# Exchange Rates between What Sorts of Currencies?

*Leland B. Yeager*

## Incoherent Straddles

One point is no less central for being familiar: A compromise exchange rate system is the worst of all. Either of two opposite extreme arrangements makes better sense: complete monetary unification replacing formerly distinct currencies or else freely fluctuating, unmanipulated exchange rates between national currencies. The incoherent straddle aims to manipulate or even fix the exchange rates between distinct currencies. Even supposedly permanent fixity is a sham as long as the currencies remain distinct and subject to the management of their different national authorities. Many currency crises over the decades have demonstrated the incoherence of the straddle.

Crises are not the only reason for calling the pegged rate system unsatisfactory. Far from imposing supposed "discipline" on national monetary authorities, pegging tends on balance to drag the relatively responsibly managed currencies down with the less responsibly managed ones. The Bretton Woods system demonstrated this inflation bias.

Yet even nowadays we often hear the burst of double-digit worldwide inflation in the mid-1970s blamed on the loss of discipline caused by that system's collapse, together with the predation of OPEC. That remark combines forgetfulness of history with ignorance of monetary theory. Worldwide money-supply inflation in the early 1970s, followed with normal lags by price inflation, was caused by the protracted last-ditch defense of the system. Central banks around the world created new domestic money as they bought up U.S. dollars in ultimately futile attempts to keep their own currencies from appre-

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ciating beyond their fixed parities against the dollar. Even the emboldening of OPEC in or around 1973 traces largely to the money and price inflation resulting from futile defense of the Bretton Woods system.

## The Undefined and Speculative Dollar

As these historical remarks help suggest, exchange rates are not the primary issue. The overriding issue is the nature of the currencies whose prices in terms of one another are quoted on the foreign exchange market. What defines and determines the value of each unit of account—the dollar, franc, or whatever?

The dollar is admired for its relative stability, and dollarization or a dollar-based currency board is widely recommended to Third World countries and countries emerging from communism. Yet the dollar has lost roughly 95 percent of its purchasing power since before World War I and 85 percent in the last 50 years (that is, since the peaking of the inflation during and right after World War II). (Admittedly, long-term price-level comparisons are inexact and even conceptually dubious; still, severe price inflation is unmistakable.) Most countries have suffered even worse inflation than the United States. Only the Swiss franc comes to mind as a currency that has depreciated less than the dollar since before World War I. (Anyone tempted to mention the German mark should be reminded that the current mark is the successor of two earlier marks that met destruction in the aftermath of the two world wars.) In the last 50 years, only the currencies of Switzerland, Germany, Japan, and the Netherlands have depreciated clearly (but not spectacularly) less than the dollar; a few others have suffered roughly the same depreciation. Such severe and worldwide inflation has been functionless; it is hard to believe that it has sustainably benefited output and employment through some sort of Phillips curve. Around the world, monetary units are insecure. The variability of their exchange rates is a subsidiary problem.

The undefined nature of the dollar and other units leaves excessive scope for changing conjectures about their future values and about policy measures affecting them. These conjectures affect business decisions, capital flows, and the stock market. To judge from the media, economists are largely concerned with predicting how the Federal Open Market Committee will set interest rates at its next meeting, for much apparently hangs on what the Fed will do. Volatility spreads and becomes self-reinforcing. Listen to the testimony of William Poole (1999), former professor and current president of the Federal Reserve Bank of St. Louis:

> Expectations influence market activities day in and day out. Traders in the federal funds futures contracts on the Chicago Board of Trade, for example, pore over testimony and speeches of the Chairman and Federal Reserve officials, searching for hints about whether the FOMC will change the intended federal funds rate at its next meeting, or some meeting after that. Financial markets can gyrate widely in response to a remark whose interpretation is contrary to the prevailing impression.
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> . . . The fact that markets so often respond to comments and speeches by Fed officials indicates that the markets today are not evaluating monetary policy in the context of a well-articulated and well-understood monetary rule [p. 7].
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> . . . there is a circularity problem because it appears that the bond and money markets respond significantly to changes in Fed policy and to changes in expectations about Fed policy. The more confidence the market has in the Fed, the more the market will concentrate on what the Fed is doing and the less the market will concentrate on fundamentals other than the Fed.
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> . . . The market watches the Fed because the Fed is well informed and because the Fed is the dominant player in the money market.
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> The more confidence the market has in the Fed's willingness to do whatever is necessary to maintain low inflation, the more sense it makes for the market to concentrate on the Fed's actions rather than forming an independent judgment about future inflation prospects. Therefore, the Fed cannot use the behavior of interest rates in the bond market to provide useful information on how it should adjust the federal funds rate [p. 11].

