

International Currency Alignment

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Discussion of international currency reform has taken on a new air of plausibility since the dramatic joint intervention following agreement at the G-5 meeting of ministers of finance and central bankers in New York on September 22, 1985.

U.S. intervention was particularly noteworthy as the U.S. did an abrupt about-face from its traditional hands-off attitude and starting pushing hard to rectify the dollar's overvalued position. While the September G-5 intervention was the most dramatic indication of this shift, U.S. interest in a more reasonably valued and stable dollar was also evident in the November Kemp-Bradley congressional conference on currency reform and in President Reagan's January 1986 State of the Union declaration that America is studying the possibility of convening an international conference for reforming the international monetary system.

Background and issues

The current debate on international monetary reform was initiated at the May 1983 Williamsburg Summit, when the assembled heads of state and government asked the G-10 to define the conditions for improving the international monetary system and consider the role that a high-level international monetary conference might play in this process. The results of this study are summarized in the G-10 Representatives' Meeting Report and the Tokyo Communiqué approved by the G-10 last June. In their conclusion, they state that the present system of floating exchange rates is basically sound, but it does have its weaknesses, and there is a need for functional improvement centering on multilateral surveillance and cooperation, including concerted intervention. In effect, last June's G-10 report foreshadowed the events since September's G-5 meeting, and the experiment in reforming floating exchange rates is already under way.

Figure 1 shows Japan's current account balance and the yen's exchange rate since floating exchange rates were instituted in 1973. As seen, the two were in rough cor-

respondence until 1981 or so as exchange rates functioned to correct the current account imbalances. Since then, however, the yen has tended to be weak despite Japan's massive current account surpluses, and exchange markets have not functioned to equalize the current account imbalance.

It should be remembered, however, that the problem in the 1980s has not been yen undervaluation so much as dollar overvaluation. Figure 2 shows the exchange rates for the world's four major currencies from 1978 through 1985. For about five years starting in 1981, only the dollar was overvalued and the other currencies were undervalued, during which time the U.S. saw its current account deficit soar and the world economy was exposed to the dangers of protectionism.

Although the dollar's overvaluation was corrected in the wake of the September G-5 decision, the world economy has been confronted with new dangers since the start of the year. As plummeting crude oil prices threatened to exacerbate the developing countries' debt crisis, it was feared that the dollar would collapse to plunge the world economy into recession and world currency markets into chaos. As a result, there were alarmed calls for exchange market stability and a rapid and dramatic decline in U.S. interest rates to ensure continued international liquidity. Hinging on the question of how the leading countries can cooperate for sound economic management, international currency reform is thus an issue having a major bearing on the future of the world economy.

Currency fluctuation to rectify current account imbalances

There are two problems behind this instability in the international monetary system: the problem of floating exchange rates per se and the misalignment of economic policies.

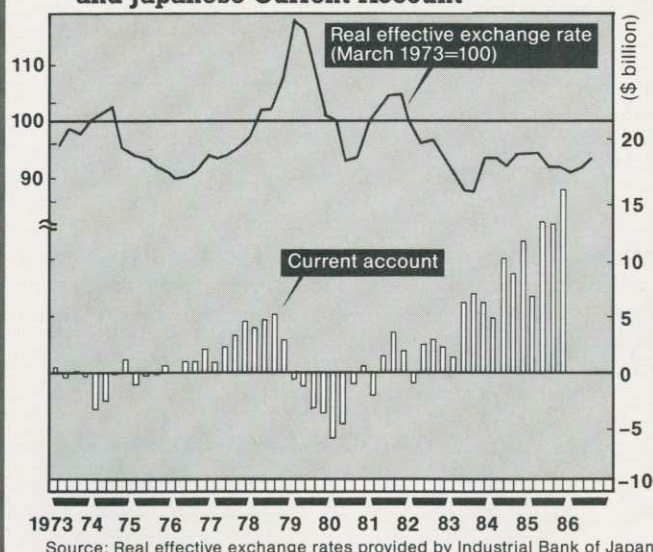
The rapid increase in international capital movements since 1980 has seriously damaged the floating exchange system's ability to correct current ac-

count imbalances. As international capital movements have proliferated, exchange rates have come to be determined more by capital movements than by trade relations, such that the exchange rate reflects the relative values of two countries' capital assets more than it does the relative values of their goods. In such cases, the exchange rate is determined by the rate at which the two countries' capital asset markets are in balance, but there is no assurance that this will always be the same as the rate needed to balance their current accounts as indicative of their goods markets. Even if it is possible to achieve balance in both the current account rate and the assets market rate by drawing on foreign currency savings and reserves, this adjustment process will be a slow one and the actual exchange rate will be divorced from the current account balance rate for the interim.

This problem has been exacerbated by the misalignment of economic policies among the major powers, especially the United States, and this has resulted in the major medium-term fluctuation of the dollar.

As announced in 1981, Reaganomics was designed to stimulate the U.S. economy from the supply side with major tax cuts and austere fiscal policies centering on reducing government spending. In fact, even as taxes were cut, it proved impossible to trim government programs as much as had been originally projected and defense spending was sharply increased, resulting in ambitious Keynesian reflation rather than the supply-side policies originally envisioned. The combination of massive current account deficits and an overvalued dollar resulted from the combination of activist fiscal policies and financial tightening by the Reagan administration. In addition, the dollar's overvaluation was further exacerbated by the opposite Japanese and European policy mix of fiscal austerity and moderately stimulative financial policies during the same period.

