Domestic Stability Versus Exchange Rate Stability

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Purchasing Powers and Exchange Rates

In accepting the title assigned for this paper, I do not mean to agree that the two stabilities *necessarily* conflict. Often, to be sure, they do. Countries that clung to the fixed gold parities of their currencies in the early 1930s, including France and other members of the European gold bloc until 1936, suffered worse contagion of the world depression than if they had let their currencies depreciate. Other countries mitigated the contagion by accepting relatively early depreciation, as Great Britain and the Sterling Area countries did in 1931 and as Spain did around the same time.

Experience with the Bretton Woods system of fixed exchange rates after World War II provides many examples of countries suffering imported inflation in consequence of attempts to maintain fixed rates despite bullish speculation on their currencies. The upward floats of the German mark in September 1969 and May 1971, of the Swiss franc in January 1973, and of the Singapore dollar in June 1973, to mention just a few cases, were attempts, belated attempts, to ward off the further import of inflation. The worldwide spurt of monetary inflation in the early 1970s, followed in due course by accelerated price inflation, traces largely to attempts to keep dozens of currencies from rising against the U.S. dollar. This last-ditch defense of the Bretton Woods system finally collapsed early in 1973. The world economy would have fared better in the 1970s and afterwards (I could so argue) if policymakers had voluntarily abandoned the Bretton Woods system years earlier, before the worst damage had been done.

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None of this is to say that floating exchange rates guarantee domestic monetary stability. A floating rate can soften the domestic impact of monetary instability originating abroad, but no economist known to me ever argued that floating rates would provide insulation against all foreign disturbances. None ever argued that they would make sound monetary institutions and policies unnecessary. My own chief argument for abandoning the Bretton Woods system was that doing so would largely relieve national monetary authorities—or the more responsible among them—of balance-of-payments problems and other international complications and allow them to concentrate more nearly fully on achieving stability for their own countries. I did not hail the collapse of Bretton Woods when it actually occurred, for I regretted the particular way it came about and recognized that it represented no intellectual conversion on the part of policymakers.

Neither exchange rate stability nor purchasing power stability guarantees the other (for example, a domestically stable currency would fluctuate against unstable foreign currencies). The two stabilities could be compatible, however: Rates could be fairly stable among currencies of dependably stable purchasing powers.

Volatile and Misaligned Exchange Rates

Today's world exhibits both types of *in*stability. It is most conspicuous in exchange rates. Bilateral rates have fluctuated 10 and 20 percent over weeks and months and sometimes several percent from day to day or even within days. Over hours, days, months, and perhaps even years, gross capital transactions—transactions to reshuffle asset portfolios, including speculative transactions—have far overshadowed trade in goods and services. The *daily* volume of foreign exchange trading in the United States, Britain, and Japan alone is estimated to total nearly $200 billion (*Wall Street Journal,* 28 December 1987, p. 24).

One apparent source of rate volatility is "noise" (cf. Black 1986). High-technology communications and data processing bring facts and figures and rumors to the attention of traders more frequently and in more discrete bits than in the past, causing frequent shifts in noise-oriented trading decisions. The special role of the U.S. dollar as the predominant transactions, vehicle, reserve, and intervention currency places it in a particularly conspicuous and vulnerable position. Participants in sensitive markets must eagerly watch each day's economic and political news and must not only form their own interpretations but must also wonder what other people's interpretations

are likely to be. No wonder quasi-speculative capital movements, and exchange rates in consequence, are as volatile as they are.

Official market intervention, though ideally smoothing exchange rate movements, contributes to the noise. It is an unsettled issue whether intervention, together with news and rumors of its being started, altered, or suspended, has made exchange rates more or less volatile on the whole than they otherwise would have been. (My 1976, chapter 14, discusses how intervention might increase volatility and surveys episodes in which it apparently did.) For several years I have been collecting stories from the *Wall Street Journal* and other financial publications purporting to explain hour-to-hour, day-to-day, and week-to-week jumps in exchange rates. Remarkably often the stories point to changes in intervention and to rumors and supposed clues about it, including statements and offhand remarks of government officials. I wonder how the foreign exchange market would have behaved without such disturbances.

Floating rates have exhibited not only short-run volatility but also medium-run misalignments, resulting—critics plausibly allege—in distorted patterns of trade and production and in wasteful shifts of resources between domestic industries and export and import-competing industries. Only in a tautological, pollyannistic sense can one say that the exchange rate of the dollar has been "right" all along, even at its trough of mid-1980, its peak of early 1985, and its current depressed level.

Superficial Advice

It is superficial to conclude that we should have kept exchange rates fixed 15 years ago and that we should fix them again now. Prodigious efforts to keep them fixed simply collapsed. But if those efforts had somehow prevailed a while longer, what even more immense foreign-exchange crises would have destroyed the system in the face of the even more unstable "fundamentals" of the 1970s and 1980s, including the oil situation and swollen national budget deficits! (One can plausibly argue, however, that even OPEC's predation was largely triggered by worldwide inflation tracing, in turn, to last-ditch defense of the Bretton Woods system.) More recently, even efforts to peg exchange rates loosely within fuzzy and unannounced ranges—the Louvre accord of February 1987—collapsed later that year. What is the point of saying that something should have been done or should now be done if in fact it could not and cannot be done?

