

International Currency Changes
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Good evening! I am honored by your invitation to speak on the topic of international currency changes. The international sector has become increasingly important to the performance of the U.S. economy, and the health of foreign trade and investment depends in a fundamental way on the smooth workings of the underlying currency system. I'm also pleased by the interest of Georgia's Japan America Society in this subject. Organizations such as this play an important role in the process of greater worldwide economic integration by fostering cooperation between economies. Such cooperation should in turn speed progress toward the attainment of benefits that greater trade and investment usually bring, while helping to resolve problems that may arise during the transition period.

My comments today will begin with a review of the history of today's international currency system and factors that have recently generated pressures to modify existing arrangements. Next I'll focus on the Japanese-American currency relationship. By way of conclusion, I shall discuss some of the major problems in the international currency situation, including the yen-dollar relationship, that remain to be solved and suggest certain policies that I feel ought to be adopted.

Background

From the end of World War II until 1973 the international currency system was based on fixed exchange rates. Known as the Bretton-Woods system, this arrangement worked well for almost three decades because of widespread stability in three areas-- trade flow patterns, inflation or monetary growth rates, and commodity prices.

However, by 1973 several major developments had rendered this system unworkable. These developments included growing strains in the relationships of the leading industrialized economies, commodity price shocks, and increased capital flows.

First, strains arose in economic relationships among the world's advanced economies. America's "guns-and-butter" fiscal policy during the Vietnam War contributed to a significant acceleration of inflation here. West Germany was reluctant to inflate along with the United States. As a result, trade imbalances developed as America lost its price competitiveness. Eventually, some major advanced economies grew unwilling to continue holding U.S. dollars used to finance persistent American balance-of-payments deficits. Another source of strain among the world's major economies was the limitations that fixed exchange rates imposed on monetary policy. Under a fixed-rate regime, efforts by monetary policy makers to address domestic economic imbalances such as inflation or stagnant growth are constrained by the spillover effects of international currency system requirements. If a country has a balance-of-payments deficit, for example, its central bank must defend the established exchange rate by supplying foreign currencies and absorbing excess domestic currency. At the same time, this action reduces the domestic supply of money and credit. If the central bank's goal at the time is to stimulate economic growth, the effects of foreign-exchange requirements may conflict with preferred monetary policy options.

A second major development--and one that served as the final straw, so to speak, leading to the termination of the Bretton-Woods arrangement--was the oil and other commodity price shocks of the early 1970s. The difficulty of absorbing these commodity price increases caused many countries to experience rapid inflation. Sharply higher commodity prices altered trade flow patterns. For example, oil-exporting countries became major exporters, whereas the export earnings of some countries, especially those

that were not commodity producers, diminished as their terms of trade deteriorated. The United States meanwhile was running trade deficits. The trade imbalances that followed from these commodity price increases generated pressure to abandon fixed exchange rates in order to adjust established international trade flows.

A third development, closely related to the sharp jumps in commodity prices, was the increase in international capital flows, especially the recycling of payments surpluses including petrodollars. External-trade earnings of oil-exporting countries, denominated mostly in dollars, were cycled through commercial banks in the United States and other advanced economies. These funds were ultimately lent to many in need of capital, including a number of less developed countries, or LDCs. These LDCs quickly built up a heavy debt burden in an effort to deal with problems they faced. The growing volume of international borrowing and portfolio investment, together with the resulting linkages in capital markets, created widespread demand for a currency system that could adjust quickly to economic changes.

As a result of these influences, a floating-exchange-rate system was adopted in the early 1970s. We should keep in mind that this was not a worldwide system. Many LDCs continued to peg their currency to the U.S. dollar. Certain countries of Western Europe gradually developed the European Monetary System, whereby their mutual exchange rates fluctuate only within narrow bands and must be renegotiated from time to time as inflation in one country outstrips that of others or other distortions arise. Furthermore, East-West trade remains undergirded by a much less flexible system based on fixed, indeed artificial, currency relationships.

The new system, like any human endeavor, was not without certain problems. For one thing, exchange rates became much more volatile. Also some countries developed

extreme trade imbalances as currencies became "misaligned." On the whole, however, floating rates worked well for the ensuing 7 to 8 years. The world's currency system became much more flexible, giving policy makers greater autonomy from foreign-exchange considerations and allowing for greater flexibility in monetary policies. Floating rates also relied on the market rather than on bureaucracies to adjust the value of currencies of different countries, usually a smoother and more realistic process. This flexibility helped relieve many of the strains on international trade and capital flows.

Recent Problems in the International Currency System and Corrective Actions

Despite the generally good record of floating exchange rates, certain problems became sufficiently serious in the last few years to generate widespread proposals for change and even some policy actions. What were the major problems? First, the U.S. dollar appreciated some 90 percent, on a trade-weighted basis, between 1980 and 1985, leading to the widespread view that the dollar was "overvalued." This occurred, even though U.S. current account deficits in the last two years have been of record size. The drag exerted by America's sluggish net export growth retarded U.S. economic expansion in 1985. The resulting imbalances in the U.S. economy led to growing demands for protectionism here and to related fears abroad that important U.S. outlets for European, Japanese, and LDC products could suddenly be shut off.

