787 Constitution assigned exclusively to the federal government the right "to coin money and regulate the value thereof." The same Constitution also guarantees freedom to move funds and goods without hindrance between States and regions.

A single central monetary authority is a necessary implication of the combination of a single currency, capital mobility, and free trade. When the U.S. Federal Reserve System was set up in 1913, the authors of the legislation provided for twelve District Banks. They anticipated that the Banks could differ in monetary and credit policies and thus accommodate the special

economic circumstances of their Districts. We still have twelve districts and twelve banks. But the idea that they could have separate interest rates, for example different in the Dallas District from what it is in the Boston District, disappeared long ago. A central national monetary policy is made in Washington, although the District Bank presidents participate in the Federal Open Market Committee along with the Board of Governors of the System. It is impossible to have more than one monetary and credit policy along with completely integrated financial markets.

This system, a single currency together with perfect capital mobility, has great advantages: gains from trade, economies of scale and scope, diversifications of risk. The disadvantages are the vulnerabilities of regions and sectors of the economy to shocks that reduce their competitiveness. When currency revaluations, capital controls, and trade restrictions are ruled out, other remedies have to be in place, both to alleviate the pains of transitions and to facilitate viable adjustments.

One remedy is, of course, just the natural response of competitive markets. Labor, capital, and commodities move across regions and sectors, encouraged by changes in job and profit opportunities and in relative prices and wages. In the United States we always have depressed areas, but they are not always the same. Mobility of labor and capital prevents areas from being permanently depressed. In addition, the federal government generally assists depressed regions and sectors, to ease the distress of transitions due to the natural shocks of economic development. Responses of both kinds are, I think, essential to make a single currency system work.

Capital mobility, speculation, and macroeconomic autonomy.

Floating rates are the other extreme in this spectrum of currency regimes, that is, "clean" floating in which diverse currencies are allowed to assume market values without interventions by the various governments or central banks. That exchange rate system can be combined either with restraints on capital mobility and foreign exchange transactions or with free movement of capital. For any one member of the system, the gain from exchange controls or restrictions on capital movements is greater autonomy in the making of macro-economic policy, monetary policy in particular. The disadvantage is the loss of many of the advantages of capital mobility in allocating savings to areas of highest marginal productivity.

Losses of national macroeconomic autonomy are of two kinds. First, capital mobility surrenders some autonomy to the rest of the world, specifically to the foreign policy-makers who determine world interest rates and the other attractions of external assets. Second, capital mobility gives considerable power to speculators who can generate excess volatility of exchange rates in the same way that they produce excess volatility of stock prices.

Clearly many international monetary regimes fall between the extremes. Most intermediate systems involve adjustable parities, rates that are fixed but not fixed forever. Under the Bretton Woods system the parities could be, and frequently were, changed by the country itself, almost always by devaluations. Although the International Monetary Fund in principle had the right to veto proposed changes in exchange rates, in practice it was impossible for the IMF to prevent a government from devaluing if it really

wanted to do so.

The Bretton Woods system was quite asymmetric as between surplus and deficit countries. Countries had no choice but to devalue when they ran out of reserves and international credit, but there was nothing beyond pious words to stop surplus countries from accumulating positive reserves indefinitely. This kind of asymmetry is almost inevitable in any system of adjustable pegs. The European Monetary System is another example, a Bretton Woods system applied to a smaller area.

From a system of adjustable pegs it is not a big jump to "dirty" floating-rate systems. Consider, for example, the present-day regime of the Group of Seven, really of the Big Three, the EMS (mainly in practice Germany), the U.S., and Japan. The governments and central banks sometimes agree on ranges for the dollar vis-a-vis the yen and the Deutschmark, and these are enforced by central bank interventions. Thus, even though the system is in principle a floating rate system, in some short runs it approximates a fixed rate system. The ranges are adjusted by mutual agreement from time to time, and are not always effective. On occasion the central banks of G-7 lose control to private speculators.

