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Targeting the Exchange Rate?

Less than eight months after the memorable New York "Plaza" meeting of the finance ministers and central bank governors of the Group of Five (G-5), the Tokyo Economic Summit on May 4-6 aimed at consolidating the progress made in economic convergence and in the coordination of economic and monetary policies. This progress is indeed noteworthy: through joint action the dollar was sent down by 25 percent against the Deutsche mark and 33 percent against the Yen; nominal interest rates have declined by roughly one percentage point since September 1985, providing a stimulus to domestic demand and lowering the debt servicing burden of the international debtor countries; inflation is down to figures well below 5 percent in almost all major economies, thanks partly (but not entirely) to the crash landing of the oil price; and with the further picking up of the rate of economic expansion in Europe expected for the current year – again partly due to the terms-of-trade effect of the oil price fall – growth rates will be "harmonized" at levels around 3 percent that are generally considered appropriate. A good time, therefore, to consolidate.

On the other hand, a number of economic weaknesses and conflicts remain: high unemployment continues to plague the European economies; in the triangle United States – Japan – Europe major current-account disequilibria persist and are likely to increase further in nominal terms as a result of the J-curve effect of the past exchange-rate adjustments; with protectionist sentiment spreading in the U.S. (and to some extent also in Europe) the "hidden" trilateral trade war may well erupt into open conflict, threatening the very foundations of the GATT system upon which international integration and economic prosperity are based; the debt crisis is anything but solved; and on the monetary front disagreement on the desirable future course of interest rates and exchange rates is apparent.

The approach of the Summit to dealing with these issues is far from convincing. The "Tokyo Economic Declaration" is conspicuous for its omissions. None of the more pressing controversial questions is explicitly and constructively dealt with in the Declaration: Should interest rates go down further or not? Is the present grid of exchange rates considered satisfactory (for the time being)? If so, by what policy action is it going to be supported? If not, how is the desired exchange-rate structure to be achieved? What joint action has been agreed upon to counter the protectionist tide in commodity trade? Not only is the Declaration silent on these issues, the Summit participants conveyed the impression that they were indeed divided on how to address them.

The Declaration, apart from highly generalized (and noncommittal) statements of intent, mainly refers to institutional and procedural matters. To improve the coordination of economic policies, a new Group of Seven (G-7) finance ministers will be set up "which will work together more closely and more frequently in the periods between the annual summits". In addition the G-5 finance ministers have been requested "to include Canada and Italy in their meetings whenever the management or the improvement of the international monetary system and related economic policy measures are to be discussed and dealt with". With these "improvements" the Western industrialised nations now have at their disposal (at least) seven forums for economic policy coordination: the informal but effective Group of Three (U.S., Japan, Germany) on monetary policy; the traditional G-5 meeting four times a year on a

routine basis; the new G-5 + 2; the new G-7 (without the EC Commission); the G-7 Summit Group (including the EC-Commission); the G-10; and the OECD (with its committees). Not included in that number are the consultative bodies within the EC and the forum provided by the Bank for International Settlements (BIS).

As to the procedural side, economic (policy) coordination is to be improved by the use of economic indicators: GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, monetary growth rates, reserves, and exchanges rates. A rich menu designed to meet everybody's taste! Indeed the great variety of indicators will allow every country to choose those variables that are best suited to rationalize its own preferred policy course. Without clear guidance on the ranking of these indicators the approach is not likely to lead to any positive results.

A more credible alternative would have been to focus, for the purpose of securing international policy compatibility and consistency, on a more limited set of indicators. The exchange rate lends itself as a pivotal target variable. The high degree of exchange-rate volatility experienced since the transition to floating in 1973 and, even more important, major and protracted deviations of exchange rates from their medium-term trend path must be considered detrimental to investment and growth. In the past five years (up to the "Plaza" agreement) a grossly overvalued dollar, while providing temporary windfall profits to European and Japanese firms, has eroded the very basis for profitable business activity of many U.S. industrial and agricultural producers and given rise to the protectionist drive that is so difficult to reverse even now that the underlying conditions have changed. Likewise, the recent strengthening of the non-dollar currencies has compounded the problem of agriculture in Europe and created problems for the manufacturing industries, especially in Japan.

Investing in the international sector has become a game of chance to many producers, given the possible size of exchange-rate misalignments and the duration of the exchange-rate "cycle". It is the detrimental effect on investment activity generated by the present exchange-rate regime which is the major rationale for setting internationally agreed exchange-rate targets. The time for such a move is favourable. The current exchange-rate structure is close to the medium-term norm. There is therefore no need to push the exchange rates into the target range first.

Using the exchange rate as a guide-post for coordinated macro-economic management has proved to be a workable solution both in the heyday of the Bretton-Woods system and in the European monetary system (EMS). Yet it would certainly not be feasible to attempt installing an EMS-like system, with narrow margins and strict intervention rules, on a global scale. This would imply that the advantages the present system offers – among others the ability to "de-couple" from the rate of real interest in the United States – would have to be sacrificed. A less rigid agreement, with wide margins (± 10 percent) around adjustable reference rates, however, would offer advantages over the present system, especially if the U.S. could be brought to comply with the joint discipline.

A lesson to be learnt from the Bretton-Woods system and the EMS is the importance of a "stable" key-currency country for the proper functioning of the international economy. Since the U.S. cannot be relied upon to accept that role, return to more stable exchange rates ought to be supported – as Professor McKinnon has proposed – by an obligation by the major participating countries (the G-5?) to control their money supplies in such a way that the rate of growth of their aggregate money stock, however defined, is consistent with global price level stability. The assignment of specific monetary growth rates to the individual countries would then be subject to their exchange-rate position.

By agreeing on simple rules for monetary and exchange-rate management, along the lines sketched here, the economic progress achieved in the world economy could be better secured than by inflating the number of bodies for policy coordination or taking recourse to a whole bundle of indicators. However, this requires more determination than was demonstrated in Tokyo.

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