Exchange Rate Choices: Discussion

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Richard Cooper has presented us with a characteristically comprehensive and innovative interpretation of both the intellectual and the real-world evolution of the exchange rate system. He has covered both the industrial and the developing countries. He addresses the long-run sweep of history as well as the current and prospective problems that face policymakers, the markets, and the intellectual community.

In my view, Cooper emphasizes two particularly important themes. One is the high cost of freely flexible exchange rates, that is, the likelihood that market error will be as great or greater than governmental policy error. Second is the need to view the exchange-rate system as an evolutionary process that may now be in an intermediate period, en route to a more fundamental regime choice in a decade or two. My remarks will focus on these two ideas.

Cooper is clearly correct about the high costs of free floating for most countries, especially for emerging market economies, but for highly industrial countries (including the G-3) as well. He could have stressed even more the enormous costs of our one true experience with free floating in the industrial world, the United States under Beryl Sprinkel in the years 1981 to 1985: the prolongation of recession for much of American manufacturing and agriculture, with some irreversible effects because of induced foreign investment; the substantial threat to the global trading system that ensued from the resultant outbreak of American protectionism (leading the "free trade" Reagan Administration to install import quotas on cars, machine tools, and steel and prompting key Congressmen to say that "the Smoot-Hawley tariff itself would have

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passed had it come to the House floor in 1985"); the shift of the United States from the world's largest creditor to the world's largest debtor country, the full impact of which will only eventuate over time; and the several near misses of a "hard landing" due to the sharp decline in the dollar that occurred in 1987.

At the same time that free floating is so costly, relatively few countries meet the criteria for the adoption of a currency board (or its more extreme form, dollarization): very small open economies (à la Hong Kong) or those with such traumatic experience with hyperinflation that they are willing to undergo virtually any adjustment cost to find a stable anchor (à la Argentina).[1] Hence the "corner solution"—the view that until recently has been so fashionable in the academic literature, that the only sensible choice is between free floating and unalterable fixity—is of limited relevance in the real world.

Given the costs and problems of both free floating and unalterably fixed exchange rates, *the practical policy issue for most countries at most times—including the United States and the rest of the G-7—is how they should operate a managed float*. But a move to "greater exchange rate flexibility"[2] leaves open all the important and interesting questions, including the following:

- What *range of fluctuation* is consistent with underlying economic fundamentals and hence acceptable?
- What *policy tools* can be deployed to keep rates within those limits?
- Should the limits be *decided in advance* or implemented ad hoc?
- If decided in advance, should they be *announced* or implemented quietly?
- Should the country pursue its regime *unilaterally or in tandem with other countries*?

I will suggest answers to these questions after addressing Cooper's second major theme, that we are now in an unstable transition period. This proposition leads him to reiterate his proposal that the G-3 should adopt a vision of creating a currency union "a decade or two into the twenty-first century." I believe that Cooper's case for moving in that direction is correct. But that leaves us needing a transitional regime for at least the next 10 or 20 years, which Cooper implies comes down to a choice between target zones and McKinnon's "alternative but not dissimilar arrangement" for targeting G-3 monetary policy on a common price index.

If this is the choice, there is no choice. We know that the three major

[1] See Williamson (1995).

[2] As advocated in many recent statements by officials and by Barry Eichengreen, a former advocate of the "corner solution," in Eichengreen (1999).

industrial areas are not going to adopt a new monetary regime primarily for international purposes. They are not going to install a common, or indeed any, inflation target. Nor would they commit to unsterilized intervention, even at rather wide currency margins. Hence target zones are a much more feasible prospect than the "McKinnon rule."

I believe my own advocacy of target zones rests on a more positive case, however.[3] That case rests on three simple propositions.

First, *target zones are an effective method for managing flexible exchange rates*. They feature wide bands of ± 10 to 15 percent (contrary to Cooper's suggestion that target zones can have wide "or narrow" bands and that Bretton Woods, which he properly characterized earlier in his paper as an adjustable peg system, was a target zone regime). Assuming that the authorities can get the rates roughly correct, and establish and maintain their credibility in the market, rates will float virtually all the time (as in the European Monetary System after it shifted from an adjustable peg regime to target zones in 1993). Target zones cannot properly be viewed as a variant of fixed rates.

Second, *target zones have a very limited and very simple purpose: avoidance of large, prolonged misalignments*. They do not seek to limit currency volatility (though they might well have that effect). They do not purport to discern precise equilibrium levels; hence they do not seek to fix rates or even fine-tune them. They seek simply to avoid huge and prolonged misalignments, like the dollar in the middle 1980s and the yen on several occasions since (as described by Cooper), which are so costly to both the countries involved and the world economy as a whole.

Third, *target zones would be defended by a combination of three factors*: the wide margins themselves, which should normally promote stabilizing speculation and mean reversion; sterilized intervention, which has been demonstrably successful on most occasions since 1985 when pursued properly (most recently, to strengthen the dollar in spring-summer 1995 and to strengthen the yen in summer 1998); and, probably on rare occasions, by changes in national monetary policies—undertaken by either the appreciating-currency country or the depreciating-currency country, depending on the state of the world economy[4]—and generally in a direction that is consistent with the long-term requirements of the domestic economy.[5]

In today's real world, the practical choice is between target zones and the ad hoc episodic intervention practiced by current G-7 officials (including in the United States). The problem with the latter alternative is

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[3] As elaborated most recently in Bergsten and Henning (1996). See also my "How to Target Exchange Rates" in *The Financial Times*, November 20, 1998.

[4] Per the guidelines laid out in Williamson and Miller (1987).

[5] As testified in the case of the United States by Volcker (1995) and in more detail in Gyohten and Volcker (1992).

that it is almost always undertaken too late; as Cooper notes, the yen should never have been permitted to appreciate to 79:1 in 1995 (actually, more than Cooper indicates) nor to depreciate to 145:1 in 1998. The fact that sterilized intervention succeeded spectacularly in both cases—in the latter, leading to a rapid yen appreciation all the way back to 108:1—suggests that the officials could have held a target zone of, say, 90:1 to 110:1 (as proposed by Volcker, me, and several others from 1994 forward) without disturbing monetary policy in either the United States or Japan. Moreover, the absence of official guidance has left, indeed led, the markets to drive rates far from their long-run equilibrium levels.

No exchange rate regime is perfect or without costs and risks, nor will it work perfectly on every occasion. But widespread adoption of target zones, especially by the G-3 but by a large number of emerging market economies as well (probably as *crawling* bands), would seem to have several advantages at the present time. Zones would achieve most of the virtues of both fixity and floating while avoiding the worst features of both, as emphasized by Cooper. They could provide a transitional regime that, via progressive narrowing of the bands as experience built, would enable the world to move over time in the direction of Cooper's G-3 monetary union. If a large number of developing countries decided to dollarize (or euro-ize), target zones would become even more valuable, because it would then be even more important to avoid large, prolonged misalignments of G-3 rates. The target zone option should be seriously considered in the current debate over the future of the international financial architecture.

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