Avoiding a Currency War

How a new "dual-key" exchange rate system could help the United States, Japan, the eurozone—and China—find a way out.

BY ADAM S. POSEN

A conflict over exchange rates is brewing. The burden of adjustment the United States needs to close its trade deficit has fallen mostly upon the euro-dollar exchange rate, to the tune of 30 percent versus eighteen months ago. Meanwhile, the yen-dollar exchange rate has moved only 17 percent in the same period, largely because the yuan-dollar rate has not moved at all. The weak and, in part, export-driven recovery in Europe makes the eurozone governments antsy about further rises in the euro against the dollar. And U.S. presidential candidates are formulating legal challenges to those countries that are seen as blocking the orderly decline of the dollar. Governments and interest groups do not like feeling as if they are being taken advantage of by foreign economic policies.

Outright "management" of exchange rates, however, is not in the offing—none of the major governments are willing to subordinate domestic monetary or fiscal policy to achieve exchange rate goals, and they would have to do so

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in order to actively manage exchange rates. This external laissez-faire stance is justified economically for each of the three major currency issuers—the United States, Japan, and the eurozone—since the exchange rate does not have a significant effect on domestic price levels or growth rates until large misalignments are sustained. Politically, though, this is not a sufficient argument to stave off either self-serving arguments from import-competing sectors or more valid government-to-government complaints about burden-sharing and exchange rate manipulation.

A system of dual-key exchange rate intervention agreed to by the United States, Japan, and the eurozone should be adopted in response to this situation. The governments would agree that they would not intervene in foreign exchange markets to affect the value of their home currencies against either of the remaining two, unless one of the other two players agreed to intervene as well. No more unilateral intervention would occur, as for example done on an enormous scale by Japan over 2003 and the first quarter of 2004.

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Were one of the three currency issuers to engage in unilateral intervention, presumably to weaken its home currency versus one or both of the others, the other two would commit to offsetting that intervention. Since issuers can always weaken their own currency by simply selling more of it on world markets, the threat to offset is credible and no prior agreement about reserves would be necessary. In the improbable situation that one of the three currency zones wished to appreciate its currency against the other two, and neither of the other two would agree to coordinate on that direction of intervention, they could combine reserves to sell on the market (in all likelihood, they could expect the market to join them in opposing the appreciation, for the unilateral intervener could only strengthen its currency to the extent it had foreign exchange reserves with which to buy up its own currency).

The first obvious advantage of this dual-key arrangement would be the calming of political pressures over apparent competitive depreciations—none of the big three issuers could be accused of exchange rate manipulation, and that accusation no longer could be used as a rallying cry for protectionism or nativist complaints about burden-sharing. Further advantages would accrue as well:

- Exchange rate interventions would become far more credible since they would only be undertaken when coordinated, and thus backed by all countries involved (we already know that coordinated interventions are more effective when known to be joint).
- Information disclosure and sharing about economic situations and exchange rate goals between the three issuers would be reinforced, since a government wishing to intervene would have to persuade the other issuers of the benefits of so doing.
- Independent central banks would be reassured about external pressures on price stability, since this would restrict an elected government's use of its control over exchange rate intervention to offset monetary policy.
- Exchange rate expectations would be better anchored since the outer limit of how far a major currency could depreciate would be the lower of whatever the other two issuers would be willing to accept at a given time.
- There would be diminished incentive for any of the major economies to accumulate vast reserves of either of the other two major currencies, which would in turn reduce uncertainty about, and potential cross-border politicization of, capital flows.

The governments involved would give up very little in practice to gain these benefits by agreeing to a dual-key system. The United States essentially ceased to intervene unilaterally over a decade ago, believing that only coordinated intervention has sufficient beneficial impact; to date, the eurozone member governments have largely displayed the same sentiment, and the European Central Bank certainly feels that way. Unless one is engaged in competitive depreciation, there is little reason to keep a country's intervention plans secret from the governments responsible for the other major currencies. This plan does nothing to compromise governments' ability to surprise markets with their exchange rate interventions, should that prove tactically useful (which is not always the case in any event).