Compromise systems, with fixed but adjustable rates or with ranges, do not seem to me to be as different in fact from floating rate systems as they are usually said to be. The reason is that the chosen parities are never irrevocable. There can be speculation against them, and we know there will be speculation against them, whenever funds are allowed to move across currencies. Speculation is not the same in a Bretton Woods system or within EMS as under market-floating. Instead of speculation on what the currency market will do tomorrow, speculation under Bretton Woods was on whether, when,

under what circumstances, and how much country X would devalue its currency. In floating rate systems, speculation concerns both economic influences on rates and government interventions.

In contrast, there is no speculation in a single-currency system; no one is betting on changes in rates of exchange between the Connecticut dollar and the California dollar.

Speculation takes a different form in markets where the prices involved move continuously hour by hour and day by day, from speculation in markets where the prices move only in discrete jumps. The changes in exchange rates under a semi-fixed parity system are usually very traumatic. They are called crises every time they happen, and they draw much more attention than market rate changes day to day, which are more gradual and impersonal. Large discrete changes in exchange rates under government control are probably more disruptive of private business plans and transactions than the day-by-day fluctuations of floating-rate markets.

A single currency?

Although in one sense a single currency is one end of a spectrum, it really differs dramatically -- in kind, not just in degree -- from any monetary system that has separate currencies. I do not think one can approach a single currency system by small steps. I do not think an optional common European currency, "ecus" that can circulate alongside national currencies, would be more than a symbolic step towards a single monetary unit. I doubt that Europe can gradually reap the gains of a single currency by moving progressively to greater fixity of rates among separate national currencies. A single currency is what Americans call a "brand new ball game."

The big monetary question for Europe is this: Can there some day be a unique European Currency? Can Europe establish the necessary pre-conditions? Can Europe replicate the structures that enable the system to work among the fifty states of the American Union? If so, when and how? I put the questions. I certainly do not know the answers.

It is not necessary to have a completely centralized government. We in the U.S.A. have fifty-one governments. The States do many things and do them quite differently. They have different taxes, regulations, and public services. Certain basic functions are centralized in the federal government, and it is those that are perhaps necessary to run a successful common currency system.

As I see it, the projected liberalizations in Europe in 1992 amount mainly to an increase in capital mobility. Europe already has a semi-fixed currency parity system, a baby Bretton Woods so to speak. Maybe somewhat greater commitments to fixed rates are involved in the 1992 liberalizations. But it seems that the existing exchange rate regime is going to be combined with a substantial increase in capital mobility. I also suspect, maybe wrongly, that the projected increase in capital mobility is much greater than the increases in mobilities of goods and services and of labor, which are already very mobile within the European Community.

Europe is making capital more mobile and financial markets more integrated, anticipating the advantages of a common currency and the associated central institutions. It will be interesting to see how well this partial movement towards currency integration will work.

Monetary policy in a currency area.

Where will the locus of macro-economic control and policy reside in a system of this kind, i.e. in a fixed exchange rate regime with much greater capital mobility? If there are several independent centers of policy, -- governments or central banks -- and if each is trying to conduct its own national monetary policy, who is responsible for the overall monetary policy of the group? The several centers jointly deploy enough instruments to determine all the exchange rates among their currencies plus the group's overall macro-policy. But the latter will be an unintended and accidental by-product of the monetary strategies the several members of the group are playing in their game with each other. To put it in an illuminating but probably overly simple way of describing monetary policy, suppose each central bank is worrying about its interest rate relative to the interest rates of other members. Nobody among them is worrying about the average interest rate of the group or its average exchange rate vis-a-vis nonmembers.

How was overall policy determined in the pre-1914 gold standard? In the Bretton Woods System? How has it been done in the European Monetary System? In each of those cases, I think, one country was the decisive monetary policy-maker. It was the interest rate determined by the hegemony of that country which the other countries had to accept as the point of reference. From that international rate their own policies made deviations in response to local conditions, so far as the mobility of capital permitted deviations at all. The dominant country was Great Britain before the First World War and the United States in the Bretton Woods era, the first quarter century after the Second World War. It is the Federal Republic of Germany in the European

Monetary System.

