The role of the exchange rate in monetary policy

*The **Governor** discusses[1] the role that should be given to the exchange rate within monetary policy. He affirms the desirability of stable real exchange rates, both as a necessary complement to free trade and in the context of domestic policies aimed at achieving monetary stability. But, he argues, the cart of exchange rate stability should not be put before the horse of domestic stability. And he suggests that if countries were more successful in their pursuit of stability—which is an increasingly widely shared approach, and in Europe is reflected in the convergence criteria of the Maastricht Treaty—that would go a long way towards bringing about more stable exchange rates.*

As Honorary President of Forex London, it gives me immense pleasure that you should have returned here—to what is more than ever the hub of the world's foreign exchange markets—after an interval of 12 years. And in my other role, as Governor of the Bank of England, I am genuinely delighted that you should have chosen to return in what is a particularly important year for the Bank—our tercentenary year. I am grateful to each one of you for helping us to mark that occasion through your presence here in the City.

The close relationship between the Bank of England and the foreign exchange market, of course, goes a long way back into our history. It is a multi-dimensional relationship. We directly supervise many of the market participants under the Banking Act and more recently we have had a formal responsibility for wholesale financial market supervision under the Financial Services Act. But we have long been involved in matters of market structure and standards of behaviour in the professional market—through, for example, the Joint Standing Committee. In this context, we played an important part in establishing London Forex and the ACI, through the still well-remembered person of Roy Bridge. We operate continuously ourselves in the market, on behalf of our customers—including government departments and our central bank customers. And we operate in the market, of course, on behalf of the Government itself—managing the foreign exchange reserves and at times intervening in sterling to influence the exchange rate in support of monetary policy.

It is this last, monetary policy dimension of our relationship with the exchange market that I thought I would talk about this morning, because while there is a strong and increasing consensus among monetary authorities internationally on the role of monetary policy generally, there are still widely-differing views within that consensus on the role of the exchange rate.

Of course, that was not always the case. For years, with occasional intervals, until the 1930s, the gold standard —maintaining a fixed gold parity—*was* the effective substance of monetary policy internationally. And fixed exchange rates, adjustable only as a last resort, were at the heart of the Bretton Woods international monetary arrangements for more than 25 years after the Second World War. A more likely topic for a talk of this kind during that period would have been the role of monetary policy in support of the exchange rate. Why is it then that the discussion now is apparently turned on its head?

In looking at any set of arrangements a useful starting-point is what went before. The creation of the IMF at Bretton Woods was intended to restore order to international monetary arrangements and was clearly, in an important sense, a response to the inter-war depression and to the perception of beggar-thy-neighbour exchange rate practices designed to export unemployment—just as GATT was a response to beggar-thy-neighbour trade policies. And both these institutions have been spectacularly successful generally in preventing predatory behaviour. But the IMF framework of fixed but adjustable exchange rates was designed to do more than this. It was designed to ensure that the IMF member countries pursued domestic policies necessary to *sustain* exchange rate parities. And in this respect it was ultimately less successful.

Volumes have been written on the reasons for that. But a key factor for my present purpose was that in the post-war period the predominant problem increasingly became the problem of inflation rather than unemployment; and the IMF framework—even though it operated asymmetrically in practice through adjustment pressure on deficit, or inflation-exporting, countries—proved to be an inadequate discipline on domestic policies, not least in the United States, the anchor country. The framework of fixed exchange rates eventually collapsed under the weight of outflows from the US dollar taken into official reserves on such a scale that the dollar's official convertibility into gold had to be suspended.

Efforts to rescue the fixed but adjustable exchange rate system in the early 1970s were unsuccessful—in part because of the global economic uncertainties caused by

(1) In a speech to the annual congress of the Association Cambiste Internationale (ACI) in London on 4 June.

successive hikes in the oil price, though the problems were more fundamental than that. And we have lived ever since with an untidy patchwork of exchange rate arrangements which vary both from country to country and from time to time.

