

***THE FAILINGS OF
THE FLOATING EXCHANGE RATE
SYSTEM***

by Leigh Harkness

Prepared for the Economics Society of Australia
24th Conference of Economists
Adelaide, South Australia
24-27 September 1995

THE FAILINGS OF THE FLOATING EXCHANGE RATE SYSTEM

by Leigh Harkness

Abstract

Floating the exchange rate did not address the cause of Australia's current account deficit. It only shifted the symptoms of the problem from a decline in government foreign reserves to a rise in private foreign debt. It also created many new problems for industries in the economy.

Under the floating exchange rate system foreign investment and foreign loans inflate the exchange rate, reducing national income, increasing the proportion of expenditure spent on imports and raising foreign debt. The system constrains the economy as it does not allow exports to rise unless imports (or investment overseas) rise also. It reduces the incomes of existing exporters when new exporters enter the market. In effect, it makes exporters compete with each other rather than the rest of the world.

Countries that use the system and are attractive to foreign investment have suffered unemployment and inflation. Countries that use the system and invest overseas have experienced full employment and low inflation.

*Leigh Harkness
Buoyant Economies
11 Brereton Street
Queanbeyan
NSW 2620
AUSTRALIA*

*Phone/Fax: (02) 6297 3208
International: +61 2 6297 3208
E-mail: leigh@pcug.org.au
September 1995*

THE FAILINGS OF THE FLOATING EXCHANGE RATE SYSTEM

by Leigh Harkness

1. Role of the Exchange Rate

Article IV of the Articles of Agreement of the International Monetary Fund (IMF) requires members ". . . to promote a stable system of exchange rates. In particular, each member shall:

- (i) *endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability. . . ;*
- (ii) *seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions; . . ."*

The floating exchange rate system has failed to meet these objectives for an exchange rate system. This paper considers why it has failed.

It is the second paper in a series of three. The first paper explained how some sources of growth in the money supply can cause current account deficits. It revealed that the balance of payments was related to the money supply, not the exchange rate. Therefore, exchange rates can not rectify balance of payments problems. Exchange rates can have only a short term effect upon the current account balance. If an economy has appropriate monetary policy, its current account can be balanced at any exchange rate.

1.1 Devaluation

For example, let us assume that a country has a fixed exchange rate, its financial system does not create new money when it provides loans, and it receives no foreign capital inflow. Such a country would only increase its money supply when exports exceeded imports. If it were to start spending more on imports than it earned in exports, it would reduce its money supply and its national income. They would continue to fall until it reduced the country's national expenditure to a level where spending on imports fell to equal income from exports.

If such an economy exported a fixed quantity of goods regardless of the exchange rate, the value of those exports could be represented as:

$$X = \frac{P_f}{e} Q_x \quad (1)$$

where X is the domestic value of exports;
 P_f the foreign price of the exports per unit;
 Q_x is the number of units exported; and
 e is the exchange rate in terms of the amount of foreign currency exchanged for a unit of domestic currency (eg. A\$1 = US\$0.70).

We will assume that the country's imports are give by:

$$M = emE \tag{2}$$

where M is imports at domestic prices;
 E is national expenditure; and
 m is the marginal propensity to import (when $e = 1$).

As all money available to finance expenditure is earned as income, we can say that national expenditure is equal to national income. That is:

$$E = Y \tag{3}$$

National income would be at equilibrium when imports equalled exports which is when:

$$Y = \frac{X}{em} \tag{4}$$

where $\frac{1}{em}$ is the export multiplier.

Exports equal imports at this level of national income as, using equations (2), (3) and (4):

$$M = emE = emY = em \frac{X}{em} = X \tag{5}$$

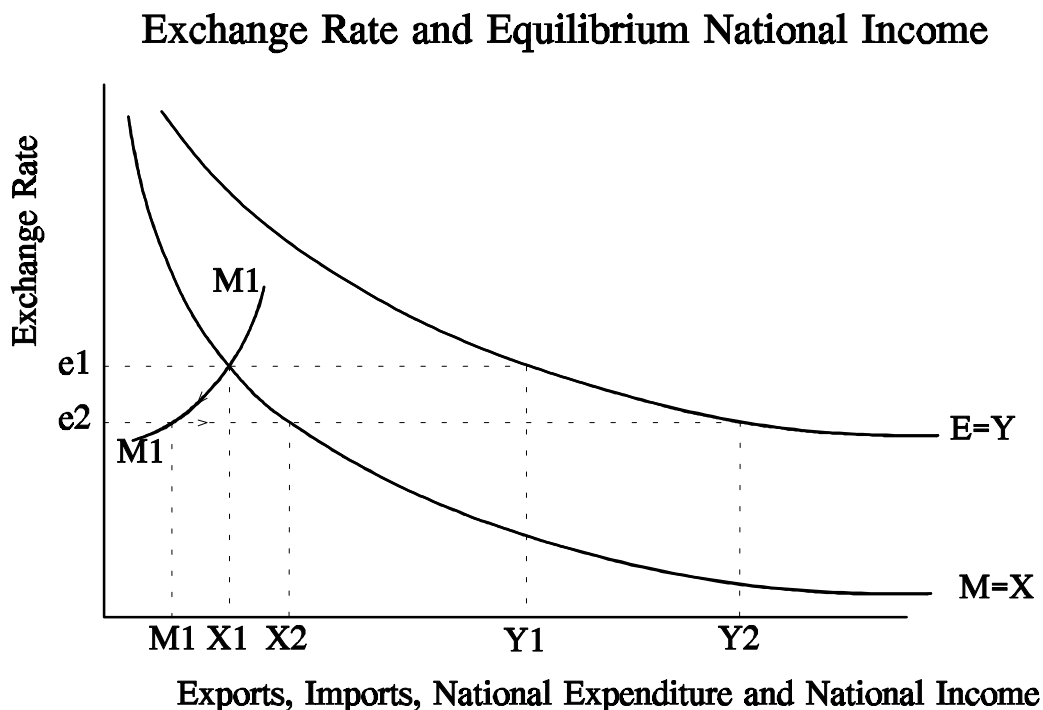


Figure 1

This is presented graphically in Figure 1 which plots the relationship between imports, exports, national income and national expenditure at equilibrium in such an economy. If the exchange rate were initially at $e1$, exports and imports would be at $X1$ and national income and expenditure would be at $Y1$.

