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Exchange Rates: Government, Moral, or Market Order

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I

Discussions of international asset exchanges and capital flows occur in a real world of institutional, political and hence moral settings. International trade and exchange rates are for the people affected quite specific, particular constraints. And the result of the constraints are, in effect, different for different actors. This particularistic view is not usually stressed in policy discussions.

A good example is found in a recent issue of Challenge (Jan.-Feb. 1986), an influential American liberal journal of economic opinion. Robert Triffin and Lewis E. Lehrman engaged in a kind of debate on the issue of exchange rates. We say "a kind of debate" because in the articles, Triffin and Lehrman presented their arguments without reference to each other. In reading the two pieces, we were not surprised to see Triffin and Lehrman repeat generalized positions which represent currently held views of other protagonists.

Triffin, one of the imposing figures of international economic analysis, repeated his previous calls for government intervention and collusion, or in short government order. Lehrman, better known as a conservative politician, attempted to place the contentious issues in a setting of almost moral order.[1]

Yet the particularistic nature of the effectiveness of policy and program, we feel, is an essential ingredient of policy for it is undertaken to influence the course of events, a global concept, by influencing individual actors. Both writers, we feel, tend to treat policy as somehow directly affecting classes of economic actors rather than individually situated actors whose reactions to policy create the class reaction. The significance of the particulars of time and place are generally played down in economic analysis and prognosis.

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[1] R. Triffin, "World Money Reform," and "Back to Gold", an interview with L.E. Lehrman, *Challenge*, Jan./Feb. 1986.

Our comments largely flow from what may be considered an eye level rather than overhead, general view of the problems, which admittedly are, and should be, stated in their generalities. We are concerned that the Triffin and Lehrman debate like most discussions are abstracted from real world concerns.

In recent months, academics, government officials, and corporate officers have increased the color of their rhetoric on the costs and benefits of the current exchange rate system. Those decrying the present system of floating exchange rates (really managed rates) have called acceptance of today's system a "bizarre" phenomenon. For them today's system is a "scandal" and a "debacle."[2] The *prima facie* case against the current system is the obvious "overvaluation" of the dollar, in spite of the sharp decline of the recent past.

In most of the current discussion overvaluation leads to increasing U.S. deficits on current accounts, actual and threatened bankruptcies and consequent unemployment, of firms exposed to foreign competition (e.g. in the oil industries) and the sponging of savings from poorer and less developed nations to feed the U.S. current account deficit. Furthermore, the dollar's decline and its related reduction of U.S. interest rates may shortly reduce the flow of savings from Europe and thereby exacerbate American investment shortages. Opponents of the current system also contend that the present exchange rate system produces an uncertainty which reduces trade and/or increases costs. Some supporters of free and open economic systems have been maintained that free trade without stable exchange rates is sheer fantasy.[3]

The various suggested roads to financial sanity differ. To some a return to the gold standard is the way. It may even rekindle a hope of the 1840s that no paper money be permitted at all, or of 100% reserve argument of the 1930s. Some maintain that we must "rule out" the official reserve-currency status of the dollar.[4] Reserve currencies supposedly eliminate discipline (putting a burden on nonreserve currencies) and foreign countries are "required" to buy up extra-dollars. A gold price set above the marginal cost of production will produce a step up output of a monetary base. Others, such as Triffen, simply call for a greater effort of trading nations to align domestic and international policies to keep stable the value of currencies, (e.g. a European monetary snake (EMS)). The proponents of a floating exchange rate, market based, system are forced to battle the moral order imposed by an ideal, sacrosanct metal, or that of a government order directed by an

[2] For examples of such rhetoric see Triffen (1986) and Lehrman (1986). Lehrman calls the present managed floating rate system "order of the jungle," p. 23. Triffin calls support of floating rates a "bizzare conclusion" (p. 5) and the present international monetary system "a scandal" (p. 14). Triffen furthermore warns of a debacle (p. 14) unless policies are changed.

[3] Lehrman (1986) calls for fixed exchange rates as a precondition for free trade.

[4] Lehrman (1986) maintains that the U.S. official reserve currency is not "fair" to all other participating countries (p. 27).

interventionist, sovereign government pursuing its ideal of the public good, by recommending a market imposed ordered.

