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HOW WELL ARE FLUCTUATING EXCHANGE RATES WORKING?

REPORT

OF THE

SUBCOMMITTEE ON INTERNATIONAL ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

AUGUST 14, 1973

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LETTERS OF TRANSMITTAL

AUGUST 10, 1973.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the members of the Joint Economic Committee and other Members of Congress is a report of the Subcommittee on International Economics entitled "How Well Are Fluctuating Exchange Rates Working?"

The views expressed in this Subcommittee report do not necessarily represent the views of other members of the Committee who have not participated in the hearings of the Subcommittee or in the drafting of this report.

Sincerely,

WRIGHT PATMAN,
Chairman, Joint Economic Committee.

AUGUST 7, 1973.

Hon. WRIGHT PATMAN,
Chairman, Joint Economic Committee,
Congress of the United States,
Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith is a report of the Subcommittee on International Economics entitled "How Well Are Fluctuating Exchange Rates Working?" The report has been approved unanimously by the members of the Subcommittee.

The Subcommittee wishes to express its appreciation for the guidance it has received from the Administration officials and private experts who appeared before it as witnesses during the hearings which preceded this report.

Sincerely,

HENRY S. REUSS,
Chairman, Subcommittee on International Economics.

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HOW WELL ARE FLUCTUATING EXCHANGE RATES WORKING?

On February 12, 1973, the United States announced for the second time since the end of World War II its intention to reduce the official gold value of the dollar. This devaluation followed by 14 months the agreement reached at the Smithsonian Institution in December, 1971, to realign exchange rates. The first postwar dollar devaluation was part of that realignment.

This two-stage reduction in the gold value of the U.S. currency, amounting to 18 percent, failed to ease pressure against the dollar in exchange markets. Throughout the remainder of February and early March, 1973, foreign central banks were obliged to intervene in the exchange markets and buy dollars to prevent the value of their currencies from exceeding the limits agreed upon by International Monetary Fund (IMF) members at the 1971 Smithsonian conference. Once the inability of intervention to restore confidence had been demonstrated, exchange markets were closed to give monetary officials an opportunity to decide what measures should be instituted next. In early March, these officials determined that most major currencies would be allowed to float in exchange markets. Six EEC members (Belgium, Denmark, France, Germany, Luxembourg, and the Netherlands), later joined by Sweden and Norway, resolved that their currencies would float together.

Exchange markets reopened on March 19, and generally stable conditions persisted until early May. At that time, however, as a result of a variety of factors—especially the deepening political crisis and unchecked inflation in the United States—a new slide in the external value of the dollar began. Since the beginning of May, the dollar cost of purchasing a West German mark has soared—alternatively, the external purchasing power of the dollar has plunged—by over 17 percent, and significant, although smaller, declines in the exchange value of the dollar have occurred with respect to other major currencies. As the accompanying table indicates, the external value of the dollar in terms of a number of major currencies has declined sharply since the beginning of 1971.

FOREIGN EXCHANGE RATES

[Dollars per foreign currency unit, percent change from Dec. 31, 1970]

Country	Dec. 31, 1970	Dec. 31, 1971		Dec. 31, 1972		Feb. 28, 1973		Apr. 30, 1973		July 31, 1973	
		Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Canada	0.9898	0.9978	0.81	1.0044	1.48	1.0059	1.63	0.9968	0.71	0.9990	0.93
Belgium	.0201	.0223	10.95	.0227	12.94	.0253	25.87	.0248	23.38	.0284	41.29
Denmark	.1335	.1416	6.07	.1460	9.36	.1618	21.20	.1600	19.85	.1830	37.08
France	.1812	.1914	5.63	.1951	7.67	.2280	21.85	.2188	20.75	.2456	35.54
Germany	.2741	.3060	11.64	.3123	13.94	.3517	28.31	.3525	28.60	.4315	57.42
Italy	.0016	.0017	6.25	.0017	6.25	.0018	12.50	.0017	6.25	.0017	6.25
Japan	.0028	.0032	14.29	.0033	17.86	.0037	32.14	.0038	35.71	.0038	35.71
Netherlands	.2780	.3073	10.54	.3100	11.51	.3503	26.01	.3372	21.30	.3911	40.68
Norway	.1401	.1490	0.89	.1504	7.35	.1672	19.34	.1684	20.20	.1900	35.62
Sweden	.1934	.2056	6.31	.2106	8.89	.2237	15.67	.2212	14.37	.2492	28.85
Switzerland	.2418	.2554	5.62	.2650	9.60	.3197	32.22	.3086	27.63	.3536	52.61
United Kingdom	2.3938	2.5522	6.62	2.3481	−1.91	2.4900	4.02	2.4888	3.97	2.5276	5.59

