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INTERNATIONAL ECONOMIC POLICY: THE ROLE OF EXCHANGE RATES

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ABSTRACT

This paper examines the role of exchange rate changes in the international economic adjustment and policy process. The pre-1973 academic literature on flexible exchange rates is examined in light of the experience since 1973. Some thoughts on the efficacy and appropriate role of exchange rate changes in the international economy are then presented.

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Edwin M. Truman¹

The reallocation of resources that follows upon sharp changes in exchange rates and competitive positions is, of course, not instant or automatic. It takes time and it takes effort.

For the longer run, the outlook seems to be promising for the achievement of a sufficiently flexible international adjustment mechanism so that we need not again experience the very large and persistent international imbalances that have been so troubling during the past few years.

The above quotations are from testimony by Federal Reserve Governor Dewey Daane in May 1973. The United States was struggling with an imbalance in its international payments after two devaluations of the dollar. Two months previously, the industrial countries had resorted to what was hoped would be a temporary generalized floating of their currencies in the face of frustration (at least by the markets) that the process of adjustment was so slow. At the same time, Daane held out the hope that this period of instability would be followed by a regime designed by the Committee of 20 in which the adjustment of international imbalances would be smoother and, implicitly, one

1. Staff Director, Division of International Finance, Board of Governors of the Federal Reserve System. This paper represents the views of the author and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or other members of its staff. I have benefitted in preparing this paper from suggestions by Hali Edison and Peter Hooper. A version of this paper was presented at the International Finance and Financial Policy Conference in honor of Dewey Daane on his retirement at Vanderbilt University, Nashville, Tennessee on April 13-14, 1989.

in which exchange rates would be stable but adjustable, with provision for floating in particular situations.²

Dewey Daane had it about right in May 1973: Exchange rates can play a powerful role in the international adjustment process, as long as they are assisted by other policies and patterns of behavior, which is a point he elaborated on in his testimony. It also was reasonable to hold out the hope of greater international monetary stability in the future without excessive reliance on changes in exchange rates.

I have long been bothered by frequently heard complaints that the advocates of floating exchange rates among the academic economists in the 1950s and 1960s promised policy makers substantially more than what more flexible exchange rates have produced. I have conducted a non-exhaustive search of the academic literature from that period.

First, I consulted Milton Friedman's famous 1953 essay and offer four quotations to jog the memory:

First, advocacy of flexible exchange rates is not equivalent to advocacy of unstable exchange rates. The ultimate objective is a world in which exchange rates, while free to vary, are in fact highly stable. Instability of exchange rates is a symptom of instability of underlying economic structure. (page 414)

Under flexible exchange rates freely determined in open markets, the first impact of any tendency toward a surplus or deficit in the balance of payments is on the exchange rate. (page 416)

In effect, flexible exchange rates are a means of combining interdependence among countries through trade with a maximum of internal monetary independence; they are a means of permitting each

2. The last part was implicit because it was not yet U.S. policy.

country to seek for monetary stability according to its own lights, without either imposing its mistakes on its neighbors or having their mistakes imposed on it. (page 430)

The actual path of adjustment may involve repeated overshooting and undershooting of the final position, giving rise to a series of cycles around it or a variety of other patterns. We are here entering into an area of economics about which we know very little, so it is fortunate that a precise discussion of the path is not essential for our purposes. (page 433)

My search, as often is the case in such examinations, was inconclusive. The first quotation acknowledges, at least on a charitable reading, that flexible exchange rates need not be stable. The second suggests that flexible exchange rates would always tend to move in a way to close an imbalance.³ The third makes the now-familiar case for policy independence. The case is implicitly qualified; that is, the case is made for the maximum, not total, independence. On the other hand, the fourth quotation suggests some concern about the dynamics of the adjustment process and implicitly opens the door for some management of the results caused by changes in exchange rates alone.

Milton Friedman comes out reasonably well on this reading: The case for flexible rates is a bit overstated, but after all he was making his case 35 years ago.

