

THE ADVANTAGES OF FIXED EXCHANGE RATE SYSTEMS:
OLD MYTHS AND NEW REALITIES

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Will Rogers once claimed that "All I know is what I read in the papers." If he were here tonight, it's clear what he would know about floating exchange rates: They're awful! Editorial writers, columnists and virtually everyone else has widely condemned the overvalued dollar in particular and the floating exchange rate system in general. The high value of the dollar is criticized for making U.S. products less competitive, resulting in massive trade deficits in the first half of the 1980s. Wide fluctuations in the value of the dollar have been criticized for complicating long-term planning both here and abroad. They have also resulted in esoteric new financial instruments designed solely to reduce currency risks.

And yet, during the 1980s, the benefits of increasingly expanding foreign trade are obvious. Greater imports of foreign goods have enabled us to enjoy rising living standards. Greater imports of foreign savings have enabled U.S. businesses to modernize at lower costs and contributed to increased investment in the U.S.

Of course, while we have gained from the benefits of greater specialization and increased efficiency that accompany increased international trade, these general gains have been associated with some specific costs as well. While, in general, U.S. consumers, businesses and workers have gained from the existence of world-wide markets, some U.S. firms and workers have lost out to more efficient foreign producers. Such adjustments are a necessary result of achieving the net benefits that trade brings.

The main question seems to be: "Has the floating rate exchange system helped or hindered the adjustments that accompany increased international trade?" This issue is what I would like to discuss this evening. I want to look at how exchange markets work to facilitate these adjustments and assess the tradeoffs that we face in choosing between our current system of floating exchange rates and its alternatives.

For more than 500 years, until very recently, exchange rates did not float. Instead they were generally based on a commodity standard--more specifically, the gold standard. Under a gold standard, central banks promise to exchange their currencies, on demand, for a fixed quantity of gold. Before the British Empire's dominance of world and financial affairs, the Italian, Spanish, and Dutch currencies, all tied to gold, successively provided the world's currency standard. From the late 1600s until 1931, the value of the British pound sterling was fixed in terms of gold; similarly, the U.S. dollar was tied to either silver or gold from 1787 until 1971. The only exceptions to fixed exchange rates took place during major wars--the Napoleonic wars and World War I for the British and the War of 1812 and the Civil War for the U.S. Yet each country returned to the gold standard following these wartime interruptions. Consequently, a fixed exchange rate system was ultimately enforced by the world's dominant currency being defined in terms of gold.

Rumors and nostalgia to the contrary, the mere establishment of a gold standard does not eliminate exchange rate movements or speculation about changes. The Bretton Woods System, which reigned from 1944 until 1971 was, for the United States, a gold standard. Yet, there were many exchange rate changes during this era. Whenever domestic events or

policies led to widespread expectations of devaluations, holders of the troubled currency would try to convert it into gold. This meant that the country's central bank found its gold or foreign exchange reserves falling; conversely, gold and foreign reserves would flow into the central bank if an appreciation, or revaluation, were anticipated.

A gold standard, then, can be summed up as a guarantee that the central bank stands ready to exchange its currency for gold at the stated par value. As a result, the supply of dollars is automatically adjusted to maintain the gold price. When domestic policies or international events generate expectations of changes in the official par value, however, the central bank must decide whether to defend the exchange rate by meeting the demand for gold or to change it.

By defending the exchange rate, of course, domestic monetary policy would be undergoing a de facto change--the money supply, other things equal, would shrink as currency was redeemed for gold. This would result, over time, in a slowing of the domestic economy, lower interest rates and lower inflation; ultimately, either the causes of the exchange rate imbalance would come to an end or the central bank would run out of resources. Alternatively, by resetting the exchange rate, the terms of international trade could be modified sufficiently to eliminate the accumulation of "unwanted" currency by foreigners--that is, currency they would want to redeem for gold. In this case, domestic economic policies and the country's resources could be maintained. This tradeoff between changing domestic policy to maintain the exchange rate versus changing the rate is key in considering how exchange rate systems differ.

