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

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increasingly voiced by the public there. Fortunately, such a boom could be triggered by policy changes which require modest if any increase in the budget deficit: by providing tax deductibility for mortgage interest payments offset by ending the present exemption of taxation on much interest income; by expanding the availability of mortgage finance at lower interest rates and at longer maturities; and by regulatory changes to permit much higher buildings in both the cities and suburbs. Japan is not short of land, but is rather guilty of exceedingly inefficient land utilization policies--which opens the possibility for dramatic changes.

On the broader issue of tax cuts, it is interesting to note that a number of countries have begun to express concern that the new tax structure in the United States, by reducing marginal rates so sharply on personal income, may renew the "brain drain" by attracting their talented nationals to this country. The obvious answer for them is, of course, to cut their own marginal rates correspondingly--and some are already moving in this direction.

The structural difference in fiscal positions between the United States and most of these other countries, however, suggests that the context for such tax cuts is very different abroad and can thus make an important contribution to the necessary international adjustment at the macroeconomic level. In the United States, the existence of huge budget deficits dictated that our tax reform package attempt to be revenue-neutral--so that the cuts in personal tax rates were offset by

broadening the tax base and raising corporate levies. In several other major countries, however, the strong fiscal positions which have been achieved over the past five or six years mean that similar personal tax reductions--as already planned in Germany and Japan--need not be offset immediately by tax hikes elsewhere. Hence the need for changes in tax structures abroad could be employed to achieve simultaneously the needed fiscal thrust, boosting aggregate domestic demand and contributing substantially to the international adjustment.

Third, and closely related to these macroeconomic changes in the United States and abroad, there is a need for some further adjustment of the exchange-rate relationship between the dollar and some other major currencies. The dollar has now declined by a trade-weighted average of about 30 percent against the other industrial countries. The overvaluation at its peak, however, was about 40 percent against these currencies. A further fall of perhaps 10 percent is thus needed if the American budget and foreign growth adjustments cited above are made; in their absence, a still larger currency change would have to ensue.[9]

9. Note that the adjustment achieved to date is only about half what is required even though the currency change is more than half the initial overvaluation. This is because the growth component of the adjustment is yet to occur, because currencies outside the indexes cited are increasingly important, as noted below, and because each successive percentage point of dollar depreciation achieves more correction than the previous percentage point via the progressive restoration of a smaller gap between the level of exports and imports.

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The key equilibrium rates at this time would seem to be about 150:1 for the yen and 1.80:1 for the DM (with parallel changes for the other EMS currencies). For the longer run, the yen will probably have to appreciate steadily--perhaps to about 120:1 by the end of the decade--because of faster Japanese productivity growth, lower inflation and steadily rising investment income (as its net creditor position moves to about $500 billion by around 1990). Failing any pickup of growth abroad, the yen would probably have to rise beyond 140:1 now and the DM might have to go to about 1.60:1.[10]

It is therefore essential that the new United States-Japan agreement not deter the yen from returning close to its equilibrium level of at least 150:1. And it is crucial to avoid any renewed strengthening of the dollar that would undercut the trade correction already underway.

Fourth, a few additional countries will have to contribute to the adjustment process. The most notable case is Taiwan, which is now running a current account surplus equal to about 20 percent of its GNP and has accumulated foreign exchange reserves of $40 billion--about as large, in absolute terms, as those of

10. It should be noted that these proposals, which are consistent with those expressed by the Treasury Department in its statement with Japan on October 31, imply a short-term appreciation of the DM and other EMS currencies against the yen (as well as against the dollar) whereas most Europeans want to see a further depreciation of their currencies against the yen. The need to resolve this disagreement adds substantially to the case for Japan to promote much more rapid growth of its domestic demand and for further appreciation of the yen over the medium run as suggested in the text.

Japan. Its surplus needs to fall by $10-15 billion through a combination of increased domestic demand, currency appreciation and trade liberalization. Korea is running a global surplus this year (of perhaps $4-5 billion) for the first time in its modern history and understandably desires to begin repaying its sizable foreign debt, but will need to make a modest contribution via currency appreciation and further reduction of import restraints.

