

The Exchange Rate System Needs a New Look

BY PAUL A. VOLCKER

Almost three decades ago, the United States made the dramatic decision to cut the link between the dollar and gold. That action led to the end of the fixed-exchange-rate/par-value system for setting exchange rates established after World War II.

As a result, major financial powers permit their currencies to float more or less freely, one against the other. Smaller countries have been left to determine their own approach: whether to float their currency, fix its value against another currency or choose something in between.

Some initially viewed this as a desperation move—a “non-system” in response to a breakdown in international cooperation. More generally, observers see it as an inevitable corollary to the desire for national monetary autonomy in a world where international capital flows and money mobility have reached unprecedented size and fluidity.



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Mr. Volcker's essay is the second in a series of annual essays prepared exclusively for The Conference Board's Annual Report. The first, by Peter Drucker, appeared in last year's Annual Report.

Since the Bretton Woods system broke down, floating has been strongly supported by theoretical models—models perhaps most eloquently expounded by Nobel laureate Milton Friedman. Those models are still the standard fare of academic teaching.

The theoretical construct is appealing. Responding to the decisions of innumerable independent market participants, exchange rates will respond in an orderly and predictable way to differences in national inflation and interest rates, changes in economic structure, unanticipated shocks, or other events. Abrupt exchange rate adjustments, typically made under strong speculative pressure as “par values” became untenable, would be a thing of the past. Instead, “stabilizing” speculation would maintain market continuity. Necessary adjustments to new economic and policy conditions would be relatively painless, conducive

to maintaining high levels of international trade and investment. The point was strongly pressed that a floating exchange rate regime, while technically “flexible,” would in practice provide a greater degree of stability.

The large and disturbing fluctuations in actual exchange rates in the early years of floating could, in that view, be dismissed as a learning period in a particularly disturbed setting. The 1970s were marked by high and widely varying rates of inflation, successive oil crises, economic instability, and consequent uncertainty—all fertile ground for exchange rate turbulence.

Now, 30 years later, ample evidence demonstrates that the orderly adjustment process promised by the theoretical model is not reflected in the real world. Instead of moving gradually in response to different trends in inflation and interest rates, exchange rates have been subject to huge swings over the course of a year or two—shifting 50 percent and more between the dollar and the yen—on a recurring basis. This remained true long after price levels in both countries stabilized



and during periods when economic conditions and interest rates had not changed radically in either country.

Contrary to most expectations, the newly created euro declined by more than 25 percent against the dollar in 18 months. That is a far larger change than any that occurred during the Bretton Woods period. The change lacks really convincing ex-post rationales, and those offered are not mutually consistent.

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The European Union, the United States and Japan have huge, diversified economies closely competitive over a broad range of industries, each

operating close to price stability. Open markets for money and capital provide ample opportunity and resources for stabilizing speculation. Yet, over periods of several years—long enough to be highly significant for investment and trading decisions—the relative prices of their goods and services have experienced extremely wide swings, up and down, as a result of exchange rate variations. The exchange market appears to be increasingly dominated by financial flows responding to strong herd behavior, amplifying and exaggerating exchange rate volatility. The evidence is clear: effective patterns of stabilizing speculation that would keep exchange rates reasonably close to a competitive equilibrium have been absent.

The fact is, in the face of wide swings in market exchange rates, any sense of a sustainable market equilibrium by either governments or market participants has essentially disappeared, contradicting the preconditions upon which the theoretical model depends. Instead, the trading instinct is “to follow the trend.” Few are prepared to take strong

positions against that trend until the change is extreme.

One result has been to amplify swings in trade and current account balances among the three large economies, with deficits and surpluses substantially larger than would be expected as a result of changes in rates of economic growth or inflation.

At times, those changes in trade flows may coincide with, or reinforce, the immediate objectives of national stabilization policies. For instance, the unprecedented American trade deficits of recent years and the related Japanese and European surpluses have helped damp inflationary pressures in the United States and supported needed growth elsewhere. But there is also a substantial risk that the inevitable need to reverse (or at least narrow) those imbalances, accompanied by a sudden reversal in exchange markets, could greatly complicate economic management at a later time.

These major centers of economic activity, broadly diversified and self-sufficient, are relatively less exposed to



international trade. Rightly or wrongly, countries judge even extreme exchange rate instability to be less costly to their economies than any action they might need to take to dampen down exchange rate fluctuations. The United States' leading partners long accused it of "benign neglect" in the face of exchange rate instability. These days, the United States has plainly been joined in that practice by its two large trading partners.

Such policy insouciance isn't really an option for much smaller economies that depend more heavily, relatively speaking, on international trade and are now exposed to the full force of global financial markets. Even nations so well developed economically as those of continental Europe have long been sensitive to the risk of large and

abrupt exchange rate changes among themselves. They feared, correctly in my view, that so much instability would undermine the cohesion and objectives of their common market. After a long period of debate, part-way measures and planning, they have now dealt with that threat in the most definitive way possible: by abolishing their national currencies and adopting the euro as a common currency.

Much more difficult are the circumstances of smaller, emerging economies that lack the political cohesion, the economic strength, and the relative self-sufficiency of the European Union. Typically, they do not have long-established records of domestic political or price stability that would anchor expectations. Nor do they have deep, diversified, and resilient domestic markets. Even if well-managed, their financial institutions are typically too small to absorb and diffuse volatile flows of international capital and related exchange rate shocks.

On the contrary, the repeated lesson of experience is that exchange rate crises will amplify domestic economic and financial weakness, and vice versa.

The chorus of voices, official and non-official, warning that weak attempts to fix an exchange rate are not sustainable in a world of open financial markets, is certainly correct.

