7

Hypothetical History

It may be helpful to indicate how some of the major macroeconomic issues of the last decade and a half might have been influenced had the world already had in place an effective functioning reference rate system. This chapter looks at Japan in the 1990s; Thailand, Indonesia, Russia, Brazil, Turkey, and Argentina before their crises; and the current global imbalances.

In telling an alternative hypothetical history, it is necessary to pick some particular value for the reference rates that would have been in force. I have done my best to select levels that are consistent with what I believed and wrote at the times under consideration, but these were not all cases on which I pontificated in public, and one's memory is not always perfect. There is a danger that some of the figures for reference rates that I assume are influenced by considerations that became clear only ex post. I acknowledge the problem, have done my best to avoid it, but in the last analysis have to rely on readers to use their judgment as to whether or not I have succeeded.

Japan in the 1990s

Whereas in the 1980s there were fears in the United States that high and sustained Japanese growth would lead to Japan becoming the new economic superpower, the 1990s were a decade of slow growth and recession in Japan. A few economists, most notably Ronald McKinnon (see McKinnon and Ohno 1997), have argued that the reversal in Japanese fortunes should be blamed on the post-Plaza pressure to correct the dollar's overvaluation. According to this line of thought, the yen appreciation required a declining

Japanese price level in order to sustain the Japanese current account surplus that reflects the savings surplus in Japan relative to the United States. The Japanese price deflation caused the recession and the banking problems in Japan.

The alternative view is that yen appreciation need not have implied Japanese deflation if the normal fiscal-monetary tools had been employed to expand internal demand in Japan in the 1980s, i.e., if Japan had not resisted adjustment. (Naturally a symmetrical reaction to expand US savings would have been needed; but even when tax wimps were running the US government, one could have relied on the Fed to give the necessary boost to net US savings as an alternative to letting inflation take off.) Instead the Bank of Japan was so dedicated to conquering inflation that it overshot and headed into deflation. Rather than promptly clean up the banking problems this created, Japan floundered for a decade.

When I first calculated a fundamental equilibrium exchange rate (FEER) for the Japanese yen, for 1983Q1, I estimated that a figure of $1 = ¥205 would be appropriate (Williamson 1983, 34). Two subsequent calculations yielded figures of ¥198 for 1984Q4 and ¥114 for 1990Q1 (Williamson 1994, 217). The difference appears large but is in fact fully explained by differential inflation, trend factors (the Houthakker-Magee effect, the large productivity growth in Japan in that period, and asset accumulation), the oil price decline of 1986, and a postulated change in current account balance targets (Williamson 1994, 219). William Cline (1989) developed his Economic Adjustment and Growth model that estimated the needed rate to be ¥102 at the end of 1989. The next calculation with the Institute for International Economics imprint was that by Simon Wren-Lewis and Rebecca Driver (1998, 69), who calculated an equilibrium rate for 2000 between ¥77 and ¥95, the central rate between which is ¥86. Although I was responsible for the current balance input to these calculations, I was surprised at the time that they had ended up with such a strong figure for the yen. However, it may have been because throughout the 1990s it seemed to me reasonable for Japan to allow the yen to be significantly weaker than its FEER, so as to allow the foreign sector to contribute to the revival of the Japanese economy. Now that Japan has recovered, a case for tolerating Japanese dollar purchases when the yen is weaker than its FEER no longer exists. Bearing in mind the substantial cumulative disinflation in Japan, partly offset by the high oil price and the fact that Japan is unusually dependent on foreign oil for its energy needs, I would put the current equilibrium yen-dollar rate in the 80s. Cline (2005) estimates a rate of ¥82 to be implied by his adjustment scenario.

A reference rate system with the reference rates following the above pattern might have influenced events in Japan in two ways. The first is that it would have made it easier for the Japanese authorities to mount a defense against the strong yen in 1995, when the yen peaked at about ¥80. On the above figures, its reference rate at that time would presumably have been around ¥95 (halfway between the above estimates for 1990 and 2000).