The adjustment process launched at the Plaza thus needs to be broadened in several directions. To date, it has primarily encompassed exchange rate changes between the dollar and a few other major currencies--with substantial but inadequate results. The effort must now be expanded to include significant macroeconomic steps by both the United States and the major surplus countries, and adjustment by a wider range of nations than has been involved to date.

In essence, the United States has carried out about half of a normal, IMF-type adjustment program. It has achieved much (though not all) of the needed external correction, via currency depreciation, but has only begun to work out the needed internal correction (via restoration of fiscal balance).[11] A failure to cut the budget deficit now, while the economy is still growing at least modestly, runs the risk that the red ink will rise to $300 billion or so during and after the inevitable next recession.

11. I described a number of the disturbing parallels between the US debt buildup and that of the developing countries in "The Second Debt Crisis," a speech presented in London in February 1985 and reprinted in Vital Speeches, April 11, 1985 and Challenge, May 1985.

This could have two extremely adverse repercussions. It would mean a shortage of investible funds as the budget deficit came to far exceed the trade deficit, and hence the supply of capital from abroad, which could produce a sharp rise in interest rates and severe "crowding out" of private investment. (Note the irony if the ultimate impact of Reaganomics were thus to decimate the private sector because of the gargantuan demands of the government budget.) And such huge budget imbalances would almost certainly induce their eventual monetization, to at least a substantial degree, which could bring inflation roaring back.

From a global perspective, the choice is between correcting the huge imbalances via a combination of largely expansionary measures, as advocated here, or via a very sharp (and possibly prolonged) recession. In the worst case, the United States could plunge into recession because of the "crowding out" caused by a failure to reduce its budget deficit in tandem with the trade deficit (and availability of foreign funds), or from a sharp rise in interest rates due to a free fall of the dollar, while the largest foreign countries met a similar fate from failing to expand domestic demand by enough to counter the fall in their trade surpluses.

Such an outcome would be enormously costly in terms of lost production and unemployment, and would deeply exacerbate such international problems as protectionism and Third World debt. Indeed, as noted, the contractionary option would also prove more likely to rekindle inflation--by threatening eventual monetization of the ever larger US budget deficit which could

result. The case is compelling for Europe and Japan to expand, and for America to act on its budget, before it is too late.

Reforming the System

There is a also a central long-run implication of the buildup of huge international imbalances in the early 1980s, the difficulties in initiating their correction in the mid-1980s, and the inevitably complex process of unwinding them in the late 1980s: the need for a more effective international monetary system. As noted, the crisis of the early 1970s brought the collapse of the Bretton Woods regime of fixed exchange rates. I believe it is highly likely that the present crisis will lead to major modifications in the current nonsystem of unmanaged flexibility, and that such changes are already underway.

There are three major indictments of unmanaged flexibility. First, it has permitted a misalignment of the dollar, the system's key currency, by at least twice the amount--about 40 percent versus 20 percent--that produced the ultimate demise of fixed rates. By encouraging bandwagon effects and discouraging government intervention to stop them, it may have even promoted this huge disequilibrium.

Moreover, the recent dollar overvaluation was only the latest, and most extreme, misalignment to develop over the thirteen years of floating. The dollar became undervalued in the late 1970s, adding to American and world inflation. The yen and

DM have gyrated in opposite directions from the dollar. The pound sterling has experienced even greater overvaluation than the dollar (in 1980-81). Indeed, misalignments have been the rule rather than the exception under floating rates--with enormous costs to countries on both surplus and deficit sides of the ledger, and to the system as a whole.

Second, the system has failed at its basic task of supporting an open trading system. It is an irony of the 1980s that international capital movements have become increasingly liberalized while international trade flows have become increasingly restricted--an opposite juxtaposition to the assumptions on which the Bretton Woods system was created. There is probably a causal link between these trends: increased scope for capital movements has led to increases in the net flow between countries which increasingly dominate trade in the determination of (flexible) exchange rates, which in turn distort underlying competitive positions and produce the external imbalances which intensify pressures for trade restrictions.[12] It would seem far preferable to reorder the monetary system than to reverse the trend toward capital liberalization, but one or the other may prove necessary if renewed trade liberalization--via the Uruguay Round for example--is to be achieved.