If the economy devalues its currency to $e2$, imports would initially decline along the import schedule $M1-M1$ to the amount $M1$ and exports would rise to $X2$. The reduced spending on imports is offset with increased spending on domestic products. This raises national income. The increased exports also raise national income.

Initially exports would exceed imports, raising the money supply and raising national income and expenditure. As national expenditure rises, spending on imports would rise also, until the spending on imports was equal to income from exports. At this point, leakages equal injections, and the economy would be in equilibrium again. National expenditure and national income would be at $Y2$ and exports would equal imports at $X2$.

In this example, the devaluation of the currency caused an initial or short term balance of payments surplus. However, in the long term, the economy returned to equilibrium with exports equal to imports.

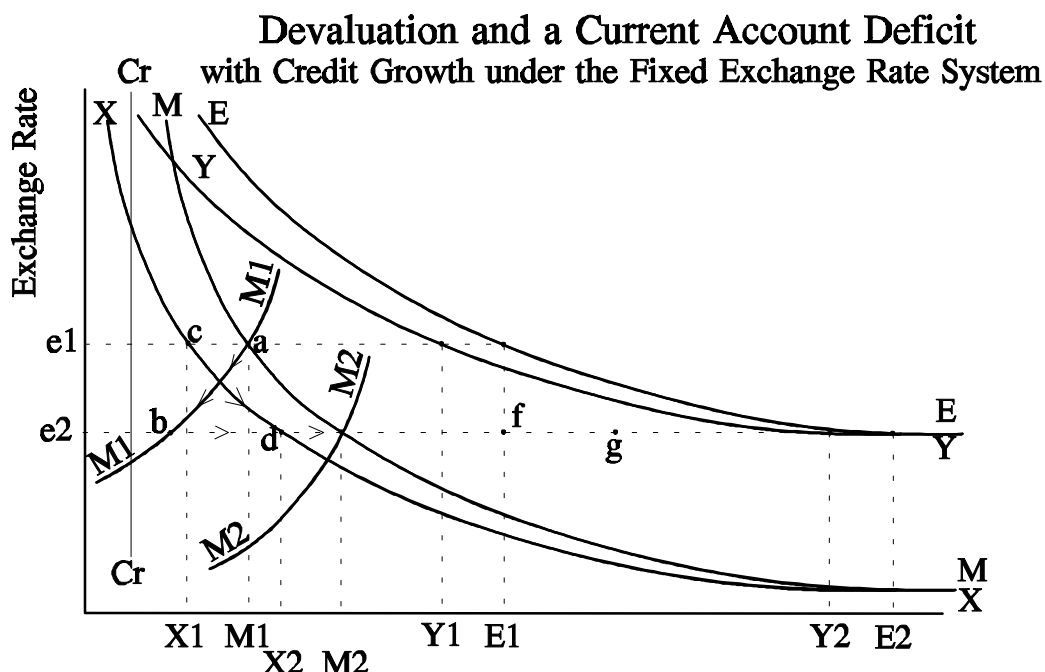
In the long term, the devaluation of the exchange rate raises not only exports but imports. This is because the higher level of exports raises national income which increases national expenditure. Eventually, the higher level of expenditure generates more imports at the lower exchange rate.

This analysis reveals that devaluations can be used to raise national income. If the economy were already fully employed, devaluation may cause a rise in inflation which may return relative prices between domestic and foreign products to the position before the devaluation. However, if the economy had unemployed resources, devaluation could employ those unemployed resources and raise real national income.

1.2 Devaluation and a Current Account Deficit

A country with a persistent current account deficit must have some source of monetary growth, other than income, that causes expenditure to exceed income. For a country with a fixed exchange rate system, this source can be foreign capital, bank credit and/or the issue of cash to finance government expenditure. A country with a current account deficit may be able to devalue and reduce its current account deficits in the short term. However, in the long term, devaluation will not reduce the current account deficit.

This is shown in Figure 2 where the growth of bank credit in an economy, shown as the line $Cr-Cr$, finances national expenditure, $E-E$, to exceed national income, $Y-Y$. This excess spending causes imports, the line $M-M$, to exceed exports, the line $X-X$. Imports are equal to exports plus the growth in bank credit.



Bank Credit, Exports, Imports, National Income and National Expenditure

Figure 2

Initially, the economy's exchange rate is assumed to be at e_1 with exports at X_1 , imports at M_1 , national income at Y_1 and national expenditure at E_1 . National expenditure exceeds national income by the amount of the credit growth. This excess demand causes an equivalent current account deficit which is the difference between M_1 and X_1 .

The economy is then assumed to devalue to e_2 . At this new exchange rate, imports may initially decline along the M_1 - M_1 line from a to b . Exports would rise as in the first example, from X_1 to X_2 . Initially, this would reduce, if not eliminate, the current account deficit. However, national income would rise as export income has increased and spending on domestic products would have increased from the interval M_1 - E_1 to the interval b - f . Thus, total income would initially rise from Y_1 to the point g . National income, national expenditure and the money supply would continue to rise while export income plus the growth of credit exceeded imports. Imports would equal exports plus the growth of bank credit at M_2 . This would have been achieved when national expenditure had reached E_2 . National income would then be at Y_2 and the current account deficit would be the difference between M_2 and X_2 . National expenditure would continue to exceed national income and imports would continue to exceed exports by the amount of the growth in bank credit.

A country in this position would experience balance of payments difficulties and falling foreign reserves. This would normally drive the government or central bank to apply credit restraint. If the source of monetary growth were foreign capital rather than bank credit, the country would have a current account deficit but it would not experience any fall in foreign reserves.

These examples reveal that the exchange rate has no long term effect upon the current account deficit. It is consistent with Australia experience. When Australia devalued its currency in March 1983 it had no apparent effect upon the current account deficit.

2. Floating Exchange Rate and Monetary Growth

When Australia floated its exchange rate in December 1983, it caused the exchange rate to vary over a wide range. Yet whether the exchange rate was high or low, it had no apparent effect upon the current account deficit. The reason for this was that floating the dollar did not constrain the growth of bank credit. However, it did stop foreign capital from directly increasing the money supply and thereby adding to the current account deficit.

When a country adopts the floating exchange rate, it has an established exchange rate, money supply and level of exports, imports, national income and national expenditure. If it did not have any growth in the money supply and there were no net foreign capital movements, the supply of exports and the demand for imports would determine the exchange rate for that economy's currency. This is shown in Figure 3.