It is superficial to argue against floating exchange rates by deploring the apparent consequences—first of the strengthening and then of the weakening of the U.S. dollar in the 1980s. A legitimate comparison between floating and fixed exchange rates must refer to otherwise similar circumstances—if, indeed, circumstances could have been kept otherwise similar. It is illegitimate to compare actual experience with a situation lacking the circumstances (such as those of the U.S. government budget) that made the dollar swing as widely as it in fact did. If we want to consider how things would have worked out with the dollar prevented from rising to its peak of early 1985, for example, we must specify how its appreciation would have been prevented. Monetary expansion, accomplished either by unsterilized exchange market intervention or by Federal Reserve policy, would have inflated prices of domestic goods relative to prices of internationally traded goods—would have lowered the latter prices relatively—and so would have affected resource allocation and the country's trade balance in a way similar to what in fact occurred. Preventing dollar-strengthening capital inflows, conceivably by direct controls, would have relieved domestic producers of internationally traded goods from some adversity; but it would have allowed interest rates to rise and government deficit spending to crowd out some interest-sensitive investment activity, including housing. (See, in part, Gradison 1986 and Frankel 1985.)

Where Lies the Absurdity?

It seems absurd to let so pervasively influential a price as a country's exchange rate jump around in response to investors' and speculators' changeable whims about their asset holdings. It seems absurd that changes in and expectations and rumors about monetary and fiscal policies, trade policies, and market interventions should be allowed to exert such quick, magnified, and pervasive effects. But we should be clear about just *what* is absurd. It is not the free flexibility of exchange rates (they are not *freely* flexible anyway). It is not the free-market determination of prices on the exchange markets.

The absurdity consists, rather, in what those prices are the prices *of*. They are the prices of national fiat moneys expressed in each other, each lacking any defined value. The purchasing power of each national money depends on confrontation between a restricted quantity of it and the demand for holdings of it. At bottom, the unit of account in the United States is whatever value supply and demand fleetingly accord to a scruffy piece of paper, the dollar bill. The value of each money thus depends on conjectures about the good intentions

of the government issuing it and about its ability to carry through on its good intentions. These conjectures are subject to sharp change, quite understandably.

It is an absurd system in which people cannot count on money's future purchasing power. Money's value simply emerges as the by-product of the monetary authorities' doing whatever seems best to them month by month and day by day. It is an absurd system in which the Federal Reserve gets badgered daily with diverse unsolicited advice in *Business Week* and the *Wall Street Journal* by such people as Alan Blinder, Paul Craig Roberts, Irving Kristol, Milton Friedman, and miscellaneous editorial writers.

Given this fundamental absurdity, it is irrelevant to propose mere changes in the details of how governments manipulate exchange rates. (The proposal for "target zones," it seems to me, is hardly more than a superficially attractive combination of words, words calling for all of the advantages and none of the disadvantages of both floating and fixed exchange rates.)

A fundamental solution would give defined values to currencies. A meaningful definition of a currency's value must consist of something more than a specified rate of exchange against one or more foreign currencies, each of which continues to lack a defined value. The most familiar and plausible kind of meaningful definition would run in terms of one or more commodities.

Commodity Money

Should gold be the single defining commodity? I agree with those who say that the world should never have gone off the gold standard, which means that the nations should never have blundered into World War I. I fervently wish we could repeal World War I and all its many evil consequences, but I do not see how. Restoring the special historical circumstances under which the gold standard appeared to flourish (but only for a very few decades) would have to include restoring certain attitudes that seemed more prevalent in public affairs before 1914 than now. Those attitudes favored limitations on government activity and restraint on seeking special advantage through the instrumentality of government. Without a return to liberal attitudes and self-restraints, a restored gold standard would not work well and would hardly endure. After all, the gold standard is simply a particular set of rules for monetary institutions and policy; and these rules are no more inherently self-enforcing than any other set of monetary rules. Even today, before we have gone back to a supposed gold standard, there is reason to suspect that what some of

its supporters are advocating is not a real but a pseudo gold standard, to echo a distinction made by Milton Friedman (1961).

The durability of a particular set of monetary rules will depend in large part on its performance characteristics, and those of the gold standard are far from ideal. (I waive discussing the difficulties of a *transition* back to gold; uncoordinated steps by individual countries would surely work badly.) A unit of account defined as the value of a quantity of a single commodity like gold is preposterous in the same general way as, though perhaps in lesser degree than, a unit coinciding with a unit of a fiat medium of exchange like the dollar bill. Like fiat money, gold has an unstable value in relation to other goods and services. The stock of gold is historically given and cannot rapidly accommodate changes in demand. The demand for it, under a gold standard, arises primarily from its use as coins and, especially, as a reserve and redemption medium for other forms of money; it is largely a monetary demand rather than a purely industrial or consumption demand. That demand shifts with changes in money-holding and reserve-holding practices, with the availability of near-moneys, and with other financial innovations.