How is this policy dilemma solved under a floating rate system? The exchange rate is just a price. For example, the dollar's exchange rate in yen is the price of the U.S. currency in terms of Japanese currency. Like any other economic good, the price of the dollar is determined by the law of supply and demand--that is, the price rises when demand increases relative to the supply, and the price falls when supply rises relative to demand. The exchange rate increases, for instance, when the U.S. inflation rate falls, when U.S. interest rates rise, or when there are rising prices for commodities set in dollar terms, such as oil.

Under a floating rate system, there is no automatic change in the supply of dollars as there would be under a gold standard. Instead, the exchange rate adjusts in place of the money supply. Conversely, a floating exchange rate system can be thought of as allowing domestic policy to be completely different from the policies of other countries. This permits a country, for example, to choose a lower inflation rate, a reduction in taxes, or other policy actions whose short run effects imply exchange rate changes. Under a gold standard, such policies would generate money supply changes that would offset the effects of the policies.

Now, of course, the cries for more stable exchange rates propose neither returning to a gold standard nor completely eliminating floating rates. The primary thrust of the contemporary debate, as advanced by Treasury Secretary Baker and others, appears to be a hybrid: exchange rates will be allowed to change when events dictate. In normal circumstances, however, they will be maintained within target zones of one another. There will neither be an objective standard of value (like the gold standard) nor any ties to a specific currency. This proposed

system is apparently modeled after the European Monetary System, or EMS. Before we rush to endorse such a system, however, we might first see how successful the EMS has been in stabilizing exchange rates.

The EMS comprises eight of the twelve European Common Market countries; their currencies are maintained in a joint float against other currencies. That is, except for limited fluctuations, each of the eight currencies has essentially a fixed exchange rate against each of the other seven; however, each floats independently against the other world currencies. Despite close consultation between the finance ministers of the member countries, this arrangement has not stabilized their exchange rates.

For example, in the most recent EMS realignment in mid-April, the German mark and the Dutch guilder were revalued by 3 percent and the French franc was devalued by 3 percent. Thus, political compromises resulted in joint currency changes even though most observers agree that it was French domestic economic policy which had necessitated the change. Moreover, these negotiations did not eliminate the policy discrepancies within the EMS that led to the realignment. Thus, they did not really stabilize the exchange rates at the new "zones," strongly suggesting further EMS realignments with attendant political turmoil among the countries involved.

The fundamental difference between floating and fixed exchange rate systems, then, is that a fixed rate system, whether a gold standard or joint float, imposes external constraints on domestic policy choices. In the case of a gold standard, domestic monetary and fiscal policies must maintain a zero inflation rate as measured in gold. It is no accident that, under the gold standard, inflation in Britain and the U.S. was

nonexistent for over 100 years. In the case of a joint float, each country compromises its independence over domestic policy in order to maintain common inflation and interest rates with its float partners: economic independence is exchanged for joint political decisions among the countries involved. In either case, failure to abide by the relevant constraint leads to exchange rate changes.

As the EMS experience indicates, policy coordination has not been sufficient to preclude realignments even between close trading partners. Even worse, realignments are frequently undertaken against the backdrop of political crises of the sort the system was intended to avoid. For example, last summer the Italian government coalition almost collapsed prior to a realignment; the devaluation of the franc and revaluation of the mark in 1983 took place only after acrimonious discussions and debate. To avoid such outside influence over their domestic policy, the British have declined to join the EMS—even though they are observers in its policy discussions and a member of the Common Market.

It is clear, then, that the discussion over fixed versus flexible exchange rates is, in some sense, misdirected. The issue is not whether exchange rates should be constant forever, regardless of events. The issue actually is what system will permit exchange rate changes to occur with the least disruption to trade. Under any system, exchange rates will need to be changed periodically because, as we have seen with the EMS, there will always be cases when domestic policies are not effectively coordinated or when relative commodity and manufactured goods' prices change due to innovation, productivity or other reasons.

