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Managed Exchange Rate Regimes, Price Stability
and the International Monetary System

Remarks by

Wayne D. Angell

Member

Board of Governors of the
Federal Reserve System

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Thank you for giving me the opportunity to be here with you today. Last April, when I accepted the invitation to speak, there seemed to be a growing sense of optimism in the world about the prospects for European Monetary Union. The Maastricht Treaty had been negotiated and signed, and expectations were building that it would soon be ratified. Discussions about the details of moving forward to stages II and III-- such as where to locate the proposed new European Central Bank and how to meet the convergence criteria--were taking place. Not wanting to be excluded from the perceived benefits of belonging to a potentially powerful international bloc, Austria, Sweden, Finland, and even Switzerland had applied to become members of the European Community, and Norway had indicated its intention to apply. The European Community appeared to be well on its way toward achieving the goal of economic and monetary union.

In the meantime, some surprising and dramatic events unfolded. The Danes astonished the world by narrowly voting down the Maastricht Treaty. The Irish approved it, but as the date of the French referendum on the Treaty approached, pressures on exchange rates developed. Finland, which had been unilaterally pegging to the ECU, allowed its currency to float. The pressures spread to the Swedish krona. Then other currencies came under attack. Defending against these pressures, the European central banks conducted exchange market intervention on an unprecedented scale. There were spectacular interest rate hikes, currency devaluations, and the temporary withdrawal of some currencies from the Exchange Rate Mechanism of the EMS.

Europe's struggle to preserve its currency system and move toward monetary union in the face of the enormous pressures we have witnessed has resulted not only in significant changes in currency and interest rate relationships among the European nations but also in much soul-searching among policy makers. In Finland, Sweden, and the member countries of the European Monetary System, the last few months have tested the commitment of the monetary authorities to their exchange rate regimes. Some have chosen to stay the course; others thought it wiser to change the course. In each case difficult choices were made. The European drama exhibited in a vivid way some of the difficulties and risks that managed exchange rate regimes can pose when they are pushed to their limits.

In my presentation today, I would like to share with you some thoughts on the links between managed exchange rate regimes and price stability, a necessary condition for maximum sustainable growth in output and productivity in the long run. In the last decade, it has become evident that central banks around the world have increasingly taken price stability as their primary concern. Indeed, price stability is explicitly set forth as the primary objective for the European System Central Bank in the Maastricht Treaty. I will also consider the evolution of the international financial system, including the international role for the dollar, the movement towards regional currency blocs, and the management of exchange rates between the center currencies of those blocs.

Managed Exchange Rate Regimes and Price Stability

To achieve price stability, each of the many types of exchange rate regimes requires some sort of nominal anchor. Different regimes permit the possibility of different anchors. At one extreme, a country allows its currency to float freely in the market with no attempt by the monetary authorities to influence its value. Because there is no explicit management of exchange rates under this regime, a country generally relies on some other target as its nominal anchor, such as the money stock, nominal GDP, or the price of gold or other commodities, to attain price stability.

In an adjustable-peg exchange-rate regime, explicit target values for exchange rates are declared. When necessary, countries use the tools available to them--sterilized intervention, monetary policy, or even exchange and capital controls--in order to keep market exchange rates close to the target values. Occasionally, a country finds itself unable or unwilling to contain the market value of its currency and resorts to an adjustment of the target value. In the adjustable peg system, the targeted exchange rates serve as nominal anchors for all but one country in the system. The remaining country--the key currency country--has a special responsibility to provide the ultimate nominal anchor for the whole system. In a system with unrestricted capital flows, the key currency country has a strong influence on the monetary policies of the other member countries. Under normal circumstances, the monetary policies of the other member countries cannot be far out of line with that of the key currency country lest exchange rates move too far from their target values.

