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Toward an Exchange Rate Stability

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The United States, EU, Japan, and the IMF should declare to the world that they recognize that stable exchange rates among the three major currencies - dollar, euro, and yen - is vital to the global economy and that they are determined to cooperate with one another to realize this goal.

The foreign exchange market has attracted the world's attention since late last year for two reasons. One is that from the financial crisis that struck East Asia. Russia, and Latin America, emerging economies learned both the importance and the difficulty of maintaining stability between their currencies and the major currencies. An emerging country needs a stable foreign exchange rate to bring in foreign capital and increase exports. The market, however, will not overlook the inconsistency of a country that tries to stabilize its currency while ignoring the degenerating fundamentals of its own economy. The market will shift a massive amount of capital quickly and destroy the fallacy. When an emerging economy depends upon more than one major currency, any excessive fluctuation in the exchange rates between those major currencies will only bring the emerging economy chaos and undesirable risks.

From this experience, some countries no longer peg their currencies to major currencies (e.g., the dollar-peg system). Yet, other countries that place greater importance on stable foreign exchange rates advocate a currency board system with a built-in automatic financial adjuster and, in extreme cases, the replacement of their currencies with the dollar.

The other reason that has brought the foreign exchange market into the limelight is the advent of the euro, the standard currency for Europe. The euro is the fruit of the EMU nations, led by Germany and France, that campaigned for the currency for many years backed by strong political support. Outside the EMU, however, there was a strong sense of what may be called "Anglo-Saxon cynicism" among those skeptical that the euro would succeed. This skepticism, however, underestimated the strength of the desire among the countries in the region to unite. The realization of the euro is one of the largest events in the global economy this century.

No one can deny that the euro, created by a region with a population of 300 million and an economy as large as that of the United States, holds the potential of becoming a major international currency on par with the dollar. Should this happen, the euro will have various effects not only on the EMU countries, but also on the global economy.

The euro is anticipated to rejuvenate the EMU economy by eliminating foreign exchange risk, expanding capital markets, and increasing competition. At the same time, greater importance will be placed on the foreign exchange rates between the euro and other major currencies, in particular the dollar, in economic relationships between EMU countries and non-EMU countries. Leaders of Germany and France have shown their eagerness to stabilize the exchange rates between the dollar, the euro, and the yen since last fall because of their desire to maintain the EMU region's price competitiveness against non-EMU countries.

Should the euro become a key international currency that rivals the dollar, the international currency system will see changes of historical proportions. What this means is that the dollar, which has functioned as the key international currency through the gold exchange standard system of the Bretton Woods Age and the de facto dollar standard age since 1971, is about to see its basic roles change. When market players around the world are given two equal options - the dollar and the euro - the United States will lose the seigniorage and the benefits of the benign neglect policy that it had enjoyed as the sole issuer of the key currency. The United States will be forced to assign greater policy priority to balancing international payments and maintaining the dollar exchange rate. Whether such a situation will bring stability or instability to the international currency system is difficult to predict. What is certain is that the mere possibility that such a situation could arise from the creation of the euro has brought renewed interest in stabilizing the exchange rates among the major currencies.

Under the Bretton Woods system that was maintained for a quarter of a century after the end of the World War II, exchange rates were determined by the given conditions, and were not a means or variables of economic policy. Under the Bretton Woods system comprised of the gold exchange standard system and fixed exchange rate system, the global economy for the most part experienced steady recovery and growth while trade and investment increased steadily.

In the late 1960's, however, the relative weakening of the American economy jolted the Bretton Woods system. Then, in 1971, the gold exchange standard system was abandoned. In 1973, the fixed exchange rate system for major currencies was also discontinued. It marked the advent of the de facto dollar standard system and the floating exchange rate system.

Despite initial concerns, the floating exchange rate system appeared to be functioning smoothly without much turbulence, at least for a while. There was even optimism that the floating exchange rate system will effectively and automatically bring international payments in balance. In the late 1970's, however, the dollar began to fluctuate wildly. This is when the concept of managed floating exchange rate appeared. This concept calls for intervention by authorities even in a floating exchange rate system. The internationally coordinated intervention to halt the dollar's fall in 1978 and the prevention of the dollar's appreciation by the Plaza Accord in 1985 are indeed acts of managed floating exchange rate system.

In 1987, the Louvre Accord called for an attempt to keep the exchange rates between the yen, the mark, and the dollar within a certain target range. This experiment, however, proved to be an utter failure. There are two reasons for the failure. One is that the Accord attempted to stabilize the exchange rates based on the rates as of the day of the Accord. Unfortunately, the market was not fully satisfied with the exchange rates at the time. The market felt that the dollar should depreciate further. The second reason is that the countries to the Accord were not fully committed and prepared to keep the promise, and as a result, the market failed to see a strong message coming from the Accord.

Since the failure of the Louvre Accord, the world lost the enthusiasm to aggressively stabilize foreign exchange rates. Instead, the concept of policy coordination, or the emphasis on stabilizing the macro economies of major countries, became mainstream policy. Policy coordination has not been successful either, however, since the countries have failed to establish the rule that deficit countries and surplus countries bear responsibilities alike and also for lack of a concrete political agreement to mandate coordination.

As these examples illustrate, the world has had a rough time stabilizing foreign exchange rates. Europe, on the other hand, has been stimulated by such an international problem, and has made a devoted effort to unify the economies in the European region and, as a facet of this activity, to unify the currencies. The EMS (European Monetary System), founded in 1979 to stabilize the exchange rates between European currencies, has survived a number of crisis. In the 1990's, the motion to unify currencies was boosted by the huge momentum of the unification of European markets and, finally, the unified currency euro was born. The exchange rates during the few months after its creation provide no indication that the euro will be a stable currency against other currencies.