Hence, below ¥85 the Japanese authorities could have expected strong support in intervening to stem the dollar's rise, which might have prevented such a strong overshooting and the damage it did to the prospects for prompt recovery of the Japanese economy.

The other impact would not have been so helpful, because it would have precluded the extensive intervention in the opposite direction undertaken by the Japanese authorities in much of the period 1993–2004. Even the original variant of the reference rate system would have prohibited dollar purchases when the yen was weaker than around ¥108 in 1993 and ¥94 in 2000, which means that it would have prevented the big buildup of Japanese reserves in the 1990s. (The two alternative variants would have been even more restrictive.) Such a prohibition might of course have benefited the rest of the world, but one could only argue that it would also have benefited Japan if it had prompted the Japanese authorities to act sooner than they did to clean up the banking system. Ceteris paribus, an effective ban on dollar purchases by the Japanese authorities would have worsened the stagnation of the Japanese economy. In this instance it cannot be claimed that a reference rate system would have helped steer macro policy in a favorable direction.

Thailand Before 1997

Thailand's 1997 crisis reflected the large and sustained current account deficits of the previous years. For a long time these deficits were financed, indeed overfinanced, by capital inflows. Had the exchange rate been flexible, there is no doubt that it would have floated upward and that the current account deficits would in consequence have been even larger. It is only during the final months before the crisis that one would have expected a weaker exchange rate that would have helped promote the adjustment that Thailand needed.

Had there been a reference rate for the Thai baht before 1997, it would have had to be for a rate that at full employment would have been expected to generate a deficit of 3 or 4 percent of GDP, the traditional rule of thumb for a prudent, sustainable maximum to the level of capital inflow. A Thailand with a floating baht would have been allowed to intervene to build up its reserves while the market was pushing funds at Thailand. The policy difference would have occurred when the market first became suspicious of Thailand in late 1996. Under the canonical variant of the reference rate proposal, the authorities would have been obliged to permit a depreciation at least close to the reference rate (i.e., to a more competitive rate than that which in fact held). The absence of a commitment to defend a particular exchange rate might well have encouraged them to permit a depreciation to beyond the reference rate in the first half of 1997. It is conceivable that this would have headed off the crisis, at least assuming it was supported by fiscal-monetary measures to restrain demand.

It is thus possible, and even likely, that floating with a reference rate would have performed better than a regime of unmanaged floating. The government would have been permitted to intervene to buy dollars in the years when capital inflows exceeded the current account deficit, thus mitigating the excessive appreciation that would have been likely under floating. The attempt to manage the exchange rate would have been a disincentive to the creation of the Bangkok International Banking Facility, which increased the inflow of unstable bank loans to Thailand. Even if appreciation had still occurred, the fact that the government was signaling that it believed the currency to be overvalued during the boom years would have encouraged businessmen to continue basing their export-oriented investment on a more competitive value of the baht. The economy might thus have been in a significantly stronger position by 1997. Instead of wasting reserves on defending the indefensible before July 2, 1997, the authorities would still have been holding reserves after the crisis broke (assuming pessimistically that there had still been a crisis), with which they could have sought to limit the collapse of the baht. I thus see little reason to doubt that a reference rate system would have been beneficial in Thailand.

Indonesia in 1997

Indonesia was in a very different situation from Thailand before the East Asian crisis. Exports were still increasing at a healthy rate (some 7 percent a year), unlike in Thailand, suggesting that the exchange rate was not overvalued. GDP was growing at over 4 percent a year; inflation was significant (about 8 percent a year) but under control, and its payments impact was neutralized by a crawling devaluation; foreign debt was high but not overwhelming; the current account deficit was reasonable (3.4 percent of GDP in 1996); and the fiscal accounts were in surplus. We are now very conscious that the regime was corrupt, its banking sector was chronically weak, and the social situation was potentially inflammable, but the record of the preceding quarter century was impressive, and macroeconomic policy was exemplary.

