The Wall Street Journal Position on Exchange Rates

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1. Introduction

The SOMC is a collection of individuals, so we do not always agree fully on all issues. There are certain similarities of viewpoint across individuals, however, that give a recognizable flavor to most of the committee's analyses and positions. Three leading examples are beliefs that governmental interference with market allocations is often harmful, that inflation rates should be kept low—close to zero when correctly measured—and that inflation rates are determined primarily by central-banks' monetary policy stances. In addition, the writings of the SOMC have, over the years, exhibited a fairly consistent leaning toward the position that floating exchange-rate arrangements are often preferable (for major economies) to exchange-rate values set by central-bank or government actions at specified par values—or even ones fixed more firmly by (e.g.) currency-board arrangements.[1]

The Wall Street Journal is an important newspaper that similarly features writings by a number of individuals in various capacities, but whose editorial and op-ed writings convey a reasonably consistent position on many economic issues. Among these, it seems, are preferences for minimal amounts of government regulation of markets and near-zero inflation, together with an assignment of inflation responsibility to monetary policy. Thus the Wall Street Journal (henceforth, WSJ) positions on inflation and market regulations are broadly similar to those of the SOMC.

[1] See, e.g., Schwartz (1993), Stockman (2000), McCallum (1999), and Meltzer (1997).

When it comes to exchange-rate arrangements, however, the WSJ's editorials and op-ed writings have almost invariably favored firmly fixed exchange rates, not floating-rate regimes.[2] Considerable support can be found for currency-board and "dollarization" arrangements, and an occasional but unmistakable whiff of gold-standard sympathy can be detected by the regular reader. On this issue the WSJ and SOMC positions are not only different but actually opposed.

Accordingly, it is my purpose, in what follows, to provide a discussion of several aspects of the WSJ position on exchange rates. The discussion will develop my own views and will be directed primarily to readers who share preferences—common to the WSJ and the SOMC—for very low inflation and minimal government regulation of economic activity. A few references will be included but the WSJ position will not be documented in great detail. Instead, the ascribed views will mostly reflect my impressions based on regular reading over a number of years, buttressed by examination of Robert Bartley's book, The Seven Fat Years, and a study of recent writings by Robert Mundell.

2. Some Terminological Issues

As a way to begin, let me first take up a suggestion that appears with some regularity in the WSJ to the effect that economists who believe as we do are guilty of a particular intellectual error, or sloppiness. Specifically, Bartley (2001) suggests that "floating exchange rates are [is?] not a policy, but the lack [absence?] of a policy." In this regard, he is echoing Robert Mundell, "my guru on exchange rates" (Bartley, 2002). In a recent wide-ranging paper, Mundell (2000, p. 7) asks, "How can you compare a fixed rate, which is a monetary rule, to a flexible rate, which is a non-committal absence of a monetary rule?" Here Mundell's point is that to promote a "floating rate" or "flexible rate" policy regime is an

[2] An exception is provided by the occasional articles contributed by Martin Feldstein.

incomplete specification of monetary policy. That is entirely correct, but we SOMC members do not disagree in the least.[3] When one of us promotes a floating rate, he/she typically has in mind a particular fully specified rule for monetary policy, such as an inflation targeting rule, or a Taylor-style rule, or a price level rule, or a base money growth rule, or a M2 rule, or a nominal income growth rule, just to mention some actual examples. In each case the rule would specify an instrument variable and a "target" variable, i.e., one whose path the rule is designed to achieve.[4] Each one, moreover, would be designed with a specific long-run average inflation rate or price level path in mind, as an underlying objective, so for some analytical purposes it might not be necessary to say which of the target variables one has in mind. The Bartley-Mundell accusation might be appropriate if applied to central bank officials in some countries, or to some (not all!) journalists, but it does not apply to members of the SOMC—or to the economists with whom we work or talk regularly.

