

ECONOMICS U\$A LESSON #28

Announcer: Funding for this program was provided by the Annenberg CPB Project.

(MUSIC PLAYS)

Stasio: Economics U\$A, one of a series of programs designed to explore Twentieth Century micro and macro economic principles. The subject of this edition is Exchange Rates. Our guest is Robert Solomon, Guest Scholar at the Brookings Institution. I'm Frank Stasio.

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Stasio: We regularly hear reports on the strength of the dollar and whether it rose or fell on international markets, but what do we mean when we talk about a currency's strength. How is it measured? Does the relative strength or weakness of the dollar in foreign markets have an effect on the domestic economy? Any one who has traveled abroad knows something about differing values of currencies. When American travelers exchange their dollars for a foreign currency they're quoted an exchange rate. This is simply the price of one currency with respect to another. Currently, the value of the U.S. dollar is flexible with respect to another. Currently, the value of the U.S. dollar is flexible with respect to other currencies. Robert Solomon, Guest Scholar at the Brookings Institution explains how flexible exchange rates are established.

Solomon: They're established in, as between England and the United States at least by markets, people buying and selling, demand and supply, the old story of economics just as the price of potatoes is determined by demand and supply.

Stasio: There are, of course, many important factors that influence the supply and demand for money, which we'll discuss in detail in a moment. Right now, let's look at how the value of currency was set before it was lumped in the same sack as potatoes. There was a time when the dollar and the currencies of America's foreign trading partners were fixed to the price of gold, so they did not fluctuate with changes in demand. Nations agreed that their dollars or pounds or francs would each buy a fixed amount of gold.

Solomon: What was done back in the Nineteenth Century when England was the major power in the world and countries, the industrial countries at least, did fix their currencies in terms of gold, which meant basically fixing in terms of the British pound. The U.S. dollar was worth...I mean the British pound was worth something close to five dollars in those days for quite a long period of time.

Stasio: But explain how that works? Why is it then fixing exchange rates to the gold...to gold is in effect attaching it to the pound?

Solomon: Well, it's just that the pound's value was fixed in terms of gold as well, and the dollar was fixed to gold and it was also fixed to the pound, and the pound was the currency that was used in day-to-day transactions, not gold. Gold moved from one central to back to another and it was held in private as well, but the currencies were used then as they are today to finance trade and other international transactions. Each country

by fixing its currency in relationship to gold and trying to maintain it kept what we would call a fixed or stable exchange rate.

Stasio: Under the gold standard, countries transferred gold from their reserves to buy foreign currencies, which they used to pay for imported goods. Nineteen Century economists argued over whether a country might buy so much from other countries that it would empty its reserves. The issue was resolved by Scottish Philosopher David Hume. Hume argued that gold reserves of trading countries would automatically stay in balance because changes in a nation's reserves would also change prices. Say for example France finds itself importing more from England than England buys from France. We presume this is because the prices of English goods are relatively low, but what happens to French prices as French gold is shipped across the English Channel. According to the quantity theory of money, French prices will fall as gold supplies decline. Likewise, as English reserves grow, British prices will tend to rise. So at some point, British goods become less attractive than French products and there is a shift in the direction of trade. British gold then flows back into French reserves. Today the value of foreign currencies is no longer fixed to gold or each other. A system of flexible exchange rates evolved in Nineteen Seventy-three. As Robert Solomon has pointed out, flexible exchange rates rely on the principles of supply and demand to set the price.

Solomon: Let's assume that a new product appears in the United States, a new computer or a new VCR or what have you, and the people in the other countries want to buy American products 'cause they look very attractive. People need dollars to buy them and they will rush to buy those dollars and that would tend to drive up the price or the exchange rate of the dollar.

Stasio: As the price of one currency increases with respect to another it is said to appreciate in value or strengthen. As the currency weakens in value, it is said to depreciate. American travelers who went to buy foreign currency several times as the dollar was appreciating would find they needed fewer and fewer dollars to buy foreign dominations. As Solomon suggests, the demand for currency in part reflects the demand for a country's product. So a country's domestic economy has a strong effect on exchange rates.

