

FLOATING EXCHANGE RATES IN THE 1970s: A DISCUSSION OF THE HELLER PAPER

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The first section of Dr. Heller's paper consists of four assertions about the consequences for the world economy of the move to floating exchange rates. On the basis of these four assertions Dr. Heller proceeds to make recommendations first for the future conduct of U.S. economic policy, and second for the future shape of the international monetary system.

In these comments it will be argued first that his four assertions on the consequences of exchange rate flexibility are at the least misleading and, in some cases, not supported by any evidence at present available. It will then be shown that his policy recommendations for the future of the international monetary system are based on misunderstanding both the causes of exchange rate volatility and the reasons for international capital movements. The comments conclude with a summary of what appear to be the true lessons of the floating exchange rates experience of the 1970s.

DR. HELLER'S ASSERTIONS

Dr. Heller asserts that "the operation of the flexible exchange rate system since 1971 has entailed a significant increase in costs to

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the business sector." The trouble with that statement is that Dr. Heller does not make clear what comparison he is making when he says costs have increased. There has been a substantial increase in the dispersion of inflation rates in the O.E.C.D. (Organization for Economic Cooperation and Development) area in the 1970s as compared to the 1960s.¹ Had exchange rates remained pegged despite this change, they could only have been kept so by an increasing proliferation of exchange controls to restrict capital movements and of tariffs and quotas to restrict trade, and by increasing volatility of national monetary policies. It is impossible to believe that these developments would not have imposed costs on the business sector, and Dr. Heller certainly does not demonstrate that these costs would be less than the costs imposed by floating exchange rates.

Indeed, it should be pointed out that there is absolutely no evidence in support of Dr. Heller's view that floating exchange rates have inhibited international trade. This issue has been studied fairly extensively, and there is not one study which has found that floating rates have had any dampening effect whatsoever on world trade. But despite that, there may be some truth in this particular belief.

All studies so far undertaken have looked at the effect of the exchange rate regime on international trade as a whole. Recent

¹See Geoffrey E. Wood and Nancy Aamon Jianakoplos, "Worldwide Economic Expansion: Are Convoys or Locomotives the Answer?" Federal Reserve Bank of St. Louis Review, July 1978.

theoretical work by Ronald McKinnon,² supported by forthcoming empirical work by Stephen Carse, John Williamson and the present author,³ suggest that this is not appropriate.

A substantial part of international trade is in primary or semi-manufactured goods. The prices of such goods are continually held close together across countries by arbitrage. Thus traders in such goods are not affected by exchange rate fluctuations provided that they hold inventories equal to their indebtedness arising from trade -- and the evidence is that to a first approximation they do. There is therefore no reason to expect trade in these goods to be in any way affected by exchange rate changes, whether or not these changes are anticipated. In contrast, manufactured goods do not have their prices quickly arbitrated into equality internationally.⁴ Traders in such goods are therefore exposed to exchange risk. Tests for the effects of exchange rate fluctuations on trade should focus on these categories of goods, rather than on trade as a whole; looking at trade as a whole may have led to the concealing of the effect of exchange rate fluctuations on a sub-section of trade. (This hypothesis is currently being explored by the present author, but no results sufficiently reliable to report are at present available.)

²Ronald McKinnon, Money in International Exchange, Oxford University Press, New York, 1979.

³Stephen Carse, John Williamson, and Geoffrey E. Wood, Financing Practices in U.K. Foreign Trade, Cambridge University Press, Cambridge, 1980.

⁴See e.g. John Williamson and Geoffrey E. Wood, "The British Inflation: Indigenous or Imported?", American Economic Review, September 1976.

So, despite the absence of confirming evidence, Dr. Heller may be correct in saying that trade has been inhibited by exchange rate fluctuations. But three points should be emphasized. First, he provides no evidence to support his assertion. Second, he should have compared what would have happened to trade under a fixed rate system defended against the consequences of divergent inflation rates by proliferating controls, with the effect of exchange rate fluctuations on trade. Third, even if he is correct that exchange rate fluctuations inhibit trade, it is far from clear that official exchange market intervention is thereby justified.

His second major assertion is that flexible exchange rates have "not brought about a climate for the conduct of more effective stabilization policies." The only possible response to that is to ask why on earth they should. Under a fixed exchange rate system, the burden of mistakes in stabilization policy by any country's government was in part borne by the foreign sector. Excess demand was in part met by foreign supply, while deficient home demand was in part offset by demand from overseas, so long as the demand and supply imbalances were at least partly due to monetary policy. (An example of this is the United Kingdom experience in the 1960s; see Williamson and Wood, *op.cit.*) Floating exchange rates, by eliminating flows across the foreign exchanges, close this safety valve; one should therefore expect (other things being equal) that the performance of stabilization policies should deteriorate rather than improve under floating rates.

