IN SEARCH OF FURTHER STABILITY IN YEN EXCHANGE RATES

Institute for International Monetary Affairs

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Institute for International Monetary Affairs

Occasional Paper 3

Occasional Papers

No. 3

IN SEARCH OF FURTHER STABILITY
IN
YEN EXCHANGE RATES

Published by
I I M A ©
Tokyo
1997

Preface

This paper is the abridged and translated version of the one entitled "In Search of Further Stability in Yen Exchange Rates", written by a special committee of the Japan Foreign Trade Council, Inc., a leading private nonprofit organization representing the interests of the Japanese trading community (the "Council"), and originally issued by the Council in Japanese in March of 1996.

The paper is the first comprehensive study undertaken in Japanese industrial circles on the international monetary system, and we thought it important to encourage discussion on this issue in broader circles, both at home and abroad, by publishing this version compiled by the Council in our occasional paper series.

In connection with the original paper, the Council also held a symposium entitled "Towards More Stabilized Yen Exchange Rates" in Tokyo and Osaka in June of 1996, which was co-sponsored by IIMA.

Institute for International Monetary Affairs
January 1997

On the occasion of the publication of this abridged translation from the original version "In Search of Further Stability in Yen Exchange Rates"

The Japan Foreign Trade Council, Inc. established the Research Committee on Yen Stability in October, 1995, and finalized the special study report, "In Search of Further Stability in Yen Exchange Rates", in March, 1996.

Koichiro Ejiri, Chairman of the Japan Foreign Trade Council, Inc., and Chairman of the Board of Directors of Mitsui & Co., Ltd., chaired the said Committee, Mamoru Ishida, Advisor of Itochu Finance Corp., headed the study, and Hiromasa Kubo, Deputy General Manager of the Research Dept. of Marubeni Corp. was in charge of the Working Group, which prepared materials for the Committee.

Both the English and Japanese versions abridged in this booklet were prepared by Mamoru Ishida, and its publication was supported by the Keizai Koho Center (Japan Institute for Social and Economic Affairs).

Any inquiries should be addressed to the Public Relations Department of the Japan Foreign Trade Council, Inc. (Tel. 81-3-3435-5972, Fax 81-3-3435-5979, Home Page URL http://www.fjt.co.jp/JFTC/)

Japan Foreign Trade Council, Inc.
January 1997

What are the issues?

The Yen-Dollar exchange rate, which had moved around 100 Yen to the Dollar in the summer of 1994, appreciated to 79.75 Yen in April 1995 and then declined to around 100 Yen in October. There were no changes in economic fundamentals to justify this. The 20 Yen fluctuation in a relatively short period of time not only made Japan's economic slump even more serious than it otherwise would have been, but it also accelerated structural shift of production abroad. Such an accelerated production shift would not have taken place without the 20 Yen swing. The shift overseas continued through 1996, when the Yen stayed more or less stable around 110 Yen to the Dollar.

The reason for this is simple: a prudent management would not make large scale investment in Japan on the basis of a 110 Yen to the Dollar exchange rate, once they had seen the Yen appreciate to 80 Yen. In such circumstances, it is impossible to predict when such domestic investment will turn out to be a money-losing venture. That is why Japanese firms have shifted production to countries where costs are low enough to absorb possible exchange rate changes. The shift of production abroad, which would not have taken place without the 20 Yen swing if the Yen had always been at the level it is now, will have a negative effect on Japan's GDP and employment for a long time to come. The damage has been done. Such volatility in exchange rates in such a short time is not only unnecessary, but it is also detrimental to the economy.

It cannot be denied that the Yen-Dollar exchange rate fluctuations have accelerated the process of cutting Japan's huge current account surplus, but the negative impact on the Japanese economy itself could spill over to the rest of the world. That is one of the reasons why the major industrialized countries agreed in April 1995 to reverse the falling Dollar/ rising Yen trend.

Some economists have established that the historical Yen-Dollar exchange rates have tended to converge toward the theoretical exchange rates based on the purchasing power parity of tradable goods between Japan and the United States, and in this way they justify implicitly or explicitly the historical exchange rates. A pitfall of such ex-post analysis is that it underestimates or overlooks the underlying fact that Japanese firms firstly practise what is termed "pricing to the market"- cutting their profits - and then, when they start losing money and cannot hope to restructure their operations in Japan to become profitable, shift production abroad. From Japanese industry's point of view, the convergence of historical and theoretical exchange rates simply explains that no firm has been able to keep losing money indefinitely.

In view of Japan's large external surplus and the United States' large external deficit, the long-term trend of Yen appreciation against the Dollar is only natural. Structural changes in the Japanese economy accompanying normal appreciation of the Yen are also natural, even necessary. That is, indeed, how the market mechanism works. It may take longer for Japan's current account surplus to decrease, but it will do so without such a negative impact on Japan's economy as G7 recognized in April 1995. During the natural adjustment process, Japan should recycle the current account surplus to those countries in need of capital.