The value of gold-based money is thus conventional or artificial only in lesser degree than the value of fiat money. The effective size of a gold-defined unit of value, like that of the fiat dollar bill, is defined poorly and is maintained only precariously. It is changeable in a way just not true of other units, like the meter or kilogram.

When, furthermore, the supply-and-demand situation calls for a change in the value of the money unit (that is, in the general price level) and if the supply of money is not cleverly manipulated to accommodate the demand for it, then monetary disequilibrium persists, bringing macroeconomic pains (Yeager 1986). In particular, prices and wages are not and cannot be flexible enough in the downward direction quickly to correct an excess of the demand for money holdings over their supply. And even if they were flexible enough, the associated rise in the real value of outstanding debts would cause trouble. A catch-22 plagues a system exposed to emergence of excess demand for or excess supply of money: It is damned both if prices *are* flexible enough and if they are *not* flexible enough to correct monetary imbalance quickly.

Money of Stable Purchasing Power

These considerations recommend seeking a system that would maintain balance between the demand for and supply of money at a stable general price level. The old issue of money of stable purchas-

ing power is ripe for reconsideration. A tentative judgment in its favor would have to be thrown out if no satisfactory way of *implementing* it turns out to be available. Before considering implementation, though, I want to review arguments for and against regarding a stable unit as an ideal.

Money whose value is under no pressure either to rise and fall is money whose actual quantity is in balance with the quantity demanded. By that very token, the economy employing it escapes the pains of monetary disequilibrium. Why monetary disequilibrium can be so painful and its avoidance so important hinges on certain distinctive characterictics of money, notably that it, among all goods, lacks a market of its own and a single price of its own on which the pressures of supply-demand imbalance can come to a focus and work effectively to maintain or restore equilibrium. The importance of this point is far out of line with how briefly it can be stated. (Admittedly, statement is not explanation; again, see my 1986 discussion.)

A more familiar line of argument for stable money—which can be challenged, as I recognize below—draws analogies between the unit of account and units of weights and measures. A seriously unstable unit impairs the meeting of minds between borrowers and lenders and other transactors. Economic calculation and the coordination of economic activities are at stake; for the unit of account is used pervasively in proposing the terms of transactions, in assessing costs and benefits, and in business and personal planning. Imagine the difficulty of constructing and equipping a house if the foot varied capriciously in size. The absurdity of unstable money is like letting the length of the meter fluctuate according to supply and demand in the market for meter sticks. A stable unit, in contrast, provides a sound basis for economic calculation and contracting.

Objections to the Goal of Price-Level Stability

One objection to seeking a stable unit of account rejects the analogy between such a unit and units of weight and length and other physical magnitudes. The kilogram and meter are widely applicable across time and space, and any redefinitions made are mere refinements (e.g., definitions of the meter as one ten-millionth of the distance between the equator and the north pole, then as 1,650,763.73 wavelengths of the radiation of krypton 86, and currently as 1/299,792,458 of the distance that light travels in one second). The definition of a unit of value in terms of a price index or basket of commodities, however, must concern itself with the quality characteristics of each commodity, the terms of its delivery satisfying the rules of specified

commodity exchanges, and other such technicalities. If changes in supply and demand conditions affecting commodities in the bundle defining the unit of value should require respecification of that bundle, it might be more difficult to keep the new and old values exactly equal at the time of redefinition than in the case of redefinition of the meter. The definition of the unit of value has a subjective aspect, furthermore, that is absent in the definition of physical units.

All this may be true, but it amounts to mere quibbles. Of course analogies between physical units and a value unit are just that, analogies, and not exact correspondences. So what? People do regard the unit of account—the money unit, under our existing system—as the unit for measuring values. They so use it every day. They so use it in trying to quantify prospective costs and benefits of purchases and sales and other activities and in forming and carrying out plans. Its use plays a vital role in coordinating the activities of different persons. People do not care about the dollar size or gold-unit size of a particular price, income, debt, or accounting magnitude except as it indicates value in relation to a much wider set of goods and services. A unit of greatly variable purchasing power subverts people's calculations and degrades the information supposedly conveyed by prices and accounting. If we take seriously the burgeoning literature on various subtle damages wrought by inflation, we should appreciate the importance of a stable unit.

Admittedly, the choice of a particular price index or bundle of goods and services for defining the unit is bound to be somewhat arbitrary, but we should not exaggerate the difficulty. What sorts of goods and services to consider, and even criteria for weighting them, should command a broad consensus. A real distinction holds between unmistakable change in the value of money as shown by *any* reasonable indicator and, on the other hand, genuine doubt about any trend in its purchasing power as some prices hold steady, others rise, and still others fall under pressures specific to their own markets. Maintenance of such doubt would count as achievement of a stable unit and would reflect avoidance of any severe monetary disequilibrium.

