Commentaries

America is not immune

Roger Altman, "Beware America, the World Financial Crisis Is Serious," *International Herald Tribune,* June 24 (appeared first in the *Los Angeles Times*). *Altman served in the Treasury Department in the Carter administration, and was Clinton's First Deputy Treasury Secretary.*

"Despite last week's tremors, an eerie calm hangs over U.S. financial markets, which reflects a seeming oblivion to the spreading international financial crisis. The stock market remains at stratospheric highs, interest rates have hit 30-year lows, and Wall Street sees the economy as impregnable. It is America as a financial island.

"But this isolation is increasingly untenable. A financial firestorm is spreading across East Asia, Russia, and parts of Latin America. Currencies have collapsed, capital has fled, and economies have sunk on an unprecedented scale. . . .

"All this constitutes the worst financial crisis since the birth of the international monetary system in 1944, and it seems to be accelerating. The U.S. Federal Reserve and Treasury are increasingly worried about a world market meltdown. . . .

"Apart from nuclear weapons, [the financial markets] are the most powerful force the world has experienced. In recent months the markets have obliterated governments overnight and imposed previously unthinkable changes on one nation after another. One day President Suharto of Indonesia is still omnipotent. Then, after the markets render their verdict, he is gone.

"Those who think that the mighty United States is immune to such forces are wrong. This is a dangerous moment."

John Kenneth Galbraith, interview in *The Observer,* London, June 21.

Asked about the potential for a financial crash, economist Galbraith replied, "I, of course, don't use the word crash; I repair to financial language and talk not about a major correction but a major adjustment. (I am considering retitling my book on the 1929 crash *The Major Adjustment*.). . .

"Greenspan has been doing admirably what the Federal Reserve has always done—which is nothing. . . . There should have been far more warning about the speculative splurge on Wall Street and the extent of citizen participation. That was the mistake that the Federal Reserve made in the '20s, and the mistake that it has made again now. And the reason for it is simple: you cannot warn against a speculative splurge without taking responsibility for what happens thereafter; no head of the Federal Reserve wants to be held responsible for a dip in the stock market. . . .

"One thing is wonderfully clear—when trouble comes on Wall Street, the blame will all be passed to Indonesia, Malaysia, and maybe Japan. Wall Street insanity—let me use a slightly milder expression, Wall Street 'speculative error'—now has a perfect cover. . . .

"As is happening now in East Asia, the peculiar genius of the IMF is to bail out those most responsible, and extend the greatest hardship to the workers, who are not responsible, who are innocent participants."

Interview: Arthur J. Rolnick

The case for fixed exchange rates

On June 20, the Minneapolis Star Tribune *took up the debate on the need for a new world financial system, in an article entitled "Falling Yen Raises Questions About Floating Currency," by columnist Mike Meyers. A section of that article was entitled, "A New Bretton Woods." Meyers identified two economists from the Minneapolis Federal Reserve, Arthur J. Rolnick and Warren Webber, who, "for nearly a decade, . . . have made the case for a return to fixed international currency rates. . . . Rolnick and his allies at the Minneapolis Fed argue that today central bankers around the world accept the idea that stable domestic prices are a cornerstone of sustained economic growth. In effect, that removes one old argument against fixed international currency values."*

Rolnick, Senior Vice President and Director of Research of the Federal Reserve Bank of Minneapolis, was interviewed by Richard Freeman on June 22.

EIR: You are quoted in the *Minneapolis Star Tribune* of June 20 as advocating a fixed-exchange-rate system, which it said, you have been advocating for a decade.

Rolnick: A fixed-exchange-rate system should be reconsidered. I co-authored an essay on this subject that appeared in the 1989 *Annual Report* of the Federal Reserve Bank of Minneapolis, which was titlted, "The Case for Fixed Exchange Rates." I argued that within a few years after the world went to a floating-rate system (about 1973), it was clear that exchange-rate movements were not being driven by fundamentals. I think that this is an inherent problem with fiat monies.

My views are based on research by professors Neil Wallace and John Kereken. They argue that fiat monies are special, that unfettered markets cannot determine their rates of exchange, that there is a fundamental price indeterminancy. In other words, exchange rates can take any value. Consequently, you can end up with large fluctuations in exchange rates. And, it's not because of inflation per se. Even if you

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have low inflation, under floating rates, for any reason, your currency can fall. There is nothing that ties the currency down.