But Dr. Heller did not write very precisely at this point; he does not say exactly what he means by the "climate for the conduct of more effective stabilization policies." He may mean not the actual

achievement of such policies, but rather how policymakers have responded to divergences of the economy from its desired path. If that is what he means, then he is pretty clearly wrong. The U.K. is a good example. It was only after the collapse of sterling's foreign exchange value in 1975 that the U.K. government took any serious measures to end the gradually accelerating inflation of the previous twenty years. Why they so responded can only be conjectured; but the explanation may be that floating exchange rates bring home to the electorate the costs of inflationary policies rather more quickly than did fixed rates, and thus may influence their voting behavior at the next election.

Dr. Heller next claims that floating exchange rates have not "decreased the cost of [foreign exchange market] intervention to central banks." Dr. Heller is really very careless in his use of the word "cost." He never tells us what costs he has in mind in the present instance. It is certainly clear, however, that the amounts of intervention have been large, and it is on this issue rather than the undefined one raised by Dr. Heller that we next comment.

Why have exchange rates been so volatile? Where have the private stabilizing speculators been? Dr. Heller does not attempt to answer these questions. Fortunately, an answer has been provided by a large body of previous work. Exchange rate volatility is, in large part, the consequence of volatile national monetary policies. This has been true not just in the 1970s; it was also true in the 1920s. The conclusions of a recently published paper by my colleague Roy Batchelor summarize the evidence very well.

Stable inflation rates are all that is required to keep the trend in exchange rates steady... efficient exchange markets should keep fluctuations around the trend within the same margins as in the 1920s. What is necessary for exchange rate stability is that monetary expansion be predictable...⁵

The reason for this is admirably expressed in the quotation from Gustav Cassel with which Jacob Frenkel concludes the paper he presented at this conference.

The international valuation of a currency will, then, generally show a tendency to anticipate movements, so to speak, and become more an expression of the internal value that the currency is expected to possess in a few months, or perhaps in a year's time.⁶

The more volatile is a nation's monetary policy, the more frequently will the expected future internal value of its currency change, and so the more frequently will its exchange rate change. The primary source of exchange rate volatility is therefore volatility in national monetary policies. Understanding that is central to drawing the correct lessons for future policy of the exchange rate experience of the 1970s.

Understanding that also helps explain the absence of private stabilizing speculation; because of the volatility of national monetary policies, speculators have had very little basis on which to form expectations of future exchange rates.

In this context, it is worth pointing out that (as Jacob Frenkel shows) exchange rates have been no more volatile than prices in other

⁵Roy Batchelor, "Must Floating Exchange Rates be Unstable?" Annual Monetary Review, Centre for Banking and International Finance, The City University, London, England.

⁶Gustav Cassel, Money and Foreign Exchanges after 1919, pp. 149-150, Macmillan, London, 1930.

asset markets, thus emphasizing the common cause of such volatility. Further, it must be stressed that D. Heller's belief that "speculative activity may well accentuate rather than reduce exchange rate fluctuations" is totally contradicted by evidence that there are no traces of speculative "runs" in the foreign exchange markets.⁷

His last assertion is that floating exchange rates have "fostered the decline of the dollar as the world's leading currency." By this he means that floating exchange rates have led to a fall in the proportion of dollar-denominated assets in the portfolios of individuals and central banks. He is clearly right. Portfolio diversification was to be expected as a consequence of the move to floating rates, and it has indeed happened. But so what? Why is that undesirable? Nowhere does Dr. Heller answer these questions.

U.S. POLICY RECOMMENDATIONS

Turning first to his recommendations for the future conduct of U.S. policy, these are manifestly sensible -- they comprise recommending the announcement of intermediate monetary ranges targeted by base control so as to ensure hitting them. The empirical and theoretical work on the causes of exchange rate volatility, which was referred to earlier, clearly indicates that such a policy would make exchange rates much less erratic in their movements, and such a policy would also help stabilize the U.S. economy as a whole.

⁷See for example Donald S. Kemp, "The U.S. Dollar in International Markets, mid-1970 to mid-1976," Federal Reserve Bank of St. Louis Review, August 1976.

INTERNATIONAL POLICY RECOMMENDATIONS

Dr. Heller does not advise a return to pegged exchange rates; he recognizes that so long as national inflation rates are as diverse as they currently are such a move would not be sustainable. He does, however, encourage official intervention in the foreign exchange markets.

There are, as Dr. Heller recognizes, costs to such intervention-- in particular, there may very well be an impact on domestic monetary policy. Since steady and predictable money growth is the foundation of reasonably stable exchange rates, there are considerable risks that central bank foreign exchange intervention would buy only short term stability. And what are the benefits of exchange rate stability achieved by official intervention in the foreign exchange markets? What can justify official intervention?

Central banks do not in general have any better knowledge than does the private sector of the future course of economic variables. There can be occasions when they do have such knowledge -- because they know their own intentions but have not published them, or because they are privy to the otherwise undisclosed intentions of a foreign central bank. In that case, intervention to prevent a temporary market fluctuation may be justified but such intervention is inferior to making public the confidential knowledge on which it is based. Making the central bank's intentions public would help stabilize not just the foreign exchange market but, to differing degrees, every other market. Publicity, therefore, clearly dominates intervention.

