For release on delivery
12:30 p.m., E.D.T.
September 17, 1986

Address

by

Manuel H. Johnson

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Conference on Exchange Rates and International Monetary Reform

American Enterprise Institute

Washington, D.C.

September 17, 1986

A discussion about exchange rates and international monetary reform is perennially appropriate at this time of year, just a couple of weeks before the annual meeting of the International Monetary Fund. It helps each of us to clarify our own thinking, if not for the formal sessions themselves at least for the associated corridor discussions or for reading the newspaper accounts.

This year such a discussion seems especially appropriate. During the past year there have been two major international policy developments related to this topic. There was the Plaza announcement in New York almost exactly a year ago, in which finance ministers and central bank governors from G-5 countries reiterated their intentions to pursue policies consistent with restoration of better balance internationally and expressed their view that exchange rates did not then reflect this convergence of policy or of economic performance. And at the May economic summit in Tokyo, efforts to enhance the international coordination of economic policy were given strong political impetus.

Moreover, developments in exchange markets, themselves, have helped to make this topic interesting and important. Over the past year and a half, the exchange value of the dollar has declined about 40 percent against both the Japanese yen and the Deutsche mark. This followed a rise in the dollar's value over the previous four years or so of 80 percent against the DM but only 20 percent against the yen.

I might observe at this point that it is not easy in general to characterize the change in the value of any particular currency against all others--even in nominal terms, let alone adjusted for changes in relative price levels. Unless a currency moves uniformly against all others, a summary measure of the change in its value depends upon the weighting system used. The staff at the Federal Reserve Board uses an index based on multilateral trade weights and G-10 currencies; it shows that the dollar rose 80 percent from 1980 to early 1985 and then fell about 70 percent, bringing it currently to about 20 percent above its 1980 level. Other weighting systems--using bilateral trade weights or including an alternative set of currencies--would show a different--typically somewhat damped--path. No single weighting system is best for all purposes; it depends upon the question being asked and the analytical framework in which the index is used. But in the context of stability of exchange rates, the question of how one measures exchange rate changes is not just a technical one.

Notwithstanding this measurement question, it is clear that the dollar rose significantly from 1980 to early 1985 and subsequently has declined significantly. As the dollar was rising, there were those who bemoaned its rise. In the United States, a wide range of firms and individuals--including those who produce manufactured goods, agricultural goods, and even services--decried the loss of competitiveness associated with its rise. Abroad, some noted the inflationary consequences of the associated decline in their own currencies.

So far, complaints about the decline in the dollar's value have been more muted, though certainly not nonexistent. Not surprisingly, it is now exporters in other countries who have voiced concern. In the United States, some have expressed concern about the deleterious effect of a decline in the dollar on the willingness of foreign investors to purchase U.S. debt, especially at a time when the U.S. federal budget deficit remains high.

What's going on here is clear. Changes in exchange rates involve changes in relative prices, at least in the short run, and involve substantial distributional effects. Those who readily accept the benefits derived from an exchange rate change in one direction do not happily give up those gains when the exchange rate move is reversed. To use an example appropriate to a luncheon address, those who got accustomed to dining in Paris at 9 or 10 francs to the dollar do not digest their food quite as easily at less than 7 francs to the dollar; they forget that not so long ago they managed to enjoy Paris at 4 francs to the dollar.

In short, one senses a yearning for stability, in exchange markets as elsewhere. As a general principle, I share that yearning. would welcome a world in which, even in a regime of freely floating exchange rates, conditons were such that exchange rates in fact moved relatively little. In a world in which the mix of monetary and fiscal policies within each country and the mix of policies across countries were well harmonized, and in which major shocks were rare, we would presumably not have to worry much about the nature of the exchange rate regime. A floating rate regime would approximate a fixed rate regime.

It will come as no surprise, I'm sure, when I assert that we do not live in such a world. Obviously, economic conditions in the industrial world over the last several years have not provided an ideal environment for stable exchange rates.

What are the conditions I have in mind? Let me begin with the tax changes in the United States in the early 1980s, which I believe had a profoundly favorable impact on this country. They stimulated productive activity, investment, and demand in general; they provided the basis for a strong and prolonged recovery from the trough of the recession in 1982.

Unfortunately, the cuts in federal government outlays that should have accompanied the tax changes were not agreed to. Stalemate on the spending front and revenue losses from the recession caused the federal budget deficit to rise dramatically. In the face of the strong and credible anti-inflation posture of the Federal Reserve and the tax incentives that had been created, the United States was such an attractive place to invest--not just for U.S. investors but also for investors abroad--that we were able to attract savings from abroad in great volume. As a consequence, interest rates were lower than they otherwise would have been, and the burden of the deficit on traditional interest-sensitive sectors was mitigated. In the process, however, as the exchange rate for the dollar was bid up and then the trade and current account deficits widened or expanded, sectors of the economy that were sensitive to competition from abroad began to be disadvantaged. The beneficial effects of the rise in the dollar on inflation in the U.S. economy as a whole were not perceived as benefits by those competing with producers whose prices were falling.

