File- Monetary Policy Issues-Exchange Rate Intervention – Part A

Reference MG-MAMC/D/0002/001

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Footnotes

1. A misalignment is defined as a persistent deviation of the real effective exchange rate from the "fundamental equilibrium exchange rate" (FEER), the level that can be expected in the medium term to reconcile internal and external balance. These concepts are sketched in Section III.

2. I see two decisive objections to the proposal to use a fixed exchange rate as a mechanism for inflation control. The first is that it risks destruction of the tradable goods sector, since the strategy relies on the currency becoming overvalued. The second is that it has a poor track record (cf Britain and France in the 1960s or the Southern Cone in the late 1970s).

3. However, simulations undertaken by Edison, Miller and Williamson (1987) cast some doubt on whether a monetary relaxation inspired by an attempt to keep the dollar in a target zone would in fact have been very damaging to the cause of inflation control.

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# CRISIS AND REFORM OF THE INTERNATIONAL MONETARY SYSTEM

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## The Nature of the Problem

The international economic system is now experiencing the largest imbalances of the postwar period. The United States is running trade and current account deficits of about $150 billion and will soon compile a net foreign debt of half a trillion dollars. Japan is running an external surplus of almost $100 billion and will soon be a net creditor of $500 billion. The international trading system is eroding rapidly as new protectionist measures are adopted almost weekly by most of the major countries--especially by the United States, the previous (and hopefully future) leader toward freer trade.

The exchange rates of the leading nations have changed by larger amounts over shorter periods of time than ever before, but the trade imbalances remain huge. The cooperative adjustment effort launched at the Plaza in September 1985 soon gave way to an anti-Plaza currency conflict with intervention at cross purposes--as American officials continued to talk the dollar down while European and Japanese central banks bid it up. The nascent movement of a year ago toward serious monetary reform degenerated

into the Tokyo summit accord on "indicators," an international equivalent of Gramm-Rudman-Hollings in the sense that both embody process as a substitute for action.

The situation could become much worse. The decline of the dollar has been orderly to date, but could at almost any point turn into a "free fall" and jeopardize global financial stability. Conversely, the dollar could again rise sharply and undo some of the correction achieved to date. The Congress could still pass trade legislation which would disrupt, even destroy, the world trading system--or the Administration, in its continuing effort to head off such legislation, could take steps which would have a similar result. Monetization (rather than correction) of the massive American budget deficits--which, despite the progress promised for 1987, could rise again in 1988 and beyond unless considerable further action is taken--could eventually plunge the world into renewed inflation. Many observers, both at home and abroad, believe that the international competitive position of the United States has become hopeless.

Perhaps most seriously, incorrect handling of these problems could precipitate a new and perhaps severe global recession. Either the United States or the other major industrial countries, or both, could fall into a new downturn as a result of a failure to adjust their international imbalances. Such a recession would in turn intensify all the problems already cited, notably the threat of trade unraveling, and reignite the Third World debt crisis.

These considerations illustrate the depth and potential further deterioration of the international economic crisis. Fortunately, some improvement is already underway toward reducing the largest of the global imbalances and most can be corrected by the adoption of judicious policies. There are a few signs of constructive movement--notably the new United States-Japan monetary agreement, which begins the essential movement toward a target-zone exchange rate system; the launching of the Uruguay Round of trade negotiations, although the subsequent resort to still more import controls by both the Congress and Administration must temper one's optimism about its prospects; and the new Mexican program with the International Monetary Fund and commercial banks, which further limits the systemic risks of Third World debt. But the absence of needed policies, especially on the macroeconomic and monetary issues, remains extremely worrisome and will be the main focus of this presentation.