Many smaller countries have chosen to peg their currencies unilaterally to other major currencies or to various currency baskets—adjusting the peg only rarely or quite regularly, some seeking an external discipline in support of domestic counterinflation while others have attached more weight to seeking to protect (or improve) their external position.

The major currencies—as well as many others—have floated. For much of the time, the float has been relatively clean, with the exchange rate essentially a residual outcome from domestic policy. But 'benign neglect' at other times produced disorderly markets and serious misalignments of real exchange rates, so that periodic attempts have had to be made—whether unilaterally, or through concerted intervention or co-ordinated policy action—to manage the float with, it must be said, varying degrees of success.

And in Europe, of course, there has been the ERM which, on a regional basis, is a lineal descendant of the fixed but adjustable exchange rate system of Bretton Woods, but with the important difference that it was seen increasingly as the precursor to EMU and a single European currency.

All of these arrangements—including the Bretton Woods system itself—became greatly complicated by the progressive removal of capital controls, by financial deregulation, by advances in information technology, and by the huge, associated increase in global finance and international capital flows. The fashionable concern with derivatives and hedge funds is only the latest manifestation of this.

It would take a bold man—or a foolish one—to seek to derive from all this a single policy prescription for the role of the exchange rate in monetary policy, and I do not intend to try. Instead I will offer you some general observations that may have a bearing on how official attitudes towards the exchange rate will evolve as we move—in the terms of your conference theme—'Towards 2000'. I will concern myself essentially with the major currencies. Smaller countries, whose economies are more closely integrated with those of their larger neighbours, choose in practice in many cases to maintain a more-or-less fixed exchange rate link, with the corollary that they accept too the monetary policy of their larger neighbours.

I think we can all agree that *real* exchange rate stability is a desirable feature of international economic relations. It encourages the growth of international trade and promotes the more efficient allocation of investment in the world economy. And any businessman will tell you that he *needs* exchange rate stability so that he can make plans for investment and production on the basis of a business judgment rather than guesses about future exchange rates.

But we need to be careful about precisely what we mean. Exchange rate stability is not an absolute good, nor is it an end in itself. Nominal exchange rates will need to adjust to reflect sustained divergences in rates of inflation. And some movement even in real exchange rates may be necessary in the long run to reflect, for example, changes in the prices of products in which a country specialises. But there is no doubt that much real exchange rate volatility has arisen in the past from large and unpredictable changes in monetary and fiscal policies. After a period, the domestic price level adjusts. But in the meantime, there can be large and disruptive swings in real exchange rates. The case for exchange rate stability in this context is much the same as the case for domestic price stability in a national context. But given the general desirability of stable real exchange rates, is it nevertheless feasible to have any exchange rate objective in a world of free international capital movements?

There is a popular misperception of the foreign exchange markets as a huge, single-minded pack of wolves acting in unison to hunt down and destroy one largely defenceless currency after another in an insatiable lust for short-term profit. As I look out at this vast audience this morning, I can understand how that misperception arises! But it is a misperception.

It is true that there is a huge volume of liquidity in the world's money markets that can move suddenly from one currency into another. And freedom of capital movements —which brings great benefits in terms of the international allocation of investment—is a real complication for those seeking to preserve something approaching exchange rate stability.

Among those controlling these liquid funds, there are certainly some pure speculators who take open positions in currencies purely in the hope of making capital gains. In doing so, of course, they expose themselves to corresponding losses and they tend, therefore, to take very large open positions only when they are very confident in their view.

But there are legions of others, who *look*, and *walk*, and even *talk* exactly like speculators, often managing other people's funds, who are seeking to protect the value of the assets they control against losses by diversifying risks or covering their currency exposures. And all these principals transact their business through bank intermediaries, which are typically restricted in the size of the positions which they themselves may take.

The whole point about financial markets—and above all the foreign exchange market—is that they comprise tens, indeed hundreds, of thousands of different participants, with different resources, different responsibilities and objectives, and different expectations about values. In most situations where expectations are diffused, quite small movements in prices will be enough to balance market supply and demand. The problems arise when market expectations are all one way, and in a direction that conflicts with the relevant authorities' objectives for the exchange rate.

