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Importance of Exchange Rate Stability

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Calls for exchange rates to be stabilized are growing throughout the world. In a speech at the Foreign Correspondents' Club of Japan on Dec.15, Finance Minister Kiichi Miyazawa said: " It is our task to examine the possibility of creating an exchange rate regime that would bring greater stability and at the same time needed flexibility among the yen, the dollar and the euro." In meetings with Prime Minister Keizo Obuchi during his European tour this month, French President Jacques Chirac, Italian Prime Minister Massimo D'Alema, and German Chancellor Gerhard Schroeder agreed on the importance of a stable exchange rate between the yen and the euro. On Jan. 16, a conference of finance ministers of the Asia - Europe Meeting (ASEM) issued a statement emphasizing that the launch of the euro was an appropriate occasion to step up efforts to further stabilize exchange rates.

Also meriting attention is the assertion by academic and media figures in the United States that exchange rates between the dollar and other currencies should be stabilized.

Fred Bergsten, director of the Institute for International Economics in Washington, wrote in the Nov. 20 Financial Times that the Group of Seven industrial countries should adopt a European Monetary Union - type agreement to stabilize the exchange rates of their currencies. Paul Volcker, former chairman of the Federal Reserve Board, is one of the few knowledgeable persons who have for years advocated stabilizing exchange rates among key currencies.

There are two developments behind the recent surge in international concern over exchange rate stability: the currency crisis in East Asia and the birth of the euro.

The Asian currency crisis has drawn international attention to the exchange rate issue for two reasons. One is that all the countries caught in the crisis had for years pegged their currencies to the dollar. Unfortunately, the exchange rate between the dollar and the yen, another key currency for these countries, has fluctuated violently during the past 10 years, from \240 to \80 to the dollar and then swinging back to \140 to the dollar. These countries lacked the flexibility to deal with these fluctuations. As a result, they accumulated windfall trade surpluses when the dollar declined sharply against the yen, but those surpluses evaporated when the dollar bounced back. Their economies were destabilized by these fluctuations and lost the confidence of the market. This

was one of the major factors that triggered the crises.

The second was massive speculative sell - offs of their currencies when market confidence collapsed. The countries hit by the speculative attacks attempted to shore up their currencies by using large amounts of foreign exchange reserves, but they failed to maintain their dollar pegs. In the end, they abandoned attempts to stabilize the exchange rates of their currencies, and allowed them to plummet. The depreciation was tremendous: 54 percent for the Thai baht, 46 percent for the Malaysian ringgit, 85 percent for the Indonesian rupiah and 55 percent for the Korean won. Because of the crashes, the burden of repaying foreign - currency debts swelled tremendously, and a grave crisis arose over foreign currency liquidity. This was the first and the most serious blow to the East Asian economies in the currency crisis. Concern over currency stability surged because it was understood that the crises were closely related to the excessive fluctuations in exchange rates.

The other main reason for the growing international concern over exchange rates was the birth of the euro on Jan. 1. Before its launch, there were worries over what the exchange rates would be between the euro and such currencies as the dollar and yen. There were concerns outside Europe that if the region's economy became more self - sufficient as a result of currency unification, attention would then focus on stabilization of the euro's internal value, i.e., curbs on inflation within the euro zone. There was the worry that Europe might ignore the importance of keeping the value of the euro stable against other currencies.

Judging by the positions of the leaders of Germany, France and Italy, however, it has become evident that Europe itself is seriously concerned about the stability of the euro's external value. One reason for that is the philosophy of the center - left governments of those countries, that it is not wise to allow their economies to be ruled by the market. Their position is that “market forces" are not infallible and thus there should be controls based on broader guiding principles for economic management.

Moreover, there is general aversion to the fact that the international monetary system has for so long been dominated by the dollar. This has allowed the United States to put priority on its domestic economy and follow a policy of “benign neglect" concerning the greenback's external value. Europe's challenge is to promote the euro as an international currency comparable to the dollar and create a situation in which the United States must be concerned about the dollar's stability against the euro. There are fears that the dollar - euro exchange rate could become unstable if the world economy is dominated by a bipolar system consisting of the two currencies. This would be unwelcome not just for Europe, but for the world economy as a whole.

Looking back, there have been many vicissitudes in the history of the world's exchange rate system. The Bretton Woods regime established in 1944 rested on two pillars: the gold - dollar standard system (which guaranteed the dollar's value by ensuring its convertibility into gold) and the fixed exchange rates between the dollar and other currencies. However, as a result of swelling deficits in the U.S. balance of payments and a decline in the U.S. economy's relative international strength, the gold standard system collapsed with the “Nixon shock" of 1971.

