Friedman: Float or Fix?

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With the passing of Milton Friedman on November 16, 2006, we lost one of the great champions of free markets. Friedman's obituaries and commentaries on his life's work and enormous influence have invariably mentioned his advocacy of floating exchange rates, leaving the impression that he always favored floating rates. This was not the case.

Types of Exchange Rate Regimes

For Friedman, there were three distinct types of exchange rate regimes: floating, fixed, and pegged—each with different characteristics and different results (Table 1). Indeed, in his response to the opening question posed in an eight-part debate on exchange rates with Robert Mundell, Friedman insisted that the dichotomy (floating or fixed) be replaced by a trichotomy (floating, fixed, or pegged) (Friedman and Mundell 2000). What Friedman meant by these terms differs from the meanings they are often given, and to understand Friedman's thinking, one must understand the differences.

Free-Market Regimes

In Friedman's sense, strictly fixed and floating rates are regimes in which the monetary authority is aiming for only one target at a time. Although floating and fixed rates appear dissimilar, they are members of the same free-market family. Both operate without exchange

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TABLE 1
Friedman's Foreign–Exchange Trichotomy

Type of Regime	Central Bank	Exchange Rate Policy	Monetary Policy	Source of Monetary Base	Conflicts between Exchange Rate and Monetary Policy	Balance-of-Payments Crisis	Exchange Controls
Floating	Yes	No	Yes	Domestic	No	No	No
Fixed	No	Yes	No	Foreign	No	No	No
Pegged	Yes	Yes	Yes	Domestic and Foreign	Yes	Yes	Probably

controls and are free-market mechanisms for balance-of-payments adjustments. With a floating rate, a central bank sets a monetary policy but has no exchange rate policy—the exchange rate is on autopilot. In consequence, the monetary base is determined domestically by a central bank. With a fixed rate, or what Friedman often referred to as a unified currency, there are two possibilities: either a currency board sets the exchange rate, but has no monetary policy—the money supply is on autopilot—or a country is "dollarized" and uses a foreign currency as its own. In consequence, under a fixed-rate regime, a country's monetary base is determined by the balance of payments, moving in a one-to-one correspondence with changes in its foreign reserves. With both of these free-market exchange rate mechanisms, there cannot be conflicts between monetary and exchange rate policies, and balance-of-payments crises cannot rear their ugly heads. Floating- and fixed-rate regimes are inherently equilibrium systems in which market forces act to automatically rebalance financial flows and avert balance-of-payments crises.

Pegged Rates

Most economists use "fixed" and "pegged" as interchangeable or nearly interchangeable terms for exchange rates. Friedman, however, saw them as "superficially similar but basically very different exchange-rate arrangements" (Friedman 1990: 28). For him, pegged-rate systems are those where the monetary authority is aiming for more than one target at time. They often employ exchange controls and are not free-market mechanisms for international balance-of-payments adjustments. Pegged exchange rates are inherently disequilibrium systems, lacking an automatic mechanism to produce balance-of-payments adjustments. Pegged rates require a central bank to manage both the exchange rate and monetary policy. With a pegged rate, the monetary base contains both domestic and foreign components.

Unlike floating and fixed rates, pegged rates invariably result in conflicts between monetary and exchange rate policies. For example, when capital inflows become "excessive" under a pegged system, a central bank often attempts to sterilize the ensuing increase in the foreign component of the monetary base by selling bonds, reducing the domestic component of the base. And when outflows become "excessive," a central bank attempts to offset the decrease in the for-

eign component of the base by buying bonds, increasing the domestic component of the monetary base. Balance-of-payments crises erupt as a central bank begins to offset more and more of the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it is only a matter of time before currency speculators spot the contradictions between exchange rate and monetary policies (as they did in the Asian financial crisis of 1997–98) and force a devaluation, the imposition of exchange controls, or both.

