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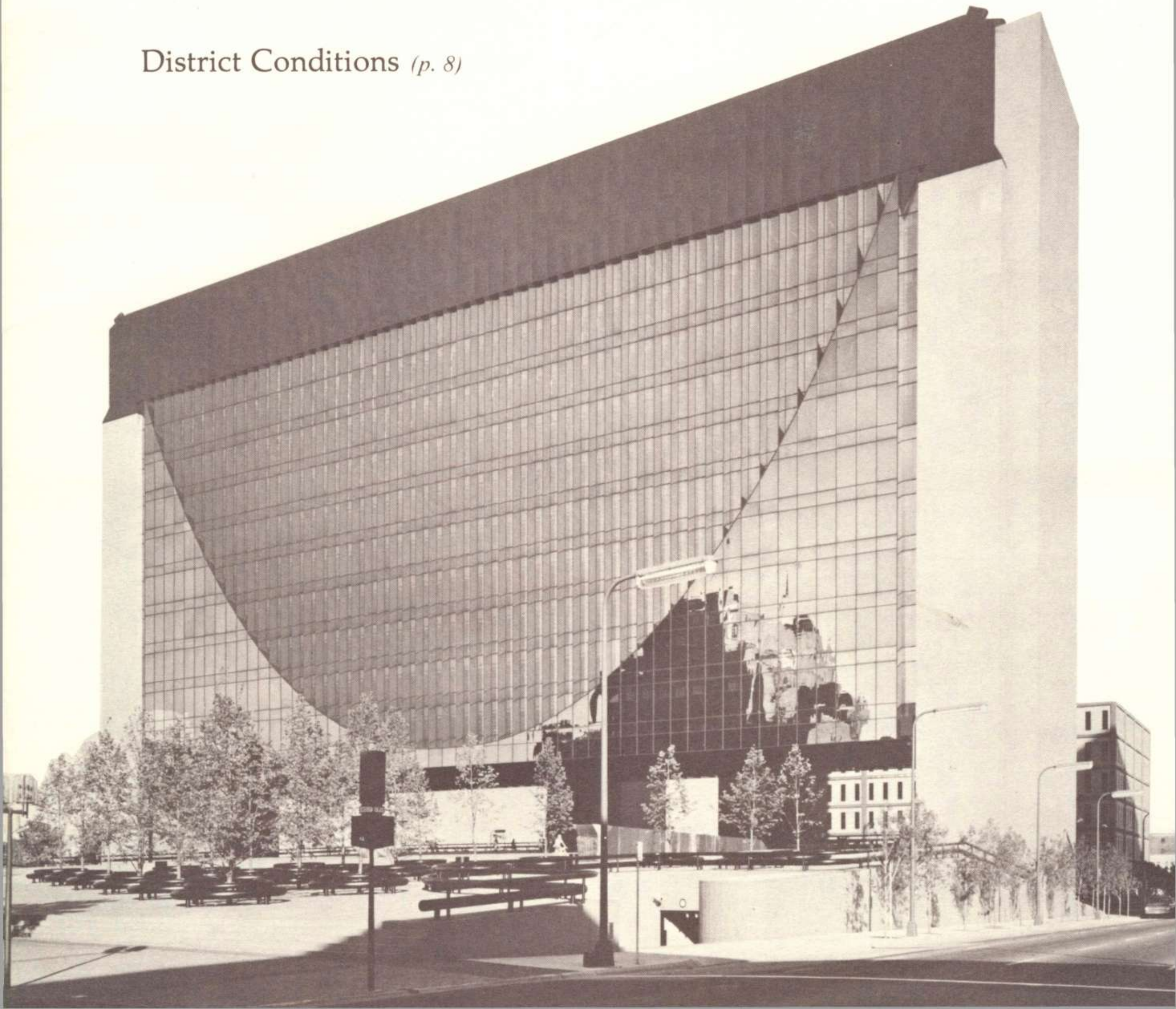

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This publication primarily presents economic research aimed at improving policy making by the Federal Reserve System and other governmental authorities.

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Does the sinking U.S. dollar mean the float isn't working?

When the major industrial countries moved from fixed to floating exchange rates in the mid-1970s, many economists predicted a new era of international stability and prosperity. Government interference in the world monetary system would be unnecessary, and independent national budget policies would still be possible. All this would happen because the "invisible hand" of free markets would produce exchange rates reflecting the underlying strength of each economy. But it hasn't worked quite that way.

The recent plunge in the U.S. dollar is just one sign that something's wrong. While governments have been pursuing independent budget policies, they have not been dropping barriers to international trade or restrictions on international borrowing and lending. And they have still been intervening in the currency markets.

A movement to change the world monetary system again is inevitable if these policies continue much longer. But to change it, governments need to know the options. Can a free market, floating rate system work? And if not, what will?

Our feature article in this issue answers both questions. "International Monetary Reform: The Feasible Alternatives" (p. 2) says the free market, floating exchange rate system is not economically feasible; it simply cannot produce an equilibrium set of exchange rates. For a workable international monetary system, governments have only two options: floating rates with capital controls but independent budget policies or fixed rates without capital controls but coordinated budget policies. In other words, governments must choose between freedom in international borrowing and lending and freedom in national budget policies. They can't have both.