Solomon: Perhaps other countries are having more inflation than the United States, and therefore, American products tend to look less expensive to them, because the prices of American products are going up less rapidly than the prices of products in other countries. People in these other countries were there...for want to buy American goods that will...trying to raise the price of the dollar and push up the exchange rate, and therefore, push down the exchange rates of those other countries.

Stasio: There is also a relationship between a country's economic growth rate and the rate of exchange. Countries with a strong economy tend to increase their imports raising demand for foreign currency. This, in turn, weakens the value of their own currency. Conversely, countries with a sluggish economy tend to import less so the demand for foreign currencies is low raising the price of its own currency. Imports and exports are not the only factors that affect the demand for foreign currencies. Investment also plays a role. If a foreigner wants to invest in the U.S. he must convert his money to dollars. Foreign investment is attracted by relatively high interest rates, so the flow of foreign capital into the U.S. further strengthens the value of the dollars. But Solomon points out that a strong dollar should not be confused with a strong economy.

Solomon: The strong dollar, which means that...what simply means a high price for the dollar in terms of other currencies, this we said earlier. Probably the major explanation though it's not fully understood, but probably the major explanation for it is that interest rates in the United States have been higher than those in other countries, and therefore, people in other countries have wanted to lend in the United States to buy American securities which pay a higher return than what they could earn in their countries and to do it if they have to buy dollars, and as they buy dollars, they drive up its prices and raise the price of the dollar not only for those who want to make investments, but for those who want to buy American goods. By the same token, they lower the price of foreign currencies to Americans, therefore, making it less expensive for Americans to buy foreign goods.

Stasio: Fiscal policy also influences exchange rates. During the Nineteen Eighties, there was some feeling that the huge budget deficit run by the federal government helped keep the dollar strong.

Solomon: Life is complex but it is thought that in the case of the United States in recent years at least that the budget deficit which has to be financed by issuing securities, Treasury securities, that issuing securities and demand for funds has driven up American interest rates higher than interest rates in other industrial countries, and this is thought...why they thought to be a major reason for the strength of the dollar, the high value of a dollar.

Stasio: But as Solomon says, life is complex. For instance, suppose the deficit had caused inflation. As we've already explained, inflation reduces the value of currency.

Many experts believe that tight monetary policy which kept interest rates high in the early and mid-Nineteen Eighties dampened inflation and kept the dollar strong. Suppose during this time in the early and mid-Nineteen Eighties the Fed had a looser monetary policy, what could we expect then in terms of the strength of the dollar?

Solomon: Well, if the Fed had had a looser monetary policy in a time when we had a substantial budget deficit as we still have in the mid-Nineteen Eighties, we might have had more inflation. Nobody can be sure of that, but we might have had that but beyond that if the Fed followed a...an easier monetary policy, interest rates would have been lower in this country and the dollar would have been less strong.

Stasio: Economic conditions in the United States may have strengthened the dollar in the Eighties but then the strong dollar itself became a part of America's domestic economic picture. Like trade, the relationship between the domestic economy and exchange rates is a two-way proposition.

Solomon: The exchange rate has reduced in the United States in the first half of the Eighties. The exchange rate led to a very slow expansion of exports and American companies have felt that and complained about it. It has led to a large increase in imports, which has been favorable to consumers who like foreign products. It has tended to hold down prices that made its contribution to the reduction in inflation in the United States, which everybody seems to approve of. So you get benefits as well as costs from these movements of exchange, but they do as you say have an impact on the domestic economy while they also react to the condition of the domestic economy as it interacts with the economies of other countries.

Stasio: Sharp changes in exchange rates carry some costs that are difficult to add up.

Each time a country is forced to increase or lower its production capacity to accommodate changes in demand, it pays so-called adjustment costs.

