DON'T GO FOR THE GOLD

BY JEFFREY SACHS

UNTIL RECENTLY, international monetary reform was not a glamorous issue. When the world monetary system was collapsing in the early 1970s, Bob Haldeman rushed into the Oval Office to announce that there was dangerous speculation against the Italian lira. The Watergate transcripts record President Nixon's classic response: "I don't give a [expletive deleted] about the lira." Now everybody is talking about exchange rates. They dominated the Tokyo economic summit in May. Representative Jack Kemp sees monetary reform as his ticket to the White House in 1988.

But exchange rates are a strange political issue. They do not pit liberals against conservatives or the president against Congress. Nor is there an orthodoxy of the economics profession, as there is, say, about free trade. Monetarist Milton Friedman and Keynesian Paul Samuelson are staunch defenders of floating rates, while supply-side guru Robert Mundell and former Carter administration official Richard Cooper urge a move back toward fixed exchange rates.

History provides little guide for many of the questions in the current debate. For most of the past century, monetary policies and exchange rate policies were easier. Most currencies were fixed in value to gold, or were fixed in value to other currencies that were in turn fixed to gold. Governments adjusted their money supplies to maintain these fixed values. That basic system, with some warts and scars, ruled the world economy from 1870 to 1970. It broke down only temporarily during wars and the Great Depression. But since 1971 the major currencies have no longer been backed by gold. And since 1973 there has been no organized system to maintain their relative values. They have fluctuated freely according to supply and demand. The period between 1973 and 1986 is the longest peacetime experiment in fluctuating exchange rates in centuries, and the first in the era of worldwide interdependent economies.

When the system of gold and fixed exchange rates crumbled in the late 1960s, men of affairs mourned while many academic economists, led by Milton Friedman, looked forward to a free market in national currencies. These economists argued that speculators would keep exchange rates fairly stable and close to their "fundamental" values by buying currencies that got too low and selling those that got too high.

Recent events have not borne out this optimism. The floating exchange rate system has been plagued by large and unpredictable swings in the values of the major currencies. Ten years ago, in January 1976, a dollar bought 2.6 deutsche marks. Four years later it bought only 1.7. By January 1985 it was back up to 3.1. Now it's back down to 2.2. Similar swings have affected other currencies as well as the price of gold. From 1879 to 1933, an ounce of gold cost $20.54. At the bottom of the Depression, the dollar was devalued to $35 per ounce, where it remained fixed until August 1971. Since then, the price soared to $160 in 1974; fell to $125 in 1976, peaked at over $1,000 in 1980, and since has declined sharply to $340. The farm crisis and the international debt crisis owe much to a similar boom-and-bust cycle of prices in other commodities during the past 15 years.

Businessmen and financiers are dismayed. Huge currency fluctuations make it impossible to plan rationally for international trade. Whole industries in the United States were made unprofitable by the strong dollar during the first Reagan term, and millions of jobs in export sectors were lost. If the dollar continues to weaken, it will next be German and Japanese exporters that are seriously squeezed, if not eliminated. And wherever exports are squeezed, pressure grows for trade protectionism. The overvalued dollar has been the greatest threat to free trade in decades. The damage when the currency market swings against you far exceeds the benefits when it swings toward you. What the nations of the world need is neither overvalued nor undervalued currencies, but stable currencies.

Since floating exchange rates are a historical novelty, it is understandable that speculators have not performed their assigned task of stabilizing prices. The supposed "fundamental" values of the exchange rates and commodities prices depend heavily on government monetary and fiscal policies, and the direction of those policies often has been hard to fathom in the past 15 years. Far from aiming to stabilize exchange rates, the Carter and Reagan administrations have pursued a bewildering array of contradictory policies concerning the value of the dollar. At first the Reagan administration bragged about the strong dollar as a vote of confidence in Reaganomics by the world financial community. More recently, it has bragged of its success in talking down the dollar, in order to improve the U.S. trade position and forestall protectionism.

It is certainly possible to prevent large swings in exchange rates and commodities prices. But what's possible and what's desirable are two different things. The real problem is that we have come to demand a lot more from monetary policy than just stable exchange rates. We want our monetary system to help bring low unemployment, low interest rates, low inflation, and so on. Balancing these...
goals is even more complicated because many governments must be involved in the decision process.

The easiest way to avoid big swings in exchange rates would be a common world currency. After all, we don’t worry about the exchange rate between Louisiana dollars and Massachusetts dollars. A single large market with a common currency is central to America’s economic might. Why not extend the same benefit to the whole world, or at least to the major industrial countries? Because governments treasure their right to issue their own currency. Last year, when a finance minister in Israel proposed using the dollar as Israel’s currency, he was booted out of office in less than a day. More than national pride is involved. A government without its own currency can’t pursue its own monetary policy. The same loss of freedom is involved, to a lesser extent, when a government decides to fix the exchange rate of its currency to another currency or to gold.