When Friedman first distinguished among fixed, pegged, and floating rates, fluctuating exchange rates were rare, and in fact the International Monetary Fund discouraged them. By the 1990s, many countries were practicing what is often termed managed floating, in which the monetary authority does not promise to maintain any particular level of the exchange rate, but intervenes from time to time to influence the rate. Despite having a fluctuating rate, managed floating falls under what Friedman termed pegged exchange rates, because the monetary authority is aiming at more than one target at a time. Perhaps today it would be better to use the term "intermediate" exchange rates to express the gamut of arrangements between a Friedman-style fix and a Friedman-style float. What Friedman meant by a floating rate is what is now usually called a clean float, to distinguish it from a managed float.[1]

Friedman: An Advocate of Fixed and Floating Rates

Contrary to what most people think, Friedman was not simply an advocate of floating exchange rates. His exchange rate trichotomy makes this clear. As a matter of principle, Friedman favored both floating and fixed rates, and rejected pegged rates as "worse than either extreme" (Friedman 2000: 28).

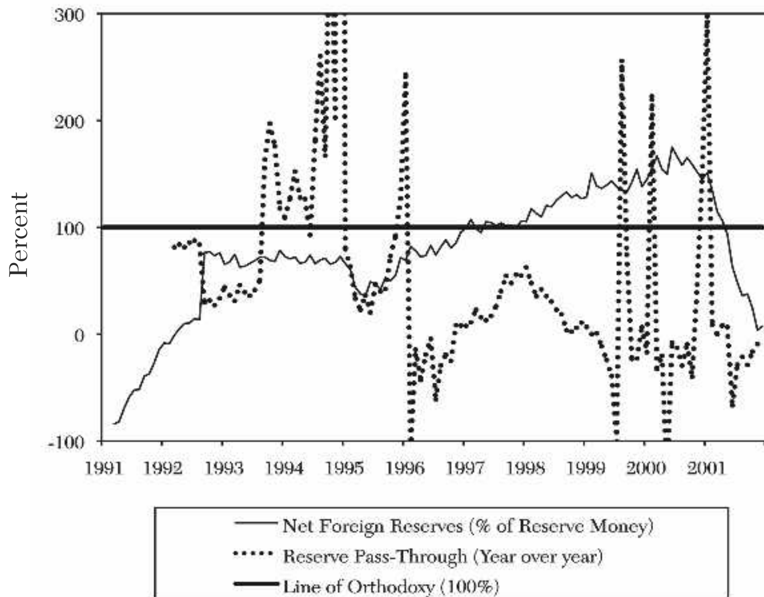
Friedman, however, laid great stress on the fact that a fixed exchange rate administered by a central bank is dangerous. There is always the potential for a central bank to engage in discretionary monetary policy and to break the one-to-one link between changes in foreign reserves and changes in the money supply. This point was brought home to me during a May 1992 dinner in Mexico City. A

[1]Friedman makes clear the distinction between fixed and pegged rates in Friedman (1968: 267–72).

year before (April 1991), Argentina had passed its Convertibility Law, requiring the central bank to maintain a rigid exchange rate. During the dinner, the conversation touched on Argentina. Friedman insisted that Argentina's central bank was the Achilles' heel of convertibility. He didn't trust the central bank. Even though the system had worked well so far, Friedman thought that the central bank would eventually adopt a discretionary monetary policy and convertibility would get into trouble. He was later proved right: Argentina's central bank simultaneously attempted to maintain a rigid exchange rate and engaged in an active monetary policy. This culminated in a balance of payments crisis, exchange restrictions, the end of convertibility, and a peso devaluation in January 2002 (Hanke 2002: 210–12).

Friedman's problem with Argentina's system was that the central bank would exploit loopholes in the Convertibility Law and create deviations from orthodox fixed-rate currency board operations. Figure 1 shows how unorthodox Argentina's system was. For an

FIGURE 1
WAS ARGENTINA ORTHODOX?