If after 1992 under the EMS the Bundesbank is still going to be essentially the European Central Bank, then one problem is solved. But another remains. Should one member of the Community set the tone for the whole European economy?

If the members of the EMS are going to permit more freedom of funds to move among their financial markets, then they are further reducing their monetary and macroeconomic autonomy. They are further reducing their room to differ from the policies of the Bundesbank in regard to interest rates and other macroeconomic variables.

Do nominal exchange rates matter?

Does it really matter whether exchange rates are fixed or floating? That is, does it matter for the real outcomes -- production, consumption, relative prices, terms of trade -- that determine economic welfare? In the classical tradition in economics, "money is a veil," obscuring for the uninitiated truly important economic events and fundamental magnitudes. Absolute or nominal prices -- currency units per units of goods -- are of only transient interest, in contrast to relative or real prices -- units of one commodity per units of others. The exchange rate is doubly nominal, the price of one monetary unit in terms of another. Won't the real terms of trade, the volumes of exports and imports, and the performances of nations and regions be the same regardless of exchange rates? The classical answer is affirmative.

New classical macroeconomics has revived this doctrine, and since the 1970s it has been taken seriously by powerful governments and central bankers. It is commonly said, both by economic theorists and by central bankers, that

there is no useful tradeoff between unemployment and inflation and no real social cost in following a monetary policy geared exclusively to price stability. The major European governments and central banks consequently took no active monetary or fiscal measures to stimulate demand to facilitate recovery from the 1979-82 recession. They had faith that their economies would return to equilibrium as natural adjustments of nominal wages and prices brought them back into line with normally growing money supplies. Do not adjust money and credit to prevailing nominal prices, rather count on the economy to adjust nominal prices to prevailing supplies of money and credit.

In practice these classical policies were little more successful than similarly complacent policies during the Great Depression. The United States, in contrast to Europe, enjoyed a full recovery in the 1980s -- not because of Reagan's supply-side policies but because Volcker's Federal Reserve "fine-tuned" its monetary policies to bring about a demand-driven expansion.

On the international side, the classical recipe is similar. Do not adjust your exchange rate to your nominal wages and prices, rather count on your economy to adjust them to the exchange rate. This was certainly the theory of the gold standard, the basis for the claim that it prevented domestic inflation at no social cost. In similar vein, hitching the national currency to an external currency of proven stable purchasing power is a policy often adopted in recent years and still more often advocated. In some cases, no doubt, it is an effective way of disciplining the unions, businesses, consumers, and banks of an inflation-prone society. On the other hand, both history and recent events are full of cases where fixing and defending too high an exchange rate have entailed severe real costs. Nominal wages and prices just cannot adjust fast enough to escape those costs.

Recent British experience is a cautionary tale. The U.K. chose to adhere to the ERM at an extraordinarily high value of sterling. The Bank of England raised U.K. interest rates to double digits to boost the pound prior to formal adherence and then had to keep them high to sustain its parity. This policy may keep inflation under control, but it deters exports, employment, and growth. British enterprises and workers would be more competitive at a lower pound.

John Major's overvaluation of the pound is reminiscent of an earlier Chancellor of the Exchequer, Winston Churchill. In 1925 he returned to the gold standard at the 1914 parity. But after British inflation during the first world war the old parity overvalued sterling in dollars and francs. Consequently, Britain slid into depression several years before America and continental Europe. The Chancellor's decision inspired Keynes's polemic The Economic Consequences of Mr. Churchill.

Overvaluations of this kind can be corrected. Devaluation of sterling in 1931 put Britain on the road to recovery. The United States, in turn, did not begin to recover from the Great Depression until 1933, when President Roosevelt reversed previous policies and devalued the dollar against gold and sterling.