The repeated Japanese unilateral interventions of the last year were often justified in terms of limiting exchange rate volatility, so perhaps a restriction on such frequent inter-

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vention could be argued as negative. But the fact is that exchange rate intervention to limit volatility does not work, and volatility has not proved to be so bad. We do not even really understand exchange rate volatility, since in recent decades monetary policy's commitment to price stability and limiting activism has deepened (removing what Milton Friedman thought would cause instability), and the real economies of the major issuers have become more flexible (diminishing what Rudiger Dornbusch thought would cause overshooting), and still exchange rate volatility has increased. Meanwhile, all empirical evidence indicates that the costs to businesses and economies arise from sustained misalignments—not from volatility—of exchange rates.

Such an agreement on dual-key exchange rate intervention would defuse the political pressures on the exchange rate system without promising too much in terms of specific deliverables or requiring too much in terms of specific actions from the major governments. It is damaging to have the strategy of competitive undervaluation seemingly accepted amongst the big three currencies, as now appears to be the case. Making progress on trade or aid could well be sidelined by the conflicts and mistrust that unilateral intervention breeds.

If China were to revalue the renminbi, or even if simply the political winds were to shift in the face of the Japanese recovery, Japan could find itself under harsh attack for its "manipulation" of the exchange rate that had taken place under the cover of China as primary target of U.S. interest groups and politicians. Similar problems could result if the eurozone countries (or some particular member countries of the eurozone) were to unilaterally draw a line on euro appreciation against the dollar in coming months, even if there were a strong "fairness" argument to be made for the eurozone so doing in the face of U.S. fiscal profligacy.

It is worthwhile to compare this dual-key proposal with the older overly ambitious proposals for G3 target zones. Unlike target zones, a dual-key intervention system would not require the major currencies to specify publicly the acceptable range or targets for the exchange rates. Without such specified targets, the governments would not be subject to market attacks or suspicions of their will to defend the targets as the outer bands were approached. Without such specified targets, the governments would be able to, in consultation but in real-time, flexibly change their underlying willingness to intervene as conditions changed. They would not have to pre-announce the changes and worry about the credibility and signaling effects of changing targets too often, or the economic difficulties of changing target zones too infrequently.

This dual-key system would have been particularly handy in recent months as Japan went from a period of stagnation and danger of deflationary spiral (which all participating governments would have agreed justified forestalling any rise in the yen exchange rate) to a period of sustained recovery and prospects of future positive inflation (which at least two of the governments and the Bank of Japan would agree is consistent with a modest rise in the value of the yen). It would similarly have been useful to deal flexibly with the concerns about deflation emerging in the United States following the information technology bubble. The major governments would have been forced into a practical discussion of what was mutually acceptable as the limit, making something actionable out of the framework of outlook discussions that already take place in the G7 and OECD.

An explicit resetting of a target zone, on the other hand, would be subject to misinterpretation by the markets as some sort of election year deal between President Bush and Prime Minister Koizumi or to questioning as to whether it was consistent with the market's own outlook for the relative Japanese and American recoveries. A target zone that was not reset under those circumstances, however, would have been even worse: it either would have locked in a misaligned exchange rate, limiting the much-needed adjustment of surpluses between Japan and the United States, or it would have been such a wide target zone as to be meaningless.

Target zone advocates will claim that there is a loss from not having explicit boundaries, since the boundaries themselves, if credible, would limit exchange rate movements. Most recent research has shown, however, that these boundaries are only made credible through intervention and demonstrated defense of them, and that credibility has to be reestablished time and again with changes in economic circumstances and political leadership. In short, this advantage of target zones was always theoretical if not fictional, while the disadvantages of explicit exchange rate commitments (just as in adjustable pegs for emerging markets) are real.