Falling somewhere between the freely floating and adjustable peg exchange rate regimes is the managed float. In this regime, exchange rates are allowed to float but with some "guidance" from a country's monetary authorities. The degree of guidance falling under this rubric is quite wide. For example, official intervention operations may be relatively infrequent, and market forces may be allowed to set exchange rates without official influence for long periods of time. Alternatively, a country may intervene daily in an attempt to smooth market movements in exchange rates. What distinguishes this regime from the adjustable peg is not the degree of exchange rate management but the explicitness of the exchange rate targets. In the managed float, these targets may or may not be well known, but they are not officially declared. The nominal anchor may include the exchange rate, but the extent to which it is considered is not declared.

At the opposite end of the spectrum from freely floating rates is a monetary union. Exchange rate management is unnecessary in a monetary union, because economic regions choose to forego exchange rate adjustment entirely. In one form of monetary union, different currencies can coexist but their exchange rates must be irrevocably locked. Belgium and Luxembourg provide an example of this type of union. In another form, a common currency is established for the whole union. A common currency area can be established unilaterally--in the sense that one country chooses to use the currency of another, such as Panama and the U.S. dollar--or it can be a negotiated joining of two or more previously distinct currencies--such as is proposed for EMU. In either type of monetary union, only one monetary policy can exist, unless there are capital controls or other frictions in the system that inhibit arbitrage.

Within the monetary union, it is up to the central monetary authority to provide the nominal anchor, just as it was in the freely floating exchange rate system.

The success of any of these regimes in achieving price level stability depends in part on how accurately or appropriately the variable, or combination of variables, chosen as the nominal anchor signals the need for an adjustment of policies. The success of the regime also depends on how reliably the monetary authorities adjust their policies to the signals given by the anchor. An exchange rate target provides a relatively good nominal anchor for an economy to the extent that prices in the counterpart country are relatively stable and the two countries are subject to relatively similar economic shocks. This arrangement might be particularly useful to a small country that conducts the bulk of its trade with a large, stable country. Furthermore, the extent to which an explicit exchange rate target is missed is readily apparent, so it is easy to judge how reliably the monetary authorities are responding to their declared targets. As long as authorities adhere to the designated nominal anchor, any of these exchange rate regimes can be successful.

For many years, the world operated under a global fixed (but adjustable) exchange rate system. The experience of the United States and the U.S. dollar in that Bretton Woods fixed exchange rate system provides an example of how anchors can become vulnerable to the stress of divergent macroeconomic policies and structural changes in the world economy.

Under the Bretton Woods regime, the nominal anchor was a dollar exchange rate for most of the countries in the system. The United States

served as the key currency country, and its anchor was in principal the dollar price of gold. Foreign central banks stood ready to buy or sell their currencies against dollars at exchange rates around fixed parities with the dollar, and the United States was similarly committed to exchange dollars for gold (and vice versa) with other central banks at a fixed par value

With the establishment of the Bretton Woods system, the dollar was acknowledged to be the principal reserve currency and, along with gold, the principal reserve asset. Foreign central banks accumulated dollar reserves as they intervened to counter the downward pressures on the dollar against their currencies that arose from U.S. balance of payments deficits. These deficits came about in the late 1950s and early 1960s in part as investment by U.S. residents in the reconstruction of Europe and Japan generated large capital outflows. At first, this growth in dollar reserves was welcomed because it enabled central banks to augment their reserve balances as their economies grew. As the 1960s progressed, however, this sentiment began to change. The accomodative stance of monetary policy in the United States along with the fiscal stimulus associated with U.S. spending on the Vietnam War led to repeated balance of payments deficits. During this time, U.S. monetary policy was not sufficiently aimed at price level stability to spur U.S. competitiveness or to stem capital outflows associated with relatively low real interest rates. As the accumulation of dollars in official reserve portfolios grew, foreign central banks increasingly requested that the United States exchange the dollars they had accumulated for gold.

