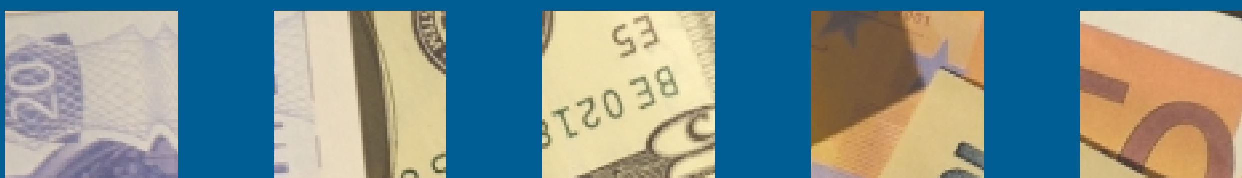
Woodrow Wilson International Center for Scholars

Project on America and the Global Economy

THE CURRENCY CONUNDRUM

EDITED BY KENT HUGHES



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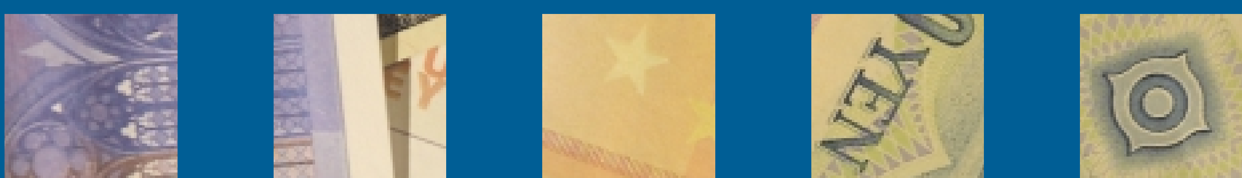

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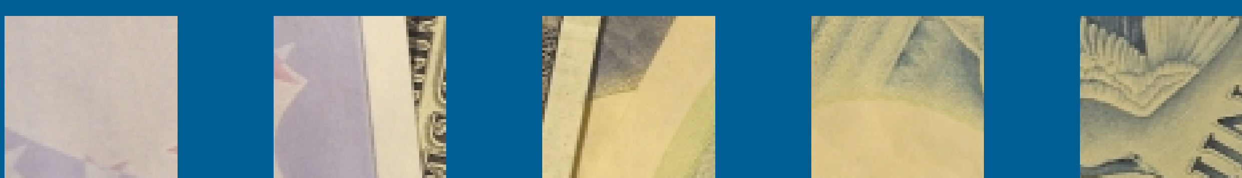

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ABOUT THE CENTER

The Center is the living memorial of the United States of America to the nation's twenty-eighth president, Woodrow Wilson. Congress established the Woodrow Wilson Center in 1968 as an international institute for advanced study, "symbolizing and strengthening the fruitful relationship between the world of learning and the world of public affairs." The Center opened in 1970 under its own board of trustees.

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INTRODUCTION

KENT HUGHES, Woodrow Wilson Center

America and the Global Economy

For most of the twentieth century, Americans rarely needed to understand the intricacies of foreign currencies. The every day "greenback" has been the only currency most of us used or even thought about. Traveling Americans would wrestle with converting dollars into French francs, British pounds, and Italian lira, but they seldom thought about them in terms of America's economic stability. Throughout the 1960s, the business community focused almost exclusively on the American market and a "good as gold dollar." Because most major commodities such as oil were and continue to be priced in dollars, foreign currencies played a relatively small role in America's imports.

Times have changed. Americans can no longer afford to ignore the relationships between the dollar and other major currencies in the global economy. The sharp increase in the value of the dollar in the early 1980s penalized U.S. exports and helped accelerate a painful restructuring of American industry. The mid-1980s decline in the dollar boosted U.S. exports and provided support for a period of sustained economic growth. The dollar and its relationship to key currencies matter.

Fluctuating Dollar—Impact Overseas/Impact at Home

An increase in the value of the dollar can also affect the domestic economy through its impact on overseas markets. The 1997-98 Asian crisis is a recent example. With many Asian currencies linked to the dollar, the mid-1990s rise in the value of the dollar made Asian exports less competitive on world markets. That lack of price competitiveness contributed to the collapse of the Thai baht and the spread of the currency crisis to several other Asian economies. The impact did not stop there. Investors fled Asian currencies for dollars and dollar-based investors sought the safe haven of U.S. government securities. Even solid American companies were finding it difficult to secure credit. Many observers look back at the period and credit the Federal Reserve for stabilizing American financial markets by making three quick cuts in short-term interest rates.

As Bush Administration officials decide how to manage the international financial challenges occurring on their watch, they will inevitably focus on the value of other major currencies and their impact on American commerce. The growing importance of international financial markets can be traced to several factors:

- **Single Currency in Europe—**A single currency, the euro, is replacing most national currencies in the European Union; independent monetary policies are giving way to a European Central Bank—Europe's answer to America's Federal Reserve Board. Already used as a unit of account, the euro will replace national bills and coins on January 1, 2002. Euro denominated bonds already account for a significant share of recent hard currency issues.

- **Yen Zone in Asia—**Despite a decade of stagnation, Japan remains the world's second largest economy. Extensive Japanese investment in East and Southeast Asia continue to fuel speculation about an eventual yen bloc.

- **Growth in Foreign Trade and Investment—**Exports and Imports now account for 25% of U.S. gross domestic product—double the level of two decades ago. Most American manufacturers and a growing number of service industries face foreign competition in the U.S. market. Rapid growth in foreign direct investment now links a host of U.S. industries and communities to overseas firms.

- **Currency Transactions not Traditional Trade—**The amount and speed of currency transactions has grown dramatically over the past two decades. By the time of the 1997 Asian financial crisis, $1.25 trillion dollars passed through currency markets every day.

- **Communications and Computers**—Aided by the communications revolution, billions of dollars move from one country or one continent to another with a touch of the keyboard. The ease and importance of global financial markets have attracted a growing number of players. Banks, financial institutions, and individual speculators frequently and actively participate in the global currency markets.

The value of the dollar in terms of other key currencies can have a major impact in the United States and in much of the world. Expectations about future currency values can influence everything from short-term interest rates to long-term investment decisions.

With a new President and a new Congress, the Wilson Center decided it would be useful to explore recent trends influencing the relative value of the world's three major currencies.

Wilson Center Tackles the Currency Conundrum

On January 11, 2001, the Woodrow Wilson Center convened a day-long conference on the world's major currencies, the dollar, the euro and the yen to address the growing importance of currency values and exchange rates and to analyze the options for U.S. policy. Among the participants at that conference were some of the leading financial experts in the world. They included practitioners who have affected currency markets themselves, as top Finance Ministry and Treasury Department officials or private financial market players at some of the largest firms in the world. This report includes the formal presentations and discussion at the Wilson Center conference plus additional analysis by the Center's scholars. In a final section, the report draws on the conference to define a series of currency related challenges facing the United States.

The Dollar, the Euro, the Yen and Target Zones

Leading off the January conference was Robert Hormats, Vice Chairman of Goldman Sachs International. He spoke on the January 2001 strength and future course of the dollar. Norbert Walter, chief economist for Deutsche Bank, assessed the outlook for the euro as a reserve and trading currency as well as tracing its evolution since its adoption in 1998. Eisuke Sakakibara, former Vice Minister of Finance in Japan and currently the Director of the Global Security Research Center at Keio University, examined the likely future of the yen in light of current economic and political conditions in Japan. C. Fred Bergsten, Founder and Director of the Institute for International Economics, explored the need for target zones that would limit the fluctuations in the values of the major currencies.

A Panel of Experts and a View from Congress

A panel of experts, John Walsh, Executive Director of the Group of Thirty, Adam Posen, Senior Fellow at the Institute for International Economics, and Paula Stern, former Chair Woman of the International Trade Commission and President of The Stern Group, added further political and economic perspectives to the individual presentations. Senator Paul Sarbanes concluded the day by providing a view from Capitol Hill on global currencies and the related question of large American trade and current account deficits.

A Prologue to the Conference—Understanding the Links between Currencies, Foreign Investment and Trade

The key measure of one year's borrowing or lending is the current account deficit, which includes international trade in goods and services, dividends, and the funds American residents send to family or friends overseas.

Over the past twenty years, the American economy has become much more tightly woven into the global economy. The importance of exports and imports to the American economy has more than doubled and now amount to more than 25% of total output. Most manufacturers and a growing number of service providers now face global competition as well as global opportunities. Overseas investors in the American economy have brought with them new technologies and new ways of doing business that have helped make American businesses more productive and more competitive. New competitors have spurred innovation, helped create better paying jobs, and helped make faster overall growth possible. At the same time, the power of global competition has often required painful adjustments by workers, industries and whole communities.

Global financial markets have grown even more rapidly than international trade. Through linked capital markets, savers in one country find it much easier to invest in another. Such overseas investment might take the form of a new factory, office, or research lab or the simple acquisition of stocks and bonds. Many global investors opt for very short-term investments that can be moved rapidly in response to a shift in interest rates or the perception of added risk.

There are other reasons for this explosive growth in the international movement of capital. Central banks purchase dollars as part of the reserves they hold to settle their country's international accounts or to add stability to their own currency. Private investors will often acquire dollars when they think the value of the dollar will rise compared to other major currencies. On the other hand, if the dollar is declining or likely to decline, foreign investors may shy away from buying American stocks and bonds. Changes in the dollar's value can also have an impact on exporting industries and on industries that compete with imports. The same is true of industries in countries that have tied their currency to the dollar.

All of these movements and fluctuations in currency values are directly linked to the United States' trade balance and to foreign direct investment in our economy. Today, and for at least two decades, the United States has been consuming and investing more than it produces. Foreign investors and foreign investments have made up the difference. The key measure of one year's borrowing or lending is the current account deficit, which includes international trade in goods and services, dividends, and the funds American residents send to family or friends overseas. At \$435.4 billion

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dollars, the year 2000 current account deficit was a record in terms of absolute dollars and in comparison to the size of the U.S. economy.

During World War I, the United States became a net creditor. Governments and individuals around the world owed Americans more than Americans owed them. At the beginning of the 1970s, America was the world's largest creditor. But persistent trade and current account deficits gradually eroded our creditor position and have now turned America into the world's largest debtor. On the day of *The Currency Conundrum* conference, America's external debt had reached $2 trillion dollars or more than 20% of American gross domestic product.

Since 1973, the dollar has risen and fallen relative to the currencies of the other major powers.

The steady flow of foreign capital to the United States has helped keep interest rates low and allowed a faster rate of growth. But this continued dependence on foreign capital poses at least two questions for the United States:

- First, will overseas investors keep their holdings in the United States?
- Second, will those same investors continue to finance future current account deficits by adding to their dollar holdings?

How currency markets determine the value of the dollar is one of the key factors that will decide the answer to those questions and the future of the U.S. trade balance.

Since 1973, the dollar has risen and fallen relative to the currencies of the other major powers. To a large degree, the dollar has become like any other product that can be bought and sold on international markets. It is, however, a unique commodity—its price influences the price of American exports and imports as well as the attractiveness of U.S. stocks and bonds. When the dollar rises or appreciates against other major currencies, it acts like a tax on exports and a subsidy to imports.

In the early 1980s, the sharp appreciation of the dollar cost many American exporters their overseas markets and contributed to a rapid and painful adjustment in a number of American industries that competed with imports. By the late 1980s, a more competitive dollar (as a result of a gradual fall in the dollar's value) reduced the relative size of the trade deficit and improved the prospects for American industry.

In early 2001, there were thus several reasons to assess the future direction of key currencies. The United States was entering new territory as the current account and the external deficit set new records. Both professional economists and Wall Street analysts began asking if the United States could continue to finance a large and rapidly rising current account deficit?

In Europe, an improved economic outlook had helped strengthen the euro. In addition to speeding European economic integration, the euro was also intended to deepen European political ties. Both developments are of significant interest to the United States. As the second largest economy, Japan continues to loom large in the thinking of international economists. The decade-long stagnation of the Japanese economy has led to a gradual weakening of the yen which creates trade competition for much of Asia and could add to trade pressures on American industry.

Finally, the conference was timed to anticipate a new Administration in Washington. In its first year, President Bush and his economic team have already faced serious international economic challenges. The overall slowing of the American economy coupled with the sharp drop in information technology investment had weakened the export-oriented economies of Asia. Financial challenges facing Argentina and Turkey have threatened the prospects for emerging market finance. The tragic attacks of September 11 have created added uncertainty for the global economy. Longer-term trends pose their own challenges. The Japanese economy continues to sputter. The United States has been a decades long supporter of economic and political integration in Europe. The very success of that integration may, however, make Europe a more attractive target for investors at the expense of the United States. The question is particularly acute in light of the significant amount of European investment that has come to the United States during the past decade.

Twentieth Century Origins of Global Finance

The twentieth century opened with Great Britain as the dominant military and financial power. Much of the world was experiencing the first age of globalization. International trade and investment were growing rapidly. Innovations – whether bought or "borrowed" – spread rapidly through Europe, North America and much of the world. Immigrants flooded into the United States to help fuel industrial growth.

Until World War I, the world was largely on the gold standard. Business and individual investors relied on currency and coins that were backed by gold. By tying national currencies to gold, governments felt they were keeping prices as well as the value of their currency stable. Having a stable currency facilitated international trade – there was little risk that the value of a currency might fall. Because economies were growing more rapidly than the supply of gold, there was a downward pressure on prices that favored consumers at the expense of producers. The stability and downward pressure on prices also favored lending and the lenders. Many American farmers were struggling to pay debts while the price of their crops fell. When William Jennings Bryan cried out against "crucifying mankind on a cross of gold," it was the gold standard he had in mind. Without that standard, governments could have printed more money, reduced the value of loans, and made life easier for the many American farmers who had sunk into debt. The whole system was backed by the Bank of England and, indirectly, by the strength of the British economy. No American Federal Reserve System existed at the time.

World War I disrupted global trade and the international financial system. After the war, the victorious allied powers (including France, Italy, the United States and Great Britain) attempted to reestablish the gold standard and rebuild the economic links that had been broken or strained during the war. Great Britain, however, could no longer play the same leadership role. Even before the war, Germany, Japan, Russia, and the United States were challenging Britain's military dominance. Britain's economic preeminence was also in decline. The United States had already emerged as the world's major industrial power. Germany and other countries on the continent had also been successful in reducing the industrial gap between themselves and Great Britain. In several newer industries, Britain had clearly fallen behind.

Despite the shift in global economic fortunes, Britain sought to reestablish the pound sterling as the bedrock of world finance. But the British government set a value of the pound that made British industry less competitive on global markets. This led directly to economic weakness at home and erosion of influence abroad. In retrospect, economists and historians point to the United States as the country and economy that might have sustained a new global gold standard. The United States, however, had returned to the jazz age. It was a time when America was 'speaking easy' rather than carrying the world's financial stick.

Interwar Competition. After World War I, the United States had a relatively brief transition to a peacetime economy. An initial slowdown gave way to renewed prosperity until the onset of the Great Depression. Much of continental Europe was trying to rebuild. The peace settlement imposed enormous war reparations on Germany that fueled anger and resentment. Because reparations could take the form of exports, they posed a potential problem for other European countries attempting to rebuild. The war had cost Britain a generation of national and colonial leaders and forced the sale of British investments in Latin America and elsewhere around the world. Saddled with an overvalued pound, British manufacturers were struggling to recover.

In place of the relative stability of the gold standard era, countries sought new ways to support and rebuild their economies. In some cases, individual countries devalued or reduced the price of their currency in gold. The cheaper currency, they reasoned, would promote exports and discourage imports. In other cases, countries raised tariffs to protect domestic industries from foreign competition. The United States took the latter route by raising its own tariffs after passage of the well-known Smoot-Hawley Tariff Act of 1930.

The economically destructive competition among nations was not the sole or even the principal cause of the Great Depression. A collapse in investor confidence triggered an initial decline, but many contemporary economists point to the decision to tighten monetary policy and seek a balanced budget as key factors that helped turn a recession into a depression. The economic costs were severe and global in their reach. American statistics are one good measure. From the perspective of 2001 with unemployment near 4%, it is hard to imagine that in 1936, 25% of the American workforce was unemployed. If anything, the Great Depression had even greater political consequences. In the Soviet Union, Stalin turned from tentative engagement with the world economy to autarky. In Europe and parts of Latin America, there was the rise of an authoritarian brand of fascism. Germany turned to the Nazis. World War II began under a cloud of economic decline.

After World War II: Creating a New Global Economy

Even before World War II had ended, the United States and Great Britain were working to design an international economic system for the postwar era. In looking forward, they were also looking back at the failures of reparations imposed at the end of World War I and the destructive use of currency devaluations and trade protectionism during the interwar period. The organizations they created are generally referred to as the Bretton Woods institutions after Bretton Woods, New Hampshire where the United States and forty-four other nations reached an agreement.

In place of reparations, the United States, Great Britain and the other allies focused on postwar reconstruction. In helping to rebuild countries devastated by the war, the allies created the International Bank for Reconstruction and Development (IBRD) now known as the World Bank. The IBRD did not act alone. U.S. leadership, technical assistance and financial support were all critical elements in rebuilding Europe and Japan. But, by making reconstruction a multinational effort, the IBRD helped speed recovery and laid the basis for long-term international cooperation.

