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MONETARY POLICY

Crisis Management in Exchange Rate Policy

by Joachim Starbatty, Tübingen*

The behaviour of the dollar exchange rate last year and the concerted action by central banks in the autumn of 1985 have given renewed impetus to the demand for internationally co-ordinated exchange rate management. How should such attempts at co-operation in the economic and monetary fields be viewed?

The most conspicuous monetary event of 1985 was the rise in the dollar to DM 3.47 and its subsequent descent to around DM 2.50, aided by co-ordinated central bank action in the autumn of last year. The dollar seemed to have lost its appeal and talk was of the possibility of a soft landing and the forms it might take when the currency began to soar once again, even though there had been no underlying change in the economic fundamentals.

These sharp exchange rate fluctuations appear to bear out those who consider the behaviour of the dollar to be too important to be left solely to the foreign exchange markets or the speculators operating there. Last autumn's central bank operation and the dollar decline it initiated seem to endorse the view that exchange crisis management is essential.

In this context, crisis management means that politicians intervene on the basis of certain stabilisation objectives to steer exchange rates into specific target zones or prevent them exceeding given target levels. Such action stands the greatest chance of success if the burden of intervention is spread over several pairs of shoulders. An operation involving several participants not only reduces the volume of interventions each party has to bear, but it also has a greater impact on foreign exchange markets, so that a smaller total volume of interventions achieves the desired effect. However, operations of this kind must be agreed in advance. For this purpose monetary conferences are held to discuss the aims and means, the time and the place of action. As a rule, there is also a public relations side to such conferences. Politicians and experts demonstrate their grasp and determination, they are seen to be tackling the problem, they point out the consequences of their

action; they are clearly in a position to cope with difficult situations, to "manage" crises.

The recent central bank operation also drew criticism. The former German Economics Minister Graf Lambsdorff described the points agreed between the ministers of finance and central bank governors of the five most important industrial countries as pure eye-wash. None of the previous interventions had been a success; exchange rates were determined by supply and demand, which in turn reacted to macro-economic factors and relative rates of return, such as different interest rate levels. He suggested that governments should make it a rule not to accept political responsibility for exchange rate developments but instead to influence those economic factors that determined capital movements. They should rely not on discretionary decisions and the ad hoc measures to which they gave rise, but on a particular exchange market order, namely exchange rate determination by the prevailing conditions of supply and demand. If exchange rates posed problems for the world economy in that an important currency could be regarded as overvalued because the resulting inflow of imports was squeezing out or threatening to squeeze out domestic production and provoke the introduction of protectionist import barriers, adjustments would have to be made to the factors that attracted investors to that currency and drove it above the level compatible with long-term national competitiveness.

Lessons of the Past

Let us briefly review the experience we have been able to have, or more precisely have been forced to have, with various types of cyclical and exchange policy applied in different countries in recent years. Being

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small open economies, most OECD countries are, so to speak, vast laboratories in which the lessons, hypotheses and suppositions of international currency theory and cyclical theory can be tested on a continuous basis. Traditional macro-economic management, whereby discretionary countercyclical pressure is brought to bear on macro-economic variables, is generally considered to have failed, but the monetarist variant has not proved itself a viable alternative either. At present, either countries are going through cyclical agony, because their governments are still clearing up after the laissez-faire fiscal policies of recent years, or they have adopted a strategy that lies somewhere between strict adherence to rules and manual control of cyclical policy. For example, the Deutsche Bundesbank's practice of setting an annual target range for money supply growth and managing the money supply partly in the light of cyclical factors can be described as potential-orientated adherence to rules with discretionary scope for exceptions.

