

## EXCHANGE RATE MANAGEMENT<sup>1</sup>

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### Introduction

Exchange rates lie at the heart of the global financial system, and in George Soros's words "If people like me can crash a currency system, there is certainly something wrong with the system". The present exchange rate regime has two major weaknesses. The most spectacular is the familiar liability of rates to crack at times of financial crises; but equally serious in the longer run are the effects of continuing fluctuations and misalignments in rates on industry and employment in both developing and industrialised countries.

Exchange rate instability, the volatility of international capital movements and bubbles in asset prices, are all closely interlinked. In the 1997 Asian crisis, for example, the stampede to invest in the 'Asian miracle' countries led to a flood of inward capital, a boom in share and property prices, and upward pressure on exchange rates. A change in sentiment led to a reversal of capital movements, a collapse in asset prices and a sharp fall in exchange rates.

Tackling such crises requires action on a broad front. There is no one panacea. This note deals with the exchange rate problem, but what is needed is a consistent set of measures which will reinforce each other - including reconsideration of the use of controls on capital movements by developing countries, improved regulation of banks and other financial institutions and taxation of financial transactions - as well as reform of the exchange rate system.

Crises apart, exchange rates set the terms on which countries trade each others' goods and services, and the level of rates can have a powerful effect on industrial output and employment. From industry's point of view the two objectives are that rates should be competitive and stable. Under the present regime of floating rates, neither objective is assured. Foreign exchange markets do not (as economic theorists once suggested) adjust rates so that countries' international payments come into balance – they never did. But today the overwhelming determinant is the movement of short-term capital. The result is that when it is fashionable, a country's currency may become overvalued and its exports uncompetitive, with disastrous consequences for many of its industries. But when the rate comes down, firms will not automatically increase export capacity again and take on more staff, because they will have no means of telling where the exchange rate will be in 6 months' or a year's time. Such a situation is starkly at odds with the development of multi-national industrial companies who find themselves unable to plan future investment or operations rationally when variations in exchange rates can alter the relative costs of plants in different countries from month to month in an unpredictable fashion. An unjustifiably high exchange rate in one country may lead to production cuts or plant

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closures in that country with disastrous economic and social consequences for the people and areas concerned. One country's loss is not automatically another's gain.

The answer to the problem of achieving a more stable system is not to go back to a fixed rate regime. Both fixed rate and free-floating systems suffer from serious weaknesses. The major weakness of the "fixed" rate system is the difficulty of adjusting rates when relative costs in different countries get out of line. Under the Bretton Woods regime, such adjustments were generally delayed until they were long overdue and then forced on the country by a run on its currency and consequent devaluation in crisis conditions. The same thing applies today to countries with rates pegged to the dollar or some other major currency. Industry suffers from the delay in adjustment, and to deter speculation finance ministers are compelled to deny that devaluation is a possibility until a run on the currency market makes it inevitable. Their credibility is then in tatters. No wonder politicians tend to prefer floating rates : even if industry suffers, finance ministers do not get the blame!

### **Managed rates**

One answer to the quest for stability is to form a currency union, such as the EMU, which effectively fixes the rates of the participants for all time by adopting a common currency. But this is only a practical route for countries which have achieved a high degree of economic and political integration, and even then may cause serious strains if costs in one area get out of line. A more general solution is to adopt some form of "managed" rate system, under which countries seek to achieve target rates for their currencies: these can be either informal and unstated, or publicly stated parities and bands, as in the ERM.

The history of the ERM highlights two fundamental difficulties that have to be overcome if a system on similar lines is to operate successfully elsewhere. The first is the difficulty of getting agreement on adjustments in rates. The second is the need for an effective mechanism for intervening in the markets to keep rates within their stated bands. The break-up of the ERM in September 1992 reflected the inability of the members to agree on such changes and their inability to resist speculative pressure when their increasingly unrealistic rates came under attack. These two problems are inter-linked, because an essential prerequisite for being able to resist speculation is that the rates should be seen to be realistic and sustainable.

