

SECRET & PERSONAL

PRIME MINISTER

27 November 1987

Exchange Rate Policy

Your interview with the FT, published on Monday, and in particular the section dealing with exchange rates, was a much needed corrective to the Chancellor's recent pronouncements on this subject.

In his three recent major speeches (Washington, Mansion House and earlier this week) he has made it perfectly clear that in his view:

- the move to a regime of managed exchange rates, starting with Plaza and re-emphasised at Louvre, is the foundation for external financial stability in the world economy,
- there is no point in holding another G-7 meeting unless all those involved are prepared to contribute wholeheartedly to the stabilisation of the dollar,
- the idea that exchange rate stability promoted stock market instability, and may even have been a significant factor in bringing about the crash, is "poppycock",
- UK exchange rate policy is to maintain a stable exchange rate against the Dm, regardless of the amount of foreign currency we have to buy or in future will have to sell.

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It has now become clear, that over the past two years, the Treasury have been a leading international voice in arguing for managed exchange rates and co-ordinated intervention, and that, having been frustrated in their intention to join the EMS, they have pursued a de facto policy regarding the £/Dm rate as if we were full members of the EMS.

The Louvre agreement and managed exchange rates

This approach originated following the frustration felt by Finance Ministers with the "overshooting" of the dollar in 1984 and 1985. Rather than put the emphasis on tackling the fundamental problem - namely the burgeoning US deficit - they put the emphasis on bringing down the dollar (Plaza) and then on maintaining exchange rate stability (Louvre).

I enclose a recent lecture by Profesor Martin Feldstein of Harvard, who is a distinguished academic and who could never be described as a traditional monetarist (Appendix A). As you will see he is very sceptical of the current approach to managed floating for a number of very good reasons:

- governments can intervene in markets and influence nominal exchange rates but they cannot ultimately influence real exchange rates (changes in nominal rates adjusted for changes in inflation): this is because holding nominal rates involves central banks buying and selling foreign currency which lead to increases and decreases in money and therefore ultimately in prices, which in time change real exchange rates and therefore frustrate the objective of the policy,

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- although governments continue to intervene "most economists and central banks that have studied the evidence on this issue have reached the opposite conclusion. A special task force of central bank representations from around the world reported to the IMF in 1983 that their analysis of past experience and of the previous statistical studies indicated that exchange market intervention per se could not be expected to have any sustained effect on the performance of exchange rates." (p.18)
- the greatest risk following present co-ordinated exchange rate intervention is inflation,
- summits and international co-ordination have achieved little success in changing countries' policies, which have been influenced mainly by their concern over domestic factors,
- it would be far better if countries concentrated on pursuing sound domestic policies and resolved international co-operation for trade and national security.

*That was  
the Goldsmith  
speech*

### The Louvre Agreement and the stock markets

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The Feldstein lecture was written before the stock market collapse.

Yet all of the following criticisms of the Louvre agreement could be sustained and would be very much in sympathy with his general approach:

US TREASURY NOTE/BOND YIELDS \*

Chart 2

Per cent per annum

12 -

- 12

11 -

- 11

10 -

- 10

*Louvre Agreement.*

10 years

9 -

- 9

4 years

8 -

- 8

2 years

7 -

- 7

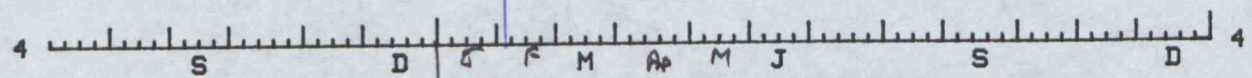
1 year

6 -

- 6

5 -

- 5



1986

1987

\* Wednesday Close

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- it has resulted in massive foreign exchange intervention which has been inflationary;
- these inflationary expectations pushed up bond yields (see attached graph);
- the reverse yield gap (return on bonds less return on equities) became unsustainable at these new levels;
- this resulted in a market collapse (since 5 October, 29% in London, 26% in New York and 11% in Tokyo),
- which was also accompanied by a major devaluation of the dollar against the Dm and yen.

	<u>£ERI</u>	<u>£/\$</u>	<u>£/DM</u>	<u>\$/DM</u>	<u>\$/YEN</u>
15 October	73.5	1.6650	2.9953	1.7990	141.90
2 November (date of last meeting)	74.6	1.7305	2.9739	1.7185	137.10
25 November	75.7	1.7897	2.9927	1.6722	134.70
% change since 15 October	+ 3.0	+ 7.5	-	- 7.0	- 5.1

UK exchange rate policy

The Louvre agreement has little immediate impact on the UK as the agreement deals primarily with the currencies of those countries with great imbalances (Germany, Japan and the US).

