5a The Adjustment Process and the Monetary System: Comment on Davidson

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Professor Davidson's paper forces us to think, once again, about the reasons for the failure of the various proposals that have been put forward from time to time for establishing a single international money as means of settling international transactions and the actual institutional arrangements developed for implementation of these proposals.

We have had a long and varied history of such institutions, going back to the now defunct gold standard. The gold standard system itself worked relatively smoothly for a while in the latter third of the nineteenth century, but by 1914 it had already fallen on rough ground. Though restored in modified form after the war, it fell apart in 1931 when Britain abandoned it. After Bretton Woods, and in the aftermath of the dislocation caused by the World War II, the United States dollar came for a time to supplant gold as international currency. But that system also has now developed serious cracks. Experiments with other systems of "currency areas", of which the Sterling Area was and is the leading example, have similarly foundered.

So far as the experience with the gold standard is concerned, the lesson to be learned from it is that its relative success, so long as it lasted, was based in large part on the preeminence of Britain in world trade and finance as well as on the colonial status of a large group of primary producing countries on to which the burden of adjustments could be thrown. Under the gold standard system, the whole world was, in a sense, the sterling area, with London as the economic and political centre of the system.

But the structure of the world economy has changed a lot since

then. Britain has become a relatively minor economic and political force. Hegemony passed for a time to the United States economy and gave to the US dollar its pre-eminent position. But now, other national centres have risen to prominence. In this more pluralistic world we find a reemergence of tendencies to the formation of exclusive clubs (Davidson calls them UMS) among groups of countries seeking to create, through the medium of a common money, a basis for maintaining balance among themselves while insulating their internal economic system from changes external to the group. Into this arena there comes now the proposal for a Europa currency which Davidson describes.

There are, of course, differences in the mechanism of operation of different monetary regimes, as between, say, a fixed-exchange-rate regime (like the gold standard) and a flexible or managed exchange rate system. But, as a general matter, there is one problem which is common to all of them. This is that they are based on the vain hope that, if only there existed some kind of commonly accepted international currency, then the regulatory forces of the free market could be relied upon to ensure balance in the trade and payments relations among participating countries and stable growth and development for all of them. But we know that any such currency regime, operating under the usually presumed principles of automatic adjustment of bank credit, interest rates, prices, and multiplier-induced reactions, is inherently unstable. This is, in part, for simple straightforward textbook reasons. In particular, the price elasticities of demand and supply and marginal propensities to import may not be exactly right, so that trade and payments imbalances tend to widen instead of narrowing. The adjustment process itself may set in motion an explosive inflationary spiral. And there are usually perverse distributional effects involving sharp reductions in income levels for some social groups. The result of these circumstances is that, in practice, some form of state intervention becomes necessary which works to neutralize the operation of the adjustment process in the internal economy and, in effect, pass off the burden of adjustment on to others. These consequences must ultimately lead to the breakdown of the monetary regime itself.

So far as the proposed Europa system is concerned, Professor Davidson shows that its success as an international money with stable purchasing power would require international coordination of incomes policies among member states. This argument is undoubtedly correct. It must also lead one to wonder how it would be possible to

achieve such a systematic coordination on an international level when it has not proved possible to pursue successfully an incomes policy on the national level.

One might take this argument a bit further by recognizing that there are powerful economic forces which would operate systematically to produce instability in the purchasing power of an internationally money like the proposed Europa. These arise from what I would call tendencies toward uneven development, associated with differential growth rates of income and differential productivity growth among member countries as well as the process of concentration of capital as it affects prices, profits, and productivity. These factors make it necessary to have coordination, not only of incomes policies, but also of tax and expenditure policies and industrial concentration policies among the different countries.

A related point, quite separate from the foregoing, which has been emphasized elsewhere by Minsky (e.g. 1980), is that there are endogenous destabilizing forces operating within any sophisticated modern financial system, deriving from the profit seeking activity of the financial institutions themselves. These forces constantly upset and undermine the simple rules and regulations that the policy makers develop.

Viewed in this context, the search for a monetary solution to the problems of the European economies may appear to be the pursuit of a will-o-the-wisp. This may not be entirely so in fact, as the proposed solution of a Europa currency may well provide some palliatives. It would seem however that there are definite limits to such a proposal and it could only have a short term impact.