One way to overcome these problems is to review the rates at relatively frequent intervals, say monthly, and make only relatively small adjustments in rates. (There is an analogy with the way central banks review interest rates once a month.) For example, if the agreement was that rates would be kept within a band of  $\pm 2.5$  per cent of their stated parities, and their parities were moved up or down by 1 per cent after the monthly meetings, the new parity would still lie within the old band and the spot rate the next day might be no lower than it was before. This would considerably limit the scope for making major speculative gains. The broad aim would be to keep "real" rates broadly stable i.e. rates after allowing for differing rates of inflation.

The second innovation would be that intervention in currency markets to stabilize rates should be

*automatic* rather than discretionary. Discretionary intervention involves *ad hoc* consultation and action by central banks. It takes time and their foreign exchange resources are limited in relation to market turnover. Automatic intervention would be most effective if it were the responsibility of a special stabilization fund set up with adequate resources for this task, rather than left to co-operation between central banks. Making the same committee of central bank and governments officials responsible both for setting rates and running the stabilization fund should ensure that the rates are realistic and maintainable. Once the system is seen to be effective, the stabilization fund should in practice have little cause to intervene.

### **A two-tier system**

A system of this type, and indeed any managed rate system, formal or informal can only operate effectively among a small enough number of participants to be able to reach mutual agreement on rates. It would not be practical on a worldwide scale. This suggests that the achievement of greater exchange rate stability depends on a two-tier approach, with arrangements to manage rates both within regional country groupings and also between such regions. Such a movement is likely to take the form initially of developing regional arrangements in Europe, America and Asia, based on the euro (and sterling), the dollar and the yen, and then a “tri-polar” system for managing the rates between these three groupings. Such systems would vary from region to region. The EU grouping would operate a new ERM mechanism on these lines to stabilize the relation between the euro and EU members outside EMU, including sterling.

In Asia, under the Chiang Mai initiative, 13 countries have agreed arrangements to monitor foreign exchange markets, with swap and repurchase mechanisms to aid currencies in difficulties. China, with its huge foreign exchange reserves of over \$150 bn, is a participant and arrangements are in hand to formalize the present *ad hoc* arrangements. The US, which shot down an earlier Japanese plan for an Asian monetary fund has supported the new initiative.

In Latin America, the current issue is “dollarization” i.e. other countries adopting the US dollar as their own currency. This raises serious political and economic problems for both sides, since American monetary policy would become the monetary policy for the dollarized countries without their participation in the Federal Reserve System. A more flexible form of mutual currency management on the lines outlined above would in the longer run be a more widely acceptable alternative.

Stability at the global and regional levels is inter-related. It would, for example, be much more practical to maintain a stable relationship between the pound and the euro, if the euro were more stable relative to the dollar. Similarly in the East, it would be easier for Asian countries to have stable rates vis-à-vis the yen, if the yen were stable relative to the dollar. While arrangements would vary from continent to continent, there is a strong case for *stated* parities and bands (reviewed say, monthly) and *automatic* stabilization arrangements.

## **Determining rates**

If exchange rate parities are to be determined by discussion between the participants in the system, two conditions are essential. The first is that in entering the system countries' rates must be at a reasonable level. It is essential to avoid countries entering at unrealistically high rates which damage their industry and cannot be maintained, as happened when sterling entered the ERM in 1990 – or conversely others entering at extremely low ones. The negotiation of initial rates is, however, bound to be tricky because of the clash of industrial interests between the countries involved – mitigated by the divergence.

The second, and more complex condition, is that any international discussion of exchange rates must be based on a view as to the desired pattern of payments between the countries concerned. Where most members of the group are more or less in payments balance, this is not of prime concern, but where there are countries with substantial deficits or surpluses, there has to be a view (tacit or overt) as to whether the continuation of these surpluses and deficits is acceptable in setting rates, or whether rates should be adjusted to reduce the imbalance.

