Princeton
Economics
International Ltd

210 Carnegie Center, 4th Floor
Princeton, NJ 08540 (USA)

8 Bolton Street
Piccadilly, London W1Y BAU, UK

USA Tel. 609-987-0600 FAX 609-987-0726

October 25, 1985

President Ronald Reagan
White House
Washington, D.C. 20510

Dear Sir:

In response to your invitation to attend the U.S. Congressional Summit on Exchange Rates, I would look forward to this opportunity to meet such a distinguished gathering. Nevertheless, I do find this subject of major international importance which has been at the very foundation of the concerns expressed by our clientele. Even though our firm profits from the current floating rate system through the consultation services which we provide, we are prepared to set personal benefits aside for a worthwhile cause to revise this monetary system. It is the position of our firm, that unless constructive efforts are taken virtually immediately to revise this system, the free market volatility will force upon the world a mandatory reform in any event. We are prepared to assist in whatever capacity is necessary to effect an orderly change for the benefit of the international economy. It has become clear that unless this issue is seriously addressed, the stability of the world both on an economic level as well as a political level will be drastically effected within just the next few years.

Undoubtedly, you will notice that our firm takes its name from its native location in Princeton, New Jersey. Nonetheless, we represent perhaps one of the few truly international economic firms in the world since we maintain offices in London and Geneva and service corporate, institutional and private international clients.

Personally, I have held numerous seminars for our clients both here in North America and in Europe. The problems that we deal with are not those solely from an American perspective. It is my deepest concern that as an American we do not truly comprehend the strength behind the dollar. This cannot be understood unless you deal day in and day out with the very people who buy or sell currencies. This is not simply an American issue for it is not the Americans who have openly sought the dollar on international foreign exchange markets. It is imperative that this point is understood for any measures of the best intentions can lead to drastic volatility which in the end could easily harm the American economy for many years to come.

There has been a growing cry for protectionism around the world. Governments have sought to intervene on behalf of political-economic goals. These efforts have produced only short-term victories and in the end the free market forces have always dominated. Perhaps the finest example of this has been the U.S. attempt to maintain a gold backed dollar between World War II and 1971. Eventually, that policy had to be abandoned after the U.S. gold reserves had been depleted from 75% of the official holding down to 23%. Granted, it lasted for many years, but time is the enemy of any political system when it attempts to control the free markets.

Intervention is nothing new. May I point out that the U.S. government has intervened in many markets as have the various European governments. I am enclosing a chart reproduced from The Wall Street Journal published in 1932. During that period of time, foreign exchange was a serious problem. Silver, as you will recall from history, was a component of money. Like the dollar today, world confidence swung towards the United States and the value of silver began to rise dramatically as well. The U.S. intervened and froze the price but international demand was too strong and the intervention succeeded for less than one year. Once lifted, silver rose from $1 to $1.40. Then as the war came to an end, international confidence began to turn back and the immediate pressure subsided "naturally". Silver collapsed from $1.40 to .50 cents in one year after the unsuccessful intervention. Feeling that this was too drastic of a decline, the U.S. Congress authorized 200 million ounces to be bought between 1920-1923 in an effort to support the price of silver. This effort was effective short-term, but once again intervention did not solve the problem long-term and silver fell into 1932 declining to .25 cents.

I have also enclosed a chart of the Federal Reserve action moving into the infamous 1929 Panic. This chart clearly outlines the actions of the Federal Reserve and its attempt to control the economy during 1922-1929. Steps taken by the Fed only increased the volatility as we are witnessing today. Traders,

bankers, investors and speculators await each week's economic numbers and immediately take action based upon their interpretation of what the Fed will or will not do. This drastically affects the marketplace and adversely affects the domestic economy as seen in the agricultural sector. This further increases volatility in all markets and as a result disrupts political-economic policy. Intervention was used by ex-President Carter who authorized the Treasury gold auctions and this effort was joined by the IMF. To no avail, the dollar declined to post-war record lows moving into 1978- 1980 and gold rallied to $875 despite the official intervention efforts. I can provide countless examples of intervention and why it failed every time to provide a lasting solution to an age-old problem of free market volatility.