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Far more important as far as we are concerned is the Chancellor's strong commitment to cap the Dm/£ rate at 3 and not to allow it at some future date to fall below 2.80-2.95 when under pressure. The immediate problem we face is the inflationary potential of buying in foreign currency to protect the rate. The problem next year - in view of the differential inflation rates between US and Germany - is more likely to be pressure on the pound.

On the basis of the previous analysis the Chancellor's general approach must be called into question.

Rigidly sticking to the 3 Dm rate has become the cornerstone of the Chancellor's anti-inflationary policy. By not allowing the exchange rate to rise now and by being under pressure to allow it to fall if people start selling sterling, the Chancellor is taking a real gamble with both our own rate of inflation and our own rate of growth.

**Conclusion**

The stakes in this strategy are very large. At the very least, the issue deserves serious discussion in a larger group than just the Chancellor.

*Brian Griffiths*

BRIAN GRIFFITHS

Prime Minister

23 October 1987

You may care to have another  
glance at this before you see Martin  
Feldstein.

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Rethinking International Economic Coordination

Martin Feldstein\*

A Lecture on the Occasion of  
The Fiftieth Anniversary of  
Nuffield College, Oxford

I am delighted to be here and honored by the invitation to give this lecture celebrating the fiftieth anniversary of Nuffield College. Nuffield will always be a very special place for me. It was when I migrated along the High Street from Brasenose to Nuffield in the autumn of 1962 that I began in earnest my graduate training as an economist. Nuffield provided an excellent environment for a fledgling economist: good lectures and seminars, excellent fellow students, and the frequent discussions about current economic issues that implicitly reminded us why the study of economics was so important.

It was my good fortune to stay at Nuffield for five years, serving as a Research Fellow and subsequently as an Official Fellow. How grateful I am for the unique experience of a graduate social science college with links not only to this great university but also to the government and the business community in London. The combination of high quality technical

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\*Professor of Economics, Harvard University, and President of the National Bureau of Economic Research.

economics in the seminar rooms and of stimulating debates about economic affairs in the Common Rooms and at High Table have left a permanent and pleasant impression.

Today I want to talk about an important aspect of economic policy that has been very much in the news: the international coordination of macroeconomic policy and exchange rates. I think that this is a particularly fitting subject in light of the strong links between economics and politics that have always been a part of the Nuffield tradition.

I should perhaps begin these remarks by emphasizing that I am not opposed in principle to international cooperation in all economic matters. I should also add that I do not favor government actions that are designed to promote conflict between national economies that goes beyond the normal conflict that is inherent in ordinary market competition.

I start with these obvious assertions because in my remarks today I shall be stressing the counterproductive consequences of the international coordination of macroeconomic policy.

I do not deny that the economies of the world are linked in a way that makes the monetary and budget policies adopted in one



country affect the economic performance of other countries. But I believe that many of the claimed advantages of cooperation and coordination are wrong, that there are substantial risks and disadvantages to the types of coordination that are envisioned, and that an emphasis on international coordination can distract attention from the necessary changes in domestic policy. ✓  
Moreover, the attempt to pursue coordination in a wide range of macroeconomic policies is likely to result in disagreements and disappointments that reduce the prospects for cooperation in those more limited areas of trade, defense and foreign assistance where international cooperation is actually necessary.\*

In stressing the limited scope for international cooperation in macroeconomic policy and in exchange markets, I do not wish to imply that such cooperation is never appropriate. Far from it. -  
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\*My criticisms of international macroeconomic coordination were sketched first in an article that I wrote for the Economist magazine ("The World Economy Today: Signs of Recovery" June 11, 1983). An earlier version of the present lecture was presented as one of my two 1986 Horowitz Memorial Lectures of the Bank of Israel. The general subject of international economic cooperation (in macroeconomic policy, exchange rate policy, international trade and developing country debt management) was explored at an April 1987 conference of the National Bureau of Economic Research. The conference volume presents valuable survey papers, personal comments by individuals who have had significant experience in government and business, and an extensive bibliography that makes it unnecessary to provide such references in the current talk; my own views are summarized in an introductory chapter. See M. Feldstein, International Economic Cooperation. University of Chicago Press, 1988. See also M. Feldstein, International Economic Cooperation: Summary Report. The National Bureau of Economic Research, 1987.

There are some small and very interdependent countries where such cooperation and coordination should undoubtedly be the general rule. There are also some conditions when the potential gains from cooperation and coordination are such that all countries could expect to benefit from participation. But the active coordination of the macroeconomic policies and of exchange rates among the United States, Japan and Germany will generally be inappropriate. Moreover, as I shall explain in these remarks, the United States is particularly unsuited to participate in an on-going process of economic coordination.