Solomon: Some of the obvious potential costs would be something like this. If when the exchange rate goes up as the dollar's exchange rate has done in the last few years, it becomes less profitable to export and American producer...and more imports have a low cost and they come in and they...so you get import competition with American industry, and American exporters have trouble producing profitably. Those American exporters tend to establish plants abroad where costs are lower and export from abroad rather than from the United States. Now, that may affect employment in the United States. When the dollar goes down, will they try to move back again and what are the costs involved in first building a plant abroad, then abandoning that plant and coming back to the United States, if that's what they do, and we don't know to what extent they're doing it or will do it, but that's the potential adjustment cost. And when people are thrown out of work in an industry because the exchange rate is high and then when the exchange rate goes back, they come back to work, or what have they done in the meantime. Whatever they've done has been costly to them and, therefore, to society. That's another example of an adjustment cost. These are subjects about which we don't have an enormous amount of information. In particular industries, you can go and talk to an autoworker. There's no doubt that you'll find out very...very strongly what his adjustment costs have been.

Stasio: The difference between a country's imports and its exports is called the trade balance. If a country imports more than it sells abroad, it has a trade deficit. If it exports

more than it buys from foreign countries, it has a trade surplus. By itself, having a trade deficit may not be undesirable. Solomon points out that the important issue for any government is why are imports exceeding exports.

Solomon: So as you had asked, what are the conditions that determine whether individuals spend more than their income or less than income? Some of us save some of our income 'cause we spend less than we earn. Others of us, depending upon our stage in life and all sorts of other conditions may spend less...spend more than our incomes and we've financed that by borrowing or perhaps someone like a parent gives us an inheritance and we don't have to borrow but just in order to spend more than our income, but it varies among people and it varies among countries, and some of the same condition. It also depends upon the stage of life of countries. A country that's less developed as they're called. Countries in Latin America or Africa or Asia are...normally will have deficits in their balance of payments. They'll tend to buy more abroad than they sell abroad and they use that difference to help develop their own countries by increasing the investment.

Stasio: Running a trade deficit is not the same as being in debt. In many cases, a nation's assets abroad such as holdings in real estate and factories may exceed the claims of other countries on its own wealth. In this case a country is considered a net lender or creditor. It is possible for a net lender to run a trade deficit, that is, to import more in a given year than in exports. For most of the Twentieth Century, the United States has been a net lender, but in the early Nineteen Eighties, the U.S. became a net borrower. In Nineteen Eighty-three, the United States became a net borrower. Is that a cause for concern?

Solomon: Well, I don't know if it's a cause for concern all by itself. What that says is that some time, whether it was Eighty-three or Eighty-four or Eighty-five, even that is not certain but what that says is that our liability to the rest of the world came to exceed our claims on the rest of the world...our assets in the rest of the world taking your country as a whole. Well, that...there's nothing sacred about zero in economics and the fact that those two happen to become equal that year is in itself isn't so important, but maybe of greater concern is the direction of movement. We're becoming a debtor country and as...as that debt to the rest of the world increases, we're gonna have to use more of our own income to service the debt, to pay interest to the rest of the world, and that's gonna have an effect on the standard of living of future generations and that may be of concern if this balance of payments definitely continues for a long time.

Stasio: But as...as you pointed out earlier, the simple fact that you're in debt may mean different things depending on where you are in your own history?

Solomon: Right. Well, the United States was a large debtor in the Nineteenth Century. We developed by borrowing from the rest of the world just as Brazil has been doing here, and since World War Two, and we gradually worked our way out of that debtor status and became a very large creditor until recently when we moved back the other way. Now we are a highly developed country and it doesn't make much sense in the longer run or even the medium run for us to be a net debtor, and one assumes that this is a temporary condition.