Background of the Subcommittee's Hearings

In September, 1972, the Subcommittee conducted hearings to investigate, among other issues, the foreign exchange market intervention activities of the Treasury and Federal Reserve System. Previous to August 15, 1971, the Federal Reserve had borrowed heavily under a swap network established among major central banks to finance purchases of weak currencies. These drawings by the Federal Reserve under the swap network carried an exchange rate guarantee. When the 7.9 percent dollar devaluation was agreed upon at the Smithsonian, these guarantees cost the Federal Reserve and the Treasury together approximately $330 million.

The Subcommittee received assurances in September, 1972, from Under Secretary of the Treasury Paul Volcker and Federal Reserve Board Chairman Arthur Burns, that in the future swap drawings would not be made to finance chronic U.S. payments deficits, but would be used only to avoid disorderly conditions in exchange markets and to finance capital outflows that could be expected to return to the United States in the near-term future. In a report issued November 15, 1972, the Subcommittee recommended: "The swap network among central banks should be used to finance only temporary payments outflows that can be expected to reverse themselves in a matter of months. Exchange market intervention financed through either the swap mechanism or Treasury obligations bearing an exchange rate guarantee should never again be used to postpone an exchange rate adjustment necessitated by fundamental balance-of-payments trends."[1]

In late January, 1973, the Federal Reserve engaged in a significant amount of exchange market intervention to attempt to halt the slide in the external value of the dollar then under way. This effort proved unsuccessful and, with the announcement of a 10 percent devaluation on February 12, U.S. monetary authorities implicitly acknowledged that the 1971 devaluation had been inadequate and had left the U.S. balance of payments in fundamental deficit.

When the announcement of the second formal devaluation failed to remove skepticism about the future worth of the dollar, monetary authorities appropriately resorted to the expedient of permitting exchange rates to float and letting the market determine the dollar price of other currencies on a day-to-day basis. This alternative was clearly preferable to that of continued intervention and the accumulation of additional billions of U.S. dollar debts to foreign monetary authorities. Such massive intervention efforts in the past had invariably failed, and had produced inflationary bulges in the domestic money supplies of those countries, notably Germany and Japan, receiving large amounts of dollars.

The Advantages and Disadvantages of Floating Rates—What the Witnesses Said

Given the strictures expressed by the Subcommittee in our last report regarding official intervention in exchange markets and, hence, a favorable disposition toward letting market forces establish exchange rates rather than relying upon central bankers and finance ministers to

[1] "Gold, SDR's, and Central Bank Swaps". Report of the Subcommittee on International Exchange and Payments of the Joint Economic Committee, U.S. Congress, November 18, 1972, p. 10.

manage exchange parities, we were interested in the impact on the international trade and capital flows of the March decision to permit exchange rates to fluctuate among several of the major currencies. Hearings were therefore held June 20–27, 1973, to obtain the views of academic economists and U.S. officials, and especially to gain first-hand information from corporate financial officers and commercial bank exchange traders who had been dealing day-to-day with the realities of floating exchange rates.

In brief, the response obtained from our witnesses was mixed.