If there is no domestic monetary growth or international capital flows in an economy, national income and expenditure would be at equilibrium when the foreign exchange market was at equilibrium. The floating exchange rate system ensures that the foreign exchange market is at equilibrium at all times. Therefore, national expenditure is

at equilibrium at any exchange rate that the foreign exchange market determined. The equilibrium level of national income and expenditure would be represented by the Y/E - Y/E line. At this level of expenditure, spending on imports would rise with the exchange rate as shown by the line $M-M$. Income from exports, represented by the $X-X$ line, would rise as the exchange rate falls. The foreign exchange market is cleared at the intersection of the imports and exports curves with the exchange rate at e and with imports equal to exports at X . Income from domestic sources, and expenditure on domestic products, are represented by the interval N .

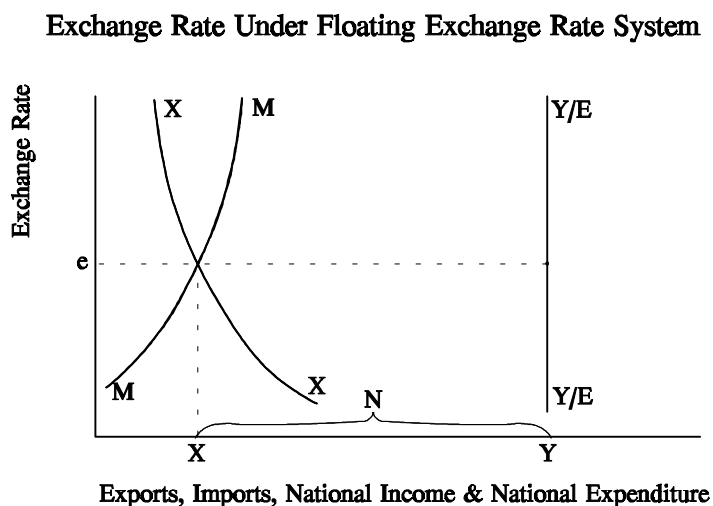
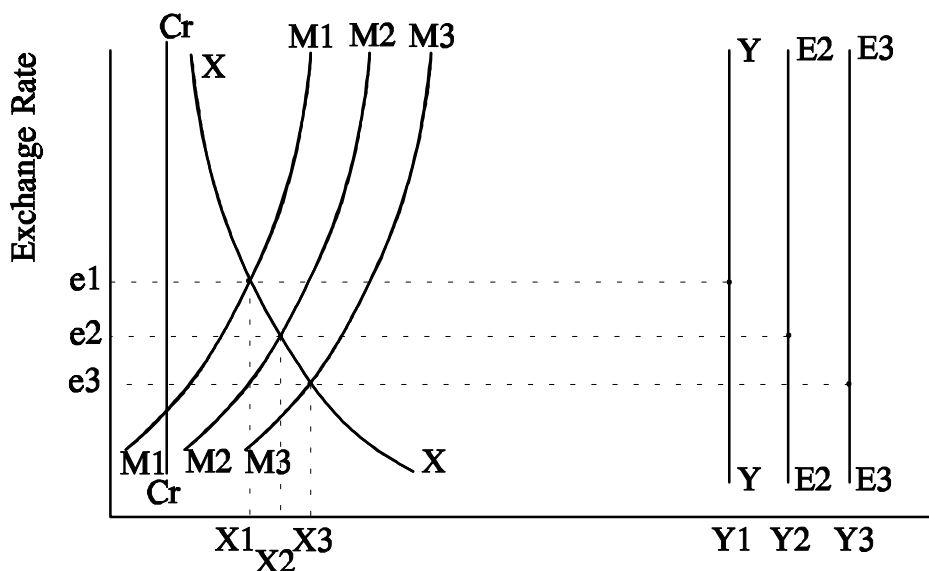


Figure 3

If this economy were to create additional bank credit and increase the money supply, it would raise national expenditure. This would increase demand for imports and reduce the

exchange rate. Income from exports would rise at the lower exchange rate to equal imports. The increased exports would raise national income to equal national expenditure. The exchange rate would continue to fall while there was credit growth and no capital inflow. Such an economy is likely to also experience high rates of inflation but it would not experience current account deficits.

Exchange Rate Under Floating Exchange Rate System with Credit Growth



Credit Growth, Exports, Imports, National Income & National Expenditure

Figure 4

This is shown in Figure 4 where the demand for imports is initially at $M1-M1$ with income and expenditure at $Y1$, exports and imports at $X1$ and the exchange rate at $e1$. Bank credit growth causes the money supply to increase. This is represented by the line $Cr-Cr$. This raises national expenditure from $Y-Y$ to $E2-E2$. As it does, it raises imports to $X2$ and causes the exchange rate to depreciate to $e2$, raising exports also from $X1$ to $X2$. Spending on domestic products rise also to the amount represented by the interval $X2-Y2$. Hence national income and national expenditure is raised from $Y1$ to $Y2$.

If bank credit continues to raise the money supply, it would raise national expenditure to $E3$. Demand for imports would shift to $M3$ causing the exchange rate to fall to $e3$ with exports and imports rising to $X3$. Income from domestic sources would rise to the equivalent of the interval $X3-Y3$. Hence national income would rise to national expenditure at $Y3$.

3. Floating Exchange Rate, Monetary Growth and Foreign Capital

When an economy's currency depreciates as in Figure 4, foreign investors may speculate against a further fall. Such speculation can cause the exchange rate to stabilise. It increases the demand for domestic currency, offsetting the increased supply from rising imports. This case is presented in Figure 5.