The monetary unification of East and West Germany, an ongoing experiment in creating a single currency, also contains some lessons. Freezing exchange rates, Herr Pohl of the Deutsches Bundesbank warned in retrospect, is not a step to be taken lightly. Conversions at wrong rates may cause considerable damage. In the German case, political imperatives understandably took priority. Monetary unification was symbolically important. From July 1, 1991 residents of the German Democratic Republic could convert limited quantities

of their marks into deutsche marks at parity (1:1), although most asset conversions were at a rate of 2 marks per DM. Most important for the economy, wages, salaries, and other recurrent payments were converted at full parity, not at the 2:1 rate the Bundesbank recommended.

Ex ante, 1:1 did not seem so unreasonable. GDR wages in marks had been about 1/3 of FRG wages in DM. Labor productivity was thought to be at least 1/3 of that of workers in West Germany. Therefore, East German businesses and workers should have been able to compete. It didn't turn out that way. The economy of East Germany collapsed. Industrial production fell 50 percent, it is estimated, and 30 percent of the work force lost full-time employment. Evidently prior estimates of East German productivity and competitiveness were far too optimistic.

In the best of circumstances, the economic transition of East Germany was bound to entail many difficulties and frustrations, and East German workers would be sorely tempted to go West. Yet if their DM wages had started 50% less, as the Bundesbank proposed, enterprises and workers would have had better chances to survive, while learning how to produce and compete in free markets. Unlike the adherence of Britain to the ERM, the marriage of the mark to the DM allows no divorce. Likewise, once lire, DM, francs, pounds, etc. are replaced by ecus, there will be no devaluations to rescue uncompetitive nations from unemployment.

International policy coordination: fixed exchange rates.

In a fixed exchange rate regime with funds highly mobile across currencies and frontiers, an individual country has little monetary autonomy. Its interest rates can differ very little from those in the outside world. It

must rely on fiscal policies for countercyclical policies. But even so it may confront an impasse, a "fundamental disequilibrium," in the old jargon of the International Monetary Fund. Domestic full employment, given the fiscal policy required to sustain it, may imply chronic trade deficits and continuous drains of international reserves. One way out is devaluation, provided the nominal depreciation of the exchange rate succeeds in achieving a real depreciation, restoring competitiveness. If this way out is excluded, the country must somehow contrive to have very flexible prices and wages.

The role of policy coordination, worldwide or regional, is to prevent collectively counterproductive jockeying for macroeconomic advantage. When national central banks are focusing on interest rate differentials, as they must do in a world of capital mobility, the overall average of interest rates will be nobody's business. It may end up too high for general prosperity, or too low to keep inflation at bay. The world interest rate level, or the European interest rate level, requires international coordination. Likewise coordination is needed to define permissible national deviations from the agreed average.

A country whose economy is underemployed can reasonably have relatively low interest rates, while those of a country with an overheated economy should be relatively high. These criteria of under- and over-employment and production must necessarily be each country's own. But they must be declared in advance and consistently adhered to, used in the joint decisions both on average interest rates and on the national deviations.

International policy coordination: floating exchange rates.

Policy coordination is also necessary in a floating exchange rate regime. Experience the last twenty years has refuted the extravagant claims of some advocates of floating rates, that national monetary policies could proceed without external concerns, leaving the currency markets to reconcile the policies and macroeconomic performances of the several economies. National monetary policy is a more effective tool of domestic demand management than in fixed rate regimes. But it works by moving the exchange rate, depreciating it to shift demand from foreign to domestic goods or appreciating it to shift demand in the opposite direction. It can be a "beggar-thy-neighbor" policy for employment and output in the first case, and for inflation in the second. Differential interest rate movements, actual and anticipated, are the mechanisms by which national monetary policies move exchange rates. As in the fixed-rate regime, the world average interest rate level may become an accident of national game-playing in the absence of coordination.

However, floating rates add some degrees of freedom. Interest rate differentials of importance for domestic demand management can be sustained in international money markets by compensating expectations of currency appreciations and depreciations. Thus a country in need of demand stimulus from interest rates lower than the rest of the world -- like the United States in 1991 -- could in principle carry out this policy with an appropriately low exchange rate which is rationally expected to appreciate gradually.