Poole implies a point that my colleague Roger Garrison has made explicit: The Fed watches the markets for clues to what may sooner or later prove to have been deficient or excessive total spending, while market participants watch for and act on clues to what the Fed may be intending to do. Circularity operates. What the Fed sees in the markets is to some extent responses to its own actual or conjectured policies. Any anchor for expectations is adrift.

## Ignorant Critics and What They Overlook

Even conservative publications, commentators, and presidential aspirants have been condemning the Federal Reserve for its supposed obsession with a nonexistent inflation and for harming the country with too tight a policy (see the first three items in the References). Steve Forbes, for example, worrying about deflation, said that Alan Greenspan's policy is based on the "bogus theory that prosperity causes inflation." Such thinking is epitomized in an illegibly signed cartoon in the Auburn Bulletin of 21 July 1999. Three people and a

dog are pigging out on a cake labeled ECONOMY. Props at hand indicate a Wall Street boom and general prosperity. Alan Greenspan, garbed as a fireman and carrying a fire extinguisher labeled INTEREST RATES, bursts into the room, flattening the door. He says: ". . . there are *too* many of you people working and you're having *too* good of a time! *That worries us*!" A child asks whether the party is over.

What, according to such critics, explains the almost noninflationary prosperity that we have been enjoying lately? Is it a pure gift of nature, unrelated to a policy that tries to be forward-looking? Mass-man thinking as diagnosed by José Ortega y Gasset is on display: the critics feel free to make insistent suggestions out of their own ignorance.

How can we try to dispel such ignorance? First, we can make a subsidiary point: setting interest rates is not the function of the Federal Reserve. The federal funds rate merely happens to be the instrument currently adopted by the Fed in trying to control the money supply appropriately. More important, the Fed has learned that monetary policy works with lags. By the time that prices show unmistakable signs of inflation, it is too late to stop it without unpleasant side effects: an anti-inflationary shift of monetary policy then causes a recession or a real economic slowdown. To avoid the economic slumps and spurts associated with a stop-and-go monetary policy, the Fed must pursue a steady course. It must try to avoid any short-run overstimulus that will have to be reversed. It must look ahead for signs that its policy is becoming too expansionary, meaning inflationary. It must look for signs not just in prices, including flexible commodity prices, but even in the real economy—in unsustainable growth of output and decline of unemployment and even in Wall Street and other financial markets. It must do so because such signs of overexpansionary policy usually occur ahead of the general prices increases that will follow if the overexpansion is not promptly stopped.

The "unsustainable" changes in output and employment would indeed be welcome if only they were sustainable after all. If output grows because of a larger or better educated and healthier labor force or because of technology-based gains in productivity, fine. It is likewise fine if unemployment shrinks because of a better matching of workers and jobs and job vacancies, thanks perhaps to improved management skills and even to the opportunities offered by a steady economic environment (as opposed to one beset by stop-and-go policy). Real factors like these, contributing to an impressive real growth rate, are of course not to be resisted by monetary policy. They permit an accommodating increase in nominal spending and in the supporting quantity of money without price inflation.

Such real-based growth in output must be distinguished from an unsustainable spurt in output due to an overexpansionary monetary policy. (Financial innovations and other developments have made the money-supply-and-demand relation more complicated than before, making it harder to distinguish in time between merely accommodating policy and overexpansionary policy.) A spending spurt tends to impinge first on production and employment, price increases following with a lag (and then tending to reverse the real growth spurt). In such a case, as I said, a tightening of monetary policy delayed until increases actually become unmistakable comes too late to stop the price inflation and further tends to produce a slump. That is why the Fed must look ahead, seeking clues even to what is happening in factories and on farms, on Main Street and Wall Street.