Another objection to maintaining a stable unit is the argument against price-fixing. Prices, even including the value of the money unit, should be determined on free markets rather than determined by authority. Freely flexible prices and wages have functions to perform. (Anderson 1929 loosely alludes to such an argument, as does Rothbard 1985, p. 6.) Yes, but this is properly an argument for free-market determination of individual prices and wages, not against appropriate specification of the unit of account. Adopting a stable unit would aid, not impair, the working of markets. (I sympathize

with advocates of the gold standard when they are criticized for supposedly advocating price-fixing. The critics should recognize the difference between fixing some ordinary price and adopting a quantity of gold as the unit of account. Consider an analogy: Offering a specific definition of a unit of length, the meter, is not properly open to criticism of the sort that would be justified against governmental decrees about the length of trouser legs and the dimensions of rooms in houses. Instead of being criticized for recommending a defined monetary unit, gold-standard advocates might better be criticized for the particular definition they recommend.)

Still another line of argument insists that cheapening of real costs of production through the rise of productivity ought to show up in declining prices (and conversely for a deterioration in productivity). David Davidson expounded such arguments with the aid of examples. A policy of stabilizing the price level would deprive a creditor of any share of the gains from a general rise in productivity, while someone who had borrowed for productive purposes would unfairly keep the entire gain for himself. Or consider two owners of farm land, only one of whom had leveraged his holding by debt. A general rise in the output of land would tend to depress the prices of its products and so not unambiguously press the money value of the land itself either up or down. A monetary policy of stabilizing the product price level, however, would raise the land's money value; and the leveraging landowner would gain differentially, which also seemed unfair to Davidson. Presumably money should be stabilized, if at all, in terms not of products but of labor and other factors of production. (Davidson 1906. Davidson and Knut Wicksell debated such issues over many years in the pages of *Ekonomisk Tidskrift*. I have not yet had access to the issues after 1908; but Uhr [1960] 1962, pp. 270–305, summarizes the debate.)

Admittedly, one may think up cases and propound ethical judgments according to which the holder of a nominal claim should share, through a change in the price level, in the gain or loss caused by a rise or fall in productivity. It is hard to see, however, how detailed conditions, varying from case to case, can be taken into account by monetary institutions and policy. It is unreasonable to burden the monetary system with the task of preserving justice between debtors and creditors and between other groups of the population in the face of multifarious changes in productivity and other conditions. No single institution can do that.

A monetary system should do what it can reasonably be expected to do, and other institutions should undertake tasks more suitable for them. Savers need not restrict themselves to buying interest-bearing

securities of fixed nominal value; they can diversify. They can try to take account of prospective changes in productivity by investing in equities. Likewise, would-be borrowers need not borrow only in nominal terms; they can sell stock or obtain loans with equity participations. A sound monetary system with a stable money unit can help provide such opportunities by facilitating the development of financial intermediation. In and by itself, a monetary system cannot solve all sorts of problems.

George Selgin (in personal correspondence) supposes the technological cheapening of some particular good whose price figures significantly in the general price level. As a matter of arithmetic, the price level then falls (unless monetary institutions or policy resist this spontaneous tendency). The cheapened good is not and has not been in excess supply, for its producers have cut its price, painlessly, in line with its reduced cost. The technological advance presumably raises the output of the affected good or of other goods into whose production factors have been released. Thus the real volume of transactions to be lubricated increases, and so does the associated demand for real cash balances. That increased demand is more or less accommodated automatically, however, through money's rise in purchasing power over the cheapened good. The arithmetical decline of prices on average must not be seen as evidence of monetary disequilibrium being corrected, perhaps sluggishly. Monetary expansion to resist this price decline would have "injection effects," probably including the distortion of interest rates, and so would itself be a source of disturbance to market equilibrium.

Such effects were apparently the reason why F. A. Hayek, in early publications, was skeptical about price-level stabilization. Keeping prices constant following an increase in productivity requires banks to expand money and credit by lowering their interest rates. The loan rate that might keep prices from falling is likely to initiate a cumulative and unhealthy investment boom, and the increase in the loan rate that might stop it is likely to reverse it into a downturn, which would require an interest-rate cut before the downturn gains momentum. Hence, an interest-rate policy to stabilize the price level would entail rises and falls around the original or normal level of prices. These oscillations might spawn a growing collection of unfinished and abandoned capital processes, and the waste involved might even overshadow the initial rise in productivity. (Hayek [1931/1935] 1967, Lecture IV; see also the discussion by Uhr [1960] 1962, p. 283.)

Such arguments seem to take it for granted that pursuing a money unit of stable general purchasing power means manipulating the quantity of a fiat money, or of what would be a fiat money except only

for the price-level rule. Whether this supposition about how the policy would be implemented is necessarily valid will be examined later in this paper.

Of course a particular good affected by a technological advance tends to fall in price relative to other goods and services and so to fall in price as expressed in a unit of stable general purchasing power. If the index or bundle defining the pricing unit happens to include the affected good, then its price still falls. (It is legitimate to use the terms "price index" and "bundle" almost interchangeably here, for a price index involves a bundle whose total price is being compared over time.) The individual prices of the bundle's other components rise, however, in such a way that the price of the bundle as a whole remains unchanged. This is a straightforward implication of how the unit is specified. The appropriateness of such a specification is what is at issue.

