



FRIEDMAN'S ROAD MAPS

WITH THE DEATH OF MILTON FRIEDMAN IN November we lost a great champion of free markets. And what does “free market” mean in the context of foreign exchange? The simplistic answer is that “free” means floating exchange rates. Yes, Friedman favored floating exchange rates. But he also favored fixed rates. How could this be? Aren't these positions mutually exclusive?

Look more closely at what Friedman really thought about foreign exchange. The ratio of one currency to another is just what's on the surface. What matters more is the freedom of capital to move from one country to another. Such freedom is consistent with both fixed and flexible exchange rates.

Friedman's first—and most famous—foray into the exchange-rate debate, an essay entitled “The Case for Flexible Exchange Rates” (1953), was originally written as a memorandum in 1950, when he served as a consultant to the U.S. agency administering the Marshall Plan. At the time European countries were imposing a plethora of controls on cross-border currency flows. Friedman opposed restrictions on international capital flows. He concluded that the adoption of floating exchange rates across Europe would remove the need for exchange controls and promote economic freedom.

In the 1960s Friedman turned his attention toward monetary problems in developing countries, where inflation and exchange controls were pervasive. For these countries Friedman was skeptical about floating exchange rates because he mistrusted their central banks and doubted their ability to properly manage the money supply. To rid developing countries of exchange controls his free-market elixir was the fixed exchange rate, but with one major proviso: Any country that adopted a fixed exchange rate must dump its central bank and adopt a currency board (or “dollarize,” as Panama did in 1904).

A currency board issues notes and coins fully backed by foreign reserves and fully convertible at a fixed exchange rate into an anchor currency.

A board has no monetary policy—changes in the money supply are determined by changes in a currency board's foreign reserves.

Friedman laid great stress on the fact that a fixed exchange rate administered by a central bank is dangerous because there is always the potential for a central bank to buy and sell domestic bonds, thereby engaging in discretionary monetary policy and breaking the one-to-one link between changes in its foreign reserves and changes in the money supply. In April 1991 Argentina passed a law requiring the central bank to maintain a fixed exchange rate. But Friedman didn't trust that bank—he expected that it would eventually engage in monetary mischief and the system would get into trouble. He was right: Convertibility blew up in December 2001.

I proposed a currency board and a fixed exchange rate for Estonia in early 1992. A book I coauthored then, *Monetary Reform for a Free Estonia*, carries the following dust-jacket endorsement by Friedman: “A currency board such as that proposed by Hanke, Jonung and Schuler is an excellent system for a country in Estonia's position.” In June 1992 Estonia dumped the Russian ruble, and its

currency board began exchanging kroon at a fixed rate of 8 per German deutsche mark (subsequently 15.65 per euro).

The results have been spectacular. The Heritage Foundation/Wall Street Journal 2007 *Index of Economic Freedom* ranks Estonia twelfth, the highest of any former communist country. Estonia's GDP per capita has increased tenfold since the currency board was installed, to

Floating or fixed exchange rates? What matters is the freedom of capital to move across borders.

a projected \$12,900 for this year.

Friedman admired Hong Kong for fixing the Hong Kong dollar's exchange rate against the U.S. dollar in 1983—and doing without a central bank. He thought Hong Kong a “showplace of free markets,” as evidenced by its number one rank on the economic freedom index. Mainland China is a very different beast, with a managed exchange rate for the renminbi and limited freedom of movement for capital. In Beijing the managed exchange rate comes with an interventionist central bank and controls on the movement of capital in and out of the country.

We've got plenty of interventionists on these shores, too. Congressmen with a mercantilist bent want the value of the yen to be pushed up, artificially if need be. Free markets are not popular with politicians.

Look-back time: One of my investing recommendations in 2006 was to buy the **iShares Dow Jones Select Dividend**. This exchange-traded fund (**71, DVY**) gained 11.6% from my April mention to year-end (assuming a 1% trading cost), versus 10.9% for an equal investment in the S&P 500. **F**



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