What disturbed this situation a few weeks after Thailand's float was a sympathetic withdrawal of funds from the rupiah. Had the IMF asked Indonesia to take a $30 billion loan on condition that it not change its policies, it is conceivable that the country would have ridden out the crisis. But in fact the IMF welcomed the decision to float the rupiah that the central bank governor announced on August 14, 1997. Many of the entrepreneurs whose businesses had borrowed uncovered dollars saw matters differently and rushed to buy dollars to hedge their exposure. This rush intensified the depreciation and ultimately led to the crisis that caused a severe recession (a 14 percent decline in GDP in 1998) and brought down the regime. The best

one can say in favor of the course that was pursued is that maybe Indonesia got democracy a bit quicker than might otherwise have happened.

If Indonesia had had a reference rate, presumably it would not have been that different from the center of the band at the start of the crisis, since there was no reason to think that the rupiah was particularly overvalued at that time. The reference rate against the dollar would surely have depreciated subsequently to reflect the collapse of the neighboring currencies, since they were all strong export competitors, but it would not have depreciated nearly as much as the actual value of the rupiah did. Conceivably a demonstration that the international community saw no sense in a severe depreciation would have helped head off the total economic collapse that occurred, but one may doubt if it would have made a lot of difference. It would have been more helpful if Indonesia had moved to a float well before the crisis, when confidence was still strong, so that Indonesian businesses had been given both the incentive and a chance to cover their exposure without unduly weakening the currency before the opportunity vanished. What seems crystal clear in hindsight is that the switch to floating came at the worst time. But it is difficult to believe that the existence of a reference rate system would in this case have done a lot to mitigate the disaster.

Russia in 1998

In 1998 Russia was still in the early stages of emerging from the chaos of the transition. It had decided that a key policy objective should be stabilizing inflation, and it had tied the ruble to an almost fixed exchange rate with the dollar in an attempt to achieve that. An unfortunate consequence of this policy was the real appreciation of the ruble, which had made imported consumer goods extremely attractive to consumers and had therefore led to great difficulties for Russian import-competing industries almost across the board. The current account was still (more or less) in surplus because of energy exports, but industrial output was extremely weak.

The other unfortunate consequence was unsustainable debt dynamics. High interest rates were needed to sustain the overvalued currency. These interacted with weak tax revenue, which resulted from soft budget constraints extended by the energy industries to manufacturing in the attempt to prevent the latter being eviscerated by the overvalued exchange rate, to produce a large fiscal deficit. The deficit then required even higher interest rates, resulting in unsustainable debt dynamics.

The crisis of August 1998 led to the abandonment of this policy regime. GKOs (ruble-denominated short-term debt) were unilaterally reconstructed in such a way as to greatly reduce their present value. And the ruble was allowed to float. Against official expectations, the initial spike in inflation and a further decline in output were soon countered by industrial revival

and a slowing of inflation. This made it possible to harden budget constraints, which reinforced the beneficial trends. There may well have been unfortunate spillover effects on the rest of the world, like the run on Brazil and the collapse of Long-Term Capital Management (LTCM), but ruble devaluation was just what the Russian economy needed.

Any reasonable estimate of a reference rate in 1998 would have been for a substantially more competitive rate than that which prevailed before the crisis. The IMF could hardly have designed a program like that of July 1998, predicated on the attempt to defend an overvalued exchange rate (by more foreign loans, a commitment to a future primary surplus, and a market-based debt swap). By being forced to adjust its policy regime to conform with reality rather sooner, it is possible that Russia would have avoided the need for debt reconstruction. I thus believe that a reference rate regime would have benefited both Russia and its creditors.

