

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## A Critique of Monetary Protectionism

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**E**conomists have long questioned the wisdom of attempting to achieve current-account objectives through a monetary manipulation of nominal exchange rates. Nevertheless, this seems to be the approach of choice among many national leaders. We refer to these attempts as *monetary protectionism* to emphasize their similarities with more traditional types of protectionist policies, such as tariffs and quotas.

Calls for monetary protectionism do not stem from a clear, unequivocal demonstration of market failure. They grow instead from political institutions and incentives that encourage those dissatisfied with the market's outcome to supplant the automatic and nondiscriminatory responses of markets with the discretionary, politically motivated decisions of governments.

This *Economic Commentary* explores the political economy of monetary protectionism in order to illustrate its economic shortcomings and to understand its political appeal.<sup>1</sup> As a counterweight to the political pull toward monetary protectionism, we recommend that nations adopt monetary constitutions, which focus monetary policy on long-term price stability and recognize market-determined exchange rates.

### ■ The Mechanics of Monetary Protectionism

To understand the mechanics of monetary protectionism, consider the case of a country with a balance-of-payments deficit. Monetary protectionists would

call for an expansion of money growth, which, other things being equal, would produce a *nominal* currency depreciation. If individuals are unable to adjust prices immediately, or if they are slow in perceiving the inflationary aspects of this policy, a *real* depreciation will accompany the nominal depreciation. The inflation rate eventually will respond to the monetary expansion, however, offsetting the nominal depreciation and returning the real exchange rate to its initial position. Nevertheless, the tenuous, short-lived relationship between money and the real exchange rate is seductive enough to convince politicians that monetary policy can serve mercantilist designs.

Our focus on this issue stems from a firm belief that central banks can do no better than to guarantee long-run price stability and that any compromises to this guarantee will not improve economic welfare. A central bank that attempts to maintain price stability and a nominal exchange-rate target has more policy targets than policy instruments. At times, these two objectives may be compatible, but just as easily, they can conflict, forcing a central bank to trade one objective against the other.

Realizing the possible incompatibilities, markets will view neither price stability nor exchange-rate stability as a credible policy. The knowledge that central banks will deviate from price stability to pursue an exchange-rate objective will raise uncertainty about future inflation and could distort savings and

**Despite the political appeal of exchange-market manipulations, monetary protectionism is unsupported by economic arguments. Manipulation of nominal exchange rates has no permanent effect on the terms of trade and risks inflation.**

investment patterns. Similarly, attempts to maintain nominal exchange rates will not eliminate exchange-rate uncertainty, since countries will periodically realign exchange rates. Hedging exchange risk will remain an important aspect of international commerce.

Despite its growing attraction, monetary protectionism is not a product of floating exchange rates. Monetary protectionism can result anytime that a government lacks a strict monetary constitution and will accept nonmarket criteria for exchange rates. In principle, a gold standard or a fixed exchange-rate regime, both of which tie money supplies closely to the flow of international reserves, should limit the scope for monetary protectionism. In practice, however, neither system precludes adjustments of exchange-rate pegs. The competitive depreciations in the 1930s offer an example of such monetary protectionism.

## ■ Economic Arguments for Monetary Protectionism

Interventionists often portray exchange rates as excessively volatile and misaligned, characteristics symptomatic of “market uncertainty” or “market disorder,” resulting from imperfect information. Exchange markets, like other asset markets, are highly efficient processors of information and pay substantial rewards for investments in knowledge. At times, government authorities can possess better information than the market; for example, when they contemplate policy surprises. Usually, however, market participants and government bureaucrats receive and respond to the same information.

The interventionists' characterization of exchange rates as misaligned presumes that they know the equilibrium exchange-rate path. Theoretically, a sustainable equilibrium exchange-rate path is consistent with our concept of general equilibrium—simultaneous clearing in all markets. Unfortunately, economists simply lack sufficient knowledge to specify accurately such an equilibrium path for a sophisticated, dynamic economy. Failing this, interventionists designate equilibrium values in terms of a limited set of “fundamentals” that they hope will track the general-equilibrium path sufficiently well enough that a policy of forcing market rates to this path will increase economic welfare.

We are highly skeptical of such efforts. Most often, analysts specify the equilibrium exchange-rate path in terms of purchasing power parity or in terms of a stable current-account balance—one equal to “normal” capital flows. Besides the obviously formidable technical problems associated with this approach, the relationships between nominal exchange rates and the current-account balance and between nominal exchange rates and price indexes need not remain stable over time.

In truth, governments lack better information than the market about what constitutes the equilibrium exchange-rate path. Under these circumstances, at-

tempts to force the exchange rate to a designated equilibrium are unlikely to enhance economic welfare.

Building on the idea that exchange rates should respond to trade flows, a second interventionist theme justifies active manipulation of exchange rates as a means of fostering international adjustment when prices, most notably wages in the deficit country, are “sticky”—slow to adjust to prevailing economic conditions. A real depreciation is particularly necessary, because strong propensities to spend in home markets reduce the effectiveness of income-adjustment policies. With sticky prices, a nominal depreciation alters the terms of trade, offering a necessary incentive to switch the global pattern of expenditures.<sup>2</sup>

The key here is an “active manipulation” of nominal exchange rates. Floating rates can indeed promote efficiency and aid in international adjustment, especially when prices are sticky. For example, an increase in foreign demand for U.S. goods produces a dollar appreciation, which dampens that demand. Such exchange-rate adjustments promote mutually beneficial trades and thereby enhance economic welfare.

