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Current International Monetary Arrangements

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Statement prepared for the Subcommittee on International Exchange and Payments of the Joint Economic Committee
Washington, June 21, 1973

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Allan H. Meltzer

The decision in February 1972 to let the dollar float more or less freely on the exchange markets must be regarded as a decision to accept the best available alternative. Those committed to some grand scheme for the reconstruction of the monetary system and those opposed to free markets have recognized, at least for the present, that the likely alternative to fluctuating exchange rates is the proliferation of controls on capital movements and increased controls on trade and payments. Since the principal benefit claimed for fixed exchange rates by its proponents is that fixed rates encourage trade, there is not much point to restricting trade to protect fixed exchange rates. Any argument to the contrary would seem to confuse means with ends.

Much more can be said on behalf of current arrangements. Trade continues to expand. At a relatively small increase in the cost of hedging against fluctuations in exchange rates we have gained an important benefit -- the improved opportunity to stabilize the economy at the current rate of inflation. Foreigners have gained as much, and some appear intent on taking this opportunity to reduce their rates of inflation. In some countries, deflationary policies are now in operation.
As long as countries pursue, or desire to pursue policies that produce, or are expected to produce, substantially different rates of inflation, there can be no choice between fixed and floating rates. The relevant choice is between more orderly or less orderly adjustment of the exchange markets. Some useful indication of the difference in the way adjustments are made under the two systems can be gained by comparing the crisis atmosphere that accompanied or followed the British decision to float last summer and the 10% devaluation of the dollar in February 1972 with the more orderly adjustment last month when the dollar declined by 7%.

Some Current Problems

To say that the current system is the best currently available alternative should not suggest the absence of problems. Three problems concern me.

The first and probably the most important is that exchange controls and restrictions have not been removed but have been increased. The attempt to maintain the fixed exchange rate system with the dollar overvalued and the mark and the yen undervalued led countries to place restrictions on capital movements. Trade and capital restrictions should be removed.

Second, the opportunity for crises has not entirely passed. Some countries in the E.E.C. maintain fixed exchange rates under a complex arrangement known as the common float with the "snake in the tunnel". We have reason to expect that the rates of inflation of the countries in this group will differ. If the common float gives way easily to independent floats or adjustment of exchange rates, little harm will be done. However, if countries
attempt to maintain exchange rates by restricting capital movements and
trade, the world will lose. Past history suggests that the governments
of some countries prefer restrictions to adjustments of exchange rates,
so the danger of restrictions remains.

A third and related problem is that several countries are not only unwilling
to float but unwilling to have the dollar float. If they confine their action
to accumulating dollars, they give us goods or services at bargain prices,
and it is two our advantage to accept their gift. However, there are frequent
demands that we intervene to maintain the exchange rate, or in the language
of the central bankers, "defend" the currency. Giving in to these demands
is a step back toward the fixed rate system with its repeated crises.

Those who believe that formulas can be devised under which we buy and
sell currencies but on balance neither accumulate nor decumulate seem to
me to miss the point to be gained from recent experience. Any formula for
intervention that requires the central bank or the Treasury to defend
a particular rate or rate of change improves opportunities for speculators.
A fixed exchange rate is a special case of a rate that changes by less than
market participants and currency speculators believe to be warranted. Attempts
to maintain a rate or slow the rate of change reduce the risk to speculators
and, therefore, increase speculation. In February, the Swiss floated the
franc, and avoided the large inflows of dollars. The Germans "defended" the
mark by absorbing many additional billions and increased the speculators' gains.

For years, practical men have told us that fixed exchange rate discourage,
and floating rates encourage, speculation. Recent history suggests that the
opposite is more nearly correct.

Float Clean

Those who favor guidelines for intervention argue that speculators are not always correct and often do not take a long enough view of the value of a floating currency. The central bank may hold a different view and wish to prevent appreciation or depreciation that is regarded as excessive. The opposite is also true. Central bankers are no more clairvoyant than speculators. The difference between them is more likely to turn on a different point. The speculators generally bear the cost of their own errors. The central bankers do not. The grand gesture which required the head of the central bank to resign with the announcement of devaluation has gone the way of other grand gestures. And, fortunately so. If, as I believe, the likely current alternatives to devaluation and floating are either restrictions on trade or deflation, we do not want to encourage central bankers to choose either of these latter alternatives when a choice must be made.

This Committee has taken a leading role in the effort to prevent the central bank or treasury from intervening to prevent or postpone exchange rate adjustments demanded by the market. However, the statements by Under Secretary Volcker and Chairman Burns on this subject are too vague, in my judgement, to constitute a commitment. I believe the Congress should fix more definite limits and at a minimum should limit the permitted volume of swap agreements with any country and the aggregate volume of swap arrangements outstanding.
The present system of permitting interventions in the foreign exchange market wastes resources. One reason is that the Federal Reserve operates on the money market in substantial volume. Its operations there affect the covered spread between rates in New York and rates in other countries and, thereby, bring foreign as well as domestic lenders or borrowers into or out of the money market. No supplementary operations are required, a point Bagehot understood 100 years ago.