The problem for the Japanese economy has not been normal Yen appreciation, but excessive volatility and chronic overvaluation of the Yen against the Dollar. As long as such large fundamental disequilibrium remains between Japan and the United States, and the latter's net external liability position increases, certain changes in the American economic or political climate, or such external events as the Mexican crisis of 1994/95, may possibly trigger a Dollar crisis. This would still be possible, even if Japan's surplus decreased substantially, as is likely. As an example, even after her surplus disappeared, Germany has experienced frustrating appreciation of the Deutsche Mark whenever the market let the Dollar fall. It is naive to believe that sharp Yen appreciation will not happen again, if Japan's current account surplus decreases substantially. Should the Dollar plunge in another Dollar crisis, it is most likely to do so against the Yen.

Japanese industry has neither initiated nor participated in any study on how to stablize the Yen exchange rate. Individual firms, both manufacturers and trading houses, have accepted volatile exchange rate fluctuations as a given and made every effort to minimize the negative impact on their profit position by shifting production and procurement abroad. They cannot be blamed for concentrating on maintaining and increasing their earnings per share by so doing. However, discussions on exchange rate volatility and its remedy should not have been left to government officials, economists and bankers for so long, since they have offered no convincing explanation as to how exchange rates are determined nor any satisfactory policy proposals for stabilizing the Yen exchange rate .

Considering the damage that has been done, and may still be done, by excessive volatility and chronic overvaluation of the Yen, Japanese industry cannnot afford to be indifferent any longer. We believe it is time for Japanese industry to voice its views on these questions and use its experience of struggling with Yen volatility and overvaluation to revise the current exchange rate determination theory and help produce proposals as to how to stablize the Yen.

Trading houses may be in a better position to do this work than other firms, for, while other firms are often either export or import oriented, trading houses normally handle both. The exchange rates which individual manufacturers consider appropriate are also very diverse; some can cope with 80 Yen to the Dollar, while some others insist on 110 or an even weaker Yen. Thus, trading houses can be said to be unbiased and may therefore be able to put forward more credible views. Moreover, the fortune of trading houses basically rises or falls with the Japanese economy.

The Japan Foreign Trade Council, Inc., an association of Japan's trading houses and some manufacturers, set up a study group consisting of managers of finance and research departments of large trading houses. The group conducted a thorough review of historical exchange rate fluctuations and their causes in order to make proposals for stabilizing the Yen exchange rate. Ours is not an academic study as such, but an attempt to put forward industry's views to government officials and economists based on our experiences under the floating exchange rate system, so that they may take them into consideration when formulating policy or conducting research.

Our study consists of two parts. The first is about reform of Japan's financial market, which is solely Japan's own responsibility, and the second part is about reform of the international monetary system, which is a matter for the whole world and has to be addressed internationally, if Japan should play an active role to bring it about.

This report is an abridged translation of the original. To begin with we will give a brief summary of the first part of the study on reform of Japan's financial market. The second part will then be covered in more detail in "II. Reforming the International Monetary System."

I. Reforming Japan's Financial Market

First of all, why is it considered necessary to reform Japan's financial market in the context of stabilizing the Yen exchange rate?

The United Kingdom and the United States developed London and New York, respectively, into major international financial centers when they were the largest exporters of capital. Foreigners borrowed capital in

Pounds Sterling or US Dollars; that is, in the currencies of the capital exporter countries. London and New York provided long-term capital for economic development as well as short-term capital for trade between third countries by means of banker's acceptance. Exporting current account surpluses in such a manner made the exchange rates of their currencies stable, as it reduced the overall surplus by the amount of net capital export.

Japan became the world's largest exporter of capital in the late 1980s, but has failed to deregulate the financial market fast enough to facilitate the export of its current account surplus. That is why Japanese firms have overwhelmingly issued their bonds in the Euro-market rather than in Tokyo, and Japanese investors have purchased these bonds. It is not surprising that a very small number of non-resident issuers have come to the Tokyo bond markets. The primary bond market in Tokyo remained underdeveloped until the early 1990s, though some progress has been made rather belatedly since then. The secondary bond market remains notoriously inefficient.

As few non-resident issuers borrowed in Tokyo, Japanese institutional investors had to export capital by investing in assets denominated in foreign currencies. They bought large amounts of US bonds in the 80s and suffered seriously from exchange losses in the second half of the 80s, when the Yen appreciated beyond all expectation. This is the most important reason for their ceasing investment in US bonds in the early 90s. A possible exchange loss from the appreciation of the Yen against the Dollar would be too big for a modest gain from interest rate differentials between the Dollar and the Yen.

Thus, Japan's current account surplus was not exported in the early 90s as it was in the 80s. This is one of the reasons for the sharp appreciation of the Yen, but the Clinton administration's talk-up of the Yen also magnified it. The Bank of Japan had to intervene to buy the surplus dollars in the market. That was how Japanese capital was exported in the early 90s' to the United States and financed its current account deficit.

It is clear from these experiences that a reform of the Japanese financial market is badly needed. If reform was undertaken, Japan's current account surplus would be automatically exported, the supply-demand relationship of the Yen in the foreign exchange market would be more balanced, and exchange rate fluctuations would be less volatile. The importance of the Yen as an international currency would be enhanced.

With this and with the creation of the EU's single currency, the relative importance of the US Dollar as an international currency will decline accordingly, and automatic financing of the US current account deficit will not be as easy as it has been. In addition, the Unites States will find it more difficult to resist for long economic policy coordination and reform of the international monetary system to involve symmetrical obligations of every country. In short, a reform of Japan's financial market could contribute to a reform of the international monetary system.