Some asserted that the increased cost of insuring against rate fluctuations had curtailed international trade and intensified inflation. In the event that insurance was unavailable, international transactions were said to have been stifled. The critics of fluctuating rates asserted that central bank intervention was necessary to avoid wild fluctuations in market prices for the major currencies and to help establish a trend. The fear was expressed that politically influential domestic economic interests in each of the major industrial countries would attempt to influence the direction of a float and, hence, that competitive exchange rate changes, such as in the 1930s, might result. To prevent rates from floating in a direction that was not desired by a particular country's authorities or private interests, controls over capital flows might be introduced. Finally, the fluctuations associated with floating exchange rates could upset domestic economic policies and add to the uncertainties of economic planning—especially for developing countries.

By contrast, other witnesses asserted that the cost of insuring against exchange loss was no more under fluctuating rates than it had been during periods of uncertainty with fixed rates. They reported that many manufacturing firms and financial institutions were adjusting with minimal difficulties to a fluctuating rate regime. Fluctuating rates were credited with preventing the huge international capital flows that had occurred when fixed rates had assured speculators against any substantial loss. Proponents of fluctuating rates maintained that introducing this regime had prevented the imposition of additional capital controls and had given policymakers an additional degree of independence in formulating and implementing domestic policies.

A complete economic analysis of the advantages and disadvantages of floating versus fixed exchange rates cannot appropriately be contained within the pages of a committee report. Moreover, the hearings conducted by this Subcommittee were not sufficiently extensive to serve as a basis for such an analysis. Instead, we are faced with the practical choice between the floating exchange rate regime that exists today and the alternative return to a fixed rate system managed by monetary authorities. The international monetary reform discussions now being conducted by the IMF's Committee of Twenty may provide additional options.

A period of political tension in the United States is hardly an appropriate time for judging the desirability of fluctuating exchange rates. In some respects, however, this may be the best time for testing a fluctuating rate regime. A negative standard can be applied: if the international monetary system survives this period of political difficulties under a fluctuating rate regime without a contraction in international trade and investment and without the widespread introduction of additional exchange restrictions, then the fluctuating rate regime will have demonstrated its resilience and vitality.

In any event, a reformed international monetary system will not be agreed upon and implemented for two or three years. The major effects of a fluctuating exchange rate system, therefore, deserve examination and review.

Why a Return to Fixed Rates, Prior to Adoption of a Reformed Adjustment Procedure, Would Be a Mistake

Until the IMF's Committee of Twenty produces an international monetary reform proposal that is endorsed by the required majority of member states, there will be no generally agreed procedure among national monetary authorities on how and when to adjust exchange rates. In the absence of general agreement on the mechanics of such an adjustment mechanism, the alternative to fluctuating exchange rates would at this time be a return to an announced set of fixed parities. These parities would necessarily be defended by mutual lending arrangements to finance central bank exchange market intervention.

A return to the fixed parity regime would be a mistake. The reinstatement of fixed rates would produce more serious difficulties than now exist. Problems would arise in terms of (*a*) market stability, (*b*) impediments to international trade and investment, (*c*) competitive exchange rate movements, and (*d*) domestic economic policymaking.

(a) Market stability

From mid-March, 1973, when monetary authorities announced their decision to allow most exchange rates to float (or in the case of several European countries, to float jointly), through the end of April, fluctuations in market rates were relatively modest. Since the beginning of May, however, the slide in the exchange value of the dollar and the complementary increases in the dollar prices of many other major currencies have been precipitous. The failure of this trend to reverse itself, and the consensus among economists that the dollar is now undervalued internationally, exposes the fluctuating exchange rate system to the charge of chronic instability. If dollar exchange rates vis-a-vis most other major currencies now indeed understate the true international competitive prowess of the United States, why isn't a reversal clearly under way?

Undoubtedly there are many exchange dealers and international traders who would like to see monetary authorities take a stand regarding exchange rates and try to bring about a tunraround and subsequent rise in the dollar's value through massive intervention, if necessary. At the same time, many observers of international economic developments remain skeptical about the ability of U.S. policymakers to restrain inflation and keep domestic demand under control.

If a new set of exchange parities were announced, the reaction of many holders of liquid assets would be to test the determination of authorities to maintain these rates by moving large amounts of funds out of dollars and into other currencies. Such capital transfers would be precautionary as long as inflation continues in the United States, current political difficulties are not resolved, and an obviously sustainable strengthening of the U.S. balance-of-payments position has not yet occurred.