In such situations, the market might simply have got it wrong, collectively exaggerating particular risks or misinterpreting either the financial situation or official intentions. That can produce unnecessary, disruptive exchange rate movements if, in the event, those expectations prove to be unfounded. But more often that not, in my experience of markets, there is a serious rationale for strong market movements, which as I say do not result from the judgments of a small group of particular individuals but from the aggregate judgments—backed up by having money at risk—of thousands and thousands of separate market participants. Often such strong movements are based upon a perception of inconsistencies in official policy such that the particular exchange rate level is not sustainable. And the pressure will tend in these situations to be heavier where there is a precise, published exchange rate objective, because of the risk that this objective can change abruptly imposing significant capital losses or providing significant capital gains.

Confronted with a strong market challenge, the authorities have a number of options. They can accept that there is indeed a policy inconsistency and correct it, by modifying the exchange rate objective or adjusting domestic policy to validate the existing objective. Or they can contest the market view—through intervention and associated explanation. Before choosing this latter course, they need to be pretty confident in their judgment.

Attitudes to the effectiveness of intervention vary. At one extreme, there are those who point out—rightly—that official reserves are limited by comparison with the resources in the market, so that intervention on its own is unlikely to be effective for very long against strong market pressure. Others argue that intervention is not primarily designed to affect the balance of supply and demand in the market *directly* (though discreet intervention can help modestly to ensure that some demand is seen in what would otherwise be an entirely one-way market); the main purpose of intervention, which needs to be visible to the market at large for this purpose, is on this view to demonstrate the authorities' attitude to the exchange rate and cause the market participants to question whether, in the light of the official attitude, they are really sure of its ground. It carries the implication that the scale of the intervention could become quite substantial even in market terms, and that it could be supported by domestic policy action if that became necessary. There have been many instances—such as Plaza, with which you will be familiar—where intervention has found important sectors of the market heavily short or long of a particular currency, causing a sharp reversal in sentiment as they scrambled to cover in the light of the new information which the intervention represents.

But there have of course been many other episodes where intervention has failed either to convince or to reverse the tide. My own view is that intervention can be tactically useful in some situations where the predominant market opinion is out on something of a limb, without great confidence in its view, and that it can on occasion usefully buy time until more fundamental corrective action can be taken—but that its role is a limited one. Certainly, there are situations too in which the weight of market opinion is *looking* to the authorities to intervene, and where a failure to do so would send strong, unhelpful signals.

Beyond that, if the market as a whole remains persuaded that there is indeed a conflict between domestic and external objectives, then one or the other has to give.

Overall, I think it *is* practicable—even in a world of free movement of capital—to have at least a loosely defined exchange rate objective, but that a necessary condition for pursuing it is that it must be fundamentally consistent with domestic policy objectives and with the actual thrust of domestic policies.

The question then is how can that consistency best be assured?

The Bretton Woods arrangements—and indeed the ERM which was descended from them—set relatively tightly-drawn *nominal* exchange rate relationships which were intended as a constraint on domestic policies. That domestic discipline ultimately proved inadequate in the Bretton Woods system, as I said earlier. And the ERM margins had to be substantially widened last year, to accommodate the exceptional tensions generated by divergent domestic policy needs in the different member states arising importantly out of German reunification.

There has been a growing international consensus about the conduct of economic policy in the last decade and more —including fiscal discipline, a reduction in the role of the public sector, often involving privatisation, internal and external liberalisation, and with the main focus of monetary policy in particular directed at domestic—internal—price stability as a necessary condition for wider economic stability. It is true that we have not all been equally successful in implementing these policies. But if we *were* more successful, then that would go a long way towards bringing about also more stable exchange rates. And if we can't achieve greater internal stability as a matter of national self-interest, then I'm not at all sure that a nominal external anchor would necessarily be a more compelling general discipline.