The theoretical research is determined by the empirical results of economists [Richard] Meese and [Kenneth] Rogof. In a 1983 paper, they show that since the world adopted floating exchange rates, economic fundamentals have not helped to predict exchange-rate movements. Indeed, they find that the best technique for predicting exchange rates is a random walk model.

The bottom line is that, from an economic efficiency point of view, the best arrangement is a fixed-exchange-rate system.

EIR: Have you written other things on this subject?
Rolnick: In 1993, I co-authored an article, "In Order to Form a More Perfect Monetary Union," which shows that America's monetary system changed when we adopted the Constitution. Under the Articles of Confederation, many states issued their own bills of credit. You had 13 states issuing their own currency, and the country experienced exchange rate variability that it found unnecessary and undesirable. But the Constitution stopped that. It prohibited states from issuing bills of credit.

EIR: In 1944-45, the world economies adopted a fixed-exchange-rate regime known as the Bretton Woods system. It was hoped that a regime of stable exchange rates would help to reconstruct the war-shattered countries of Europe and Japan. How did that system function?
Rolnick: In the early years of the Bretton Woods system, countries could still petition to get their exchange rates changed. Currencies were pegged to the dollar, which, in turn, was supposed to be pegged to gold. While there were some difficulties in the beginning, by the 1960s, exchange rates were fairly stable. And, prior to 1973, world economies were doing pretty well, a sign that the system was going in the right direction.

EIR: Why did the Bretton Woods system end?
Rolnick: The problem was that the United States had the war in Vietnam, and instead of taxing its people to pay for the war, it printed dollars. It ran a [budget] deficit and printed dollars. It then exported the dollars to the rest of the world. The U.S. exported its inflation and dollar problem to the rest of the world. We were printing too many dollars. [French President Charles] de Gaulle, among others, was unwilling to hold dollars and started demanding gold in return.

EIR: At a critical point, on Aug. 15, 1971, President Richard Nixon took the dollar off the gold reserve standard.
Rolnick: Milton Friedman played a role.

EIR: Friedman? I know of the role of Paul Volcker, who was Treasury Undersecretary for International Monetary Affairs, and also John Connally, as well as House Banking Committee Chairman Henry Reuss (D-Wisc).
Rolnick: It is my understanding that Friedman was very influential. He had been writing on this issue since 1953. [In the bibliography to Rolnick's 1989 article, "The Case for Fixing Exchange Rates," Rolnick cites a 1953 article by Friedman, "The Case for Flexible Exchange Rates," which appeared in *Essays in Positive Economics*.]

EIR: Right now there are nations in Asia that have been attacked by the hedge funds and speculators, that have seen their currencies fall in value compared to the dollar by 30-80%. This increases their dollar-denominated debt by that amount, and contributes to destroying their economies.
Rolnick: We have seen that, under floating exchange rates, there can be large fluctuations of exchange rates. Businessmen must pay a hefty fee to hedge this risk. They incur currency risk whenever they engage in an international transaction. Exchange rate risk is a dead weight loss. Uncertainty about government intervention only adds to this risk.

EIR: What do you think it would take to put together a new Bretton Woods system?
Rolnick: I think it depends on the Americans, Germans, and Japanese making the decision to tie their currencies together. If they decide to do it, it will happen. Most countries in the world have already fixed their currencies to one of these three countries' currencies.

EIR: In the new Bretton Woods or fixed-exchange-rate system that you envision, would there be adjustment of currencies every 6 or every 12 months?
Rolnick: No. They would be fixed forever. In the beginning, countries may need to make some adjustments. But really, it doesn't matter what rate is set. Once the system is credible and ongoing, the initial rates are not that important.

EIR: Let me play devil's advocate. The supporters of a floating-exchange-rate system say that if a country is in trade deficit—is importing more than it's exporting—then the country can devalue its currency and it will export more.
Rolnick: Yes, that's the argument. But look at the history of devaluing currencies. If a country is devaluing its currency, other countries may respond by devaluing their currencies. But, even if a country is successful in devaluing its currency relative to other countries, does it really help a country to have a lower exchange rate? If a country has a high exchange rate, it can import more goods, and in particular, more capital goods.

Hence, it is not clear that lower exchange rates create more jobs in a country; I'm not sure that that country is better off. I think that instead of changing exchange rates, you should change the fundamentals that are causing the problem. Moreover, if a country has a stable exchange rate, businessmen are more likely to invest in that country.

That is the crux of the issue. That is why a fixed-exchange-rate system is economically efficient.