The current consensus favours a laissez faire approach for a country's choice of exchange rate regime. But this free-for-all contains a radical flaw

choose their exchange rate arrangements by agreement. The reference of this point extends well beyond the cur- rent architecture. In the next quarter-century, China's importance is likely to grow further and other countries such as India will become key countries. Major real exchange rate changes will be necessary in response to differential rates of productivity growth. Smooth realignments are unlikely if the pre- vailing non-system continues.

What should be the eventual shape of an exchange rate system for key coun- tries? A fixed exchange rate or a "hard" exchange rate target area is a political non-starter, as it would involve a significant loss of monetary autonomy. It would imply adjusting to large, asymmetric disturbances - such as the differential rates of productivity growth already allowed to - by internal price changes. This would be an ineffi- cient as well as undesirable.

So the key countries will have to float. (In China's case, this could only happen eventually, after negotiated step changes in its exchange rate in the interim.) But unmanaged floating can sometime result in exchange rate "heroic behaviour" that is manifestly insane, for example the US dollar hob- ble of 1985-86.

That leaves only two realistic options. Exchange rates between key currencies could float in unmanaged fashion most of the time but with occas- ional co-ordinated intervention. Or, as suggested by John Williamson of the Peterson Institute for International Economics, reference rates could be periodically agreed, intervention being allowed (but not compulsory) only if undertaken to influence market exchange rates in the direction of refer- ence rates. Both schemes would require regular dialogue among the key coun- tries about their exchange rate rela- tionships, as well as occasional macro- economic policy co-operation. No such forum currently exists. The group of "Seven+ One" appears to me to include China but excludes some countries that are no longer economically important.

Where does the International Mon- tary Fund fit in? Though one motive in setting up the IMF was avoidance of exchange rate conflicts, it gave up any such role after the second amendment of its articles in 1978. This amendment emasculated the principle of freedom of choice in exchange rate arrangements. It also forbade "exchange rate manipula- tion" but the term was never coher- ently defined and the relevant provi- sion became a dead letter. Moreover, the IMF has no leverage over countries. It could useful provide informa-
tion, technical expertise and "early warning". But when the chips are down, an exchange rate agreement between key countries is the only real- istic way forward.

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