Looking in the other direction, however, there is one related terminological point that might well be attended to before turning to matters of greater substance. It concerns the habit of several writers in the WSJ of using the words "float" and "devaluation" as pertaining to the same policy action—i.e., as synonyms. A few examples are mentioned in the attached footnote.[5] But a devaluation is a change from one government-supported fixed (or pegged) exchange rate to another fixed rate, one of lower exchange value. A float, by contrast, involves no official promise or intention to support the exchange rate at any particular value. With a float, the rate in principle could appreciate or depreciate—i.e., increase or decrease in

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[3] See, for example, my last SOMC paper (McCallum, 2001), which devotes four pages to emphasizing this particular point.

[4] To be operational, the instrument should be some variable that the central bank can actually control either directly or closely, such as a short term interest rate or a very narrow monetary aggregate such as the monetary base. If the rule's objective is to stabilize a price, such as the dollar price of gold or an exchange rate, an alternative method would be to offer to buy and sell the item at specified prices via "standing facilities."

[5] Editorial (2001), Editorial (2002), O'Grady (2002).

exchange value. The reader can usually understand what the writer has in mind when such usage occurs—i.e., usage that fails to distinguish between a devaluation and the change to a floating-rate regime—but it is nevertheless detrimental to analytical clarity and in some cases can lead to confusion.[6]

3. Choice of a Target Variable

The main substantive issue, of course, is whether a nation's monetary policy rule should have an exchange rate as its target variable, or instead some other nominal variable.[7] In fact, at the level of principle we agree with Mundell (1997, 2000) that the best choice will depend upon the characteristics of the economy under consideration. As leading contenders for the target variable, Mundell (1997, p. 4) mentions the price level, the money supply, the exchange rate, and the price of gold. He also mentions that a weighted average of these variables, and possibly others, is another possibility. This way of presenting the issue makes it clear that dedicating monetary policy entirely to the maintenance of a fixed exchange rate represents a very special case. From the perspective of macroeconomic stabilization it is almost inconceivable that a fixed exchange rate would represent the optimal policy, given all of the possibilities.

From a practical perspective, nevertheless, it makes sense to focus on the leading contenders, rather than all possible weighted averages. In doing so, it might be useful to add the nominal wage rate, nominal income, and a Taylor-style hybrid variable (inflation plus the output gap) to the list being considered. But whether these variables are added or not, it is my impression that the exchange rate does not appear highly attractive. In particular, it

[6] This does not imply that the WSJ is wrong to argue that it is questionable whether devaluations are effective in improving current-account balance positions.

seems hard to believe that a country's price of foreign exchange is more important to that country's households and firms than the price level for its own goods (produced or consumed) or the level of nominal incomes in the country. Certainly if the main macroeconomic objective is to maintain a near-zero inflation rate, then a rule that responds to the inflation rate itself—or to its expected value in the near future—would appear to be more appropriate than one that responds to the exchange rate. In any event, there is no evident reason to favor the latter, from a macroeconomic perspective.

There are, certainly, reasons involving microeconomic efficiency for favoring use of a single medium of exchange (i.e., a single money) over a wide area. These stem from the very nature of a medium of exchange, the use of which is enormously more efficient than exchange conducted by barter. This is why it would obviously be undesirable to have separate currencies used in the District of Columbia and the Maryland or Virginia suburbs of D.C., or in Maryland and Virginia, or in Belgium and Luxembourg. But it is unclear that this reason, which Mundell (1997) emphasizes, would pertain to France and Germany, much less the United States and Japan. Mundell (1997) mentions reasons why certain considerations would call for a single world-wide currency, but his discussion does not actually make the argument that such would be optimal when all considerations are taken into account.

The main offsetting consideration, of course, is that having a single currency used over a wide area makes it impossible to have different monetary conditions or policies in different regions of that area. Thus if different shocks hit the various regions, there cannot be different monetary policy responses. From a very long run perspective, this will not matter because of long-run monetary neutrality. But in actuality adjustment periods can be quite

[7] A real variable, such as output or the output gap or a real interest rate or a real exchange rate, would leave the economy without any nominal anchor unless private agents possess money illusion. There probably exists a bit

long, and the costs along the way quite large. The United Kingdom's version of the Great Depression began not in 1930 but in 1921,[8] and I find it hard to escape the conclusion that this extended slump was largely due to the monetary stringency that was being generated in an attempt to adjust the U.K.'s real exchange rate with the U.S. without changing the nominal rate, following the different experiences during World War I.