Brazil

Brazil finally stabilized the longest-running period of high inflation in history in July 1994, with the Real Plan. The essence of this plan was the replacement of the old monetary unit by a new money that consisted of the former indexation unit. The new money was initially allowed to float, whereupon it floated upwards. To limit the loss of competitiveness, the Brazilian government eventually tied the real to the dollar and then initiated a crawling devaluation. Unfortunately the crawl was not fast enough to avoid further losses of competitiveness, let alone to reverse the initial loss of competitiveness suffered from the appreciation of the real in its first weeks, so that Brazil moved into strong current account deficit. Yet Brazilian policymakers were anxious to maintain a strong real, which became thought of as the anchor for the price level, and to that end ran astronomical real interest rates to attract funds to finance the current account deficit and counter the highly expansionary fiscal policy. By 1996 the real was significantly overvalued (though inflation had by then been reduced to a level where competitiveness was marginally improving).

When investors looked around the world after the Russian devaluation and the demonstration that the IMF would not always bail out countries in trouble, it was natural that they should focus on Brazil as a country that might be vulnerable to a run. The initial run in the second half of 1998 was thwarted by a large IMF loan granted on condition that the much overdue tightening of fiscal policy should finally be put into effect. This loan held the situation for several months, till after the Brazilian elections and until the world economy had emerged from the vulnerable state created by the LTCM crisis. But then in January 1999 a governor refused to pay his state's debts, which provoked a new run on the real. After an abortive attempt at a limited devaluation, a new governor of the central bank took office, the real was

floated, and interest rates were raised. To general surprise, Brazil posted positive (if small) growth in 1999, though the reason turns out to have been that the central bank had bought many dollar debts to largely shield the private sector from the cost of currency mismatches.

Just over three years later, the public opinion polls predicted that Lula would win the presidential election. The financial markets thereupon panicked. Country risk went to over 2,500 basis points, the exchange rate collapsed, and—driven by the size of debt inherited from the 1999 crisis and the weight of dollar-linked debt in the total—debt dynamics looked dangerous. The recovery started even before Lula took office, following announcement of one of the better Fund programs in which the crucial conditionality was a promise by all the serious candidates to maintain responsible macro policies if elected. The subsequent maintenance of firm fiscal policy, plus for a while a highly competitive exchange rate, led to unprecedented current account surpluses, some reduction in the debt/GDP ratio, and a dramatic reduction in the ratio of external debt to exports.

Had a reference rate system been in effect, the reference rate would surely have been something like the value of the real at the beginning of July 1994. It would have indicated that the real was allowed to become, and remain, far too strong for much of the second half of the 1990s. After the float, the real initially depreciated too much, but then bounced back, until the contagion of the Argentine crisis. (The idea that this crisis caused no contagion is wrong, as an examination of the value of both the Chilean peso and the Brazilian real in late 2001 shows.) The real was already somewhat undervalued before the panic caused by the prospect of Lula's election but then became extremely undervalued during the campaign. It was rather slow to recover but has now become somewhat overvalued again.

How much difference would it have made if the international community had promulgated a reference rate? One has to assume that it would have made a difference to Brazilian economic policy in the 1990s, since a part of the rule book suggested above is that interest rates held above their internally optimal level would be illegal if they were holding a currency above its reference rate. The reference rate would also have restrained the purchase of reserves while the real was undervalued in 2003–04. Whether it would also have influenced the private sector is more debatable, but at the very least one can surely say that it would not have done any harm.

Turkey

The repeated stabilization and reform programs introduced by Turkish governments from the 1970s onwards had succeeded in some dimensions, like opening the Turkish economy and maintaining a reasonable growth rate, but had dismally failed to tackle inflation. Through the 1990s the average inflation rate in Turkey had been almost 70 percent per year. To counter

this, Turkey embarked on an IMF-supported program at the beginning of 2000 embodying a preannounced decelerating crawling peg exchange rate regime with widening bands, which would end up as a floating rate after 18 months. All went well for the first few months, with declining inflation and interest rates and a large inflow of capital, primarily short term. However, inflation did not fall fast enough to avoid a large real appreciation, partly in consequence the current account deficit widened substantially, and short-term capital inflows intermediated by the weak banks financed the large fiscal deficit. The first speculative attacks on the Turkish lira in November 2000 were beaten off, but a renewed attack sparked by political bickering in February 2001 led to abandonment of the exchange rate regime and a float of the lira. The severe depreciation consequent on abandonment of the exchange rate regime caused corporate and banking crises, a credit crunch, and a 7.5 percent fall in GDP in 2001.

