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International Economic Policy Coordination: A Two-Edged Sword

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When I spoke to the Fraser Institute last year, in Toronto, my talk dealt with the instability that inflation causes and the merits of a monetary policy that strives for zero inflation. Policymakers in Canada and the United States have become more aware that a commitment to price stability is the most important contribution monetary policy can make to achieving full employment and maximum sustainable growth. Governor Crow and other Bank of Canada officials have publicly supported the goal of price stability. In the U.S., Federal Reserve Chairman Alan Greenspan and other Federal Reserve officials have publicly supported House Joint Resolution 409 which would make zero inflation the primary overriding goal of the Federal Reserve. Today, I would like to build on this basic idea and discuss international markets, exchange rate volatility, and international policy coordination.

Two decades ago, many nations embraced flexible exchange rates as a means to promote worldwide trade, economic growth, and higher standards of living. In fact, Canada's experience from 1950 to 1962, when its exchange rate was allowed to float, encouraged those hopes. Today, though, some critics are claiming that the system of flexible rates has failed to provide exchange rate stability and adjustments in trade imbalances. These critics seek, instead, a system of negotiated exchange rates maintained through international policy coordination.

I hope to convince you today that some forms of coordination, particularly foreign exchange market intervention, do not promote certainty and do not reduce fluctuations in exchange rates. Holdings of foreign currencies by the Federal Reserve and the Treasury were at $45.2 billion in January 1990. More than one-half of this large accumulation took place over the past year as concern over the rising value of the dollar prompted officials to intervene extensively in foreign exchange markets. But throwing money at the alleged problems only worsens the situation, because we are not focusing on the real problems: defective fiscal and monetary policies.

Volatile Exchange Rates: A Case for Intervention?

Those who argue for intervention in foreign exchange markets note the increased volatility of exchange rates since the demise of the fixed exchange rate system of Bretton Woods. Unpredictable fluctuations in exchange rates pose a risk to people who buy and sell goods and services internationally -- a risk that cannot be completely eliminated through hedging. It is true that exchange rates, both nominal and real, have been more volatile since the advent of the floating rate regime in 1973. But there is no reliable evidence that this volatility has reduced trade or international commerce, or that systematic intervention can reduce volatility in exchange rates.

Another complaint is that the floating rate system has failed to promote adjustment in nations' trade accounts. Critics cite the existence of prolonged current account imbalances around the world as evidence that some intervention is necessary to move markets toward long-term equilibrium and economic stability and growth.

A system of floating exchange rates, by itself, cannot be expected to promote a balance in each country's trade accounts. First, there are many other factors that contribute to trade imbalances. Most important among those factors are monetary and fiscal policies, which are beyond the control of markets. Second, economists have not found a clear correlation between nominal exchange rates and international current accounts. And third, despite its size, it is not clear that the U.S. current account deficit represents disequilibrium, or even that it is unsustainable given present circumstances.

Convincing evidence does not exist that foreign exchange markets suffer from avoidable imperfections. Exchange markets are highly efficient information processors. There are many participants, and none dominates the market. Moreover, there are few barriers to entry. As flexible rates adjust rapidly to supply and demand shifts, they act as a cushion to the international transmission of shocks that otherwise would more severely affect other economic variables--prices, interest rates, and employment.

Uncertainty and Policy Intentions

In a flexible exchange rate system, the equilibrium rate is determined by factors affecting the supply of and demand for currencies. Some of the factors -- like domestic monetary and fiscal policies -- lie within the realm of control of policymakers, while others -- like changes in productivity, demographics or supply shocks -- cannot be controlled by policymakers. The fundamentals that are controllable by policymakers should not be allowed to contribute to confusion and volatility in markets and prices.

Policymakers can minimize uncertainty by adopting sound policies; namely, policies that have clear objectives, are verifiable, and embody rules that are consistently adhered to. If policymakers follow sound policies, then decisionmakers can factor the effects of such policies into foreign exchange prices, contributing to stability in foreign exchange markets. Unfortunately, the absence of sound and credible economic policy objectives around the world has forced decisionmakers to focus on short-term governmental actions, adding to uncertainty and volatility in foreign exchange prices.