Such a reform is also a surplus country's responsibility to the world. Regrettably, however, there is a long way to go before the Tokyo market can function as an efficient international financial center. The short-term money market as well as the long-term capital market is outdated because of restrictive regulations and practises. Taxes such as turnover tax on bonds or withholding tax on the interest from the short-term Treasury Bonds have been maintained for domestic reasons and are an obstacle to foreigners acquiring Yen assets.

Japan is the only major industrialized country to keep rigid foreign exchange controls - more rigid than some ASEAN countries. Since 1995 Japanese industries have been actively asking the Ministry of Finance to abolish them. The Japan Foreign Trade Council, Inc. has been one of the most active organizations in this campaign.

In June, 1996, a committee sponsored by the Ministry of Finance made a recommendation that Japan's exchange controls be deregulated to the same extent as other industrialized countries. Though it is a welcome step in the right direction, it is still possible that the Ministry of Finance may overlook the fact that other industrialized countries have no exchange controls as such. Whether the recommendation is to be fully implemented or not depends on the success of work to enact a bill which is in accordance with the committee's recommendation.

It is Japan's own responsibility to make the Tokyo financial market efficient so that the current account surplus may be exported to help other countries finance economic development or a temporary current account deficit.

II. Reforming the International Monetary System

1. Explanation on Exchange Rate Fluctuations

We will firstly attempt to explain how excessive volatility and chronic overvaluation of the Yen has been caused. This will amount to revising current exchange rate determination theory so that exchange rate fluctuations in the real world may be explained better; a process indispensable in considering reform of the internaional monetary system. We will then study existing reform proposals and make our recommendation.

A normally accepted theory is that exchange rates are determined by the supply and demand of currencies in the market. It is current account balances, accumulated current account balances and capital account balances that determine the supply and demand of currencies. If psychological factors at times change market expectations and cause larger fluctuations, such fluctuations are considered temporary aberrations. Being temporary, exchange rates should return sooner or later to where they belong. Economists, in both academic circles and market place, normally adhere to this line of reasoning.

We do not refute this theory, but do not think that it alone can adequately explain the excessive volatility and chronic overvaluation of the Yen exchange rate, against which Japanese firms have had to struggle to survive. Our experience is that what are considered temporary aberrations are of a more material nature and have more lasting effects on the level of exchange rates than can be appropriately termed temporary. They represent, in fact, the very volatility and chronic misalignment of exchange rates which we have seen under the floating exchange rate system since 1973.

At this point, it is appropriate to reiterate the earlier observation on the convergence of the historical and theoretical exchange rates. If the historical exchange rate eventually converged toward the theoretical exchange rate based on purchasing power parity, it happened as a result of a number of individual firms having had to give up operations in Japan. They were faced with swings in exchange rates, such as we saw in the first half of 1995, which could not be explained by changes in economic conditions. All this has had a negative short-term cyclical as well as long-term structural impact on the economy.

It is worthwhile to note briefly what was expected of a floating exchange rate. According to Milton Friedman, the first impact of any tendency toward a surplus or deficit in the balance of payments is on the exchange rate. A rise or fall in exchange rate will offset the incipient surplus or deficit. Changes in exchange rates occur rapidly, automatically and continuously, and so tend to produce corrective movements before tensions can accumulate and a crisis develop. A floating rate system will not interfere with each nation's pursuit of domestic stability according to its own interests. Exchange rates, while free to vary, are in fact highly stable. Friedman is dubious that speculation would be highly destabilizing. Paul Volcker writes in retrospect that Friedman's writings depicted "an idyllic picture of a benign world," in which the natural operation of exchange markets would automatically correct international disequilibrium, and domestic policies could go their own way because shifts in exchange rates would take account of different national rates of inflation.

Why then did the floating exchange rate fail to generate automatic international equilibrium and a stable exchange rate? In our view, each country's freedom to pursue its own domestic economic goals, coupled with the present political climate, resulted in a weakening of policy discipline - more in some countries than others - so that internal and external disequilibrium, which neither governments nor foreign exchange market have been able to cope with, has developed. The foreign exchange market panicks easily when it is concerned about the value of a major currency. In his testimony to the U.S. House of Representatives Committee on Banking, Finance, and Urban Affairs on April 13, 1994, George Soros said,"The instruments of hedging transfer the risk from the individual to the system.••••••• It behooves the people in charge of the system to provide stability. When everybody is out for themselves, they can destroy the system."

Except in the first half of the 1980s, when the Dollar was overvalued mainly due to the large interest differentials between the Dollar and the Yen, there have been repeated sharp rises of the Yen and falls of the Dollar, of which the immediate cause was often the talk-down of the Dollar by American administrations. Exchange rates nomally move in accordance with the economic principle of supply and demand, as with any other commodity. However, it is our experience that the talk-down of the Dollar or talk-up of the Yen have had significant effects on market expectations and thereby substantially magnified otherwise normal exchange rate fluctuation to produce excessive volatility and overvaluation of the Yen.