The initial value of the crawling peg was fixed after careful analysis, so one may assume that a reference rate would have been similar. In subsequent months the Turkish lira appreciated relative to that value. One possibility is that the evidence of growing divergence would have prompted a revision of policy, such as a tighter fiscal policy, in the course of 2001. Another possibility is that the markets would have been rattled by the evidence of growing overvaluation and would have refused to lend as much. Since higher interest rates would have been ruled out by the overvalued lira, the government would have been forced to reduce its borrowing, and the ultimate crisis would have been attenuated. A reference rate would thus have been helpful.

Argentina

Argentina was another country with a history of extreme instability, which appeared to have stabilized in the 1990s. What was supposed to be the definitive stabilization had been achieved on April 1, 1991, when the Argentine peso had been locked 1:1 to the US dollar through an act of the Argentine Congress backed up by almost turning the central bank into a currency board. As is the normal pattern with an exchange rate–based stabilization, inflation fell rapidly but not quickly enough to prevent a substantial overvaluation emerging. Fiscal deficits fell but were not replaced by the sizable surpluses that would have been needed to establish full credibility for the fixed exchange rate. The country rode out the Tequila Crisis of 1994–95, but the devaluation of the real and the levitation of the US dollar to which the peso was tied made Argentina's situation increasingly untenable after 1998 (when production peaked). Argentina got a big loan from the IMF in late 2000, and yet more money in August 2001. Its price level was by then falling against the dollar, which might in due course have been expected to do something to reverse the large current account deficit that had devel-

oped. But all this was to no avail: A run on the banks and out of the peso developed in December 2001, debt servicing was suspended, Congress changed the law to allow the peso to float, and a crisis rapidly overwhelmed the country.

Initial policy measures, like asymmetric pesification, made the situation worse rather than better, and Argentina entered a very deep recession (an 11 percent fall in GDP in 2002, to a level nearly 20 percent below the 1998 peak). But several factors soon started to work toward recovery. When the fixed exchange rate was abandoned, the peso depreciated to a level that acted as a big spur to exports (even after the government imposed heavy export taxes on many commodities) and discouraged imports. The government has since stabilized the peso at a value of a little over 3:1. The fiscal situation was relieved by the reduction in the real value of government personnel expenditure and the decline in debt service payments, which was made permanent after sufficient bondholders accepted the debt reconstruction of 2005. In fact, output recovered its precrisis level in 2005 and is still growing rapidly as this is written.

A reference rate would have been at a level substantially more competitive than the rate that prevailed in the second half of the 1990s and up to the crisis but substantially less competitive than the current rate (September 2006). It would have affected policy before the crisis to the extent that the authorities took it seriously. Even if the authorities tried to ignore it, a reference rate substantially weaker than the market rate might have discouraged banks and bond buyers from lending so much and encouraged wealth owners to move out of the peso while the going was good. In that way it is likely that Argentina would have been unable to maintain its doomed system for so long (and therefore lenders would probably not have lost so much money and Argentineans would not have suffered as much). Of course, if one thinks it important that misguided national authorities should be helped to impoverish their citizens (as well as foreigners), one will deplore such an incursion in national sovereignty.

In the past several years, a reference rate system would have prohibited Argentina from buying dollars to add to its reserves, given that its exchange rate was weaker than the reference rate would have been. The expected consequence would have been an appreciation of the peso and therefore lower exports, higher imports, a less positive trade balance, and slower growth (but less inflation). To maintain an equally fast rate of growth, the country would have been obliged to stimulate a somewhat faster growth of domestic demand. In most countries it is all to the good if the authorities are required to maintain a balance between external and internal demand rather than relying overwhelmingly on either, but in the particular case of Argentina one can argue that the exceptionally rapid improvement in the external position mitigated the prevailing lack of market confidence. If one believes that such cases may occur from time to time, then one might want to legislate an escape clause in the reference rate rules,

for this is a case in which a reference rate would have impeded recovery. On the other hand, it would have been unambiguously beneficial before the crisis.