What are the alternatives? Defining the unit as an amount of some single commodity exposes the whole range of goods and services to price inflation if that commodity, say gold under the gold standard, happens to be the one affected by technological advance. That possibility is one of the reasons for defining the unit by a broad bundle in which no single commodity carries a heavy weight.

In reality, all sorts of micro changes are continually occurring, raising the real or relative prices of some goods and lowering those of others. In such a context, it is hard to see what kind of monetary environment is preferable to the one provided by a unit of stable general purchasing power. Selgin's counterexample, like those of Davidson mentioned earlier, seems tacitly to presuppose a fiat money managed in some ideally clever way so as best to suit each particular constellation of circumstances as it arises and is perfectly and instantly diagnosed. But such an instruction to the monetary authorities cannot be operational. It would provide a poor basis for the orientation of expectations and for confident calculations by market participants.

Sometimes it is said that while influences on the price level coming from the side of money should be avoided, influences from the side of goods should be allowed their full natural scope. General changes in productivity, as distinguished from changes affecting only a particular good, enter into this argument. A gentle downtrend in prices would be the natural consequence of generally rising productivity.

I wonder whether such ideas do not rest on some underlying money illusion, some unarticulated belief that money has a value of its own, a value in a profoundly true sense, distinct from its purchasing power as mirrored in the price level. (Davidson 1906 and Anderson [1917] 1922, especially p. 57, did try to distinguish, though not

in a way intelligible to me, between the value of money and its purchasing power, the reciprocal of the price level.) On such a notion, situations may arise in which money remains stable in value while goods in general are becoming dearer or cheaper in real terms, and both their individual prices and their average price level should be allowed to reflect these real changes.

Well, rising productivity cheapens some goods relative to others (notably, consumer goods relative to human effort), but it can hardly cheapen goods and services in general relative to goods and services in general. It seems reasonable to expect each good's price to express its value relative to others, which is what pricing in a unit of stable general purchasing power does. The money-side/goods-side distinction does not bear much weight, for growth over time in the physical quantities of goods and services to be traded operates as much on the money side as on the goods side. It leads people to raise their demands for holdings of money, which exerts a deflationary effect, unless the supply of nominal money is somehow made to keep pace with the growing demand for it.

Money in Adversity

Something more needs to be said about the case of an adverse supply shock, one like or worse than the international oil shock of 1973–74. Prices directly affected rise, and keeping the average level steady means pressing other prices down. Because many of those other prices exhibit downward stickiness, the necessary deflationary process will depress production and employment as well. Far from indicating an excess supply of money, the initial price rise shrinks the money supply in real terms, and a contraction of the nominal money supply in addition would aggravate the deflationary damage to the economy.

Considerations like these have led Robert Hall to recommend a quasi-automatic policy aiming at a stable price level only as a long-run target, while tolerating strictly temporary deviations from the target level. (See Hall 1986 and my comment that follows there.)

If a major calamity or a great war should require distributing the adversity or burden widely throughout the population, an inflationary tax on cash balances and on nominal incomes can hardly be ruled out a priori as one of the means to be employed. (Apparently Wicksell, toward the end of his life, modified his call for price-level stabilization to allow for some such cases of extreme scarcity of goods; see Uhr [1960] 1962, pp. 300–305.)

A country's monetary institutions, like its other institutions, cannot be constructed with guaranteed robustness in the face of external calamities. Institutions should serve the relatively normal conditions in which they have a good chance of surviving and flourishing. It can even be argued that stable money provides a better basis for government borrowing and money issue in rare emergencies than money that commanded little confidence in the first place. (One argument made by advocates of the gold standard in Russia during discussions in the late 19th century about reforming the country's floating paper currency was that a gold standard would provide a sound starting point, a standard to go *off of*, in some future war.)

Implementation

Some objections to the goal of money of stable purchasing power are really objections to more or less tacitly assumed *methods of implementing* the policy. Critics (e.g., Anderson 1929) often assume that efforts to stabilize the price level would work only through money and credit manipulation by the Federal Reserve. "Austrian" economists worry about "injection effects" or "Cantillon effects" of expanding the money supply to keep the price level from sagging in a technologically advancing and otherwise growing economy. New money impinges first at particular points in the economy, where it distorts the price signals that guide resource allocation. In particular—so goes one familiar story—injection of new money is likely to lower interest rates below the real, natural, or equilibrium rate and so lead business investors to embark on capital-construction projects that will eventually turn out to have been unwise. This is supposedly what happened in the United States in the 1920s: Although monetary expansion was not extreme enough to cause actual price inflation, it prevented what would otherwise have been a healthy decline in prices; and through interest-rate distortions in particular, it set the economy up for the Great Depression that followed (Rothbard 1975).