Though all this appears self-evident to us, it does not seem to be given adequate attention in normal exchange rate determination theory. Economists go so far as to recognize that psychological factors influence exchange rates, but seem to be reluctant to admit governments' attempts to change market expectations into their theory, for they do not fit well in sophisticated models. That is why the normal theory fails to explain fully the exchange rate moves we have experienced. Looking at the facts as they really are will be the first step to a more satisfactory explanation, and will in turn lead to convincing policy proposals to reform the international monetary system.

Now, let us examine the three phases of Yen appreciation since major currencies started floating in 1973, by referring to the Chart 1 "Historical Moves of the Yen-Dollar Exchange Rates." Remarks by former central bank and government officials such as Paul Volcker and James Baker and by professional economists will be quoted to show more succinctly than detailed analysis of the causes of exchange rate volatility.

We exclude the Yen appreciation phase following President Nixon's announcement on August 15, 1971 to terminate the American obligation to pay gold against the Dollar balances owned by foreign governments from our consideration, because it represents a correction of the chronic misalignment which had developed under the Bretton Woods fixed exchange rate system. To study it here will not serve our purposes.

The first phase (306 Yen to the Dollar in December, 1975 to 184 Yen in October, 1978)

We share the view Kathryn M. Domingues and Jeffrey A. Frankel expressed in their 1993 "Does Foreign Exchange Intervention Work?" that the substantial depreciation of 1977-78 began with a deliberate attempt by Treasury Secretary Michael Blumenthal and others in the Carter administration to "talk down" the Dollar. It was justified, in the absence of a willingness among trading partners, as a means to stave off the emerging trade deficits of the United States. But, as Domingues and Frankel say, the decline soon got out of control.

The second phase (260 Yen to the Dollar in February, 1985 to 124 Yen in May, 1988)

The second Reagan administration also practised talk-down of the Dollar. Treasury Secretary James Baker admitted at the Joint Economic Commitee on 30 January, 1987 that he had deliberately talked down the Dollar until the spring of 1986 at least. Paul Volcker later wrote on the precipitous declines in the value of the Dollar that the secretary of the Treasury at times seemed to be inviting further Dollar depreciation. It is no wonder that the market panicked, resulting in the plunge of the Dollar and sharp rise of the Yen.

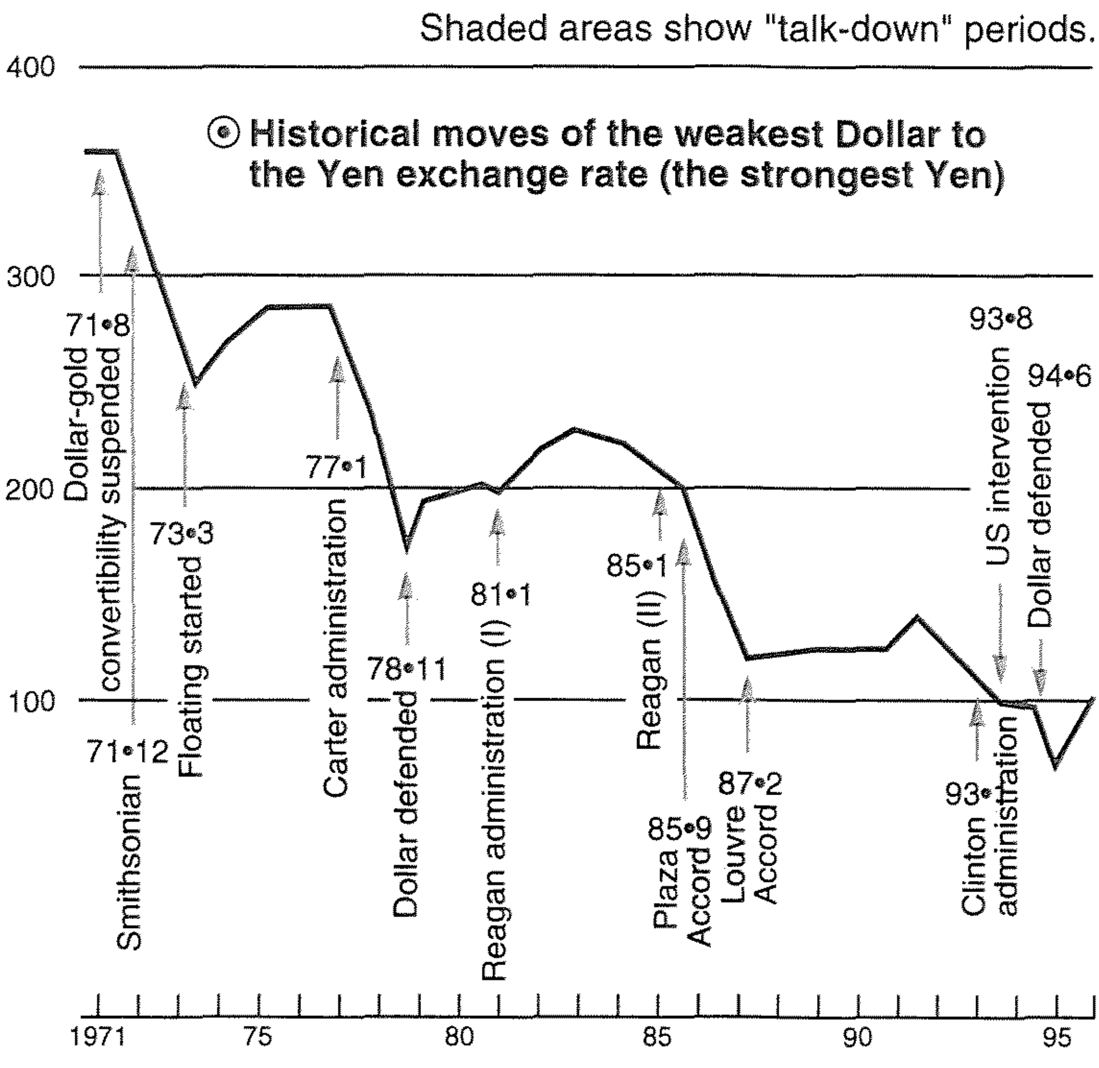
The third phase (260 Yen to the Dollar in February, 1990 to 79.75 Yen in April, 1995)