In line with the key currency standing of the dollar, U.S. authorities sought to keep the dollar a leading standard and store of value by maintaining a fixed par value for the dollar in terms in gold. As the stock of U.S. gold declined amid growing official requests, U.S. authorities, as well as others, became concerned that the ability of the United States to convert dollars into gold at the fixed parity might become threatened, which, in turn, might threaten the stability of the exchange rate system.

U.S. authorities sought to maintain convertibility, but without taking steps toward increased monetary restraint. Beginning in the early 1960s, the United States participated very heavily in the Gold Pool, a consortium of monetary authorities from leading countries who had agreed to help stabilize the private market price of gold in the London market near the official par value. These gold sales were sterilized. Also, commercial policies and capital controls were instituted that attempted to reduce the balance of payments deficits. U.S. monetary policy tightened briefly in 1969, which temporarily helped to support the dollar. But monetary conditions eased again as domestic economic activity slowed, and, as a result, heavy selling pressure on the dollar resumed.

By August 1971, it became clear that these measures would be insufficient. Germany had already abandoned its parity with the dollar and let the mark float. Official demands for gold conversions continued to increase. Finally, on August 15, the United States suspended the convertibility of dollars into gold for foreign monetary authorities. It had already given up on attempts to stabilize the private market price of gold three years earlier. That anchor for U.S. policy was abandoned.

Over the next couple of years there were attempts to revitalize the Bretton Woods system with negotiated currency realignments and devaluations of the dollar, but none of these repairs held the system together for very long. By May 1973, the system of fixed parities was no longer operational, and the G-10 countries adopted a policy of generalized floating.

One lesson from the Bretton Woods experience is that a fixed exchange rate system will be subject to extraordinary pressures as long as the key currency has no true price level anchor. Technological change, wars, natural disasters, and other productivity shocks can create divergent economic circumstances across countries. Policy authorities may desire to assist in the adjustment of their countries' economies to these shocks, and a climate of stability in the key currency country will help in that regard. The United States failed to provide a price level anchor. Had U.S. authorities more vigorously restrained money growth during those years, the system could well have survived, assuming that appropriate adjustments of the fixed parities were made from time to time in response to pressures from real shocks.

One might argue that the recent turbulence in European markets also involves a divergence in economic circumstances. The fiscal stimulus associated with German unification caused German monetary policy authorities to tighten monetary policy to deal with the ensuing upward pressures on German consumer prices and money growth, even though commodity prices were falling in DM terms. At the same time, much of the rest of Europe was experiencing recession or slow growth, and inflationary pressures in those countries were generally diminishing. Because monetary policies in the various countries were linked through

their exchange rate system, there was little flexibility for the central banks outside Germany to independently address deflationary or recessionary forces. Furthermore, the EMS, in the rush to EMU, lost the adjustable aspect of its "fixed but adjustable" initial character. The European countries attempted to maintain their exchange rate targets, keeping monetary policies tight and intervening, at least for awhile. The result for these countries during that period was higher interest rates and, likely, a further slowing of growth.

Without exchange rate adjustment, fundamental disequilibria in relative price levels between two countries must be addressed through changes in domestic price levels in either or both countries. It is not enough for inflation rates to converge: identical inflation rates only prevent relative price levels from moving further out of line. If relative price levels are not already in equilibrium, identical inflation rates do not obviate the need for further adjustment either in the level of prices and wages or in exchange rates. One might argue that this was the situation in the EMS. Sterling, for example, was arguably overvalued at the time, given the domestic price levels in the United Kingdom and in its major trading partners. Even though U.K. authorities made much progress in reducing the rate of U.K. inflation, what would be required eventually to restore equilibrium, short of an exchange rate adjustment, was that the U.K. inflation rate move below that of its trading partners and remain below it until relative price levels returned to equilibrium. Given the state of the U.K. economy, this did not appear to be the most likely choice the U.K. policy authorities would make.