But the further advice to solve the problems with a floating exchange rate is not, for most of those emerging economies, convincing. Experience amply demonstrates their financial and economic vulnerability to sharp exchange rate changes. The instinctive tendency has been to seek an anchor by somehow linking their domestic currency to the dollar, to the currency of a major trading partner, or to a basket of international currencies.

At the extreme, we now see some countries fixing their currencies in a decisive way by means of a currency board, or by adopting the U.S. dollar and potentially the euro.

That approach can hardly be satisfactory for a country with strongly diversified trading patterns if the



currencies of their trading partners are themselves volatile. That has clearly been the case for Southeast Asian countries with their trade divided among Japan, the United States and Europe. In fact, the wide swings between the dollar and the yen were undoubtedly a precipitating factor in the Thai exchange crisis that set off the much deeper and broader economic debacle among emerging Asian nations a few years ago.

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In light of all these concerns, the obvious question is why so little thinking and so little effort have gone into developing more satisfactory exchange rate arrangements. One important

reason is widespread and deeply held concern among policy-makers that policies to deal with exchange rate volatility would at times—perhaps much of the time—be inconsistent with appropriate “domestic” policies. Surely, such “dilemma cases” can and will arise. But my own sense is that the concern is greatly exaggerated.

As suggested earlier, the issue has been less pressing for continental-sized and broadly diversified economies. They are better able to absorb the impact of exchange rate changes without economic or financial distress. Moreover, it is not irrelevant that many large “players” in financial markets look upon exchange rate volatility less as a threat than as an important source of trading and speculative profits. After all, sophisticated financial institutions closely in touch with markets virtually minute-by-minute are comparatively well positioned to anticipate and profit from exchange rate fluctuations. Volatile markets also provide other profitable opportunities to sell their commercial customers vehicles for hedging their risk.

However, even for financial firms, exchange rate volatility is an important business risk, and it would be surprising if such volatility does not have important adverse consequences for more and more industrial and commercial firms heavily involved in international trade and investment.

The swings in exchange rates we have been experiencing carry implications for those firms' marketing, pricing and investment decisions. The impact would appear to dwarf the influence of tariffs that have long been the focus of so much international negotiation.

Whatever that logic suggests, these effects, if in fact important, have not been clearly and consistently articulated. Other problems may be more pressing and more amenable to correction by public policy.

Efforts by econometricians to pin down and quantify the impact of exchange rate volatility on economic efficiency and the allocation of capital have not been convincing and are often contradictory. Perhaps in this area, even more than in many others,



the necessary diagnostic methodology to “hold all else equal” is fraught with difficulty. Or perhaps there has simply not been enough experience over time to provide the number of observations necessary for persuasive results.

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That is one reason why I look forward to a new survey The Conference Board is launching in cooperation with the Group of 30 and others. The object is simple: to obtain a better sense of the impact of volatile exchange rates on business decision-making and ultimately on business efficiency, by directly questioning a broad cross-section of businesses around the world.

This is an effort for which The Conference Board is particularly—even uniquely—suited. It has a well-deserved reputation for independent analysis of business behavior. It has close contacts with, and the confidence of, business firms here and abroad. It has also demonstrated competence in conducting surveys of opinion.

The project has attracted strong leadership. Professor Marina Whitman of the University of Michigan, a member of the Group of 30, is serving as project chair. She brings to the effort a unique combination of academic standing and objectivity with highly relevant business and public service experience. A distinguished advisory panel will further assure both objectivity and relevance.

While I cannot forecast the outcome and conclusions, the work should certainly contribute to better informed discussion of exchange rate issues among international business executives and policy officials. My hope is that this study will lend impetus to a long-overdue effort to consider practical

means of restoring greater stability to the exchange rate system.

There is general recognition of the strong—I think irresistible—technological and ideological forces pushing toward globalization of the world economy. The relative insulation of the United States from external influence is plainly diminishing. What has not been, in my mind, so generally recognized is the logical currency counterpart.

Changes are taking place, piecemeal and without recognition of the larger implications. The creation of the euro is the most striking manifestation, eliminating in one fell swoop 11 currencies. More than a half dozen nations have ruled out devaluation by effectively adopting the U.S. dollar or the euro. In effect, their deep-seated urge for exchange rate stability and for financial stability generally has outweighed the benefit of maintaining national monetary autonomy—an autonomy that is becoming increasingly illusionary for them in a world of global finance. Even countries as large as Mexico and Canada are debating the merits of

adopting the U.S. dollar, given their already strong economic relations with this country.

Those significant but sporadic initiatives fall far short of well-considered international reform. By their nature, they will not resolve the

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volatility among the major currencies. The tendency for currencies to drift into regional currency areas—each strong, diversified, and relatively self-sufficient—may well be consistent with even greater volatility between those areas, as the inattention to the euro/dollar rate suggests. The potential exists for nations to drift apart politically, as well as experience economic friction.

These regional arrangements are an entirely unsatisfactory “half-way house” for many nations in Asia and elsewhere. Trading patterns, culture, and history do not suggest a natural regional “anchor” for their currency.

How much better if—alongside our broadly successful collective efforts to free trade, to open financial markets,

to reach common understanding on financial regulation and accounting standards—we could find ways to reduce the endemic instability of currencies. I happen to believe that the ultimate logic of economic globalization is a stable and common unit of account and an internationally accepted means of payment—in other words, a common world currency.

That vision is not for my lifetime. But I am convinced we can do better—that we can collectively manage to reconcile national economic policies and objectives with greater exchange rate stability. I know that conviction is challenged; the conventional view is that it is a mere chimera—an impossible dream.

What cannot reasonably be challenged, it seems to me, is that the time has come for a fresh look at the exchange rate system, a look with open minds, minds sensitive to the experience of repetitive crises and to the implications of truly global markets. The risks for economic development are too great to forgo the effort.