Three things, it seems to me, are unsatisfactory about this line of objection. First, it relies on a dubious business cycle theory (Yeager 1986, pp. 378–82). Second, it does not demonstrate the quantitative importance of the effects alluded to, nor does it demonstrate the harm done by fairly steady, mild monetary expansion even if that expansion did serve as a marginally significant way of making the savings of the economy available for investment purposes. Third, it unwarrantedly presupposes that new money is put into the economy in particular ways that lower interest rates and skew resources into business investment.

If inserting new money in the assumed channels did have real and quantitatively important effects of the asserted kind, those particular channels might be avoided. For example, newly created money could serve as a supplement to government tax revenues, perhaps ideally to finance tax reductions.

Prominent arguments against price-level stabilization center around lags. Lags are likely to occur between incipient monetary disequilibriums and their reflection in the price index on which the central bank may be targeting. Lags occur between index movements and the adoption and impact of corrective policy actions. By the time these actions take effect, they may no longer be appropriate. Thus, attempts to heed a price-index rule might turn out more destabilizing than stabilizing.

This difficulty would presumably bedevil a policy of large, sharp changes, not a steady policy. Policymakers might further circumvent the problem of lags by watching sensitive commodity prices, growth rates of monetary aggregates, industrial production, and possibly even interest rates and exchange rates and other early indicators of monetary disequilibrium pressing on the target price level and by promptly countering such pressure. The rule imposed on the monetary authorities should insist that any such early indicators of disequilibrium serve that purpose only and not be erected into goals rivaling the price-level target. Perhaps, too, the salaries of the money managers might be calculated so as to penalize departures from the target level of the specified price index.

Their instructions might be reinforced by saddling the monetary authorities with an obligation to *do* something at the initiative of private parties. They might be required to maintain two-way convertibility between dollars and whatever quantity of gold would command a physically specified basket of goods and services. This (changeable) quantity would be calculated, perhaps every day, from the actual market prices of gold and of the specified goods and services. The system would be a commodity-basket standard rather than a gold standard; and something other than gold, perhaps specified securities, might more conveniently serve as the redemption medium. (This suggestion is inspired by, but is not the same as, Irving Fisher's 1920 proposal for a "compensated dollar.") Even more so than a gold standard, this system would deprive the monetary authorities of any substantial discretion. It would seem to circumvent the problem of lags. It would also circumvent the supposed problem of injection effects; for instead of being injected and withdrawn through the loan market, money would be injected and withdrawn at numerous points in the economy almost automatically as arbitrageurs acted to profit

by, and thus nip in the bud, discrepancies between money's actual and defined values.

Standard worries about lags envision a central bank managing a fiat money with its ordinary policy weapons, notably open-market operations. The supposed problems of lags and injection effects and, perhaps more important, the danger of governmental abuse of money might better be overcome by the more radical reform of privatization. Having been abolished, government money could no longer serve as unit of account.

The government might designate a new unit and promote its general voluntary adoption by using it in its own accounting, taxation, contracting, wage payments, and other operations. The new unit would be defined as the total value of a bundle of suitably chosen goods and services. If the standard bundle were rather comprehensive, the general level of prices expressed in the unit so defined would be approximately stable. Thus endowed practically by definition with a stable purchasing power, the unit of account would no longer fluctuate capriciously according to changing demand for and supply of the medium of exchange.

The issue of notes and checkable deposits would be left to private banks (which might well also offer checking privileges against equity mutual funds). The quantity of these media of exchange would accommodate itself to the demand for them at the price level corresponding to the definition of the unit of account; imbalances, showing up in incipient movements of the price level and in the spread between interest rates on deposits and on banks' earning assets, would trigger corrective arbitrage. This automatic maintenance of equilibrium between demand for and supply of media of exchange at a stable price level would prevent price inflation and major recessions.

It is unlikely that the privately issued notes and deposits would be directly redeemable in the actual goods and services defining the unit of account, for that practice would be too awkward for all concerned. Instead, their issuers, disciplined by competitive pressures, would stand ready to redeem them in convenient redemption property (gold or, more probably, agreed securities) in amounts having the same total value in bundle-defined units of account, at actual market prices of the day or hour, as the denominations of the notes and deposits to be redeemed. Most redemptions would probably take place at clearinghouses, where banks acquiring notes issued by or checks drawn on other banks would routinely present them for settlement against their own obligations presented by others. Net balances at the clearinghouse would be settled by transfers of the

agreed redemption medium. The necessary calculations and operations would be carried out every business day by professionals, and the ordinary person would no more need to understand what determined the purchasing power of the unit of account than he needs to understand what determines the purchasing power of the dollar nowadays. (The proposed system is described in Greenfield and Yeager 1983. Further published and unpublished articles provide clarifications and answer objections. The present paper hardly offers scope to make a convincing case for the system. It can only emphasize that alternatives are available which circumvent several of the most prominent objections to seeking *government* money of stable purchasing power.)