The activist view, however, rejects floating rates because they can permit large, persistent current-account deficits. This approach assumes that current-account deficits are disequilibrium responses to policy errors, which market imperfections aggravate. In contrast, recent work questions this approach by suggesting that large current-account deficits can be an equilibrium attempt to smooth consumption over time.<sup>3</sup>

We previously addressed the most important criticism of this “activist” view. Trade flows depend on real exchange rates. Monetary-induced changes in nominal exchange rates will alter real rates only temporarily, to the extent that prices are slow to adjust. In the long term, monetary policy cannot alter real exchange rates.

Another recent justification for monetary protectionism stems from alleged inefficiencies in government macroeconomic policymaking. Because a few, very large countries dominate international macroeconomic policy, the actions of any one may have significant spillover effects on all other nations. Through policy coordination, governments can internalize these spillover effects and achieve superior policy choices. Many of the recent calls for fixed exchange rates or target zones stem from policy coordination arguments.

In contrast to the appealing theoretical arguments for policy coordination, empirical studies find only small gains and suggest that policy spillovers are not critical to the economic well-being of the largest industrial countries. A major argument against attempting to achieve these small gains is that we lack sufficient knowledge about the nature of international economic interactions to agree on a specific model and on a properly coordinated policy stance. This uncertainty about the true economic model raises questions about the stability of institutions for coordination and, more basically, about the ability of policy coordination to enhance welfare.

## ■ The Political Economy of Monetary Protectionism

The interventionist literature assumes that governments always act in society's best interest. In contrast, a rich literature on political economy characterizes elected officials as seeking their own self-interest. Politicians and bureaucrats attempt to extend the scope of their political influence by responding to the demands of the most politically active (voting) constituencies. This literature has offered important insights into traditional protectionism.<sup>4</sup> What follows are some thoughts on similar elements relating to monetary protectionism.

Elected officials might find exchange-rate manipulation attractive because it defers criticism while buying time for more fundamental actions. By 1985, for example, dollar exchange rates

were at their zenith, and the U.S. current account was deteriorating rapidly. U.S. manufacturers, facing increasingly stiff competition worldwide, besieged Congress for trade legislation. Most important, analysts increasingly linked the deterioration in the external accounts with fiscal policies of the administration and Congress. The opportunity cost of government inaction, measured in terms of votes lost, seemed to rise sharply.

The administration realized that the U.S. current-account deficit reflected imbalances between savings and investment in the United States and in West Germany and Japan. Governments, however, cannot easily redress such structural relationships through fiscal policies because of strong vested interests in maintaining various tax and expenditure patterns.

Lacking an ability to address these structural problems directly and quickly, policymakers might resort to exchange-market intervention, chiefly to buy time for more fundamental adjustments and to defer criticism. When coordinated through the Group of Seven, such intervention offers a highly visible signal that governments are responding to the wishes of their constituencies.<sup>5</sup>

In addition to simply buying time, exchange-rate policies can offer temporary benefits to specific constituencies. When goods prices adjust slowly, a nominal currency depreciation is equivalent to a temporary, across-the-board tax on imports and a subsidy to exports. Political constituencies in the traded-goods sectors can realize benefits from monetary protectionism similar to those afforded by commercial policies. Ultimately, any benefits from monetary protectionism will dissipate with a higher inflation rate and with a reduced credibility of monetary policy, but the inflation costs of monetary protectionism are dispersed across a wider spectrum of individuals and over a longer time horizon than the temporary benefits. Usually, then, constituencies benefiting from monetary protec-

tionism (exporting and import-competing firms) will be politically more cohesive and forceful than any constituency for price stability. For this reason, a policy that seems economically myopic can be politically farsighted.

Direct restraints, like tariffs and quotas, seem increasingly difficult for legislators to enact. Even those who seek restraints recognize that as a general policy, protectionism is costly and inefficient. Perhaps more important, however, Congress faces a growing anti-protectionist lobby.<sup>6</sup> Multinational firms and domestic exporters fear that U.S. trade sanctions could trigger foreign retaliation. Domestic importers of consumer goods and firms that use traded goods as component parts face higher costs because of import restraints. In addition, traditional import restraints often violate existing treaties or tend to compromise other types of foreign-policy initiatives.

Another seemingly attractive aspect of monetary protectionism is that Congress and the administration can justify it in terms of broad macroeconomic considerations, such as exchange-rate "misalignment" or current-account "imbalance," rather than industry-specific considerations, such as automobile and steel employment. Consequently, interest-group-serving aspects of monetary protectionism are less obvious than those of commercial policies and, if justified in terms of macroeconomics, monetary protectionism runs less risk of foreign retaliation.