Experience with fixed but adjustable parities in recent years demonstrates that officially announced exchange rates, even if defended through massive market intervention, fail to guarantee stability in the face of what holders of liquid assets consider to be fundamental economic disequilibria. In fact, fixed rates and intervention merely permitted holders of assets denominated in suspect currencies to convert their resources at officially subsidized rates into assets denominated in strong currencies. Thus, fixed rates tended to induce larger international transfers of short-term capital than fluctuating rates. These transfers were temporarily financed through market intervention by monetary authorities, but such intervention could not be maintained indefinitely. When exchange rate changes came, they tended to be larger and more disruptive than under the present fluctuating mechanism.

(b) Impediments to international trade and investment

To date there is scant evidence that the adoption of a fluctuating exchange rate system has produced a decline in the growth of international trade below the rate that might otherwise have been expected. Although some witnesses testified that the cost of buying or selling foreign exchange in the future to insure against the risk of losses had risen, other experts asserted that such costs had been just as high at times under the fixed rate regime. If the attempt were still being made to adhere to fixed parities, the cost of insuring against exchange losses would most likely be little different from actual costs.

Investment across national boundaries has, of course, been affected by fluctuating exchange rates. Some of these effects have been desirable, and others, at least from the United States point of view, have been no worse than could have been expected under fixed rates.

The most helpful consequence has been the capacity of fluctuating rates to prevent massive international transfers of liquid assets. Previously such funds tended to move from one country to another as financial managers sought either to avoid devaluation losses or to make quick gains resulting from expected increases in the exchange value of strong currencies. Under fluctuating rates the exchange value of a suspect currency immediatly depreciates in the event of substantial sales, and the cost of purchasing a favored currency rises significantly in the face of strong demand. Large transfers of funds for short-term investment therefore tend to be stemmed before they can get under way.

When, under the fixed parity system, foreign central banks were obliged to purchase dollars offered on exchange markets in amounts exceeding private demand for dollars, these capital flows into strong currency countries led to equivalent or even larger increases in domestic money supplies. The domestic monetary expansion induced by exchange market intervention was often large enough to be inflationary. The absence of large speculative international capital flows has eased the problems of monetary management for the officials of countries that previously attracted funds from abroad. Moreover, because fluctuating exchange rates have removed most of the incentives that previously produced sudden shifts of liquid assets from one country to another, the controls on capital flows that one might have expected under a fixed rate regime have, in fact, been avoided.[2]

The deterioration in the exchange value of the dollar—as long as it continues—discourages foreign portfolio and direct investment in the United States. This circumstance would exist regardless of whether the dollar were in danger of being devalued again or, as has actually been the case, it was allowed to depreciate gradually from day-to-day in the face of selling pressure on exchange markets. As long as there is a reasonable prospect that dollar denominated investments can be obtained cheaper in the foreseeable future, the prudent foreign investor will delay. This factor, perhaps backed by a self-reinforcing pessimistic attitude among exchange dealers and liquid asset holders about the immediate prospects of the dollar, contributed to the sharp deterioration in dollar exchange rates. The deterioration in the external value of the dollar has apparently been halted. Once a reversal in the previous trend is evident, investment will begin moving into this country in substantial volume.

The decline in the exchange value of the dollar is no cause for jubilation; it has curtailed the real incomes of Americans and, under present conditions of short supply in agriculture and many industries, tends to be inflationary. It has, however, had the desirable effect of causing U.S. manufacturing concerns to reconsider the transfer of their operations overseas. A growing over-valuation of the dollar prior to August, 1971, had encouraged the export of U.S. jobs and caused the shut-down of production lines for goods that can today be manufactured here at competitive prices. Permanent undervaluation of the dollar would be cause for the same kind of concern that the previous over-valuation elicited. But the current temporary slump may well help to redress a balance that had been pushed too far in the other direction.