Your distinguished panel of economic advisors indeed offer some impressive credentials. But I implore you to seek new methods, new ideas. To continue to shape the future by the same tools and methods employed in the past is to rob the future of this great nation of the very essence which has made it great; progress and innovation, not stagnation and intervention. We must improve upon our methods of government or be lost to an endless cycle of repetitive error.

The problem does not solely lie within the United States. It does not lie in the fact that interest rates were higher here at one time. The interest rates peaked in April 1981 and have steadily declined into 1985 while the dollar has continued to rise to post-war highs against every currency in the world except three. Had interest rates been the sole factor, then the Euro-dollar market, which pays on the average 1- 1.5% more than domestic dollar deposits, would never have declined by nearly 50% in deposits itself. Interest rates remained higher in Canada throughout the past four years. Yet the Canadian dollar has fallen to 10-year record lows against the U.S. dollar.

We deal with real live Europeans, Canadians, Australians, Japanese and Arabs as well. We do not deal with theories in a closed room which make sense on paper yet fall apart in the reality of the marketplace. People, corporations and institutions are willing to take less in interest in favor of a domestic dollar deposit for numerous reasons ranging from geopolitical to fears of the U.S. cancelling the currency and replacing it with blue dollars for domestic circulation and red dollars for international circulation thereby making a Euro-dollar somehow worthless in purchasing power compared to a domestic dollar. These were methods used by Italy, Britain, France and Germany in the past and remain a concern about the U.S. options for the future.

Our firm is willing to help develop new ideas in harmony with the international community. But I warn you. The eyes of the world are now focused upon the G-5

actions. If they fail, government will lose the respect of the international community and intervention will be laughed at as a mere feeble attempt. The marketplace will respond to its own interpretations and assume that government is incapable of managing its own affairs much less the international markets. There are methods which would work to demonstrate stability and determination and these must be sought out objectively. But even cries for a return of the gold standard will also fail in the future.

The free market has forged the dollar to record highs in direct contrast to all normally accepted economic theories. Ask yourself this question. If the U.S. deficits have reached unprecedented proportions, the money supply has expanded far greater than ever before in the history of the United States and the national debt is now approaching $2 trillion dollars, how is it possible that the dollar is at record highs rather than record lows? If supply and demand are correct, then this huge expansion in dollars should have led to record lows. Yet in reality, worldwide demand has outpaced the supply and in direct contrast to monetarism inflation remains flat despite an increase in money supply.

This is not something which can be looked upon lightly. Granted, perhaps your distinguished panel is well versed in economic theory which has been completely wrong on this issue, but are they well versed in the understanding of the true causes of this historical economic imbalance? Have they talked to people, not politicians or theorists? There and only there can one obtain an understanding for the confusion that now exists in every corner of the monetary system.

The free floating exchange system has allowed the public their vote of confidence in a worldwide election process. Their vote has been clearly cast in favor of the American economy. The only means to shift that vote is to lose that confidence in the American economy and that is not in favor of the United States. Therefore, intervention is a short-term medicine for a long-term illness. It cannot cure it and at best it will only serve to agitate the problem and dramatically increase the volatility as was seen in the silver market in 1920, the gold market in 1980 and in the foreign exchange markets these past five years.

We must sit down and analyze the problem. If you seek to restore international stability to foreign exchange, it is the system which must be revised. If internationally this problem cannot be placed on the top of the roster, time itself will be its greatest enemy. Within the economy, many products are priced in dollars from oil to gold. This constantly creates a demand for dollars to satisfy international payments. Since the world business community has sought to make the dollar the unit of international exchange, and this natural demand for dollars will undoubtedly disrupt the domestic policies of this nation, the only solution is

to develop an international unit of payment similar to that of the ECU. This is a drastic step and one which should be addressed.