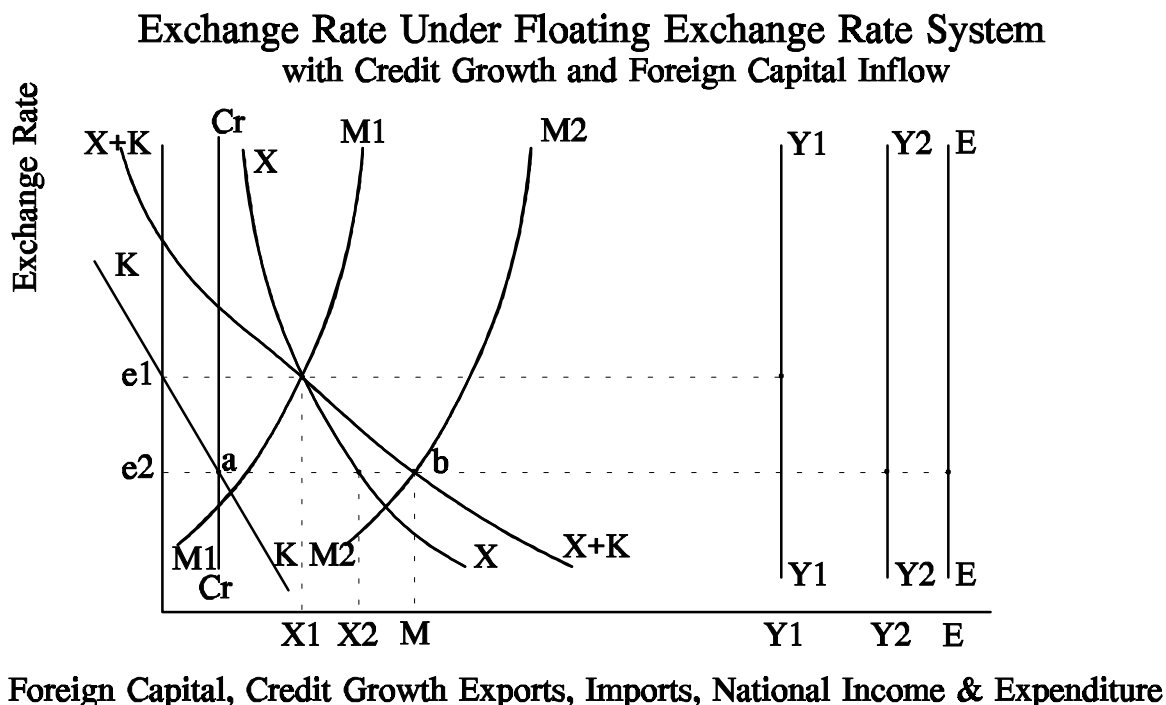


Figure 5

In Figure 5, the national income and expenditure of the economy is initially at $Y1$. Exports are represented by the $X-X$ line and imports by the $M1-M1$ line. The exchange rate is initially at $e1$ and imports and exports are equal at $X1$. At exchange rate $e1$, there is no foreign capital inflow. Initially, there is no growth in bank credit.

Bank credit then rises to the line $Cr-Cr$. As in the previous case, this causes imports to rise, the exchange rate to fall and exports to rise. As the exchange rate falls, there is an increase in foreign capital inflow. The exchange rate continues to fall until the net inflow of foreign capital equals the growth of bank credit, at the point a .

At this exchange rate, the demand for domestic currency, represented by the $X+K$ line, is equal to imports or the supply of domestic currency, represented by the $M2-M2$ line, at the point b . Imports have increased to M and exports have increased to $X2$. The difference between $X2$ and M is equal to the current account deficit which is also equal to the net capital inflow.

National expenditure has increased from $Y1$ to E . Income earned from sales to the domestic market has increased from the difference between $Y1$ and $X1$ to the difference between E and M . This together with the export income $X2$ raises national income from $Y1$ to $Y2$. The difference between national expenditure and national income is equal to the growth of credit.

This exchange rate achieved under the floating exchange rate reflects the value that foreign investors place upon the exchange rate. It may bear no relationship to the ideal exchange rate for that economy.

4. Constraining Identities

These relationships between national income and expenditure, exports, imports and foreign capital flows can be expressed algebraically using some basic identities that govern the behaviour of an economy under the floating exchange rate system. The most limiting constraint is that the foreign exchange market is always cleared with the exchange rate moving to ensure that the demand for domestic currency is always equal to the supply of domestic currency. This can be put as:

$$M = X + K \quad (6)$$

The money supply normally constrains national expenditure to national income. However, the creation of more money can increase national expenditure above national income. The only way that the money supply can be increased under the floating exchange rate system is from domestic sources such as bank credit or increases in the currency in circulation. Therefore, on the national market, the sources of finance for national expenditure can be put as:

$$E = Y + Cr \quad (7)$$

where Cr is the domestic sources of growth in the money supply including the growth of bank credit and the issue of additional currency.

National expenditure can be directed at either domestic products or imports. That is:

$$E = N + M \quad (8)$$

where N is the domestic expenditure on domestic products (and is also the income from domestic sources).

National income can come from domestic sources or exports, such that:

$$Y = N + X \quad (9)$$

Substituting equation (9) in equation (7) defines the sources of income for expenditure as:

$$E = N + X + Cr \quad (10)$$

Substitution equation (8), for the direction of expenditure, into equation (10), for the sources of finance of expenditure, reveals the conditions for clearing the national market:

$$N + M = N + X + Cr$$

or $M = X + Cr$ (11)

Substituting equation (6) into equation (11) reveals that both markets are cleared when:

$$X + K = X + Cr$$

or $K = Cr$ (12)

This algebraic analysis confirms the conclusions made in the preceding graphical section. The floating exchange rate system causes countries that attract foreign capital to suffer a current account deficit equivalent to the growth of bank credit or the money supply.