Exchange rates thus reflect domestic policies or, more particularly, differences in domestic policies between countries. Exchange rates can be the focus of domestic policy, as they are for the Swiss and, to a lesser extent, the British; or rates can be left to freely adjust for policy differences, as is the case for the United States. The one great advantage to flexible exchange rates is that they adjust continuously to news, innovation and policy changes. While such changes are not painless, they are implemented without the political uncertainty that plagues a fixed-rate system.

To make this point more emphatically, ask yourself, "Which policy choices would we have been willing to forego during the 1980s in order to maintain the dollar's exchange rate during the 1980s?" Should we have abandoned our anti-inflation policy, which reduced U.S. inflation from 13 percent in 1979 to less than 4 percent today? Should we have foregone the 1981 and 1982 business and personal tax revisions, which have raised investment to record post-war levels and contributed decisively to the longevity of the current expansion? Should we have altered other domestic policies and decreased the rise in U.S. employment, which is unmatched in the other industrial economies? Each of these policies resulted in upward pressure on the dollar's exchange value.

Considering these tradeoffs emphasizes the potential costs of an exchange rate arrangement that severely restricts our domestic policy choices. Are we ready, willing and, more fundamentally, able to give up our ability to set domestic policies in return for some vaguely constructed system of target zones for foreign exchange rates? Frankly, I think not, especially when we see the President and Congress unwilling to defer to each other on matters of deficit reduction or tax reform.

Are they really likely to concede such authority to an international agreement?

Maybe the problems of the floating exchange rate system have been exaggerated. After all, the ultimate goal of international policy is not to fix or control prices of traded goods, but to facilitate trade. Thus, our concern should be with adopting the exchange rate system which most encourages international trade.

It seems that the floating exchange rate system has done this quite well. Since the advent of the floating rate era in 1973, international trade, measured as exports plus imports, has grown much faster than national income for the United States and the other G-5 economies--France, Germany, Japan and the United Kingdom. From 1950 to 1971, the ratio of total trade to GNP in the United States grew at about one percent annually; since 1973, this trade ratio has grown at a three percent annual rate. Thus, international trade has grown three times as fast under floating rates as it did under fixed rates. The corresponding comparisons for the other G-5 economies are similar: the Japanese trade ratio, which was unchanged from 1950-71, has risen at about a three percent rate since then; the United Kingdom's trade ratio, which declined at about half a percent during the 1950s and '60s, has risen at a two percent rate under floating rates. Similarly, French and German international trade have also grown much faster since the demise of fixed exchange rates.

What these trade figures reveal is that the exchange rate system is not the primary problem in international trade; rather, the primary problem is to assure continued expansion of world trade in the face of significant protectionist pressures and barriers to free trade. It may

well be, as in Casablanca where Claude Rains tells his subordinates to "round up the usual suspects," that the exchange rate system is just the most visible suspect--and an innocent one at that.

Rather than speculate about the reasons for these criticisms, I would like simply to emphasize that floating exchange rates are an efficient way to achieve both the pleasant and painful adjustments that necessarily occur in the modern era of integrated world production and trade. Floating exchange rates have made adjustments due to changing relative prices simpler, they have imposed competitive discipline on labor's wage demands and on owners' profits, and they have facilitated the increasing specialization that has accompanied growing international trade. Trade has expanded and the world's economies, both developed and developing, have become more interdependent.

Fortunately, in my view, the recent meeting of the International Monetary Fund and the Economic Summit in Tokyo have rejected proposals to move away from floating exchange rates. Moreover, there is some evidence that important U.S. industries with significant international markets such as aircraft, computer, pharmaceuticals, and fibers are already benefiting, both domestically and abroad, from the 15-month decline in the dollar's exchange rate. Such developments should relieve domestic political pressure for exchange rate reform.

Yet, whatever the patterns of international trade, we must remember that the floating exchange rate system simply generates prices that clear the international financial markets. Domestic policies, technical innovations, cartels, elections, wars, plagues and the other details of the world's situation have substantial impacts on exchange rates.

Floating exchange rates merely reflect international economic conditions in a somewhat predictable way; they neither create these conditions, nor do they make them worse. So, in other words, Don't shoot the piano player; he didn't write the music!