Purchasing Power Parity: 1973 1Q=100

Currency instability continues in East Asia, the third largest economic region after North America and Europe. Because East Asia is economically and geopolitically diverse, the environment does not easily accommodate vertical integration, as seen in North America, or horizontal integration, as seen in Europe. What makes the situation worse is that the two major currencies in the region - the dollar and the yen - have been historically extremely unstable against each other. Another aggravating factor is that the foreign exchange rate policies of the countries in the region have not been able to properly cope with such a situation. Such problems have contributed to the East Asian financial crisis that erupted in 1997 (see Figure).

Today the reaction to a proposal to stabilize the exchange rates between major currencies of the world is, for most part, skeptical. The largest reason for this is that today's capital transactions that are dozens of times more than current account transactions are taking place as a result of the globalization and deregulation of international financial markets. Opponents to stable exchange rates claim that it would be impossible and undesirable for monetary authorities to attempt to stabilize foreign exchange rates in such a financial market.

It is true that short-term foreign exchange rate fluctuations today are the result of capital movement, and not changes in current accounts as in the past. Having conceded this as fact, there are still a number of questions left unanswered. In foreign exchange rate fluctuations, are there unreasonably sudden and large fluctuations or cases of the so-called "overshooting"? Are there cases where the misalignment in foreign exchange rates resulting from overshooting is not quickly corrected but remains unchanged for a long time? Do such overshooting and misalignment eliminate predictability from the foreign exchange market and make profit forecasting difficult? Is a distortion created because this causes difficulty for economic entities to make decisions on business transactions and investments? Is this situation holding back the growth and maintenance of trade volume? Are overshooting and misalignment often caused by distorted information in the international monetary market and the herd mentality of market players dictated by short-term profit motives?

I believe that the answer to all these questions is "Yes." Economies and economic policies of countries should take some blame for the frequent disruptions in the international foreign exchange rates that have occurred since the floating exchange rate system was adopted. It is true that the market reacted to such domestic defects. It is also true, however, that each time, the degree of the market fluctuation that followed has been much larger than that necessary to compensate for the defect. Taking the recent East Asian financial crisis as an example, the excessive depreciation of local currencies escalated the foreign exchange liquidity crisis to an abnormal level. As a result, corporate activity was unnecessarily hampered and bankruptcies soared. In essence, the shortcoming of today's international financial market can worsen such disorders by robbing foreign exchange rates of their inherent balancing function. In this respect, as a means of preventing or promptly correcting overshooting and misalignment, stable foreign exchange rates are more important than ever and should be designated an objective of international effort.

It would be impossible to revive a fixed exchange rate system, such as the Bretton Woods system, on a global scale today because there is no overwhelming concentration of economic power, such as the United States economy then, and because capital moves about more freely. As described above, however, overshooting and misalignment occur due to a distortion in market information. In essence, the problems occur when the market fails to take a look at all the information and make a rational decision, but gives abnormal priority to certain information and the market players act according to the theory of herd mentality in pursuit of short-term gains. In this respect, then, it would be necessary and possible for monetary authorities, who are expected to have more long-term and macro views, to cooperate with one another to correct the market's misjudgment.

Stabilization of foreign exchange rates can be divided into stabilization of exchange rates between major currencies and stabilization of exchange rates between a minor currency and a major currency. Since the latter tends to be affected by the circumstances of individual minor-currency country, it would be rational to first consider stabilizing the rates between major currencies.

There are two prerequisites to studying a concrete stabilization plan. First is to recognize that the objective of the plan is not to maintain a certain exchange rate, but to prevent or promptly correct overshooting and misalignment. Second is for all the countries concerned to share the common awareness that such stability is both desirable and necessary

Based on this premise, I would like to propose a multi-stage plan.

In the first stage, the monetary authorities of the three currencies - dollar, euro, and yen - and the IMF will make a joint public commitment. In the communique, they will state that they recognize that stability between the three currencies is desirable and that they are politically prepared to do whatever they can to achieve this goal.

In the second stage, the four parties will establish a currency stabilization council composed of members of deputy-finance minister and central bank vice chairperson ranks. The council will meet at least every three months or more often if needed to exchange opinions, monitor international currency trends, and determine if any action is needed.

In the third stage, the council must reach a consensus on the reasonable or permissible level or range of exchange rates among the three currencies at that point in time. What is important here is that this agreement will not be a fixed agreement, but will be reviewed at every meeting and will be changed incrementally to meet any changes in the situation. Whether to disclose the agreed exchange rates would be subject to debate. Some may feel that keeping the rates confidential would help in suppressing speculation, as it would increase the risk of speculation. As long as the appropriate exchange rates as conceived by the monetary authorities are rational and are not affected by political interests, however, it would be more comforting for the market and would aid in suppressing overshooting and misalignment to make the agreed exchange rates levels public.

In the fourth stage, when a market exchange rate deviates from the agreed level or range and, judging from the speed or momentum of the deviation, there is a strong danger of overshooting, the four parties must decide on and execute a measure to prevent or correct the overshooting. Conceivable measures range from warning the market or verbally intervening in the market to actual market intervention and change in financial policy.

It is necessary for the four parties to agree in advance on the framework on a number of policies. One is that there must be a set of measures corresponding to different scenario. Another policy, this one concerning technical aspects of market intervention, is the level, timing, size, market, and method of intervention. There must also be a policy on financing and settling the fund required for interventions.

As this plan illustrates, there must be strong political commitment and extensive preparations to realize a scheme for stabilizing the exchange rates between major currencies. It is no simple task, but not an impossible one. It is an opportune time for the four parties to begin a study of such a scheme now that there is greater interest in stable foreign exchange rates.

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