Other industrialized countries immediately endeavored to maintain fixed exchange rates in relation to the dollar by means of a “central rate formula"—despite the fact that there were no guarantees concerning the value of the dollar in the world economy. In 1973, major currencies shifted to a floating rate regime, toppling the second pillar.

At first, the floating system seemed to work well. During the second half of the 1970s, however, the dollar fluctuated violently, and the argument was made that there should be some form of intervention by monetary authorities—the so - called managed float concept. The concerted international intervention to shore up the sagging dollar in 1978 and then to prevent it from rising under the 1985 Plaza Accord were both based on this concept. In 1987, the Louvre Accord made an attempt to hem in the dollar's fluctuations against the German mark and the yen within a certain range. However, that accord was thrown together haphazardly and soon

collapsed.

The international zeal to stabilize exchange rates soon evaporated and policy coordination, with an emphasis on stabilizing the macroeconomics of key countries, became the dominant philosophy. However, policy coordination was not based on the principle that both countries with balance of payments deficits and those with surpluses should assume equal responsibility, and thus did not work. Moreover, a political accord to make coordination compulsory was never reached.

What was Japan's situation in those days? Thanks to a stable exchange rate of \360 to the dollar that lasted for 22 years after World War II, Japan experienced a phenomenal export - led recovery and rapid development. Since the collapse of the Bretton Woods regime, however, Japan has been tossed about by fluctuations in the yen - dollar rate. In particular, an aversion to a strong yen excessively affected the government's economic policies and caused a delay in structural reforms, such as deregulation.

The Japanese economy's dependence on exports is not particularly great compared with other industrialized economies. Nevertheless, it has been the worst victim of exchange rate instability because it is excessively dependent on the dollar for external transactions and the overly large role of major export - oriented industries, such as autos, electronics and electrical machinery. It is frustrating to see the cycle of anguish and relief of Japanese companies in response to fluctuations in the yen - dollar exchange rate. One has to wonder if the situation is appropriate for the world's second - largest economy.

It should be noted that Japan has not been a willing participant in international endeavors to stabilize the exchange market. There are two reasons for Japan's lack of zeal. One is the “realist" argument that stabilizing exchange rates is impossible. The other is a victim mentality, a belief that stabilizing the yen - dollar rate would simply make the yen subordinate to the dollar. There is nothing strange about such views in light of the nation's experiences. If current international economic conditions continue and there is no change in the state of Japan - U.S. relations, then the misgivings will remain valid. However, the surging international concern regarding exchange rate stabilization is a sign of change. In the world economy of today, the globalization of transactions is progressing rapidly. At the same time, the formation of regional blocs and currency blocs are becoming matters of national economic strategy. If Japan hopes to achieve sustained economic growth amid these two currents, with its main footing in Asia, it must maintain stability among the yen and the dollar and the euro. If not, it will find itself “sandwiched" between the two giants, and end up dwarfed and marginalized.

What steps should be taken? It is unrealistic to expect a high degree of exchange rate stability, such as fixed or almost fixed rates, on a global level over the short term. Thus, initially there is a need for a considerably loose accord.

In the first stage, two concurrent agreements are necessary. One would concern the range of permissible exchange rate fluctuations. Theoretically the range could be plus or minus a certain percent from a central rate. However, there is no need to stick to the concept of a central rate. It would be sufficient to set the range as “between such - and - such amounts of the yen to the dollar." It would be possible to use a real, effective exchange rate, but the nominal rate should be used because the profitability of international transactions would be calculated on the basis of the nominal rate. Regarding the range to be set, whatever the countries concerned find acceptable would do. For example, the yen range could be \110 to \130 to the dollar. At the same time, there is a need for another agreement setting the rules for changing the range, in line with changes in relevant economic conditions. This would call for flexibility. The public should be kept informed of agreements. As long as what the authorities consider to be a proper range remains compatible with market perceptions, public announcements of the range would both reassure people and curb speculation - induced or “irrational" exchange rate movements.

In the second stage, there must be an agreement on how to keep fluctuations within the permissible range. Broadly speaking, there are three steps of action which could be taken to

contain the fluctuation, i.e. warnings, intervention in the market (including agreements on the level, the size, the venue, and the technique of intervention) and changes in monetary policy. These agreements should ultimately be made binding, step by step through the accumulation of experiences, but the specifics should be kept confidential.

The primary objective of such endeavors would be to prevent excessive volatility in rates and thereby provide a degree of predictability to allow reliable calculations of profitability concerning transactions and investments.

The fundamental requirement for an international accord on exchange rate stabilization is recognition of the need for one by the countries concerned. Regrettably, there has not been such recognition shared by all major currency countries.

There are signs today of a growing awareness of such a need and preparations must begin now. Japan must take a leading role because it needs exchange rate stability the most and stands to reap maximum benefits from it.

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