I next turned to Harry Johnson, writing in 1969, and offer four more quotations:

The freedom of rates to move in response to market forces does not imply that they will in fact move significantly or erratically: they will do so only if the underlying forces governing

3. As John Makin (1989) points out, one must be careful what one calls an imbalance, but one also would be hard pressed today to endorse Friedman's strong statement of 1953.

demand and supply are themselves erratic, and in that case any international monetary system would be in serious difficulty. (page 91)

A freely flexible exchange rate would tend to remain constant so long as underlying economic conditions (including governmental policies) remained constant; . . . On the other hand, if economic changes or policy changes occurred that under a fixed exchange rate would produce a balance-of-payments surplus or deficit, and, ultimately, a need for policy changes, the flexible exchange rate would gradually either appreciate or depreciate as required to preserve equilibrium. (page 100)

Flexible rates would allow each country to pursue the mixture of unemployment and price trend objectives it prefers, consistent with international equilibrium, equilibrium being secured by appreciation of the currencies of "price stability" countries relative to the currencies of the "full employment" countries. (page 100)

. . . [G]overnments that believed in demand expansion as a means of promoting growth could pursue this policy a outrance, without being forced to reverse it by a balance-of-payments crisis, so long as they and the public were prepared to accept the consequential depreciation of the currency; governments that believed instead in other kinds of policies would have to argue for and defend them on their merits, without being able to pass them off as imposed on the country by the need to secure equilibrium in the balance of payments. (page 110)

This excursion into the later literature was only slightly more satisfying than my rereading of Friedman.⁴

The second and third quotations repeat Friedman's arguments that, in response to a change in underlying conditions, exchange rates will move (gradually) to reestablish equilibrium

4. I found in the margin next to the first quotation, a notation I made on an earlier reading. I described Johnson's assertion that exchange rates would move erratically only if the underlying forces were erratic as "overstated."

and that floating exchange rates will insulate countries and allow them to follow their individual policy preferences, implicitly without external spillover effects. In fact, Johnson did not actually write that there would be no spillover effects, but I was disappointed that he did not say there might be some.

In the fourth quotation, Johnson did note that the "deviant" country would have to be prepared to accept the internal implications of an appreciating or depreciating currency. The implication was that flexible exchange rates are not costless alternative environments in which nothing else changes except the exchange rate regime. This was encouraging to someone who did not want to believe that the economics profession had completely misled the policy makers, but it is fair to say one can understand why the policy maker was misled.

I also looked for some balance to the advocates of flexible exchange rates in the writings of others. I thought that I would find it in Henry Wallich's remarks at the AEA convention in 1968 where he declared himself "a defender of fixed exchange rates." However, Wallich chose not to take on the general issue but rather commented on U.S. exchange rate policy. I did find a reassuring statement by Peter Kenen who was part of the same panel:

I would, myself, predict that flexible exchange rates would move too often -- when change is suboptimal as well as optimal -- even as pegged rates move too infrequently. But I do not know which is worse.

The economics profession may have imperfectly understood exchange rates twenty years ago. Nevertheless, it is fair to say

we now understand that flexible exchange rates did not and do not represent a "costless" way out of difficult policy choices for countries and their leaders.

As Dewey Daane pointed out in his testimony in 1973, flexible exchange rates do not offer a painless or instantaneous way of achieving external balance. I would submit that is the basic lesson U.S. policy makers have learned in the 1970s and 1980s: exchange rates are too important to be ignored in the policy process. In early 1970s and, again, in the late 1970s, in the face of an overheating economy, a depreciation of the dollar added substantially but indirectly to inflation pressures through added demands on resources that came on top of their direct influence through higher prices of imports.

In the 1980s, changes in the dollar's external value have created unwanted distortions in the U.S. economy. In the early 1980s, the dollar's appreciation was propelled by fiscal stimulus in the United States and fiscal restraint in other industrial countries.⁵ This brought about substantial dislocation and distress in the rust belt. In the late 1980s, we have had a different potential problem: the possibility that external adjustment may proceed rapidly under circumstances in which domestic resources are essentially fully employed and the U.S. economy is not able to generate the domestic savings to replace the lost foreign savings. Under such circumstances, we would face a choice between inflation and higher interest rates

5. John Makin's (1989) analysis of this phenomenon is one with which I agree. For an earlier version of the same argument, see William L. Helkie and Peter Hooper (1987).

to curtail investment, or a combination of the two and, perhaps, slower adjustment.