Third, the present international monetary regime has no significant impact on national decisionmaking in the major

12. See C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy" in William R. Cline, ed., Trade Policy in the 1980s, Washington: Institute for International Economics, 1983.

countries. Indeed, it makes no effort to have such an impact. The result is an absence of any international pressure to compel countries to consider the external impact of their own actions, including feedbacks to themselves. National policies are therefore much less likely to be internationally compatible, and hence sustainable, in a world economy where objective interdependence is growing steadily and inexorably.

To be sure, no international regime can assure that large (or even smaller) countries will systematically factor international considerations into their economic policies. Some observers argue that faulty national policies are solely responsible for the recent and current imbalances, and that "the system" cannot be blamed.

As indicated, I fully concur in the indictment of many recent policies in the major countries. But it is a false dichotomization to segregate national policies from "the system." No system is worthy of the name unless it has consequential impact on national policies, and tilts them in the direction of greater international compatibility--and thus sustainability--at least to some extent.

Indeed, previous and current systems have done so to a significant degree. Under the fixed-rate rules of Bretton Woods, most countries met the obligation to defend their parities without violating the spirit or letter of the law. (In fact, they did so too well; the system collapsed because of inadequate currency adjustment.) Most continental Europeans do so now under

the adjustable-peg requirements of the European Monetary System. Trade policy in almost one hundred countries is determined importantly by their international obligations under the GATT, and the costs (via compensation or retaliation) of taking actions which violate those commitments.[13]

The need for such systemic influence is particularly acute in the United States. As the largest and most self-sufficient national economy, the United States quite naturally tries to export its internal problems more than most countries--and usually succeeds for longer periods of time (as in the late 1960s and early 1980s, when foreigners financed its growing budget and external deficits). But the chickens come home to roost even for the United States, which then--à la Nixon-Connally in 1971 and Baker in 1985--must seek international action to rectify its externally caused difficulties.

The history of US foreign economic policy over the past generation shows that every Administration, Republican or Democrat, has begun with essentially unilateral efforts to impose its macroeconomic and monetary views on the rest of the world. The inevitable failure of these efforts then forces a resort to pluralistic cooperation--Johnson to two-tier gold in 1968, Nixon to the Smithsonian and the negotiated realignment of 1973, Carter to the dollar defense program of 1978, Reagan to the Plaza. Once

13. These themes are developed in more detail in my "Toward a More Stable International Monetary System: Are Target Zones the Answer?", in John Makin, ed., Exchange Rate Targets--Desirable or Disastrous?, Washington: American Enterprise Institute, forthcoming.

achieved, the focus on international cooperation tends to remain intact for the remainder of that Administration. But the successor regime forgets or rejects the lessons of the past, and the dreary cycle is repeated once more.[14]

The issue is not *whether* the United States, and other countries, will adjust to the realities of international competition and global interdependence. Despite the periodic efforts of governments to play King Canute and hold back the tide, they cannot escape from doing so. The only question is one of timing: whether they will make those adjustments in a reasonably timely and efficient manner, or try to fend off the inevitable so long that huge costs arise and crises erupt.

There are thus three fundamental reasons to hope that the international economic crisis of the late 1980s, like that of the early 1970s, will lead *inter alia* to the creation of a new international monetary regime--and, this time, to one which is more stable and lasting. There is no need to return to fixed parities. There is enormous need to avoid future massive misalignments such as we have seen in the recent past, which carry such heavy costs for surplus and deficit countries alike. We essentially need a synthesis between the fixity of Bretton Woods, which became too rigid, and the flexibility of the current regime, which suffers from endemic overshooting and misalignments (and, some would add, excessive volatility as well).[15]

14. See my "America's Unilateralism" in *Conditions for Partnership in International Economic Management*, New York: Trilateral Commission, The Triangle Papers: 32, July 1986.