(c) Competitive exchange rate movements

Since the 1930's floating exchange rates have been associated with competitive devaluations. However, fixed exchange rates are also subject to competitive exchange rate management. Throughout the 1960's and the early 1970's, established parities were extensively and energetically maintained through official intervention and, to some extent, domestic economic policies. Faced with a progressively deepening competitive disadvantage, the United States suffered from a fixed parity system that permitted exchange rate adjustments only as a consequence of tremendous upheavals. Policymakers with mercantilistic orientations and major industries dependent upon export sales can, of course, work to prevent any increase in the external value of their nation's currency. But such activities can occur under either a fixed or flexible exchange rate regime, and indeed may be pursued more subtly and persistently with a fixed regime.

The outstanding contrast between present circumstances and the events of the 1930's is the level and intensity of communication among monetary authorities in the major industrial countries. As long as central bankers and Treasury officials keep talking to one another and

[2] Rep. William S. Moorhead adds: "With floating rates, the elimination of U.S. controls on capital exports—which Treasury Secretary Shultz has envisioned terminating by the end of 1974—should be feasible even sooner."

are concerned about the opinions of their counterparts, competitive exchange rate management to benefit one country and disadvantage others will almost certainly be kept within tolerable limits.

Because of the danger of competitive exchange rate management, any proposal to reform the international monetary system should include detailed guidelines specifying the amount and type of exchange market intervention that is permissible. Such guidelines, in combination with agreed procedures for adjusting exchange rates promptly as payments disequilibria emerge, would prevent monetary authorities in different countries from intervening at cross purposes, and would assure that exchange rates adhere closely to the relative competitive abilities and capital exporting or importing propensities of all IMF members.

(d) Domestic economic policymaking

Certainly at times the existence of a floating exchange rate regime can complicate domestic policymaking for the participating countries. The recent increases in prices of foods and other agricultural products in the United States, and the consequent efforts to control these increases, are an excellent example of the difficulties that may be intensified by fluctuating exchange rates. The global shortage of high protein feed grain would have driven up the cost of meat and poultry production in any case. But because this shortage occurred simultaneously with a slide in the foreign exchange value of the dollar, prices in the United States for these commodities increased even faster than they otherwise would have.

Although the U.S. economy is not nearly so open as many others, if openness is measured as the fraction of gross national product that is traded internationally, we are experiencing some of the problems that countries face when contending with inflation domestically and a drop in the value of their currency externally. The attempt to freeze domestic food prices was abandoned when it became obvious that the consequence of this policy would be to constrict the supply of meat, poultry, dairy products, and fruits and vegetables offered to American consumers.

Advocates of floating rates sometimes claim that this system frees domestic economic policy from balance-of-payments constraints. Any such assertion is an overstatement, in that no exchange rate regime can relieve a country from making the costly adjustments necessary to eliminate payments disequilibria. Fluctuating rates can, however, help minimize these adjustment costs. With fluctuating rates, adjustments are made promptly and gradually. Untenable exchange rates cannot endure long enough for either export industries to be built up, or for domestic industries supplying the home market to expire under the pressure of import competition.

Moreover, balance-of-payments surpluses and deficits manifested by increases and decreases in national reserve stocks need not occur, since the exchange rate for each currency can move up or down on a day-to-day basis to equate the amounts of the currency that private parties seek to offer and desire to purchase.

The absence of increases and decreases in reserves does produce real advantages. In surplus countries, the inflationary effects of reserve increases are avoided, and the gains from a strong competitive position or capital imports are realized immediately as imports become cheaper and more of domestic production is available for internal consumption. In deficit countries, policymakers can concentrate on maintaining domestic full employment and maximizing real income, an important component of which is the external purchasing power of the nation's currency. On the other hand, against these savings realized by adjusting promptly must be set the costs of occasionally adjusting in response to what prove to be transitory exchange rate movements.

The spokesmen of developing countries have been particularly critical of the costs that fluctuating exchange rates have imposed upon their nations. Among such costs are the need to adjust to exchange rate changes that result from events wholly external to developing nations and that may shortly be reversed. Since the ability of these countries to absorb such losses without sacrificing economic growth is minimal, these costs cannot be dismissed lightly. In reaction to such considerations, the Subcommittee included, in a panel of three economists invited to testify, one spokesman of developing country interests.