An adjustable-peg exchange rate regime does not possess these same degrees of freedom. As long as a central bank is defending its parity, it is constrained by its international reserves and their domestic monetary effects.

In these circumstances it is not possible for markets or central banks to arrive at estimates of probabilities of depreciation or appreciation that would compensate for deviations from world interest rates. Nor could any such estimates be confirmed and reinforced by the actual paths of exchange markets.

Policy coordination must pay attention not only to short-run demand stabilization but also to trends in current accounts. The desired future pattern of current accounts should be estimated in the light of the various national domestic saving and investment balances. Currency values should be low but rising for countries with excessive current account deficits, high and falling for countries with excessive surpluses. To make these developments possible, fiscal policies should be tight in the former countries and easy in the latter countries.

Naturally, the appropriate directions of fiscal policies for long run current account equilibrium will be taken into account in determining the target pattern of interest rates. For example, in recession or incomplete recovery an economy like the United States needs low interest rates both for short-run demand management and for an exchange depreciation to correct its balance of trade. At full employment, however, the United States, could expect to have a relatively low interest rate only for the second reason and only if it were following a policy of fiscal austerity because otherwise there would be no room in the economy for an improvement in net exports.

Policy coordination of this kind is not easy, either intellectually or politically. Governments have not been notably successful in establishing effective monetary and macroeconomic policy coordination. The G-7 is supposed to play a coordinating role among the major OECD Countries. So far "coordination" seems to have been directed less to policy than to one of the

outcomes of policy, namely exchange rates. The Group has sometimes been able to agree on temporary ranges of currency rates but not on the fiscal and monetary policies that would validate them. If a financially more integrated European Community chooses not to leave monetary policy to the Bundesbank, it will have to develop some institutions for policy coordination.

Speculation and taxing transactions.

Speculation on currencies is a serious problem in any regime short of a single currency. Greater freedom of capital movements brings important advantages, but at the cost of enhanced speculative opportunities. There is more scope for bubbles and for false signals from financial markets. Governments and central banks lose some autonomy to the market. Markets have whims which the authorities might not, should not, always like to follow. The markets have developed extremely efficient technologies of transactions and information. It is so easy and so cheap to make financial transactions, and the amount of private funds that can quickly be mobilized to support fashionable market opinion is so large, that countervailing official interventions have difficulty controlling exchange rates and interest rates.

I take credit, or confess guilt, for having suggested quite a few years ago a radical proposal for international monetary reform. I proposed to put "sand in the wheels" of the excessively efficient currency markets. These markets are engines that work all too well technically but do not work all that well economically, especially macro-economically. The sand in the wheels would take the form of transactions taxes, which direct traders' attention to long-run fundamentals and away from transient contagious market sentiment.

Suppose you have to pay, let's say, a one percent tax every time you

make spot transactions in foreign exchange markets (or for that matter in domestic securities markets). If you intend to hold the asset purchased for 30 years, the tax is one percent going in now and one percent coming out 30 years later. The calculation of the rate of return that induced you to make the transaction is negligibly influenced by the tax. If it was a socially worthwhile allocation of saving, within or between national economies, the tax would not interfere with it. But if you are a "day trader," in this morning and out this afternoon, for example buying sterling with dollars and then reversing the transaction the same day, that one percent tax each way eats up any gain in the value of sterling pretty fast.

"Sand in the wheels" deters traders from acting on short-run views of investments, either international or domestic. Transactions taxes would diminish excess volatility. They would focus investors' attention on longer-run fundamentals. Maybe they can secure the benefits of increased mobility without some of the costs. The intent is to slow down capital movements, not commodity trade. But even if it were not possible to exempt bona fide commodity transactions, the tax would be too small to be a significant trade barrier. In any case, it would have to be imposed by all countries and would not affect export-import balances.

At the same time, a tax on currency transactions would create room for greater national autonomy in monetary policy. A two percent tax on a round trip to another currency wipes out an eight point differential in per annum interest rates on three-month bills. The tax thus makes viable differences in local-currency interest rates that would otherwise be erased by arbitrage.