Stasio: One of the most important effects of exchange rates is to adjust the relative price levels of trading countries, so that money holds its purchasing power when it's converted

into other currencies. With flexible exchange rates, currency values float or change with changes in demand. While changes in the exchange rate can affect the domestic economy there are similar problems when governments try to fix the exchange rate as they did under the gold standard.

Solomon: Countries' endeavor to maintain that link of their currencies to gold and, therefore, to other currencies no matter what the effect was on the domestic economy. Countries could go into recession, have high unemployment. They still held onto that exchange rate sacrificing domestic economic objectives in order to maintain that external objective. That may have been possible back in the Nineteenth Century or the early Twentieth Century even, but I don't think many countries would stand for it today.

Stasio: Explain how that tradeoff would work? What would happen if you tried to maintain that exchange rate beyond the market forces?

Solomon: Well, let's assume that say a country had more inflation than its trade partners. Normally, if a country has more inflation, its currency has to go down in value relative to those of other countries has to depreciate, but if it is required by international agreement as it were to maintain a fixed exchange rate, it's as we said earlier, its exports would go down, its imports will increase and under the gold standard, gold would have moved from that country to other countries. That's how the excess imports would have been paid for. As gold flowed out of the country, the central bank of that country would have taken restrictive, adopted a more restrictive monetary policy, and that is the force that would have depressed the economy of that country. Now that depressing would have tended to

slow down the inflation that was the initial cause of the problem true enough, but it also would have caused unemployment, which is not particularly desirable.

Stasio: There is another way countries under the gold standard could bring their economies into balance. They could unilaterally adjust the value of the currency with respect to gold. Countries that found their imports exceeding exports could raise the price of gold. This is called devaluation. By reducing the value of its currency, a country makes imports more expensive and its own exports cheaper abroad. Devaluation became a common practice during the Great Depression as a way for countries to stimulate their economies and reduce unemployment. This severely disrupted trade causing countries to move away from the gold standard.

Speaker: “Our international trade relations though vastly important are secondary to the establishment of a sound national economy.”

Solomon: Gold became less dominant in the international monetary system. Countries began holding currencies in their reserves along with gold and this developed what was called the gold exchange standard. Dollars and pounds, sterling, were the major reserve currencies in the Twenties, Thirties, Forties, and Fifties, so there was a supplement to gold in the system that countries weren't quite as dependent on...on gold discoveries and gold mining as they had been earlier. But also the...the concept that one had to keep one's currency linked to that stable price in terms of gold weakened in the Twenties and Thirties and particularly when Britain went off the gold standard in Nineteen Thirty-one. That was a large shock to people who were accustomed to thinking in terms of the gold standard. When Britain devalued its currency in Nineteen Thirty-one, it was said that

Britain went off gold. It went off the gold standard. That was the term that was used at that time and that was the beginning of a period of more flexible exchange rates.

Stasio: Once free from the gold standard, however, countries adjusted their exchange rates to give themselves competitive trade advantages. This would often lead to retaliation and ultimately restrictions on trade such as tariffs or import quotas. In Nineteen Forty-four, allied governments met to work out a more stable exchange system. The Breton Woods Conferences named for the site of the talks in Breton Woods, New Hampshire once again fixed currency exchange rates. But in the Nineteen Seventy-three, the Breton Woods Agreements were abandoned resulting in a system of fluctuating exchange rates.

President Nixon: "I've directed Secretary Connelly to suspend temporarily the convertibility of the dollar into gold or other reserve assets except in amounts and conditions determined to be in the interest of monetary stability and in the best interest of the United States."

Stasio: Robert Solomon says that when governments choose a flexible system over a fixed rate, they're trading international monetary stability for domestic economic goals.

Solomon: To keep your currency stable against the currencies of other countries might require that a country undertake measures that would not seem very desirable in terms of its domestic economic performance. It may create too much unemployment or it may create too much inflation, and the countries are no longer willing to do that as they were willing to do under the gold standard. That's the big tradeoff and since countries have

not been willing to sacrifice their domestic economic goals, they have stuck to this floating system rather than going back to a fixed exchange rate system.