## The Parallel with the Early 1970s

The current international economic picture closely resembles the situation of the early 1970s. Both began with an enormous overvaluation of the exchange rate of the dollar--about 20 percent then, as revealed by the devaluations of 1971 and 1973, perhaps 40 percent at the recent peak in early 1985. As a result, the United States experienced record trade deficits while Japan and Europe ran record surpluses. In turn, protectionist pressures mounted to new highs in the Congress--the Mills bill of 1970 and Burke-Hartke proposals in 1971, the textile and House

omnibus trade bills in 1986--and the Administration of the day reacted to the pressure by enacting numerous new barriers of its own.[1]

In both instances, the huge imbalances basically resulted from a combination of five elements:

-- rising American budget deficits,

-- temporary export of much of the resulting inflationary pressure via growing overvaluation of the dollar,

-- a strong revealed preference on the part of the surplus countries for financing the American deficit rather than insisting on its adjustment or contributing to that adjustment themselves,

-- resultant neglect of the growing imbalances for several years, and

-- an international monetary system which proved incapable of achieving or even promoting adjustment.

1. The current Administration has erected or added new barriers to imports of textiles and apparel, carbon and specialty steel, automobiles, semiconductors, machine tools, lumber, sugar, shakes and shingles and a number of smaller products. In addition, export aids to agriculture have been increased sharply. The Administration rejected protection for shoes and vetoed the textile quota bill in 1986, and several previous escape clause cases expired automatically during this period.

The outcome has also proved similar: despite continued foreign financing of the American deficits, by central banks in the first episode and private foreigners this time, the United States decided that the situation had become untenable for both its economy and its ability to preserve an open trading system--and totally reversed its policy toward the dollar and the world economy. Hence President Nixon and Secretary Connally launched their shocks of August 1971, and Secretary Baker summoned the world's leading finance ministers to the Plaza in September 1985.[2]

The most worrisome part of the analogy is that the Plaza accord now seems to have gone the way of the Smithsonian Agreement of December 1971. Despite being labeled by President Nixon as "the most significant monetary agreement in the history of the world," the Smithsonian collapsed in just over a year--bringing the final collapse of the Bretton Woods system of fixed exchange rates. In retrospect, the reason for that failure is clear: at the Smithsonian, the major countries agreed to change exchange rates by only half the amount (about 10 percent) which was needed. The remaining half was forced in early 1973, and took with it the monetary order of the previous generation.

2. There were of course major differences between the two periods as well: notably, that monetary policy was easy and inflation rising rapidly in the early 1970s whereas monetary policy was responsible and inflation falling in the mid-1980s. In addition, as noted in the text, the bulk of the US external deficit was financed by official sources in the earlier period and (so far) by private investors lately.

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It now appears that the Plaza Agreement has also achieved, at best, only about half the adjustment required in the present imbalances. The American trade and current account deficits are running close to $150 billion. Under the most optimistic of adjustment scenarios, the net foreign debt of the United States will rise to $500 billion before leveling off; despite the fact that our net international income flow remains positive so far and actually improved in 1985-86 even as the net debtor position was soaring, this will require net servicing payments to foreigners of perhaps $25 billion annually by the end of the decade.

If one believes that the American current account should return to rough balance, let alone the surpluses which were traditional before 1977 and might be considered appropriate for the "world's richest country," an improvement of $150-175 billion would be needed. If the objective is balance on merchandise trade, with an eye toward defusing protectionist pressures and with continued borrowing to finance interest payments on the external debt (like many developing countries), the needed correction approximates $150 billion. In either case, the required adjustment is huge--on the order of $150 billion at an annual rate. Even if one believes that the United States could comfortably finance a current account deficit equal to 1 percent of its GNP, and should be unconcerned about the further buildup of external debt and ongoing protectionist pressures, an improvement of about $100 billion is needed.

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Unlike some observers, I take the view that the currency changes to date <u>will</u> produce a sizable reduction in the American deficit over the next two years--just as they did in 1973-75 and again in 1979-81:

-- With the dollar at its peak, we were headed toward current account deficits of $300 billion annually by the end of the decade.[3] Hence the leveling off of the deficit over the past four quarters already represents important progress.

-- The "J-curve" normally takes twelve to eighteen months to produce an improvement in the recorded data because of three lags: from currency change to price change, from price change to shifts in purchasing patterns, and from the latter to actual shipments and the recorded data. On this occasion, the lags may be even longer because of the duration and magnitude of the recent imbalance (which permits foreign exporters to cut into profit margins rather than raise prices for much longer than usual) and the demoralization of many American exporters from several years of being priced out of world markets.