Proponents of freely floating rates (FFR) often succumb to the same rhetoric battles as their opponents. They point out that the pros and cons of FFR have been often discussed.[5] Proponents of floating exchange rates point out that the economics of fixed exchange rates (based on dollars or gold) is well known. In a world of full employment and purchase power parity, an expansion of dollars for instance, would increase prices in the U.S., resulting, at present exchange rates, in lower relative foreign prices. Then dollars would flow abroad. The ebb and flow of dollars, and the flow and ebb of foreign currencies would finally bring us back into equilibrium. If, however, a foreign government holds on to these dollars (because U.S. dollars are a reserve currency), prices would increase in the foreign country. In this case the U.S. is, in a sense, a generator of world inflation.

Of course, a country could choose to change its reserves internally and sterilize the foreign influx of dollars. Then U.S. prices would not adjust downward nor foreign prices upward. This however is not seen as a long term solution.[6] Despite this obvious available policy gambit, a number of economists, Lehrman (1986) being a prominent spokesman, favor a return to the gold system. This would place a moral requirement on the government *not* to sterilize gold flows if the equilibrating mechanism is not to be stymied for all the trading partners. The failure of a gold system is not a failure of the gold standard but of government (and governance) and fixed exchange rates. The imperfections of a gold system led to the present FFR system. Return to a gold standard would remove us from the order of the jungle and return us to a higher moral order.

Proponents of floating exchange rates reflect that the present system does enforce a moral order in that it enforces a market order with its built in morality. With effective flexible exchange rates the relative values of foreign exchange are a function of expected supply and demand. Central banks are led by market forces to accept the reaction to their earlier monetary decisions. Thus, a *market* order is enforced on those unwilling to accept the moral implied in a simple gold exchange or gold reserve system order. The rules of markets, on the whole are probably better understood and complied with than moral constraints on country behavior.

Normally central banks try to manage rates. If they did not, these officials maintain, prices would be volatile and their unpredictability would hinder trade and hence *inter*

[5] For an example of previous discussions on FFR see Batten and OTT (1983).

[6] For a discussion of sterilization of foreign exchange flow see Levi (1983) p. 96. For a discussion of the role of the U.S. dollar see "The U.S. Dollar-Recent Developments, Outlook, and Policy Options." A symposium sponsored by the Federal Reserve Bank of Kansas City," (Jackson Hole, Wyoming, August 21–23, 1985).

sese currency adjustments. In short, FFR causes governments to replace an unknowable or at least unpredictable moral order by a market order. When governments, however, fail to order international markets, the blame is placed on the external villain, the unmoral market.

II

It is the present authors' opinion that a removal of the battle from the world of rhetoric (eg. bizarre, scandal, order of the jungle. . .) would benefit both camps and clarify the issues. A brief review of the principal verbal weapons and the moral order backing those implied biases is in order.

(1) Policy prescriptions must accept the realities of power and personal benefit that tend to establish relative economic positions. If not then when an American official lies it at least should be a Washington lie; that is, I know I am lying, and I know that you know that I know that I am lying. Officials of other nations have the same right. Then the pain or benefits of exchange rate policy could be properly judged; some gain and some lose while we as a government support what benefits the nation most.

(2) Overvaluation (strong dollar) is the opposite of undervaluation (weak dollar). This is a popular conception. The policy manipulations of strength or weakness, require a degree of sophistication and analytic insight. It does not follow that because the U.S. is or wants to be a politically powerful country it would or should want an overvalued dollar. In general a strong dollar does reduce the cost of imports. However a strong dollar, as an overconfident man, contains its own seeds of destruction. A strong dollar, if one is overconfident, can result in a country losing its "competitive" edge and becoming an economically "weak" country.

It is the responsibility of the national banking institution to manage the situation so that the nation retains or attains economic strength and prosperity without harming other nations in the process. The reasons for this caveat are political and economic as well as moral. This is not the time to reargue the question of whether we all live in one world. We do or we ought to. But international policies and solutions do *not* have similar results on various countries or on the several interest groups of the various countries. Degrees of benefit and disbenefit at home and abroad test the goodness of policy.