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Cooperation and coordination in macroeconomic policy-making have, of course, always been part of the dialogue of international relations. But in the past few years there has been a substantial increase in the emphasis on such active collaboration. The central proposal of the May 1986 Economic Summit Meeting in Tokyo was a call for a mutual "multilateral surveillance" of macroeconomic policies by the major seven countries as part of a new process of achieving a cooperative strategy for guiding individual country policies. This emphasis on the coordination of macroeconomic and exchange rate policies was reaffirmed at the Venice Summit in June 1987 and most recently at the September 1987 annual meeting of the International Monetary Fund and World Bank.

In practice much of the discussion of international

coordination has focused on exchange rates. I shall therefore begin by commenting on exchange rate management. I will then turn to the more general subject of the coordination of macroeconomic policies, including budget policies, monetary policies and tax structure policies. At the end, I will have some general comments about the proper role of international economic cooperation and coordination in a wider range of areas and on the links between economic and political cooperation.

### The Management of Exchange Rates

After less than a decade of floating exchange rates, the sharp rise in the value of the dollar during the early 1980s caused a renewed interest in the possibility of the international management of exchange rates and even of a return to a system of fixed exchange rates. In the five years beginning in January 1980, the value of the dollar rose more than 80 percent in comparison to the value of the other currencies of the world. Part of the dollar's rise reflected the lower rate of inflation in the United States than abroad and, as such, did not affect the relative competitiveness of American and foreign products in world markets. But even after adjusting for differences in national inflation rates during this period, the value of the dollar rose more than 70 percent in comparison to the value of other currencies.

This rise in the real value of the dollar made it very much more difficult for American firms to sell abroad and very much easier for foreign firms to sell their products in the United States. This was the primary reason why the United States shifted from a trade surplus in 1981 to a massive trade deficit by 1986. Measured in the constant prices of 1982, the U. S. trade balance shifted from a surplus of \$50 billion in 1981 to a deficit at the rate of more than \$150 billion in 1986. Exports declined over this period while the value of imports rose more than 50 percent. It is not surprising therefore that American businesses and their workers in the wide range of industries hurt by the strong dollar called for government action to stop and reverse the dollar's rise.

The dollar began to fall in February 1985 and by the end of 1986 had reversed about three-quarters of its previous rise. A further fall of the dollar since then has brought it to within about 10 percent of its real value in 1980. The sharp increases in the relative value of the Japanese yen, the German mark and the other European currencies that move with the mark caused a correspondingly sharp reversal of the recently-achieved competitiveness of Japanese and European products. Their export volumes declined and profits sagged. By 1986 the Japanese and European governments were subject to substantial domestic pressures to seek a halt to the dollar's decline.

Between 1981 and the summer of 1985, the Reagan administration argued that the value of the dollar should be left to the market and that it was inappropriate to shift U.S. domestic economic policy or to intervene in currency markets in an attempt to alter the dollar's value. This was a continuing source of conflict with the European and Japanese governments that did not like the dollar's rise because of the inflationary pressures that it imparted to their own economies, the rising real interest rates that resulted from the capital outflow to the United States, and the increased support for protectionist trade policies that was developing in the United States because of the surging U.S. trade deficit.

The meeting of the finance ministers of the G-5 countries (the United States, Britain, France, Germany and Japan) at the Plaza Hotel in New York in September 1985 was a political watershed in this process. Faced with the reality that the dollar had been declining for more than six months, Treasury Secretary James Baker abandoned the previous Treasury position that the strong dollar was a measure of foreign investors' approval of the economic policies of the United States. He acknowledged publicly that the high value of the dollar was a serious problem for American industry. And, most surprisingly and significantly of all, he agreed to participate in coordinated exchange market intervention aimed at lowering the dollar's value.

Immediately after the Plaza meeting the United States did join with other countries in a major exchange market intervention, selling dollars and buying other currencies. The Japanese central bank also raised short-term interest rates temporarily in order to make yen denominated bonds a more attractive investment and thereby to stimulate the demand for the yen.

Exchange rate targeting and economic policy coordination aimed at achieving desired levels of the exchange rates has been a frequent theme of intergovernmental meetings since that time. The first tangible example of this new spirit was the November 1986 joint statement by Treasury Secretary Baker and Japanese Finance Minister Miyazawa in which the Treasury agreed to support the idea of a stable dollar-yen rate in exchange for a Japanese commitment to stimulate their own economy by expansionary monetary and fiscal policies. The finance ministers of the G-7 countries met at the Louvre in February 1987 to assert their belief in macroeconomic coordination and to call for exchange rate stability. They reaffirmed this call at the June 1987 Venice Summit and the September 1987 IMF-World Bank meeting.