3. The possible scenarios for the US current account are analyzed in depth in Stephen Marris, <u>Deficits and the Dollar: The World Economy at Risk</u>, Washington: Institute for International Economics, December 1985. The forecasts cited in this presentation are based on an updated version of the model used in that study.

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-- Moreover, the J-curve dates only from <u>late</u> 1985 (or even early 1986) because it was only after the Plaza Agreement was seen to be working that economic agents around the world began to believe that the dollar's decline would be lasting and significant--and thus began to change their prices, procurement and production patterns.

-- Evidence is accumulating rapidly across American industry, from chemicals and paper to computers, that export orders are picking up and import penetration is subsiding. The aggregate trade data for August and September support this conclusion, especially regarding imports, and our net exports in real terms (excluding oil) improved in the third quarter.

-- Real exports have been declining in Japan and Germany, and profits of their export-oriented firms have plummeted. Correspondingly, our import prices are now rising sharply.

Hence the adjustment is clearly underway. Moreover, I believe that the underlying competitive position of the American economy is quite strong--in sharp contrast to a view heard widely in Europe, the Far East and sometimes in the United States itself. To be sure, the imbalances of the early 1980s have been so extensive and so prolonged that no analyst can be fully confident that the <u>status quo ante</u> can be reclaimed. And there

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have been structural changes adverse to the American trade balance, notably the world agricultural glut which depresses our farm exports and the rise of aggressive new competitors in the Far East. But the United States was achieving extremely impressive gains in its international economic position in the period immediately prior to our firms being priced out of world markets by the rise of the dollar:

-- From 1978 to 1980, American exports grew twice as fast as world trade.

-- We recouped market share in every industrial sector, in some cases back to the levels of the 1960s, and in every geographical region.

-- Our current account improved by almost $60 billion in just two years, excluding the direct adverse effect of the second oil shock, and was in surplus in 1980-81 despite the sharp rise in oil imports.

-- Total US economic growth in 1979-80 resulted from the improvement in our external position.

I would expect a reduction in the American trade and current account deficits by $30-40 billion in each of the next two years. Our economic growth will receive a positive stimulus of close to one percent in each year as a result. The budget

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deficit is also likely to decline by $30-40 billion in 1987 (to $180-190 billion), so the decline in capital inflows should not produce any "crowding out" or increase in interest rates. The pressures for trade restrictions could decline, perhaps markedly, as the deficit falls below $100 billion and is seen to be dropping sharply--so any new trade legislation should be deferred until that time, in later 1987 or 1988.[4]

This relatively good news is tempered, however, by two considerations. First, my forecasts are on the optimistic end of the spectrum--although I am expecting a smaller improvement, in real terms, than the United States actually achieved in 1979-80 after the correction of the previous dollar overvaluation. Some analysts, including the International Monetary Fund, foresee a very small or even no decline in the US current account deficit in 1987.[5] Second, even my results would leave the external deficits uncomfortably near $100 billion--and likely to rise again after 1988 in the absence of further remedial steps. And

4. I. M. Destler, American Trade Politics: System Under Stress, Washington and New York: Institute for International Economics and The Twentieth Century Fund, November 1986.

5. I would note, however, my success in accurately forecasting--well before virtually all other analysts--the rise in the US trade deficit to $100 billion and then $150 billion, and my initial prediction of significant trade improvement before the recent downturn in the monthly numbers (in testimony to the Trade Subcommittee of the Ways and Means Committee on September 24, 1986). By contrast, the IMF has had a dismal record in forecasting external balances because it has systematically underestimated the lagged impact of major exchange-rate changes; for an assessment see Peter B. Kenen, "International Money and Macroeconomics: An Agenda for Research," in John Williamson, ed., World Economic Problems, Washington: Institute for International Economics, forthcoming.

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few Japanese forecasters see their surplus dropping below $50-60 billion even by 1990.

