

The Case Against Benign Neglect of Exchange Rate Stability

Large fluctuations in the exchange rates of major currencies can be extremely costly, not only for the countries directly involved but also for the rest of the world. In this article, the authors propose a framework for international cooperation in stabilizing exchange rates.

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SINCE the demise in the 1970s of the Bretton Woods system of fixed exchange rates, the issue of exchange rate stability has received a great deal of attention. Governments have intervened, individually and collectively, in foreign exchange markets on several occasions in attempts to limit the damaging effects of wide swings in exchange rates and extreme misalignments. The two most elaborate arrangements set up by the major industrial countries to stabilize their exchange rates—the Plaza agreement of 1985 and the Louvre accord of 1987—have had a mixed record, however. Many observers have come to believe that governments should not waste scarce resources intervening in foreign exchange markets.

Notwithstanding the disappointing performance of the Plaza and Louvre arrangements, new avenues for exchange rate coordination should be explored, especially in light of two recent events—the financial crisis that erupted in 1997 in several emerging economies in Asia whose currencies were formally or informally pegged to the U.S. dollar and the introduction of the euro on January 1, 1999.

Impact of the euro

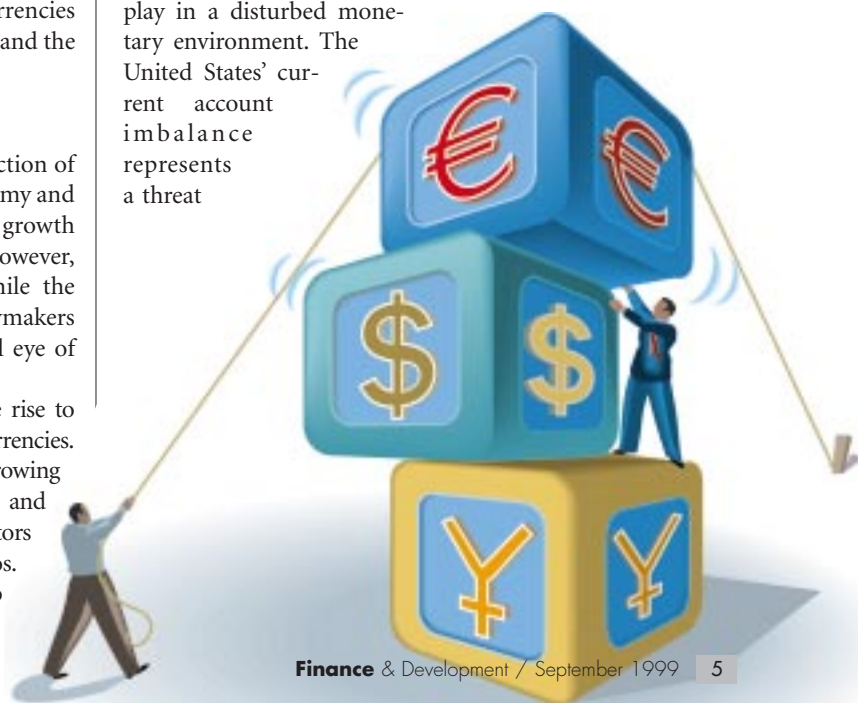
The multicurrency system ushered in by the introduction of the euro more accurately reflects today's global economy and therefore provides a more solid basis for trade and growth than a system dominated by the U.S. dollar. However, some exchange rate volatility can be expected while the world adjusts to the new system and Europe's policymakers go through the learning process under the watchful eye of the markets.

Moreover, the creation of a new currency will give rise to shocks to the demand for and supply of international currencies. With a unified European financial market and the growing substitutability between assets denominated in euros and those denominated in U.S. dollars, international investors could decide to make large changes in their portfolios. Although the euro's evolution since its launch seems to

indicate that such portfolio reallocations have not yet taken place on a large scale, it is too early to rule out this possibility. Supply shifts have already occurred, especially in the international bond markets: euro-denominated securities represented 44 percent of total issues in January–April 1999, roughly the same as the dollar (46 percent), against 35 percent and 48 percent, respectively, in 1998.