Exchange-rate targets also foster macroeconomic policy collusion among governments.<sup>7</sup> Such collusion provides tacit foreign approval of these policies and limits the probability that a foreign government will take steps to neutralize the exchange policies of another. In addition, coordinated efforts to fix exchange rates can allow individual countries to influence the policies of others and to defer some of the adjustment burdens of maintaining the peg. Such mechanisms are found in the European Monetary System and figure

in some proposals for target zones and for fixed exchange rates.

Governments might also find intervention to limit exchange-rate fluctuations attractive because it eliminates an important, immediate barometer of the market's opinion of government policies. Governments seem to have a higher tolerance for inflation than the general public and attempt to exploit short-term stickiness in prices for a higher rate of output and employment.<sup>8</sup> Collusion to fix exchange rates temporarily blunts the exchange-rate reaction to inflationary policies, lessening the near-term political cost of such policies.

Finally, exchange-rate policies might provide elected officials with greater influence over independent central banks. Exchange-rate policy often falls under the purview of treasuries and finance ministries, but its success requires the participation of central banks. As is well documented, sterilized exchange-rate intervention has no lasting effects on exchange rates. For their part, central banks often are willing participants, viewing exchange-rate management as a legitimate aim of monetary policy. Exchange-rate movements can impart useful information for policymaking and, as already noted, exchange-rate targets sometimes can be consistent with a monetary policy of price stability.

As often as not, however, exchange-rate policies conflict with price stability. For example, U.S. intervention sales of dollars in early 1989 seemed inconsistent with a goal of price stability and actions to slow money growth. When these objectives conflict, the autonomous central banks face a dilemma between their mandate of policy independence and their accountability to the broad national policy goals set by their governments. The Federal Reserve System, for example, does not wish to appear unresponsive in the eyes of the public to the wishes of the Congress and the administration. As economist Herbert Stein recently noted, "Despite all the formal provisions for its independence, the Fed seems constantly to feel that if

it uses its independence too freely it will lose it."<sup>9</sup>

Central banks might also participate in the hopes of influencing a policy that otherwise would be out of their purview. This channel of influence, however, runs two ways. Interventionist policies might enable fiscal agents to extend their influence beyond the exchange market to domestic monetary policy. Elected officials often seek easier monetary policy than central banks, hoping to lower interest rates and to stimulate real growth and employment. In choosing a nominal exchange-rate target, engaging in intervention, and encouraging the central bank not to sterilize the interventions, fiscal agents have a mechanism for such an influence. This channel of influence would not always be open. At times, however, such as when the central-bank policy committee is not in unanimous agreement, such an influence, marginal though it may be, could prove decisive in charting future monetary policy.

#### ■ Conclusion

We have attempted to instill a healthy skepticism for exchange-market manipulation, arguing that monetary protectionism is not grounded in widely supported economic evidence of market failure and, therefore, that it is unlikely to enhance economic welfare. Instead, monetary protectionism stems, as a

near-term palliative, from the political interactions of policymakers and constituencies with vested interests in particular market outcomes. Any international monetary order willing to accept nonmarket criteria for exchange rates and failing to bind governments with monetary constitutions is ripe for monetary protectionism.

To counter the political incentives toward monetary protectionism, we urge nations to adopt monetary directives along lines similar to the Neal Resolution in the United States, which focuses monetary policy on achieving long-term price stability.<sup>10</sup> This would do more for eliminating exchange-market uncertainty and for fostering the efficient worldwide use of real resources than any program to manipulate nominal exchange rates.

#### ■ Footnotes

1. This *Commentary* summarizes ideas presented in W. Lee Hoskins and Owen F. Humpage, "Avoiding Monetary Protectionism: The Role of Policy Coordination," *Cato Journal*, vol. 10 (forthcoming, fall 1990).
2. See Paul R. Krugman, *Exchange-Rate Instability*. Cambridge, Mass.: MIT Press, 1989.
3. See John K. Hill, "Demographics and the Trade Balance," and Evan F. Koenig, "Recent Trade and Exchange Rate Movements: Possible Explanations," in *Economic Review*, Federal Reserve Bank of Dallas, September 1989, pp. 1-11 and 13-28, respectively.

4. See M.G. Quibria, "Neoclassical Political Economy: An Application to Trade Policies," *Journal of Economic Surveys*, vol. 3, no. 2 (1989), pp. 107-36.
5. The Group of Seven countries are Canada, France, Italy, Japan, the United Kingdom, the United States, and West Germany.
6. See I.M. Destler and John S. Odell, *Anti-protection: Changing Forces in United States Trade Politics*. Washington, D.C.: Institute for International Economics, 1987.
7. See Roland Vaubel, "A Public Choice Approach to International Organization," *Public Choice*, vol. 51, no. 1 (1986), pp. 39-57.
8. See Kenneth Rogoff, "Can International Monetary Policy Cooperation Be Counterproductive?" *Journal of International Economics*, vol. 18 (May 1985), pp. 199-217.
9. "How to Worsen the Fed's Problem," *Wall Street Journal*, October 19, 1989.
10. See W. Lee Hoskins, "The Case for Price Stability," *Economic Commentary*, Federal Reserve Bank of Cleveland, March 15, 1990.

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