Stasio: When you talk about those domestic policies to making adjustments to keep their currency exchange fixed, aren't those policies though sound policies anyway? I mean, wouldn't a tighter money policy during a time of inflation make sense even domestically?

Solomon: Well, it might. There are times when...there are times when the policies that are needed to keep the exchange rate fixed are also suitable and desirable for domestics to votes and that's fine. That's great when that occurred but it's not always true. Let me just give one example, suppose the United States goes into a recession and this reduces the American demand for British goods and Britain finds that it has a deficit in its balance of payments, trade balance. Its interest rates are not especially high and that deficit in its trade balance tends to cause the pound to depreciate. Now if it were required to prevent the pound from depreciating it might have to raise its interest rates or take other measures that would depress the British economy even though the British economy did not have inflation. Its problem was caused by the American recession. Britain might be better off in those circumstances to let the pound go down unless it could find some way to finance that deficit and maintain the pound.

Stasio: What are some of the remedies that governments have for the adjusting their exchange rates?

Solomon: Well, these days the exchange rate between the United States and other major countries is not determined by governments, it's determined by market forces, demand and supply as we were saying earlier. So governments don't have very many direct

instruments for operating on the exchange rates. The policy is governments adopt to influence interest rates for domestic reasons will also affect the exchange as we've been saying here.

Stasio: There has been a great deal of volatility in international money markets since trading nations adopted flexible exchange rates. Robert Solomon says the challenge for those countries is to create a stable monetary system without having to return to rigid exchange rates.

Solomon: The only real answer that anybody sees is some system by which you get greater coordination of policies and economic goals among at least the major industrial countries, and really among all the countries in the world. Individual countries will all pay lip service to the desirability for coordinated policies for convergence of economic policies or for compatibility of policies. These words you all use. But when it comes down to taking actions to implementing that vague goal, countries are rather hesitant and the reasons are, as we stated earlier, that they all have their own domestic objectives, politicians that have to get re-elected. They have policy positions on which they were elected and want to be re-elected, and they will tend to take actions that are suitable internationally even if those actions appear desirable to them from a domestic point of view. That's perfectly understandable and that's the problem. Sometimes even when those actions may appear desirable from the domestic point of view, for one reason or another politicians may not be willing to adopt. One can easily think of a country where many people believe that the budget deficit should be reduced and that political leaders are hesitant to take actions to reduce the budget deficit.

Stasio: Let's review some of the main ideas in our discussion on exchange rates.

Exchange rates are the price of one currency with respect to another. The laws of supply and demand apply to the value of currency, so if the demand for a currency rises, its price will go up. When the demand falls, the price will drop. The demand for currency in part reflects the demand for a country's products, so domestic economic factors affect exchange rates. If a country's experiencing inflation, prices for its products will be high relative to other countries, and demand for its products will drop lowering the value of its currency. When a country's prices are relatively low, the demand for that country's currency increases. Relatively high real interest rates attract foreign investment creating an even stronger demand for that country's currency. There is, therefore, no direct relationship between the strength of a country's currency and the strength of its economy. Strong demand for a particular currency makes that country's exports relatively more expensive abroad reducing demand. This can lead to a slowdown in the country's domestic economy. Supply and demand determines the relative value of currencies for countries under a system of flexible exchange rates. Countries that import more than they export are said to run a trade deficit. Those that export more than they import are running trade surpluses. A country may run a trade deficit without being in debt. A country only becomes a debtor when its assets abroad are less than the claims of other countries on its own will. There was a time when countries fixed the value of their currencies with respect to gold. This provided a great deal of stability in international trade but often it came at the expense of the countries own domestic economy. As a result, the world moved to a flexible exchange rate reducing international economic stability. The challenge for most trading nations is to achieve worldwide monetary

stability without sacrificing the flexibility to cope with changes in its own domestic economy.

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