The main freedom that comes from having your own currency is the freedom to print it. By printing pieces of paper designated as money, governments are able to purchase goods and services that they do not, and perhaps dare not, pay for through explicit taxation. A $100 bill costs a fraction of a cent to print, but it buys a full $100 worth of goods. Since printing money is such a lucrative activity, governments monopolize it. Of course too much paper printing leads to high inflation and a falling exchange rate. A national currency also allows a government to use monetary policy to affect interest rates, prices, and employment. Like a single world currency, any managed exchange rate system reduces each country’s monetary freedom. When a country fixes its currency to gold, it must be ready to buy and sell gold at the official price. If it prints too much paper currency, it will run out of gold if it doesn’t raise the price. Likewise, if a foreign government pegs its currency to the U.S. dollar, the government will run out of dollars if it prints too much currency of its own.

In an international exchange rate system, the participating countries must agree to rules. If they decide to fix the rates, they must also decide how to share the responsibility for monetary management. For Germany and the United States to have a fixed exchange rate, they must be expanding their money supplies at about the same rate. But who should set the rate?

The classical gold standard, in its heyday between 1879 and 1914, was the fixed exchange rate system par excellence. The coordination problem was largely avoided because each currency was pegged to an outside asset—gold. Exchange rates between currencies were fixed as a side effect of the fact that each of the currencies was fixed to gold. The gold standard effectively tied the money supplies in each country to the amount of gold in the world economy. In periods of major gold discoveries, money supplies soared and world prices rose. In periods of little gold discovery, world prices tended to fall.

The system had one great virtue: by limiting money supply increases to gold discoveries, the gold standard solved the problem of chronic inflation. Price increases in some periods balanced price declines in others. On the other hand, with money supplies tied to the vagaries of gold discoveries, inadequate gold discoveries caused intense economic hardship, such as the first “Great Depression” of 1873 to 1896. In the Great Depression of the 1930s, finance ministers learned that they could spur their economies to recovery by abandoning the restraints of the gold standard and expanding their money supplies.

The Bretton Woods system, designed largely by John Maynard Keynes, provided the monetary framework between 1946 and 1971. The hope was to build a system that was not as vulnerable to the vagaries of gold discoveries, or as inflexible in the face of mass unemployment. Price and exchange rate stability was no longer enough. After the torment of the 1930s, the public expected the monetary policymakers to focus at least as much on unemployment as on the more traditional aims of central bankers.

The resulting system was a hybrid. The United States undertook to fix the dollar at $35 per ounce of gold, while the rest of the world undertook to maintain their currencies at a fixed value to the dollar. Only in extreme circumstances, with international approval, could countries change their exchange rates. In effect, they could print more money if necessary to avoid high unemployment.

For the U.S. promise to buy and sell gold at $35 per ounce to be credible, U.S. monetary policy had to be strongly linked to the country’s gold supplies. But there was little taste for this kind of discipline. The tension was settled definitively during the Vietnam War. The United States simply printed too many dollars to be able to give an ounce of gold to anyone who showed up at Fort Knox with 35 of them. In 1971 President Nixon announced that the U.S. government would no longer honor its commitment to sell gold. This repudiation was far more important than any possible debt repudiation by a Latin American country today. The United States left the rest of the world holding a huge stock of rapidly depreciating dollars that all had assumed were as good as gold!

The other countries of the world had a choice. They could continue to peg their currencies to the dollar, and follow whatever monetary path the newly liberated United States chose to pursue. Or they could break with the dollar and pursue their own policies. The first approach was tried in the so-called Smithsonian Agreement of December 1971. That monetary savant Richard Nixon hailed it “the greatest monetary agreement in the history of the world.” Almost immediately, the United States went on a spree, as Federal Reserve chairman Arthur Burns pumped up the economy in time for the 1972 election. The fixed exchange rate system automatically passed along this inflationary spree to all of the other currencies pegged to the dollar, thereby setting off the inflationary explosion of the 1970s. In March 1973 Germany, Switzerland, Japan, and others had had enough and chose to break loose. The floating rate system was born.

During the first Reagan term, the dollar rose by about half in relation to other currencies. The devastating effect on America’s international competitiveness, more than any-
thing else, has reawakened interest in some kind of return to fixed exchange rates. The trouble, as always, is that stable exchange rates require coordinated monetary policies. The main cause of the strong dollar was higher interest rates in the United States than abroad. Both Reagan’s large budget deficits and Fed chairman Paul Volcker’s tight monetary policies pushed up U.S. interest rates and thereby attracted investment capital from Europe and Japan. As foreign investors rushed to buy dollar assets, the value of the dollar rose.

