Dollar, Yen and Euro: Confusion at a High Level

(published in a slightly revised version as: „Note to Summers“ in International Economy)

by

Heiner Flassbeck

During the summer the Japanese government has been heavily criticized by Larry Summers, the new Treasury Secretary of the United States, for intervening in the exchange market to avoid a further appreciation of the Yen against the US-$. Instead of leaning against market forces, the Japanese government should rather concentrate their efforts on a stimulation of domestic demand, given the high current account surplus of Japan, urged the critic. At that time Summers was known to have criticized the Europeans too time and again for not stimulating their domestic demand, given their high current account surplus and sluggish growth. Not mentioned, however, in the case of Europe was the fact that their currency, the Euro, depreciated sharply vis a vis the US-$ during the first half of 1999, thus reducing for Europe the need to stimulate domestic demand as they could expect to export their way out of the slump.

The US Secretary of the Treasury criticizes Japan in their attempt to block an appreciation of the Yen although the Japanese government had been working very hard in the last two years to stimulate domestic demand. But he refrains from asking the Europeans to prevent a depreciation of their currency although Europe has not worked hard at all to stimulate domestic demand. This reveals a strange asymmetry in the argument which is difficult to understand just weighing the facts on both sides. Given the fundamentals in Japan on the one hand and Europe on the other hand, both currencies are clearly candidates for an appreciation vis a vis the US-$. Actual inflation differentials as well as expectations concerning future inflation differentials which can be derived from actual growth differentials are clearly not in favor of a strong Dollar. The high overall current account deficit of the US and the bilateral deficits with both partners point in the same direction. Only interest rates are higher in the States than in Japan and Europe. But if this is taken as an argument, the much higher differential with Japan, seen from the US, could only lead to an even more pronounced devaluation of the Yen, not a revaluation, if such a differential justifies the decline of the European currency.

Two currencies with fundamentals pointing in the same direction but de facto moving into opposite directions give economic policy no rational choice. Put it in different way: The US orthodoxy, „leave the exchange rate to the market„ obviously yields contradictory results. If theYen is not stopped from rising, the Japanese recovery will falter and thus render much more difficult the „job„ of the Japanese government to stimulate demand effectively and help to bring down the global disequilibria in trade. Fortunately for Japan, to stop the rise of the Yen and to give domestic demand via monetary policy a boost are not directly in conflict. This is much more difficult in Europe. If the Euro is stopped from falling by means of monetary policy, e.g. rising interest rates, it may be impossible to stimulate domestic demand. But if the Euro is not stopped from falling European economic policy will not be forced to stimulate domestic demand at all but will again take a free ride on growing exports thereby aggravating the global imbalances in trade. A consistent strategy of the G 3 is without a chance as long as the US sticks to its general dogma of leaving the determination of the exchange rate to the markets.

When questions like these were raised at the beginning of the year by the former German finance minister Lafontaine the US answer was stereotype. Secretary Rubin would have stressed, and he did that in the public before the spring G 7 finance ministers' meeting in Bonn, a very simple case. He said that from his point of view it would never be reasonable to raise interest rates in a recession just to defend a certain parity, i.e. avoid a depreciation of the US $ at the high price of deepening the recession. This is an absolutely convincing argument if it describes the relevant situation correctly. But, as illustrated by the Japanese case, it may be fully beside the relevant point if the exchange rate doesn't follow Rubin's theory but rather a random walk. The question currently asked in Japan is: How can a deepening of the recession or a renewed slowdown be avoided as monetary policy, due to interest rates already close to zero, has lost its strength and the currency is nevertheless under the pressure of markets to appreciate - not depreciate? There is obviously no answer in Rubin's theory to this question.

Exchange rates, left to be determined by the market, do not follow rational paths of adjustment or even facilitate rational decision making by economic policy. Sometimes, by chance, they may help to complement monetary policy in a certain cyclical situation. But as this cannot be expected in a systematic manner there is virtually nothing that can be left to the market alone. Moreover, exchange rate changes, a depreciation for example, may work in the same direction as a reduction in interest rates. But there are additional effects on the allocation of resources. The relative price between tradable and non-tradable in every country is changed at the same time as the price between domestically produced and foreign goods is altered. If Europe's recovery today would be based to a very large part on the effect of a depreciation instead of demand stimuli from economic policy, the overall outcome on production in the European economy may be similar to the one that can be achieved by lowering interest rates. The necessary by-product of an exchange rate based strategy in Europe will be a further increase in the gap between exports and imports on the one hand and an increased profitability of exportable goods compared to non-tradables like services. The opposite will occur in the United States. In the medium and long run it will become even more important then to turn around this kind of development. Thus, the larger the misalignment today the more probable is a full swing in exchange rates later with all its complementary effects on investment in fixed capital on both sides of the Atlantic.

The US-Government will learn the importance of these considerations as soon as growth rates plummet under the burden of higher exchange rates plus higher interest rates. The Euro may follow the example of the D-Mark at the beginning of the 80s when, in comparable cyclical circumstances, the real $-value of the D-Mark nearly halved in a period of only three years. In this case the US economy will feel the strain and the US Government will react. It is only due to successful macroeconomic policy in the 90s that up to today a benign neglect approach of the US administration seems to be feasible. But the bubbles, including the one that is blowing up between $ and Euro in 1999, will burst. Only an early cooperation between the G 3 can help to avoid what will later be called a major misalignment with all its repercussions on the real economy. The lesson of the 80s is a simple one: There can be preemptive strikes by international monetary policy to avoid unjustified changes in the external value of money and this is justified as the effects of these changes are at least comparable to the effects of dramatic changes in the domestic value of money (unanticipated inflation or deflation).

Why is it that the market for currencies misalignes time and again whereas we do believe that all the other markets, the markets for everyday consumer goods as well as those for extremely expensive investment goods, work effectively? A radical liberal thinker, F.A.Hayek, has led the way towards a solution. According to Hayek's theory of markets, the goods markets are efficient because on these markets millions of participants collect trillions of individual information units which determine the prices of a huge variety of goods. A government can neither collect nor process this information reasonably and thus cannot produce prices which adequately reflect scarcity. The market for currency is organized in a quite different way. On this market information is collected which stems mostly from government sources like statistical offices or central banks. This information is interpreted in a certain way by, even on a global scale, a few traders. They try to match the views which, like in a beauty contest, are seen as representing best the views of the majority of traders. The aim of the game is not to buy the product because it is needed to produce or sell something that forms part of an individual activity of profit making but to make the highest profit with the best forecast of the final outcome of the game.

That is not to say that exchange rate changes in the global economy are not needed any more. If convergence of the monetary conditions, i.e. the convergence of inflation rates, is not yet achieved exchange rate changes should reflect the resulting differences adequately to equilibrate the competitive positions of regions or nations. But if convergence is given, as in the European Union, and the participating nations feel have the stamina to stick to their obligations in terms of preserving their competitive level without relying on changes in the value of money, the exchange rate is not needed any more. Europe since the beginning of this year has achieved an extraordinary success. It has closed one of the biggest casinos in the world and time will tell that this was a rational decision. But the rest of the world is not terra incognita. The European achievement is only a half way house if it is not complemented by more monetary cooperation on the level of the G 3 and regional arrangements between the G 3 and the emerging markets which pave the way for closure of the other casinos in due time.