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Fixed-Exchange Foolishness

By Leo Melamed

During 1985 the power of the free market proved as seldom before its unequaled strength in determining fair value. Alas, it was also during that year that man, his eyes shut to the clear evidence, futilely schemed once again to overcome the honest evaluations of supply and demand.

On the one hand, OPEC, the once all-powerful oil cartel, abandoned its system of artificial price edicts in the face of unrelenting market truths, and the London Metals Exchange fought to survive the massive collapse of tin prices resulting from the artificial price structure created by the International Tin Council. On the other hand, the U.S. Treasury, along with several other ministries of finance—the so-called "Group of Five"—picked up the torch on behalf of artificial price rule by committee.

This time it will be different, they try to assure us, because the universal laws of supply and demand are different for foreign exchange than for oil or tin. Meanwhile, some of our most principled free-market advocates look the other way, mumbling something about the occasional virtues of pragmatism over idealism.

Nonsense! I submit that the fundamental truths governing the value of money are no different than those for all commodities. The market forces that ultimately overpowered a man-made method to artificially ordain the value of oil will be the same market forces that will undo the manipulations of the G-5 or any other artificial system attempting to dictate the relative value of the dollar. I submit further that a fixed rate or targeted range for currency in international capital markets will last in today's world only so long as market forces agree with it.

Truth and Pain

The G-5's Sept. 22, 1985, quick fix seemed successful simply because the market agreed with the result. The dollar had already endured the blowoff stage of its four-year-long bull market. By early September it had already fallen 23% against the deutsche mark, 33% against the pound and 10% against the yen. The Group of Five struck during the final stages of consolidation after this initial downswing. Its timing was excellent. With prospects for lower U.S. interest rates in sight, the dollar responded to the added pressure of the moment. Had the ministers not acted, I dare say free-market forces would have achieved a similar result soon enough.

The danger of believing otherwise is the same as with believing in any false messiah: The truth will be painful. Faith in the new intervention god will cause many to demand its use with increasing frequency, but its effects will diminish with each application. Market volatility and uncertainty will increase as intervention rumors and denials filter through the system. Eventually, the stark truth will reveal itself when the market completely refuses to abide by our desired price targets or when the respective ministers no longer agree on relative values.

Because of the mistaken perception the G-5 was somehow responsible for the yen's move against the dollar, pressure is mounting from Japan to take countersteps.

Much of this dire prediction is already unfolding. Long overdue market forces and a changed U.S. interest-rate environment have forced rapid realignment of currency values; this was especially dramatic relative to the Japanese yen. The consequences necessarily affect every economic sector as well as every financial market and not always to everyone's liking. Recent changes in the yen's value have made our Japanese friends nervous and unhappy. They may also have a detrimental impact on our long-term bond rates. Unfortunately, because of the mistaken perception that the G-5 was somehow responsible for these results, and because statements attributed to government officials exacerbate price movements, the pressure is mounting, particularly from Japan, to take concerted countermeasures. If the G-5 is foolish enough to make the attempt, it will serve only to perpetuate the false belief and take us further down the road to chaos. Seldom, if ever, have policy makers been able to outsmart for any extended period the collective judgment of buyers and sellers. The current volatile market environment, a consequence of U.S. and world financial conditions, cannot for long be arbitrarily directed by government officials. For better or worse, we will have to live with the realities.

Unfortunately, intervention, as with every intoxicating elixir, has a certain mass appeal. After the G-5 meeting it became fashionable to call for a return to the Bretton Woods fixed-rate system. Leading this call for the U.S. were two able and well-intentioned men, Sen. Bill Bradley (D., N.J.) and Rep. Jack Kemp (R., N.Y.). While each approached the issue from a different economic philosophy, they both proclaimed that the high dollar value was evidence of a failure of flexible exchange rates. Thus, they called for a new international "Bretton Woods" conference in order to reestablish rigidity in foreign exchange.

I submit that the world of 1985 in no way resembles the world of 1944, when the war had ravaged every aspect of international commerce and trade. The U.S. financial system and its dollar were the sole survivors of the free world's economic fabric. It is therefore sheer folly to believe the agreements achieved at Bretton Woods—at a time when the U.S. could virtually dictate any resolve—can be duplicated today even if such an effort were economically desirable, which it is not.

I do not for a moment question that Messrs. Bradley and Kemp have the best intentions in calling for a return to a more fixed monetary order. They are both dedicated to global prosperity, modification of a tax code that penalizes savings and investment, reduction of the budget and trade deficits, and to the removal of trade barriers world-wide. Unfortunately, they are misguided in believing that those worthy goals can be advanced by revisiting Bretton Woods.

If we examine our experience since the abandonment of fixed rates we find that free-market forces did indeed thereafter correctly reflect economic realities. Our dollar's value dropped sharply in 1973 to 1980 when the U.S. experienced high inflation and weakened economic conditions. It rose beginning in 1981 when our policies dramatically changed under the leadership of the Federal Reserve. Certainly, this record does not bespeak of failure on the part of flexible exchange rates.

Messrs. Bradley, Kemp and others who echo their sentiments are fueled by the issue of our current massive trade deficit. They argue that the main culprit of the imbalance is the dollar's high price, which makes it cheaper to import than to export and thus causes a multitude of our economic woes. While that is obviously true, it is not the complete picture. The dollar's price is not a cause but, rather, a symptom of the problem. It is axiomatic that price is a reflection of a fundamental value in the market. To argue, as they do, that the high dollar hurts our economy does not explain how or why the price got there nor does it prove that the flexible exchange-rate system has failed. Rather, the opposite is true.

Funding the Deficit

Our extraordinary federal budget deficit could only be funded in one of three ways: restricting investment, increasing savings or exporting our debt. We rejected the first alternative, were insufficient in the second and thus relied heavily on the third. Accordingly, rather than being the cause of our trade deficit, the strong dollar resulted from the fact it was the main equilibrating factor that enabled trade exports and imports to make the adjustment necessary to satisfy our extra-large debt appetite. It is therefore imperative that we understand and correctly evaluate the actual role of floating exchange rates in the present situation, to wit: Given the need for foreign capital and the inevitable trade deficit it entails, permitting the price mechanism of floating exchange rates to determine how that trade deficit is to be achieved is the most equitable, and certainly the most efficient, means of getting a very difficult job done.

Surely, such an appraisal is not meant to deny that there are substantial economic costs as a result of the high dollar. We must not, however, allow such consequences to panic us into unsound or unwarranted actions. Floating exchange rates, while far from perfect, are the best system to sort out the complexities that make up relative value of currency. As E. Gerald Corrigan, president of the New York Fed, said last fall in a speech before the Japan Society: ". . . the widespread sense of frustration with the current system of floating exchange rates is understandable and we certainly should be sensitive to opportunities to strengthen the system, but to think that a return to fixed exchange rates or to something like a gold or commodity standard is going to provide magical and painless solutions to our problems is sheer folly."

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