The Current Global Imbalances

The latest IMF *World Economic Outlook* (for September 2006) forecasts that in 2006 the United States will have a current account deficit of $869 billion. Offsetting this deficit will be a surplus of $505 billion by the oil exporters, $184 billion by China, $167 billion by Japan, and $79 billion by the Asian newly industrialized economies (NIEs). The picture is rounded out by a net $51 billion surplus by other industrial countries (consisting of $322 billion deficits marginally outweighed by $373 billion surpluses), a net $102 billion deficit by other developing countries, and a statistical discrepancy of a mere –$16 billion.

Some of the increase in the US current account deficit is a direct result of the higher price of oil. However, this does not appear to be the major explanatory factor. The April 2006 *World Economic Outlook* (p. 91) says: "the increase in oil prices since 2003 has directly worsened the US current account deficit by over 1 percent of GDP. . . ." So perhaps $120 billion of the expected $869 billion deficit could either be expected to adjust naturally as the oil price declines to more normal levels or be adjusted by increased imports from the oil-exporting countries if the oil price increase proves permanent. There remains a deficit of maybe $740 billion, about twice the level that corresponds to a 3 percent of GDP deficit, which a rule of thumb sometimes considers to be safely sustainable and which has been widely treated as a target for the United States.

The three other surplus areas identified above are all in Asia. Japan was long considered to be a less compelling candidate for adjustment action than other surplus countries because of the difficulties it was encountering in using other policy instruments to stimulate demand. That reason no longer looks compelling in the light of the Japanese recovery. China and the Asian NIEs all look anomalous in the light of standard theory, which identifies developing countries as likely to be short of capital and therefore natural capital importers (i.e., countries with current account deficits). One of the Asian NIEs, namely Singapore, now has a level of per capita income at which it is conceivable that there are many better investment opportunities abroad rather than at home, but in all the other cases a current account surplus that is used to build up reserve holdings beyond a prudent level appears an irresponsible waste of resources.

My colleague William Cline (2005) attempted to calculate a scenario that would support US adjustment of the magnitude envisaged. Naturally the exchange rate changes that he conceived would need to be supported by appropriate changes in demand, by tightening fiscal policy in the United

Table 7.1 Exchange rate change for US external adjustment

Country/region	Exchange rate
Brazil	R2.16 per US dollar
Canada	0.75 US cents per Canadian dollar
China	RMB5.67 per US dollar
Euro area	$1.36 per euro
Japan	¥82.0 per US dollar
Korea	Won 859 per US dollar
Mexico	Pesos 8.5 per US dollar
Singapore	Singapore $0.91 per US dollar
Switzerland	SwFr 1.00 per US dollar
United Kingdom	$2.13 per pound

Source: Cline (2005).

States, and by corresponding expansionary policies almost everywhere else. But he also calculated a set of 27 exchange rate changes that, in conjunction with the changes in demand, could be expected in due course to produce a fall in the US current account deficit to about 3 percent of GDP. Most of the changes that he calculated (with the exception of that for Canada, which has already been far surpassed in the market) look rather large, but it must be remembered that—except for countries geographically close to the United States—the resulting changes in effective exchange rates would be far smaller, since the main trade partners of other countries would also be appreciating against the dollar. That said, table 7.1 shows a sample of his results, which (despite my specific reservations, notably with regard to Canada and the United Kingdom) are as good an estimate of where reference rates might be as currently exists.[1]

Suppose that this set of rates had been adopted as reference rates in the past. The question is whether it would have made a difference to global payments positions. Would exchange rates have been affected? Would countries' policies have been adjusted? Would payments outcomes in consequence have been different?