Current Market Fundamentals: Foreign exchange dealers base their price quotations partly on current economic conditions and partly on the actions of policymakers. Recognizing the links between monetary growth, inflation and foreign exchange rates, dealers pay particular attention to central bank actions. Dealers scrutinize a variety of central bank data -- changes in reserves, changes in the discount rate, and conditions in the money market -- for clues about changes in the Federal Reserve's objectives and its reaction to current economic conditions. For example, if Federal Reserve actions are interpreted by the market as a policy of unexpected easing, that will cause a rise in the U.S. inflation rate and the U.S. dollar exchange rate may decline. In this way, unexpected changes in the money stock contribute to exchange rate volatility.

Future Market Fundamentals: Changes in the expected future value of market fundamentals are also integrated into foreign exchange prices. Foreign exchange rates always embody expectations of central banks' longer-run policies. Where intentions are unclear, the market is forced to place heavy emphasis on central banks' behavior as an indication of their future expected policies. Put another way, the lack of sound and credible policy causes unnecessary uncertainty and consequently, unnecessary volatility in exchange markets.

Conflicting Objectives Increase Uncertainty

The Federal Reserve, like most central banks, has a lengthy list of policy objectives -- high employment, maximum output growth, balance of payments equilibrium, exchange rate stability, and price stability. The lack of an overriding objective, or an explicit prioritization of the current list, makes it difficult for markets to know how the Federal Reserve will respond to the latest economic data. Although the Governors of the Federal Reserve and the 12 Federal Reserve Bank presidents are on record in support of price stability, there is neither an explicit timetable for achieving it nor as strong a public mandate to do so as I would like.

A central bank that attempts to maintain price stability and a nominal exchange rate target has more policy objectives than policy instruments. At times, these two objectives might be compatible. For example, in the late 1970s, limiting rapid dollar depreciation through intervention was compatible with a contractionary monetary policy to eliminate inflation. As often as not, however, these two policy objectives will be incompatible, and generally, foreign exchange intervention activities are sterilized, or offset, so as to avoid interfering with domestic policy objectives. U.S. intervention sales of dollars in early 1989, for example, seemed inconsistent with a goal of price stability and with Federal Reserve actions at that time to slow monetary growth. That intervention carried a risk of sending confusing signals to foreign exchange and bond markets, since the markets may have thought that U.S. monetary policy had become less focused on lowering the inflation rate.

Under such conditions, markets may not view either price stability or exchange rate stability as credible policy goals. The knowledge that central banks will deviate from a policy of price stability to pursue an exchange rate objective will raise uncertainty about real returns and will distort the allocation of resources across sectors and over time. Moreover, without sound monetary and fiscal policies, attempts to maintain nominal exchange rates will not eliminate exchange rate uncertainty, since countries inevitably will resort to periodic exchange rate realignments. Hedging exchange rate risk will remain an important aspect of international commerce.

Interventionists argue that a sterilized approach, in which the central bank offsets any monetary effects of intervention, can influence the exchange rate without compromising domestic policy. If this view has any merit, the effects are very short-lived. Furthermore, distinguishing between the two types of intervention -- sterilized and unsterilized -- is difficult in practice and bound to create additional uncertainty on the part of private decisionmakers.

Policymakers can best minimize uncertainty by reducing government interference with market mechanisms. To be sure, providing an institutional framework that protects individual property rights is a necessary role for governments to play. But government policies to control market prices can be destructive. Unlike the market, the machinery of government includes no automatic mechanism to promote efficiency. Rather than fostering efficiency, intervention slows and impedes the market's natural adjustments. Furthermore, such intervention will, sooner or later, be at odds with publicly stated domestic goals, causing substantial confusion and speculation.

The Attractiveness of Market Intervention

Conventional wisdom suggests that elected officials and markets usually do not share the same incentives and goals. While market forces promote long-run efficiency and equilibrium, governments often react to shorter-run factors and the pressures of their constituencies. These diverse and often conflicting goals tend to reduce the credibility of domestic policies, increasing uncertainty and volatility in foreign exchange markets.

Elected officials might find exchange rate intervention attractive because it defers criticism while buying time for more fundamental actions. In 1985, U.S. domestic manufacturers were experiencing stiff competition from abroad. Competition was intensified by extremely high dollar exchange rates, and lobbyists besieged Congress with proposals to restrict imports.