Another reason exchange rate instability may increase in the near term is that the euro-dollar exchange rate will be of less concern to the European Central Bank than it was to the national central banks because the economy of the euro zone as a whole will be more closed and inward looking than the individual members' economies. The euro zone's openness rate (measured by the ratio of trade in goods and services to GDP) is about 14 percent, compared with 25 percent for France and Germany.

All of these factors enter into play in a disturbed monetary environment. The United States' current account imbalance represents a threat





to the stability of the dollar, while the yen suffers from deeply rooted domestic weaknesses, and many emerging currencies are just beginning to recover from exceptionally severe crises.

Pitfalls of instability

The instability of floating exchange rates is well documented and, although moderate currency fluctuations can be accommodated without major difficulties, significant misalignments are harmful, especially between the major currencies.

First, exchange rates between major currencies have the character of public goods for the world economy. Europe, Japan, and the United States are large export markets for many countries; wide swings in the dollar-euro and dollar-yen exchange rates have a destabilizing impact on these countries, as in 1997, when the appreciation of the U.S. dollar contributed to the collapse of the Asian currencies that maintained a formal or informal peg to it.

Although some of these countries may draw from the crisis the conclusion that they should let their currencies float freely or, on the contrary, adopt a currency board, the argument remains valid for countries with an intermediate regime.

Second, exchange rate misalignments could be a cause of concern for domestic reasons. In the United States, they may trigger conflicts between different interest groups and fuel protectionist pressures. Furthermore, higher substitutability between dollar and euro assets, combined with the need to finance the U.S. current account deficit, should increase the potential for abrupt portfolio shifts and make U.S. debt issuers and policymakers more sensitive to exchange rate developments. Wide exchange rate swings would probably give rise to conflicts in Europe as well, because not all governments are equally responsive to the demands of the traded goods sector. This could cause difficulties in the management of the European Economic and Monetary Union. Some governments might insist on making use of the exchange rate policy instruments provided for in the Maastricht Treaty, while others might refuse on the ground that this would threaten the European Central Bank's independence.

Lessons of the post-Bretton Woods era

Exchange rate coordination in the post-Bretton Woods era has been a process of trial and error. Consensus has emerged only under the pressure of events, when uncoordinated economic policies led to massive exchange rate misalignments and domestic tensions, or when attempts at exchange rate stabilization failed.

This trial-and-error process is best illustrated by the policy shift in the United States in the mid-1980s. The first Reagan administration pursued a policy of *laissez-faire* on exchange rate markets. By February 1985, however, the dollar had jumped to so high a level and the U.S. trade deficit was so large that the United States decided to take action.

Under the terms of the Plaza agreement, signed on September 11, 1985, the finance ministers and central bank governors of the United States, France, Germany, Japan, and the United Kingdom agreed to talk the dollar down and cooperate more closely.

A second agreement was reached at the Tokyo summit in May 1986, when the finance ministers of the large industrial countries, asked to collectively review their economic objectives and forecasts, drew up a list of indicators (including GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, monetary growth rates, reserves, and exchange rates) that have served as the tools for coordinating economic policy ever since.

By the end of 1986, the dollar had depreciated, and the United States and Japan agreed to stabilize the dollar-yen parity. Their agreement was formalized in a multilateral framework—the first Louvre accord, signed on February 21–22, 1987—that secretly established a narrow intervention grid for the currencies of the Group of Seven countries. The agreement worked well for some time; however, international commitment to it eventually waned. Germany raised interest rates in 1990, following reunification, while the United States eased monetary policy to counteract a decline in economic activity. Although the interest rate differentials between the United States and Europe caused several European currencies to appreciate, the Group of Seven did not react. Nor did it try to halt depreciation of the yen in 1990. By 1993, the Louvre accord was virtually dead, as domestic objectives took priority over internationally agreed targets. Political shocks (such as German reunification and the invasion of Kuwait) and economic facts (such as the persistence of Japan's current account surplus in spite of a strong yen) also weakened commitment to the accord. The Group of Seven's approach changed from "high-frequency" to "low-frequency" activism, with ad hoc interventions only in cases of extreme misalignment, and the focus shifted from exchange rate levels to exchange rate volatility.