(3) Since degrees of benefit differ between countries as well as within countries we lack an operational definition of an overvalued or undervalued currency and against which currencies the dollar is over (under) valued. In a complex trading system, the impact of overvaluation and undervaluation of a currency must not be determined at the country

level. Even if the currency is somehow overvalued, some producers and some consumers gain above (below) the average rate (producers and consumers surplus). Even when the currency is in equilibrium, sectors of the nation will regard the currency as over or undervalued. Their bias will depend on the price of a company's imports/exports relative to the related average price of major foreign competition. In short not only is overvalued/undervalued a difficult concept to measure, it is a relative concept; relative to the country and firm of comparison.

Admittedly this point of view places a burden on the developing countries. For developing countries one factor in their lack of development is their dependence on the goodwill of the major powers. Exchange rates and exchange policies of the developed lands has a great bearing on the future of developing countries. Resources are not enough to assure growth.

(4) The above is not to assert that a currency should or should not be supported by government market intervention to create a particular position. Government decision will however be based on its own personal assessment of the political realities. Any currency level hurts/helps various sections of the economy. Government officials must realize, however, that their ability to create exchange rate levels desirous of particular section of the economy is severely limited. The supply and demand for currencies is so large that no Central Bank, not even of the U.S. would be able to act as an arbitrary intervenor. A large country can intervene, using its own resources, and by the persuasion of other traders and Central Banks. Temporarily it is possible to strengthen one position and weaken another. Governments, however, do not exist in an economic vacuum. Without appropriate macro economic policies designed to support and sustain the desired levels, economic fundamentals will do the best central bank desires.[7]

The difficulty of "coordinating" the economic policies of major states is apparent in the lack of agreement and lack of success in current international money policy. Neither currency support policies nor expansion policies, on the international level have been particularly successful, nor perhaps even widely accepted. The Monetary Fund (IMF) has not been able to exercise great leadership nor have the vagaries of the dollar vis-á-vis European and Asian currencies been Controlled.[8]

(5) Proponents of an undervalued (overvalued) scenario point to the resulting ownership by foreigners of U.S. assets as an example of the needed change in rates to reduce

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[7] G. Canarella, "Econometric Testing of Efficiency Hypothesis in Far Exchange Markets." *International Journal of Business & Economics*, Vol. 32, (1985), No. 10–11, pp. 1031–1046.

[8] See for example the New York Times, Business section, Sept. 23, 1986—K.A. Gilpin, "Dollar up 2% Against the Mark," (D1) and "IMF Parley to Test Baker's Coordination Policy," P.T. Kilborn. Self interest differences provide major hurdles to friendly governments.

American reliance on foreign capital. Of course no criticisms or concerns are directed at U.S. citizens' ownership of foreign investment. In fact, Americans and criticized Servan-Schrieber's *American Challenge* as French xenophobia. Now Americans criticize foreigners holding U.S. assets (real and financial).

No mention of course is made of the possible beneficial effects of open capital flows on economic development. If a foreign firm or poor nation receives superior return on capital, how does that affect domestic consumption? How does the foreign firm which obtains foreign capital purchase goods? In short, there is no evidence that America's soaking up foreign funds damages *total* production. The difference between U.S. assets being owned by foreigners and the reliance or need for savings generated abroad, is not usually made. That a fraction of U.S. railroads and parts of U.S. industry were historically financed by foreigners surely helped American development. Furthermore, if cross national economic reliance might tend to reduce international political tensions, then *vive* international investment.

Moreover, to the degree that foreign capital comes to the U.S. there is no necessary future day of reckoning. The U.S. has spent considerable effort creating a well functioning financial system. The liquidity and safety offered by U.S. financial markets encourages investment in the U.S. The financial funds flow should be regarded as much an export of services as a real capital sale. A forced undervaluation of U.S. dollar would merely place unacceptable constraints on "free" flow of capital.

Thus again we see that the rhetoric hides the reality. There is imply no way to measure the possible negative effects of soaking up foreign savings on assets just as there is no way to measure a forced (over or under) valuation on real assets or economic growth. One cannot reify exchange rates as a price for a conceptually homogeneized bundle of utilities to be bought or sold. Purchases and sales are of particular products, at particular relative prices.

III

To some, response to the problems of intricate and complex economic order seem simple enough.