In contrast to these assertions, I believe that the dollar must continue to decline because the future trade deficit implied by the dollar's current level will be too large to finance.

Experts estimate that without a further decline of the dollar the U.S. trade deficit will remain at more than \$100 billion a year and the current account deficit will grow explosively because of the interest and dividends owed on the U.S. net borrowing from abroad. Only a decline of the dollar can achieve the change in the relative prices of American and foreign goods that can induce American consumers to import less and foreign consumers to buy more American made goods. The more rapid growth in Japan and Europe that the finance ministers continually stress as an alternative to a dollar decline simply cannot be powerful enough to make a significant dent in the U.S. trade deficit. Similarly, while a decline of the American budget deficit would help to shrink the U.S. trade deficit, it would do so by lowering U.S. interest rates which in turn would reduce the value of the dollar; budget deficit decline is not an alternative to dollar decline as a means of shrinking the trade deficit.\*

I believe that the pursuit of exchange rate goals is likely to be both futile and economically damaging. I believe that this is true not just in the current circumstances but more generally as well. The primary risk is that the pursuit of exchange rate targets over an extended period of time would increase the rate

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\*For a longer but nontechnical discussion of why the dollar must decline, see my "Correcting the Trade Deficit," Foreign Affairs, Spring 1987.

of inflation in every country. An exchange rate policy can also hurt the process of capital formation, weaken the capital goods and construction industries, and delay the recovery of the manufacturing industries that are hurt by an overvalued exchange rate.

### Nominal and Real Exchange Rates

To understand the likely effects of an exchange rate policy, it is crucial to distinguish between changes in nominal exchange rates and changes in real exchange rates. The change in the nominal exchange rate between two countries is the change in the actual exchange rate that prevails in the market. The change in the real exchange rate is equal to the change in the nominal exchange rate adjusted for differences in the inflation rates in the two countries.

An example will illustrate this difference and show why it is the real exchange rate that is the important one. One dollar now (October 1987) buys 1600 Mexican pesos. A year from now that might rise to 3200 pesos, a one hundred percent increase in the nominal exchange rate between the dollar and the peso. But the fact that the dollar buys more pesos would not necessarily imply that the dollar buys more Mexican goods at the end of the year than at the beginning of the year. If during the same year the level of prices in Mexico also rose by 100 percent, the dollar



would buy the same volume of Mexican goods at the end of the year as it did at the beginning of the year. If moreover there was no change in the price level in the United States, a dollar would also buy the same volume of American goods at the end of the year as it did at the beginning of the year. If the dollar buys the same relative volumes of American and Mexican goods at the end of the year as it did at the beginning of the year, we would say that the real value of the dollar is unchanged. Thus in this example the nominal value of the dollar relative to the peso rose 100 percent but the real value remained unchanged.

In contrast, if the nominal exchange rate rose 100 percent while Mexican prices rose 110 percent, the dollar would buy fewer Mexican goods at the end of the year than at the beginning of the year. In this case, we would say that the real value of the dollar relative to the peso fell even though the nominal dollar-peso exchange rate rose 100 percent.

As these examples indicate, it is the real value of the currency that influences the competitiveness of the country's products and thus its exports and imports. This point is worth emphasizing for two reasons.

First, the political discussions about exchange rate targets, target zones and exchange rate management are always in terms of the nominal exchange rates. Therefore even if the

politically agreed exchange rate targets were achieved and maintained, the relative competitiveness of the countries could change substantially because differences in inflation rates caused the real exchange rates to change. In short, exchange rate management is likely to be misguided because it focuses on the wrong target.

Second, economic policies that change a country's rate of inflation can easily alter nominal exchange rates without changing the real exchange rates. There is therefore a serious danger that an agreement to stabilize exchange rates would lead to increased inflation without any change in the real exchange rates that influence imports and exports.

Consider for example the sharp rise in the real value of the dollar that began in 1980. The dollar rose because American bonds and stocks became more attractive to portfolio investors around the world. The primary reason for this increased attractiveness was the sharp rise in the real interest rate in the United States that resulted from the massive increase in current and projected budget deficits. In addition, the fall in inflation, the 1981 changes in tax rules, and the appreciation in the price of oil all contributed to the rise in the real value of the dollar relative to the currencies of the other major industrial countries.