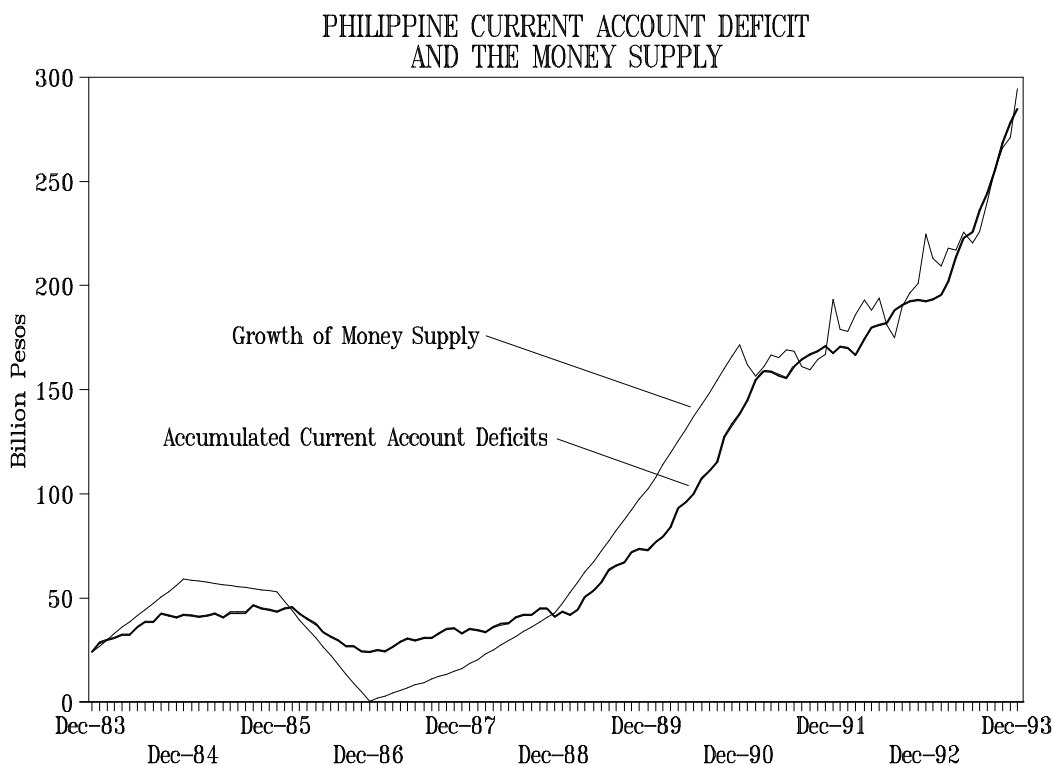


Figure 6 Source of Data: Bangko Sentral ng Pilipinas

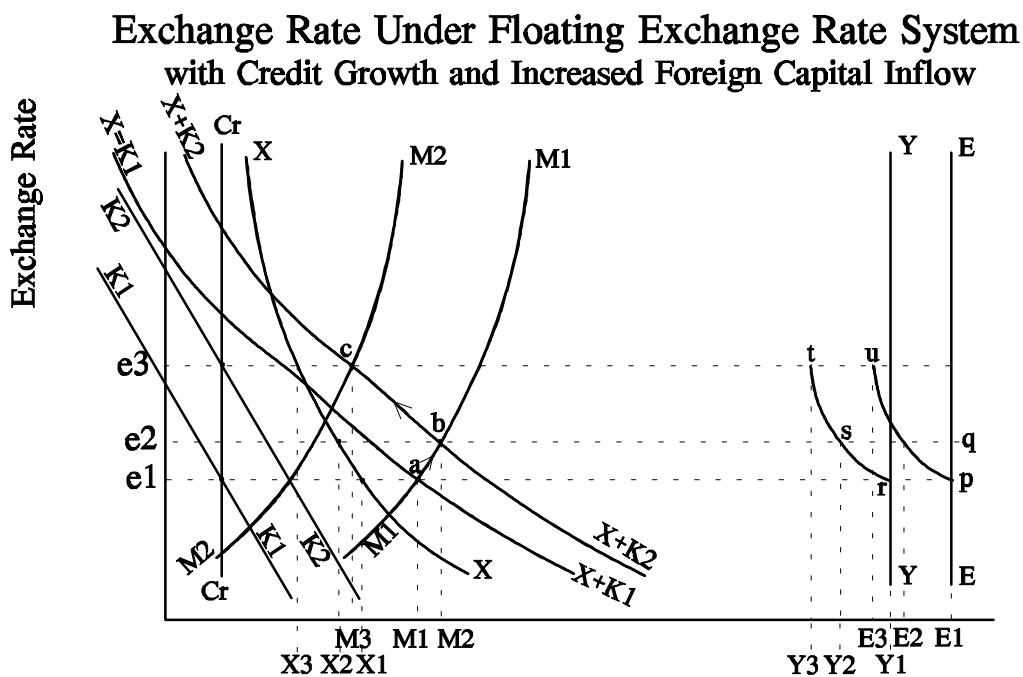
This outcome is also confirmed by the data. The first paper in this series revealed that this condition existed in Australia. Figure 6 reveals that the same relationship exists in the Philippines. The money supply in the graph is defined as currency plus commercial bank

liabilities other than savings deposits. Similar relationships should be evident in other countries.

This analysis reveals that economies that attract a net inflow of foreign capital, use the floating exchange rate system and have rising bank credit are likely to incur current account deficits. Economies need an increase in the money supply to facilitate growth. Under the floating exchange rate system the main source of money for such economies is derived through increased bank credit. Therefore, if such economies are to grow, they must incur current account deficits and rising foreign debt, or foreign equity.

5. Increases in Foreign Capital Inflow

Any increase in the supply of foreign capital is likely to inflate the exchange rate. This would reduce national income as it would shift spending from domestic products to imports and it would reduce export income. The lower level of national income would reduce expenditure on imports.



Foreign Capital, Credit Growth, Exports, Imports, National Income & Expenditure
Figure 7

These effects of an increase in the supply of foreign capital are presented in Figure 7. National expenditure is assumed to be initially at E_1 and national income at Y_1 . The supply of foreign capital is initially given by the line K_1-K_1 . The growth in the money supply is given by the $Cr-Cr$ line. The supply of exports is given by the $X-X$ line. National expenditure is given by the $E-E$ line and expenditure on imports is initially given by the M_1-M_1 line. The demand for domestic currency on the foreign exchange market is

given by the $X+K1$ line while the supply is given by the import or $M1-M1$ line. The intersection of these demand and supply lines is at a . At this point, the exchange rate is at $e1$, exports at $X1$ and imports at $M1$. The current account deficit is equal to the net capital inflow and to the growth of the money supply.

The supply of foreign capital inflow is assumed then to rise from $K1-K1$ to $K2-K2$. This raises the demand for domestic currency on the foreign exchange market from $X+K1$ to $X+K2$. The supply of domestic currency remains the $M1-M1$ line. Therefore, the foreign exchange market would be cleared at the point b with the exchange rate at $e2$, imports at $M2$ and exports at $X2$.

However, the domestic goods market is not in equilibrium at this exchange rate. The higher exchange rate has increased spending on imports from $M1$ to $M2$. Hence, domestic spending on domestic products has fallen from the interval $a-p$ to $b-q$. Also, exports have fallen from $X1$ to $X2$. Therefore, national income has fallen to $Y2$.

