Comments and Discussion

Stanley Fischer: Each of the four papers in this symposium is extremely convincing on many points. But they differ on the central issue, whether we should return to fixed exchange rates—or their judicious equivalent, target zones for exchange rates. My comments will be directed to uncovering and evaluating the judgments that lead the authors to their different conclusions. I conclude in agreement with the Branson-Dornbusch team, though not for identical reasons, that target zones are not a good idea.

Table 1 summarizes the positions of the papers on the two key questions isolated by Rudiger Dornbusch. The agnostic entries represent positions taken in the papers for this symposium, not necessarily the views of the authors expressed on other occasions.

Here are the five points in the papers on which we should agree and on which I believe all four authors agree.

—Nominal and real exchange rates have fluctuated a great deal in the past thirteen years, far more than the proponents of flexible rates would have predicted.

—Real exchange rate appreciations bring protectionist pressures that are potentially destructive of one of the major achievements of the post–World War II era—the restoration of world trade to the levels of the 1920s.

—From William Branson we see that manufacturing output is, other things being equal, negatively correlated with the real exchange rate, "other things" being trend, the real price of energy, and the employment ratio. This is evidence that a less valuable dollar in the past five years would have produced a different composition of U.S. output—and the point extends to agriculture and the likelihood that the farm problem would have been less severe.

Table 1. Anatomy of Exchange Rate Policy Positions

		Exchange markets function efficiently		
		Yes	*Agnostic*	*No*
Manage rates directly	Yes	. . .	Cooper	Williamson
	No	Branson	Dornbusch	. . .

—From Branson and Dornbusch, formally, and from Richard Cooper, less formally, we see that the Mundell-Fleming-Dornbusch model accounts for the real appreciation of the dollar in the past five years as the inevitable result of the world policy mix of tight fiscal policy abroad, loose fiscal policy in the United States, and tight monetary policy in the Organization for Economic Cooperation and Development.

—Exchange market intervention by itself, in the form of jawboning (Cooper) or sterilized intervention, would not be powerful enough to reduce exchange rate fluctuations substantially. At the least, monetary policy would have to be exchange-rate oriented; at best, in John Williamson's world, fiscal policies would be better coordinated than they are now.

Remarkably, the authors' policy views are nonetheless different, as outlined below.

Branson: The exchange rate has been reacting appropriately to policy. There is no prospect of fiscal policy coordination, without which monetary policy can do little. What can be achieved is best done through quiet diplomacy among the central banks. A new Bretton Woods would fail not only for lack of political will to coordinate policies, but also for lack of the analytical ability to calculate appropriate exchange rates.

Cooper: This paper is less a discussion of target zones than the others and more a discussion of the U.S. policy mix. Cooper argues that the mix has been a disaster for many firms and workers in goods-producing sectors, including agriculture. The U.S. debt, internal and external, is a major problem for the longer term. The United States should steadily tighten its fiscal policy, compensating with monetary expansion, to drive down the dollar. Jawboning helps, and the exchange rate initiatives of September 1985 were appropriate and useful.

Dornbusch: There is substantial agreement with Branson's views, but an even stronger emphasis on the impossibility of fiscal policy

Table 2. Explaining Exchange Rate Policy Positions

		Exchange markets function efficiently	
		Yes	*No*
Manage rates directly	Yes	Target zones will constrain government policy.	Target zones can reduce excess volatility and will constrain government policy.
	No	Markets work fine, but target zones will not constrain government policy.	Capital flows are unstoppable, and target zones will not constrain government policy.

coordination. Dornbusch believes that the best that can be hoped for at present is ad hoc intervention, in the form of monetary policy intervention or taxes on capital flows or both. He does not express a preference between the Tobin tax on all international capital flows and the type of tax on capital inflows used by the Israelis in 1979–81 to try to prevent an attempted disinflation from producing too large an appreciation. Dornbusch argues that international capital flows are motivated in large measure by tax evasion rather than any socially useful purpose.

Williamson: Williamson wants the dollar to move another 10 percent. The world needs exchange rate target zones, agreed to by a formal group consisting of the major industrial countries and the International Monetary Fund. They will figure out zones that produce basic balance in the current account in the medium term. The zones would be 10 percent above and below the targets, and soft at the edges, which must mean 12 percent and harder at the edges. The targets would be achieved through monetary policy. Williamson's paper substantially advances the discussion by including an interesting collection of supporting judgments that reveal why he differs from the other panelists on the feasibility of the target zone approach. His most important judgment is that fiscal policy is not necessarily independent of exchange rate regimes.

How can such sensible people differ? Table 2 summarizes the judgments that divide them, using a scheme similar to that used in table 1. None of the four boxes can be ruled out a priori. If target zones could restrain inappropriate government policy—and in the mid-eighties thoughts turn to fiscal policy—there would be no contradiction between believing that exchange markets are efficient and believing that target zones are desirable. A person with those views would occupy the top left box. John Williamson appears in the top right box, believing both that governments will be constrained by target zones and that the exchange markets are inefficient. In the bottom left-hand corner we find the essence of the Branson view, which is that the exchange markets are efficient and that governments will not be constrained by exchange rate targets. I would place myself in the bottom right-hand box, doubting that the exchange markets are efficient, but believing that governments will not be constrained by target zones and that the zones could not in any event withstand the capital flows that now move about the international financial system.