In the interwar period, tit-for-tat protectionism had left everyone with less trade and weaker economies. The concern about trade protectionism was not limited to strictly economic questions. The victorious allies linked the economic failures of the interwar period to the rise of fascism, the onset of the war and the horrors of the Holocaust. In looking to restore a system of world trade, the allies felt they were building peace as well as prosperity. Their initial answer was to propose an International Trade Organization that would have provided an ambitious framework for international economic coordination. In the end, the proposal proved too ambitious and was not acceptable to the U.S. Congress. The commercial chapter did survive and became the General Agreement on Tariffs and Trade or GATT. After providing the framework for a series of international trade agreements, the GATT merged into a newly created World Trade Organization in 1994.

During the interwar years, countries had also turned to competitive devaluations of their currencies in hopes of shielding their home market from imports and giving their exports a competitive edge. The overall result paralleled the impact of simple trade protectionism and also brought declining world trade and weaker national economies. In place of competitive devaluations, the allied architects of the postwar world sought to return to the stability of the gold standard. In this case, they looked to the U.S. dollar. The dollar was backed by a U.S. promise to convert dollars into gold at a fixed price. To monitor the new international financial system, the allies created the International Monetary Fund (IMF). In addition to overseeing the agreement on exchange rates, the IMF was designed to help countries that had temporary balance of payments deficits. Instead of resorting to potentially destructive devaluations, the country in difficulty could turn to the IMF for a temporary loan until it had made the adjustments necessary to restore balance.

The End of the Fixed Exchange Rate Era. By the late 1960s, the Bretton Woods system of fixed exchange rates was under serious pressure. Over time, overseas holdings of dollars passed the amount of gold the United States had to back them. Worse, with inflation rising more rapidly in the United States than in Europe, Japan and other major trading countries, exchanging dollars for gold became an increasingly attractive option. Because exchange rates were fixed, the U.S. could not easily devalue the dollar to offset the impact of domestic inflation. Under the Bretton Woods agreement, it was possible for other countries to raise (or revalue) their currencies to maintain the stability of the system. Only Germany and the Netherlands pursued this option and then only to a limited extent.

The combination of industrial recovery abroad and inflation at home meant that more and more American industries faced serious international competition. By the time of the first Nixon Administration in 1969, affected American industries and workers began to call for a sharp change in American trade policy. Faced with growing domestic concern over international trade, President Nixon saw limited prospects for pursuing another major round of trade negotiations. Instead, he was forced to deal with legislative proposals that ranged from protecting specific industries to one that called for limiting the market share of all imports that created competion for American industry.

For every trillion dollars of international trade there are many more trillions of dollars of financial transactions.

In 1971, President Nixon responded with dramatic action. He broke with the Bretton Woods system of fixed exchange rates, indicated that dollars could no longer be exchanged for gold and imposed a surcharge (an added tariff) to a wide array of imports. The Nixon steps proved to be politically effective. The calls for protection made little legislative headway, and Nixon secured authority from the Congress to launch a new round of multilateral trade negotiations. The move away from fixed exchange rates did not, however, provide a lasting answer to America's penchant for large trade deficits.

In 1973, the major trading powers formally agreed to move from the system of fixed to one of flexible or floating exchange rates. The fixed exchange rate era had come to a close, but only after playing an important role in postwar economic recovery and almost three decades of global growth. The three Bretton Woods era institutions – the World Bank, the IMF, and the GATT – lived on to help shape the decades ahead.

The Era of Floating Exchange Rates—1973 to the Present. Since 1973, the global economy has grown in importance for most national economies. Overall economic growth has been significant and the growth of international trade has been even more rapid. Foreign direct investment has become an important element in bringing new technologies and added competition to domestic markets. Pension funds and individual investors now own significant stakes in companies scattered across the globe. Short-term capital can flow in and out of an economy at the stroke of a computer key. In 1973, economists still thought the demand for trade largely determined the value of exchange rates. If Americans wanted to buy more French goods, they would buy more francs and thus drive up the price (or exchange rate) of francs in terms of the dollar. That still happens. But today, analysts focus on the decision to buy assets – factories, stocks and bonds, even the currency itself – or a decision to lend money by depositing it in a bank. For every trillion dollars of international trade there are many more trillions of dollars of financial transactions.

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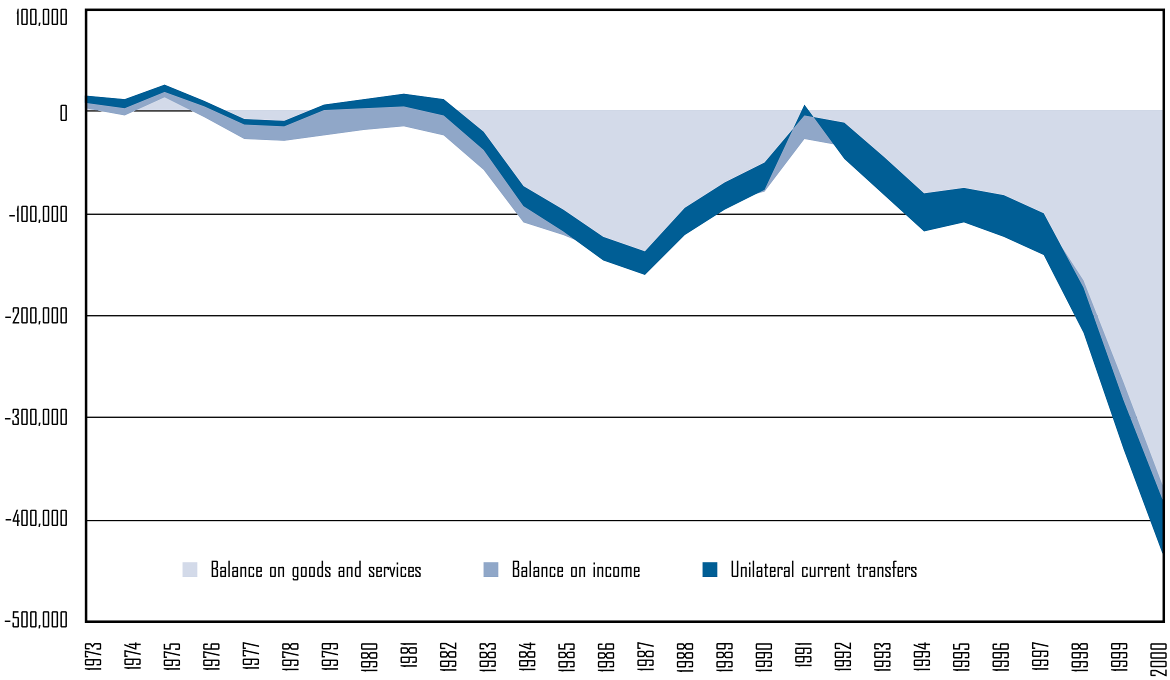
U. S. Current Account (Goods and Services + Income + Unilateral Current Transfers), 1973–2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, Balance of Payments (BOP) and Related Data, Table 1 of the International Transactions Accounts (as of March 15, 2001), www.bea.doc.gov/bea/dil.htm

The trading world has also changed. Many more countries are involved. In 1973, a relative handful of countries were key to writing the trade rules. Those countries are still important but now must negotiate with the 140 members of the World Trade Organization. Countries that were just beginning the process of rapid growth in 1973 are now major competitors in high technology markets. The nature of trade has changed as well. Countries and companies are increasingly trading parts as well as products. The multinational company has continued to grow as a force in international commerce to the point where a significant portion of exports and imports are actually intra-company transactions.

Trade in bulk commodities also continued to grow. By the 1970s, the United States, Europe and Japan were heavily dependent on imported oil. Some of the major oil exporters – for instance Saudi Arabia – had enormous reserves of oil but relatively small populations. When the price of oil jumped sharply over the course of the 1970s, several oil exporters were left with enormous financial surpluses that found their way to American and other international banks.

Flush with what were then called petrodollars, the major banks found ready customers in a number of developing countries focused on rapid economic growth. By the early 1980s, borrowing had run ahead of the ability to repay. Major banks in the United States, Europe and Japan were faced with what became known as the LDC (less developed countries) debt crisis. The problem started with a threatened Mexican default but quickly spread elsewhere in Latin America. Negotiations over the debt and how to deal with it lasted until the end of the decade.

CURRENCY BOARD: A national body charged with maintaining a fixed exchange rate by expanding or contracting the issue of domestic currency in line with holdings of foreign currency and other liquid assets. Unlike a central bank, a currency board cannot simply issue new domestic currency without one-to-one backing, or act as a lender of last resort. Currency boards link their domestic currency to a foreign currency as the exchange-rate peg to the US dollar maintained by the Hong Kong currency board. *The Penguin International Dictionary of Finance,* © Graham Bannock and William Manser 1999

Exchange Rates – The Search for Stability. Flexible exchange rates did eliminate the rigidities that helped bring the fixed exchange rate era to an end. But they came at the cost of stability and certainty. Importing or exporting products now carried the added risk that the exchange rate might change. The same was true with investors. A company producing in Europe but reporting their earnings in dollars looked better when the euro gained in value and worse when it declined against the dollar. International traders and investors often sought ways to limit their risk through futures contracts or offsetting transactions. Security came at a price and was often incomplete.

Some countries sought stability by pegging or tying their currency to one of the world's major currencies – the U.S. dollar, the German deutsche mark (now replaced by the euro) or, to a lesser extent, the Japanese yen. Pegging sought to assure investors and international merchants of a certain predictability. In recent years, several countries have taken a step beyond pegging and opted for **currency boards** that require a foreign currency (usually the dollar) as backing for the domestic currency. In a few cases, countries have simply adopted the dollar as their national currency. Pegging, currency boards, or even the adoption of a foreign currency could not, however, assure complete stability because the dollar or mark or yen could also rise or fall in value. Where countries were still struggling with inflation but wanted added stability they could adopt a crawling peg that provided for periodic adjustments. Other countries opted for floating rates but sought to modify extreme swings in their currency by intervening or buying currencies on the international market. This combination was generally referred to as a dirty float.

Many economists think that financial markets will occasionally overshoot – pushing a currency too high or too low compared to what is actually happening in the economy. How could they return to the stability of the gold standard or fixed exchange rate era and still keep the advantages of flexibility? For a number of economists, the answer lay in target zones defined by economic fundamentals. In other words, an analysis of economic conditions could suggest a stable value for the dollar, the mark and the yen. The currencies would be allowed to fluctuate within a band or zone around the established values for the three currencies. When fundamentals changed, the bands or zones would change with them. The gains from greater stability would also apply to the wide range of countries that had pegged or tied their exchange rates to the dollar or one of the other main currencies.

Periodically, the major industrial powers did attempt to guide their respective exchange rates. The Plaza Accord of 1985 and the Louvre Agreement of 1987 were both designed to bring currencies in line with economic fundamentals.

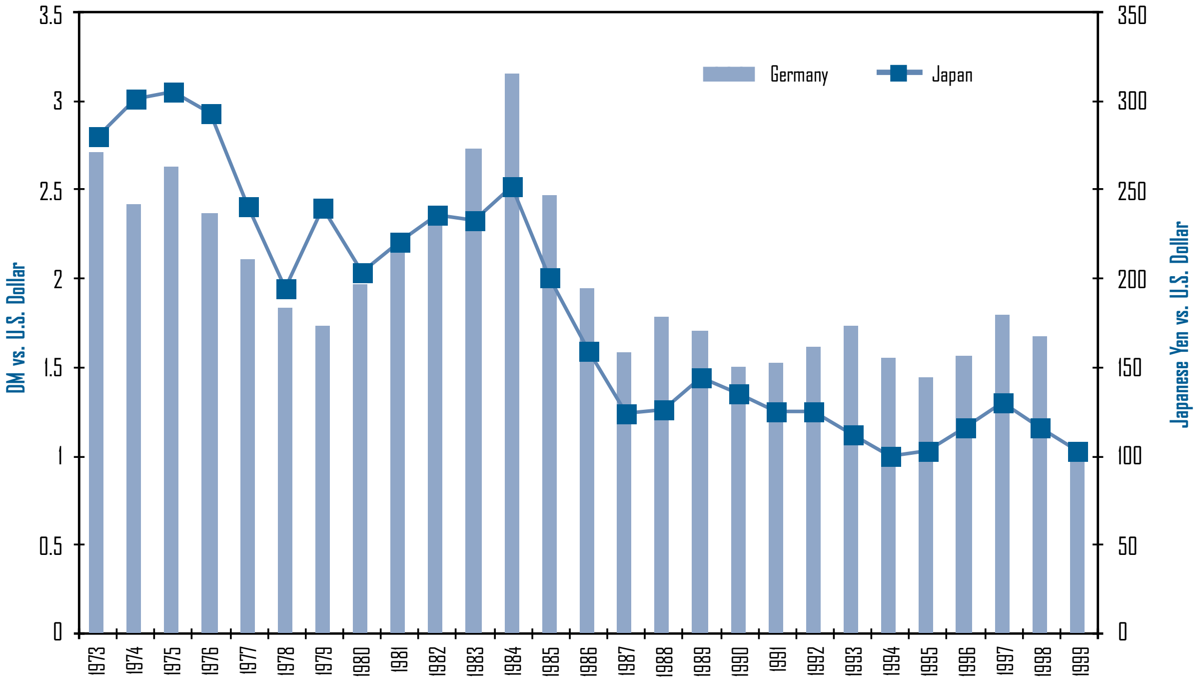
The Asian Financial Crisis of 1997. The 1990s saw a boom in Asia that included East Asia, the ASEAN countries, and China. In several years, national growth rates reached double-digit levels. As their economies grew, Southeast Asian nations opened their capital markets to short-term and long-term foreign investors. Money flooded in. Unlike Latin America in 1980, banks or corporations rather than governments did most of the borrowing.

In many cases, the banks were borrowing short-term money but lending it to corporations that were making long-term investments in factories, office buildings or hotels. The U.S. Saving and Loan Industry had experienced a similar problem in the 1980s when they made long-term loans based on short-term deposits. Many Asian banks were carrying the added risk of borrowing in a foreign currency – usually dollars – and lending in a local currency.

The situation started to unravel in Thailand. With the United States as their major customer, the Thais had pegged their currency, the baht, to the dollar. Like much of Asia, the Thais were borrowing short-term in dollars but investing long-term in illiquid assets. By 1997, they were suffering a double squeeze. Inflation and uncertainty about the long-term loans were making the baht vulnerable to international speculators that anticipated a devaluation. At the same time, a rising dollar had made Thai exports less competitive in many markets.

Speculators attacked and quickly forced the Thai government to allow the baht to float and then sink on international markets. Investor sentiment turned sharply negative towards the entire region. The sudden exit of short-term investors forced other countries to devalue and left banks and companies saddled with debt. Because of the devaluations, it now took more local

Deutsche Mark and Japanese Yen vs. U.S. Dollar



Source: International Financial Statistics Yearbook, Vol. LIII, 2000 (International Monetary Fund)

currency to repay any debts denominated in dollars. The International Monetary Fund, the World Bank, and the Asian Development Bank all struggled to stabilize the situation. One government fell while another imposed capital controls to keep foreign investors from withdrawing their capital. Several countries were forced through wrenching change without the benefit of an established safety net for their workers.

The contagion did not stop with Asia. Soon the speculators turned to Russia and eventually Brazil. In retrospect, it is clear that many countries opened their capital markets prematurely. They did not have the laws, the regulatory structure or the private sector experience to manage the resulting flood of short-term investments. Most observers also thought that pegging or fixing their exchange rates to the dollar added to their vulnerability. In the wake of the Asian financial crisis, more and more countries are opting for floating exchange rates or going to the other extreme and adopting a currency board. For the time being, pegs, crawling pegs and dirty floats have fallen out of favor.

THE AFTERMATH OF SEPTEMBER 11

Even before the tragic attacks of September 11, the U.S. economy had slowed to almost a no-growth pace. In the wake of September 11, most observers expect further slowing in the third quarter and possibly beyond. Further slowing in the U.S. economy will add downward pressure to the export oriented economies in Asia and elsewhere. The September 11 attacks disrupted key sectors of the American economy and reduced consumer and business confidence. The Federal Reserve Board and key central banks around the world responded decisively to September 11 by assuring the financial markets of adequate liquidity. On October 2, 2001, the Fed reduced its target federal funds rate to 2.5% with the prospect that additional cuts may come. Also in response to September 11, President Bush and the Congress cooperated on an immediate increase in federal spending to support security and the airline industry. Negotiations on added fiscal stimulus were progressing rapidly in the early days of October.

For the first half of 2001, the synchronous slowing of the U.S., European, and Japanese economies did not lead to a dramatic change in currency values. By mid-year, there was only a modest dollar decline relative to the euro and the expected weakening of the yen. The shattering events of September 11 have affected relative currency values with both the euro and the yen rising in value relative to the dollar. Japan has now entered the problem territory sketched in Eisuke Sakakibara's testimony—with a Nikkei that has fallen below 10,000 and a yen that is appreciating. The Japanese government has responded with several interventions in global currency markets in an effort to reverse yen appreciation. The added uncertainty in global markets has been a further blow to the efforts of emerging markets to attract added overseas capital investment.