At this lower level of income, demand for imports would fall, thereby reducing the supply of domestic currency on the foreign exchange market. This would cause the exchange rate to rise even higher, further reducing national income, national expenditure, imports and exports.

Equilibrium in both the foreign exchange market and the goods market is achieved when foreign capital inflow equals the growth of the money supply at point c . At that point, the exchange rate is at $e3$, national income has fallen to $Y3$, national expenditure to $E3$, imports are at $M3$ and exports are at $X3$. To attain this equilibrium state, national income would have moved along the line $r-s-t$ and national expenditure moved from p to u .

The growth of credit would have increased both nominal national income and nominal national expenditure. However, the capital inflow would have reduced real national income and expenditure from where they might otherwise have been. Hence it is likely to have caused inflation.

Also, such an economy may experience mixed signals. The sectors receiving the foreign investment may be booming while the export and import competing industries may be in recession.

6. Increased Exports

If an economy with foreign capital inflow and a growing money supply tries to raise exports, it would not reduce its current account deficit. However, it may be able to raise its national income.

This is shown in Figure 8 where initially, the exchange rate is at $e1$, national income is at $Y1$, national expenditure at $E1$, exports at $X1$ and imports at $M1$. The $K-K$ line represents

the supply of foreign investment, the $Cr-Cr$ line is the growth of the money supply, $X1-X1$ is the initial supply of exports and $M1-M1$ is the initial demand for imports.

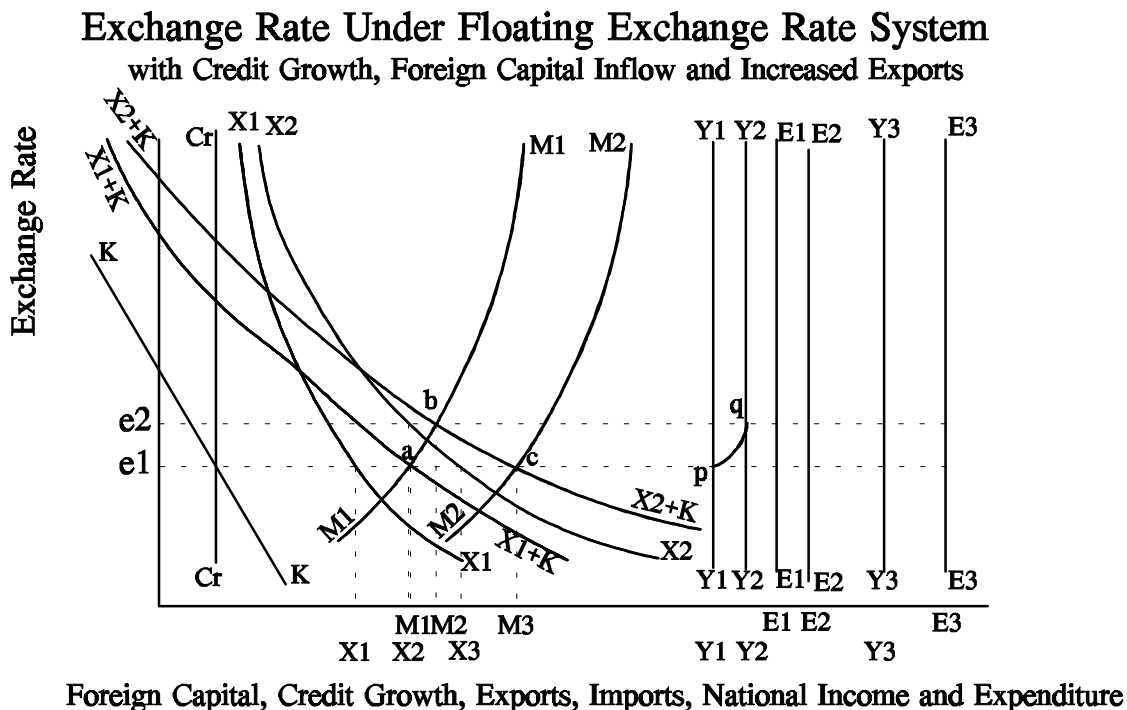


Figure 8

The supply of exports are then assumed to increase from $X1-X1$ to $X2-X2$. This shifts the demand for domestic currency on the foreign exchange market from the line $X1+K$ to $X2+K$. If demand for imports and supply of exports were independent of each other, we would expect the equilibrium position on the foreign exchange market to shift from a to b with the exchange rate rising to $e2$.

At the exchange rate $e2$, exports would be at $X2$ and spending on domestic products would be equivalent to the interval $M2-E1$. Hence national income would rise with the exchange rate along the line $p-q$ to $Y2$. Note that the rise in total exports has been achieved at the cost of domestic sales and lower incomes to the old exporters.

However, such an outcome is unlikely as it is not an equilibrium position on the national goods market. When national income rises, demand for imports would rise also, shifting the import line $M1-M1$ to the right. Also, the rise in the exchange rate reduces foreign capital inflow, and the current account deficit, below the growth of credit. As explained using Figure 4, such disequilibrium causes the exchange rate to depreciate.

Equilibrium can be achieved on both the goods and foreign exchange market if national expenditure rises to $E3$ so that the supply of imports rises to the line $M2-M2$. This

equilibrium would be achieved at the point c and at the original exchange rate of $e1$. Imports would be at $M3$, exports at $X3$, national income at $Y3$ and national expenditure at $E3$.

This outcome reveals that increased exports can raise national income if the exchange rate is, in effect, fixed. However, the speed of the adjustment is much slower than under the fixed exchange rate system. Under the fixed exchange rate system, increased exports can increase the money supply and cause national income and expenditure to rise rapidly. Under the floating exchange rate system, economic growth is limited to the growth of credit.

The value that foreign investors place on the Australian dollar does reflect commodity prices. This suggests that foreign investors are prepared to maintain their investment at the higher exchange rate generated by increased export income. Such behaviour would reduce the benefit to Australia of the increased export incomes. The Australian exporters would not benefit from the rise in commodity prices, nor the remainder of the economy from the flow-on of exporters' increased expenditure.

7. Exports and Competition

To consider the effect of the floating exchange rate system on competition, we will return to a simple model. We will assume that there is no growth in the money supply nor are there international capital transactions. In that case, any increase in exports would require the exchange rate to rise and increase imports to provide domestic currency to the foreign exchange market.