Soon after the inauguration of the Clinton administration both President Clinton and Treasury Secretary Lloyd Bentsen started talking down the Dollar, at times as a means of U.S. trade policy. It is interesting to see a German view as reported in the article "The Americans Pursue the Yen Appreciation Calmly" published in the Frankfurter Allgemeine Zeitung in August 1993, when the Dollar fell to 100 Yen for the first time. It stated that "the fact that it means depreciation of their own currency plays only a secondary role."

After the breakout of the Mexican crisis toward the end of 1994, the administration tried to calm the market, by repeating that it wanted a strong Dollar, but it failed to recover the market's confidence. International investors required too high a risk premium to buy and hold a currency, which government officials had kept stating that they wanted to see it depreciate. In 1995 the Dollar plunged under 80 Yen. James Baker, former

Treasury Secretary, who had practised talk-down himself while in office, said in an interview with the Nihon Keizai Simbun on the effects of the talk-down by the Clinton administration,"Since both President and Treasury Secretary have repeated openly that they wanted a weaker Dollar, the market has come to believe in their statements. It is now difficult to convince the market that is not the case ."

Chart 1: Historical Moves of the Yen-Dollar Exchange Rates



Based on Nikkei Business, September 19,1994

The above remarks by the former U.S. officials confirm our own experiences. In the three phases of Yen appreciation, talk-down tactics by the American authorities were interpreted by the market as a "signal" that it wanted to see a weaker Dollar, and caused concern about the value of the Dollar. There was a good reason for a decline in the value of the Dollar in any case; the United States had lost economic policy discipline under the floating exchange rate system. Both the IS balance and trade balance had been deteriorating. To engineer a further fall of the Dollar, there was no need for the authorities to sell the dollars in the market. Talk-down sufficed, for the market panicked easily and in this way depreciation of the Dollar and appreciation of the Yen can be said to have been artificially magnified.

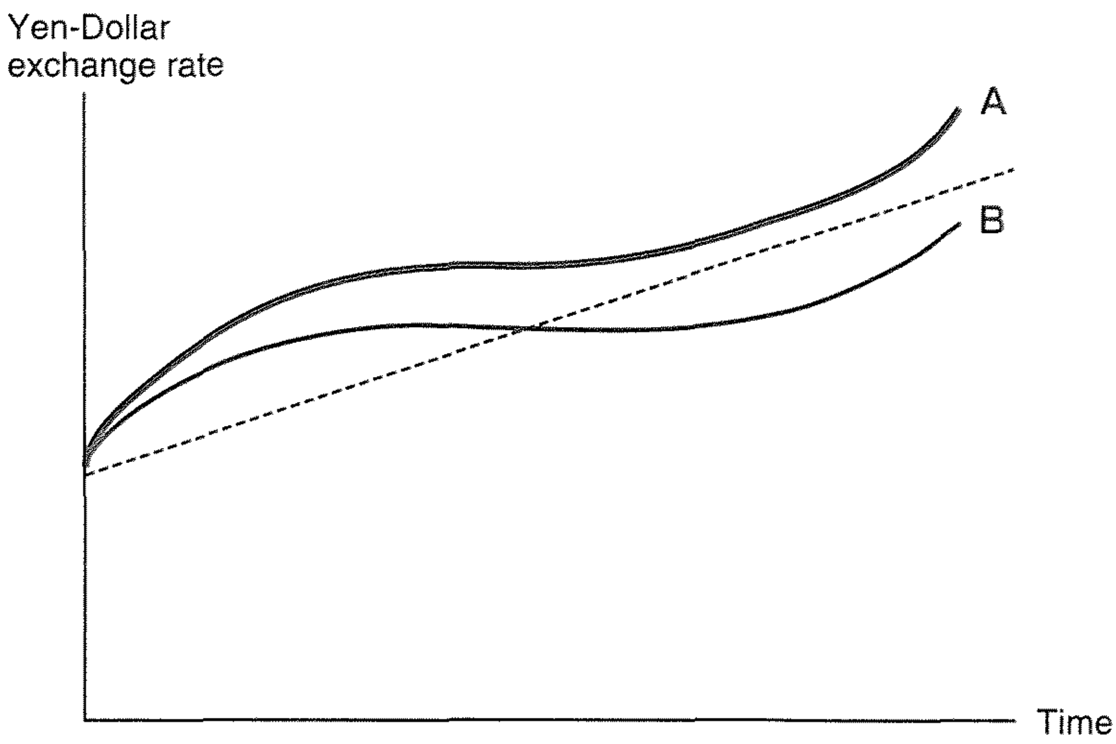
In their study on the intervention policy, Domingues and Frankel defined "signaling channel" as "a hypothesized means by which monetary authorities can use intervention to convey the information about future fundamentals to the market." We think likewise that talk-down, or talk-up as the case may be, can also be considered as a signaling by the authorities, for it is meant to convey to the market their view of the value of a currency in order to change the market's expectations. It is different from intervention policy, in that it is verbal and does not require financial resources. It may be cruder than well-organized intervention, but can be very effective, as our review of the three Yen appreciation phases has shown. Talk-down has often been enough to cause the Dollar to fall. On the other hand, after the market has panicked, it has proven difficult to support the Dollar by talk-up alone.