Most of these problems occurred in the U.S. economy; yet the leading role of the United States in the international financial system and as an "engine of growth" for much of the rest of the world made these problems a matter of concern for other economies and indeed for the entire international currency system. By the middle of 1985 the situation had come to have ominous implications for the world economy since the expansions of Japan and much of Europe depend heavily on continuing strong demand in U.S. markets. A slowdown in the advanced economies could in turn dampen demand for

products of developing countries. Reduced LDC exports might lead to disastrous repercussions for the international financial system because of the heavy debt burden of many less developed economies to commercial banks in the industrial nations. Finally, the pronounced volatility of exchange rates was creating an atmosphere of uncertainty, which could harm trade and investment.

The debate over how these problems should be corrected has revolved around a relatively small number of options. Some people advocate modifying the international currency system to limit exchange-rate fluctuations within a predefined range through central bank intervention. Such a change would, of course, imply certain constraints on individual countries' monetary and fiscal policies. Others argue that the taproot of the problem lies with U.S. fiscal policy. Huge federal budget deficits since 1980 and, until recently, the expectation that these would persist indefinitely have contributed to the sharp appreciation in the foreign-exchange value of the dollar by putting upward pressure on U.S. interest rates. High rates have in turn attracted foreigners to dollar-denominated assets and boosted the price of the dollar on foreign-exchange markets, thereby retarding U.S. export growth. Higher U.S. interest rates also make it more difficult for LDCs to service their external debt. The policy measure that was actually adopted--the G-5 accord--called for definite progress on the part of the United States toward solving the deficit problem. At the same time, the G-5 accord offered some immediate measures to ameliorate current problems. This dual approach was necessary since it has become all too clear that reducing the deficits will probably be a difficult and extended process.

The G-5 accord, which was adopted last September and named for the group of five advanced economies that were party to it--the United States, Great Britain, France, West Germany, and Japan--called for intervention on foreign exchange markets to lower

the value of the U.S. dollar against the currencies of the four other countries. The agreement also proposed certain changes in the domestic economic policies of all five countries. Japan, Britain, France, and West Germany were to increase fiscal stimulus at home in order to generate greater demand and help take up the slack created by slower U.S. growth. The United States was to modify the mix of monetary and fiscal policy to achieve more accommodation in the former and less stimulus in the latter. This change was intended to lower U.S. interest rates by making more money and credit available while reducing the government's financing needs. Lower U.S. rates vis-a-vis those in the other four countries would in turn lower the value of the dollar.

Intervention succeeded in lowering the dollar about 10 percent, bringing total dollar depreciation since its February 1985 peak to about 25 percent. Less progress has been achieved in the area of domestic fiscal policies. The Gramm-Rudman law, which Congress enacted in December, is a step in the right direction, but it is still only a promise to reduce future deficits. No budget cuts have yet been enacted, and projected deficits thus far in fiscal year 1986 are running ahead of last year. Recent Japanese budgetary activity actually reduced that country's deficit. Also, the other three nations have not implemented the fiscal expansion called for by the accord.

Thus, the present international currency situation is characterized by a somewhat improved alignment of major currencies. This adjustment in the foreign-exchange value of the dollar should result in at least a modest upturn in flagging U.S. exports later this year and thereby help mitigate other problems such as protectionist sentiments and threats to continued progress toward reducing LDCs' heavy debt burden. Nonetheless, several fundamental issues, such as budget deficits in the United States and sluggish domestic demand in other advanced economies, remain to be resolved and, in fact, may

be beyond the capacity of international currency reforms to deal with. Before I address these unresolved issues, however, I'd like to spend a few moments discussing more specifically the yen-dollar relationship.

Japanese-American Currency Relations

The foreign exchange rate of the currencies of Japan and the United States has undergone dramatic change over the past decade. The dollar had advanced from a low of 175 yen to the dollar in October 1978 to a peak of 280 yen per dollar in October 1982. Last year in February, when the dollar reached its highest point against all of its major trading partners on a weighted-average basis, the yen stood at 263 to the dollar. In the ensuing six months or so the exchange rate declined slowly to stabilize around the 240 level through mid-September. This decline resulted primarily from lower U.S. interest rates, which narrowed the differential between U.S. and Japanese interest rates from the record level of 300 basis points that had prevailed in March 1985. Lower U.S. rates relative to those in Japan were due to slower economic growth and a more expansive monetary policy here. Meanwhile, Japan's interest rates remained stable. Following the G-5 meeting, the dollar-yen exchange rate fell a further dramatic 17 percent, reaching a level of 215 by October and by mid-November entering the range of 200 to 205, where it essentially has remained.

The dramatic rise of the yen against the dollar since September occurred primarily because of two factors--massive intervention in the foreign exchange markets by the G-5 countries, notably the U.S. and Japan, and a lower interest-rate differential. U.S. purchases of foreign currencies in September and October exceeded all such activity in the previous five years, and Japan matched the scale of our intervention. Meanwhile, U.S. interest rates continued to fall as the pace of economic expansion remained rather sluggish, rapid money supply growth persisted, and expectations began to mount that