Conclusion

Situations can arise in which exchange rate stability and domestic monetary stability are incompatible objectives. Then, it seems to me, the case is persuasive for giving priority to domestic stability. Domestic and exchange rate *in*stability can easily go together, as current experience all too clearly shows. The current volatility of exchange rates is hardly puzzling, given the undefined character of the national monetary units among which the foreign exchange market determines relative prices. A reform must occur first and fundamentally on the national level. Achieving stable money along private-enterprise lines is eminently feasible as a matter of economics. Although such a reform is outside the range of immediate political feasibility, that fact should not discourage our considering it. The force of ideas can eventually change what is politically feasible. By providing a sharp contrast with our existing unsatisfactory system, furthermore, far-out reform ideas can help us perceive and evaluate existing features that we might otherwise take so much for granted as not even to recognize them.

As long as national currencies remain distinct fiat units, absurd units whose management comes under the shifting influences of government irresponsibility and political pressures, there just are no such things as long-run or medium-run or "fundamental" equilibrium exchange rates between them. Actual rates necessarily are short-run market-clearing rates pushed around by fleeting pressures. Barring reform of the currencies themselves, attempts to manipulate exchange rates will do more harm than good. The misalignments and volatility we observe nowadays may be disillusioning, yet nothing is clearly preferable to letting exchange rates continue to float until we undertake fundamental monetary reform.

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Is Managed Money the Root of All Evil?

Ben W. Crain

The Conventional Approach to the Stability Question

A conventional paper on "domestic stability versus exchange rate stability" would highlight some familiar current topics: the Louvre Accord and dollar stabilization; calls for strengthening or abandoning international monetary coordination; proposals to establish target zones or commodity price indicators.

The paper might begin by asking whether monetary policy can hit two targets—one by creating the right amount of money, another by altering the composition of assets that the central bank purchases in the process of creating money. It would probably conclude that, except for short periods, monetary policy is really limited to one instrument, one target.

Then it would ask how that target should be chosen. For some countries, an exchange rate target might be the best way to attain "domestic" stability, which I take to mean price stability. Indeed, for large portions of the world economy a fixed exchange rate system would surely be optimal, if it could ensure stability for the system as a whole.

This discussion would open the door to a consideration of proposals to establish an explicit system for exchange rate management, and to an appreciation of the difficulties in doing so. In particular, it would address the problem of determining who sets policy for the system as a whole. The logic of one instrument, one target implies that N-1 countries must devote their one instrument to pegging exchange rates, while the Nth country is free to determine monetary growth for the system as a whole. Monetary coordination then becomes the political art of obfuscating any explicit, clear-cut assignment of these

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powers and responsibilities among sovereign nations, while somehow holding the system together in practice.

Yeager's Approach

Leland Yeager virtually dismisses this whole complex of questions, because they all presume that money is issued and managed by governments. Managed money, he argues, is the fundamental cause of instability. He wants to dethrone managed money, not improve, ever so marginally, the way it is managed.

Nonetheless, he does offer a brief assessment of the behavior of exchange rates between managed moneys. He supports the determination of prices—including exchange rates—in competitive markets. But he accepts the charge that floating rates have been the *proximate* cause of much mischief: There has been persistent serious misalignment; real resources have been misallocated and wasted; speculation has been destabilizing.

There is, however, no way to rid managed money of these ills. Cat-and-mouse intervention to scare speculators has probably enhanced, not dampened, exchange rate volatility. More formal intervention commitments only buy time, solving nothing, as demonstrated by the collapse of the Bretton Woods system.

Yeager usefully reminds us that the dollar became overvalued under the nominally "fixed" regime of Bretton Woods. The "prodigious" efforts made to sustain that regime had to fail because they could not accommodate any of the avenues by which real exchange rates could adjust to relieve dollar overvaluation. Germany would not accept substantial inflation and we would not accept substantial deflation. The expanding scope for capital flows among major currencies eventually forced the hand of policymakers, who chose to sacrifice exchange rate stability rather than abandon or compromise their preferred versions of "domestic stability."

Consider the dollar overvaluation of 1982–85. Yeager insists, and rightly so, on asking how a fixed exchange rate regime would have prevented dollar appreciation. Would we have acquiesced in the continuation, probably even the acceleration, of double-digit inflation? I doubt it, since inflation was a major factor in the unseating of an incumbent president. Would we have run an entirely different fiscal policy, never enacted tax changes, or never increased defense spending? I doubt it, since a popular president was elected with a very specific mandate on those issues. Could a commitment to fixed rates—a largely irrelevant abstraction to most Americans—exert enough

"discipline" on our political system to have blocked major changes desired by most Americans? Of course not.

Whether or not those changes were wise is not the point. Their proponents won the right to implement those changes as clearly and cleanly as any major policy changes can be legitimated in our democratic system. The flexibility of exchange rates served us quite well, for it permitted those policy changes to be tested in practice—indeed, it made the implementation of those changes relatively easy, since dollar appreciation accommodated a huge capital inflow and allowed the widening gap between domestic savings and investment to be closed.

Flexible exchange rates did exactly what you would want them to do: They gave us good running room to try new policies, and they cleanly transmitted the consequences of those policies into market and political pressures for corrective adjustments. Flaws in the original policies, or in the ensuing correctives, can hardly be blamed on flexible exchange rates.

