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Commentary

ALLAN MELTZER HAS PRESENTED a paper that rescues Milton Friedman's 1953 defense of flexible exchange rates from its critics and presents an impressive amount of empirical evidence against today's received opinion favoring fixed exchanges. Nothing is more bracing than the refutation of conventional wisdom nor more satisfying than the vindication of the simple faith that the market is always right against the latest interventionist fads of central bankers, which is what I take to be the practical consequence of the paper. Anything that could make Europeans think again about imposing a contrived monetary union in the EC is most welcome.

My comments start with Meltzer's summary of Friedman's case for floating rates. Then I make a quick evaluation of the force of the data presented in refutation of those who have asserted that flexible exchange rates have not worked as anticipated. I make this evaluation without in any way claiming, however, to have redone Meltzer's calculations or amassed some different evidence. The reason for not focusing on the empirical part of Meltzer's paper, except as evidence of how the world seems to function, becomes apparent in the following section. After a simple-minded exposé of what Meltzer's results mean for the day-to-day business of a central banker and a portfolio manager, I try to contrast the empirical relations given in Meltzer's paper with the assumptions implicit in the project for a European Monetary Union. Finally, I reflect on the conditions that explain why monetary zones appear and on whether the benefits of a freely floating independent currency become larger than the costs.

Meltzer underlines how Friedman refrained from claiming too much for floating exchange rates and also how prescient he was about problems that would plague fixed exchanges at the time when the Bretton Woods accord was being implemented.

Friedman, as I have confirmed by rereading his 1953 paper, did not present flexible exchange rates as optimal under all circumstances. He started by defining the new arrangement he wanted to criticize:¹

the Western nations seem to be committed to a system of international payments based on exchange rates between their national currencies fixed by governments and maintained rigid except for occasional changes to new levels.

He then prudently said that "whatever may have been the merits of this [Bretton Woods] system for another day it is ill suited to current economic and political circumstances." If the fixed exchange system must have had some merit when it was being used within currency zones—some as large as the one in which he lives—for Friedman, the flexible rates system had the superior political consequences, namely: (a) fostering the liberalization of trade; (b) reducing the need for exchange controls; (c) easing the path for necessary extraordinary expenditures, such as the rearmament that turned out to be necessary with the Cold War; and (d) alleviating the constant brushes between central bankers and treasuries over domestic monetary and fiscal policies.

¹See Friedman (1953).

These indirect advantages are important and correspond contrastingly with the political advantages claimed by those who defend pegging exchanges of countries or a group of countries to some standard or to some more reliable currency. In this case the political advantage lies in putting a check on the oversupply of money and forcing monetary authorities to minimize their inflation tax and maintain the value of money. An exchange fixed onto gold, some basket of goods or another reliable currency such as the deutsche mark is a sort of superindependence clause in the central bank bylaws because it turns the Bank in effect into a currency board.

In Meltzer's paper there is little discussion of possible data related to these elements of comparative advantages of flexible vs. fixed exchange rates from the political and social point of view. In his paper there is a useful explanation of what Friedman really meant, but not an empirical evaluation of the relative size of the functional relationship he posited. The elements of a comparative analysis of floating exchange rates vs. fixed are listed by Meltzer, but their quantitative importance is not evaluated.

Recognizing that optimality of flexible rates cannot be established, Friedman limits his claim to the judgment that flexible exchange rates are more desirable socially than the...alternative means of offsetting changes in international position... (1) official changes in currency reserves; (2) changes in domestic price levels and incomes; (3) periodic realignment of parities; and (4) direct controls.

Of these, periodic realignments are the most important for a judgment on the functioning of the European Monetary System (EMS).

I found a remark in Meltzer's conclusion that "several of ...[the four] conjectures were correct." These conjectures are such things as the positive political effects on the liberalization of trade. Regarding Friedman's (b) avoidance of direct controls, Meltzer says the following:

Direct controls on capital movements have been reduced since 1973 in all developed countries and in some developing countries.

With respect to Friedman's (c), Meltzer notes the following:

It seems likely that rearmament (defense spending) would have provoked greater conflict about payments imbalances in the 1980s under fixed exchange rates than under the system that prevailed.

Finally, there is the following indirect treatment of the possible evidence on Friedman's (d), the harmonization of internal monetary and fiscal policies:

Flexible rates permitted countries to choose how much of the stimulus emanating from the United States they wished to absorb. Many countries, indeed most developed countries, both purchased dollar securities and appreciated their currency.

that is, they both absorbed and sterilized the stimulus.