The United States and much of the world have turned their attention to a global campaign against terrorism. The shift in focus, expected decline in global growth, and sharp change in macroeconomic policies have made currency predictions all the more difficult. With the United States itself a target of attack, the usual uncertainty driven flight to quality has not led to a short-term appreciation of the dollar. It may be, as a number of specialists suggest, that investors have decided to keep more of their investments closer to home. Large U.S. current account deficits, rising external debt, and the physical replacement of European national currencies with euro bills and coins are all consistent with further long-term weakening of the dollar in terms of the euro.

CONFERENCE PROCEEDINGS

The brief look at global finance in the twentieth century is designed to add perspective and context to the Wilson Center's conference on *The Currency Conundrum*. In thinking about the formal presentations and discussion that follow you will hear echoes of both the triumphs and the failures of twentieth century capital markets.

All of the presentations put individual currencies in the context of economic trends and domestic politics while stressing the interdependence of the major economies. As Europe becomes a more attractive target for investment, it may become harder to finance America's current account deficit. If the Japanese economy continues to weaken, a falling yen could add to America's trade deficit and create difficulties for competing exporters throughout Asia. There is frequent reference to improved coordination among governments and serious discussion of whether or not to establish target zones for the major currencies.

In several instances, presenters will stress the link between exchange rates and political support for open trade. They also note the power of economic integration to deliver rapid growth and rising incomes. Like most students of the international economy, the presenters are also keenly aware of the political and economic costs of an international economy gone sour.

The Wilson Center conference on *The Currency Conundrum* drew on leading experts to assess the future course of the world's major currencies. Individual presentations on the dollar, the euro and the yen were complemented by a thought-provoking proposal to limit the fluctuations among the three leading currencies. An afternoon panel provided a political and economic assessment of the morning's discussion. Senator Paul Sarbanes, now chairman of the Senate Committee on Banking and a senior member of the Committees on Budget and Foreign Relations added a Capitol Hill perspective.

The Wilson Center staff has prepared a brief summary of the individual presentations, the panel discussion and Senator Sarbanes concluding remarks.

THE DESTINY OF THE DOLLAR

ROBERT HORMATS
Goldman Sachs & Co.

Robert D. Hormats opened the day with a detailed look at the American economy, global capital markets and the likely future course of the dollar. Hormats is currently the Vice Chairman of Goldman Sachs (International) and Managing Director of Goldman Sachs & Co., a major Wall Street based investment bank with worldwide interests. Veterans of Goldman Sachs are no strangers to the world of policymaking. Robert Rubin, a former Goldman Sachs partner served as director of President Clinton's National Economic Council and later as Secretary of the Treasury. Another former Goldman Sachs partner, Jon Corzine, has just been elected to the Senate by the voters in New Jersey.

Hormats had a distinguished career in Washington before joining Goldman Sachs. Starting in 1969, Hormats served on the National Security Council as the principal advisor on economic policy to NSC Directors Kissinger, Scowcroft, and Brzezinski. Hormats later served as Deputy United States Trade Representative and Assistant Secretary of State for Economic and Business Affairs. In addition to his duties at Goldman Sachs, Hormats is a much sought after commentator on developments in the global economy.

Today's Global Currency Markets. Hormats opened his remarks with a brief overview of recent changes in the size and nature of global capital flows. Over the last five years, daily turnover in global markets has grown sharply from $1 trillion to $1.3 trillion. As the volume of currency flows has grown, its composition has changed. Fewer currency transactions are related to international trade (2.8% in year 2000 versus 3.6% just five years ago) and more are tied to portfolio investment and cross border mergers and acquisitions.

Standard explanations of fluctuations in a currency's international value have focused on the balance of payments and on interest rate differentials. In other words, a country with large trade and current account deficits will tend to see its currency depreciate. Higher relative interest rates generally push currencies in the same direction as investors seek greater returns on their investments. Allowing time for currencies to adjust to changes in payments deficits or interest rate differentials, the standard approach does help describe the typical relationship between the yen and the dollar. The dollar's movements relative to the euro, however, have been significantly influenced by other factors, especially European investors buying American securities or European companies acquiring American companies.

Direction of the Dollar. In Hormats' view, the dollar will be under considerable downward pressure against a number of currencies over the course of the coming year if growth abroad exceeds growth in the U.S. and investment returns abroad also improve. He thought this should be particularly true in terms of the euro. Relative to the yen, Hormats suggested the dollar would strengthen (each dollar can buy more yen) in the first six months of the year. If the Japanese economy does recover in the second half of the year, the dollar might then weaken. Hormats cautioned that projections for the Japanese economy were subject to different interpretations. He noted that the Japanese government continued to predict improvement while most independent economists were still adjusting their estimates downward.

Why the expected decline in the dollar? Hormats pointed to a rising current account deficit coupled with a slowing economy. The current account is financed through foreign investment and the slowing economy will make U.S. investments less attractive to overseas investors. There will be negative earnings surprises in the U.S. and positive ones in Europe.

The year 2000 current account deficit is expected to be in the range of $430 to $450 billion, a U.S. record in terms of dollars and relative to the size of the U.S. gross domestic product. The deficit has been financed by an inflow of foreign capital into government and corporate bonds, corporate stocks and direct investment. From the perspective of January 2001, Hormats expected some decline in foreign purchases of bonds and in direct investment. In the case of securities, Goldman Sachs was expecting an actual reversal with the $100 billion inflow in year 2000 turning into an outflow of $30 billion in 2001. The combined impact of slowing foreign investment will be an ex ante financing gap of around $250 billion. The financing gap, should it occur, would likely be worked out through a downward movement of the dollar, particularly against the euro.

For several years, America has been consuming more than it was producing and investing more than it was saving. This is reflected in rising trade and current account deficits. A high return on investment in the U.S. has attracted the funds needed to finance this imbalance.[1] Several years of deficits have left the United States with an external debt approaching $2 trillion dollars. In part, the low savings rate has been linked to a rapid rise in the value of American stocks. As those stocks come down in value, personal savings may rise. With a slowing economy, investment should also slow. Both trends will take some pressure off the current account deficit over time. The actual volume of imports may already have begun to decline. But if the dollar were to fall further and faster, the dollar value of imports would rise.[2]

Euro Euphoria, Asia and Energy

Hormats stressed the positive changes in Europe that had already contributed to the nearly twenty percent rise in the value of the euro against the dollar. Europe, in Hormats' view, had been making changes in macroeconomic and microeconomic policy that would contribute to more rapid European growth. The changes in policy have made Europe a more attractive target for investors, including those in the United States.

The prospective weakness in the Japanese economy is partially mirrored in a number of the other Asian economies. Japan and Asia more generally also have been major exporters to America's information technology sector. If slower growth in the United States leads to lower investment in information technology, Japan and a number of other Asian economies will suffer.

As a final risk, Hormats added the question of energy supplies and prices. The political uncertainty in the Middle East made it a risk that was hard to quantify. Based on past experience, any serious disruption to energy supplies would be a major shock to currency markets. The result would probably be bullish for the dollar, medium bearish for the euro and very bearish for the yen.

The Challenge for the Administration

Some early statements by the Clinton Administration suggested that a lower value of the dollar might be good for U.S. exports and the overall balance of trade. The statement triggered dollar selling in the financial markets and a negative reaction in a number of foreign capitals.

For much of the Clinton Presidency, however, the Administration pursued the Rubin/Summers strong dollar policy. (Throughout their tenure, Rubin/Summers consistently said that a strong dollar was good for the United States.) The Rubin/Summers policy was not designed to seek a specific value of the dollar. The dollar was free to move up or down against the other major currencies. The Rubin/Summers policy was designed to change the perception of the money markets. Rubin/Summers wanted to be absolutely clear that the U.S. did not have a policy of benign neglect toward the value of the dollar or a policy that looked to the dollar as an element in trade policy.

As the new Bush Administration took office, the American economy grew more slowly than continental Europe's economies. As the U.S. slows, there are likely to be negative earnings surprises (earnings below market analysts' expectations). These negative surprises could increase the outflow of equity capital from the United States to Western Europe. Economic conditions point to a weakening of the dollar relative to the euro.

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Hormats asked, "What does the new Administration do in this environment?" Hormats suggested that the Administration may have to "…reinterpret the Rubin/Summers strong dollar policy and simply say 'we are not going to use the dollar as an instrument of trade policy, we are not going to adopt a policy of benign neglect.'" Hormats went on to suggest that they express a preference for a strong dollar but recognize the current pressures for depreciation by indicating they "…will let the market determine the actual value of the dollar."

"The danger," Hormats continued, "is that you already have people in the financial market making the following judgment: O'Neill [Secretary of the Treasury Paul O'Neill] is from a company [Alcoa, a major supplier of aluminum] that benefited from a lower dollar and that the corporate sector in this country traditionally likes a lower dollar, and therefore he will be less vigilant about keeping the dollar strong than Rubin or his successor Larry Summers were." Investors will seize on the slightest hint that the Administration will be willing to accept a weaker dollar to drive the dollar lower than either the Administration or the Federal Reserve wants.

The new Administration must accept the likelihood, indeed the desirability, that the dollar will ultimately decline but "not look eager to [see] it and not look like they want to totally abandon the idea of a strong dollar being…good for the United States." At the same time, it would be a mistake to commit to any particular exchange rate. In his upcoming testimony, Hormats thought it would be best if O'Neill indicated he would be the sole Administration spokesperson on exchange rates and that he favored a strong dollar. He should indicate that any weakening should occur "in a measured, market-oriented, orderly way rather than in a way which is disruptive to capital flows here or disruptive to Fed [Federal Reserve Board] policy." But if the economy weakens further it would be useful to back off of the strong dollar rhetoric and simply talk about the desire to sustain a strong economy—and let the currency move as it will, without U.S. jawboning.

If strong dollar rhetoric has no effect, than not saying anything will not matter. If it is holding the dollar at artificially high levels, than it is inappropriate in the environment of a weak economy and certainly should not be repeated. In any case, Hormats does not believe that the Administration will intervene in currency markets to stop the dollar from falling if it weakens in an orderly fashion.

The Dollar and the Fed

The dollar also creates a potential dilemma for the Fed. The fear is that a weaker dollar will not only raise the cost of imports but also opens the opportunity for domestic producers to increase their prices. In Hormats' view, "the danger is that if the dollar were to weaken precipitously, about ten percent or so in the course of several weeks… [it would become] more difficult for some of the [inflation] hawks on the [federal] open market committee to go along with further [interest rate] cuts."

With an eye on the economy, the Administration also has an interest in seeing lower interest rates. There was the possibility that a weakening dollar might make the markets more concerned about the Federal Reserve Board's willingness to make further cuts. It was, however, Hormats' judgment that the Fed would probably cut rates even in the face of a sharp drop in the value of the dollar.

There is the added question about the impact of further rate cuts on the foreign investment needed to finance the current account deficit. "Americans are just waking up to the fact that things have changed in Europe in the last couple of years." With that recognition, Europe is likely to become more attractive to American investors. There is a fear that lower U.S. interest rates will trigger an outflow of capital as the U.S. interest sensitive securities become less attractive for foreign investors. Hormats also pointed out, however, that lower interest rates could mean a strong equity market and more activity in terms of mergers and acquisitions. With their growing importance in global capital flows, the overall impact of lower interest rates could be positive.

Selected Questions and Answers

Q: Are there any other tools for exchange rate management than the rhetorical commitment to a strong dollar?

A: The markets do look at economic fundamentals. But there is also an important psychological element in market behavior. The wrong rhetoric can lead markets to overshoot with damaging consequences for the real economy.

Q: Three months ago, all the talk was about the impact of a strong dollar. Now we are concerned about a weak dollar.

A: I do not foresee a weak dollar but rather a weaker dollar. Some depreciation is very likely because of the large current account deficit and likely shifts in investment capital from overseas. The risk is centered on how gradually we arrive at that weaker dollar.

Q: You did not mention fiscal policy. In 1981, a major tax cut contributed to a strong dollar. Would a major tax cut today have the same result?

The faster savings and investment change, the sooner the current account deficit will decline.

A: The economic environment is very different today. In 1981, the Federal Reserve Board had tightened monetary policy in an attempt to reduce inflation. The U.S. also had a rough balance in its current account and was the world's largest creditor. In that environment, the tax cut did contribute to a sharp appreciation of the dollar. That stronger dollar, in turn, helped bring inflation under control.

Today you have to ask different questions about a tax cut. Will it contribute to a revival of the U.S. economy over the next year? Will an improved U.S. economy continue to be attractive to foreign investors? Will the Federal Reserve Board be more reluctant to lower interest rates?[3] In any case, Hormats felt that there could be a modest cut in marginal tax rates without running the risks of an overvalued dollar.

Q: The current account deficit results from a deficit of savings relative to investment. In your statement, you suggested that savings would increase and investment fall—decreasing the deficit. Yet you also said the current account would increase.

A: It is a question of timing. The Federal Reserve Board policy has been designed to increase savings and reduce investment. But that will not happen right away. The faster savings and investment change, the sooner the current account deficit will decline.

Q: In 1999, the European Central Bank intervened to strengthen the value of the euro. Since their intervention, the euro has risen by around 20% against the dollar. Did they have the timing right? Did the intervention break market psychology?

A: Hormats agreed that intervention can be effective. In 1999, the euro was almost surely undervalued and intervention may well have turned the psychology of the market. Hormats reminded the conference how cautious Secretary Rubin had been about intervention. If an intervention did not work, Rubin was more fearful of the loss of credibility than the cost in dollars. Hormats did say that if the dollar fell dramatically, there was a case to intervene to "modulate that decline."

Q: You indicated that the Fed might hesitate to cut rates because it was concerned about weakening the dollar. What if the Fed intervened in the foreign exchange market to strengthen the dollar while it was cutting interest rates? Would that not signal that the Fed was focused on a weakening economy and not the dollar?

A: Hormats agreed that they could. He also thought that the Treasury would want the Fed to lower interest rates in response to the weakening economy. The Treasury is usually the initiator of a decision to intervene in the exchange markets. There have, however, been instances in which the Fed favored intervention but the Treasury said no.[4]

Q: Your underlying model of the economy is one in which savings and investment are independently determined. Capital inflows are determined by foreign investors. It is the exchange rate that eventually brings the three into balance. What if it is expected rates of return that drive investment? Then the decision of overseas investors could lead to the current account deficit rather than the decisions of American savers and investors.

A: Expected rates of return are a key. The challenge for the U.S. is that expectations are changing. Over the past two years, positive earnings surprises in the U.S. have attracted capital. Now the positive surprises are more likely to be in Europe.

In his closing remarks, Hormats again emphasized the importance of an Administration that spoke with one voice and that adopted an appropriate version of the Rubin/Summers strong dollar policy. At one congressional hearing or another, the Administration will be asked if a weaker dollar will be good for the competitiveness of American industry or will help reduce the trade deficit. The Administration needs to avoid any response that might trigger a flight from the dollar.

Notes

1. The current account includes other current financial flows of income such as interest, dividends and royalties as well as the figures measuring international trade.

2. Economists refer to the mismatch between the shift in volume and the change in a currencies value as the J curve effect.

3. In his January 25, 2001 testimony before the Senate Banking Committee, Federal Reserve Board Chairman Alan Greenspan spoke in support of tax cuts and, at the same time, endorsed continued fiscal discipline. He did not indicate that a tax cut would make future interest rate cuts less likely.

4. It is the Treasury not the Federal Reserve Board that decides whether or not to intervene in foreign exchange markets. Once the Treasury decides to intervene, the actual intervention is carried out by the Federal Reserve Bank of New York.

EURO EUPHORIA

NORBERT WALTER
Deutsche Bank Group

Norbert Walter provided the conference with a detailed look at the two-year history of the euro, its current strength, and the important role played by the European Central Bank. Walter is currently the Managing Director of Deutsche Bank Research and Chief Economist of the Deutsche Bank Group, a major financial force in Germany with pan-European and global interests. Before joining Deutsche Bank, Walter had a distinguished academic and research career. For several years, he served as head of research groups at the Kiel Institute of World Economics.

The Outlook: The Euro, the Dollar, and the Yen

Walter opened his presentation by noting that the euro had appreciated relative to the dollar by twenty percent in the last few months. He felt that the euro had been significantly undervalued for some time. He had invested funds expecting a rise in the euro and had realized a healthy return. Although he was less confident about predicting a further appreciation of the euro, he would not be surprised to see the euro return to parity with the dollar or even reach $1.10.

The economic slowdown in the U.S., the continuing weakness of the Japanese economy and recent appreciation of the euro suggest the need for a worldwide reduction in interest rates. Walter included the European Central Bank (ECB) in his call for lower rates. In Walter's view, there was little risk of European inflation. He noted that over the past two years the combination of a depreciating euro and rising energy prices had pushed the European cost of oil up four-fold. Yet inflation had not exceeded 2.0% in Germany and stayed below 2.5% for all of Europe. Because of past criticism of the ECB, he was concerned that the ECB would "follow interest rate reductions with hesitation." On the other side of the spectrum, there was also some risk that exaggerated expectations of a downturn in the U.S. could cause excessive dollar depreciation. Europe would then be hit with slowing demand in the U.S. and the loss of international price competitiveness as the euro rises.