The key judgments that are being made here are on the questions of whether governments will be constrained by exchange rate rules and whether capital flows can be withstood. And underlying those questions is the basic issue that William Branson emphasizes, whether we would be better off if exchange rates were more stable. The answer is yes only if there is indeed excess volatility of exchange rates and governments have sufficient knowledge to choose the right rates, and if more stable fiscal policies are appropriate and we can constrain governments to follow such policies through exchange rate rules.

In deciding where to stand on these issues, it is useful to draw on the lessons of the breakdown of Bretton Woods and of the existence and operation of the European Monetary System.

Given that the Bretton Woods system lasted well over twenty years, the target zone system cannot be dismissed out of hand. The question is what the breakdown of the Bretton Woods system tells us about target zones. One lesson is that fiscal and monetary policies can diverge internationally even under tightly fixed exchange rates. It could be argued that was possible only because the United States was not constrained under Bretton Woods—but there is no reason to think the United States would agree to be constrained this time around either.

The Bretton Woods system became progressively less stable as the strength and volume of private capital flows increased. The second important lesson is that it is very difficult to manage a fixed exchange rate system when there are free private capital flows.

The European Monetary System was slighted in the four papers we had in this session. That institution operates substantially the way John Williamson wants the international economy to operate. It has target zones. Rudiger Dornbusch remarks that the EMS is merely the German monetary union, but that should not obscure the significant fact that countries are voluntarily in that union. The governments of France and Italy find it politically useful to operate under the constraint of German monetary policy. Thus the EMS provides some evidence in favor of the view that exchange rate targets would constrain government policies.

But there is another lesson from the EMS. Capital controls have been needed to keep the French and Italian exchange rates in line. Both Italy and France operate exchange controls, which, although not watertight, are tightened when a change in the exchange rate looks imminent. That again suggests that capital flows will be a key to the operation of a target zone system.

What should we conclude from all this? First, there is a question of how agreement will be reached on a desirable basic current account balance for each country. Richard Cooper and John Williamson talk as if the United States should have a balanced current account. That is not a good idea if Latin America is trying to pay off its debt. Agreement on the underlying balances will not be an easy matter.

Second, the big bands around the targets are a sales device. Williamson's targets are miragelike. The zone is ten percent wide, but when you get close to the edge, you can readjust the target, and, besides, it is soft at the edges. If the target zones mean anything, there will come a time when domestic policy has to be readjusted and exchange rates have to be defended, for monetary policy will not be able to withstand capital flows unless there is an appropriate policy adjustment. It is at that point that countries have to decide whether they want to subordinate their monetary or fiscal policies to the defense of the exchange rate.

Will they do it? For the United States the answer is no. When push comes to shove, the U.S. Congress is not going to change fiscal policy, or anything that matters to its constituents, in order to maintain the exchange rate. Ask yourself whether the target zones could have withstood the Reagan revolution, which is implicitly what is being argued. Or do you believe the United States would have negotiated with its trading partners for permission to move the exchange rate so it could undertake the massive Reagan tax cuts without violating the targets? The United States will not operate that way. Target zones are not a likely prospect in the United States, Germany, or Japan.

Instead we are moving at present toward a three-currency-block world. Europe is happy to operate in the EMS, which Britain may soon join. Then the three-block system will operate in the modified Branson-

Dornbusch mode: there will be occasions when it is perfectly obvious that exchange rates are out of line and when they can be nudged back into line with monetary policy or with direct intervention. But mostly the blocks will operate independently, running their own monetary and fiscal policy, meeting every now and then to try to persuade the others to change policy, and occasionally surprising everyone by agreeing on the directions in which exchange rates should move and succeeding in moving them.

General Discussion

Rudiger Dornbusch reiterated his view that the most compelling reason for targeting exchange rates has to be the belief, which he does not share, that the existence of target zones would force national governments to adopt more responsible fiscal and monetary policies. Otherwise, either the target zones would have to be adjusted frequently to accommodate bad policy or the target zone system would break down entirely. Robert Gordon noted that exchange rate targeting would not have affected U.S. fiscal policy during the early 1980s because that policy was pursued on the grounds that it would produce falling deficits and interest rates. The large budget deficits actually experienced were not predicted by those responsible for the policy.

William Branson commented that the so-called misalignment of the dollar in recent years was in fact an equilibrium reaction to the change in U.S. fiscal policy under Reagan. The exchange rate movement brought about the large U.S. trade deficit that made room for the increase in the U.S. structural budget deficit. William Nordhaus challenged the view that the appreciation of the dollar could be attributed solely to U.S. fiscal policy. The dollar began to appreciate after the third quarter of 1980. But the first credible forecast of large budget deficits did not appear until the Congressional Budget Office's February 1982 report. He concluded that the explanation for the pre-1982 rise in the dollar must be traced to the October 1979 shift in monetary regime and its effect on interest rates. John Williamson acknowledged that much, though not all, of the exchange rate movement was a rational response to U.S. macroeconomic policies. But, he argued, that does not mean that those policies would have been invariant to the exchange rate regime.