This is very little on a large part of the controversy about fixed vs. flexible exchange rates, but it will have to be a topic for a different paper because Meltzer prefers to concentrate on a previous problem that Friedman dealt with implicitly, though at length. Says Meltzer:

The point that concerned later critics most, variability or instability, is dismissed early with the claim that exchange rate instability reflects instability in the economy and is not a property of a flexible or floating rate system . . . Friedman appears to have anticipated this outcome. He devotes more space to refuting or dismissing the charge of instability than to making the positive case for the four benefits claimed for flexible rates.

This is also what Meltzer does, in the belief that the question of overshooting and of destabilizing speculation has to be resolved before the political cost-benefit analysis of flexible rates can be addressed.

The evidence Meltzer does present bears on five points that would clearly be important as preconditions for evaluating Friedman's main political theses: (1) whether the variability of exchange rates in the main OECD countries increased after the breakdown of Bretton Woods—especially whether the EMS currencies showed less variability; (2) whether and over what period can exchange rates be considered to move along a random walk; (3) connected with 2., whether money supply and government spending policies do affect real and money exchange rates significantly; (4) connected with 3., why real and monetary rates seem to move together; and (5) whether exchange rates are congenitally unstable, whether they show a tendency to return to mean values and if so, over what period.

The results presented by Meltzer are most valuable and should become standard with the profession if confirmed by rerunning them for

different periods and countries, and especially for the present episode of instability in the EMS.

VARIABILITY AND ITS POSSIBLE WELFARE EFFECTS

The figures presented for 1973 through to 1990 moved over a relatively wide range. This behavior of the exchanges could, as Friedman said, turn out to reduce the variability in some real phenomena, such as output or employment. The variability could also derive from more acute and frequent real shocks in this period.

This is as may be, but Meltzer concentrates on whether the variability is merely apparent and is robust under different measures used. If the said variability could be traced to the more frequent movements in a flexible regime but left relative prices unmoved, the visible variability could have only small real consequences. See table 1: R , the real exchange rate, and N , the nominal rate, varied much less in the EMS countries than in other OECD countries. (One would in any case want to see the variance after what happened on September 26.) The relative price changes between countries, however, were unaffected by the exchange regime.

THE RANDOM WALK MODEL

At the end of his paper, Meltzer has a section on the possible limitations of his empirical findings. One is possible simultaneity, which he corrects by lagging and for which he finds no evidence of relevance. Another is that the results are not derived from a structural model, but from a simple model of permanent and transitory changes which is, by the way, a traditional Friedmanite approach. Meltzer maintains that the whole empirical exercise "nests the effects of money and defense spending within a popular statistical model, the random walk," so significant departure from the null hypothesis would precisely be a most striking refutation of the random walk theory of foreign exchanges.

I can summarize the results with a quotation: "transitory random variation increased under flexible rates, but the increase is much smaller than is commonly alleged"; and a move from annual to quarterly data does not significantly change the results. Daily data would, however, probably show much more randomness.

REAL CAUSES

And the yearly and quarterly movements of exchange rates are not random because

changes in money and changes in defense spending relative to GDP have considerable effect. For example, a 0.1 percentage point change in the share of defense spending changes the real exchange rate between 1.4 percentage points and 2.4 percentage points. ... The 1982 increase in defense spending alone appreciated the dollar by 8.7 percentage points.

Not only government expenditures, but also increases in real GDP and changes in real money balances seem to have significant effects on the real rate of exchange. Within the black box, we could surmise that increases in expenditures will contribute to raising interest rates and attracting foreign capital and that increases in GDP will also lead to higher rates through the same mechanism and through the increased demand for money. On the other hand, a fall in real money supply will also push up the real exchange rate. Deficits, on the other hand, seem to have no significant effect of the real (and money) rates.

REAL AND MONEY EXCHANGE RATES

David Ricardo in 1817, in the passages of his *Principles* where he discussed the distribution of precious metals in the world, under the gold standard, saw that advances in productivity in a country led first to a fall in costs and real prices, then to an accumulation of reserves and an increase in money prices, and finally for a time to an overvaluation of the money exchange rate until domestic prices fell to an equilibrium. The process would be the inverse for a country falling back in productivity. Hence the tendency of real and money exchanges to fluctuate constantly in separate directions turned out to be characteristic of a fixed exchange rate regime. (Of course, it is contrary to the rules of a fixed interest regime, especially of the gold standard for the bank to sterilize foreign funds.)

In contrast, it was therefore expected that, under a flexible exchange regime, because the inflow of money from increased productivity and exports does not go into reserves but into foreign exchanges, the index of money prices would be governed much more directly by the prices of tradeable goods.

Meltzer gives an additional reason for the joint movement of *real* and nominal rates. He has shown reductions in real balances to be a powerful cause of the increase of real exchange rates; and real balances also govern money exchange rates.