The market evidently began to sense that the existing parities would not be sustained. The subsequent pressures that ultimately

developed in European financial markets were too great to be dealt with through intervention alone. With fundamental disequilibria in relative price levels, arising from the absence of policies sufficiently oriented to price level stability, and free capital flows, fixed nominal exchange rates were not credible. In these circumstances, even vast amounts of intervention are ineffective. In some cases, the authorities resorted to changes in monetary policy stances; in others, exchange and capital controls were reinstated or strengthened. In still others, the costs of subordinating diverse domestic policy goals in defense of an exchange rate target were seen as too great, and the currencies were allowed to float.

The EC central banks, as well as central banks in other countries that have expressed a desire to become members of the EC, have set for themselves a very challenging task of achieving fiscal reform, the convergence of inflation rates at low levels, and, ultimately, the convergence of relative price levels at fixed exchange rates. This convergence process may well be continuing, despite the present disruption of the exchange rate system. These countries may well acquire new anchors or reacquire old ones at more sustainable exchange rates. Hopefully, the disruption of the system does not indicate the abandonment of the goal of price level stability but only the need on the part of some countries for more flexibility in the choice of nominal anchors.

The Dollar and the Evolution of the International Monetary System

The international financial system has changed markedly in the two decades since the demise of the Bretton Woods system. One aspect of the change we have seen over the years is a lessening or removal of restrictions on international capital flows in many countries. The consequent pressures on domestic financial systems from foreign competition and previously unavailable arbitrage opportunities have spurred further the liberalization of domestic deposit and lending rates. These changes in policies, along with technological changes in the information and computing industries, have promoted the development of swifter and stronger linkages across international financial markets.

As markets in other currencies and instruments have become more accessible, we have also seen some decline in the dollar's role as a key international currency. While the dollar remains the most actively traded currency in the world's financial markets, its share in total transactions has been moving down. According to a survey of major market participants conducted by the Federal Reserve Bank of New York, the dollar's share in the total of reported foreign exchange transactions in the New York market was 89 percent in 1992, down only 7 percentage points from the last time the survey was conducted three years ago. The flip side of this proposition is that the share of nondollar transactions in the New York market nearly tripled in the last three years, reaching 11 percent. The mark and the yen were the next most widely traded currencies, having a part in 39 percent and 25 percent of the transactions, respectively. Another indicator of the lesser role for the dollar is the reduction in the dollar share of official foreign currency

reserves. According to data published by the IMF, appropriately adjusted, the dollar share in total identified official holdings of foreign exchange for the industrial countries excluding the United States has declined between 1980 and 1991 from more than 80 percent to less than 60 percent. In contrast, the mark share over the same period has grown from about 11 percent to 17 percent, and the yen share has also grown, although it accounts for less than 10 percent of official holdings. How rapidly these trends will continue depends in part on the extent to which financial liberalization and market development move forward and in part on the extent to which the United States is successful in achieving price level stability.

As the world becomes more integrated financially and the European economies and Japan have shown strong economic growth and an increased commitment to price level stability, it is natural to ask whether we are moving toward a tripolar structure for the international monetary system in which the dollar shares more and more of the leadership role with the ECU and the yen. One element in this issue is the extent to which currency blocs are forming. Are we seeing the international monetary system evolving toward a system of three currency blocs centered on the ECU, the dollar, and the yen?

Clearly, Europe has made the greatest strides in this regard, despite recent events. In fact, some argue that the recent turbulence in European financial markets should strengthen the case for EMU and, consequently, for an ECU bloc developing in Europe, because it provides evidence that the EMS as currently formulated is not able to withstand the potential pressures arising from large and unrestricted capital flows. Proponents of EMU claim that if the current system of cooperative

policies and institutions were replaced by a system of common policies and institutions, disagreements about monetary policy responses to shocks that may come along could not result in divergent policies. Furthermore, eliminating the possibility of divergent policies would remove the incentive for speculative capital flows that threaten to break the system apart.