Blocking or reversing these fundamental factors could have prevented the dollar's rise or caused it to decline at an earlier time. But if the United States had agreed in 1983 to the demands of the French and others who wanted us to stop the dollar's rise, there is no reason to believe that any changes would have been made in these fundamental factors. Instead the easiest way to depress the dollar or stop its rise would have been for the Federal Reserve to ease monetary policy. The easier monetary policy would have temporarily lowered real interest rates and that in turn would have caused a temporary decline in the real value of the dollar. More importantly, the easier monetary policy would produce inflation and the inflation would cause the dollar's nominal value to decline. In the end, there would be no change in the real exchange rate or the trade deficit but a higher price level and a high rate of inflation.

Of course there are two sides to every exchange rate and the relative value of the dollar could have been depressed by a tightening of monetary policy in Europe and Japan that lowered the inflation rates in those countries. There was in fact some tightening of monetary policy in Europe in response to the rising dollar but that process was inevitably limited by the increased unemployment that resulted from such a monetary contraction. Political reality would inevitably have required that a change in monetary policy to stabilize the dollar be an inflationary easing by the United States rather than a deflationary tightening in the

other countries of the world.

The current attempts to slow the rise of the yen and the German mark provide a further example of the risk that exchange rate coordination is likely to be inflationary. The process of intervention in both Germany and Japan has led to very rapid increases in the money supply and in overall liquidity. This has increased the fear of inflation and raised long-term interest rates in both countries. Although the governments of Germany and Japan have asked the United States to raise interest rates as an alternative way of maintaining the value of the dollar, the U.S. has been reluctant to do so in the context of a recovery that has already lasted five years and with an election next year. Although the German and Japanese intervention has not yet produced any significant rise in inflation, a continuation of the associated increases in money and overall liquidity for an extended period would undoubtedly begin to do so.

#### Fiscal Discipline

There are some who argue that a commitment by the United States to stabilize the dollar in 1983 or 1984 would have caused a reduction in the budget deficit and therefore a decline in the real value of the dollar. On the basis of my experience as a participant in the making of American economic policy at that time, I do not believe that an exchange rate agreement would have

produced such a change in budget policy.

The Reagan Administration was already trying to reduce the budget deficit by a strategy that combined major domestic spending cuts with a conditional tax increase. There is no reason to think that they would have taken a more conciliatory position with Congress in order to deal with the high dollar. Treasury Secretary Reagan apparently believed that the budget deficit had no effect on the dollar. In addition, many experts both inside and outside the government argued that the strong dollar showed only that monetary policy was too tight and therefore argued in favor of depressing the dollar by a monetary expansion.

Although there is no way to be confident about events that did not occur, I believe that if the United States had been committed to stabilize the dollar in 1983 or 1984 it would have done so by a more inflationary monetary policy. The adverse effects of the budget deficit on international trade and domestic capital formation would have persisted but the exchange rate target would have added the additional adverse consequence of raising the rate of inflation.

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The present goal of stopping or slowing the decline of the dollar might also be achieved by a change in fiscal policy but doing so would require fiscal changes that would in themselves be undesirable. An increase in the U.S. budget deficit would raise

real interest rates, making dollar investments more attractive and increasing the value of the dollar. A reduction of the budget deficits in Germany and Japan would reduce interest rates in those countries and cause their currencies to depreciate. The use of fiscal policies to stabilize the dollar exchange rate would thus exacerbate the long-run budget and capital accumulation problems of the United States and would deny Germany and Japan a desirable short-run fiscal stimulus.

### Gains and Losses of an Overstrong Dollar

There are of course some who believe that the real value of the dollar can be influenced by exchange market intervention in which the government buys or sells dollars in exchange for foreign currencies. It is sometimes said that this is more effective if such purchases or sales are done in support of an explicit policy aimed at keeping the exchange rate in relatively narrow bands. Others argue that the psychological effect of intervention is magnified when several countries coordinate their intervention actions. Before considering whether such a policy could be expected to work, it is good to ask whether stabilizing the dollar would in itself have been desirable in the economic context of 1983 and 1984 and would be desirable in today's world economy.

Stopping the rise in the dollar's real value in early 1983

would have reduced the subsequent U.S. trade deficit. Output and employment would have deteriorated less in our export industries and in those firms that compete with imports from abroad. But that is only half of the story. The reduced trade deficit would automatically have meant a reduced capital inflow from abroad. Real interest rates would have been higher in the United States. Investment in plant and equipment and housing construction would have been depressed. The pattern of employment would have been different but there is no reason to suppose that total employment and output would have been higher. Moreover, the lower rate of capital formation would have reduced the growth of productivity.

In short, stopping the dollar's rise earlier would have had both good and bad effects on the American economy. There is no way to know whether the favorable effects on the export industries and firms that compete with imports would have outweighed the adverse effects on capital investment. I believe that in the absence of clear evidence or analysis to the contrary, it is best to assume that the market produces a better solution than government intervention. That is as true about exchange market intervention as it is about so many other aspects of government interference with the market economy.