Exports would increase only if domestic expenditure shifted from domestic products to imports. The increased exchange rate would reduce the incomes of pre-existing exporters. Therefore, the increased exports would have reduced the incomes of import competing industries.

This is revealed in Figure 9 where the supply of exports is initially given by the line $X1-X1$ and imports by the line $M-M$. The supply and demand for domestic currency on the foreign exchange market is cleared at the point a where the exchange rate is $e1$ and exports and imports are equal at $X1$. National income and national expenditure are equal at Y .

If there were an increase in the supply of exports from $X1-X1$ to $X2-X2$, then the foreign exchange market would be cleared at the point b with an exchange rate of $e2$ and imports and exports of $X2$. However, at this exchange rate imports would have increased, thereby reducing the national expenditure on domestic products from $X1-Y$ to $X2-Y$. Also, those exporting before the shift in the supply of exports have contracted their export income along the first export schedule from a to c . Their income has fallen from $X1$ to $X3$. In this case, the increased supply of exports has not added to national income. It has only

squeezed the incomes of pre-existing exporters and of import competing industries.

Therefore, the floating exchange rate system makes exporters compete with each other and with import competing industries. Only the most efficient and competitive businesses will succeed in this competition with other domestic industries.

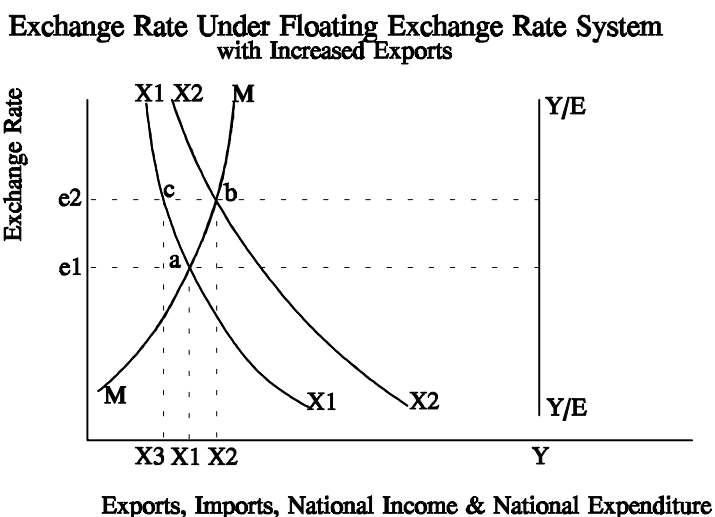


Figure 9

It is worth noting also that the new exports would have improved the market for importers at the expense of local industry.

9. Capital Outflow

On the other hand, net international capital outflow can assist an economy to increase its export revenue. Capital outflow increases the supply of domestic currency on the foreign exchange market. This deflates the exchange rate and increases export income. The lower exchange rate also shifts domestic spending away from imports to domestic products. This also raises national income.

An example of this is shown in Figure 10. In this case, the economy is assumed to initially have national income and expenditure at Y . The demand for imports is given by the $M-M$ line and the supply of exports is given by the $X-X$ line. The foreign exchange market is cleared initially at a with an exchange rate of e_1 and exports and imports of X_1 .

The economy then engages in foreign investment. Its supply of capital to foreign economies is given by the K_0-K_0 line. This shifts the supply of funds on the foreign exchange market from $M-M$ to the $M+K_0$ line. The foreign investment also reduces national expenditure below national income to E . The increased supply of domestic currency causes the equilibrium point in the foreign exchange market to shift from a to b . The exchange rate falls to e_2 , exports rise to X_2 and imports fall to M_2 .

The lower exchange rate has causes export incomes to rise to X_2 and income from domestic sales to rise to the interval M_2-E . When these two sources of income are added together, they equal national income, Y . Therefore, despite the fall in national expenditure, the exchange rate falls and maintains national income at its previous level, Y .

Hence, a country investing overseas could continually build its international wealth without sacrificing national income.

9. Credit Growth with Capital Outflow

When an economy that is a net investor on the international capital market also has a growing money supply,

it can attain more rapid economic growth with a current account surplus. The credit growth increases the demand for both domestic products and for imports. The spending on imports increases the supply of domestic currency on the foreign exchange market. This deflates the exchange rate, increasing exports and shifting domestic spending from imports to domestic products. This raises national income even further.

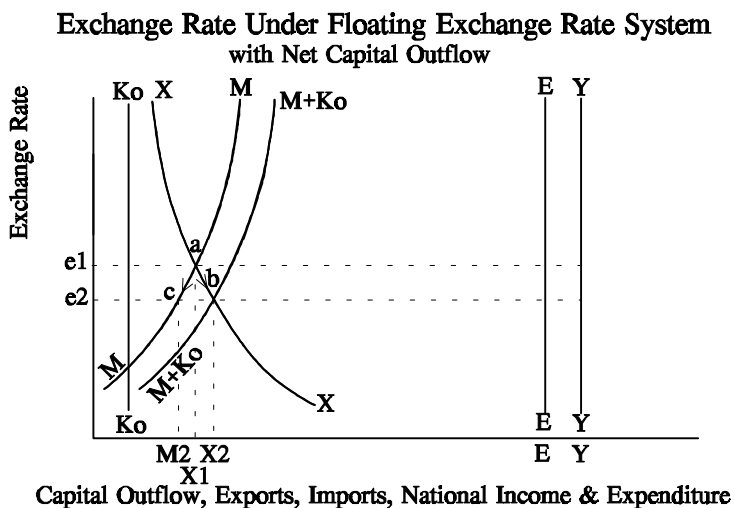
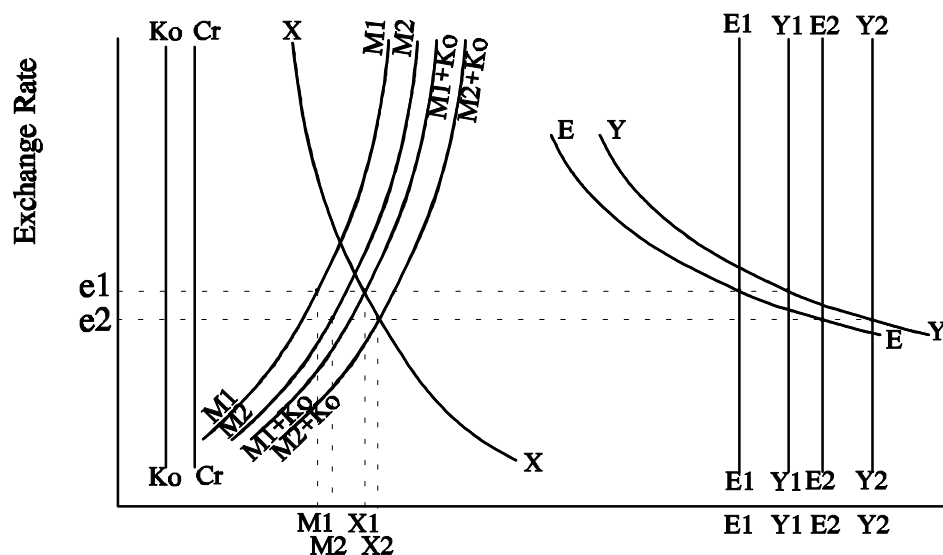