We have to recognize the actual effectiveness of talk-down, define it as the authorities' signal to the market to influence its expectations and give it a place in exchange rate determination theory. This requires an addition to that part of the theory which deals with market psychology. Then, the gap existing between our perception of exchange rate fluctuations and exchange rate determination theory would disappear.

The point is to have a theory that will explain reality better.

The three phases of Yen appreciation can be made into a model as shown in Chart 2 "Effects of Signaling." Curve B shows exchange rate moves that would result from economic conditions alone. Curve A, which represents actual exchange rate moves, is shown as "added on" Curve B. The area between Curve A and Curve B represents by definition that part of the exchange rate moves which is magnified by the authorities' signaling.

Chart 2: Effects of Signaling



Curve A: Actual exchange rate moves
Curve B: Exchange rate moves that would result from economic conditions alone

Some decline of the Yen after each appreciation phase shows a partial correction of overshooting. In each of the three phases of Yen appreciation, talk-down resulted in a Dollar crisis, after which a coordinated Dollar defence operation by major countries was undertaken. The Yen still tended to be overvalued even after partial correction, when next Yen appreciation phase set in. Thus, the level of the Yen rose higher and higher, representing chronic overvaluation of the Yen.

We believe it is essential to take the effects of talk-down into consideration to explain the exchange rate fluctuations in the real world. It should be the first step in studying how to reform the international monetary system. Otherwise, it would be impossible to find out which alternative to reform the international monetary system would be likely to eliminate excessive volatility and chronic misalignment of exchange rates.

It appears that successive U.S. administrations have taken advantage of what we might term "weak Dollar economics," which some American economists have maintained. They seem to apply the equation S-I=Ex-Im (savings minus investment equals current account balance, roughly speaking, export minus import) mechanically as a matter of economic policy, with neither side of the equation considered superior to the other. In short, the United States has two more or less equally valid policy alternatives to reduce the trade deficit; either to cut the budget deficit and thereby improve so-called IS balance or to weaken the Dollar to increase exports and decrease imports.

The weak Dollar economics has been politically convenient, as the U.S. administrations can avoid both tax increase and expenditure reduction, which are unpopular among the voters, by practising the theory that a weaker Dollar will eliminate the trade deficit. The weak Dollar economics as well as the weak Dollar policy reflects the U.S. political climate, and so it is almost irrelevant to talk about exchange rates without considering politics.

In summary, the floating exchange rate system has allowed the U.S. to lose economic policy discipline. Both the IS balance and trade balance have deteriorated significantly and the current account deficit has been accumulating to such an extent that the U.S. became the world's largest debtor nation within a decade. It is only natural, therefore, that the market is fundamentally concerned about the value of the Dollar. It is against this background that successive U.S. administrations have signaled to the market that they wanted to see a weaker Dollar. Predictably, the market panicked at times. And the result was a Yen-Dollar exchange rate that has shown excessive volatility and produced chronic overvaluation of the Yen.

2. The Proposal by the Bretton Woods Commission

What proposals on how to reform the international monetary system under discussion in the world today might be considered an option for us? It has to be one that makes both the excessive volatility and chronic misalignment of exchange rates less likely, if not impossible. It has also to appear realistic enough to be able to invite consideration by the political leaders of at least G3.

In this sense, we have to eliminate any fixed exchange rate system as unrealistic, however attractive it may appear in theory, as it will not be taken up seriously, much less implemented, by the international community.

The most realistic is a proposal to make the current floating exchange rate system function better by strengthening economic policy coordination. However, history suggests that this is easier said than done. Policy coordination has been attempted, whenever urgently needed, but forgotten whenever the urgency is gone. That is why it has been called "ad hoc."

The informal ad hoc economic policy cordination we have known has failed to prevent each country from pursuing its own economic goals, as its political situation demanded, even when it had undesirable effects on other countries and the world economy at large. The United States, in particular, has not been able to recover the economic policy discipline it lost under the floating rate system, which had been expected to cure external disequilibrium automatically. The United States let both IS balance and trade balance deteriorate. When its trade balance did not improve as expected, the U.S. tended to regard the Dollar as still too high and practised talk-down.

At times policy coordination was used as an excuse to avoid required national policy adjustments. That was why Martin Feldstein called it "ruinous coordination." In fact, the United States has often taken advantage of its key-currency status and pressed Japan and Germany for necessary adjustments. The fact that the key currency country has the priviledge to forego the necessary adjustments, which non-key currency countries are forced to make, is known as "asymmetry." A new international monetary system will have to be more symmetrical - requiring equal economic policy discipline of every country.