In some sense this theory involves a Phillips curve, an association between output growth and (delayed) price inflation. But it is a short-run Phillips relation only, not exploitable for long-run benefits. The equation of exchange MV=PQ can illuminate these points about real and monetary factors in sustainable and unsustainable economic growth and their relation to price inflation. No one has told me first-hand that the policymakers at the Fed are aware of these relations, but their behavior and pronouncements in recent years do suggest that they have been following the theory just sketched out. The difficulty lies in getting the Fed's critics to understand this theory. Possibly, however, some of them do not want to let any such understanding get in the way of their demagogy.

Vulnerability to ignorant criticism is one defect of our current monetary institutions. I am defending not these institutions but the current direction of the Federal Reserve, which looks good in comparison with earlier performances.

## Money as a Clearing Device

A recommendation for institutional reform should take account of what money is and does. Money is fundamentally a clearing and record-keeping device. Clearing is the multilateral offsetting of claims and obligations against one another. Claims acquired by delivering goods or services to some trading partners pay for goods or services received from other trading partners. In Joseph Schumpeter's simple example (1970: 227), a surgeon operates on a singer, the singer performs at a lawyer's party, and the lawyer handles a legal case for the surgeon. If the three services happened to have the same market value, the three parties might arrange to recognize that they were square with one another without transferring any money or property.

Clearing might conceivably be accomplished by the all-around centralized recording and offsetting of transactions, but the complexity and costs of such an operation in the vast modern economy (as well as the Big Brother aspects) recommend decentralized record-keeping instead. In the decentralized process, coins, notes, and bank accounts are memoranda or tickets, so to speak—receipt vouchers for the values of goods and services delivered and generalized claims on whatever the market offers for sale. A fuller description would also recognize gifts, loans, financial intermediation, and capital accumulation; the role in economic calculation of the unit of account in which the tickets are denominated; and the flexibility and other advantages that such a system affords. Such a description does not deny but penetrates more deeply into money's role as medium of exchange. (On the centrality of the clearing function of modern money, see Schumpeter ([1917–18] 1956: 154–55; Schumpeter 1970, esp. chaps. 6 and 9; Kuenne 1958; Kocherlakota 1998; and Moini 1999.)

## Unit of Account and Fiat Base Money

The tickets or memoranda that constitute modern money must, as mentioned, be denominated in some unit of account, some pricing unit. In the United States nowadays, that unit is the unit of fiat base money issued by the Federal Reserve as notes and deposits and by the Treasury as coins. It is essentially the scruffy dollar bill. Its value depends on nothing more definite than the demand to hold it (and its fellow components of base money) confronting a limited supply. All other countries have essentially the same system, except for countries whose money units are defined by or pegged to one or a basket of the units—fiat units—of other countries. No wonder that the exchange rates among such units often exhibit extreme volatility!

The purchasing power of such an ill-defined unit depends on money-supply management whose adequacy strains the expertise of central bankers and their insecure capacity to resist political pressures. Other circumstances contribute to the precariousness of this supply/demand situation, including the facts that much or most of U.S. base money is held abroad and that vast amounts of bank accounts and near-moneys are pyramided onto relatively narrow reserves of base money. Financial innovation keeps developing new methods of accomplishing payments without money of any traditional sort, further reducing the relative importance of base money. All these complications the Federal Reserve has to cope with, somehow.

## Implications for Reform

We need a unit of account defined to be stable, probably with reference to a basket of goods and services, under institutional arrangements for keeping its definition effective. I have argued for a private enterprise system, with government out of the money business. I won't take time to repeat myself here. The academic literature on this possibility has begun finding resonance in the world of affairs, as in a 1999 speech by Mervyn King, deputy governor of the Bank of England. The kind of stability we need could also be provided, faute de mieux, by a reformed government system.

Once the largest countries or monetary areas establish institutions assuring domestically stable units of account, perhaps even by getting governments out of the business of issuing money, they can safely let exchange rates and balances of payments take care of themselves. It is diversionary to talk of reform of exchange rate systems without attention to domestic monetary systems themselves.

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