Alexandre Lamfalussy has shown from a theoretical standpoint that this procedure is not simply a second or third-best solution but that manual control is essential as long as our actions are subject to uncertainty.¹ The objection against traditional macro-economic management, namely that the consequences of cyclical measures on macro-economic aggregates cannot be predicted with sufficient accuracy and hence that the possibility of procyclical rather than countercyclical interventions cannot be ruled out, can also be lodged in principle against a strict adherence to rules: the consequences of strictly observing the rules cannot be foreseen with sufficient certainty. Nevertheless, the advocates of rules can argue that they may provide a basis for action at the enterprise level, so that the degree of uncertainty about the behaviour of the state may be reduced.

This advantage also applies, however, to adherence to rules tempered by the possibility of discretionary exceptions. Economic agents can rely on a constant policy as long as the economy behaves normally and on limited cyclical measures if, for example, exogenous factors make these necessary – provided of course that the authorities responsible for cyclical policy remain predictable in their discretionary decisions. Seen in this light, the possibility and necessity of manual control should be interpreted as a form of insurance.

The Politician's Standpoint

There are also political grounds for considering it appropriate to link adherence to rules with crisis management. From his many years' experience as an

adviser to the US Federal Government, Herbert Stein concluded that every President and every staff of technical advisers agreed that a simple rule would have produced a better fiscal policy than that actually followed by their predecessors, but that they claimed themselves to be a laudable exception.² Anyone putting this to the test in Germany by presenting politicians with a set of rules deemed to take adequate account of cyclical and exchange rate developments will quickly discover that they are not in the least prepared to allow their action to be dictated solely by such rules, whatever their political persuasion. They would rather set the rules aside completely and return to the old Keynesian manual control. For that reason, adherence to rules coupled with occasional manual control – in other words generally recognisable cyclical and/or exchange intervention – is an almost tailor-made cyclical and exchange strategy in a context of democratic decision-making procedures. Our recommendation in the "rules versus authorities" dispute would therefore be "rules *plus* authorities".

The great laboratory for cyclical and exchange experiments also provides us with a second important conclusion, however. The absence of rules or the lack of political commitment to such rules does not imply that politicians following their own instinct or that of their advisers can handle crises, but rather that their hands are tied when difficult situations actually arise because they have exceeded the bounds of their room for manoeuvre, by excessive borrowing for example. The idea that politicians must be given as much scope as they wish and appropriate instruments ignores the fact that in parliamentary democracies politicians find it hard to resist the temptation to offer jam today and to disregard future cyclical and exchange rate requirements.

The period before the floating of exchange rates was also anything but an era of successful crisis management; the universal switch to floating from the beginning of 1973 onwards was an admission by politicians that they were at a loss to know how to proceed with the management of currency crises. Viewed from today's perspective, the carefully planned monetary conferences and hastily convened crisis meetings at which "realignments" were negotiated and/or condemnation was rained upon international speculation appear to be a case of "political impotence

¹ A. Lamfalussy: Rules versus Discretion: An Essay on Monetary Policy in an Inflationary Environment, BIS Economic Papers, No. 3, Bank for International Settlements, Basle 1981.

² H. Stein: The Fiscal Revolution in America, Chicago and London 1969, p. 467.

and economic law", to adapt Böhm-Bawerk's famous saying.

After the experiences with manual control of cyclical and exchange policy, political commitments to rules should not be interpreted in any way as a constraint on the freedom of political action; indeed, they might save politicians from the danger of firing off all their cyclical and monetary ammunition prematurely to please the electorate. From this point of view we need appropriate mechanisms to ensure that politicians remain free to act in times of crisis. This recognition must play a constructive part in shaping concepts of cyclical and monetary policy. What consequences does it have for presentday exchange crisis management?

Two Areas

At present, a distinction must be made between two areas: overcoming the international debt crisis and monetary policy co-operation for purposes of exchange rate management. The international debt crisis is essentially a private sector problem that has escalated dramatically into a world economic emergency owing to the rise in US interest rates and the accompanying strong appreciation of the dollar since the beginning of the eighties. It came about because the banks, and especially those in North America, largely ignored the rules on maturity transformation and committed themselves too deeply in South America. The need to consolidate is as great as ever; many banks, and again chiefly those in North America, are still struggling to get back onto an even keel. Essentially, there is little room here for exchange crisis management.

