Clean and Dirty Floating

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

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CLEAN AND DIRTY FLOATING

by

Dr. Allan H. Meltzer

This article explains why mere intervention in foreign exchange markets by a central bank is no longer sufficient to cause an accusation of "dirty floating." The Economics and International Divisions of Pittsburgh National Bank thought it is of sufficient interest to bring to the attention of our readers. The author is Maurice Falk Professor of Economics and Social Sciences at Carnegie-Mellon University in Pittsburgh.

The recent revaluation of the German mark shows, once again, the advantages of the current system of floating exchange rates. On the day that the mark was revalued upward against the currencies of some of its neighbors, the dollar-mark relation was undisturbed. Currency markets had adjusted long before the event, in a gradual and orderly way, a marked contrast to the "crises" that periodically produced instability under the old fixed exchange rate system.

The current international system, known as floating or fluctuating exchange rates, has now been accepted by most nations as the principal means of solving international payments problems. The system began in crisis but after floating rates became the policy of the United States, in March 1973, no serious instability affected the dollar. During most of the past three years, the exchange rate of the dollar against an average of foreign currencies has
remained within two or three percentage points of the rate set by the market in 1973.

Compare the experience under the two systems. With fixed exchange rates, one exchange rate crisis followed another in the late 1960s. By the end of that decade, there was no longer much point in talking about fixed exchange rates. The choice was between two kinds of exchange rate fluctuations—large changes following a crisis or smaller, more frequent adjustments. Even the critics of fluctuating exchange rates became convinced that the benefits more than offset the costs.

Experience with fluctuating rates has been reassuring. The oil embargo and the failures of banks during the 1970s did not precipitate exchange crises. The financing of oil payments to the producers' cartel and all the related refinancing presented challenges to the market and to financial institutions. But where the market has been permitted to function, adjustments have been made and problems have proved manageable. Despite a world-wide recession, exchange controls have not become general. Instead, some controls on capital movements have been relaxed, and the problems of the pound, the franc, lira and the Mexican peso have not produced international crises.

The market has not functioned without interference; central banks buy and sell foreign exchange periodically. No one should be surprised to learn that the officials responsible for operations in the foreign exchange markets claim credit for many of the successes of the new system. They attribute the failures, both real and conjectural to the restrictions placed on their buying and selling.

The managers of foreign exchange trading for the United States are officials of the Federal Reserve Bank of New York. Like some of their colleagues abroad, particularly the French, they would like more authority to buy and sell foreign exchange. Some prefer the old system to the new. They assert that with authority to make larger and more frequent purchases or sales of currencies, short-term fluctuations and exchange rates would be smaller than they now are.

Are these central bankers right? Will exchange rates be more stable if there is more intervention? The answer to both questions is no, unless central bankers have more and better information than the market has. Sophisticated foreign exchange traders all over the world daily buy and sell in response to movements of prices, interest rates, output and anticipations of the future. These private traders support their beliefs by risking large sums. They were right about the mark, so there was a smooth adjustment of the dollar to the recent adjustment in the par value of the mark. They were right about the devaluation of the Mexican peso, but they were wrong about the timing last spring and the size of the devaluation when it came. They paid for that mistake.

Central bankers often mistake the effects of their own actions in ways that suggest incomplete understanding or even misunderstanding of the foreign exchange market. This is
particularly clear when there is discussion of intervention in the foreign exchange market, sometimes called "dirty floating."

The most common central bank operation in the United States is the purchase or sale of government securities, known as an open market operation. Our central bank, the Federal Reserve, engages in these operations in massive amounts, often buying and selling many times on the same day.

In the current system of fluctuating exchange rates, it makes very little difference whether the Federal Reserve creates dollars to buy foreign currencies or to buy U.S. government securities. Both operations temporarily lower interest rates in the United States, lower the amount of their own currency foreigners have to pay for dollars (the exchange rate) and increase the number of dollars in circulation. Sales of securities and foreign currencies by the Federal Reserve raise interest rates and the exchange rate and reduce the amount of money in circulation.

The reason the Federal Reserve operation in the government securities and foreign exchange markets have similar effects is that market participants look at both the interest rate and the exchange rate before deciding whether to invest in the United States or abroad.

Practically speaking, there is not much a government or central bank can do in the exchange market that it cannot do in the securities market. The fact that governments buy or sell foreign currencies in a given month or quarter tells very little about whether floating is managed or unmanaged, clean or dirty. In fact, deciding whether floating is clean or dirty is not an easy task.

The reason is that dirty floating is a way of describing policies to deliberately change the exchange rate so as to stimulate exports and reduce imports. The fact that a central bank buys or sells foreign currencies does not tell us that U.S. goods will be cheaper for foreigners. Buying foreign currencies, buying government securities, and lending to banks are all ways of increasing the amount of money. Unless we know how much money a central bank plans to create, we can't interpret the effect of foreign exchange operations on the foreign exchange rate. About the same foreign exchange rate could be achieved with purchases of domestic securities and no purchases of foreign currencies.

After the fact, we can observe that the government inflated or deflated more than its neighbors thereby causing the exchange rate to change. But, don't expect the government or the central bank to accept responsibility for inflation. They will blame speculators, unions, the Arab sheiks or almost anyone else for the inflation they caused. And it is inflation at a rate higher than the rate in other countries that is the main reason for a fall in the value of a currency. That is why German marks, Swiss francs and the dollar have risen in prices against the French franc, the British pound, the Italian lira, and the Mexican peso.

There is a way to monitor the exchange rate policies of major countries if the central bank announces the growth rate of money that it
expects to achieve. Traders then have valuable information about monetary policy. When money growth rates are disclosed, traders can estimate current and future exchange rates that are consistent with the economic policies, expected real growth and inflation in the various countries. The market will not always estimate correctly, but it will use the information efficiently. There will be no better prediction, on average, than the market's prediction.

Monitoring exchange rate policy is easier if a country achieves its announced growth rate of money. The exchange rate adjusts to the economic policies and their expected consequences. If money grows faster than the announced target and the exchange rate falls, it is right to conclude that the country effectively devalued. Also, if money growth is below target and the exchange rate rises, interference with the exchange rate can be claimed. Dirty floating is a legitimate charge in both of these cases. In all other cases, reasonable men will differ.

Stable exchange rates reflect stable policies—our own and everyone else's. In a world with frequent shifts in government policies in major countries, exchange rate fluctuations are not a matter of choice. The choice is between small frequent changes and large less frequent changes. Exporters will often cry "dirty" to the floating policies of other countries, but these charges are difficult to support if we do not know the monetary targets of the country or the extent to which the country inflates to get domestic advantages.

If there is a moral to this piece, it is this: floating exchange rates deny a country any long-term benefit from inflating. The same inflation that depreciates the currency raises domestic prices and the price of exports, and therefore gradually eliminates any short-term advantage that exporters gain from dirty floating.

PITTSBURGH NATIONAL BANK
P.O. Box 340777P
Pittsburgh, Pa. 15230

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