The same principle is relevant today. If intervention per se could stop the dollar's fall at the present time, that would contribute to U.S. price stability and would maintain a flow of

capital from abroad that dampens real interest rates and provides the funds to finance additional investment in housing and in plant and equipment. But the high dollar would also limit the improvement in the trade deficit, depressing activity in export industries and those that compete with imports from abroad. Ultimately, moreover, the dollar's adjustment would have to occur and would have to be larger because the dollar had contributed to a greater accumulation of net debt from the United States to the rest of the world.

### Exchange Market Intervention

This discussion implicitly assumes that government intervention in the foreign exchange market could actually change the evolution of the dollar's real value. In contrast, most economists and central banks that have studied the evidence on this issue have reached the opposite conclusion. A special task force of central bank representatives from around the world reported to the International Monetary Fund in 1983 that their analysis of past experience and of the previous statistical studies indicated that exchange market intervention per se could not be expected to have any sustained effect on the performance of exchange rates. Even the apparent success of coordinated intervention in the past seven months have left most economists and central bankers convinced that exchange rate intervention can have only a very temporary effect on exchange rates.



In considering the potential effects of exchange rate intervention it is crucial to distinguish between the so-called sterilized and unsterilized intervention. All intervention aimed at reducing the dollar's value consists of buying foreign short term securities for dollars. This automatically increases the supply of dollars and is therefore equivalent to an easing of monetary policy. By definition, in "sterilized" intervention the American government adds the further step of selling an equal amount of U.S. government bonds and thereby reducing the money supply by the same amount that the currency intervention increased it. At the end of the sterilized intervention, the government has reduced the supply of foreign securities and increased the supply of dollar securities but left the U.S. money supply unchanged. By contrast, the so-called unsterilized intervention increases the supply of dollars and therefore is an easing of U.S. monetary policy.

The distinction is important because "sterilized" intervention is a pure substitution of dollar securities for foreign securities in the world financial market while unsterilized intervention is also an easing of U.S. monetary policy. Experts agree that unsterilized intervention can affect the real exchange rate in the short run and the nominal exchange rate in the long-run because the increase in the American money supply lowers the real interest rate in the short run and raises

the U.S. price level in the longer term. In contrast, since sterilized intervention leaves the money stock unchanged, there is no reason to expect a change in real interest rates or the price level.

Although substantial past experience and economic logic both imply that sterilized exchange market intervention cannot be expected to have a sustained effect on exchange rates, the fall of the dollar in the year after the G-5 finance ministers meeting at the Plaza Hotel in September 1985 and the relative stability of the dollar since the Louvre meeting in February 1987 have led some government officials and others to attribute significant power to coordinated exchange rate intervention. I believe that that is a misreading of the recent experience. There is in fact no evidence that the G-5 Plaza meeting or the subsequent coordinated intervention had any lasting effect on the dollar's rate of decline. In the days immediately after the G-5 meeting there was a four percent decline in the dollar's value. But the rate of decline of the dollar during the subsequent year was no greater than it had been in the six months before the G-5 meeting.

Although the relative stability of the major exchange rates in the seven months after the Louvre meeting may reflect in part a reluctance of market participants to confront the central banks, especially since the Bank of Japan has shown a willingness

this year to intervene on a massive and unprecedented scale, the dollar has also been buoyed by the unanticipated rise in the price of oil (which strengthens the dollar because the United States is less dependent on oil imports than Japan and Germany), by the sharp rise in U.S. interest rates, by the reduction in the U.S. trade deficit and by the continued strength of the American economy. The experience since February 1987 should not be taken as evidence of the efficacy of intervention, let alone of the possibility of achieving a sustained shift in exchange rates through intervention alone. When the market participants become confident that the dollar must fall further, intervention will be unable to prevent that decline.

#### The Coordination of Macroeconomic Policies

Coordinated exchange rate intervention is only one aspect of the potential coordination of macroeconomic policies. Indeed there are many who accept that exchange rate intervention per se is powerless and who therefore argue for a more general coordination of monetary and budget policies. The Tokyo Summit in May 1986 emphasized such macroeconomic coordination and called for a new "multilateral surveillance" procedure managed by the International Monetary Fund. Although the details of this multilateral surveillance procedure were left vague, it was interpreted as an extension of the previous meetings between the IMF and the G-5 finance ministers. In the future the finance

ministers of the seven major industrial countries would examine a variety of indicators of macroeconomic policy and performance and take steps to modify those policies when they were deemed by the group to be unsatisfactory. This coordination of economic policy is advocated as a way of achieving more rapid economic expansion, of avoiding balance of payments problems that restrict domestic demand, and of reducing the international level of real interest rates.