(1) We simply return to a gold system with prices set at a level just above production costs. Whose production costs? South African production of gold has had no connection with gold pricing since their costs of production through forced labor is not demand related.[9] Moreover, the political realities would prevent a system

[9] This point was made by industry specialists at a recent Chicago Board of Trade Industry Seminar, December 1985 (forthcoming in *Review of Research in Futures Markets*, CBT).

which offers unusual returns to a country with forced conscription. Moreover attempts, by world alone, to replace dollars as a reserve currency by gold or SDR cannot be effective. The market will always create its own reserve.[10]

(2) Likewise the *EMS* (managed float) runs against similar political constraints. The truth is that most nations want an over (under) valued currency depending on political realities. They desire a managed float to create, those realities in the short run. In the long run, market realities will generally enforce a rate which meets equilibrium standards. When faced with the realities of international market determinations which are contrary to their desired political realities, governments call into question the market's evaluation of their sins.

(3) The fact may be that the ability of nations to agree on common concerns, including monetary/economic policy, is now at a stage that a managed rate system may create an easier business environment for some who need help. However, the FFR market had done very well meeting the surprises of the past 15 years. One wonders how well a gold system would react to riots in South Africa. One wonders how well a fixed or managed float will react to abrupt changes in the value of oil. One must wonder how five finance ministers can come to an agreement on the proper relative value of currencies, and if the decisions of a free market place would have been more costly and upsetting. If the G5 decision differs from the market, one wonders how they can keep market prices from forming against the prescribed values.

IV

Criticism of any system is easy, especially if one uses the rhetoric of economics. But fancy rhetoric cannot long replace fact. The fact is that the present system, for all its faults, has responded tolerably well to emergencies. It has even created economic forms to deal with obvious flaws (eg. future contracts, foreign currency swaps, etc.). One wonders if any government with all its opposing forces could have acted as quickly or as easily.

One also has the feeling that some governmental officials and economists habitually call for government regulation. The calls reinforce the need for their existence. Who needs managers and consultants if there is nothing to manage and consult about?

Markets respond to economic conditions. That is their nature. The responses may be too abrupt and too costly or too slow and costly. The question is whether a market

[10] For further criticism of the gold standard see R. Triffin, "The Myths and Realities of the So-Called Gold Standard" in *Evolution of the International Monetary System*, Princeton University, 1964.

can be so structured that its responses will not be onerous to its actors. In the present case managed free floating exchanges are on the agenda. But as we have shown there is no assurance that the benefits of a managed system or a gold based system are likely to be significant or equal for *all* participants. Another way is to keep the FFR while permitting *ad hoc* intervention. While this has its weaknesses, and it also has its strengths. One strength of an FFR with interventions is that it permits political and economic power, which exists, to be restrained by the very visibility of the interventions. Before we throw away the present FFR, we must be reminded that managed rates or a gold based exchange rate are not obvious solutions. If they were, economic evangelists would not have to use economic rhetoric to exhort a government order or moral order to accord with some prescribed higher values. The grist of the market mill, shorthanded into supply and demand, and the mechanism of the market, the trading process, do not necessarily respond to policy statements and other fulminations or exhortations of Central Bankers. The Central Bank must take steps to put its policy, fulminations and exhortations into play. This is done not only by using available resources so as to gain the ends sought, but supplementary actions by understandings and pressures on private as well as other public traders assist in the process. The process includes fiscal and budgetary action which take time to put into place, as well as more direct policy controls e.g. quota arrangements and monetary policies. The powers of persuasion are not limited only by the political, economic and social powers which private and public operators know or fear that the active Central Bank has at its disposal. The financial, social, political and economic world is of a piece-not seamless but also separate. Persuasion may be seen as sewing into the seamed parts of the complex which are or might be separate.

Our argument does not presuppose that the efficiency of market behavior hypothesis is null and void. On the contrary, it assumes that while actors may strive for efficiency, the brute facts of political and social reality, as well as lack of information and knowledge of what actions would be efficient, lead to structured results which do not meet the efficiency standards of any given actor.[11] In short we may not have the desired exchange rate, but only the market justified rate.

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[11] See S. Islam, *Fed. Res. Bank of N.Y.*, Winter 1983-4, Vol. 8, #4, "Currency Misalignments—The Case of the Dollar and the Yen," p. 49ff.

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