Nonetheless, the movement appears to have lost a great deal of momentum in recent months. Perhaps the biggest question is the willingness of all the European member states to continue to follow German monetary policy in the transition to EMU. Differences over this question have led to bickering among some of the leaders of the member countries and derailed the political momentum that was behind the rapid development of EMU.

Despite these recent setbacks, monetary union may yet be realized in Europe, although it may come at a later time and on different terms than those inscribed in the Maastricht Treaty. The process of moving from a Europe of individual central banks and currencies linked by the European Monetary System to a system of one central bank and a single currency has presented and will present many challenges. Among those challenges is the task of achieving fiscal reform and convergence of inflation rates and, ultimately, price levels. In one respect, Europe has come a long way towards those goals. Since the inception of the EMS, the member countries have experienced lower rates of inflation and, until very recently, reduced variability of real exchange rates and narrower interest rate differentials. On the other hand, much less progress has been made on fiscal reform. Despite the gains, however, the convergence process may not have gotten far enough along to allow a smooth transition

to monetary union. Price levels among some of the remaining participants in the Exchange Rate Mechanism of the EMS may still be misaligned at current exchange rates. Nonetheless, I suspect that the longstanding desire for European monetary union will not be extinguished as a result of the recent events, just as it was not as a result of previous setbacks, like the breakup of the earlier European exchange rate system known as the "snake." The political longing for union, at least among political leaders, appears to be quite resilient and strong. However, even if EMU never occurs, I hope that the gains Europe has made in stabilizing prices can be consolidated and furthered in whatever system prevails.

What about monetary union in North America or among the Asian Pacific nations? Do the European efforts foreshadow similar moves elsewhere in the world?

The declared motivation behind European Monetary Union is economic--to enhance the benefits of free trade within the Community. This view claims that as the Community evolves into a single economic union, it would naturally benefit from having a single currency as well. While there is some dispute about whether the economic benefits of monetary union for Europe outweigh its costs, particularly given the current situation of relatively limited labor mobility among European countries, the forces lying behind the formation of a monetary union in Europe are not entirely economic. In particular, the move toward EMU appears to have political motivations and has been accompanied by parallel negotiations aimed at European Political Union. One might argue that the Europeans have much in common--large intraregional trading patterns, a richly intertwined history, and, at least until recently,

some shared military and defense concerns. Because of these common interests, monetary and, eventually, political union may make sense for them.

In North America, a few significant steps toward even greater economic integration have been taken. A free trade agreement between the United States and Canada went into effect in January 1989, and we have seen recently the initialing of the North American Free Trade Agreement, which would add Mexico to the free trade area. There are also clearly exchange rate links among the countries. The Mexican government has made the peso-dollar exchange rate arrangements quite explicit. They allow the peso to fluctuate within an announced band that is currently slightly more than 3 percent wide. The upper limit for the peso is fixed, and the lower limit is being reduced very gradually, although the rate of the decrease of that lower limit has been doubled within the last two weeks. Canadian authorities, on the other hand, have no explicitly declared exchange rate link to the U.S. dollar, but historically the Canadian dollar/U.S. dollar exchange rate has moved in a relatively narrow range. A change in the stance of monetary policy in the United States has repercussions on monetary policy in Canada, often prompting a similar change to stabilize the exchange rate against the U S dollar.

Nonetheless, while economic and financial ties are strong and cross-border trade relatively unrestricted and abundant, there appears to be little serious discussion among the three countries on taking the further step toward forming a monetary union. The net economic benefits of that further step are not apparent, especially for the United States. One might argue that the United States is already a relatively large monetary union, and that further success in price level targeting

associated with stable commodity prices, including gold, would provide a basis for both price stability and exchange rate stability in North America.