A second defense of occasional intervention may exist if it is found that fluctuating exchange rates do, indeed, inhibit certain categories of trade. If stable national monetary policies are being

pursued, there may still appear to be a case for intervention. The case would be that some of the benefits from exchange rate stabilization accrue not as profits to speculators on the foreign exchanges, but to traders in goods. There would, in other words, be a divergence between the private and social benefits of stabilizing speculation, with the social benefits outweighing the private ones, thus appearing to justify intervention. But here, too, exchange intervention is second best. As has emerged from the literature on protection, a direct subsidy paid to the affected sector is the most efficient means of assisting a sector of an economy.⁸ In the present case, intervening in the exchange markets would mean that all traders in international money markets, not only those in goods affected by fluctuating exchange rates, were being assisted. Here, too, then, while exchange market intervention may conceivably be justified -- although the evidence which may justify it is not yet in -- again the policy is a second best one.

Two further possibilities remain. An exchange rate may be changing very rapidly -- sterling in the three months to July 1979 is an example. This was imposing very rapid adjustment costs on industries already required to respond to a substantial change in the pattern of comparative advantage. If the authorities in such a case can slow the adjustment without loss of monetary control, then there are benefits from their doing so. But the situations when they can do

⁸See J. Bhagwati and V. K. Ramaswami, "Domestic Distortions, Tariffs, and the Theory of the Optimum Subsidy," Journal of Political Economy, February 1963, and Geoffrey E. Wood, "Senile Industry Protection," Southern Economic Journal, January 1975.

so are manifestly rare. The U.K. was able to do so in that episode because a large part of the inflow seemed to have resulted from a desire to buy just the kind of securities the U. K. government would have had to sell to sterilize the inflow, but the experience of Germany in the 1960s and 1970s shows that such episodes are unusual. This case, then, does constitute a modest defense of occasional intervention -- but the circumstances are very special. (And there will still be a welfare cost to the nation if the rate of return earned on international reserves falls short of the rate paid on foreign-owned national debt.)

The fourth, and last, defense is when there is an increased demand on the part of non-residents to hold the money of some country -- not, it should be stressed, assets denominated in that currency, but the currency itself, including of course bank deposits. This does not invariably constitute a reason for supplying the currency; it may, rather, often be an opportunity for reducing the inflation rate. If, however, inflation is at its desired rate, then the increased demand for currency must be met by an increased supply, and the simplest way to be sure of supplying the correct amount is to operate on the foreign exchange market. But this is a very special case indeed.

Summarizing then, the case for official intervention in the foreign exchanges is very weak. Recognizing that there can be substantial fluctuations of exchange rates about their equilibrium values does not imply that these fluctuations should be corrected by official intervention.

Dr. Heller is also concerned about the appropriate reserve asset for the international monetary system. He believes that the currently

evolving reserve asset system is inherently unstable, and that it should be replaced by a single asset system, the asset being either the U.S. dollar or a somewhat modified SDR (Special Drawing Rights).

It is convenient to deal first with his endorsement of a dollar standard. The weakness of such a system was first diagnosed by Robert Triffin.⁹ His diagnosis can be summarized very briefly as follows. The reserve asset, the dollar, can be supplied only by the reserve centre, the United States, running continual deficits in its balance of payments -- but that progressively undermines confidence in the reserve asset which is being thus supplied. Such a system is internally inconsistent. Dr. Heller provides us with no reasons for thinking Triffin to be wrong -- indeed, nowhere does he refer to Triffin so his advocacy of a return to a dollar standard cannot be taken seriously.

The defect with his endorsement of an SDR-based system is that under one set of circumstances the scheme is unnecessary, while under the alternative circumstances it will not work. An international monetary system with all major currencies serving as reserve assets is not, despite his belief to the contrary, inherently unstable. Such a system will not be continually destabilized by capital flows responding to inflation differentials -- so long as these differentials are reasonably stable and predictable. And when these differentials are not stable and predictable, there will be sudden and large movements of

⁹Robert Triffin, Gold and the Dollar Crisis, Yale University Press, New Haven, 1960.

funds from currency to currency whatever the official reserve asset of the system may be.

Tinkering with the reserve asset of the international monetary system cannot substitute for stable domestic monetary policies.

CONCLUSIONS

The lessons for the conduct of international monetary policy which have been provided by the experience of the 1970s can be stated very briefly. Exchange rates will be volatile so long as national monetary policies are volatile. It is not clear what harm this exchange rate volatility does, although the underlying monetary instability does cause considerable harm as Alan Meltzer's paper shows. In any event, the case for exchange market intervention to reduce this volatility is very circumscribed indeed.

Nor can any case be made for trying to prevent portfolio diversification into a range of reserve assets. A multiple asset system will be stable if national monetary policies are stable, and if national monetary policies are unstable then any international monetary system will inevitably be unstable also.

The lesson of the 1970s experience of floating rates, as of every earlier floating exchange rate episode, is that the international monetary system will only be as stable as the set of national monetary systems which it links.