We are dealing here with a race against time: can the banks with a large South American exposure make sufficient provision to withstand the impending loan write-offs without being gravely damaged, without inducing a general banking crisis and sending shockwaves throughout the world? International rescue programmes, via supranational institutions for example, obviously do not solve the debt problem, only create a breathing space, but even that is something.

Calls for Co-operation

Claus Köhler, a member of the Directorate of the Deutsche Bundesbank, recently called for international co-operation in the exchange policy field in view of the increasingly close worldwide links through capital and trade flows.³ The ensuing political action would leave its mark on the international and national capital markets and would affect both interest rates and exchange rates.

³ C. Köhler: Die neue Geldpolitik, in: Zeitschrift für das gesamte Kreditwesen, Vol. 38, No. 23, 1985, p. 1066.

The former German Federal Chancellor Helmut Schmidt has also been calling for exchange crisis management for some time. He sees speculators descending on the foreign exchange markets "like a flock of sheep" and the exchange rates of the key currencies "going mad".⁴ Unfettered exchange rate determination by the market cannot therefore meet the various national interests. For example, he considers that the overvalued dollar has seriously jeopardised free world trade. The concerted central bank action of last autumn appears to endorse Schmidt's view.

This raises three questions, which we shall attempt to answer below:

- ☐ Have exchange rates really been going mad at times and is there a case for exchange crisis management from this point of view? This question was asked in particular by François Mitterand at the Versailles summit in 1982, when a high-ranking group of experts was set up to investigate the matter.
- ☐ How should we rate the prospects of the concerted central bank action designed to weaken the dollar? What conditions contribute to the success of such action?
- ☐ Is there a current need for international co-ordination, beyond the calls on the US President to take vigorous action to reduce the massive Federal budget deficit?

Influence of US Policy

The seemingly unstoppable rise in the dollar from about DM 1.75 at the end of 1979 to DM 3.47 in the spring of 1985 can be explained properly only if we also bear in mind the earlier depreciation under the Carter Administration, which also appeared impossible to halt. The international reputation of the dollar was damaged by aimlessness in foreign policy coupled with periods of weakness in domestic economic activity, which manifested itself in rampant inflation; dollar-denominated securities in international portfolios were replaced by DM paper and the dollar currency area contracted, while that of the Deutsche Mark expanded. As the Deutsche Mark is a relatively narrow currency compared with the dollar, changes in currency areas lead to disproportionately large movements in exchange rates. When the dollar became attractive again under the Presidency of Ronald Reagan it regained lost ground. This was again bound to lead to corresponding exchange rate fluctuations.

⁴ H. Schmidt: Die Weltwirtschaft ist unser Schicksal. Was jetzt not tut, ist amerikanische Führung, in: Die Zeit, No. 9 of 25th February 1983, p. 25.

The restoration of domestic stability by adopting a restrictive monetary policy had already driven interest rates upwards before the rise came to be blamed on the massive tax reduction and the financing of the resulting budget deficit in the capital market. As the tax reduction meant that even high interest rates did not check investment, the US economy sucked in capital from all over the world, thereby pushing the international value of the dollar even higher; the result was an explosion in the US current account deficit and a boom in exports to the USA. The USA acted as locomotive to the international cyclical train, so to speak.

High interest rates, a determined economic policy and a flourishing economy made the dollar so attractive that its exchange rate was pushed above the level that the productive sector in the USA could tolerate for long because of the actual or threatened loss of its traditional export markets or even domestic markets. But does this mean that exchange rate determination in the markets is a game of chance, as one would have to assume if one shared Helmut Schmidt's view that investors behaved like a flock of sheep?