The possibility of an Asian-Pacific monetary union with the yen at its center appears to be even more remote. Asian-Pacific nations are much more diverse in their historical, cultural, and institutional backgrounds than their counterparts in Europe and North America. Furthermore, there appears to be little political appetite for further intergration. While the Japanese economy and the yen have emerged as major players on the global economic and financial scene, trade between the Asian-Pacific nations and the United States has grown more rapidly than trade between the Asian-Pacific nations and Japan. Between 1980 and 1991, U.S. trade with the Asian nations excluding Japan grew about 180 percent, Japanese trade with these countries increased only about 150 percent over the same period. Furthermore, in 1991, U.S. trade with the region was roughly equivalent in total value to Japanese trade. Partly because of this pattern of trade, dollar invoicing is more prevalent in Asian trade than is yen invoicing. Furthermore, no Asian-Pacific currency (or any other currency, for that matter) is pegged to the yen, and, while the yen is in some targeted currency baskets, there is little evidence that it enters significantly into them for any Asian economy. According to some research done at the IMF, even the yen share of official foreign exchange reserves for Asian countries has declined from 27 percent in 1985 to less than 18 percent in 1990. The development of a monetary union centered on the yen or even a more loosely united yen zone among the Asian-Pacific countries appears to be quite far off.

While we do not yet have monetary union in Europe and prospects for monetary union in North American and Asia appear quite limited at this time, there are nonetheless three dominant economic regions in the current international monetary system. The EMS countries are currently linked to varying degrees, with Germany at the center, and France close behind. Italy and the United Kingdom are currently more loosely associated with the region than they had been only months ago, but the economic ties are still strong. The United States, Canada, and Mexico form another major economic region, with the United States as the dominant partner, and Japan constitutes a region unto itself.

Currently, the consultations on exchange rates among the three regions takes place in discussions among the G-7 nations as a part of the G-7 policy coordination process. As they have stated in many communiques, the G-7 nations have agreed to cooperate to foster greater exchange rate stability and to encourage exchange rates to be broadly consistent with economic fundamentals. Occasionally this cooperation takes the form of explicit exchange market operations, such as the coordinated intervention operations following the Plaza Agreement in 1985 or the Louvre Accord in 1987. However, overt exchange rate management of this kind has occurred only infrequently. In general, exchange rates are allowed to seek their own, market-determined levels, consistent with the view that exchange rates generally should reflect economic fundamentals

Clearly, the overriding concern of monetary authorities in the center countries in the last dozen years has been price stability, not exchange rate stability. And this is as it should be. In an ideal world of price stability, exchange rates can be left to take care of themselves, remaining stable if the underlying economic conditions

warrant, or moving in line with fundamentals when economic developments affect one area of the world differently from another.

One of the lessons to be learned from our studies of and experiences with various exchange rate regimes is that exchange rate volatility--either short-term variance or long-term drift--is too often the product of a lack of commitment to price level stability. The chances that any regime will function well are vastly improved in an environment in which price level stability is given priority, because price level stability essentially removes one of the major sources of stress on exchange rates

Obviously we have not yet attained the ideal world of price level stability. In fact, no country in the twentieth century has achieved price level stability over any substantial period of time. Nonetheless, we have recently made progress toward that goal, both here and abroad.

Measures of U.S. consumer price inflation--both overall and excluding food and energy--have declined from double digit levels in the late 1970s and early 1980s to their current levels near 3 percent. Inflation in Japan, as high as 23 percent in 1974, dropped down to below 5 percent throughout most of the 1980s, and is currently around 2-1/2 percent. And European inflation rates have also come down. In Italy and the United Kingdom, inflation has dropped from more than 20 percent in the early 1980s to nearly 5 percent currently for Italy and under 4 percent for the United Kingdom. French inflation has declined over the same period from around 14 percent to near 2-1/2 percent. German inflation is currently near 3-1/2 percent, half of what it was in the early 1980s.

These gains demonstrate the strong commitment of monetary authorities to price level stability in recent years. Let us hope that in the years to come, this commitment will remain foremost, so that it can become the foundation on which to build stronger, more stable, and more efficient international financial markets, and a more productive international economy.