As long as the American economy continued to recover, the dollar's strength on exchange markets in defiance of the increasing current account deficits was seen as proof that America was "standing tall," and the dollar took on an air

Fig. 1 Yen's Real Effective Exchange Rate and Japanese Current Account

of invincibility as the key currency on exchange markets. Going into 1985, however, there was a sharp slump in the American economy's growth rate and it became obvious that this was not a sustainable situation.

In June, the major countries started to study the possibilities of concerted intervention, with Treasury Secretary James Baker approaching Minister of Finance Noboru Takeshita at the G-10 meeting to talk about ways of cooperating to rectify exchange markets. This approach indicates that the U.S. authorities were aware of the changes in the American economy very early on.

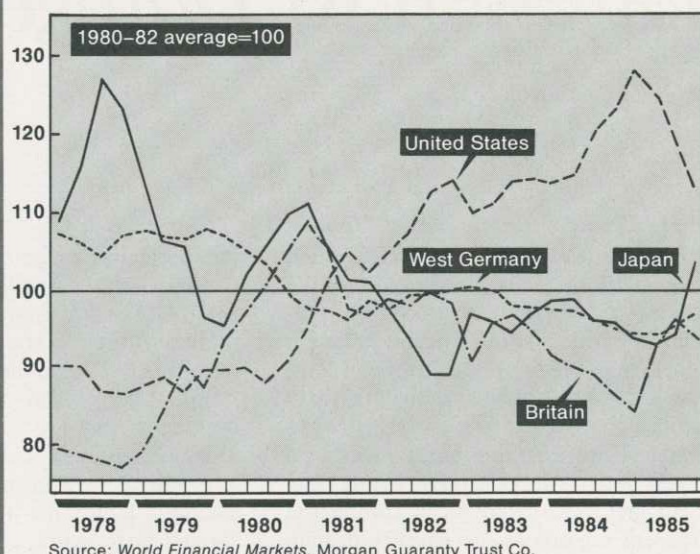
On the exchange markets, there was an emerging wariness about the future of the U.S. economy starting last spring, and the markets gradually shifted against the dollar. However, the mood was one of mixed optimism and pessimism, and the market was unable to effect any major rectification until the September G-5 meeting in New York and the subsequent joint intervention. With the October moves by the Bank of Japan to push Japanese short-term interest rates up, Finance Minister Takeshita's January comments that the Japanese economy could stand a stronger yen and other developments, the dollar fell sharply and the markets took on the appearance of a very managed float. In February, however, the mood of the markets was that the dollar would continue to weaken, and the markets became very skittish. The concerted interest cuts by West Germany, Japan, France and the United States in early March, and the subsequent counter-intervention by the Bank of Japan, were widely seen as a signal to the markets that these countries were satisfied with the

prevailing rates and wanted the markets to stabilize, and there was a lull in the downward pressure against the dollar. However, there have been a number of conflicting market expectations in the wake of the September G-5 decision, and it is still too early to say that the markets have stabilized at any particular level.

When the exchange rate as determined by the assets market balance is divorced from the current account equilibrium rate, it becomes necessary to align the two with changes in fiscal and monetary policy or by generating "news" that will change the market's expectations and thus alter the conditions for assets equilibrium. However, the experience after the September G-5 meeting has pointed up the difficulty of nudging the market to stability at an appropriate rate while controlling market expectations.

Managing exchange markets

There are limits to what floating exchange rates can do to produce equilibrium in current account balances, and the leading industrialized countries are generally agreed on the need to manage currency exchange markets at an appropriate level while ensuring stable and balanced growth for the world economy. However, there is no agreement on the specifics of how this is to be done. All that can be said at this point is that the mainstream thinking in Japan, the United States and the other G-10 countries is that it is neither desirable nor possible to return to fixed exchange rates or to set target zones, and that, making do with floating exchange rates, we

Fig. 2 Major Real Effective Exchange Rates

will have to strive for currency stability with greater policy coordination and strengthened surveillance among the major economic powers. The moves since the September G-5 meeting have been basically along these lines. While the currency authorities do have some tacit target zones in mind, these are not rigid targets and the authorities are willing to roll with the circumstances to avoid extremes in what might be called managing the markets against negative targets. In fact, even managing against excessive fluctuation portends the first move toward managed markets.

Despite the major decline in the dollar's exchange value, the United States still has major deficits in its current account and the international monetary markets are increasingly fragile. Yet given the very real possibility that the very act of setting target zones would itself provide a target for speculation and hence generate increasing instability on currency markets, this policy of managing against negative target zones seems to be the most practical way to manage currency markets at present.

Agreement on where the target zones lie and coordination for compatible policies among the major countries are prerequisite to success in this negative target management. Accordingly, insofar as the dollar is the key currency, it is imperative that the U.S. also provide the necessary market leadership. The question of whether or not this system of managing currency markets can substitute for floating exchange rates hinges upon whether or not it will be possible to institutionalize a framework for policy coordination including American moderation and cooperation. ●