I hope it will be clear to you that in saying this I am not for a moment suggesting that the exchange rate doesn't matter. On the contrary, as I've explained, real exchange rate stability is a necessary complement to free trade; and in terms of national policies in pursuit of stability, the exchange rate is far too important a price to be ignored.

In our own case, for example, although we have no specific exchange rate target, we do monitor the rate closely and continuously. We seek to distinguish between short-term and more lasting influences; and between influences originating elsewhere and those that reflect market perceptions of the state of—and prospects for—our own

economy, which we need to take into account in pursuing our primary objective of domestic stability. It clearly is the case that internal and external stability are bound up together—that they are in an important sense two sides of the same coin. But what I have just described is quite different from a fixed but adjustable exchange rate system in that, if a conflict between internal and external objectives should arise, while the exchange rate will always be an important consideration, it will not in itself be the predominant one. The emphasis would be on maintaining domestic stability; and that, I believe, would deliver greater exchange rate stability in the medium and long term. It is interesting to speculate whether, if the Bretton Woods conference was being convened now, it would still put exchange rate rather than domestic stability—as it perfectly well could—at the heart of the arrangements. Certainly it is domestic stability, rather than exchange rate stability, that is typically at the heart of IMF advice to member countries today.

However that may be, conflicts clearly can arise. Ironically, differential rates of inflation, which have typically been seen as a primary source of nominal exchange rate tension, are now lower than they have been for ages, in the context of unusually low inflation—both actual and prospective—throughout the industrial world. Yet exchange market uncertainties persist, reflecting other influences such as the different—and changing—mix between monetary and fiscal policy from one country to another, different cyclical positions and structural imbalances seen, for example, in the widely-differing levels of apparently intractable long-term unemployment within Europe, as well as in Japan's chronic external surplus with the rest of the world. I don't see that as an environment in which more structured exchange rate arrangements at the level of the major industrial countries would be likely to help. We each know what needs to be done to address these issues in our own countries and it seems to me that the substance of international discussion is better directed to supporting each other in those efforts, and to understanding their international ramifications, than to the narrower issue of exchange rate objectives *per se*.

Similarly in Europe, however appealing the vision of a single currency may be—and that is a matter for political decision—the absolutely essential prior economic condition is to establish sustainable convergence, based on underlying stability in the participating member states, as envisaged in the Maastricht Treaty. Without that, a single currency couldn't possibly function effectively: the associated single monetary policy would necessarily be too severe in some countries and too loose in others. I believe that we have a long way to go before that necessary precondition will be met.

A measure of the present imbalance within Europe—not directly addressed by the Maastricht criteria—is the intolerably high level of unemployment throughout the European Union and the huge differentials between the levels of unemployment between the different member states. It just is not good enough simply to wave all that aside on the grounds that it is 'structural'. It would be a high-risk strategy to fix exchange rates when there are such large disparities in unemployment. The solutions to structural unemployment, which more and more countries see in terms of the need for lower non-wage costs of employment and a more flexible labour market, may themselves have implications for appropriate long-run real exchange rates. With a fixed nominal exchange rate, adjustment of the real exchange rate can come about only through differences in national inflation rates, thus challenging the convergence on price stability. Until much greater real economic convergence has been achieved, flexibility of nominal exchange rates may, in some circumstances, help to speed up the process of convergence. To renounce that possibility prematurely would, as I say, be a high-risk approach—leaving the Union unnecessarily exposed to the persistence of regions of high, long-term unemployment; *or* to larger-scale migration; *or* to pressure for much larger intercountry fiscal transfers within Europe—none of which would seem likely to me to promote greater cohesion.

In the meantime, we all know what we have to do to achieve the convergence conditions, as a matter of national self-interest, as well as contributing to as much sustainable exchange rate stability within Europe as we can realistically hope to achieve. The critical thing is that we should, individually and collectively, concentrate on that job in hand.

Against that background, Mr Chairman, I expect that there will still be plenty of work for foreign exchange traders as we move 'Towards 2000'.