NON-STATIONARITY

One last element in the description of a flexible exchange rate regime is the rejection of non-stationarity by Meltzer. That there are observably persistent departures from a random walk led some authors to think that speculation could be permanently destabilizing. However, if one uses a longer span of years it becomes clear that exchanges are subject to both persistent and transitory changes. I take it that the persistent changes are responsible for the time illusion of non-stationarity. If the average real life of a shock is 3 years, the period for return to the mean rate of exchanges can be long; but return to the mean they do (I should add, if there are no capital or trade controls).

Though it may be subject to correction from further empirical research, the picture of the exchange world given by Meltzer's empirical research is striking, both for the central banker and the investor. I read these provisional conclusions with some trepidation, but hope to be corrected by the audience before I become a central bank governor or a large investor.

First, real and money exchanges move together. Price indexes will move up or down with the real exchange rate and will be governed by the real causes of real exchange appreciation or depreciation. In an open economy, therefore, a central banker can aspire to a steady or zero inflation rate only as an average over a long period—perhaps a three-year half-life.

Second, there is money to be made in foreign currency (at least until everybody starts reading Meltzer) because of long-term systematic and predictable forces in the foreign currency market. Government expenditures, GDP growth and reductions in real balances portend of revaluations to come (as long as people do not expect the Government to inflate the accumulated debt away). To put it in another way, a good long-term investment in a country blessed with a central bank that does not panic can discount exchange fluctuations if it has enough capital or is not subject to quarterly scrutiny at the stock market.

Third, the variability observed when exchanges float does not seem to spill over into the goods and services market because it does not affect relative prices. Hence the decision to float or to fix will have to be taken on sociopolitical grounds and cannot be settled on evidence of persistent overshooting.

Now given all this, the arguments with which the monetary part of the Maastricht Treaty is being defended begin to sound less convincing. The following pros and cons are usually presented.

The reduction in transaction costs from having to deal in a single currency is a benefit. Cecchini has calculated a once-and-for-all gain equivalent to 4 percent of European GDP. This may be exaggerated and is much lower than the recurrent gain from the single market.

Another benefit is the control of the central bankers of the constituent states by a European Central Bank (ECB) with the express duty to defend the value of the single currency. This has the following two drawbacks, however. The first is the suspicion that the states' central bankers do not want to reduce their sovereignty, but want rather to increase it with their seat on the ECB's executive committee because the markets themselves have made state central banks lose much of their freedom; the other drawback is that the new ECB will have quite a task being independent and refraining from playing with the exchanges, as can be guessed by the pressures recently put on the Bundesbank.

The solution to the difficulties posed by a monetary union among widely differing countries is problematic. We have already seen the points that Friedman foresaw would plague such a monetary union: policy disharmonies and the possible pressure for a central government (a sure cause of friction in Europe); a temptation to impose exchange or capital and trade controls; and indifference to implementing cushions to prevent unemployment in the less productive parts of the union.

The question is then, why do I sometimes advocate a currency board for small countries, which is a strict form of monetary union, and why are the monetary unions made up of rather large countries and sometimes of a large economy such as Germany and its close surrounding trade partners?

Let us imagine a world of competing monies that float against each other. Their market share will be decided as in any other oligopolistic industry, the producers obtaining a seignorage or markup over marginal cost, a markup limited by potential entry; and demand being for the well-known services that money provides. These services are: for transactions (of which a part is coinage for small change subject to the metal content being of less than face value); for pricing goods, services and savings; and for holding a real cash balance.

The picture that emerges from this is not only that of a world divided horizontally in zones, but also a world subject to a division in layers, where different currencies may be used for different purposes: for example, deutsche marks or dollars for trade, Swiss francs for pensions, and pesetas for local payments.

Apparently it would be ideal for consumers of money, especially those that need it to produce goods and services, if all dealings could be in only one currency. This in fact is not necessarily so, for all the reasons we have noted in this commentary. The union could, however, be approximated by the market, and the study of the non-stationarity hypothesis will confirm that over long periods currencies tend to stay around

their historical rates. If there were monetary competition, I doubt that there would be more than three currencies circulating in the United States. The smaller nations around Germany that trade intensely with her and that have similar economic structures to her—for example, the Benelux nations, Austria and Switzerland—will find it in their interest to stick to the deutsche mark. Only competition will tell how big monetary zones must be.

Avoiding hyperinflation and enjoying the services of a currency that is reasonably stable for purposes of valuing goods, services and savings may lead some people to ask that the issuer of money be separated from the creator of the budget deficit as they have recently been in the Baltic States and the Ukraine. In other places, such as Hong Kong, a currency board that pegs the local money to the dollar may inspire confidence in a highly volatile situation.

In questions of currency we live very much in a second-best world.

REFERENCES

Friedman, Milton. "The Case for Flexible Exchange Rates," in Friedman, Milton, ed., *Essays in Positive Economics* (University of Chicago Press, 1953).