Let me be clear about "sand in the wheels." There's good sand and there's bad sand. Saying that a little sand in the wheels may be a good thing

does not mean that every monopolistic restriction of entry into financial industries is justified, or that every fixing of interest rates by administrative decree is beneficial. Intervention which is impersonal, constant, and automatic, like the fixed transactions tax I suggested, will do its job in an efficient manner, compared with the usual ad hoc interferences with mobility of capital, either internal or international. The transactions tax might actually make it easier to clear up some counterproductive monopolistic and restrictive financial practices.

J.M. Keynes in 1936 pointed out that a transactions tax could strengthen the weight of long-range fundamentals in stock market prices, as against speculators' guesses of the short-range behaviors of other speculators. The same is true for the foreign exchange markets. Vast resources of intelligence and enterprise are wasted in financial speculation, essentially in playing zero-sum games. Transactions taxes might re-allocate some of these resources. To the extent that they do not, they will at least produce needed government revenues without bad side-effects. It is estimated that more than \$100 billion gross foreign exchange transactions occur every business day in New York alone. Since the currency transactions tax would have to be international, the proceeds might appropriately go to the World Bank.

Conclusion

The international integration of financial markets is a trend that cannot be stopped. The wonders of modern telecommunications and computers assure its continuation. Even if they wanted to, governments would not be able to impose effective barriers on movements of funds across currencies and borders. Goods and services and labor are becoming more mobile also, but at a

much slower pace. National governments can still impose barriers on their movements, and they do. These discrepancies create grave problems in macro-economic management. They are not easily solved by any international monetary regime.

A single currency, superseding national currencies, has great merits, but they can be realized only with other common economic, political, and social institutions, for all of which a basic sense of community is essential. Perhaps this can be achieved in Western Europe, and perhaps early agreement on a common currency will even help to create the requisite sense of community.

A system of fixed but adjustable exchange parities among national currencies does not achieve the benefits of a single currency. Those benefits depend on the permanence of the arrangement and on the confidence of the people of all the regions in its permanence. If adjustment of parities is a distinct possibility, speculation on its probability can bring large changes in the allocation of international reserves among countries. The potential volume of speculative capital movements has become enormous as money markets and securities markets have been internationalized.

In an adjustable-peg system, defense of reserve positions and parities becomes the primary concern of governments and central banks of deficit countries. No counterpart adjustment responsibilities are felt by surplus countries. The pre-war gold standard conveyed the sense of a durable single-currency system for the world as a whole until World War I and its aftermath, when Britain, the key country, could not maintain the old parity of sterling with gold without overvaluing the pound against other currencies. Likewise the gold-dollar standard of the Bretton Woods era could not survive the cessation of gold-for-dollar convertibility in 1971. Like Britain in the 1920s and early

1930s, the United States in the 1960s and early 1970s needed to depreciate its currency against other currencies. In both cases, when the surplus countries refused to appreciate their currencies significantly against the key currency, they made the continuation of the system too costly for the key country. Once the adjustable-peg system is loose from its anchor, the regime delivers neither the advantages of a permanent single currency nor those of a flexible floating rate system.

While a floating rate system by no means assures painless automatic adjustments to disturbances in trade and capital transactions among countries or to idiosyncratic differences among nations in economic policies and developments, it does have important virtues. Official reserves do not command high priority in macroeconomic policy decisions. Exchange rate movements take the place of international transfers of reserves, and their consequences are shared more symmetrically. Expectations of exchange appreciations and depreciations may provide additional degrees of freedom in reconciling diverse national monetary policies, because those expectations can compensate for departures from interest rate parities across national money markets.

International policy coordination is needed in any system that preserves national currencies and national monetary policies, whether adjustable pegs or floating rates. The speculative opportunities created by the technologies of modern financial markets and financial institutions are a threat to rational policies, both national and international. A modest international transactions tax may be useful in focusing financial investors on long-run fundamental prospects rather than short-run gains.