If we revised the international system for payments with SDR's and bring this down to the private sector, perhaps some insulation can be restored as was the original objective of Bretton Woods. Each nation would maintain its own currency unit domestically, but international trade would take place in a new international currency unit. This would help to stabilize the payments within the international trade sector and reduce the exposure each corporation inherits through the normal course of business. A fixed rate could then be restored between each nation to the international unit of value. The central clearing could be managed by the IMF. Naturally, there are many details which must be worked out, including the valuation of the fixed rates from one nation to another. But then international commodities could be priced by the private sector in terms of the international unit of value.

Concerns from the world community and the dramatic swings in confidence from each economic number released would be less apparent in any one currency. The international unit would serve as a buffer spreading the volatility among all nations thereby creating far less volatility in currency rates of all nations. The example of this has been the ECU. It has fluctuated less in comparison to any individual component.

As it now stands, intervention only adds to the volatility because corporations and institutions cannot sit back and afford the luxury of watching their assets swing 30% in a few months simply because the G-5 wishes it so. Intervention creates real losses for companies in their transactions if caught on the opposite side of government's wishes. The threat of government intervention is only seeking to demand confidence from the private sector. They buy and sell on the foreign exchange markets solely based upon their interpretation of political-economic events. If government cannot demonstrate responsibility which would in turn gain the respect of the private sector, it does not have the right to intervene in an attempt to extract that confidence.

The situation is reaching an intolerable level of instability. It should be the directive of Congress to adopt measures which will serve as a model to demonstrate its concern and responsibility, not to attack the private sector for responding to situations created by governments themselves.

Intervention has only led to greater volatility. That volatility will destroy many private companies worldwide and will only increase unemployment in all nations. If we do not reform the international system and replace the dollar with

a non-political unit of value, the volatility will seriously damage short-term trade and increase the threat of private bankruptcy due to foreign exchange losses.

Government must realize the dangers of intervention and the instability of the foreign exchange rates on an international level. It is not merely an issue of a strong dollar lessening U.S. exports. To try to solve one problem will only lead to a number of new problems. Volatility is the major threat to all nations and without a definitive step towards stability and not G-5 short-term goals, the years ahead will create chaos in the world economy and self-interests will demand from local government protection from foreign trade. The very existence of our free market system now lies at risk.

There are those who will cry out for a gold standard. But I implore you. This must not be taken unless the budget is balanced. The deposit of nearly $3 billion in gold to establish the London Gold Pool in 1968 was depleted in less than 10 days by the private sector. If confidence is not restored, dollars will be redeemed in favor of gold and the decline from 76% to 23% of the official U.S. gold reserves between 1950 and 1971 stands as witness to that warning. We cannot afford a repetition of that costly error of Bretton Woods.

Any monetary step will be a step for mankind itself. Economics is a subject which is dangerously overlooked. It was the contrasting theories between Keynes and Marx which created the Berlin Wall. The future generations and their survival is at stake. This is a time in which we must set aside political goals and join together as Americans to lead a world in the preservation of human freedom. To fail in economics will be to leave the door open to political chaos at home and provide further justification to the socialist and communistic movements within Europe itself.

I sincerely hope that due respect is paid to our prior mistakes. We must seek a new method, a new idea for the world and not merely one nation. If a concerted effort with a true understanding of the problem from an international perspective is not grasped here and now, the next four years will be plagued by protectionism as a sheer by-product of the increase in volatility within the free markets of the world.

Thank you for your time and I hope you will take these issues into serious consideration and not allow them to be dismissed with skepticism. Myself and the company will join in an effort towards a solution for the long-term, but we cannot endorse short-term cures.

Sincerely,

Princeton Economics International

Martin A. Armstrong,
Chairman of the Board