This problem arises in most acute form between the major regional blocs. A prime example of this arises in considering the rate between the yen and the dollar at a time when the US is running a large current deficit (over \$400 billion in 2000) and Japan a substantial surplus (about \$120 billion in 2000). At the moment, a stronger yen would make it more difficult to get the Japanese economy expanding again. But in the longer run, over a say five-year period, the continuation of the US deficit at recent levels seems unsustainable. Its continuation depends on the willingness of investors in other countries to fund it by buying US bonds or shares, and investing in industry or property there. A setback on Wall Street, or a loss in confidence in the dollar, could reduce, or even reverse, this flow, creating a serious financial crisis. In the longer run the US deficit must come down and the Japanese surplus, which is to some extent its mirror image must also come down. This means that sooner or later the dollar must come down and the yen go up. Agreement on this will be a delicate matter and require careful timing. The relationship of the yen and the dollar with the euro will be less difficult because the European surplus is less significant.

Similarly within regions, there will need to be consideration and agreement on the pattern of payments between participating countries, in other words, regional as well as global payment strategies.

## **Taxation**

One means of reinforcing the stability of such an exchange rate regime is the use of taxation to dampen down fluctuations in currency markets. The imposition of a flat rate Tobin Tax on currency transactions would reduce day-to-day speculative activity but would not be an effective deterrent to speculation on major changes in rates. This has led to the Spahn proposal to levy a two-tier currency tax in association with a target zone exchange rate system. There would be low tax, say 0.1 per cent, on transactions in the stated band, but a penal levy, up to 100 per cent, on

transactions outside the band. Parities would be kept realistic by a ‘crawling peg’ system of linking them to a running average of rates over, say, the last 20 trading days. The problem about the crawling peg system, however, is that although it may slow down the rate of change, once a rate is set to move downwards, or upwards, it tends to reinforce that movement.

It is suggested that such a tax could be levied unilaterally by individual countries because all transactions ultimately have to go through the payments system. It is difficult to believe, however, that such an extreme form of, in effect, exchange rate control, could operate on a purely national basis. Sooner or later we must enter an era of international taxation for transactions which can take place virtually anywhere, e.g. both currency and other financial transactions. As George Soros says: “Why should there be a Value Added Tax on physical transactions, but no tax on financial transactions?” Taxation of currency and other financial transactions is essentially something which has to be undertaken on an international basis, e.g. harmonizing existing national duties on share transactions.

### **Fiscal and monetary policy**

One corollary of moving into a more stable system of managed exchange rates would be that countries would no longer be free to use monetary policy as their prime means of managing demand. Interest rates in different countries would have to be kept broadly in line, subject to differences in their rates of inflation. (Their general level would reflect global economic conditions with particular reference to the state of the US economy.) Budgetary policy would then become the main tool available to national governments for regulating demand in accordance with differing national circumstances – as it must *a fortiori* in a currency union like EMU with a single currency and monetary policy. Greater use of fiscal policy would run counter to the prevailing political and economic fashion inherited from the monetarist 1980’s, but it is a natural consequence of globalization of international financial markets, if industry is not to pay a heavy price (as at present) in terms of exchange rate instability.

### **Conclusion**

A more stable exchange rate regime is the least discussed, but most fundamental, reform of the global financial system that we should be addressing. Both fixed and freely floating exchange rates have serious disadvantages: “fixed” rates tend to be adjusted only under crisis conditions; floating rates leave industry at the mercy of inappropriate and unforeseeable movements in rates. We need to devise systems of managed, but flexible, rates which can be adjusted to changing conditions (such as relative movements in costs), but which provide greater stability. The general model for such systems should be to have: publicly stated parities and bands - with rates reviewed, say monthly; any necessary changes made in small steps; and *automatic* intervention through special stabilization funds set up for this purpose (rather than by central banks).

Moving towards a more stable, managed exchange rate regime requires a two-tier approach, with (a) regional systems (which may vary between different regions), and (b) global arrangements to

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link the rates between them. Initially this would embody: a European grouping, managing the rates between the euro and non-EMU countries in the EU; a North and Latin American group based on the dollar; and an Asian group based initially on the yen. Such a tripolar system would then require a global arrangement (under the IMF) to manage the rates between these three groupings. But until such groupings were established, informal moves to manage the relation between the three major currencies would help to achieve greater stability.