The first such multilateral surveillance session was held in conjunction with the IMF annual meetings in September 1986. The agenda was predictable. The United States called on Japan and the European countries to expand their economies more rapidly in order to increase their imports from the United States. The Europeans and Japan called on the United States to reduce its budget deficit and to slow the decline of the dollar relative to their currencies, an inherently self-contradictory request. No serious agreements were reached. The Germans explained that their economy was expanding rapidly, that their monetary policy was if anything too loose already, and that a tax cut was scheduled for 1988. The Japanese noted that they were moving gradually toward fundamental changes in their economy that had previously been described in the Maekawa Report and that would eventually increase domestic demand and make Japan less dependent on exports. Treasury Secretary Baker said the United States was committed to eliminating the budget deficit over the next five

years as promised in the Gramm-Rudman-Hollings legislation and that the Administration would make recommendations for spending reductions to achieve that end. In short, every country said that it would go on doing just what it had been doing. And, despite the subsequent pronouncements at the Louvre meeting and the Venice summit, each country continued to pursue what it saw as its own interest, generally unaffected by the "international coordination" process.

Only when the Government of Japan became convinced in early 1987 that the sharp rise in the yen-dollar rate during 1986 would create a serious downturn for the Japanese economy did Japan abandon its goal of budget deficit reduction and adopt a package of fiscal and monetary stimulus. The budget called for tax cuts and a massive increase in government spending that produced a fiscal stimulus equal to about two percent of gross national product. This was backed up by an easing of monetary policy that significantly reduced long-term interest rates. The key point is that the Japanese decision to increase government spending and reduce interest rates was motivated not by the desire for an agreement with the United States but by the increasing evidence of the weakness in their own economy and the need for stimulative domestic policies to prevent a serious domestic recession. It is wrong to regard the shift in Japanese policy as the result of international coordination or pressure.

This is borne out by the experience of Germany which, even with high unemployment and a zero inflation rate, has not adopted expansionary policies because of a government decision to give primacy to preventing inflation and to reducing domestic labor market rigidities. Despite the pressure from the United States (as well as from the Free Democratic members of the current coalition government in Germany and Germany's key trading partners in Europe) the government of Germany has remained unwilling to provide either a fiscal stimulus or an easing of monetary policy. Real and nominal interest rates rose in 1987 and no fiscal expansion was enacted. The tax cuts scheduled for 1988 are less than one percent of GNP and are intended to be offset by other revenue increases and by reductions in government outlays. Germany also refrained from any significant active intervention in exchange markets.

The \$60 billion dollar decline in the U.S. budget deficit between 1986 and 1987 was also not the result of international actions but of domestic politics and the peculiarities of budget accounting. Approximately half of the budget deficit reduction reflects special nonrecurring features of the 1987 budget, including a large one-time surge in tax revenue that resulted from the realizations of capital gains in 1986 in anticipation of the recently enacted future rise in the capital gains tax rate. Much of the remaining deficit reduction reflected changes enacted in 1984 and 1985. Moreover, the Congress that enacted the

spending cuts and earlier tax increases did so for purely domestic reasons and never regarded this as part of a plan to elicit cooperative behavior from other governments.

This failure of the summit and other international coordination discussions to achieve any changes in domestic economic policies should not be seen as a surprise or as a reflection of the fact that the process of explicit coordination only began in 1986. It should be seen as the most likely outcome of all such meetings.

#### Constitutional Limits on American Participation

A primary reason why such macroeconomic policy coordination cannot work as envisioned is that the United States is constitutionally incapable of participating in such a negotiation. The separation of powers in the American form of government means that the Secretary of the Treasury cannot promise to reduce or expand the budget deficit or to change tax rules. This power does not rest with the President or the administration but depends on a legislative agreement between the President and the Congress. In this sense, the United States participation in any macroeconomic coordination process is fundamentally different from the participation of a country with a parliamentary system in which the prime minister or the prime

minister's representative can commit to a change in the nation's economic policy.

It is sometimes suggested that an American Treasury Secretary or President, although incapable of promising the enactment of specific budget legislation, could promise that the American government would support a particular legislative proposal. Such a suggestion ignores the negotiating nature of the relation between the President and the Congress. The President cannot propose the legislative package that he expects Congress to enact and he cannot disclose the extent to which he is willing to compromise on specific issues.