Walter Salant observed that target zones have been criticized both for being too flexible compared with fixed rates and for being too rigid compared with flexible rates. But he noted that this implies that they have the corresponding advantages of being less rigid than fixed rates and less volatile than flexible rates. The difficult political choice between stabilizing domestic policy and keeping the exchange rate on target would come up less frequently under a zone system than under fixed rates, especially if the zones were adjustable. And the risks of bubbles and excessive volatility would be less under a zone system than under a flexible system. In short, target zones would share the advantages as well as the disadvantages of both fixed and flexible rates. Dornbusch suggested that one reason why target zones have not attracted more political support is that they are not extreme enough. He predicted that any move away from floating rates would be back to fixed rates, not to an intermediate system. Dornbusch conceded that a target zone system would have the advantage of providing a forum for open discussion among countries about appropriate exchange rates. In a floating rate system, such discussion is unlikely to occur on any ongoing basis because the market determines exchange rates; in a fixed rate system, such discussion is avoided for fear it might provoke speculation. William Poole reflected that soft target zones would work just as money growth targets have: they would be ignored when it was convenient.

Some participants believed that exchange rate fluctuations could be excessive under floating rates and discussed taxing capital movements as a way to reduce erratic fluctuations. James Tobin commented that the basic rationale for taxing exchange transactions was to discourage short-term capital movements without impeding long-term investments. With such a transactions tax, short-term interest rates would not be so closely arbitraged across countries, so that governments would have more policy autonomy. In Tobin's view, a tax on exchange transactions would be useful not only with floating rates but also under a target zone or fixed rate regime, in that it would reduce the need to make exceptions or to change rates. However, Williamson argued that reducing short-term capital flows could cause dynamic instability of the exchange rate under either a floating rate or target zone system because it would hinder the capital flows needed to finance trade. He also noted that a transactions tax would not prevent currency misalignments coming from long-term capital movements, such as Japanese investment of long-term funds in the United States. Stanley Fischer believed that a tax on exchange transactions would be desirable for the reasons Tobin gave, but he argued that it would not work because foreign exchange transactions would merely be driven offshore. Nordhaus suggested that someone should look at whether day-to-day exchange rate volatility has changed as transactions costs have changed; his suspicion was that it has not. Poole drew an analogy to the real estate market, where transactions costs are very high. There is little day-to-day volatility in land prices, but high transactions costs have not prevented price movements that some observers believe to be speculative bubbles.

Dornbusch expressed concern over the consequences of implementing a target zone system in the current economic environment. He feared that those who favor target zones implicitly seek a large further depreciation of the dollar. Rather than adopting such a "beggar-thy-neighbor" policy that would export unemployment abroad, he would prefer to see the United States and other countries take coordinated steps to lower interest rates. Richard Cooper agreed with the need to lower worldwide interest rates but argued that the target zone proposals were a systemic reform and should not be evaluated as a current policy issue. Any target zone system would take at least three years to implement; by then, the economic environment could look quite different. Dornbusch replied that target zones could not be divorced from a current policy context. When they were first discussed seriously three years ago, they would have implied a policy of monetizing the huge impending U.S. budget deficits. Not having target zones permitted a different adjustment to the deficit.

Several participants discussed the longer run effects of large fluctuations in exchange rates. Branson noted that, in response to the dollar's real appreciation during the early 1980s, both foreign and U.S. firms developed sources of supply outside the United States in industries in which the United States had previously been competitive internationally. With these foreign sources established, some of the U.S. employment in those industries lost to foreign competition in recent years will not be recouped even if the dollar falls back to 1980 levels. Williamson observed that the existence of such irreversible effects from exchange rate fluctuations strengthens the case for target zones. Nordhaus, by contrast, observed that exchange rate fluctuations that lead to shakeouts in certain industries are not necessarily bad. By weeding out the weakest firms, such fluctuations might contribute to the economy's long-run performance, just as Schumpeter reasoned that business cycles did.

Robert Lawrence suggested that Branson's estimates of the effect of exchange rates on employment might be too large because they assume a constant employment-exchange rate elasticity. In fact, as a currency increases in value, exports of products with a high demand elasticity drop off first, and the volume of exports in the products that remain may be relatively insensitive to the exchange rate. This seems to explain why the volume of U.S. exports held up during the last stages of the dollar's appreciation. Charles Schultze noted that Branson's estimate of 1.7 million U.S. jobs lost because of the dollar appreciation did not allow for the volume of defense production, which also has important effects on manufacturing employment. Over the past fifteen years, defense spending has moved inversely with the dollar exchange rate, so that including it in the model might increase the estimated effect of the exchange rate on manufacturing employment.