August 2, 1976

Professor Milton Friedman
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Dear Professor Friedman:

Thank you very much for your note of June 30.

I accept your "weakest link" analysis as "the chief defect of the fixed exchange rate system", though it is fair to say that you criticize the reserve currency form of a fixed rate regime. May I presume to say that history (much of it your own) and theory provide us with several forms of fixed exchange rate regimes. A defective fixed exchange rate regime is, as you say, "as strong as its weakest link". An efficacious fixed exchange rate regime is one which tends toward equilibrium by the very nature of the mechanism or rule which governs its behavior. Such a rule should bring about precisely that harmonization of monetary policies which invariably eludes the central bankers and ministers of the great trading nations at those many and fatuous conferences, where they pontificate in the abstract about the synchronization of monetary policies---through "planning", information exchange, good will, and coordinated foreign exchange market intervention and fine tuning.

Do we agree that an enduring and efficacious fixed exchange rate regime would resemble neither the Bretton Woods, nor the post 1922 Genoa, sterling-dollar fixed exchange rate regimes, both of which systems were based on official reserve currencies? A lasting fixed exchange rate regime in the future might be characterized by the absence of an official reserve currency. An official reserve currency was in fact the agency by which undisciplined "weak links" transmitted their inflationary excesses throughout the world economy. A stable fixed exchange rate regime should rule out the creation of money through acceptance by central banks of foreign exchange, held as reserves, against the issue of domestic money.

When I contemplate, as you suggest, the position of Germany over the past decade, I must take your point, but I am inspired by another point. In a floating exchange rate system (or unsystem), characterized by a lack of discipline on the part of major or hegemonic participants, not to mention excessive intervention by the monopoly power of central banks in the foreign exchange markets (as well as hyperactive intervention in the markets for domestic financial claims), a very specific form of disorder and debilitation develops, as severe as anything produced by defective fixed exchange rate systems, such as those of Bretton Woods or the post Genoa System. That is to say, floating exchange rates in the financial system do not, I believe, liberate and enhance production, as do mobile factors of production and flexible prices in the economic system. Floating exchange rates are not, as some say, free prices in the markets for currencies. It would make as much sense to say that a hegemonic cloth buyer or an especially powerful seamstress might vary the length of the yardstick, on a day-to-day basis---the length each day dependent only upon the strongest bidder for cloth during a specific market period.

No, floating exchange rates may suit a central bank monopoly; they may serve as a rationale for a free, even mercantilist, monetary policy. To desire freedom, even license, for central bank monetary policy may require floating exchange rates. But such a requirement is not a virtue to be confused with free and open markets for the exchange of stable national monetary units. To achieve freedom of monetary policy is no more compelling an argument for floating currencies, themselves standards of measurement and units of account, than the power to vary the yardstick length, in an otherwise free and open market, justifies flexible sizes of yardsticks. For example, what happens in the short run (or in the intermediate run) to the composition of production in a country which imposes the self-denying ordinance, to which you refer, if other similarly positioned national competitors do not impose the same ordinance? Very painful adjustments may be imposed on the export sector (among others) of the self-disciplined country, adjustments easily as destructive as the inflationary consequences might be to the undisciplined national economy itself.

Professor Milton Friedman
Page three
August 2, 1976

Moreover, when the standard of value and the unit of account are redefined on a daily basis, as a result of an undisciplined monetary policy, monopolized as monetary policy is by central banks, the economic process must begin to overcapitalize the investment in suitable alternatives to an unstable monetary unit. Unavoidably resources will be diverted to stabilizing the procedural characteristics of the exchange process (through unnecessary portfolio diversification, excessive forward hedging costs, reluctance to make direct long term investment across national boundaries, even in extreme cases through barter), thus reducing the real wealth otherwise available to members of the global community. In fact, permit me to say that if the yardstick (36"?) is redefined daily as 33" or 39" by the most powerful seamstress or the most coercive purchaser of cloth, one can readily imagine a situation where the seamstress and cloth purchaser cease to exchange goods measured by the yardstick, thereby diminishing for a period the exchange process itself. During that interval, the method by which exchange is transacted will, relatively speaking and due to the uncertainty, become overcapitalized.

It is true, of course, that a floating exchange rate policy, in the absence of central bank intervention, will lead to a "de facto" stable monetary system, similar in most respects to a fixed exchange rate regime based on convertibility without reserve currencies.

But then it is also true that the difference between anarchy and order is often simply the giving of the rule to the community by the equilibrium leader, backed up by the force to make it work.

Your article in Newsweek on New Hampshire and Vermont was a masterpiece.

May I burden you with a copy of my short article on the above subject, just published a few months ago. If you have the time, I would be interested in your comments on my paper.

Respectfully,

Lewis E. Lehrman

LEL/ms
Enclosures