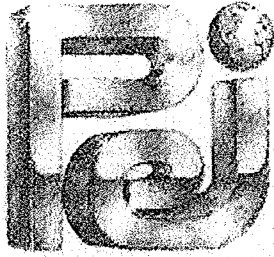

Princeton Economics International Ltd

The Following correspondence was the reply to our objections in the establishment of the G5 in 1985 to "manage" the global economy through intervention on a coordinated basis. Given the fact that the floating exchange rate system affords governments the freedom to now spend as they like pursuing their domestic policies objectives separate and apart from the international fiscal responsibility behind the value of the currency in global capital flows, it is simply unlikely that the current system will be sustainable long-term. Volatility will rise and will spread among the markets driven by swings in currency values. Eventually, in the course of events that will now follow, the global economy will become increasingly more unstable and reflect much high degrees of volatility as historically has always taken place under floating exchange rate systems. In the end game, the global economy will be attracked to the next major sovereign debt crisis that should appear going into 26 years from the 1985 birth of the G5 (2011), and perhaps culminate in new global monetary system by 2016.

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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

November 8, 1985

Dear Mr. Armstrong:

The President has asked me to respond to your letter of October 25. It is important that concerned citizens such as yourself express their views and we appreciate your efforts. We share your concern about intervention into foreign exchange markets. Numerous studies have failed to show that sterilized intervention has a long-run impact on the exchange rate, and unsterilized intervention affects the exchange rate while at the same time increasing the risk of renewed inflation. We agree that foreign exchange rate intervention is not the appropriate means by which to influence the exchange rate. We do not share, however, your concern over exchange rate volatility.

Both the high value of the dollar and the volatility of its value under the flexible exchange rate period have been sources of concern for many. The first issue which needs to be addressed is the reason behind the dollar's appreciation and the implications for our economic performance. The simultaneous existence of a current account deficit and a high foreign exchange value of the dollar are often cited as evidence that our international economic system is in disarray. Modern exchange rate theory has demonstrated that the exchange rate we observe need not be the one which balances the current account in a world of capital mobility. The exchange rate is instead influenced by both current and expected trade and capital flows. Intervention which attempts to force the exchange rate to a level thought to achieve a current account balance of zero is therefore misguided and may not be desirable.

In addition, one must remember that the exchange rate, at the same time, both reflects and affects economic variables. The exchange rate, for example, is affected by the same variables which have led to the rise in the current account deficit. One important factor driving the present current account deficit is the difference in economic growth rates between the U.S. and the rest of the world. This economic growth which we now enjoy is therefore an important factor driving the value of the dollar.

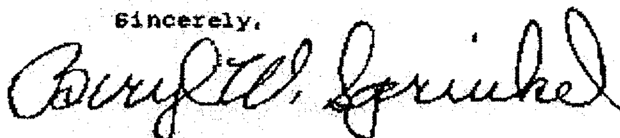
The volatility of the exchange rate is also cited as evidence of disarray in international financial markets. We do not believe this to be the case. The exchange rate is the price of an asset which, like all assets, is determined by the values of future economic variables as well as by their current values. As is the case with many asset prices, day-to-day fluctuations which reflect a reaction to news can be large; however, the apparent volatility does not indicate

market imperfections or irrationality on the part of market participants. In addition, the empirical evidence does not support the hypothesis that exchange rate volatility is an impediment to trade. On the contrary, international trade has flourished in the floating-rate period, expanding much more rapidly than it did during the fixed-rate period.

The system you proposed to eliminate exchange rate volatility essentially implies a return to a fixed-exchange rate regime. We believe that such a system would suffer from many of the same problems encountered under the Bretton Woods System. Since there is no central international monetary authority, an SDR-based system would require that the monetary authorities of various nations intervene either directly or indirectly to maintain the par value of their currency with respect to other currencies included in the SDR currency basket. This would mean that nations relinquish the ability to use monetary policy to pursue domestic policy objectives, a very unpopular alternative. The proposed SDR-based system also suffers from the reality of portfolio preferences. Countries have failed to exhibit a demand for SDR's and have preferred to either let their currencies float or to fix their currency to a basket of their own choosing. It would be undesirable to force a country to accept a system which fixed their currency to other currencies which they do not desire to hold.

In conclusion, we believe that the attributes of a floating rate system have been misinterpreted as deficiencies. Exchange rate volatility has not been linked to a decline in economic growth and merely reflects a rational response to current or expected changes in economic conditions. The high value of the dollar does not imply an economy in turmoil; rather, the dollar reflects a healthy economy. The policies which are required to reduce our current account deficit and to reduce the uncertainty surrounding exchange rate movements are those which encourage economic growth and monetary stability at home and abroad. Actions which reduce fiscal deficits, ensure noninflationary monetary policies, and yield a worldwide reduction in barriers to trade will promise progress toward such goals.

Sincerely,



Beryl W. Sprinkel

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Chairman
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COMMITTEES:
APPROPRIATIONS
SUBCOMMITTEE:
FOREIGN OPERATIONS
RANKING MEMBER

BUDGET

Congress of the United States
House of Representatives
Washington, D.C. 20515

December 14, 1985

Mr. Martin A. Armstrong
Princeton Economic Consultants Inc.
101 Carnegie Center
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Princeton, N.J. 08540

Dear Mr. Armstrong:

Thank you so much for your kind comments on our mo
conference, and especially for your ideas on monetary refor

I share your skepticism about temporary, stopgap sol
which will not work for long. I strongly agree with you
need for establishing a single international unit of acco
facilitate trade. I am not convinced, however, that the pap
will do the job.

I am enclosing my remarks from the conference, and I
you will see that we agree on a number of points. Again
thanks for sharing your thoughts with me.

Sincerely yours,

Jack Kemp