While the euro had appreciated, the Asian currencies had weakened. In Walter's view, Japan still needed significant restructuring in its economy. He expected continued weakness in the yen. He thought there were also still significant structural weaknesses in some of the Asian economies hit by the 1997 financial crisis and even in some who had avoided the crisis such as Taiwan.

A Changing Europe

Macroeconomic Policy. Walter emphasized the positive change in European macroeconomic conditions and gave much of the credit to the Maastricht Treaty.[1] Walter found few processes that had been "so successful in bringing about sound economic policies." In Walter's view, Maastricht contributed to an improvement in overall economic regimes as well as in fiscal policy.

Maastricht adopted a simple set of rules based on the inflation and long-term interest rate performance of the most stable European countries. First, countries had to be members of the European Monetary System[2] for two years before assuming full EMU membership. The criteria for full EMU membership were clear and simple: the fiscal deficit had to be no larger than 3% of GDP and the national debt no greater than 60% of GDP. Walter acknowledged that the economics profession could have come up with much more sophisticated criteria. Yet, he agreed that "those two stupid numbers had helped to bring about economic policies that would otherwise not be" in place. The numbers have become a benchmark for Europe that is watched internationally.

Fiscal consolidations continued after the introduction of the euro. So has economic restructuring. Walter emphasized that because of the level playing field created by the euro, member countries "are…in a competition for reasonable tax structures and reasonable levels of tax rates." As a result virtually all members of the EMU have reduced their level of direct taxes well below the rates common in the 1980s and early 1990s. Walter stressed the importance of tax changes for long-term incentives but also recognized their near-term stimulative impact. For instance, the German tax cut in 2001 amounts to eight-tenths of one percent of German GDP.

Corporate Restructuring. Closer economic integration has encouraged cross border mergers in Europe. As a result, the importance of European companies has grown while the persistence of traditional national champions has declined.

German corporate restructuring had been delayed by the extensive cross holdings of corporate shares by banks and other corporate agencies. The high tax on capital gains discouraged companies from selling their shares and loosening corporate ties. With the German repeal of the capital gains tax with regard to existing corporate holdings, further corporate restructuring will take place.

The relative weakness of domestic European demand has been a further spur to corporate restructuring. Without the support of a strong domestic economy, European corporations were forced to become more internationally competitive.

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Europe and the New Economy. Europe continues to lag behind the U.S. in a number of fields but is rapidly catching up. While European households are still less likely to have a computer than their American counterparts, European business has reached parity with Americans in terms of Internet and wireless communications. In terms of strictly wireless commerce, Europe probably has an edge.

The Key Role of the European Central Bank

Walter was very positive in his evaluation of the European Central Bank (ECB). Walter thought that with regard to interest rates the ECB showed "perfect timing" and justified their moves with "perfect arguments."

He was enthusiastic about the ECB's governing statute for putting a clear emphasis on price stability. He also liked the single eight-year term for the ECB Directors. Without the possibility of a second term, there is no opportunity to influence the Directors with the promise of a future appointment.

He did have reservations about the ECB's attempt to target both the money supply and the inflation rate. Without a stable demand for money, attempting to target the money supply was "rubbish." Walter noted that global use of the euro and an eventually expanding membership of the EMU would both affect the demand for money in unpredictable ways. Instead, Walter urged a "crude inflation targeting." He proposed a three-year moving average of core inflation[3] as "an appropriate target for monetary policy considering the lags and the variability of monetary effects upon inflation."

Walter also expressed some concern about the ECB's current rule of having one governor for each member country. As the European Union and eventually the EMU expand, the structure will become increasingly unwieldy. Unfortunately, at the recent European Summit at Nice, France was not helpful in modifying the governance of the EU or the ECB.

The Euro and the Exchange Rate

Walter noted the early focus on the euro's international value. By May of 1998, the markets had settled on $1.10 as a fair value. Then the money markets were rocked by the Russian default on government bonds. The

Russian crisis was followed by the near collapse of Long Term Capital Management (LTCM), the giant American hedge fund. At the time, the world feared an American recession. Money flowed into Europe. By November 1998, the euro stood at $1.20.

The November 1998 price of the euro was not justified on either cyclical or structural grounds. Some correction was to be expected in 1999. The downward adjustment of the euro was aided by disappointments in Europe and positive earnings surprises in the U.S. From being overvalued, the euro swung to the other extreme, at one point almost falling to a value of only 80 cents.

In looking at fluctuations in exchange rates, many economists stress the importance of differences between the growth rates of two countries or areas. In this case, between the United States and Europe, Walter did not find good evidence for this hypothesis. In his view "the world observes carefully only what happens on one side of the Atlantic." It is the Western side that counts. Walter felt the one-sided approach to the Atlantic was the only way to explain a strong Deutsche Mark in 1994 when Germany had the worst possible combination of policies. He thought that in 1999/2000 it was the string of positive earnings surprises in the United States that had attracted so much European capital. As those surprises wane or turn negative, he would expect less European investment and some correction in the exchange rate.

Walter's emphasis on the Western side of the Atlantic did not, however, rule out intervention in the currency markets. He noted that together the Europeans had some $200 billion in reserves (currencies plus gold) in excess of any reasonable need. Intervention would have been possible and advisable. Most reserves are held by the central banks of individual countries rather than by the European Central Bank. National central banks would just have to find out whether selling U.S. dollars would be in line with the ECB's monetary policy, which in fact was the case. Whether such intervention would have changed the exchange rate is debatable. However, had the banks used their reserves earlier, they might have reaped considerable profits as the euro strengthened.

Overall, Walter thought the euro had been a considerable success. He noted that on its very first day, the euro became the number two currency in the world. From its inception, the euro had garnered a 40% share of new bond issues – roughly the same percentage accounted for by the dollar. The euro does lag in terms of stock market transactions. Walter thought that until Great Britain joins the EMU, the euro share of stock market transactions would remain relatively small.

In sum, the ECB and the new regulators have overcome financial fragmentation, improved liquidity and developed a corporate bond market that had been largely absent from Europe. There have been clear improvements in the European money markets and some development in the stock market as well. There is even a New Market in Germany that still has only a light overlay of European issues. It is not yet a challenge to NASDAQ in either the number of stocks listed or the capitalization of listed companies.

Walter agreed that there was still much work to be done in terms of building the European financial system. The Europeans have not yet overcome the fragmentation in the regulatory environment and on clearing and settlement for financial transactions. As a result, transborder transactions cost ten times what they would in the United States. The ECB currently functions as a lender of last liquidity but not yet as a lender of last resort. As a Member of the Committee of Wise Men on the Regulation of European Securities Markets, he is wrestling with some of the needed changes himself.

... it would take a crisis to bring Britain into Euroland. Without foreign direct investment going anywhere but Britain and until the Midlands are completely deindustrialized, Walter did not think that Britain would change.

Enlarging the European Union:

Three current EU members are not members of the EMU. Denmark has twice voted to stay independent of the euro but insists that the Danish krone is fixed to the euro. Sweden insists that an independent monetary policy and exchange rate are critical in the pursuit of national targets. Walter thought that Sweden was happy to wait and see what the British would do. In Britain, Prime Minister Tony Blair wants to bring Britain into Euroland but faces considerable opposition at home. Blair's target date to adopt the euro was 2003. After the Danes rejected the euro for the second time, Blair moved his timetable to 2004.

Walter initially put the chances of Britain joining Euroland at about 60%. His subsequent evaluations were even more negative. He suggested it would take a crisis to bring Britain into Euroland. Without foreign direct investment going anywhere but Britain and until the Midlands are completely deindustrialized, Walter did not think that Britain would change.

There will be new European Union members from Central and Eastern Europe. The recent European Summit in Nice should have made clear that they are invited to become members in 2003 or more likely 2004 and 2005. By 2007-2008, the first group will be ready to formally apply to join the EMU. Many of the countries lack either the macroeconomic stability or the microeconomic foundations to join the EMU. While waiting to join the EMU, he expected a variety of temporary exchange regimes that will vary from currency boards to flexible exchange rates.

Selected Questions

Q: What are European perceptions of the current outlook for the U.S.? Will Europeans continue to pursue mergers and acquisitions in the U.S.?

A: U.S. analysts are the fastest on the globe. The Europeans are somewhat slower, riding an investment wave until its death. The Japanese are slower still, riding a wave until well after its death. To help keep up with changing perceptions, Walter said he relied on conversations with overseas Chinese and GE Capital. In those conversations, he sensed a shift in focus from the United States to Europe. As Europeans shifted their own perception, he thought there would be less direct investment in the United States.

It was harder to predict the direction of portfolio flows. He sensed that U.S. monetary and fiscal policy would both move in an expansionary fashion. In addition to further interest rate cuts by the Fed, Walter thought there would be an agreement between President Bush and the Congress that would include added spending on education and a significant cut in tax rates as well as other selected tax reductions. If that happened, the improved medium-term prospect for growth and profits would continue to attract European investment. [Shortly after Walter spoke to the conference, Fed Chairman Alan Greenspan is widely viewed as having endorsed a tax cut in his January 25 testimony before the Congress. In January, the Fed cut short-term interest rates twice by a total of 100 basis points or one full percentage point.]

Q: What progress is being made on a more uniform banking system in Europe and Germany?

A: Despite German reluctance, you will see the privatization of big savings banks and a reduction in the role of state banks (Landesbanken). How can Europe or Germany criticize Asian countries for close ties between governments and banks when the same pattern exists in Germany? If Europe adopts a less national and more truly European regulatory regime, Walter expected there would be considerable transborder consolidation among banks.

The European Union and the European Commission remain the two key forces in bringing about a more competitive environment in Europe. National industrial champions, national governments and national unions are all resistant to change.

Q: The Maastricht Treaty makes price stability the primary objective of the European Central Bank (ECB). But once price stability has been established, the treaty says the ECB should then support the general policies of the European Union which are employment and growth.

A: Walter agreed that there is a general statement on secondary goals, but he emphasized that price stability is the overwhelming priority. He did agree that monetary policy should pay attention to growth and, in fact, argued that the new economy in Europe has raised European growth potential. He did not, however, think that a direct focus on employment was an appropriate target for monetary policy.

Over the six months following *The Currency Conundrum* conference, the economic situation has changed substantially since then. For the first time since the early 1980s all regions of the G3 are in a downturn. The interaction may mean intensification and prolongation of the downturn. Over-investment in the old and new economies is the verdict—certainly in the United States. History shows that it takes two years before the economy hits bottom and stages a turnaround. As Asia is more than ever part of the world-wide division of labor—especially regarding the ICT sector—this implies parallel suffering particularly in the open modern emerging markets of Asia.

What is needed under these circumstances is resolute macroeconomic coordination among the G3. Japan should tackle its structural problems and—together with the United States and Europe—usher the yen down against the dollar and the euro, toward 135 yen/euro, if necessary by foreign exchange intervention. Europe, and the United States, then could and should strongly cut interest rates.

Notes

1. The 1991 Maastricht Treaty established the criteria for joining in the January 1999 launch of the European Monetary Union (EMU). The EMU established the euro as a common European currency, first as a unit of account to be followed by the issuance of paper bills and coins in 2002.

2. Formed in 1979, the European Monetary System (EMS) included several but not all the members of the then European Community. The EMS established relationships among the members' currencies and created the European Currency Unit or ECU as a unit of account. In retrospect, the EMS was an important step on the way to the greater integration created by the EMU. It should be noted that three members of the European Union, Denmark, Sweden and the United Kingdom, remain outside the EMU.

3. Core inflation eliminates particularly volatile items to identify the basic trend in prices. In the U.S. context, core inflation is often taken to mean the consumer price index less volatile food and fuel costs.

THE YEN: LOOKING FOR CONFIDENCE AND THE CONSUMER

EISUKE SAKAKIBARA
Global Security Research Center, Keio University

Eisuke Sakakibara is currently the Director of the Global Security Research Center at Keio University in Tokyo, Japan. Before assuming his academic post, Professor Sakakibara had an extremely distinguished career at the Ministry of Finance in Japan. After holding a series of senior positions at the Ministry, Professor Sakakibara served as Vice Minister of Finance for International Affairs. As Vice Minister, Sakakibara was frequently referred to as "Mr. Yen" as one measure of his influence. Sakakibara also played a critical role in helping East and Southeast Asian countries navigate the financial crisis of 1997. Prior to joining the Ministry of Finance, Professor Sakakibara studied, researched and taught in the United States.

In general terms, Sakakibara was not optimistic about the prospects for either the Japanese economy or Japanese politics. He described a dual economy in Japan with a dynamic, internationally competitive portion that has a productivity level that matches or even exceeds that of comparable industries in the United States. The bulk of Japan's workers, however, are in more traditional sectors–he singled out construction, retail trade, and health care—where productivity levels are about two-thirds those of the United States. These lagging sectors depend heavily on public support and public subsidies. The continued stagnation of the Japanese economy would translate into a weaker yen and a declining Japanese stock market. On the day of the conference, the yen had already slipped to 117 to the U.S. dollar. Sakakibara expected the yen to reach 120 to the dollar in fairly short order with the possibility that it could sink to 130 or even lower.

He also held out little hope for the current Liberal Democratic Party. Likely alternatives to the present premier would bring a change of personality but not a change of policy. He expected that the LDP would lose the upper house in the forthcoming, mid-year elections and could suffer further electoral defeats. He repeatedly referred to the Japanese iron triangle of business, senior bureaucrats and elected officials.

In terms of the other currencies, Sakakibara echoed the sentiments of Hormats and Walter about the euro. "If you held a beauty contest, the euro would come out on top, then the U.S. dollar with the yen coming last." He noted that the yen had depreciated significantly against the euro and the dollar in the last month and should continue to do so for the rest of the year. While some think the yen may strengthen in mid-year, Sakakibara did not.

Market pessimism is based on a perception that economic restructuring is stalled and politics are volatile.

Today's Japanese Economy

In assessing the Japanese economy, Sakakibara drew on a July 2000 McKenzie and Company study on Japanese productivity. About 10% of Japanese workers are employed in the dynamic export sector which continues to do well. Productivity levels in the export sector match or exceed that of their U.S. counterparts. The other 90% of workers are employed in sectors whose productivity is only about two-thirds of the U.S. level. The widely shared perception is that the less advanced sectors are holding back the entire economy. The traditional sectors draw heavily on public subsidies and laws that limit foreign and domestic competition.

The financial system continues to show significant weakness. By early October, Japanese banks were struggling to respond to a Nikkei stock index that had fallen below the 10,000 mark. Under international agreements (the Basle Accord), banks must hold capital that equals 8% of the value of their deposits. As the Nikkei declines, the value of stocks held as bank capital might fall short of the 8% standard, adding pressure on the Japanese government to inject capital into the banking system. Sakakibara had suggested that even a Nikkei of below 12,000 could force the government's financial hand. [In April, Prime Minister Mori was succeeded by an outspoken reformer, Junichiro Koizumi.]

Sakakibara traced many of the economic weaknesses to the current Japanese political system. It was Sakakibara's view that Prime Minister Mori's government could fall anytime in the next six months. Because "Mr. Kato's revolt [within the LDP] has been squashed," there are no alternatives to Mr. Mori that promise a change in policy. In addition, there are rumors of new scandals that could further erode the popular standing of the LDP. Market pessimism is based on a perception that economic restructuring is stalled and politics are volatile.

The yen/dollar rate now stands at 117 [it takes 117 yen to buy a single dollar]. He expected further near-term decline with the yen reaching 120 in the next two weeks. Sakakibara foresaw continued yen weakness over the course of the year. He did note, however, some factors that could slow or even briefly reverse yen depreciation in the very near term. For instance, some short-term financial players have a long position in dollars but a short position in the yen. [That is they hold dollars but have sold promises to deliver yen in the near future]. As they unwind (sell dollars) those positions to meet their yen obligations, the yen could rise to 116 or even 115 to the dollar.

Longer-term factors will push the yen in the opposite direction. Sakakibara noted that Japanese institutional investors had held back from buying U.S. securities, fearing a hard landing for the U.S. economy. They have even been reluctant to buy U.S. Treasury bonds. Low returns on stocks and bonds in Japan suggest that they will eventually reverse course and turn to the U.S. financial markets. When they do, the yen could easily be driven below 120 to the dollar.

Short-term Outlook

The short-term outlook is not bright. Japanese consumption dropped between October and November for the second consecutive monthly decline. GDP growth in the July to December period was an anemic 0.2% despite the 7.8% growth rate recorded for plant and equipment investment. With consumption also essentially stagnant in the July to September period (0.1% growth), Sakakibara would not be surprised to see an actual contraction in GDP in the final quarter of 2000.

A stagnant 2000 was Sakakibara's prologue to a gloomy prognosis for 2001. A slowing U.S. economy will hurt Japanese exports. MITI is predicting a 2.1% decline in the pace of investments in information technology compared to a 9.4% rise in 2000. There is no longer any prospect for public investment. MITI's generally negative outlook did not include the potential impact of a further decline in the Nikkei stock market index. Some Japanese financial analysts were fearful of a negative spiral in which yen weakness and a declining Nikkei drive each other further down. Some even feared a triple weakness that would spread to the value of Japanese government bonds.