Behaviour of Investors

In contrast to central bankers and politicians, speculators do not gamble with other people's money but with their own. Since in the business world losses lead to a reduction in wealth, investors will discover all

there is to know about alternative investments in order to avoid such sacrifices. An investment in information-gathering is therefore extremely profitable, so that we can assume that international investors are generally very well informed. Of course there are gamblers among them who chance their luck, but if they recklessly risk their capital they will drop out of the foreign exchange market sooner or later for lack of resources.

From the economist's viewpoint, this institutional arrangement provides the best guarantee that the exchange rate structure will accord with economic reality and the political risks. If certain exchange rates are regarded as harmful to a particular economy or the world economy as a whole, it is the economic fundamentals that must be modified, not the exchange rates, which merely reflect them. Naturally, panic reactions cannot be ruled out, but there will always be investors who keep a cool head and build up counterpositions, although they may not constitute a sufficient counterweight. In those circumstances it would really do no harm if central bankers or politicians intervened in the markets, although cynics might say that in a crisis they became more excited than professional investors.

What sense can there be in concerted central bank action if it is not designed to ward off panic reactions? Exchange rate developments depend mainly on the

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V E R L A G W E L T A R C H I V G M B H – H A M B U R G

restrictiveness of national monetary and fiscal policies and international investors' assessment of them. If they consider that a restrictive stance and high interest rates cannot be sustained for political reasons, they will not even begin to restructure their portfolios. On the other hand, if political risks cease to influence exchange rates, even small changes in interest rates are sufficient to set capital flows in motion. Exchange rate fluctuations then reflect the size of the induced flows.

Behaviour of the Central Banks

This is the conventional wisdom, but is it not contradicted by the fact that the concerted central bank action of last autumn forced the dollar down? Not in the least! If the US Federal Reserve and the other central banks in the "Group of Five" sell dollars in the market they depress the dollar exchange rate by expanding the money supply circulating in dollars and creating a shortage of the money supply in other currencies. Such action corresponds to an expansionary monetary policy in the USA and a restrictive one in the other countries. Interest rates and hence exchange rates must then react. What we have here is therefore an open market policy in foreign currencies. Since such action attracts considerable attention by indicating political determination, there may be associated overshooting effects.

Of course, policy must then remain consistent; the USA must confirm the incipient decline in interest rates by pursuing an easy monetary policy, something that at present it is clearly willing to do, while the other central banks must maintain a relatively restrictive money supply stance and tolerate relative increases in interest rates. However, the central banks of most OECD countries have made it plain that they are unwilling to do either of these things. For example, by widening the money supply growth range by as much as half a percentage point in relation to last year's target and declaring its hostility to interest rate increases, the Deutsche Bundesbank has given notice that it is not considering a change in monetary course to defend particular exchange rate targets.

Possible Consequences

Such central bank behaviour can have two consequences:

□ If defence of the politically desired exchange rate level does not succeed for lack of support from monetary policy, the action must be repeated, causing investors to pay it less and less regard and to dismiss it as mere bluster. Having failed to underpin their open market policy by taking the necessary domestic

measures, politicians are then easily tempted to flesh it out by making ad hoc statements that unsettle the foreign exchange markets ("open mouth policy"). Political pronouncements of this kind have already been heard. Hence a climate of uncertainty is created more or less systematically, in which information costs rise dramatically and the conditions for panic reactions flourish.

□ The second variant might be even more probable in present circumstances. The US Federal Reserve could secure the exchange rate level it desired by accentuating its expansionary policy. The US money supply figures are so far off target at present and the explanation that the divergence is justified on cyclical grounds is so seductive that inflation in the USA must be expected to accelerate. This would constitute an ominous expansion in concerted exchange market co-operation, however. The temporary fall in US interest rates and reawakened inflation expectations would stimulate a carefree spending spree, the apparent prosperity would do nothing to slake the American thirst for consumer goods, imports would not decline, but import prices would rise across the board owing to the weakening of the dollar. Workers and trade unions would seek to protect their interests and the wage-price spiral would begin to turn again; President Reagan would find himself in the same situation that prevailed when he came to office, with the additional burden of massive budget and current account deficits. In these circumstances, however, there would be no "soft landing" for the dollar.