In principle, there are numerous ways to achieve such a synthesis. The most promising is to adopt target zones, under which the major countries would agree on the criteria which should guide their exchange-rate relationships and then set currency bands of perhaps 15-20 percent based on those criteria. For example, today's target zones might range between 135:1 and 165:1 for the yen-dollar--compared with the range of 150:1 to 165:1 suggested by the United States-Japan agreement of October 31--and between 1.60:1 and 2.00:1 for the DM-dollar. The authorities would alter the ranges over time to reflect differential inflation rates, differences in productivity growth and shocks (such as large oil price changes) which had different effects on the different currencies--so that the yen-dollar zone, for example, might crawl upward to perhaps 110:1 to 130:1 by 1990.[16]

Free floating would remain the norm, but authorities would act whenever rates moved toward the edges of the zone. They could start with Plaza-type jawboning and intervention, and make changes

15. It is interesting to note the development in the late 1960s of widespread intellectual support for such intermediate systems, notably at that time wider bands and crawling pegs, rather than for unmanaged flexibility as eventually "chosen" by the world's authorities. See, for example, C. Fred Bergsten, George N. Halm, Fritz Machlup and Robert V. Roosa, eds., Approaches to Greater Flexibility of Exchange Rates: The Bürgenstock Papers, Princeton: Princeton University Press, 1970.

16. The details of determining and implementing target zones can be found in John Williamson, The Exchange Rate System, Washington: Institute for International Economics, revised June 1985. A simulation of how target zones might have worked during 1976-85 can be found in Hali J. Edison, Marcus H. Miller and John Williamson, "On Evaluating and Extending the Target Zone Proposal" in a forthcoming issue of the Journal of Policy Modeling.

in monetary policy if necessary. (Fiscal and other policies would then be adjusted to maintain internal stability.) Once the regime were in place and seen to be working, private capital flows should become stabilizing--rather than destabilizing via bandwagon effects, as frequently under unmanaged floating--and reduce the need for official intervention. The new monetary agreement between the United States and Japan appears to represent an important step toward creating a target zone for the most important bilateral currency relationship in the world--and it will be interesting to see whether other countries, particularly in Europe, accept the invitation in the United States-Japan statement of October 31 to participate in that arrangement.

The chief contemporary alternative to target zones is the "indicators" approach agreed at the Tokyo summit, under which each of the Group of Seven countries is to produce quantitative forecasts for ten of its economic variables and the IMF is to check for both ex ante consistency and ex post implementation. Such an effort might work, if applied diligently and with good faith by all.

But the history of both global and European efforts to achieve monetary stability, which has posed the "economic" (Tokyo indicators) versus the "monetary" (target zone) approach for many years, suggests the practical superiority of the latter. The "exchange rate" approach of course seeks collaboration on more than exchange rates themselves. But it does not try to tackle a ten-by-seven matrix of policies and outcomes from the outset, as would the Tokyo indicators, and thus avoids the scope for

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recalcitrant countries to take advantage of the inevitable existence of some variables which would justify inaction or noncooperation. Those who would accept target zones for exchange rates only if they had target zones as well for money supplies, budget deficits and all other variables are simply trivializing the entire exercise and (perhaps deliberately?) rendering it futile.

Instead, by addressing the relationships among countries through the lens of the exchange rates, target zones focus on the policies which are most relevant for international adjustment. This will sometimes produce an emphasis on monetary policy, sometimes on fiscal policy. Intervention and even jawboning, a la Plaza, will sometimes suffice. Target zones would frame a much more pragmatic, less grandiose, system of cooperation which would be more likely to succeed in the real world. It would thus be highly desirable to direct the Tokyo exercise in the direction of functioning target zones, as suggested both by Secretary Baker's clear statements that "exchange rates and current accounts" are the most important of the indicators and by the new United States-Japan arrangement.

It will admittedly be difficult to achieve global monetary reform if we wait for all major countries to participate. The chief problem is the Europeans, many of whom seem to have relatively little interest in the exchange rate of the dollar--as indicated by their willingness to see the EMS currencies rise very sharply against the dollar, and (except for France and perhaps Italy) their indifference to recent proposals for systemic

reform. The explanation seems to be that Germany, and other Europeans, have the EMS to provide financial stability for the bulk of their trade and believe--erroneously, as suggested above--that the United States offers no serious competition to them either at home or in third markets. Moreover, Germany clearly feels more comfortable with a regional arrangement it can dominate than with a global arrangement where it could not. Europeans do worry that dollar-DM swings can disrupt the parity grid of the EMS, but this seems to be the only major interest in the exchange rate of the American currency for many of them.