SOURCE: International Monetary Fund, *International Financial Statistics* database, August 2007.

orthodox currency board, net foreign reserves (foreign assets minus foreign liabilities) should be close to 100 percent of the monetary base. Moreover, "reserve pass-though"—the extent to which changes in net foreign reserves are reflected in the monetary base—should also be close to 100 percent. Argentina pegged its currency at one Argentine peso per U.S. dollar. So, a reserve pass-through of 100 percent means that if net foreign reserves rises (or falls) by, say, $100 million, the Argentine peso monetary base should also rise (or fall) by 100 million pesos. Because of special factors connected with accounting valuations, a currency board may not always be at 100 percent reserve pass-through, but it should be close—generally within a range of 80–120 percent.

As Figure 1 shows, Argentina's convertibility system was not an orthodox currency board. Few commentators on Argentina have appreciated this fact (as Schuler 2005 shows). Perhaps because the convertibility system withstood shocks on a number of occasions, Friedman later came to view the system as a currency board, as a quote below indicates. Apparently, though, he never delved into the details of the system, and I think his earlier distrust of the central bank was the proper attitude.

Friedman's first and most famous foray into the exchange rate debate was as much an attack on exchange controls and a case for free trade as anything else. He originally wrote "The Case for Flexible Exchange Rates" (1953) as a memorandum in 1950, when he served as a consultant to the U.S. agency administering the Marshall Plan. At the time, European countries were imposing a plethora of controls on cross-border flows of trade and capital. Friedman opposed these restrictions. He concluded that adopting floating exchange rates across Europe would remove the need for exchange controls and other distortionary policies that impeded economic freedom.

It is important to stress that economic freedom was also a primary motivator for Friedman's advocacy of unified currency regimes for developing countries. Friedman (1973: 47) concluded:

> While the use of a unified currency is today out of fashion, it has many advantages for development, as its successful use in the past, and even at present, indicates. Indeed, I suspect that the great bulk, although not all, of the success stories of development have occurred with such a monetary policy, or rather an absence of monetary policy.

> Perhaps the greatest advantage of a unified currency is that it is the most effective way to maximize the freedom of individuals to engage in whatever transactions they wish.

Even though the title of Friedman's renowned 1953 article has contributed to the misperception that he was a dogmatic proponent of floating rates, a close reading makes it clear that he was not arguing so much in favor of floating exchange rates as in favor of full convertibility. He simply saw floating exchange rates as the best way to achieve full convertibility quickly in Western Europe. The overriding "free-trade" motivation is made clear when Friedman discusses the sterling area: "In principle there is no objection to a mixed system of fixed exchange rates within the sterling area and freely flexible rates between sterling and other countries, provided that the fixed rates within the sterling area can be maintained without trade restrictions" (Friedman 1953: 193).

Another factor that led people to pigeonhole Friedman as a dogmatic advocate of floating rates was the fact that Harry Johnson and other economists associated with the University of Chicago were strong, and according to most observers, one-sided in their advocacy of floating rates. Many incorrectly concluded that Friedman espoused the same views as some of his colleagues. Johnson's tendentious views on exchange rates are diagnosed by Richard Cooper. In commenting on a review article by Johnson titled "The Case for Flexible Exchange Rates, 1969" (Johnson 1969), Cooper (1999: 10–11) wrote:

> The essay is well-balanced in its overall structure: he states the case for fixed rates; the case for flexible rates; and the case against flexible rates. But only one paragraph is devoted to stating the case for fixed rates, the remainder of the section to why it is "seriously deficient." And the section on the case against flexible rates is basically devoted to knocking it down, consisting as it does in Johnson's view "of a series of unfounded assertions and allegations." It is not a balanced account; Johnson had made up his mind, and hoped to impose his conclusions on others by a devastating critique of the (unnamed) opposition.
>
> Johnson's affirmative analysis is itself based on a series of unfounded assertions and allegations, an idealization of the world of financial markets without serious reference to their actual behavior.