Managing the Three Major Currencies

Sakakibara felt that a managed float was the obvious answer. He opposed a pure float in which governments would never intervene to stabilize their currency. In his view, markets overshoot the values dictated by economic fundamentals. When markets start to drive currency values to unrealistic highs or lows there is a case for governments to step in and buy or sell currencies. He pointed to some past successes including the 1995 Japanese intervention to drive the yen down and the 1999 intervention by the European Central Bank to push up the euro. When governments do act, the intervention should be massive and determined.

Managing Minor Currencies

Current conventional wisdom, suggested Sakakibara, suggests that other currencies should opt for one of two extreme (or corner) solutions. Either minor currencies should be left to float freely in world markets or the country should opt for a currency board that links their domestic currency to one of the big three. In a few cases, he noted that countries have gone beyond currency boards to adopt the dollar as their national currency.

Sakakibara did not share the conventional wisdom. In his view, few countries ever opted for a totally freely floating currency. The real question is how they go about managing their exchange rate. He agreed that currency boards might work for some countries at some times. Argentina, for instance, broke expectations of perpetual inflation by adopting a currency board that linked the supply of pesos to their holdings of dollars. Both currencies circulate freely in Argentina. He noted, however, that Argentine exports had suffered as global uncertainty and then a booming American economy attracted foreign capital to the United States that drove up the value of the dollar. Hong Kong also had a successful currency board tied to the dollar but was, in his view, a very special case. The Hong Kong government is a particularly powerful and active financial force in the Hong Kong economy. In the past, the Hong Kong government has intervened financially to stabilize the real estate and stock markets.

Sakakibara also departed from the conventional wisdom by arguing that capital controls can be effective. He pointed to the post-1997 experience in Malaysia. Singapore has limited currency trading by non-residents in Singapore and all parties outside its borders for some time. He went on to suggest that some emerging countries could usefully adopt some "de-internationalization" of their currencies.

Internationalization of the Yen

Sakakibara viewed near-term internationalization of the yen as an impossibility. In his view, "without internationalizing the economy, you cannot internationalize the currency." Japan has taken some important steps toward internationalization. For instance, there has been significant deregulation of the Japanese financial market. During his tenure at the Ministry of Finance, Sakakibara had helped ease some tax regulations that made it easier for non-residents to hold Japanese securities. But the overall Japanese market is simply not open. Only an open economy can support a truly international currency.

Sakakibara thought it was more realistic to think in terms of some kind of currency union with Asian countries starting with Korea. He noted that

Korea and Japan were dominant factors in the world steel and shipbuilding markets. Fluctuations in the yen can either help or penalize competing Korean industries. He thought it made sense for the Korean won and the Japanese yen to float together.

He also noted that the recent swap (temporarily lending currencies) agreement among the Association of Southeast Asian (ASEAN) countries, China, Korea, and Japan was a first step toward some kind of loose currency union. As intra-regional trade increases over the next five or ten years, a currency union will become an interesting proposition.

At present, the ASEAN and other Asian countries could follow the dollar, the euro or some basket of currencies that included the dollar and the euro. Today, he thought much of Asia was essentially in the dollar zone. Looking to the future, he continued to see at least the "remote possibility of creating an Asian currency union."

… it would be a disaster if Japan should suffer the combination of a falling stock market and an appreciating currency.

The Dollar and the new American Administration

Sakakibara noted that there was market concern about whether or not the new Bush Administration would continue to support a strong dollar policy. Larry Lindsey, Assistant to the President for Economic Policy, had stated that the strong dollar policy will continue. Sakakibara noted, however, that there continued to be speculation that incoming Treasury Secretary Paul O'Neill and White House chief of staff Andrew Card may lean toward using exchange rates to reduce the trade deficit. He did not expect them to adopt that policy, but if the market perception persists, it could disrupt international currency values and national economies.

Sakakibara was critical of the early Clinton policies on exchange rate management and trade negotiations with Japan. There were, he noted, many early statements about using the exchange rate to reduce the American trade deficit. During the tenure of Secretary of the Treasury Rubin, however, he noted that there was a consistent policy of not using the dollar as an instrument of trade policy.

Sakakibara's view of exchange rate policy was partially rooted in his concern for an already weak Japanese economy. In his words, it would be a disaster if Japan should suffer the combination of a falling stock market and an appreciating currency. The endaka (rising yen) syndrome is always there in Japan. Sakakibara also saw a risk that Japanese investors might withdraw from the U.S. stock market in response to a weak dollar policy.

He thought the best policy would be to let the yen continue to depreciate. In his view, 120 or 125 yen to the dollar was about the right level. In a downward spiral, the yen could go to 130 or even 140. At some point –

perhaps 130 yen to the dollar — Sakakibara agreed that intervention would be needed.

Selected Questions

Q: Was there really a strong dollar policy? Or did strong dollar rhetoric mask a relatively weak dollar designed to force restructuring in Japan?

A: Sakakibara strongly disagreed. He noted, for instance, that then Deputy Secretary of the Treasury Larry Summers supported Sakakibara's 1995-1996 intervention to drive down the value of the yen. The U.S., he said, was quite content with a yen in the range of 100 to 120. With Larry Summers at the Treasury, there was no effort to use the exchange rate as a way of forcing restructuring. As Treasury Secretary, Summers had the expected focus on macroeconomic variables. Structural questions were generally the concern of other departments.

Q: Starting with President Reagan, new Administrations have seen an immediate rise in U.S.-Japan trade tensions. Under President Reagan, there were the MOSS (market oriented sector specific) talks; under Bush, the SII (sectoral impediments initiative); and under Clinton, the Japan Framework negotiations. Will there be an increase in trade tensions and will that affect the yen?

A: Sakakibara agreed that with a slowing American economy, there could be tensions over steel, autos and auto parts. He hoped that the U.S. would focus on structural issues including the deregulation of telecommunications, agriculture, construction and other industries instead of focusing on sectoral trade negotiations.

Q: In the recent past, the yen has fluctuated widely. Why would the Koreans want to tie their won to such a volatile currency?

A: Up to the financial crisis of 1997, most Asian countries had pegged their currencies to the dollar. That approach failed. In the case of Korea, there is intense competition with Japan in the steel and shipbuilding sectors. Korea already pays more attention to the won/yen rate than to the won/dollar rate.

Sakakibara thought other forces could lead to closer currency ties in much of Asia. Intra-regional trade was already growing rapidly. In addition, there was the reality of growing competition from China.

Q: How can the Bush Administration help Japan to restructure?

A: Sakakibara noted that there already is a U.S-Japan forum to discuss deregulation. Outgoing Deputy U.S Trade Representative Richard Fischer had proposed raising the level of the participants in the forum. In Sakakibara's view, just continuing negotiations on deregulation "would be a major factor in expediting structural reform." He thought that the Bush Administration would be more sophisticated and mature in tendering advice to Japan. Sakakibara proposed less direct pressure and more "friendly persuasion."

A FRAMEWORK FOR FLUCTUATIONS: TARGET ZONES FOR THE MAJOR CURRENCIES

C. FRED BERGSTEN
Institute for International Economics

C. Fred Bergsten is the Director and founder (in 1981) of the Institute for International Economics. Under Bergsten's direction, the Institute has developed into a major global voice on questions of international economic policy. Bergsten himself is the author, co-author or editor of some twenty-seven volumes. Before founding the Institute, Bergsten had a distinguished career in the Federal Government. Bergsten served as Assistant for International Economic Affairs on the National Security Council between 1969 and 1971, and later as Assistant Secretary of the Treasury for International Affairs in 1977-1981.

Bergsten suggested that the yen and the euro were significantly undervalued. Bergsten based his view on the record current account deficit (approaching $500 billion) and the size of the U.S. external debt (approaching $2 trillion). The Administration will have to face the reality of a significant decline in the value of the dollar. At the same time interest rates are likely to fall in response to Federal Reserve policy and a weakening economy. If the lower interest rates start to drive investors away, there is some risk the dollar might drop sharply bringing the prospect of rising prices and pressure on the Fed to reverse course and actually raise interest rates. The challenge for the Administration is to work toward a gradual decline in the international value of the dollar.

In the longer-term, Bergsten argued that the yen, the dollar and the euro were frequently over or undervalued. The resulting misalignments of currencies can disrupt economies and distort investment. The Bergsten answer is to adopt target exchange rates based on fundamentals while allowing a considerable degree of fluctuation in value around the target rate.

The Currency Crucible: The Short-Term Outlook

Bergsten opened his remarks with the bold statement that the major currencies were badly out of line. Bergsten then responded to Dr. Sakakibara's suggestion that the yen would continue to fall in value relative to the dollar. He agreed on the need for change but thought that Sakakibara had the direction wrong "because…both the euro and yen are severely undervalued." In Bergsten's view, the key questions are how great are the misalignments and what is the best way to correct them without doing great damage to the underlying economies.

As evidence of the misalignment, Bergsten pointed to the record U.S. current account deficit. At almost $500 billion dollars, the U.S. current account has reached a record in absolute dollar terms and relative to the size of America's gross domestic product. The rising current account deficit comes on top of an external debt that is approaching $2 trillion and rising at a rate of 25% a year. In Bergsten's view, the current account deficit is unsustainable in political as well as economic terms.

Several years ago, John Williamson, a senior fellow at the Institute for International Economics, developed the concept of equilibrium exchange rates based on a series of economic fundamentals including the balance between saving and investment, the current account deficit and other factors. The latest estimate from the Williamson model put the equilibrium value of the euro at $1.25 to $1.30 or 35 to 40% above where it currently trades. Similar calculations for the yen suggested an equilibrium value of 90 to the dollar, some 25% above today's exchange rate.

Bergsten stressed that he did not advocate holding currencies to their equilibrium value. His proposal had always been to allow a wide, fifteen-percent range above and below the equilibrium figure. For instance, with a Japanese economy considerably weaker than its U.S. counterpart, a fifteen-percent margin would put the yen at about 100 to 105 to the dollar. In fact, the yen had been trading in that range until it recently started to weaken again. In the late 1990s, the yen had moved toward its equilibrium value when it appreciated by about a third from 150 to the dollar in the summer of 1998 to around 100 at the end of 1999.

Challenges for the New Administration

The key imponderable is how far and how fast will the dollar fall. Until recently, Bergsten had been predicting a slow decline in the value of the dollar ending in a soft landing. There was, however, the risk of a rapid drop in the dollar that would have serious consequences for the U.S. economy. With an economy still at full employment, a rapid drop in the dollar would immediately pass through into inflation. Bergsten highlighted the risk with a familiar rule of thumb – that for every 10% drop in the trade weighted value of the dollar the consumer price index would rise by one full percentage point. As prices rose, nominal interest rates would start to rise. So would real rates if investors demanded an added premium to offset the risk of further inflation. The Fed might also respond to inflationary pressures by reversing its current course and raising rates.

The question for the Administration is "how to reconcile the need for a decline in the dollar with the risk of an excessive fall."

Both the yen and euro pose distinct challenges for the Administration. If the yen continues to fall, it will only add to an already record U.S. current account deficit. In response, the Administration is likely to hear three separate voices: One will emphasize the need for Japan to export its way out of a decade of stagnation. Bergsten did not think the strategy would work for Japan – exports are simply not a large enough share of the Japanese economy to produce a full recovery. Nor did he think an ever-larger current account deficit was sustainable for the United States.

A second view will argue that markets should always be allowed to set the international value of the dollar. Bergsten associated this "hands off" approach with Beryl Sprinkle, a former chair of the Council of Economic Advisors and Bergsten's successor at the U.S. Treasury. In Bergsten's view, the failure to intervene to moderate swings in the dollar's value resulted in considerable harm to the U.S. economy.

A third view – one advocated by Bergsten – centered on the need to work with Japan to limit depreciation of the yen. Would, Bergsten asked, the Administration find some value of the yen that was simply unacceptably low given a large Japanese current account surplus and an even larger U.S. deficit?

The euro may pose similar problems. Although the euro is appreciating or rising in value relative to the dollar it remains well below its estimated equilibrium value. There is some indication that Europeans are not anxious to see too much more appreciation. For instance, the Bundes Bank (the German central bank) thinks that parity between the euro and the dollar is about the right exchange rate. But parity between the two rates suggests an ongoing increase in the U.S. current account deficit. This development would be, in Bergsten's view, undesirable and unsustainable.

The question for the Administration is "how to reconcile the need for a decline in the dollar with the risk of an excessive fall." What should the Administration do? It should start by abandoning its proposal for a major tax cut. In making the case against a large tax cut, Bergsten anticipated a counter argument based on the U.S. experience with the Reagan tax cuts in 1981. Pro-tax cut forces see 1981 as linking tax cuts to a stronger dollar and eventual economic recovery. Bergsten stressed the stark differences between the U.S. external accounts at the end of the 1970s and today. In 1980, the U.S. had a modest current account surplus and was, by a considerable margin, the world's largest creditor nation. Today, the U.S. current account is approaching $500 billion and the external deficit is nearing $2 trillion.

Instead of major tax cuts, Bergsten urged the Administration to rely on the Fed. In Bergsten's view, there was room for the Fed to lower interest rates by another full percentage point or probably even two full percentage points. [On January 31, the Fed made the first of nine rate cuts leaving its October 2 target federal funds rate at 39-year low of 2.5%.]

Bergsten also preferred relying on the Fed because interest rate reductions held out the best chance the dollar would ease down rather than drop suddenly. If the Administration will intervene in the currency markets to prevent a sharp fall in the dollar, Bergsten expected there would be support from the other major industrial economies. A collapse of the dollar would disrupt export economies around the world that currently rely on the American market.

In sum, to manage a soft landing of the economy and the dollar, Bergsten urges no major tax cut, further interest rate reductions, and a willingness to intervene in the exchange markets to prevent any disruptive changes in currency values.

Managing Misalignment

Bergsten noted that today's current misalignment of major currencies should be a reminder that the global monetary system is prone to imbalances. And the consequences can be severe. For instance, Bergsten pointed to the huge yen depreciation between 1995 and 1998 as a factor that "deeply intensified the Asian financial crisis" of 1997. Every 1% depreciation of the yen relative to the dollar added $2 billion to the current account deficit of East Asia. The 40% depreciation of the yen relative to the dollar in 1995-1998 thus contributed heavily to the current account deficits that in turn acted as one of the triggers of the crisis.

The G7 countries (the major industrial democracies including Canada, France, Germany, Italy, Japan, the United Kingdom and the United States) have, at times, worked toward exchange rate coordination. Both the Plaza (September 1985) and Louvre (February 1987) Accords were attempts at exchange rate management. It was Bergsten's view that after the Plaza and Louvre Accords there had been a defacto target zone between the dollar and the German deutsche mark (DM). Between 1988 and 1998, the deutsche mark fluctuated between 1.40 and 1.80 DM to the dollar. Bergsten believes the range was established through the dynamics of German politics. At 1.40 DM to the dollar, the German Ministry of Finance became concerned about the price competitiveness of German exports. While at 1.80 DM to the dollar the German central bank (or Bundes Bank) became concerned about price stability. Bergsten argued that the world should not have to rely on the internal dynamics of German politics to run the international monetary system.

As an alternative, Bergsten urged the adoption of target zones. He emphasized that he is not advocating a return to fixed rates. Instead, his target zone proposal is more a way of managing flexible rates. He argued that there was already management – no one was ready to simply let currencies rise or fall to any extreme. U.S. Secretary of the Treasury Larry Summers and former Vice Minister Eisuke Sakakibara simply preferred to take an ad hoc approach rather than announcing zones. Bergsten agreed that the ad hoc system had done rather well with successful intervention to weaken the yen in 1995 and to strengthen the euro in 1999. But, Bergsten asked, could one always count on having the right people in the right offices at the right time?

With the establishment of credible target zones, Bergsten believes that market speculation would act to stabilize rather than destabilize the system. He cited theoretical work by MIT professor Paul Krugman and recent experience. As currency values approached the outer limits of the zone, market players would calculate they had reached the limits of either depreciation or appreciation and would begin to speculate on movements back toward a currency's equilibrium value. Bergsten pointed to the 1995 case of the Bank of Japan intervention to keep the yen from appreciating beyond 80 to the dollar. At that point, the market concluded that there were no further profits to be made from speculating on a further rise in the yen. Since then, the yen has depreciated. In 1998, the U.S. again intervened, this time to prevent the yen from depreciating beyond 145 to the dollar. A similar story could be told about the fall 2000 intervention to strengthen the euro.

In Bergsten's view, the 1995 and 1999 cases pointed to the success of sterilized intervention. [Intervention is sterilized when the central bank offsets the intervention in a way that leaves overall monetary policy unchanged. For instance, if the Fed buys dollars to drive up the dollar's exchange rate it might sell bonds so that the total amount of money in circulation remains unchanged.] Bergsten noted that there is an article in a forthcoming issue of the *Journal of Economic Literature* that found that sterilized intervention does work.

Why the reluctance to adopt explicit target zones? Bergsten suggested that there might have been a bureaucratic imperative. Without explicit zones to defend, any movement in the exchange rate could be blamed on anonymous market forces. No blame could be assigned to a single individual or department. Bergsten also thought the failure to prevent depreciation of the yen had been a serious error. Many of his Japanese friends said allowing the yen to depreciate from the rate of eighty to the dollar it reached in

1995 was the dumbest thing the United States had done. The strong yen was a powerful force for domestic restructuring that had now disappeared.