It is important today also to appreciate that floating exchange rates have not insulated low-inflation countries that tend to be in surplus such as Germany and Japan. As a consequence of the growing recognition that floating exchange rates do not offer an "easy way out" of countries' policy problems, we have seen a revival of the so-called "discipline" argument for greater fixity of exchange rates.

The discipline argument for greater fixity of exchange rates is respectable, maybe especially in the second-best world in which most policy decisions are taken. However, one must be careful not to let the pendulum swing too far back toward the situation of excessive fixity that prevailed prior to 1973.

In this connection, we should consider that exchange rates have both micro-economic and macro-economic implications. The wide swings in exchange rates during the 1980s probably contributed to an increase in manufacturing productivity in this country and abroad. As the dollar rose, U.S. manufacturers were forced to look abroad for new lower-cost sources of supply and were forced at home to adopt improvements in production methods that they never would have considered in the absence of the impetus from the dollar's appreciation. As the dollar declined, the same process was repeated in other industrial countries. This might be described as a Schumpeterian view of the role of exchange rates in the modern industrial economy.

This is an elaborate way of saying that there may be benefits at the micro-economic level of flexible exchange rates and wide swings in exchange rates. Moreover, the costs of flexible exchange rates in terms of their adverse effects on investors or on the volume of international trade have not yet been convincingly established. A recent review of the literature by Hali Edison and Michael Melvin (forthcoming) concluded (1) "one must be very careful when drawing conclusions regarding the effects of exchange rate volatility" on investors and (2) "research has not produced one-sided evidence that exchange rate variability has any particular effect on the volume of international trade."

Aside from the issue of the micro-economic costs and benefits of flexible exchange rates, changes in exchange rates are sometimes viewed as being ineffective at the macro-economic level in bringing about external adjustment. As described by John Makin (1989), this view has led some to an advocacy of increased reliance on managed trade.⁶

In part, the view that exchange rates are ineffective in bringing about external adjustment is based on a suspicion that the mechanism by which changes in exchange rates are transmitted to prices of imports has been altered in recent years, at least for the United States, because of changes in the structure of our trade or changes in the structure of markets. Peter Hooper and Catherine Mann (1989) recently examined this

6. I think it is correct to speak of "increased" reliance on managed trade since many areas of trade are already rather heavily managed.

issue carefully and reached the conclusion that there is little evidence to support the proposition that the so-called "pass-through relationship" between exchange rates and the prices of imports has changed over the past decade.

If proof of the effectiveness of changes in exchange rates in bringing about external adjustment in today's world is needed, one should consider the situation of the heavily indebted developing countries. Faced with an external borrowing constraint, many of these countries have brought about substantial changes in their real exchange rates and have achieved substantial changes in their external trade positions since the early 1980s. The experience of these countries has important implications for the United States: in the absence of sufficient internal adjustment of savings, the result in these developing countries has been high real interest rates in the domestic market and accelerating inflation. Moreover, contrary to the views of some, such as Ronald McKinnon (1988), who argue that changes in exchange rates are irrelevant to the adjustment process because changes in nominal exchange rates will be swamped by changes in domestic price levels or induced income effects, changes in real exchange rates in the developing countries have been sustained.

John Makin (1989) presents the case why we should not worry about the sustainability of the U.S. external deficit. He makes the case more convincingly for why we should worry about our external deficit and the associated buildup of our external debt when he states (p. 25): "The burden of the debt, beyond

servicing it[,] lies with the fact that its existence means that policy mistakes or unforeseen shocks are punished more severely."

In my view, exchange rates are extremely important economic variables. Moreover, exchange rates have an important role to play in the process of cooperation, consultation and coordination of economic policies internationally. Their behavior has broad implications for the health and smooth functioning of our economy and the world economy, and policy makers ignore them at their own risk.

If economists in the 1950s and 1960s believed that flexible exchange rates offered a panacea to makers of economic policies -- a proposition about which I remain somewhat skeptical -- they were mistaken. However, those economists were wise to try to move the focus of the debate about the international monetary system away from the regime of fixed exchange rates of that day. Dewey Daane spent a great deal of time listening to and participating in those debates. I regret to say that not much progress has been made in the 15 years since he left the Federal Reserve Board in reforming the international policy environment in which these issues are discussed, but we are still trying.

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