Because it is impossible for the United States to reach an international agreement on specific budget, tax or spending policies, any actual agreement would have to call for a change in U.S. monetary policy. International macroeconomic coordination could thus be a recipe for the wrong policy change in the United States. For example, if the United States had entered into an agreement in 1983 or 1984 to shift policy in a way that reduced the value of the dollar, the agreement would have required an inflationary increase in the supply of money. Moreover, even such an agreement would be beyond the legal authority of the Treasury Secretary or the President since it would require the agreement of the independent Federal Reserve.



For the United States, the constitutional and legal restrictions on international policy agreements reinforce the economic fact that there is little potential gain to the United States from international coordination. Because exports are a relatively small share of U.S. gross national product, a more rapid expansion of demand in other countries has a very small effect on demand and production in the United States. Similarly the small share of imports in U.S. GNP and the ability of the United States to borrow readily in world markets meant that the United States can expand demand at home without worrying about the resulting impact on its trade deficit and balance of payments.

In short, the United States lacks both the incentive and the legal ability to participate in the type of international macroeconomic coordination that is so widely advocated.

Although the other major industrial countries appear to have a greater incentive to participate in international macroeconomic coordination, I believe that incentive is more apparent than real. Uncertainties about the actual state of the international economy and uncertainties about the effects of one country's policies on the economies of other countries makes it impossible to be confident that coordinated policy shifts would actually be beneficial. The Germans still remember and regret their agreement to serve as a "locomotive" for worldwide expansion after the Bonn

Summit meeting. Today the Germans argue that foreign pressure for more expansionary German policy exaggerates the potentially favorable effects of such a change on foreign economies and ignores both the underlying strength of German demand and the need to achieve structural reforms in the German labor market as a precondition for reduced unemployment. A few years ago U.S. Treasury Secretary Regan argued that foreign pressure for the U.S. to reduce its budget deficit was misplaced because budget deficits do not influence interest rates, exchange rates and capital flows. When there are fundamental disagreements about the way the world economy works, there is little reason to believe that coordinated policy will produce improved performance.

The difficulties of coordination and the risk that coordination will be counterproductive do not imply that there is no scope for international macroeconomic coordination. Smaller countries with very interdependent economies are more likely to benefit than larger countries in which trade is a relatively small share of national income. Economic coordination therefore makes more sense within Europe than between Europe, the United States and Japan. Similarly, the potential for successful coordination becomes greater as the state of the international economy becomes less satisfactory. Coordination therefore makes more sense if there is a major world-wide slump than if the goal is to reduce minor business cycle fluctuations.

It is important to remember that to a very great extent a nation has the ability to achieve its economic goals by itself. Although the levels of demand, inflation, and interest rates in one country do affect the economies elsewhere, a country can manage its own monetary, budget and tax policies to offset many of the effects from abroad. Thus changes in domestic monetary policy can counteract the contractionary or inflationary pressures from abroad and structural tax policies designed to encourage investment can offset the effects of a worldwide rise in real interest rates.

Moreover, although fortuitous foreign economic policies can sometimes make it easier to achieve some domestic goals, those same policies often make it harder to achieve other goals. For example, although the rising dollar in the early 1980s and the accompanying increase in the U.S. trade deficit raised demand in Europe and reduced the balance of payments pressures that had discouraged domestic expansion, the dollar's rise also created inflationary pressures in Europe and the trade deficit brought with it a capital outflow that raised European interest rates.

There is also a serious risk that economic summits and ministerial meetings will inhibit appropriate changes in national economic policies. Governments may not take the politically painful steps that they should because they believe that foreign actions will make such policies unnecessary or because they want

to use their own lack of action as part of a bargaining strategy to induce desired policies on the part of foreign governments. Thus the assertion at the Louvre ministerial and at the Venice summit that the dollar will stop declining may have contributed to a complacency that reduced pressure on the German government to provide adequate domestic stimulus and that may even have contributed to the failure of the American Congress to make greater progress in reducing future budget deficits.

### Concluding Remarks

It is unfortunately easy and often politically convenient to exaggerate the potential gains from international economic coordination and to understate the ability of a nation to guide its own economic destiny. It would be a serious mistake if the pursuit of international economic cooperation in exchange markets and in macroeconomic policy management became an excuse for not pursuing appropriate domestic policies.

Moreover, although international cooperation in macroeconomic policy-making sounds like a way to improve international relations more generally, there is the serious risk that it would have the opposite effect. An emphasis on international interdependence instead of sound domestic policies makes foreign governments the natural scapegoats for any poor economic performance. Pressing a foreign government to alter its

domestic economic policies is itself a source of friction and the making of unkeepable promises can only lead to resentment.

It would in general be far better if the major industrial countries concentrated on the pursuit of sound domestic economic policies and reserved the pursuit of international cooperation for those subjects like international trade and national security in which cooperation is truly essential.

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