It may therefore be necessary for the United States and Japan to proceed with the de facto "Group of Two" launched on October 31.[17] There is compelling logic in such a move, because the United States and Japan have been hardest hit by the monetary shortcomings of the past fifteen years--experiencing three extreme sequences (1969-71, 1976-78 and 1981-85) of substantial misalignment, sharply increased imbalances, economic distortions, trade friction and substantial deterioration of their overall political as well as economic relations. They have the greatest interest of any major nations in preventing future repetitions of this cycle and thus should take the lead in forging a better regime. And since the dollar-yen rate has probably moved closer

17. Such a group was called for by Robert V. Roosa, The United States and Japan in the International Monetary System 1946-1985, New York: Group of Thirty, 1986 and in my "The United States-Japan Economic Problem: The G-5 Plaza Agreement After Six Months", an Address to the Japan Society in New York on March 12, 1986.

to its equilibrium level at present than any of the other currency pairs cited above, when it neared 150:1 recently, they are in the best position to proceed. Moreover, we have learned from the history of trade (and other international) negotiations that partners who are ready to move ahead should do so--rather than being delayed or blocked by the least common denominator.

Indeed, it is interesting to speculate on the implications of the new "G-2 target zone" for global monetary arrangements. Will the United States and Japan actually begin to coordinate their economic policies in a systematic way? Will other countries, perhaps those such as France which have indicated strong past support for target zones, accept the invitation to participate? Could the United States and Japan induce the needed adjustment by other countries, as advocated above, by intervening together in the currency market themselves? Could a yen-dollar "bloc" simply evolve over time as a counterweight to the EMS, with the world coalescing around two major monetary zones rather than the three (EMS, dollar and yen) which are often hypothesized?

My own view is that the G-2, having now taken a major step on its own, should make every effort to broaden the exercise in the pursuit of global economic stability. However, this will require more intensive United States-Japanese cooperation and collaboration from Europe (and Canada?). The United States and Japan should not be deterred from proceeding on their own if the broader grouping does not quickly take shape, but should be continuously alert to the desirability of restoring a multilateral framework for managing the world economy.

Conclusion

The massive international imbalances of the 1980s developed because both the United States and the surplus countries (especially Japan) ignored the international consequences of their domestic policies and were permitted by the international nonsystem to do so. As a result, both global financial stability and the open trading system are at risk.

That risk is compounded by the premature stalling out of the Plaza initiative, which embodied an essential reversal of American policy and for a brief time encompassed the extensive international cooperation needed to avert disaster. Like the Smithsonian Agreement of 1971, however, the Plaza has accomplished only half the needed adjustment. Yet disharmony has now reappeared between many of the major countries, boding ill for any prospect of dealing effectively with the substantial problems which remain.

Those problems can be disaggregated into three components: achieving the needed US adjustment of $100-150 billion, allocating that adjustment in the least disruptive way throughout the world, and creating an international monetary system that will both prevent such massive imbalances in the future and respond more effectively to the inevitable disequilibria which will occur from time to time. There are sound remedies available for each of these components--focussed on substantial budget cuts in the United States, expansion of domestic demand in Japan and Europe

and the creation of target zones among the major currencies. The new United States-Japan monetary arrangement is an important first step toward some of these goals.

The issue, as always, is whether the major nations will recognize the urgency of constructive and comprehensive action and adopt the policies needed before it is too late. A fundamental paradox underlies this central political problem. In a world of independent states, nominal sovereignty is absolute. But with today's reality of economic interdependence, real sovereignty is significantly limited--even for the largest and most powerful nations.

As the United States has learned during these past two years, and as Germany and especially Japan are learning now, the chickens do come home to roost. Internationally incompatible policies are simply unsustainable. The issue is whether governments can learn to control the process, or will continue to let it control them. For once, let us hope they can learn from history and will move in time to prevent at least the worst excesses which could derive from the current crisis.

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