Thus Mundell's optimal currency area (OCA) approach, to which I subscribe in principle, suggests that a fixed exchange rate (especially in the form of a common currency) is relatively more suitable for small and highly open economies that conduct many transactions with neighboring economies that tend to experience the same shocks. Correspondingly, a fixed rate is much less suitable for large and relatively self-contained economies. To go beyond that comparative statement requires quantitative analysis that is exceedingly difficult. It is not clear to me whether or not a properly conducted optimal currency area analysis would place all twelve of the actual Euro nations in a single currency area,[9] but whatever the outcome I would argue that the actual motivations of the European nations were more political than economic in motivation.

The foregoing argument does not imply that a floating exchange rate is desirable for every national economy, and should not be interpreted as representing that position. What it does imply is that the Mundellian type of OCA analysis does not suggest that the optimal number of currencies for the world is 1.0.

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of such illusion in actuality, but this would not provide the basis for a satisfactory monetary policy.

[8] The U.K.'s unemployment rate jumped from 2.5 to 17 percent in 1921, and remained over 10 percent (except for 9.8 percent in 1927) until 1940.

4. Gold

The real mystery of the WSJ position is why gold is given such a favored position. Let us suppose that it were agreed that a "price rule," rather than a quantity rule is superior—i.e., that the target variable should be a price level for an exchange rate, or for goods in general, or for some specific good, rather than a monetary aggregate. And let us set aside the exchange rate choice so as to focus on the price level vs. gold price comparison. In this regard, there seems to be no reason whatsoever to favor the latter, if a workable monetary policy rule for the price level can be designed.[10] But that is what an inflation targeting rule is, or, to be more precise, a price level rule is a special case of inflation targeting. Several significant national economies have adopted such rules over the last dozen years and all have fared relatively well thus far. There is every reason to believe, on the basis of evidence to date, that rules of this type will yield lower variability for the general price level than prevailed during the heyday of the Gold Standard.[11]

Perhaps the WSJ idea is that a gold standard would be more long-lasting, because a gold standard links monetary values to something that is intrinsically valuable, i.e., a quantity of gold. But there is nothing to keep a government from changing the par value of gold from year to year, except the belief that to do so would be to risk loss of credibility. But precisely that same motivation pertains with a specified path for the price level.

Next, suppose that the argument for the gold standard is that it can be implemented, not by means of a rule that adjusts interest rates (or monetary-base growth rates) in response to current conditions, but rather by having the central bank stand ready to exchange the

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[9] McCallum (1999) argues that the OCA approach is theoretically desirable but, in practice, is probably non-operational.
[10] One was designed long ago, of course, by Irving Fisher (1913).
[11] For evidence on variability under the gold standard, see Bordo and Schwartz (1999).

economy's paper money for specified quantities of gold. Even in this case the same can be provided for the price level, however, by a modified version of the Fama-Hall-Greenfield-Yeager scheme that that would have the government stand ready to buy or sell claims to a fully-specified, broadly defined basket of goods that reflects the general price level.[12] Such an arrangement would not only stabilize a preferable price index, but could also be designed to rely principally upon financial market arrangements so that very little physical storage of goods (which is wasteful) would be required.

Finally, it is conceivable that someone might argue that gold is special or even unique because of historical and semi-mystical reasons. But this type of position relies on a belief that it would be possible to again create a general public opinion not only that gold is very special, but also that the price of gold should not change over time, even as a result of wars and other cataclysmic events.[13] This opinion would have to be created not only among the public, but also probably among economists and other policy analysts. I do not know if the other members of the SOMC would agree, but I find this possibility too remote to warrant discussion.

5. Conclusions

The Wall Street Journal is propagator of economic commentary that is in most respects highly constructive. It would be even more useful in this regard if it did not take the unreasonable position that fixed foreign exchange rates are (almost) always and everywhere to be preferred to inflation-preventing monetary policy rules of alternative types that entail floating exchange rates.

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[12] For a review of such proposals as of 1985, see McCallum (1985). There is no reason why all such schemes should embody the defects that are pointed out in that paper. There is, for instance, no logical necessity for the absence of government involvement in the scheme, as is favored by Greenfield and Yeager (1983).

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