THE INFLATION RATE OR THE EXCHANGE RATE: WHAT'S A POLICYMAKER TO CHOOSE?

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At this time of year, we typically reflect on the past and speculate about the future. Therefore, having listened to Murray's and Larry's reflections and speculations, I thought it might be helpful to place their remarks, and mine, into a seasonal setting. Their comments could well have been inspired by the three Spirits or Ghosts that appear in Dickens' famed story, A Christmas Carol; between them, they've certainly covered the past, the present and the future.

My remarks, on the other hand, are far more closely akin to that other Christmas story, The Grinch That Stole Christmas. Simply put, I'm here to make it clear that the Federal Reserve is not Santa Claus. That is, despite widely-held beliefs to the contrary, the Federal Reserve cannot provide the necessary conditions for long-run price stability and, simultaneously, deliver short-term "fixes" for other economic problems.

One such problem that has received considerable attention for some time now is the foreign exchange value of the dollar. Many people believe that the dollar's value is too high; they are convinced that it must decline in order to make our goods less expensive and, thus, more competitive abroad. Moreover, there is widespread feeling--indeed, almost fear--that our $500 billion-plus foreign indebtedness is too high and must also decline. I have no doubt that if U.S. economic performance slows significantly next year, concern about the "over-valued" dollar--and associated public pressure to drive its value down--will grow even more intense.

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A question that seldom arises when these issues are discussed, however, is "Would we really benefit from higher exports and lower imports?" Despite what you might think, the answer to that question isn't really all that obvious. Some individuals clearly benefit; producers of exported goods and import-competing goods immediately come to mind as examples. However, others of us are clearly affected adversely by this result; chief among this group are the consumers, who would face higher prices and fewer goods and services. Moreover, trade deficits have a mirror-image, which is the offsetting capital inflows from abroad. Reducing the trade balance will reduce the amount of foreign savings available for capital investment in this country.

In fact, once all things are considered, it isn't obvious at all that increasing our exports and reducing our imports would necessarily make us all better off. This statement is true even when we take into account our country's externally-held debt. While $500 billion is a considerable sum, it represents only about 1 percent of the value of this nation's assets. While I won't ask for a show of hands, I am willing to bet that few of us have debt-to-asset ratios that low.

Regardless of the merits of their case, however, many people do want a lower-valued dollar--and they generally look to the Federal Reserve for help. Specifically, they want a "looser" monetary policy--that is, faster money growth--in order to drive down U.S. interest rates and, thereby, push down the dollar's value. Others demand even more immediate action; they want the Federal Reserve to intervene directly and forcefully in foreign exchange markets.

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However, before too many of us become convinced that the Federal Reserve really can do this--that it really is Santa Claus, at least in the foreign exchange market--it might be helpful to examine this view a bit more carefully. And the best place to start is to look at what actually determines the dollar's value in foreign exchange markets.

What do we know about the exchange rate? Simply that it is the price of the dollar in terms of another country's currency. Like all prices, it is determined by the forces that underlie the demand for and the supply of dollars. Thus, other things the same, if the Federal Reserve should increase the supply of dollars--either by domestic open market operations or by foreign exchange intervention--the price of the dollar should fall. And, the lower value of the dollar should then encourage more exports and less imports.

Now, what's wrong with the logic and thrust of this analysis? Oddly enough, practically everything! First, it ignores the domestic effects of increased money growth. Second, it ignores the reactions of foreign central banks. Third, it ignores the "realities" of how direct intervention in foreign exchange markets is typically conducted. And, perhaps worst of all, it focuses on the wrong exchange rate. Let's look at each of these errors in turn.

First, what do we have to give up if the Federal Reserve increases money growth to drive down the dollar's value internationally? Part of the cost to us is the associated reduction that takes place in the dollar's value domestically--that is, increased inflation. The rest is the adverse impacts that usually accompany higher and more uncertain inflation; chief among these are higher interest rates, increased financial risks, lower real growth and lower standards of living.

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Of course, we won't get these effects all at once. In particular, inflation will not accelerate immediately; empirical evidence suggests that it takes several years before faster money growth is fully incorporated into higher inflation. In a sense, it is extremely unfortunate that the lag between faster money growth and higher inflation is so long; as a result, we seemed to be blind-sided, time and time again, by the adverse longer-run consequences of short-sighted monetary policy actions.

At any rate, it is important, at least here and now, that we don't lose sight of this trade-off; that we understand that the cost of faster money growth to drive the dollar's value lower now is higher inflation in the years ahead.

Suppose, however, that we were willing to sacrifice domestic price stability in order to reduce the dollar's value and encourage more exports. In the byzantine reality of foreign exchange markets, there is no way that we could be sure of achieving our goal. Other nations, equally interested in protecting their own export markets, could simply increase their money growth accordingly. In this event, the net result would be a standoff in the exchange markets with increased inflation worldwide; in other words, all cost and no gain. The problem here is that only relative monetary policy actions across countries can influence currency values. What one country can accomplish in terms of exchange rate movements, other countries can easily undo, as long as they are willing to accept the costs of their actions. And why shouldn't they be? After all, we started off by supposing that we were willing to do so.