Fine-tuning exchange rates is neither feasible nor desirable, if only because the exchange rate is an important instrument for market-driven macroeconomic adjustment. The rise and fall of the U.S. current account deficit in the 1980s showed that a flexible exchange rate could play a significant role in adjustment, even though the parallel rise of the Japanese surplus showed that this role should not be overstated. Furthermore, the commitment to policy coordination promised by the Plaza and Louvre arrangements was unrealistic for political reasons, given the difficulty large, relatively closed economies have in maintaining a constituency for external stability. There is no room for another Bretton Woods in today's economic and political environment.

For the same reasons, target zones, although they may have some value for emerging economies, are not a practical alternative for large economies. On the one hand, intervention margins need to be narrow to be stabilizing. On the

other, large asymmetric shocks or market tensions may occur, making it politically costly either to change or to defend the exchange rate. To survive, target zones need to be relatively wide, in which case they become variants of floating exchange rates.

Changes in the environment

Numerical targets for exchange rates are unlikely to be effective for other reasons as well—namely, evolving attitudes toward monetary policy and structural changes in foreign exchange markets.

In the 1990s, the major economies have come to favor a monetary policy with a single main objective—domestic price stability. Exchange rate management is given far less weight. As a result, monetary policy can be used to coordinate policies at the international level only if external objectives are consistent with domestic monetary strategies. For example, the European Central Bank would raise interest rates to counteract a depreciation of the euro if price stability were threatened, but it would probably not lower rates in the event of an appreciation associated with fiscal expansion.

Structural changes in foreign exchange markets have been dramatic. Between 1989 and 1998, net turnover on foreign exchange markets roughly tripled, reaching \$1.5 trillion a day, while world exports increased only 80 percent in nominal terms. The introduction of the euro created, overnight, an integrated market for bonds and monetary instruments comparable in size to the U.S. market. And markets have become far more concentrated: London and New York now account for 50 percent of global turnover, up from 42 percent in 1989, and the combined market share of the top 10 dealers has risen from 44 percent to 50 percent in London, and from 48 percent to 51 percent in New York, in the same period. Furthermore, with the development of new instruments such as forward markets and derivatives, the spot market's share of total transactions has shrunk, from 59 percent in 1989 to 40 percent in 1998.

Although such structural changes make it possible for agents to diversify risk, thereby contributing to macroeconomic stability, they also increase the risk of large, destabilizing movements. This risk is intensified by the fragmented dealership and lack of information on transactions that characterize the spot market. Information about macroeconomic fundamentals, although easily available, is of little help to market participants in the short run owing to the poor fit of empirical exchange rate models at this horizon. Because of transaction costs, information can easily remain trapped in some segment of the market until it is revealed by a participant, triggering a large number of operations.

This has important consequences for exchange rate analysis and management. First, theoretical views on exchange rate determination are changing. As is well known, floating exchange rates can, in some instances, depart lastingly from macroeconomic fundamentals even though they revert in the long run to their equilibrium. Representative agent

models of exchange rate determination now include explicit optimizing behavior over time, and growing attention is being devoted to issues such as the heterogeneity of expectations, the link between prices and order flows, the impact of unpublished information, and the way information is aggregated by the market. Second, interventions now require larger reserves, careful preparation, and vocal intervention, and are most effective when they support policy changes.

A two-handed approach

In light of these changes, the emphasis in any new international arrangement should be on coordinating responses to macroeconomic shocks, rather than on setting numerical targets for exchange rates, and on monitoring developments in foreign exchange markets and providing information to market participants.

Coordinating responses to macroeconomic shocks. Uncertainty regarding the future course of monetary and fiscal policy can trigger exchange rate instability. During the Russian crisis of August 1998, for example, markets had divergent expectations on how the United States and Europe would react—the former was expected to react aggressively, the latter to keep interest rates on hold. Within a few weeks, the currencies of the future euro countries appreciated by more than 10 percent against the dollar. But Europe cut interest rates on December 3, 1998, and April 8, 1999, helping to reverse the depreciation of the dollar vis-à-vis the euro and, by the spring of 1999, the euro-dollar exchange rate had returned to the level of the previous summer. These exchange rate swings could have been avoided by the involved countries' agreeing that reactions to the crisis would be symmetric and informing the markets accordingly.

Reducing policy uncertainty could be done through either discretionary coordination within the Group of Seven or the adoption of rules. Discretionary coordination is problematic for Europe, however, while the rules-based approach preferred by Europe because of its internal structure has little appeal for the United States.

