Improving the Exchange Rate System

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With magisterial simplicity the heads of state agreed at Rambouillet to work for greater stability in monetary affairs. Proposals for achieving stability were to be worked out by finance ministers and central bankers. Next week at Jamaica the ministers meet to discuss their plans.

Rambouillet is significant. We are no longer in an era of grand designs, like the sixties, when a series of impressive but misconceived plans for restructuring the monetary system circulated more rapidly than the finance ministers who were supposed to discuss them. Some modest steps to increase the stability of international financial markets is the most that can be expected from a new agreement.

One reason is that the present system of international exchange works well. But it can be improved or worsened by a new agreement. I propose some changes to make the system better.

Fixed and Fluctuating Exchange Rates

The postwar system of fixed exchange rates ended in 1971. After several attempts to restore the fixed rate system failed, the effort was abandoned in 1973. Governments no longer promise to exchange their money at fixed prices for other money, so there is no longer a guaranteed price at which one currency can be exchanged for another.

Currently, exchange rates are determined in markets, not at international meetings. Dollars like any other good are worth more when they
are demanded by traders and travellers, and they are worth less when there is less demand.

The system in which markets determine exchange rates is known as the fluctuating exchange rate system. Changes in the demand for dollars, or other major currencies, cause the price or exchange rate to fluctuate. When the demand for dollars increases, purchasers of dollars pay more foreign currency to buy a dollar, American tourists and traders get more foreign currency per dollar. The dollar is strong. When the dollar is weak, foreigners use less of their money to buy a dollar.

The relative merits of fixed and fluctuating exchange rates have been discussed for years. A main conclusion is that countries that choose to maintain fixed exchange rates must limit the use of monetary and fiscal policies to increase employment. If governments are unwilling to increase unemployment, at times, so as to maintain fixed exchange rates, they must be willing to let exchange rates change.

The experience of the last thirty years tell us much of what we need to know about the choices that were made. In this area, as in too many others, there is an enormous gap between the governments' promise and performance. Repeatedly, high officials talked about "defending" the value of their currencies. They never succeeded for long.

One exchange rate crisis followed another in the late 1960's. By the end of the 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 of fluctuating exchange rates more than offset the costs.
The Current Debate

Two years of experience with fluctuating rates has shifted the burden of proof from proponents to opponents. The oil embargo and the failures of the Herstatt and Franklin National banks did not precipitate exchange crises. The financing of oil payments to the producers' cartel and all the related refinancing continue to present 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. A severe worldwide recession has not been an excuse for new exchange controls. Instead, some controls on capital movements have been reduced. It is regrettable that the same cannot be said about tariffs and import restrictions, but at least there is no sign of a cumulative movement toward protection.

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 present system and attribute the failures, both real and conjectural, to the restrictions placed on intervention.

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. They claim that with authority to make larger and more frequent purchases or sales of currencies, they can reduce short-term fluctuations in exchange rates. The Rambouillet agreement appears to grant the basic point by promising operations to smooth fluctuations in exchange rates.
Are the central bankers right? Will exchange rates be more stable if there is more intervention?

The answer to both questions is no unless the central bankers have more and better information than the market. Sophisticated foreign exchange traders all over the world daily buy and sell in response to movements of prices, interest rates, and output and their anticipations of the future. The private traders support their beliefs by risking large sums.

More importantly, central bankers often misstate 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.

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 volume 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 exchange or to buy government securities. Both operations temporarily lower interest rates in the United States, lower the amount of their own currency foreigners pay for U.S. dollars (the exchange rate) and increase the number of dollars in circulation. Sales of foreign exchange and securities by the Federal Reserve raise interest rates and the exchange rate and reduce the amount of money in circulation.

The reason that Federal Reserve operations 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. A sizeable group of investors throughout the world watches the difference between foreign and U.S. interest rates after adjustment for exchange rates. When the Federal Reserve temporarily lowers interest rates in the United States by buying securities, investors move funds abroad. They sell dollars, lowering the exchange rate and buy foreign securities. When the Federal Reserve sells foreign exchange to lower the exchange rate, it becomes profitable for traders to sell foreign securities, buy dollars and use the dollars to purchase U.S. securities. These operations occur quickly, at times within minutes of the Federal Reserve's action. They are as riskless as any transaction can be, and they eliminate any important difference between Federal Reserve operations in the securities and foreign exchange markets.

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 exchange in a given month or quarter tells very little about whether floating is managed or unmanaged.

An agreement at Jamaica to permit purchases or sales to offset currency speculation but to permit non-speculative changes in currency values cannot be monitored. All leading countries have the power to change their exchange rates before Jamaica, and they will have those powers after Jamaica.
A Proposed Improvement

There is a way to monitor the exchange rate policies of major countries. The proposed change is easy to implement and has the desirable side effect of reducing uncertainty about the future.

Each country should announce the growth rate of money that it expects to achieve during the next six or twelve month period. Traders would then have valuable information that is not available currently and often is unknown by the central bank governors and finance ministers. Whenever planned money growth changes, the change should be announced. Announcing planned growth rates of money reduces uncertainty.

When money growth rates are announced, the market will estimate current and future exchange rates consistent with the economic policies, expected real growth and inflation in the various countries. The market will not always estimate correctly - because no one can expect to predict the future correctly. But, the market will use the information efficiently. There will be no better prediction, on average, than the market's prediction.

Monitoring exchange rate policy is made easier. If each country achieves its announced growth rate of money, the exchange rate adjusts to the economic policies and their expected future consequences. Purchases and sales of foreign exchange are one means of achieving the announced growth rate of money. Essentially the same exchange rate would have been achieved by buying or selling securities.

Countries that exceed their announced monetary targets depress their exchange rates. The reduction in exchange rates, for a time, encourages exports and reduces imports from the rest of the world. Countries that
produce less than the announced growth rate of money raise their exchange rates and for a time increase imports and reduce exports.

Three countries, the United States, West Germany and Switzerland, have announced their monetary policy objectives. If the other leading countries join them, the market will have more information. Mistakes will be fewer and smaller. The market will fluctuate less. Central bankers like the rest of us, will know more about policies in other countries and even in their own.