On current policy and prognoses, the international imbalances are thus likely to remain quite sizable and carry with them two continuing perils. First, the United States would still need to borrow almost $100 billion annually from the rest of the world. At almost any point, foreigners' willingness to provide such amounts at current exchange rates and interest rates--and Americans' willingness to avoid speculating against the dollar--could dry up as a result of economic considerations (renewed inflation? a sharp slowdown?) or noneconomic developments (a change in Administrations? a change in leadership at the Federal Reserve?). Our interest rates might then have to rise sharply to stop a precipitate and excessive fall of the dollar. The crowding out of private investment, which was widely feared to result from the massive budget deficits in the early 1980s but was avoided via inflows of foreign capital, would then emerge unless the budget deficit had been cut by much more than now seems likely. Sharp price increases or a sharp recession, or both, could result.

Second, protectionist pressures could remain strong and even grow further. The American political system may not be willing to tolerate indefinite external deficits on the order of $100 billion or so, with their permanently negative impact on the manufacturing and farm sectors--and on American's prestige as a world leader. Indeed, <u>can</u> the world's largest debtor remain the world's leading power? These internal implications of incomplete

adjustment could be even more serious than the external implications, as has been the case to date.

Despite this prospect for continuing large imbalances and attendant high risks, there seems to be a growing consensus outside the United States--and even in some quarters within this country--that the Plaza and related adjustments have achieved their purpose and that no further action is needed. The United States itself has failed to take serious action on the budget deficit, its crucial contribution to the global imbalance. The central banks of Japan and Europe have intervened heavily over the past months to halt, or at least slow, any further decline of the dollar. None of these countries seems willing to institute adequate new stimulus measures to promote adjustment through noncurrency means. The new agreement between the United States and Japan indicates that even the Administration has given up the effort to achieve further adjustment via one route, the yen-dollar correction, which has heretofore been emphasized. The revealed preferences for continuing to finance at least a very large part of the American deficits, rather than correct them, are apparent once more.

This reluctance to adjust further is quite understandable. As noted, the United States probably needs an improvement of $100-150 billion in its external position. Only a modest part of this correction, if any, should be pushed onto Latin America or most of the developing countries--since doing so would intensify their own need for external finance which, unfortunately, is unlikely to materialize any time soon.[6] Canada, our largest

trading partner, is already in global deficit and has been actively trying to avoid a further weakening of its currency.

Most of the change must therefore come at the expense of Japan and Europe--perhaps $50-75 billion for each. Their economies have relied heavily on export stimulus during most of the recent past, and such shifts could throw them into recession unless they simultaneously expand domestic demand by sizable amounts.

Likewise, the internal adjustment required for the United States will be considerable. Via the trade deficit and associated capital inflow, we have become complacently hooked on spending more than we produce and investing more than we save. Indeed, we can now understand the miracle of supply-side economics--at least at the margin, the foreigners supply most of the goods and all of the money. It will be jarring to accept the reverse situation, in which we produce for consumption abroad and learn to live on our own resources.

As indicated, however, the United States did experience export-led growth as recently as 1979-80[7] and should be able to

6. I would advocate an increase of $10-20 billion in annual capital flows to the developing debtor countries, which would enable them to increase their current account deficits by a like amount, but unfortunately cannot foresee any such increase in the near future. The normative analysis is in Donald R. Lessard and John Williamson, Financial Intermediation Beyond the Debt Crisis, Washington: Institute for International Economics, September 1985, and Bela Balassa, Gerardo M. Bueno, Pedro-Pablo Kuczynski, and Mario Henrique Simonsen, Toward Renewed Economic Growth in Latin America, Washington: Institute for International Economics, September 1986.

do so again. Japan and Europe learned, after 1971 and again recently, that rising currencies produce welcome anti-inflation effects and spur their competitiveness. The twin unsustainabilities of continuing large American deficits, on the external and internal sides, are simply too likely to plunge the world into renewed crisis to be permitted to continue. The costs of inertia are far greater than the problems of resolving the imbalances, difficult though those problems may be.

But I must conclude that, as of now, the Plaza and related recent steps seem to have gone the way of the Smithsonian Agreement of 1971. The adjustment achieved, at best, meets roughly half the need. Meaningful cooperation among the Group of Five is dead, at least for the moment, and has already begun to be replaced by a Group of Two in which the United States and Japan seek progress--itself inadequate to date--without the Europeans. Basic disagreements have replaced the short-lived consensus of a year ago.