The administration realized that the U.S. current account deficit reflected imbalances between savings and investment in the U.S., West Germany, and Japan. These structural imbalances could have been corrected through adjustments in fiscal policies. However, governments cannot easily change fiscal policies because of strong vested interests in maintaining various taxes and expenditures. The continued struggle to balance the U.S. federal deficit typifies the problem. Similarly, in the early 1980s, West Germany and Japan were extremely reluctant to adjust fiscal policies for balance-of-payments purposes.

Lacking the ability to address these structural problems directly and quickly, policymakers find it easy to resort to exchange market intervention. When coordinated and publicized through the G-7, such intervention offers a highly visible signal that governments are responding to the desires of their constituencies. In this way, government intervention can serve to diffuse criticism of its policies, to stall protectionist demands, and to buy time for more fundamental policy adjustments.

In addition, it has been a longstanding belief that a nation can offer temporary benefits to specific constituencies by adjusting monetary policy to depreciate the value of its currency. However, unless markets are imperfect or unduly constrained, such a policy cannot succeed in the marketplace for any substantial period of time. Furthermore, depreciation of a nation's currency via monetary policy will eventually cause domestic inflation.

Economists have long questioned the wisdom of attempting to achieve current account objectives through a monetary manipulation of nominal exchange rates, and most have come to reject this practice as little more than a near-term palliative. Nevertheless, aiming monetary policies at nominal exchange rate targets increasingly seems to be the approach of choice among national leaders.

Intervention and Defective Public Policy

The ability of governments and central banks to intervene freely in foreign exchange markets has not really promoted effective policy coordination and has not materially affected exchange rates. Nations that commit to sound economic policies can live with flexible or rigid exchange rate regimes, but a rigid structure of exchange rates cannot be maintained when nations pursue fundamentally different domestic economic policies. For example, it is hard to imagine a fixed exchange rate system that would encompass the high-inflation policies of Latin American nations as well as the low-inflation policies of West Germany and Switzerland. Foreign exchange market intervention cannot bridge the gap between such different monetary and fiscal policies.

Yes, exchange rates have been volatile over the last 17 years. However, intervention has contributed to this volatililty by enabling governments to procrastinate in adjusting defective monetary and fiscal policies. One of the most important roles that governments can play -- furnishing a sound and stable currency -- is frequently overlooked in a coordinated system of intervention.

Conclusion

Any successful system of international coordination must be founded on the proper economic incentives for each individual country. Price stability offers nations the opportunity for the highest possible economic growth and would reduce fluctuations in exchange rates. Over the long haul, it is in society's best interests for governments to commit to a policy of price stability, or zero inflation. Every recession in Canada's and the United States' recent history has been preceded by an outbreak of cost and price pressures. And these results aren't confined to North America. Evidence from a number of countries with various institutions and economic conditions indicates that persistent inflation erodes long-term growth by favoring projects with quick paybacks and discouraging the formation of capital.

Policy coordination should not be abandoned. However, important economic fundamentals should not be ignored and market forces should not be encumbered by public policies. Attention to the fundamentals will encourage the adoption of goals -- specifically, price stability -- that are essential to reach the highest levels of social and economic welfare for each nation and the world as a whole. To attain price stability, we need to adopt a sound policy -- one that is verifiable, with clear objectives and rules that are consistently adhered to.

If we cannot get firm commitments for zero inflation, should we abandon floating rates and resort to a fixed rate system? The answer is no! As long as there are separate, sovereign nations, we must accept the possibility of varied domestic agendas. A system of floating rates can accommodate these interests with the least governmental interference. The key is adherence to sound policies; as long as governmental policies are predictable, uncertainty can be minimized.

In a system of floating exchange rates and free trade, resources will find their best use. Flexible exchange rates themselves can actually contribute to price stability by providing another channel through which markets can work. If governments choose to inflate at different rates, a floating rate system will quickly price the respective currencies accordingly.

International coordination should be viewed as a journey, not a destination. Policy coordination should not take the form of intervening to slow the natural adjustment of exchange rates, or to fix them. While markets may not be perfect and may not always coincide with the interests of politically driven systems, they generally outperform the actions of governments.