Figure 10

Exchange Rate Under Floating Exchange Rate System with Credit Growth and Capital Outflow



Credit Growth, Capital Outflow, Exports, Imports, National Income & Expenditure

Figure 11

These effects are evident in Figure 11. This economy is assumed, initially, to be in a state similar to that arrived at in Figure 10. National income is initially at $Y1$ and national expenditure at $E1$. The supply of exports is given by the $X-X$ line and imports by the $M1-M1$ line. Net overseas capital outflow is given by the $Ko-Ko$ line. The supply of domestic currency on the foreign exchange market is given by the $M1+Ko$ line. Therefore, the exchange rate is at $e1$, imports at $M1$ and exports at $X1$.

The economy is then assumed to increase bank credit and thereby the money supply. This increase is shown as the $Cr-Cr$ schedule. It increases national expenditure from the $E1-E1$ line to the $E2-E2$ line. The increase in national expenditure raises imports from $M1-M1$ to $M2-M2$. The supply of domestic funds on the foreign exchange market rises to $M2+Ko$ and so the exchange rate falls to $e2$. The increase in national expenditure has raised imports from $M1$ to $M2$. The lower exchange rate raises exports from $X1$ to $X2$. Spending on domestic production has increased from the interval $E1-M1$ to the larger interval $E2-M2$. National income rises to $Y2$ where it exceeds national expenditure. It is equal to export income plus income from domestic sales.

The effect of the credit growth upon the economy is similar to the outcome from depreciation in a country with fixed exchange rates (see Figure 1). In that case, depreciation of the currency increased exports, national income, the money supply, national expenditure and imports until a new equilibrium position was attained. In this case, credit growth increases the money supply and has a similar effect. The lines $E-E$ and $Y-Y$ in Figure 11 plot the effect of increasing credit upon national income and

expenditure. These lines are similar to the equilibrium national income and national expenditure lines in Figures 1 and 2.

We can conclude that an economy that is a net investor on the international capital market and also increases its money supply will find that its exports will grow because its lower exchange rate ensures that its products are competitive on international markets. It will accumulate wealth on international capital markets and it will experience rapid economic growth. This growth is likely to ensure full, or even over-full, employment. Despite the growth in the money supply, the rapid economic growth would ensure that inflation is kept low.

10. Experience under Floating Exchange Rate System

The experience of countries under the floating exchange rate system confirms the conclusions made in this review. Countries that use the floating exchange rate system and are net recipients of foreign investment such as Australia, New Zealand, the United States of America, Canada, the Philippines, the United Kingdom and many other European countries have experienced low rates of economic growth, high rates of inflation, high unemployment, current account deficits and growing foreign debt.

Many of these countries have tried to form regional trade groups to overcome the failings of the floating exchange rate system. In Europe, they have established the European Economic Community (EEC) which is now called the European Union (EU). They have gone as far as trying to establish a common currency. The North Americans have established NAFTA. Australia and New Zealand have established Closer Economic Relations (CER). However, regionalisation is a process whereby countries force themselves to buy products from other than the cheapest suppliers on the world market. It does not provide the benefits of free world trade.

Countries such as Japan that have been a net investor on international markets have experienced high rates of economic growth, low rates of inflation, low unemployment, current account surpluses and growing foreign wealth. Since 1991, Japan has reduced its rate of monetary growth and reduced its net foreign investment. This has dramatically reduced its rate of growth and caused its exchange rate to rise. In August 1995, it permitted life insurance companies to invest part of their assets overseas. This has allowed investment overseas from Japan to rise and reduce the value of the Yen. This is likely to stimulate the Japanese economy.

11. Conclusion

While the floating exchange rate system is a market system for determining the exchange rate it does not accord with our professed objectives and obligations as members of the International Monetary Fund. It does not encourage trade as it inflates the exchange rate when exports rise. Therefore, rather than sustaining sound economic growth through

export growth, it hinders it. It does not provide a stable exchange rate. It does not foster price stability. It does not prevent erratic disruptions to the economy.

The floating exchange rate system allows capital transactions to distort the foreign exchange market, inflating the currencies of countries that are attractive to foreign investment. In such countries it causes high unemployment, high inflation and slow economic growth. Their industries become uncompetitive on world markets and many have to look to establishing regional trade in attempt to overcome their problems.

On the other hand, economies with a net capital outflow experience current account surpluses and growing foreign wealth. They have high rates of economic growth, low rates of inflation and low rates of unemployment. Their industries are made internationally competitive, they flourish in world trade and do not find any need to join regional trade groups.

Australia is an example of a country that uses the floating exchange rate system and is attractive to foreign investment. That investment has acted upon the floating exchange rate system and inflated the Australian exchange rate, making Australian industries uncompetitive on world markets. Also, the floating exchange rate system has contributed to Australia's high unemployment rates and high inflation rates.

These problems can not be overcome by adopting world best practice, lower wages and more efficient governments. These problems are caused by the inherent failings of the floating exchange rate system. While Australia continues to use this system and remains a recipient of foreign investment, it will continue to have these problems.

The government may be able to minimise these problems by acting on the foreign exchange market to stabilise the exchange rate. However, such action would be just a prop for a failed system. What is needed is an alternative market based exchange rate system that is not distorted by capital flows. In my third paper I present the optimum exchange rate system that provides such an alternative.

REFERENCE

- Friedman, M. 1966 *The Case for Flexible Exchange Rates*
in *Essays in Positive Economics*
University of Chicago Press, Chicago, Ill.