Bretton Woods collapsed because Germany insisted on reclaiming monetary sovereignty. I see no reason to think that, in the foreseeable future, the United States, Germany, or Japan will or should sacrifice any substantial degree of sovereignty just to preserve nominal exchange rate stability. Thus, I concur completely with Yeager when he asks, in reference to the rate-pegging effort under the Louvre accord, "What is the point of saying that something should have been done or should now be done if in fact it could not and cannot be done?"

Monetary Stability and Disequilibrium

Now let me turn to the real topic or Yeager's paper, his attack on managed money. He wants to abolish money, as conventionally understood. He certainly wants to abolish monetary policy. Why? Because he sees no satisfactory way to manage money.

He does write that "if the supply of money is not cleverly manipulated to accommodate the demand for it, then monetary disequilibrium persists, bringing macroeconomic pains." That statement implies that the supply of money could, in principle, be manipulated with sufficient skill to preclude monetary disequilibrium. But Yeager does not really believe that it can be. Since he urges the abolition of government money as the only route to guaranteed price stability, he necessarily rejects all common approaches to the management of money, including gold standards, commodity price indexes, and monetarist rules.

Purely discretionary money management is characterized as absurd and preposterous. Manipulating money to stabilize the price of gold, or a commodity price index, is judged to be only somewhat less absurd. Yeager laments the demise of the gold standard, while recognizing that we lack the "liberal attitudes and self-restraints" necessary for it to work relatively well and to endure. But even if we could rekindle those attitudes and self-restraints, a gold standard would be far from ideal.

A monetarist rule likewise fails to preserve monetary equilibrium. Monetarism itself insists that any such rule will be suboptimal. It promises only a degree of average long-run stability better than discretionary management could realistically deliver.

Assessing Yeager's Attack on Managed Money

Yeager's attack on managed money has at least one important virtue. It undermines the conventional dichotomy between rules and discretion in the conduct on monetary policy. That dichotomy typically posits a sharp distinction between unbound discretion to create and exploit monetary disequilibrium, and a rigid commitment to manage money according to some rule or "objective" standard. But that distinction is not as hard and fast as it is typically depicted.

The most rigid gold or commodity standard is a rule for money management. A gold standard, Yeager writes, "is simply a particular set of rules for monetary institutions and policy; and these rules are no more inherently self-enforcing than any other set of monetary rules." Any set of rules can be sustained only if the rules perform satisfactorily, and the performance characteristics of the gold standard "are far from ideal." A broader commodity standard might perform better, but would still fall well short of sustained monetary equilibrium. No one, I would add, should doubt that, in a modern democracy, the first serious failure of any rule or standard to sustain modest growth would spell its quick demise. (A similar failure of discretion does not, however, spell the demise of discretion. It simply induces a discretionary shift in the direction of policy.)

Yeager's treatment of discretion, rules, and standards as variations on the common principle of managed money is well taken, but his attack on managed money is overdrawn and misdirected.

I cannot accept his characterizing as *absurd* a system in which people cannot count on money's future purchasing power. Long-term price stability is a major objective of paramount importance. But the problem should not be cast in such absolute terms. Taken

literally, his characterization implies democracy itself is absurd, since any system, any structure, and any set of policies— including Yeager's own private money alternative—lie at the mercy of future democratic majorities. In practice the politics of "guaranteeing" stable prices would quickly be transformed into the politics of guaranteeing full employment and other noble objectives, with disastrous consequences all around.

One should not, therefore, take Yeager's hyperbole literally. But the question remains: Has the actual performance of managed money been so miserable that one is driven to his radical alternative? I think not. The expectation of tolerable price stability in Germany and Japan is pretty solid. It is less so in the United States, but there is no inherent reason we cannot equal German or Japanese price performance. Indeed, at the moment, the Fed enjoys considerable prestige, having won a major victory for discretion over the past few years.

Let me quote two recent witnesses before the House Banking Committee on that point. Robert Hall (1987), whom Yeager cites as a source of inspiration for his plan to overthrow managed money, testified that "the Fed's performance in the 1980s has been sufficiently successful as to cast doubt on the desirability of an autopilot . . . current monetary policy is on the right track." He notes, moreover, that the commodity bundle that most closely tracked inflation as of 1981 completely collapsed, as a reliable indicator, in the ensuing years. He argues, instead, for a nominal income target, which would certainly require considerable discretion in money management.

Another witness, William Poole (1987), noting that higher money growth has offset declining velocity, stated, "I thought . . . that higher money growth ran the risk of reigniting inflation. But Paul Volcker called it right at the time."

Yeager recognizes that his radical alternative is "politically unrealistic." It is unrealistic not just because it could not be enacted under present conditions; that would be a trivial criticism of his proposals. Institutional revolutions of the magnitude he champions depend on major crises that completely undermine the credibility of the current regime. Such crises would, however, most likely push policy toward price controls and greater regulation of credit and financial markets—not toward laissez-faire money. It is not in the nature of democratic governments to respond to crises by abandoning their field of activity. Surely, then, the optimal strategy is to try to avert such crises by improving money management, however modestly, instead of defining the perfect, but unattainable, alternative to managed money.

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