Scope for Co-ordination

It is self-evident that economic policies are interdependent in the context of the international division of labour, particularly in view of the tremendous expansion in international capital flows in recent years. The earlier conventional wisdom that national autonomy is increased by flexible exchange rates – a theory that was also an accepted political tenet at one time – has long since been refuted or modified. Modern literature on the exchange rate issue has made almost casuistic play of international economic interdependence under flexible exchange rates and differing monetary and fiscal policies. It is therefore obvious that there will be calls for international co-ordination of the various types of policy.

Claus Köhler has pointed out that widespread unemployment is an international phenomenon.⁵ He thus suggests the conclusion that internationally co-

⁵ C. Köhler, *op. cit.*, p. 1066.

ordinated action should be taken to combat unemployment worldwide. However, if unemployment has arisen because changes in relative prices – entrepreneurial income and wages on the one hand and rates of return on physical and financial capital on the other – have made investment in new and existing jobs insufficiently profitable to absorb the growth in the labour force or workers made redundant by structural change, then an internationally co-ordinated employment drive will provide little relief. In these circumstances, it is up to individual economies or those operating in them to make fresh investment profitable again.

What then could be co-ordinated internationally? Monetary policies? In our analysis of the joint exchange market operation we have already seen that the countries involved have little inclination for this. Moreover, from the political point of view it cannot be expected that some partner countries should pursue a high interest rate policy merely to spare the dominant economy the effort of balancing its budget.

Is there a need for co-ordination of fiscal policies? It does not take a new round of co-ordination to realise that the USA is under strong pressure to take action. It has often been suggested that other economies should take over the role of locomotive of the world economy, but if the high level of international interest rates impedes additional investment in real capital, what is gained if the massive deficit of the dominant economy is replaced by many smaller deficits that add up to a massive total?

Germany as the Locomotive?

The locomotive suggestion is perhaps directed primarily at the Federal Republic of Germany, which enjoys virtual price stability and could therefore curb any tendency for interest rates to rise by easing its monetary restraint. This would be a repetition of the experiment of 1978, when the German Government responded to the prompting of the Bonn world economic summit by generating massive budget deficits that could be

financed at low interest rates in view of the rapid expansion in the money supply. The German balance of payments on current account behaved according to the rules; within a very short space of time a handsome surplus had given way to a massive deficit, the largest that any industrial country had “produced” up to then.

Against the background of declining economic activity, the Deutsche Bundesbank stemmed the developing inflation expectations and reversed the current account trend by means of a rigorous policy of restriction. In other words, the brakes were applied long and hard and caused considerable pain, without ultimately preventing the world economy from descending into a stubborn phase of stagnation. In theoretical terms too a repetition of the locomotive function makes little sense if the cause of inadequate world economic growth lies in the distortion of relative prices.

We can even state with a fair degree of certainty that such efforts to play the locomotive not only fail to have a lasting effect but on balance further sap the strength of the world economy. We can take it as an economic axiom that the size and timescale of business investment depend on investors' confidence in the future. A high level of confidence reduces businessmen's information costs. Stability in the value of money is a confidence-creating factor of the first order with a particularly strong positive effect on innovative investment. If economies attempt to haul the world economic train and develop a head of steam by pursuing an expansionary monetary policy, we must be prepared not only for a setback to investment owing to the change of policy that will inevitably follow but also a structurally lower rate of innovation. At any event, there is strong evidence that such locomotive games also have a prejudicial effect on the world economy. We can do without international co-ordination designed to induce some countries to practise fiscal laissez-faire in order to make good the omissions of others.

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