In the 1960s, Friedman turned his attention toward monetary problems in developing countries, where inflation and exchange controls were pervasive. For many of these countries, Friedman was skeptical about floating exchange rates because he mistrusted their central banks and doubted their ability to adopt a rule-based internal anchor (such as a money-supply growth rule). To rid developing countries of exchange controls, his free-market elixir was the fixed exchange rate (an external anchor). As Friedman put it: "The surest way to avoid using inflation as a deliberate method of taxation is to unify the country's currency [via a fixed exchange rate] with the currency of some other country or countries. In this case, the country would not have any monetary policy of its own. It would, as it were, tie its monetary policy to the kite of the monetary policy of another country—preferably a more developed, larger, and relatively stable country" (Friedman 1974: 270).

In many cases, he advocated fixed exchange rates rather than floating. For example, in response to a question during his Horowitz lecture of 1972 in Israel, Friedman (1973: 64) concluded:

> The great advantage of a unified currency [fixed exchange rate] is that it limits the possibility of governmental intervention. The reason why I regard a floating rate as second best for such a country is because it leaves a much larger scope for governmental intervention.… I would say you should have a unified currency as the best solution, with a floating rate as a second-best solution and a pegged rate as very much worse than either.

It is not surprising that Friedman was clear and unwavering in his prescription for developing countries: "For most such countries, I believe the best policy would be to eschew the revenue from money creation, to unify its currency with the currency of a large, relatively stable developed country with which it has close economic relations, and to impose no barriers to the movement of money or prices, wages, or interest rates. Such a policy requires not having a central bank" (Friedman 1973: 59).[2]

[2]It should be noted that, for Friedman, "most" means most, not all. For example, in an interview published posthumously (Varadarajan 2007), Friedman responded with an unambiguous "yes" to the interviewer's first question: "Should China float the yuan?"

In 1992, I co-authored a book, *Monetary Reform for a Free Estonia*, which carries the following dust jacket endorsement by Friedman: "A currency board such as that proposed by Hanke, Jonung, and Schuler is an excellent system for a country in Estonia's position." On May 5, 1992, I presented our proposal to the Estonian parliament and on June 24, the Russian ruble was replaced by the kroon, which traded at a fixed rate of 8 per German mark (subsequently 15.65 per euro).

During the Asian crisis of 1997–98, Friedman again entered the fray. As former Indonesian President Suharto's advisor, I proposed that the rupiah be fixed to the dollar via a currency board. Shortly thereafter, the *Far Eastern Economic Review* (March 26, 1998) published "The Sayings of Chairman Milton." His thoughts on a currency board for Indonesia were: "If the Indonesians would live by the discipline, it could be a good thing. What else can they do?" Well, they could be forced to abandon the currency board idea by a U.S.-IMF led phalanx aiming to oust Suharto, which is just what happened (Hanke 2002: 215–18).

Where did Friedman stand with regard to one of the world's showcase free-market economies? He favored Hong Kong's fixed exchange rate. Indeed, when drafting his proposal to reinstate Hong Kong's fixed exchange rate regime in 1983, John Greenwood consulted Friedman, who was an enthusiastic supporter (Greenwood 2007: 105). As Friedman wrote in 1994, "The experience of Hong Kong clearly indicates that a particular country like Hong Kong does not need a central bank. Indeed it has been very fortunate that it has not had one. The currency board system that was introduced in 1983 has worked very well for HK and I believe it is desirable that it be continued" (Friedman 1994: 55).

Conclusion

These examples should put to rest the widespread notion that Friedman exclusively favored floating exchange rates, even for developing countries. Indeed, at a conference at the Bank of Canada in 2000, Friedman set the record straight, saying: "My position has always been that a small country should do one of two things: eliminate its central bank and really hard peg—that is, unify its currency with the dominant currency the way Argentina has done with its currency board and Hong Kong has done with its currency board; or it ought to float completely" (Bank of Canada 2000: 418).

Friedman clearly favored both floating and fixed exchange rate regimes in principle. However, as a matter of practice, for most developing countries he favored fixed over floating rates. Yet most economists and financial journalists believe that he espoused floating rates as the sole solution. Friedman's real position was that an exchange rate driven by a free market was best, and that both fixed and floating exchange rates had equal claims to be considered market-determined.

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