Though appropriately modest in ambition, an agreement among the major three currencies on dual-key intervention is more than just a stop-gap response to current political pressures. It is also a useful step in the building and maintenance of the international financial architecture. The eurozone would be forced to unify its decision-making

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about exchange rate intervention in order to be able to speak with one voice in these discussions; such discipline would provide an important institutional precedent for the eurozone's needed unification on financial supervision and representation in the international financial institutions. The United States would be required to acknowledge the effects of its currency movements upon other countries, at least in extremis, and could get an opportunity to visibly foreswear unilateral action (in fact, comfortably doing so in an area where unilateralism usually works against it, rather than where it exercises such). Japan could claim an explicit co-equal status with the United States and the eurozone for its currency, at least in this regard, while reassuring many observers that the Chiang Mai and follow-on Asian monetary agreements would be solely directed at the defense of neighboring currencies subjected to market panics or attack—and this would in no way be constrained by a dual-key G3 agreement.

Of course, the cause of much of the current exchange rate stress is the emergence of China, and its maintenance of the renminbi peg to the dollar at an undervalued rate. Although a dual-key agreement between the eurozone, Japan, and the United States would not address this directly, it would usefully nudge China towards a constructive adjustment over the longer term. First, it would make more attractive China shifting to tracking a basket of the three major currencies from a strict dollar peg, which should be more politically if not economically sustainable in the medium term. Second, it would isolate China's unilateral intervention practices, removing the example of Japan or any other major economy to point to as "they do it too." This would increase political pressure upon China to behave responsibly regarding its peg (or to float).

Third, it would give China a forum or club specifically in the exchange rate realm in which to aspire to membership. This club membership could be opened to China at any time immediately upon the Chinese government's agreeing to the virtual "exchange of keys" to intervention. It would require no re-weighting of quotas (as would be needed to increase the Chinese vote in the International Monetary Fund) or replacement of current members by China to keep viably sized (as in the G7), dependent upon votes from those members losing seating. Once in, China would be able to trade information disclosure about economic goals and forecasts, highly valuable to the other three members, for protection from political attack on exchange rates. In effect, China would not be confronted about revaluation in a way likely to backfire, but given a positive inducement to do so apparently voluntarily.

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Proposals for exchange rate coordination among the major currencies have been still-born since the Louvre Accord because they both promise too much and require too much of the issuing governments. The potential for resentment against exchange rate adjustments—and adjustments foregone—spilling over into trade conflicts or lack of cooperation on financial and development issues, however, grows more evident every day. Unilateral exchange rate intervention is the flash point for these conflicts because it visibly embodies a country willfully pursuing its own perceived national interest at the expense of its major trading partners—yet such intervention is rarely effective or beneficial, even for the country engaging in it.

The eurozone, Japan, and the United States would all be better off if they were to agree upon a system of dual-key exchange rate intervention. Such a system would not only stave off the political risks from perceived competitive depreciations. For the major economies, it would also strengthen the effectiveness of intervention when undertaken, force more actionable information exchange, protect the commitment of their central banks to price stability, and diminish the incentive to accumulate reserves, reducing distortion of capital flows. Dual-key exchange rate intervention would also induce constructive, system-enhancing behavior from the three major economies—unification of eurozone positions; visible rejection of unilateralism by the United States; and commitment by Japan that Asian monetary unification would not be used against the euro or dollar—conducive to a more stable international financial architecture. It would even encourage China towards greater responsibility in its exchange rate management.

And all it would take would be a simple agreement among three allies. Unlike most proposals for change in the architecture of exchange rate management, dual-key intervention requires no creation of new institutions or bureaucracies, no commitments to spend additional resources, and no side payments to buy off other countries' vetoes. Maybe the major three currency issuers will find time to consider this proposal before they escalate charges of exchange rate manipulation or depreciation efforts against each other. ◆