The point is, therefore, what is meant by "strengthening economic coordination" in such a proposal. In this sense, we believe that the proposal which the Bretton Woods Commission made public in July 1994 on the 50th anniversary of the Bretton Woods Conference deserves serious attention. The Bretton Woods Commission is a study group consisting of former government and central bank officials, bankers and professional economists, and is headed by Paul Volcker, former Chairman of the U.S. Federal Reserve Board.

The following are extracts from the Commission Report.

"The governments of the major industrial countries should give a high priority to international monetary reforms aimed at reducing large exchange rate fluctuations and serious misalignments. However, this has to be based on a broad improvement in economic policies. Therefore, the major industrial country governments should take two successive steps.

- first, strengthen their macroeconomic policies, and achieve greater economic convergence, and
- second, establish a more formal system of coordination to support these policy improvements and avoid excessive exchange rate misalignments and volatility."

"In time, this system could possibly involve flexible exchange rate bands, within which exchange rates could move without mandating a policy response. If so, the system will have to define government obligations when exchange rates threaten to break the boundaries of those bands. And it must define rules for making exchange rate adjustments, which serve to shift the bands themelves and ensure the necesssry long-term flexibility of the system."

"The IMF should be given a central role in the development and implementation of these reforms."

Governments interpreted the above "flexible exchange rate bands" as meaning "target zone" and reacted adversely to the proposal. A target zone would bind the United States so that it would lose the freedom to pursue its own economic goals. They knew that U.S. politics would not tolerate this. That was probably the main reason why the proposal was renounced as unrealistic.

Surplus countries, which had to import inflation from the United States under the Bretton Woods fixed rate regime, now suspected that history might repeat itself under the new target zone. However, a target zone is different from a fixed rate system in that differentials in inflation among the participating countries are adjusted by shifting the target zone accordingly. Therefore, if the United States fails to recover the economic policy discipline, surplus countries will not have to import inflation as under the fixed exchange rate system. They will not be in any worse position than they are now. Therefore, the possible import of inflation from deficit countries cannot be an excuse for surplus countries to refuse to consider the Bretton Woods Commission proposal.

Should reform of the international monetary system largely in line with the above proposal be realized, macroeconomic convergence among the major industrialized countries would be enhanced. And if a more formal system of policy coordination should lead to flexible exchange rate bands, governments, including the U.S. government, would be obliged to make necessary economic policy adjustments to keep exchange rates within these bands, until inflation differentials became large enough to justify a shift of the bands. The U.S. government would have to persuade the American voters that it is in their interests to keep the international commitment, for, as John Williamson and Randall Henning said, "each country will benefit by rules that tie down others in an equivalent way." There would not be room for the kind of talk-down of the Dollar that we have seen, and exchange rates would be far more stable than they have been in the past two and half decades.

Nobody would deny that it is difficult to implement the Bretton Woods Commission proposal. However, it does not seem utterly impossible for the major industrial countries to agree to start studying it for the following reasons.

Firstly, there exists an international consensus on the desirability of strengthening economic policy coordination to ensure more stable exchange rates. European countries and Japan have long complained about the unstable Dollar and asked the United States to improve its macroeconomic position. Faced with wild fluctuations of the Dollar exchange rates, Europeans established the European Monetary System in 1979, which was meant, in the words of Helmut Schmidt, to be a

European stability zone to discipline and harmonize economic behaviors of the EC member states. The European Monetary Union will be a culmination of their economic policy coordinations.

The Halifax Summit recognized that policy coordination is an important factor in promoting a stable foreign exchange market. In the United States the Competitiveness Policy Council stated in its Fourth Report to the President and Congress in September 1995, "Recent movements in the exchange rate of the Dollar against some currencies suggest the continuing need to improve the international monetary regime. Wide swings in exchange rates serve as a source of uncertainty for US exporters." It should be noted that the Competitiveness Policy Council has politicians, businessmen and union leaders as well as professional economists as its members and that the report represents their consensus. Even George Soros, known as speculator, says, "I think the people in charge of the monetary system need to coordinate economic policies so that currency fluctuations are not too great; so that you don't have fundamental imbalances." Some economists who have had influence on the U.S. foreign exchange rate policy such as Fred Bergsten have also been ardent advocates of the target zone for a long time.

Secondly, the world has tried a reference zone once, as agreed at Louvre. Diagram 1 shows a three year period of relatively stable exchange rates following the Louvre Agreement. With this historical precedent, the Bretton Woods Commission proposal cannot be said to belong in "dreamland." The reference zone "à la Louvre" collapsed, because the Agreement was an informal one and was not binding to ensure policy coordination among governments. That is a probable reason why the Bretton Woods Commission proposed "a more formal system of coordination."

The third reason is how the proposal was formed and discussed after its publication. Nearly half of the 47 members of the Bretton Woods

Commission had once been officials of the monetary authorities. The report is said to reflect a broad consensus and is addressed to the member governments of the Bretton Woods institutions. It can clearly be seen from the following extracts from the report that they meant it as a warning to the world:

"Establishing a new system is a long-term goal; work should begin on it now. ••••• Further delay would be unfortunate." "Anything that can strengthen the international economy and lay a stable foundation for building faster, sustainable growth is urgently needed."