In September 1985 the finance ministers of the “G-5” countries—the United States, Britain, France, Germany, and Japan—led by Treasury Secretary James Baker, called publicly for coordinated actions to bring down the dollar. They did not announce what specific actions they had in mind. Nevertheless, to the surprise of many observers, the dollar obliged by dropping about 15 percent against the other currencies over the next three months. U.S. interest rates fell compared to foreign interest rates, mainly because of a continuing easy money policy in the United States, and because of the expectation of budget cuts under the Gramm-Rudman law. But Germany and Japan resolutely rejected U.S. urging to help the process along by expanding their own budget deficits.

Policy coordination got two further boosts in 1986. First, the G-5 countries managed to reduce interest rates simultaneously after the oil price collapse, all assuming that the risk of renewed inflation was reduced. Then, at the Tokyo summit in May, the summiteers agreed to what they have sometimes called “enhanced surveillance” of exchange rates. This meant that the leading countries (now the “G-7,” including Canada and Italy) agreed to scrutinize each other’s policies more closely, using a series of “objective indicators,” or key economic statistics. Basically, this just means that it is fair game for countries to complain in a more organized way about other countries’ monetary policies. It does not mean a new set of rules for fixed exchange rates. “Enhanced surveillance” may seem silly. But in fairness to Secretary Baker, the leading countries can only move slowly into a new and rigid arrangement. Politically, countries are far from ready to accept the international limitations necessary for real fixed rates. And the systems favored by various “experts” are generally vague and often deeply flawed.

Consider the problems the United States would have faced recently under a fixed exchange rate system. For the first half of 1986, U.S. economic growth has been much weaker than expected. Many economists and politicians (including the White House) are pushing for easier money and lower interest rates. But under a jointly managed fixed exchange rate with, say, Japan, the United States could not unilaterally lower interest rates since that would weaken the dollar relative to the yen. U.S. monetary policy would be stuck unless Japan agreed to a cut in its interest rates. If the Bank of Japan held firm, Volcker would have to march up to Congress to explain that “yes, high interest rates are causing rising unemployment in the United States, but Japan says that they have to stay that way.”

Even if the countries could agree on ways to share the monetary responsibilities, the technical merits of alternative arrangements are still open to debate. Whatever Kemp’s expectations, the gold standard is simply a nonstarter. Gold today has lost the mystique necessary to make grown men ignore unemployment, trade, and other pressing concerns in order to honor a commitment to fix its price. Also, gold production today is heavily concentrated in the Soviet Union and South Africa, not a lovely base for a reconstructed monetary system.

There are other proposals about. One is a fixed exchange rate system based on a monetarist-style fixed growth of supply in all currencies. Another is a system in which currency fluctuations are limited to “target zones.” Still another would prevent wild swings in currency values by setting up regulatory barriers to capital flows between countries (to prevent “hot money” pulled by interest rate differentials from upsetting a given exchange rate target). But most proponents of these systems haven’t grappled with the crucial question: which countries will have to bend to the will of the others when exchange rates start to move too far? Most advocates of target zones, the leading “practical” alternative to the current system, have systematically ducked that issue.

Nevertheless, the leading countries are seriously intent on reducing the damage from highly volatile exchange rates. In judging the drama as it unfolds, viewers who give a [expletive deleted] should keep their eyes on the following issues:

First, is everyone on the same wavelength about how the world economy works? No other country is interested in sharing the same boat with a U.S. administration that denies the inflationary risks of high budget deficits, or the link between budget deficits and high interest rates. To Secretary Baker’s credit, he has toned down the supply-side nonsense of the first Reagan term. But Germany and Japan are still nervous about joining their fates to a nation deeply immobilized by a fiscal crisis.

Second, is the United States prepared to give up much of its economic sovereignty? For much of this century, we could call the world’s economic shots. Now economic power is more evenly spread, and the United States is being particularly weakened as it becomes a heavily indebted nation. Fixed exchange rates will require sharing the shots with others. Will we do it?

Third, are Japan and Germany ready to assume the responsibilities of economic leadership that their economic power now requires of them? Both now have the clout to have a major influence. (Indeed, Germany already sets the tone of monetary policy in Europe.) But with this power comes responsibility. As economic leader the United States has financed European postwar reconstruction, bankrolled the military defense of the alliance, engineered the continuing bailout of the heavily indebted Third World countries, and taken the lead in the current attempt at policy coordination.

The answers to these questions will determine the pace and success of international monetary reform.