The results may therefore also parallel those which followed the Smithsonian: renewed financial crisis, further trade erosion and collapse of the contemporary monetary system. Fortunately, the post-Smithsonian crisis was resolved in a way which avoided the worst and even paved the way for systemic improvements regarding both money (the move to floating rates) and trade (the

7. The United States recorded merchandise trade deficits in nominal terms in those years but the current account was in surplus in GNP terms (1982 dollars) and, more importantly, was improving sharply and thus providing a positive stimulus to overall economic growth.

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Tokyo Round). The cardinal issue for the second half of the 1980s is whether similar progress can emerge from the current difficulties and whether the inevitable crises can be preempted by farsighted action--for once--on the part of the leading national authorities.

Correcting the Current Imbalances

Four sets of steps are needed to complete the correction begun at the Plaza:

First and foremost, the United States must steadily and substantially reduce its budget deficit. As noted, there are likely to be parallel declines in the budget and trade deficits (about $30-40 billion each) in 1987. This is the optimum shape of the adjustment from the standpoint of the United States: the decline in fiscal stimulus is offset by improvement in the trade position, and the decline in availability of foreign funds is offset by the declining financial need of the government.[8]

Beyond 1987, similarly parallel progress is needed. Achievement of current account equilibrium would require a further reduction of perhaps $100 billion in the trade deficit, so we should aim for an equivalent further cut in the budget imbalance. This would bring the budget deficit to below $100 billion by around 1990, which should become the target for fiscal policy instead of the arbitrary numbers in Gramm-Rudman-Hollings--

8. Assuming all other key variables equal, and that the currency correction itself remains orderly.

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which, as noted, is a procedural substitute for action rather than a spur to action itself. If the new Congress really wants to deal with the trade deficit, it should substantially cut the budget deficit.

Second, some of the other major industrial countries need to achieve more rapid economic expansion for the next couple of years. A peculiar feature of the world economy in the recent past is the absence, except in the United States, of the catchup spurts of economic growth which normally follow a deep recession. The world experienced such a recession in 1981-82, and the United States achieved the usual spurt--growing at over 6 percent for eighteen months in 1983-84. But no other industrial country has done so. Indeed, unemployment remains at record levels in many countries. This includes Japan, which is growing more slowly than the other major countries with unemployment at a postwar high and expected to rise sharply over the next few years in the absence of fundamental policy changes.

Germany is largely correct that its present growth rate, at about 3 percent, is in line with the sustainable annual additions to its productive capacity and will keep its unemployment rate from rising further. But this ignores the substantial availability of unutilized capacity which remains from the last recession, and which would permit Germany to achieve above-normal growth of 4-5 percent for two years or so.

German achievement of such an outcome would enable Europe as a whole to do so, since the rest of the Continent is ready to

expand if only Germany would permit it to do so. In combination with a similar outcome in Japan, this would contribute substantially to the needed international adjustment--expanding American exports by perhaps $40 billion annually after two years in which they accelerated their growth by 2 percentage points per annum. The present time is ideal for such a growth spurt outside the United States: inflation is virtually nonexistent or even negative, budgets have been brought under effective control, and external surpluses of course provide ample room for relying on domestic demand for the next couple of years. Indeed, one wonders when, if not now, these countries would ever aim for more ambitious growth targets and hence full utilization of their domestic resources?

The most promising route to temporarily faster growth in domestic demand abroad is neither increased government expenditure, except in limited doses, nor further cuts in interest rates. (Indeed, lower interest rates in Germany and Japan could affect the international adjustment perversely by again weakening their currencies against the dollar.) In both Europe and Japan, tax cuts to promote renewed growth of consumer spending and private investment are most promising.

Japan also needs tax reform, financial innovations and regulatory changes aimed at stimulating a ten-year housing boom. Indeed, such a housing boom in Japan could be the next great spur to global economic growth. It would provide an alternative to the export orientation of the past for Japanese expansion, and meet a huge pentup demand in Japan which is