An approach based on a joint endorsement by Europe, Japan, and the United States of a core set of broad macroeconomic policy principles would provide a middle way between the U.S. discretionary model and the rules-based European model. The basis for such convergence already exists, as the Group of Seven countries have gone a long way toward developing a common economic philosophy. Arrangements for effective representation of the euro zone and its largest members—France and Germany—within the Group of Seven would have to be implemented in an effective way.

Next, common principles consistent with the objective of domestic price stability would have to be developed for sorting out the roles of fiscal and monetary policy in responding to shocks. These principles would not be binding rules but, rather, tools for reducing uncertainty and cutting transaction costs, and they would provide a structure for policy discussions. Neither the exchange rate nor numerical exchange rate

targets should be included as policy tools, although the principles should take account of the consequences that given policies would have on exchange rates. At the same time, governments and central banks should strive for greater transparency in their policy objectives and medium-term forecasts. To safeguard national autonomy, implementation could be tailored to domestic institutions. National governments would be allowed to depart from preannounced targets or principles if circumstances demanded and if they did so in a transparent manner.

Defining the appropriate response to common shocks can be relatively easy; asymmetric shocks are another matter. From a European perspective, demand shocks that hit European countries in a symmetric way (but affect the United States differently) should also be dealt with through monetary policy, and the same applies to the United States (or Japan). But such an assignment would necessarily result in some exchange rate volatility because monetary policy reactions would amplify the effect of shocks on exchange rates. Whether or not this is acceptable cannot be decided a priori. Although exchange rate adjustments should be allowed, large fluctuations might not be desirable. If this were the case, fiscal policy would have to enter into play, and the policy mix would need to be altered.

Monitoring foreign exchange markets. The changing nature of foreign exchange markets makes monitoring increasingly necessary. Monitoring should not interfere with markets but should improve the flow of information to market participants so as to limit market-induced volatility. Discussions on the new architecture of the international financial and monetary system have already produced robust recommendations aimed at improving the functioning of financial markets—namely, increasing transparency requirements for governments as well as for public and private market participants and strengthening prudential regulations and supervision.

The issue of transparency deserves a detailed discussion in light of the idiosyncrasies of foreign exchange markets. As mentioned above, information is inadequate in the spot market because order flows are not disclosed and information about fundamentals is usually not helpful in the short run. Data that may help explain the timing and magnitude of portfolio shifts—such as outstanding foreign asset positions, expectations on international returns and corresponding correlations, and the overall risk exposure of



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financial institutions—are not made available to markets, although they may be known by individual participants, which treat them—for obvious reasons—as private information.

There is no reason, however, why corresponding statistics should not be made available. More work should be done—perhaps by the Bank for International Settlements under the aegis of the newly created Financial Stability Forum—to uncover ways in which such information could be reported to central banks and market regulators, and aggregated and disclosed to the markets. Aggregate information on positions and return expectations would be released to the markets on a regular basis and without delay. When appropriate, the chairman of the Financial Stability Forum could confidentially signal to the Group of Seven the existence of an abnormal risk exposure, so that ministers and governors could issue appropriate warnings to the market. Recent liquidity shortages and the accumulation of open positions in global markets suggest that information provision has the character of a public good and cannot be left to the market alone.

Would it also be useful to compute equilibrium exchange rates that give some indication of the appropriateness of current exchange rate levels? A sizable body of empirical research has provided reasonably robust models of medium-term exchange rate determination. Although the estimates are imprecise, they provide a rational (as opposed to political) basis for discussion on exchange rates by the Group of Seven, as well as guidance to markets. Taking account of these estimates, the IMF could be asked to examine on a regular basis whether prevailing market exchange rates and the current account positions they imply are broadly consistent with medium-term fundamentals. This should enable finance ministers and central bankers to identify exchange rate misalignments earlier than is now possible and to issue appropriate signals to the markets.

Implementing the framework outlined in this article would not require radical institutional changes. It can be done in the context of the Group of Seven surveillance exercise, drawing on the expertise and advice of bodies such as the IMF and the Bank for International Settlements. And it would help protect the world economy from the harm that excessive volatility in the exchange rates between the dollar, the euro, and the yen is likely to cause. **F&D**