The panel generally agreed that a fluctuating exchange rate regime is not the best system for every country and, in fact, is probably an inferior arrangement for many developing countries. But a poorer nation is not forced to adopt a fluctuating exchange rate, even though the major industrial nations of the world do. A developing country may, on its own volition, peg the external value of its currency to that of its major industrial trading partner. Of course, if a developing nation trades in significant amounts with a number of industrial countries, adoption of this policy will not totally eliminate the problems resulting from the widespread adoption of a floating rate system. But this expedient can at least minimize the costs.

Conclusions

On balance, therefore, we conclude:

Conclusion No. 1

Comparison of the advantages and disadvantages of fluctuating exchange rates leads to the conclusion that, at this time when agreement among IMF members on how and when to adjust exchange rates to prevent balance-of-payments disequilibria has not yet been reached or implemented, fluctuating rates are presently the best available alternative, and are clearly superior to fixed parities.

The resolution of existing political uncertainties in the United States, an anti-inflationary policy that is credible to foreigners, and clear signs of a strengthening of the U.S. balance of payments will reverse the slide in the external value of the dollar that critics of fluctuating rates have scored as a psychological malady feeding upon itself. In the absence of these developments, an attempted return to fixed rates backed by massive intervention would be futile and dangerous.

In recent years the use of massive intervention to support existing exchange rates has in no case succeeded in laying to rest a strong challenge. The expansion of the Euro-dollar market, the spread of knowledge among corporate financial officers on how to transfer funds internationally, and increased sensitivity to avoiding losses, to protecting expected income streams, and to reaping potential profits, has produced international capital flows that are too large for central bankers to counter successfully. Moreover, intervention efforts have invariably led to substantial increases in U.S. dollar liabilities to official and private foreigners. In the end, the exchange rate changes that officials sought to resist have occurred. Given these circumstances, the only sensible alternative was to adopt an exchange rate regime—the fluctuating rate system—which would quell flights of capital before they began.

The question remains whether exchange market intervention can play a useful function in a fluctuating rate system. Economic theory can provide arguments both for and against intervention. The issue must thus be resolved in terms of the actual effects of intervention under varying circumstances and in different amounts.

Intervention cannot buck fundamental economic trends and what holders of liquid assets believe to be the prospective impact upon exchange rates of these trends. If official intervention has a useful role to play in exchange markets, that function includes shearing the peaks and troughs off market fluctuations and lengthening the period of these cycles. The talent that officials need is the ability to anticipate turning points in short-term fluctuations and hence to confine actual variations in exchange rates within a narrower range of the long-term trend than would otherwise be the case in the absence of intervention. Efforts by United States officials in the past to resist long-term trends have been costly in terms of reserve losses, enlarged dollar liabilities to foreigners, manufacturing jobs lost, and established positions in foreign markets captured from American firms by foreign producers. No attempt should be made to return to fixed parities. As Under Secretary of the Treasury Paul Volcker said before the Committee: "An attempt to fix now a rigid structure of exchange rates would risk a return to massive capital flows, increased restrictions, and intermittent closing of markets—precisely the conditions we want to avoid."

Conclusion No. 2

Under no circumstances should intervention in exchange markets by U.S. monetary authorities be massive, continuous, and committed to maintaining a fixed exchange rate between the dollar and any other particular currency. Intervention may be useful in reducing short-term variations in exchange rates and in establishing a psychological climate that will facilitate a recovery in dollar exchange rates when economic developments convince private interests that the United States has resolved its political tensions, has domestic inflation under control, and has strengthened its balance of payments. Any intervention that is conducted should be limited in amount, used from time to time rather than continuously, and applied with respect to an underlying trend rather than a particluar rate. Intervention should never again offer private interests the alternatives of minimal losses in the event that exchange rates do not change, or substantial gains in the event of an exchange rate realignment.

O