All the countries listed above except China currently have floating exchange rates, so radically different considerations apply with respect to China and to all other countries. Let us consider China first. *If* a reference

1. Table 7.1 shows dollar rates rather than effective rates even though it is the latter that are conceptually more relevant. The reason is that figures for absolute levels of effective exchange rates are not meaningful: It is the changes that are of interest. But (a) we lack statistics on the effective rates of all these currencies that would permit updating of Cline's figures to a more recent date and (b) it is dollar rates that stick in most people's minds. In any event, the difference is not key when all other rates are at their reference rates.

rate system had been in effect, with a reference rate of RMB5.67 per dollar, then China would not legally have been able to intervene to hold the renminbi at a value of around RMB8 per dollar (more until May 2006). One conclusion this suggests is that therefore China would not under present circumstances agree to introduce a reference rate system that it would know was going to constrain it in this way. However, suppose that the reference rate system had already been in effect when China replaced Taiwan in the Chinese seat in the IMF. Presumably a reference rate system would not have deterred China from wanting to take Taiwan's place. From then on, China would have been subject to the IMF rules. And whatever criticisms of Chinese policy one may hold, China has generally been scrupulous in obeying such international obligations as it has signed (with the arguable exception of its enforcement of intellectual property rights). Hence one has to assume that under these circumstances China would have either floated the renminbi or revalued. I do not propose to discuss here whether either of these steps would have been a good thing (though personally I am convinced it would have been good for both China and the rest of the world), I am merely concerned to make the point that there would have been a very definite impact on policy. A functioning reference rate system would undoubtedly have changed the way the world works.

The existence of a set of reference rates might have affected floating exchange rates through two channels. For given policies, foreign exchange dealers might have fed the additional information into their trading strategies, which might have changed the exchange rates at which they bought and sold currencies. Had there been such an effect, it would have pushed exchange rates toward the reference rates. The other channel is that it might have altered policies. For some of the smaller currencies, and for Japan before March 2004, the main effect would have been to constrain intervention policy. For the United States, at least during the Clinton administration, there would have been a constraint on "oral intervention" (it would have been illegal for the US treasury secretary to speak in favor of a strong dollar when the dollar was already stronger than its reference rate). To the extent that the net result had been a more competitive dollar, the US current account deficit would have been smaller and US demand would have been stronger. Except during the 2001–02 recession, one can assume that the stronger demand would have resulted in a more restrictive monetary policy by the Fed in order to make room for the additional demand (it seems that fiscal policy is nowadays invariant to the strength of demand as a reflex anti-Keynesian reaction, but monetary policy doesn't suffer from such hang-ups).

The end result would have been smaller global imbalances. The US dollar would have been weaker, US savings would have been larger, and the US current account deficit would have been smaller. Whether the effects would have been sufficiently large to avoid the risk of a global crisis is unclear, but there can be no serious doubt about the qualitative direction of impact.

Currently the major counterpart to the US deficit lies in East Asia and the oil-exporting countries, and the euro area likes to pride itself on not being a part of the problem. However, several years ago there was also a severe misalignment involving an undervaluation of the euro. Had a reference rate system been in effect, it might have helped prevent that misalignment becoming so large and/or corrected that misalignment sooner (inter alia by restraining the foolish statements of US treasury secretaries lauding a strong dollar).

The issue already discussed of whether it would make sense to publish estimates of reference rates at a time such as the present, when market rates are in many cases far from the reference rates, would arise in acute form if the system were to be introduced soon. My own view is that the usefulness of the system is even greater when market rates are far from equilibrium. They are more likely to have an impact on intervention policy, they are less likely to push that policy in an incorrect direction, and they are more helpful to the private sector in making rational investment decisions. The multilateral consultation process agreed at the spring 2006 meetings of the International Monetary and Finance Committee is a natural context in which to introduce reference rates. Announcement that the participating countries were willing to negotiate a set of reference rates, and to abide by the set negotiated, would preempt the cynicism that otherwise may greet the results of the IMF exercise.