Sakakibara Comments

Sakakibara agreed that the real question was how to manage flexible exchange rates. But he expressed two reservations on target zones. First, because the parameters of the economy are constantly changing you must have a moving target zone. Second, if the monetary authorities make the zone explicit they would be very vulnerable to speculation.

Sakakibara noted that "in the end [Secretary of the Treasury] Larry Summers and I had an implicit moving target zone." When he served as Vice Minister, the implicit zone was between 100 and 130. Intervention depended on market conditions. In practice, they would communicate with each other without mentioning a specific exchange rate and yet arrive at an implicit target rate. Sakakibara suggested that what Bergsten was suggesting was not all that different from actual practice.

In terms of identifying specific zones, Sakakibara agreed that there might be some bureaucratic thinking behind the reluctance to identify specific target zones. But, in his view, the key reason was that explicit zones would invite destabilizing speculation. He also disagreed with the idea of using the exchange rate to force fundamental restructuring. Following the 1987 Louvre Accord, there was an agreement not to use the exchange rate either as an instrument of trade policy or as a tool to force structural change. In most cases, the market should be allowed to set the exchange rate. When the market did overshoot, then it would be time to intervene.

Bergsten responded by pointing to the wide fluctuations in the yen. The actual range of 80 to 150 was well outside the implicit zone of 100 to 130 that had been identified by Sakakibara. Bergsten did agree that any zone needed to be restructured in response to fundamental changes such as a sharp rise in oil prices or inflation differentials.

> Sakakibara noted that "in the end [Secretary of the Treasury] Larry Summers and I had an implicit moving target zone." ... Intervention depended on market conditions. ... Sakakibara suggested that what Bergsten was suggesting was not all that different from actual practice.

Walter Comments

Walter posed the following question. If the U.S. market continues to be extremely attractive because of good governance, stable government and high yields, why shouldn't the world's investors continue to send their capital to the U.S.? Under such circumstances, why would the midpoint of the Bergsten's target range stay the same?

Bergsten responded that he was not suggesting the end of capital imports. But he continued to have serious doubts about the economic and political sustainability of record current account deficits on top of a $2 trillion external debt. He noted the past link between an overvalued dollar and the emergence of protectionist pressures in the United States. There was already something of an American backlash to globalization. He added that the U.S. Congress had refused to grant the President fast track (which limits Congressional debate and amendments) trade negotiating authority for the past six years despite rapid growth and low unemployment. How might the Congress react now that the country is experiencing an economic slow down?

Selected Questions

Q: If the U.S. reduces its current account deficit, what will happen to the rest of the world? Especially Asia? Where is there the economic strength that will create a market for added U.S. exports?

A: Bergsten agreed there could be short-run difficulties. But he reiterated his concern about the long-run sustainability of America's current account deficit. He again noted that the best predictor of U.S. protectionism was not the unemployment rate but the exchange rate of the dollar and the size of the current account imbalance. As the dollar becomes overvalued, more and more industries become sensitive to imports. At the same time, export industries, a traditional counterweight to protectionist pressures, are less likely to support open trade and might "even join the parade" of protectionist or activist forces.

Bergsten also thought the massive U.S. current account deficit was unsustainable. He cited, *Is the Trade Deficit Sustainable*, a 1999 volume by IIE senior fellow Cathy Mann. When Mann's study appeared in 1999, the current account deficit was heading toward \$330 to \$340 billion dollars, more than \$100 billion short of the expected 2000 figure. Mann noted that to finance the noticeably smaller 1999 deficit would take 50% of all the incremental savings (the amount above the previous year's total) in the world.

Q: The 1990s has been a decade characterized by stagnation in Japan and rapid growth in the United States. Won't that require an adjustment in your targets with a decline in the value of the yen? If Europe has really restructured, won't that require a similar adjustment upward in the value of the euro?

A: Bergsten continued to express concern about further depreciation of the yen. He did note that the 2001 *Economic Report of the President* and the accompanying report of the Council of Economic Advisors were optimistic about the economic prospects of the United States. The question about shifts in the relative weights of the major economies suggests it is time for an important new research project to reassess the target zones.

PANEL DISCUSSION

JOHN G. WALSH
Group of Thirty

ADAM POSEN
Institute for International Economy

PAULA STERN
The Stern Group

The panel was composed of three distinguished specialists with extensive backgrounds in international trade and finance. In brief comments and a spirited question and answer period they stimulated further thinking about the morning discussion as well as adding their own perspective to everything from the likely depreciation of the dollar to the prospects for economic growth in Japan.

John G. Walsh served as moderator of the panel. Walsh is currently the Executive Director of the Group of Thirty. The Group of Thirty is a not-for-profit organization composed of distinguished academics, private sector leaders from the world of finance, and former senior government officials. As Executive Director, Walsh has directed a program of studies, conferences and publications on international economic and financial issues. Prior to joining The Group of Thirty, Walsh had a distinguished career of public service on the staff of the Senate Banking Committee, in the U.S. Treasury, and at the Office of Management and Budget.

Dr. Adam Posen focused his remarks on the prospects for the yen and the Japanese economy. Posen is currently a senior fellow at the Washington-based Institute for International Economics. Posen's research interests include Europe as well as Japan and he has served as an advisor to a number of central banks. Prior to joining the Institute, Posen worked as a research economist at the Federal Reserve Bank of New York, the Okun Fellow at the Brookings Institution in Washington, D.C., and a Bosch Foundation Fellow in Germany.

Dr. Paula Stern is currently the President of The Stern Group, an economic analysis and trade advisory firm in Washington, D.C. She serves on a number of corporate boards including Wal-Mart Stores, Inc., Avon Products, Inc., and Harcourt General. She is also a member of the President's Advisory Committee for Trade Policy and Negotiations (ACTPN) and a senior advisor to the Transatlantic Business Dialogue (TABD). Prior to founding The Stern Group, Stern served as chairwoman of the U.S. International Trade Commission.

The Dollar, The Yen, and the Euro: Added Perspectives on Politics and Policy

John Walsh: As moderator, Walsh opened with an overview of the preceding discussions of the dollar, the euro and the yen as well as the proposal to create target zones to limit the volatility of the major currencies. He also noted that the combination of a slowing economy coupled with large trade and current account deficits could create political opposition to the pursuit of future trade agreements. In terms of target zones, Walsh agreed that the major countries did try to manage the regime of floating exchange rates but thought that it would be difficult to create explicit targets and zones.

Adam Posen: In his opening remarks, Posen disagreed with the Bergsten proposal for managing the relationships among the three major currencies through target zones backed by sterilized intervention. [Intervention takes place when a government buys its own or another foreign currency in order to change the exchange rate. For instance, when the central bank issues new dollars or euros or yen to purchase a currency, it increases the overall money supply. The intervention is sterilized when the central bank takes action to offset the increase in its domestic money supply by selling bonds or taking some other offsetting action.] Posen was skeptical about the ability of sterilized intervention to work. He acknowledged that some former government officials were confident about the impact of sterilized intervention. But, Posen noted, most of their experience dated to the early 1980s before the enormous increase in the daily volume of international currency transactions.

Unsterilized intervention (implying an actual change in the money supply) would move exchange rates, Posen thinks, but the domestic costs are really too high. That is why exchange rates are allowed to diverge from 'fundamentals' for extended periods – this reveals a true priority for domestic goals. In his view, monetary policy should not be used to target a particular exchange rate except in service of national inflation or output goals. Current account imbalances are insufficient justification.

He also disagreed with the proposition that either tight monetary policy or a hard-pegged exchange rate regime would be effective in forcing structural reform. In effect, he rejected the idea that a higher value of the yen relative to the dollar would force major changes in the Japanese economy. In support of his view, Posen pointed to recent research that showed that neither currency boards nor even full dollarization had resulted in needed structural reforms in countries where they were adopted.

Posen was quite critical of current Japanese monetary policy. He noted that Japan had moved in the wrong direction by actually raising interest rates in a low inflation, virtually zero growth environment. Posen proposed a monetary policy that would target a publicly approved, positive level of inflation. In response to rising prices, the Japanese consumer would stimulate growth by buying more and saving less.

What should Japan do? The first step is loosening monetary policy. In practice the tight money policy of Japan has punished the efficient tradable goods sector of the economy while the lagging sectors such as retail and construction go unreformed. The loosening policy should start with reversing the one-quarter of a point interest rate increase by the Bank of Japan last August. But it should not stop there. The loosening should continue until there are enough yen in circulation to create a tax on savings through rising prices.

Lower interest rates and a looser monetary policy suggest a further decline in the value of the yen relative to the dollar and the euro. Posen agreed that a declining yen risked capital flight but thought that risk already existed because of the low return on domestic, yen-denominated investments. Needed reform and conditional recapitalization of the Japanese banking system would do more to raise returns and improve the risk structure of Japanese investments.

What should the U.S. do with regard to Japan? Posen proposed a four-step policy. First, the U.S. should continue to turn to the World Trade Organization (WTO) to settle direct trade disputes. Second, the U.S. should emphasize sectors that promote broad structural reform (like telecommunications) rather than focusing on individual sectors primarily of interest to U.S. exporters (like auto parts). Third, the U.S. should continue to press for regulatory changes to allow greater foreign direct investment in Japan as well as more open markets. Just as Japanese direct investment in the U.S. auto industry has helped foster a revolution in U.S. manufacturing, Posen believed that U.S. direct investment in the financial and retail sectors would help drive structural reform in Japan. Finally, Posen felt that the U.S. should continue to press Japan to grow more rapidly. As for any modern economy, a truly effective growth strategy would require a combination of the right macroeconomic policy, public and private investments and on-going structural reform.

RECOMMENDATIONS FOR U.S. ACTION TOWARDS JAPAN

1. Turn to the WTO to settle direct trade disputes
2. Emphasize sectors that promote broad structural reform instead of focusing on individual sectors of primary interest to U.S. exporters
3. Press for regulatory changes in Japan's financial and retail sectors to promote greater foreign direct investment there in addition to more open markets overall
4. Press Japan to grow faster

Paula Stern: In looking at the U.S. economy, Stern stressed the transformation that had occurred in the 1990s. By adopting new production techniques and becoming more aware of international markets and trends, U.S. business had become much more globally competitive.

She also noted that almost a decade of economic growth had driven the U.S. unemployment rate to a thirty year low. For African-Americans and Hispanic-Americans, the unemployment rates were the lowest ever recorded. She also stressed that an important element in American prosperity had come through the growth in domestic competition. Deregulation, information technology and overall innovation were important elements in adding to competition.

Stern put particular emphasis on international trade and open markets in creating a decade of prosperity. In addition to opening up global opportunities for American workers and companies, import competition had stimulated domestic innovation and helped keep prices in check. That added level of competition allowed for a more expansive monetary policy and faster growth without the risk of inflation.

The economic climate should have been very promising for further trade agreements. And there had been important successes during the Clinton-Gore years. NAFTA had been improved and then approved. The Uruguay Round was completed and also approved by the U.S. Congress. In 2000, the Administration and the Congress agreed to grant permanent normal trade relations status to China as part of its becoming a member of the World Trade Organization.

But there had been setbacks as well. Despite record prosperity, Stern noted that the Congress had refused to grant new fast track (limiting congressional debate and precluding congressional amendments) negotiating authority to the Administration. Stern suggested that the resistance to fast track may be linked to the appreciation of the dollar since 1995 and the emergence of record trade and current account deficits.

Stern also turned her attention to Japan. She shared the views expressed by others about the need for long term restructuring as well as a shift in macroeconomic policy. In addition, she focused on two elements that might be viewed as almost cultural in nature. In Japan, Stern stressed, a price conscious consumer is likely to be female and thus lacks political clout. As a result, the Japanese consumer had not emerged as a major force for structural changes that could dramatically lower domestic prices. With a greater openness to international trade and a retail sector that would welcome Wal-Marts as well as mom and pop outlets, the Japanese consumer would have greater choice at a dramatically lower price. Stern went on to speculate that enhancing the role of women in the Japanese economy could eventually encourage change in a number of the lagging sectors highlighted by Dr. Sakakibara in his morning presentation on the yen and the Japanese economy.

Stern also noted the impact that immigrants have had on the economies of the United States and the United Kingdom. In both cases, immigrants have contributed a great deal to innovation and growth. With a rapidly aging workforce, Japan may have traditional economic reasons to turn to immigrants and women. Stern also wondered if a growing number of such social outsiders might not have a stimulating effect on Japan in terms of innovation and business creation.

TRADE AND CURRENT ACCOUNT DEFICITS

PAUL SARBANES
U.S. Senator from Maryland

Senator Paul Sarbanes, chairman of the Senate Committee on Banking and a senior member of the Senate Committees on Foreign Relations and Budget as well as the Joint Economic Committee, provided the conference with a Hill perspective. In his presentation, Sarbanes emphasized the political and economic implications of the U.S. record trade and current account deficits. Senator Chuck Hagel (R-NB) had planned to participate in the conference but had to remain on Capitol Hill at a confirmation hearing for Secretary of Defense, Donald Rumsfeld.

Trade and Current Account Deficits

Wilson Center Director Lee Hamilton introduced Senator Sarbanes and began his remarks by congratulating Senator Sarbanes on his recent re-election to a fourth term in the U.S. Senate. Hamilton went on to describe the Senator's distinguished career that included three terms in the House of Representatives, two terms in the Maryland House of Delegates, and service as the Executive Director of the Charter Revision Commission of Baltimore City, 1963-1964. He also mentioned that he had first heard of Senator Sarbanes when Sarbanes was the Administrative Assistant to Walter W. Heller, Chairman of President Kennedy's Council of Economic Advisors (CEA) (1962-1963). In referring to the Kennedy-era CEA, Hamilton said he could not "remember an economist who testified with more force and clarity to those of us uneducated in economics than Walter Heller." Hamilton suggested that Heller's Administrative Assistant might have had something to do with the clarity of that testimony.

In his opening remarks, Sarbanes focused on the United States' external accounts. In Sarbanes view, "…the trade and current account deficits are a significant vulnerability for the United States and world economies." He pointed to an annual current account deficit that is about $450 billion and rising. The growing current account deficits are adding to the country's overall external debt, which has already reached $2 trillion or 20% of the nation's GDP.

Sarbanes noted that the United States depended on foreign investment to finance its external debt. Should foreign investors lose their confidence in the American economy and direct their investments elsewhere, "we could be in for a very difficult adjustment." Sarbanes' concern with the trade and current account deficits led him to join with Senators Byrd (D-WV) and Dorgan (D-ND) to sponsor legislation creating the Trade Deficit Review Commission. Sarbanes also noted that a number of the Commissioners had discussed their November 2000 report at a Wilson Center conference.

In Sarbanes' view, the best scenario would be a soft landing for the economy and the dollar brought about through a loosening of monetary policy.

In its report, *The U.S. Trade Deficit: Causes, Consequences, and Recommendations for Action*, the Commission split along party lines with regard to many of the key issues. Sarbanes pointed out that they did agree on a few important questions. For instance, the Commissioners all favored strengthening the enforcement of trade agreements, the improved collection of trade statistics, and expanding adjustment assistance for displaced workers. At the very least, Sarbanes thought the Commission had provided the Congress "with an agenda for legislative attention."

Sarbanes also thought the Commission report had done a very thorough job of articulating the range of questions surrounding the trade and current account deficits. By including parallel chapters, the report had spelled out "separate road maps for understanding and responding to the trade deficit." In Sarbanes' view, the Commissioners had captured the key elements of the trade deficit "debate…within the covers of the report." Sarbanes added that if he were a university professor teaching international economics he would assign the report to his students.

Key Issue: The U.S. Economy

In Sarbanes' view, growth had been the key to financing the U.S. external debt. "As long as the U.S. economy remains strong, it was easier to ignore the trade and current account deficits." Rapid and sustained growth made the United States an attractive place to invest. The recent economic slowdown makes the deficits a more complicating factor.

Sarbanes noted that the Federal Reserve Board had already cut interest rates by 50 basis points (or one-half percentage point). [The Fed cut rates by an additional 50 basis points on January 31, 2001]. He had opposed the later stages of Fed tightening in 2000. He noted that since the announcement of the Fed's shift toward a looser monetary policy, the dollar had weakened relative to the euro. In Sarbanes' view, the best scenario would be a soft landing for the economy and the dollar brought about through a loosening of monetary policy.

Sarbanes thought the principal danger to a soft landing was a large tax cut. He feared a return to the mix of tax cuts and recession of the early 1980s. He noted that fiscal restraint in the Clinton Administration had been an important element in producing the lowest unemployment rate in thirty years, the lowest inflation in thirty years, an outstanding performance in terms of productivity growth and the movement from deficits to large fiscal surpluses. We could, Sarbanes suggested, have a reasonable tax cut, make some reasonable investments in education and elsewhere, "and still preserve a good part of the surplus to continue paying down the debt and strengthen our economic position."

The country, Sarbanes felt, was facing a very important decision. The outcome was not at all clear. The idea of a large tax cut was gaining political momentum. His final word was that the country should keep fiscal policy on a steady basis and use monetary policy to adjust to the current slowing in the economy.