The economic dynamics of this process have generated a political dynamic. Those who have not shared in the overall expansion of the U.S. economy over the past few years--farmers, other exporters, and those who must compete with imports--have raised their political voices. Pressures for protection from imports and for help of one kind or another for exports have intensified. They are likely to remain strong at least until we can point to a significant and sustained decline in the U.S. trade deficit. It was the realization that the trade deficit could not be sustained at the levels being reached late last year--could not be sustained in a political as well as an economic sense--that motivated the Plaza announcement, at least from the U.S. perspective.

I expect that the decline in the dollar that we have experienced eventually will reduce our trade and current account deficits, but the lags are long--perhaps even longer than some analysts had envisioned. Moreover, we must bear in mind that, as long as the underlying fiscal imbalance in the U.S. economy persists, the capital inflow that is the counterpart to the current account deficit helps to relieve potential strains in U.S. financial markets; a reduction in the current account deficit would simply mean that the burden would fall elsewhere. This ponts to the urgent need to cut public spending to reduce the federal budget deficit. I am hopeful that progress will be made in that direction and that better balance in the U.S. economy will be restored; but we are not there yet.

Imbalance within the U.S. economy, with its associated economic and political dynamics, is not the only factor causing pressure in exchange markets. Coordination of policies among the United States and the other major industrial countries is not complete, either. Underutilization of resources and declining price levels in many industrial countries plus a profound and urgent need to achieve a sustained increase in real income in developing countries point to the desirability of a more vigorous world economy. To accomplish this and, at the same time, to redress the external imbalances among industrial countries, domestic demand must grow more strongly in the major surplus countries relative to the United States.

Frankly, I am not confident this is happening. The magnitude of the reported rebound in German economic growth in the second quarter is heartening in this respect, but sustained growth even in that country is not yet assured, and growth appears to be slower in most other European countries. In Japan, prospects seem to be less favorable. While GNP rose in the second quarter, following the first quarter decline, the rebound was less strong than in Germany, and there is not convincing evidence to date that the reduced impetus from the Japanese export sector is being offset by increasing activity in the rest of the economy.

In the final analysis, it is up to German and Japanese authorities alone to judge whether it is necessary to implement additional monetary or fiscal policy actions to ensure satisfactory growth over the medium term. I am not raising this issue here in order to urge particular actions, although I admit that a great deal is riding on their ability to attain and sustain greater domestic growth. Rather, I am raising the issue to highlight the difficulties that must be resolved if we are to achieve full international coordination of policies, which is essential to exchange rate stability no matter what the regime.

Consider, for example, the context in which the Federal Reserve has operated this year. The slowing of growth in the United States, along with much more favorable inflation experience and prospects, suggested that some easing was appropriate and that reductions in the discount rate were called for. It was recognized that in the absence of complementary actions in other countries, such actions by the Federal Reserve might well entail a decline in the exchange value of the dollar. Nevertheless, the Federal Reserve Board decided that cuts in the discount rate were appropriate given current conditions.

To put the issue simply, the Federal Reserve Board believed that a decision by authorities in other countries to refrain from easing policies commensurately should not, in the existing global environment, prevent some easing of policy in the United States. Expressed alternatively, in the absence of full international coordination of policies, a desire to achieve stability of exchange rates should not override a desire to achieve the more fundamental objective of satisfactory growth with price stability.

I recently saw a report of an interview with Pierre Languetin, President of the Swiss National Bank. In addressing the desirability of a global target zone system for exchange rates, and specifically the EMS, he said very well what I have been trying to say here. He said:

> ...There would be no need for such a system among friendly nations in a coherent economic region if economic policies really were convergent and compatible with each other. The fact that this has not yet been quite achieved [in the EMS] is proved by the realignments that have repeatedly been necessary. The EMS has great merits. However, by comparison the relationship between Germany and Switzerland is ideal.
>
> ...the exchange rate between the Swiss franc and the Deutsche mark is right. But this is the outcome of the convergence of the two countries' monetary policies and not the result of an exchange rate policy. (Wirtschaftswoche, August 1, 1986)

By way of concluding, I will confess that I would prefer to see exchange rates stabilize as a result of coordinated domestic policy actions that maximized noninflationary growth across countries. I do recognize, however, that this view may not be realistic, at least in the near term, due to structural rigidities and political pressures that are difficult to change. Thus, perhaps some approach that serves to induce policy covergence may be appropriate. But our fundamental objective ought to be to redress the imbalances in domestic and world economies.