The existence of two centers of operations opens the prospect that one will buy as the other sells. This is not likely to occur in a direct exchange but it is no less a waste of resources if it occurs via third parties.

Let me urge the Committee to consider the bolder step of eliminating any operations in the foreign exchange market. I urge this course not only as a means of avoiding well documented tendency of central bankers to over regulate any market in which they operate but because the authority is redundant in a floating rate system.

Most importantly, a principal advantage of a floating exchange rates is that the central bank is free to pursue domestic objectives, full use of resources and price stability or a steady rate of inflation. Floating rates increase a central bank's ability to control the growth rate of the money stock. There is no advantage -- but considerable disadvantage -- in having two separate control centers, one buying or selling domestic securities and one buying or selling foreign exchange. Both centers have their principal effects by changing the monetary base and the money stock. One center should be eliminated.
In my opinion, the U.S. should float without intervention in the foreign exchange market. The Federal Reserve should confine its principal activities to stabilizing the growth rate of the money stock, currency and demand deposits. The current rate of growth should be no greater than 6% per year.

Longer-Term Arrangements

Although I regard floating exchange rates as the best currently available alternative for the U.S. and the world, I believe there is a better alternative for the future. The better alternative is the development of a uniform currency, to be used as an international money. Further, I believe, the best money for this role, is a stable U.S. dollar.

There are three main advantages of a single currency system. One is that trade expands as the costs of hedging against fluctuating exchange rates falls. A second is the elimination of costs of exchange and conversion, including in these costs the real resources required to maintain the exchange system. The third is that exchange controls and restrictions on trade and investment becomes more difficult to enforce. The last is of growing importance.

A single medium of exchange reduces costs of acquiring information, hedging and exchanging. Resources previously used for speculation, currency exchange and hedging are released to more productive uses. The saving of resources is a real gain both to individuals and firms and to society. The labor of skilled traders operating on the Euro-currency markets are part of
Similar savings are not available in a system of fixed exchange rates if there is more than one currency. The reason is that there are costs of conversion and exchange and costs of obtaining information about future exchange rates and exchange opportunities. Resources used for speculation and exchange receive positive net returns, so individuals are induced to allocate time and effort to these activities. A dual currency system, for example a European currency and the dollar, does not eliminate costs of exchange or costs of acquiring information about price levels and anticipated rates of inflation in the two areas. As long as rates of inflation differ, or are anticipated to differ in the two areas, resources will be allocated to exchange operations.

The gains from using a single currency are largest if the currency is well-known and familiar and can be produced at relatively low cost. The two assets that are best known as money and have been widely used as money are gold and dollars. The costs of production for the two are very different. Society gains much more if the dollar is used as the international medium of exchange because cost of production is much lower for dollars than for gold.

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The use of the dollar as an international money cannot be legislated. The choice depends on the willingness of transactors to use the dollar and to hold dollars and, therefore, on the relative stability of dollar prices and non-dollar prices. Policies that increase relative stability encourage the use of the dollar as an international money. A policy of maintaining relatively stable growth of the money stock benefits the U.S. and the world economy. Transactors continue to hold dollars and to use dollars.

During the postwar years we have observed the rapid growth of the Euro-dollar market and the increased use of the dollar as the medium of exchange in international trade. Tourists have found that checks drawn on U.S. banks are accepted in foreign countries. In many parts of Canada, the U.S. dollar is known and accepted in exchange by merchants and shopkeepers. Despite the variability of the exchange rate and the U.S. price level in recent years, the dollar has continued to be the principal money used for international transactions.

Once again, the reason is that costs of learning about a new currency and its properties as a medium of exchange are large. Transactors have shown themselves willing to pay the increased costs resulting from the instability of the dollar rather than incur the costs of shifting to an alternative money. If we can avoid trade restrictions and restore stability to the domestic price level, I believe the role of the dollar will increase. The increased role will result from the decisions of private transactors seeking to reduce costs, not from the actions of central bankers or international agencies or their decision to restore fixed exchange rates.
The Federal Reserve and the Treasury can do most to promote a stable international monetary system and the expansion of world trade by increasing the stability of the U.S. economy. More important than meetings, discussions, plans or proposals is the obligation of the Federal Reserve to restore stability without controls on trade, prices, wages, dividends or capital movements.

The actions of the past week are additional steps away from economic freedom and efficiency toward the inefficiencies of planning. No clearer example could be devised of the way in which one set of controls requires another and still another when regulators set out to find that non-existent grail, the set of controls that works better than the market in determining prices and outputs.