The Euro and the Yen

Sarbanes saw the recent strengthening of the euro as a good thing. He thought that U.S. investors still did not fully appreciate what the Europeans had done to make their economies more globally competitive. He also noted that in terms of international trade, U.S.-European surpluses and deficits had generally balanced out. Where a surplus or deficit did exist, it was usually within reasonable parameters.

Sarbanes saw the Far East in very different terms. He shared the concern about a weak Japanese economy expressed by virtually all the conference participants. The United States could not, he added, be the sole engine of global growth. He also noted that Japan was not only registering a large bilateral trade surplus with the United States but also accumulating massive foreign reserves.

Sarbanes wondered if the Japanese policy of accumulating reserves rather than increasing imports might have helped keep the value of the yen low relative to the dollar. It was the kind of question that could and should be addressed in periodic reports by the U.S. Treasury. Under the Omnibus Trade and Competitiveness Act of 1988, the Treasury is required to report on developments, including exchange rate management, that would affect the international economic position of the United States. Sarbanes thought that President Reagan's Under Secretary of the Treasury for International Affairs, David Mulford, had used the reports to put pressure on countries he thought "were manipulating their currencies in order to gain a trade advantage."

In addition to Japan, Sarbanes had "very serious concerns with China." China was currently running a trade surplus with the United States that was approaching $90 billion. Compared to Japan, China was building its surplus on a much smaller volume of trade. It was almost a one-way street in terms of exports. That was, Sarbanes noted, less true of Japan.

In Sarbanes' view, any imbalance of that size that persists over time would have "very severe political consequences." He had told the Japanese that the bilateral trade deficit put a great deal of strain on its ties with the United States. He thought the same tensions would eventually emerge in our dealings with China. In the case of Japan, "we have to view the trade relationship in the context of a country with whom we have a security relationship and who has been generally helpful in supporting U.S. objectives in the Far East." With China, he continued, "there is a question mark over the relationship" that includes matters such as weapons proliferation and the status of Taiwan. The economic imbalance just adds to the questions.

Congressional Action

Sarbanes did not think that Congress would act directly on the question of exchange rates. He added that he hoped they would not. As he put it, the Congress "should not walk in where Angels fear to tread." He did think that Congress would act on some of the economic fundamentals that influenced exchange rates. The key question would revolve around the question of tax cuts, spending and overall fiscal policy. In the 2000 presidential campaign, Sarbanes had been struck by the number of times candidate Bush would say that his idea of tax cuts "may not be popular, but I am sticking with my proposal for a tax cut." At the time, Bush was referring to polls showing that a majority of Americans put paying down the debt or other priorities ahead of a tax cut. Sarbanes reminded us that "there aren't many people out there in the voting public that think a tax cut is an unpopular thing." He concluded by warning against the bidding war over tax cuts that broke out between the two parties in 1981. The result was a tax cut even larger than the one originally proposed by President Reagan.

Selected Questions and Answers

Q: Initially the original Bush proposal like the Reagan proposal came from people who supported supply side economics and its emphasis on improving incentives by lowering marginal tax rates. Now that the economy is weakening, they sound like Keynesians calling for a fiscal stimulus.

A: Sarbanes responded that the current economic slow down did not call for a large tax cut. He was prepared to support a stimulative tax cut if the economic conditions called for it. His preference was to use monetary policy first. In terms of tax cuts, he favors being more selective, noting that it is difficult to reverse tax cuts should the economy call for a different approach.

Q: Proposals to cut marginal tax rates seem to be a hardy perennial of Republican campaigns. When President Bush proposed them in the 2000 campaign, why didn't the Democrats adopt President Reagan's famous phrase and simply say, "there they go again."

A: Sarbanes suggested there were several reasons. President Clinton had already endorsed a tax cut, albeit a much smaller one. Many Democrats favored specific tax cuts. For instance, most Democrats favored reducing or eliminating the marriage tax penalty. And, he added, the Democrats did not want to be seen as opposing all tax cuts, but simply one that was too large.

Q: Why has there not been more of a political response to record trade and current account deficits?

A: Trade related questions, responded Sarbanes, are "always dampened down if you have a good economic situation." At 4% unemployment, the economy has actually reached the target established by the Humphrey-Hawkins bill—a target once dismissed by many economists as hopelessly unrealistic.

Sarbanes added that what has not entered the picture is the "foreboding about globalization." The growing concern about globalization was reflected in the demonstrations that disrupted the November 1999 World Trade Organization ministerial meeting in Seattle.

Sarbanes pointed to another aspect of the current account deficit that should get more attention. The growth in the external debt means that each year more and more of the nation's earnings will go to service the debt rather than being used to raise the American standard of living. The outflow could become a burden. In Sarbanes' view, a critical question was whether the borrowing from abroad was invested or simply consumed. In the nineteenth century, for instance, foreign investment made an important contribution in creating the railroads and other infrastructure that helped build the national economy.

The growth in the external debt means that each year more and more of the nation's earnings will go to service the debt rather than being used to raise the American standard of living.

Q: *The Economist* endorsed the candidacy of George W. Bush, in part because they were concerned about trade issues. Is there any post-election sentiment on the Democratic side for trade restrictions or any response to the large trade and current account deficits?

A: Sarbanes thought there would be "a strong [negative] response in terms of expanding trade" through new rounds of trade negotiations. He viewed the introduction of restrictions on trade, however, as much less likely in part because any proposed restriction would almost surely face a presidential veto. Sarbanes predicted that if the Administration sought fast track authority (limiting congressional debate and precluding congressional amendments) they would face a major fight in the Congress. President Clinton had split the Democratic ranks on trade and picked up considerable Republican support. But, now the political dynamics had changed.

Q: President Clinton had sought to bridge the differences between those focused on expanding trade and those concerned about labor and environmental conditions. For instance, the recent U.S.-Jordan trade agreement contains provisions on labor and the environment. An almost completed agreement with Singapore includes similar provisions. What will the Bush team do?

A: Sarbanes thought that the Bush team would be heavily influenced by advice coming from the business community. American business may think that the U.S.-Jordan agreement is fine by itself, but they may be reluctant to set a precedent favoring the inclusion of labor and environmental provisions in trade agreements. He was also not sure how the Labor movement felt about the U.S.-Jordan agreement. They may be pleased at the precedent but not satisfied with the specific labor protections included in the agreement.

Sarbanes noted that in terms of trade, Singapore was the more important agreement because of the sheer volume of commerce involved and because of Singapore's key position in Southeast Asia. In the case of Jordan, the trade aspects of the agreement were complemented by important foreign policy considerations tied to stability in the Middle East.

Q: What is the new assignment for the Trade Deficit Review Commission?

A: The same Commission will look at the security implications of our trading relationship with China. Sarbanes had voted against permanent normal trading relations (PNTR) with China because of concerns about both human rights and a "very administered trade relationship." In his view, trade was the key Chinese priority. By granting PNTR, he felt that the United States had given up too much negotiating leverage.

Q: With regard to the Treasury reports on currency manipulation to gain trade advantage, hasn't a decade of experience and advice made it more difficult to make black and white judgments about currency manipulation?

A: Sarbanes noted that the Treasury still issued the reports but he felt they were now "pulling their punches…and not calling it as they see it." He mentioned hearings with Under Secretary of the Treasury Mulford where they focused on the huge reserves being accumulated by Korea and Taiwan through large current account surpluses. Sarbanes felt that the reports and their use by Mulford helped bring about a positive change in policy. Sarbanes did agree that a decade of experience often made judgments on exchange rate manipulation more difficult. Still, he pointed to the enormous reserves being built up by China and Japan.

Q: Do you worry that the Democratic Party is inward looking on trade or even becoming neo-protectionist?

A: Sarbanes noted that the Democratic Party was headed in different directions on the question of international trade. He described Democrats in terms once used by the famous humorist, Will Rogers. Rogers was once asked what organized party he belonged to. He responded that he did not belong to an organized party, he was a Democrat. Sarbanes agreed that the Administration might try to exploit the split in Democratic ranks but noted that they face divisions in Republican ranks as well.

Well beyond the specific issues of trade policy, Sarbanes thought that "one of the challenges of our times was to address the question of globalization in a way that is understandable and acceptable to working people." We needed to make sure that they were not getting the short end of the global stick. Sarbanes thought that labor and environmental provisions in trade agreements were a constructive way to proceed. If we fail to assure working people that globalization works for them, there may be sharp conflict. It is an area that is ripe for demagogues to exploit. It could again spill over into the streets as it did in Seattle. It behooves business and labor to work together to resolve the question of how all can gain from the global economy. Sarbanes added that trade related tensions could rise if unemployment increases in any significant way.

FINAL PERSPECTIVES

The conference on *The Currency Conundrum* had been arranged by Samuel Wells, Associate Director of the Wilson Center, Kent Hughes, then a Public Policy Scholar at the Center, and Barry Hager, a Washington-based specialist in international finance. At the end of the conference, Wells, Hughes and Hager each added their particular perspective to the day's proceedings.

Samuel Wells—Wells focused his remarks on Europe and the euro. Wells felt that neither the European Monetary Union nor its history were well understood in Washington. The theorists seeking to design a new Europe had always conceived of a political as well as an economic union. In practice, political union proved to be particularly difficult. By the 1980s, European theorists set political union to the side and concentrated on building closer economic ties.

The focus on economics did not mean that broader political goals had been abandoned. At its core, the European Union remained a fundamentally political project. The European theorists still believe that closer political ties would follow economic integration. In some respects, their thinking parallels the Clinton Administration's thinking about China where closer economic ties to the West are expected to bring about an eventual political transformation.

Wells expressed pleasure at how effectively Norbert Walter had combined political as well as economic elements in his presentation. Wells was also struck by Walter's assessment that no institution but the European Union could have forced structural reforms that were opposed by national political and business elites. It was the pressure of the European Union that had led to reforms in corporate government, pension arrangements, and tax policy. Wells encouraged Walter to expand his insight into a longer essay or article.

Kent Hughes—Hughes emphasized a number of key factors found in each of the presentations. Although there was general agreement that the euro could appreciate against the dollar, the speakers all spoke about the future with a reverence for uncertainty.

Hughes stressed the degree to which each of the speakers focused on microeconomic as well as macroeconomic forces in determining the long-run outlook for each of the major currencies. The period of dollar strength had been built on the high returns offered by the American economy. Those high returns could often be traced to hundreds of thousands of private sector decisions to adopt and adapt new technologies. Heightened competition in the American market–based on rising international trade, deregulation and technology–had acted as an added spur to broad based innovation. By limiting the scope for price increases, the increased competition created a solid microeconomic base for a more expansive monetary policy.

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Hughes also noted that each speaker wove political as well as economic considerations into his assessment of the future. Japan had economic problems that required a political consensus. Political considerations often determined the pace at which Europe became a true common market and hence a more attractive site for global investment. The future course of the dollar would be heavily influenced by policy decisions on U.S. tax and spending policies as well as the Fed's approach to monetary policy.

There were varying degrees of skepticism about the effectiveness of financial intervention to affect the relative values of the dollar, the euro and the yen. All agreed that political considerations – including the fear of protectionism – would influence any collective decision to intervene in world currency markets.

In the case of fiscal policy, Hughes sensed both agreement and divergence. Participants were generally skeptical of using tax policy as a fiscal stimulus to offset a mild recession. The presenters all shared the modern skepticism about the ability of democratic governments to move quickly enough to use fiscal policy to affect a typical economic downturn. For the most part, by the time administrations settle on a policy and parliaments or the Congress approve it, the recession is over. In this view, instead of priming the pump, fiscal stimulus often adds water to a river already running at full tide. Hughes noted, however, that the presenters had somewhat different views of the longer term. Several continued to stress fiscal restraint and debt reduction. Walter, however, saw recent changes in German taxes as supporting supply side changes as well as providing a fiscal stimulus. In the U.S. case, he thought tax cuts and an eased monetary policy would work together to restore more robust U.S. growth.

Finally, Hughes cited the presenters' emphasis on psychological factors, expectations and shifting perceptions. Fear of a currency collapse or the perception of a shift in a government's attitude about its currency can move the international money markets. When a currency overshoots or undershoots the underlying economic fundamentals, it can have serious consequences for the real economy. It was, Hughes concluded, a reminder that the often arcane and mathematical analysis of currency movements remained an art as well as a science.

Fear of a currency collapse or the perception of a shift in a government's attitude about its currency can move the international money markets.

Barry Hager—Hager noted that all the presenters emphasized the importance of achieving the right mix of fiscal and monetary policies. Their presentations also pointed to the difficulty of finding and maintaining the proper mix.

Hager shared Dr. Sakakibara's assessment that if the three currencies were entered in a beauty contest the euro would win. Hager also thought most Americans did not fully appreciate how much Europe had done to strengthen its separate economies. In terms of the yen, he departed from Sakakibara's uniform pessimism about Japan. We run the risk, Hager suggested, of missing the true story in Japan because the standard story has become so familiar. He sensed positive movement in Japan but agreed that it was often hard to detect.

On the United States, Hager wondered if the enormous economic prosperity of the Clinton years had not obscured some potentially serious problems. He pointed to the large trade and current account deficits and noted that Senator Sarbanes had warned that the deficits could gain more political saliency if the economy continues to slow. Hager also wondered if we were building policy on surpluses that might not be quite so large. He pointed to recent work by the Center for Budget and Policy Priorities (CBPP) which projected much smaller budget surpluses. Hager noted that conventional base line projections assumed that tax incentives and spending programs that periodically expired would not be renewed even when they have routinely been extended. Instead of relying on the conventional method, the CBPP had based their estimates on likely spending and taxing policies. The devil, Hager reminded the audience, was often found in the assumptions as well as the details.

CONCLUSION: CHALLENGES FOR AMERICA

KENT HUGHES
Woodrow Wilson Center

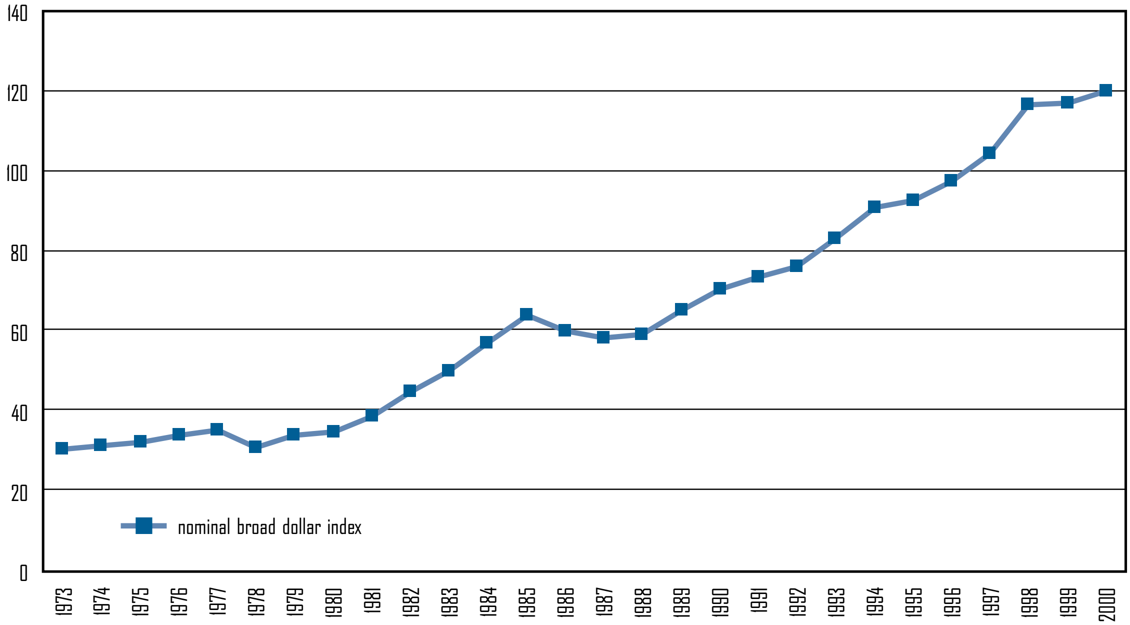
After reviewing a day's discussion on major currencies, there is little doubt about the importance of the United States to the global economy. The United States still accounts for over 25% of global output. The bulk of commodities including oil is still priced in dollars. The more unstable the situation, the more likely dollars will be preferred to a local currency. For most countries, the dollar constitutes an important part of their foreign currency reserves. In fact, as much as 50% of the dollars in circulation are held outside the United States.

The Global Dollar and American Prosperity. In discussing the world's three major currencies, the specialists generally agreed with Norbert Walter's assessment that the euro had helped deepen European economic integration and become a factor in the global bond market. After mid-2001, the euro did finally experience a modest appreciation as the U.S. economy slowed. The dollar has weakened further in the immediate aftermath of the tragic attacks of September 11. Few disagreed with Eisuke Sakakibara's view that Japan would have to become a more thoroughly open and international economy before the yen became a truly global currency. In sum, the yen holds future potential and the euro has moved quickly to become an international currency.

The discussion also left no doubt that the dollar remains the pre-eminent trading and reserve currency in the world. Because Europe does not yet have a fully integrated stock market, the dollar continues to dominate world trading in securities as well. The prominence of the dollar has brought clear benefits and, at times, identifiable costs to the United States.