"This is the time for the major industrial countries to review arrangements for global economic cooperation and to begin designing an improved international monetary system."

Moreover, the proposal was discussed at the time of publication at a meeting in which not only the members of the Bretton Woods Commission but also the incumbent government officials took part. They agreed that the present international monetary system did not function satisfactorily, in that it failed to prevent exchange rate volatility and chronic misalignment, and that policy coordination to make the system function better had not been effective enough in the past. In short, they agreed on what were the problems.

However, government officials of the United States, Japan and Germany did not agree to the proposal that a more formal system of coordination be established in which the IMF would play a central role. Their reluctance is understandable in view of the unfavorable political climate. Without strong political will to persuade the voters that reform is in their best interests, any attempt to promote the proposal would demand enormous energy but would surely fail. It seems that "to begin designing an improved international monetary system" would require pressure from above as well as from below; that is, political leadership on the one hand and the favorable opinion of business leaders and economists on the other. We have seen that business leaders were present in the US Competitiveness Policy Council. Their Japanese counterparts should also play a similar role.

At the meeting there was a consensus that it was up to G3 to improve the international monetary system. The world has been moving away from a single dominant key currency system toward a rather unstable multi-currency system, and so it is necessary to establish a stable relationship among the three poles of the United States, Japan and the European Union .

The Bretton Woods Commission proposal was formed by former government officials and central bankers, bankers with international experience and economists, and then discussed with the incumbent monetary authorities. In this sense, it has been prepared for further study like no other proposal. The proposal itself is moderate and reasonable. We agree with its message and the warning it has sent to the governments concerned. It is unlikely for any better proposal to appear in the foreseeable future. Therefore, if the international community intends to reform the international monetary system, the Bretton Woods Commission proposal is practically the only one worth serious attention.

Conclusion

We have seen that the excessive volatility and chronic misalignment of exchange rates under the floating exchange rate system have been caused by both lasting fundamental disequilibrium and governments' signaling to the market. The effects of such unstable exchange rates on the economy have proved quite serious.

A reform of the international monetary system is badly needed. In order to have more stable exchange rates, we have to have a system that will prevent both lasting fundamental disequilibrium and governments' signaling to the market. A reform proposal has to be moderate, reasonable and realistic enough to merit study by G3 or G7. The only credible proposal at the moment is the one made by the Bretton Woods Commission in 1994.

That the monetary authorities reacted negatively at the time of its publication shows how difficult it is to implement it in the current political and economic climate. A strong political will is required. As a first small step, we have called on Japanese government to try to form a consensus among G3 or G7 to start studying the proposal. We would like to see political and business leaders in each of the major industrialized countries work together, and professional economists contribute to reform in their own way.

John Ikenberry writes in his study "The Political Origins of Bretton Woods" that the Bretton Woods agreements, which represented an unprecedented experiment in international rule making and institution building, were not inevitable. What, then, made this "political miracle" possible? First of all, a common belief in the desirability of currency stability had emerged in the aftermath of the economic depression in the 1930s. "New thinkers," such as J.M. Keynes, provided the intellectual and political basis for "coalition building on a grand scale," which was indispensable for such an unprecedented international project. Political leadership, in the figure of the U.S. President Franklin D.Roosevelt, made it possible to create the Anglo-American coalition that included government officials, economists and lawyers. At the Bretton Woods conference in 1944, President Roosevelt advanced the claim that the economic health of every country is a proper matter of concern to all its members, near and distant.

In the mid 90s, there seems to exist a consensus that currency stability is desirable. The Bretton Woods Commision proposal could be an intellecual basis for coalition building. However, we see no political leadership that will create the international coalition needed for reforming the international monetary system. The time may not be right yet for such reform. Ikenberry observes that all increments of historic time are not equal. He sees that there are breakpoints when the possibilities for major changes are particularly great. In this centrury, the several years surrounding 1945 would surely be one such moment. The ending of a major war or the aftermath of a large-scale economic crisis alters the parameters of policy-making. Should we wait until such a large scale economic crisis, if not a major war, forces the international community to start studying reform of the international monetary system?

What should Japan do now? There are two alternatives; either to keep responding reactively to events as in the past and live with excessive volatility and chronic misalignment of exchange rates, or to join those in the world who demand more stable exchange rates and work to realize a better international monetary system.

We believe that the second alternative is in the interests of both Japan and the world. Even if the final goal of a new international monetary system is not achieved, a stronger world opinion for reform will affect the economic policy coordination and macroeconomy of each country for the better.

Therefore, we now call on the Japanese government and political leaders to make an effort to form a consensus among G3 or G7 countries that they should start studying reform on the basis of the Bretton Woods Commission proposal. Japan should also deregulate its financial market to the same extent as other international financial centers so that the current account surplus can be recycled to the world. Not only will it stabilize the Yen exchange rate fluctuations, but it will also allow Japan to function properly as the largest capital exporter of the world.

In spite of the importance of exchange rate fluctuations on the economy and life of the people, there have been few continuous discussions in Japan on how to stabilize exchange rates. And few Japanese views seem to have been despatched to the world. That is why we have prepared the present English version of our study. We would be more than happy, if it should stimulate dialogues between Japan and other countries on this very important issue.

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