Now, you might believe that the easy solution to this problem is simply to negotiate some agreement for coordinated policy across a number of countries. Certainly, such agreements could be of considerable help,

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at least in the short run; and, just as certainly, attempts to achieve them are worthwhile. However, these attempts are unlikely to provide a viable longer-term solution to our problem. As long as the chief purpose of this coordination is to make one country better off at the expense of other countries, it is hard to see why the losers would want to play this game for long. Perhaps this explains why previous attempts at policy coordination have often fallen far short of their intended goals.

The third source of confusion about the Fed's ability to influence the dollar's value concerns the impact of direct intervention in foreign exchange markets. Whenever word gets out that the Federal Reserve is "in the market"--that is, buying or selling dollars for foreign currencies--it makes front page headlines around the globe. When this intervention is coordinated across several of the major central banks, it makes for even bigger headlines. It isn't surprising, therefore, that the public generally believes that such intervention has a powerful impact on exchange rates.

In reality, however, direct foreign exchange intervention typically has little, if any, lasting influence on exchange rates. In general, central banks, including the Federal Reserve, "sterilize" their foreign exchange intervention activity. This means, for example, that when the Federal Reserve buys $1 billion worth of yen or D-marks in the foreign exchange markets, it simultaneously sells $1 billion worth of U.S. government securities in the domestic financial markets. As a result of this carefully balanced operation, there is no increase in the nation's monetary base or its money stock--and, consequently, no lasting impact on the exchange rate.

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If you find it hard to believe that this is how intervention is really conducted, all I can say is that this general pattern of sterilized foreign exchange intervention has been well-documented by a vast number of studies over the past decade. If you're wondering why news of such intervention should make headlines, I must confess that I'm puzzled by that, too; perhaps central banks only intervene on slow newsdays.

Now, to this point, we have discussed the loss of price stability that accompanies attempts to drive the value of the dollar down; further, we have noted the difficulty of actually doing so, even if we were willing to bear that cost. Thus, up to now, the bad news was that there is a substantial social cost associated with looser monetary policy. And, the worse news was that we may well incur these costs in vain; our actions may not actually succeed in driving down the value of the dollar at all.

Suppose, however, that looser monetary policy successfully depressed the value of the dollar in foreign exchange markets. Can we really be sure that we have increased our competitive position in world export markets? The correct answer to this question is "No, we can not be sure." The problem is that the drop in the dollar's value is accompanied by higher inflation in the U.S. To see why this is a problem, suppose that the dollar's foreign exchange value falls by 10 percent, while prices in the U.S. rise by 10 percent. In this event, the two price movements are exactly offsetting; as a result, the prices of U.S. goods abroad, and our competitive position relative to the rest of the world, will remain unchanged.

The purpose of this example is simply to point out that movements in market or nominal exchange rates tell us very little about changes in our export competitiveness. Only movements in exchange rates adjusted

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for differential inflation rates across countries--the so-called real exchange rates--affect trade among countries.

Unfortunately, monetary policy actions appear to have little permanent influence on real exchange rates. Thus, those who urge the monetary authorities to focus on exchange rates must really believe that our exports will increase significantly during the temporary lag between the drop in the exchange rate and the subsequent rise in inflation. In essence, they are betting that the short-term benefits of exchange rate movements are worth the loss of longer-term price stability. Yet, these monetary policy bets are the very same ones that we made in the 1970s, when the Federal Reserve was urged to focus on short-term interest rate movements instead of long-term price stability. Given the disastrous losses associated with those past bets, I find it puzzling that anyone would want to gamble again on such policies.

Thus, in one sense, the question that makes up the title of this talk, "The Inflation Rate or the Exchange Rate: What's A Policymaker to Choose?", can be answered easily. The goal of long-run stable prices is one that can be achieved by appropriate monetary policy actions. Policies aimed at bumping the exchange rate up or down, however, seem to have few benefits and considerable costs.

On the other hand, as long as the public believes that the Federal Reserve can produce meaningful exchange rate movements at little or no cost, the answer is not so obvious. Various episodes during the past several decades have shown us that monetary policymakers are not immune from public pressure; this has been true even when that pressure was motivated by serious misconceptions about what was really feasible and what was not.

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As I see it, there is only one sure way to guarantee that we can--and will--make the appropriate policy choices in the future. It requires correcting the public's perceptions about what monetary policy actually can do, as well as calling attention to what it should not be asked to do. I hope that my comments today will have some effect in bringing this about. Indeed, I hope that we will all greet the New Year by resolving not to ask the Fed for policy gifts that it can't deliver. If we do so, we won't throw away the progress that was made in the 1980s toward price stability in the 1990s.

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