Every country gains from seignorage—the difference between the cost of printing or minting its national currency and what the currency will buy in terms of actual goods and services. To acquire dollars, overseas investors have to sell goods, services or assets to Americans. If these overseas investors hold the currency as a reserve, use it to fund overseas transactions or keep dollars as an investment, they have, in effect, made an interest free loan to an individual or organization in the United States. By having the leading global currency, the United States benefits from a kind of super seignorage.

U.S. Nominal Broad Dollar Index, 1973-2000



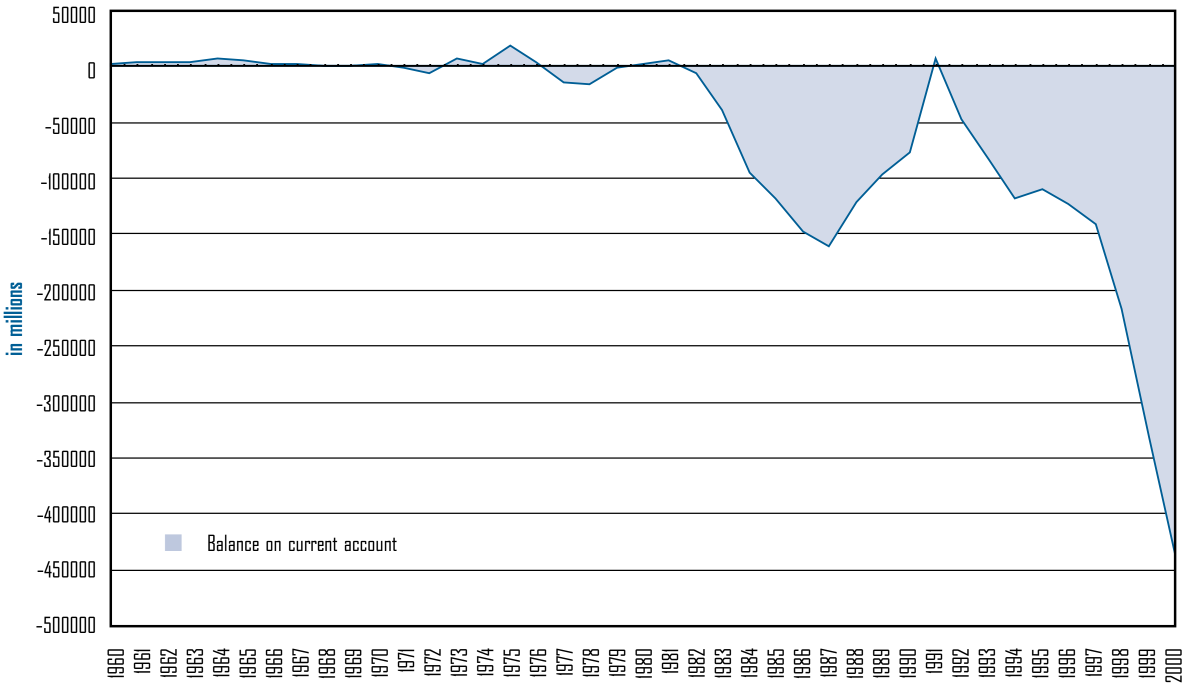
The Federal Reserve Board, Summary Measures of the Foreign Exchange Value of the Dollar, Montly Nomial Broad Dollar Index, http://www.federalreserve.gov/releases/H10/Summary/indexb_m.txt
The broad dollar index measures the dollar's strength against a basket of currencies including those of all foreign countries or regions that had at least a 1/2 percent share of U.S. non-oil or nonagricultural exports in 1997. These countries and regions generate more than 75 percent of the international GNP (outside of the U.S.). http://www.federalreserve.gov/pubs/bulletin/1998/1098lead.pdf

For many investors, the dollar may be as good as gold, but the conference participants were quick to remind us that the dollar has not returned to Bretton Woods-like stability. Over the past twenty years, the dollar has fluctuated considerably against other leading currencies and when compared to the currencies of all our trading partners.

Changes in the value of the dollar can be driven by a variety of factors. With a strong, rapidly growing economy in the 1990s, many overseas investors wanted to establish branches in the United States, acquire United States companies, or buy United States stock and bonds. That had the effect of driving up the international value of the dollar. Shorter-term investors often respond to fluctuations in interest rates. When macroeconomic policy lowers interest rates in the United States, short-term investors may shift from dollar denominated holdings to European, Japanese, or emerging market securities.

The international value of the dollar is not just a measurement challenge for academic economists. When the dollar rises in value, it makes it harder

U.S. Current Account Balance, 1960-2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, Balance of Payments (BOP) and Related Data, Table 1 of the International Transactions Accounts (as of March 15, 2001), www.bea.doc.gov/bea/dil.htm

for many American companies to compete on global markets. In his presentation, Senator Sarbanes noted that the value of the dollar could also be affected by the policies of other governments. American concern over possible currency manipulation took legislative form in the Omnibus Trade and Competitiveness Act of 1988. Under the Act, the United States Treasury provides periodic reports on whether or not other countries are manipulating their currencies to gain a trade advantage. In a sense, the reporting requirement helps guard against the kind of competitive devaluations that were also the target of the original Bretton Woods system of fixed rates.

In the late 1990s, the dollar rose for quite different reasons. As investors fled first Asia, then Russia and finally Latin America, money flooded into the United States as the best safe haven for global savings. There was a similar impact inside the United States as even solid companies were beginning to find it difficult to borrow. What is generally referred to as a "flight to quality" brought pluses and minuses to the American economy. The

... manufacturing firms conduct the bulk of private sector research and development which now accounts for more than two-thirds of the nation's total research spending.

new supply of dollars helped fund added investment and sustained the rising current account deficit. The stronger dollar made imports cheaper and added competition to an already competitive American market. By putting an even tighter check on inflation, the increased competition made it easier for Federal Reserve Chairman Alan Greenspan to expand the money supply, keep interest rates low, and help maintain a flow of credit to American individuals and companies.

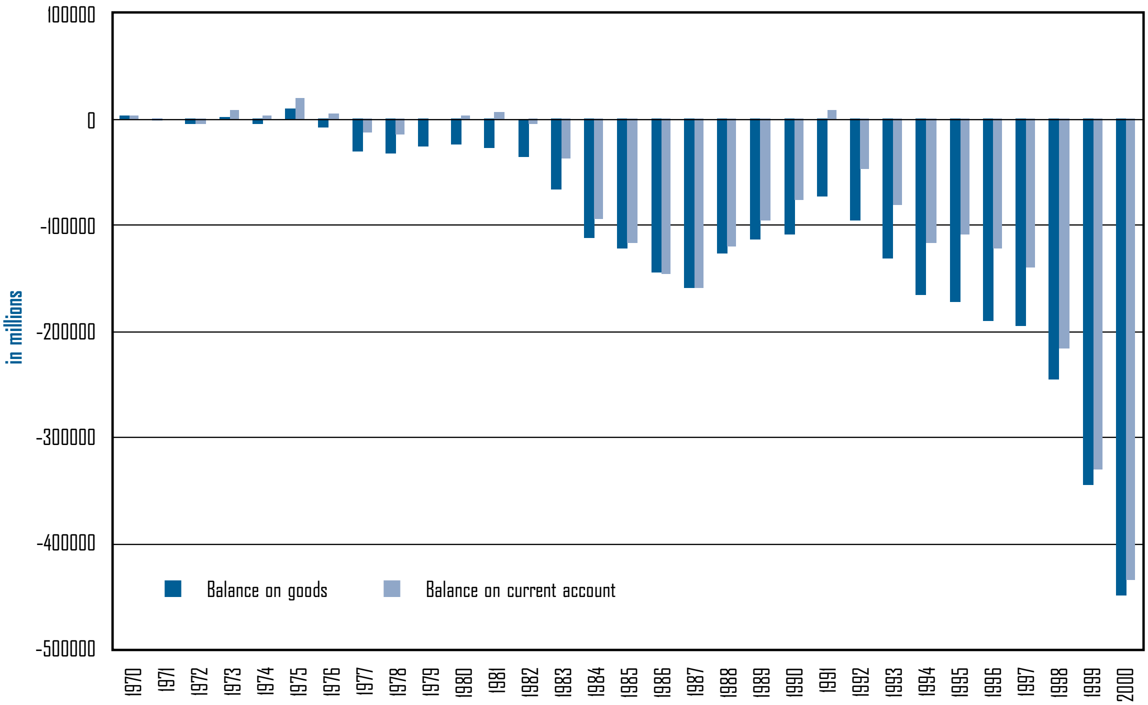
At the same time, added pressure from imports forced layoffs in a number of manufacturing sectors. The longer the dollar remains high the greater the chance that firms in the United States will close plants or even abandon product lines that would be globally competitive with a dollar that was based on economic fundamentals rather than the short-term fears of international investors. Manufacturing is a key part of many lines of business and also provides an important market for an array of business services. Although it was not stressed at the conference, manufacturing firms conduct the bulk of private sector research and development which now accounts for more than two-thirds of the nation's total research spending. The investment in research and development has been a critical element in fueling the rapid productivity growth of the 1990s and should lay the basis for future gains in national prosperity.

Borrowing to Invest or Spend. Every year since 1982, the United States has been borrowing from the rest of the world to pay for its current account deficit. The deficits first appeared in the 1970s but, at times, the sale of services or the repatriation of dividends was enough to offset a large trade deficit. The string of current account deficits, however, gradually eroded the standing of the United States as the world's largest creditor and put the country on the path to becoming the world's largest debtor.

Borrowing can be a boon to a country. Conference participants pointed to the sharp rise in American investment during the 1990s. A significant share of those large current account deficits helped pay for new factories, new machine tools or new office buildings. Some of the other borrowed funds probably went into training, research and development and other harder to measure investments. Borrowing, however, does not always lead to investment. In the 1980s, the United States was borrowing more but actually investing less than it had in earlier years. The country was going into debt to keep up its level of consumption.

The choice of investment over consumption can be critical for a country's future. By investing, a country lays the basis for future production that can pay back the loan and, hopefully, also raise the domestic standard of liv-

U.S. Current Account and Balance on Goods, 1970-2000



Source: U.S. Department of Commerce, Bureau of Economic Analysis, Balance of Payments (BOP) and Related Data, Table 1 of the International Transactions Accounts (as of March 15, 2001), www.bea.doc.gov/bea/dil.htm

ing. With more rapid growth in output and productivity, it will also be easier to meet the retirement needs of the baby boom and future generations.

Conference Conclusions. The Wilson Center conference on *The Currency Conundrum* was not designed to develop hard and fast rules for the management of global exchange rates. Although the presenters were asked to look ahead in terms of the likely performance of national or regional economies and their implications for exchange rates, everyone accepted their warnings about how uncertain the future can be. There were, however, some broad areas of agreement, some areas of clear disagreement and some important shading of opinion that could prove useful in assessing policies of the United States and other countries.

Macro Matters. There was, for instance, broad agreement that fiscal and monetary policies retained a powerful influence over exchange rates. There was also general agreement that the United States could continue to lower interest rates and loosen monetary policy without much fear of igniting inflation. Most presenters and participants favored a relatively tight fiscal policy. That view translated into support for a modest tax cut or, in a few cases, no tax cut at all. They pointed to the success of the Clinton era policies that combined fiscal surpluses, pro-growth monetary policies and high rates of investment. In this regard, Norbert Walter was a notable dissenter. He based part of his optimism about future American and to some extent world growth on the expected impact of tax cuts in Europe and the United States. He pointed to German tax cuts that promised an immediate stimulus and, by lowering marginal tax rates, the right long-term incentives. He viewed the proposed Bush Administration tax cut in a similar light.

More companies are likely to thrive where public investments in research, education, training and infrastructure complement the investments made by the private sector.

Micro Matters Too. In his opening presentation, Robert Hormats stressed the importance of overseas investors making direct investments in the United States economy as well as their purchase of United States securities. Their focus was on the rate of return on direct investments and securities. For these investors, interest rates were important for their impact on the rate of return of their other investments rather than as a direct determinant of where or whether to invest. In determining that rate of return, the participants made clear that private sector practices and public policies could also be important factors. In the United States, corporate restructuring in the 1980s had helped lay the basis for the rapid growth of the 1990s. Presenters pointed to current corporate changes in Europe and to a much lesser extent in Japan as changes that promised more rapid growth and higher rates of return in the future.

Presenters and participants also commented on the importance of supportive public policies. Walter, for instance, pointed to a change in German taxation of capital gains that was facilitating the sale of bank holdings of corporate stock. In Japan, Sakakibara pointed to the lack of government action to encourage competition and restructuring in lagging sectors such as construction, health care, and retailing. Presenters and participants commented on the pro-growth policies of the United States.

More companies are likely to thrive where public investments in research, education, training and infrastructure complement the investments made by the private sector. A national climate that favors rapid commercialization will make private sector research all the more productive.

Current Account: Concern Not Yet Crisis. All the participants pointed to the United States current account as entering record territory in both absolute numbers and relative to the size of the overall economy. No one, however, saw a sudden collapse in the world's appetite for American assets. Most agreed with Walter's assessment that Europe was becoming a more attractive target for long-term investors. The combination of an improved climate in Europe and the sheer size of the United States current account deficit led most presenters and participants to expect an eventual decline of the dollar relative to the euro.

Managing Exchange Rates. Most participants shared the view that countries should adopt flexible rather than fixed exchange rates. Where conditions call for more drastic measures, such as the rampant inflation in early 1990s Argentina, a currency board or even the adoption of a foreign currency might be appropriate. Sakakibara was the notable exception to the general consensus. He argued that few countries would really tolerate excessive swings in the value of its currency. Too rapid a depreciation could fuel inflation while too extreme an appreciation could choke off exports. In these cases, Sakakibara predicted countries would intervene in the currency market creating what specialists generally refer to as a dirty float. Sakakibara allowed that currency boards had worked in Hong Kong and might have been appropriate in the case of Argentina; but he pointed to the loss of flexibility in terms of monetary and overall economic policy.

Target Zones: Strategic Muddling or Explicit Minding. In his presentation, C. Fred Bergsten made the case for target zones. Most shared his view that financial markets could and had pushed currency values beyond what economic fundamentals would suggest. Most also shared his view of the potential benefits from greater exchange rate stability – increased trade, investment and growth. They generally differed, however, on the degree to which explicit target zones would be an effective policy. Several feared that explicit zones would create attractive targets for global speculators. All agreed that zones would have to adjust for changes in the economic fundamentals. Some wondered if fundamentals and hence investor behavior might shift more rapidly than government could adjust the zones. Walter, for instance, thought that the late 1990s investment in the United States and the resulting rise in the value of the dollar were justified by the fundamentals.

Based on his long experience in Japan's Ministry of Finance, Sakakibara suggested that the United States, the European Union and Japan were already practicing a kind of target zone management. Instead of publicly announcing zones, key financial officials arrived at an informal sense of appropriate relative currency values. At times, they would agree on joint intervention in the financial markets to maintain or restore what they calculated to be an appropriate value. In this semi-system, the informal zones were gradually adjusted as fundamentals or other circumstances dictated.

The conference summaries also demonstrated considerable debate over how effectively governments could intervene in currency markets. There was a general agreement that unsterilized intervention (where intervention creates a change in the domestic money supply) can have an impact. There was also a general agreement that sterilized intervention (where monetary policy offsets the expansionary impact of buying foreign currencies) may have been effective in the early 1980s. At that point, disagreement started. Some presenters and a number of participants thought that the enormous growth of global capital markets over the past twenty years had rendered sterilized intervention considerably less effective.

A shift in global prosperity or a change in the value of the dollar can have implications for everything from residential construction to the direction of welfare policy.

America's stake in the global economy has grown enormously over the past three decades. In strictly economic terms, American prosperity is now closely tied to global growth and global growth itself often depends on a healthy American economy. Most manufacturers and a growing array of services are competing for global as well as domestic markets. Foreign investors have provided capital that has been part of the rapid expansion of America's productive capacity in the 1990s. The United States is still the innovation capital of the world but also looks abroad for new technologies and new ideas.

As capital and currency markets have grown, the dollar has become one of the world's most important commodities. Swings in the dollar's value can help support a recovery or challenge the country's manufacturing base. That added import competition can help stimulate innovation and control inflation. There can be too much of a good thing. In the early 1980s, an overvalued dollar led to a painful restructuring that eliminated millions of manufacturing jobs and jolted entire communities.

The Wilson Center's conference and its report on *The Currency Conundrum* are designed to help throw some added light on a subject that is too often neglected in the discussion of public policy. A shift in global prosperity or a change in the value of the dollar can have implications for everything from residential construction to the direction of welfare policy. The Center's hope and intention is to make an often arcane subject more familiar and more useable to the Congress, the Administration and the policy community.

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"Americans are just waking up to the fact that things have changed in Europe in the last couple of years."

—Robert Hormats

"First, because the parameters of the economy are constantly changing you must have a moving target zone. Second, if the monetary authorities make the zone explicit they would be very vulnerable to speculation."

—Eisuke Sakakibara

"A shift in global prosperity or a change in the value of the dollar can have implications for everything from residential construction to the direction of welfare policy."

—Kent Hughes

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