Exchange rates: an intractable aspect of monetary policy

*The **Governor** recalls(1) international approaches to exchange rate management in recent decades: he notes that international dialogue has produced a high degree of consensus on broad approaches to economic management. The **Governor** then outlines the monetary policy dilemma posed by the current strength of sterling against the other European currencies.*

Throughout his heyday, Roy Bridge operated within the context of the fixed, but ultimately adjustable, exchange rate arrangements that were at the heart of the Bretton Woods system for more than 25 years after the Second World War. Those arrangements were, in an important sense, a response to what were seen as competitive, 'beggar my neighbour', exchange rate practices, aimed at exporting unemployment during the inter-war depression, just as the GATT (now the WTO) was a response to predatory trade practices. The IMF encouraged member countries—particularly countries with external deficits needing to borrow from the Fund—to pursue consistent, responsible, domestic macroeconomic policies designed to maintain agreed exchange parities, with provision for parity adjustments only as a last resort in cases of 'fundamental disequilibrium'—usually where macroeconomic discipline had failed.

Books have been written on the causes of the breakdown of these arrangements, and I do not propose to rehearse all that this evening. One important factor was the progressive dismantling of direct controls—including a relaxation of controls on international capital flows—which, though it certainly added to the potential macroeconomic benefits from international economic activity, undoubtedly made a fixed exchange rate system inherently more difficult to sustain. That development, of course, has gone very much further since then. But in addition, countries came to attach different priorities to inflation and unemployment as the immediate objective of policy, and there was disagreement about how the burden of domestic policy adjustment should be shared between countries with surpluses and deficits, including the United States, the country of the anchor currency. The fixed exchange rate structure eventually collapsed under the weight of outflows from the US dollar, which, under the parity system, had to be taken into other countries' official reserves, on such a scale that the dollar's official convertibility into gold had eventually to be formally suspended. This occurred in 1971, quite soon after Roy Bridge had retired from the Bank of England, though I do not suggest any direct cause and effect!

Efforts to rescue the fixed but adjustable exchange rate system in the early 1970s were unsuccessful. This was partly because of the global economic uncertainties caused by successive hikes in the world oil price. But more fundamentally, those efforts failed because the industrial countries could not in the end agree upon structured arrangements for allocating the burden of domestic policy adjustment between them, in a way that would sustain exchange rate stability without creating either an inflationary or deflationary bias in the world economy as a whole. And we have lived ever since with an untidy patchwork of exchange rate arrangements, ranged along a spectrum from free floating at one end to total fixity at the other, which vary both from country to country and from time to time.

The major currencies—the dollar, the yen and the major European currencies together—and a number of others have floated against each other. For much of the time, the float has been relatively 'clean', with the exchange rate essentially a residual outcome of the respective domestic policies. Periodic attempts have been made—unilaterally, or through concerted intervention or co-ordinated policy action—to manage the float, with, it must be said, varying degrees of success.

Many smaller economies have chosen to peg their currencies, unilaterally, to a major currency or to some sort of currency basket—sometimes adjusting the peg quite regularly in line with relative inflation, or sometimes only as a late resort.

Within Europe, there has been the ERM, which is a lineal descendant on a regional basis of the fixed but adjustable exchange rate system of Bretton Woods, although with the important difference that it has been seen increasingly as the precursor to monetary union and a single European currency. The decision on that is now, of course, just a few weeks away.

And a few, mostly relatively small, economies have chosen to lock their currencies to a major currency through a currency board arrangement.

In most of these cases, these various different arrangements have worked perfectly well for a time, often for quite long periods of time. But equally, they have, I think, all suffered

(1) In the annual Roy Bridge Memorial Lecture delivered on Wednesday, 1 April 1998.

from periods of tension or crisis. It would take a brave man—or a foolish one—to suggest that there is a universal 'best buy'!

In principle, floating allows countries to pursue independent macroeconomic policies suited to their domestic needs—in terms of the fiscal-monetary policy mix, for example, or to accommodate divergent cyclical positions or the differential impact of external shocks. But floating can certainly result in periodic disorderly markets, and in wide fluctuations in both real and nominal exchange rates. That can in any particular instance be very disruptive to private international business activity. It can also generate a more lasting environment of exchange rate uncertainty, reducing the potential macroeconomic benefits of international trade and investment.

Conversely, at the other end of the spectrum, exchange rate fixity can certainly produce real benefits in terms of nominal exchange rate certainty—though real exchange rates of course can still vary. But these benefits have a cost, the cost of giving up substantial national discretion over domestic policy. Whether the single monetary policy will prove over time to be broadly appropriate for the domestic policy needs of all the participating currencies is, of course, the \$64,000 or ¥8½ million question in relation to the euro. Broadly speaking, this trade-off—between relative exchange rate stability and domestic policy independence—applies at intermediate points along the spectrum, though the problem of finding a workable exit strategy, and a natural reluctance to accept the domestic policy implications of a particular exchange rate objective, can on occasion lead to the worst of both worlds.

Where countries choose to be along the spectrum is influenced by a number of factors—economic size, for example, and the extent to which their economies are integrated with the outside world, either generally or in relation to particular trading or investment partners. It may be influenced, too, by historical experience, or by political factors, including how far an external anchor is seen as a necessary support to domestic macroeconomic discipline, which some countries would see as putting the cart before the horse. It is, as I say, difficult to identify a universal best buy. But wherever you choose to be on the spectrum, you cannot simply divorce your domestic economic policy from the external context. You cannot, in fact, opt out of the global economy. Even with this patchwork of different exchange rate arrangements, and without any very clear or generally applicable adjustment rules, we all continue to have an important interest in each other's behaviour, and a collective interest in the resulting pattern of exchange rates. Within the present international monetary system, those interests are pursued at the international level through the process of surveillance, dialogue and persuasion within the G7 or G10, the BIS, WP3 at OECD, and through the various mechanisms of the IMF. At the regional European level, exchange rates remain a matter of common concern whether countries are in or out of monetary union.

The good news is that through that process of dialogue, we have in recent years achieved a remarkable degree of consensus—around the world, but also within Europe—on broad approaches to economic management. Varying degrees of emphasis on short-term demand management—to exploit the short-term trade-offs between growth and stability, and between unemployment and inflation—have largely now given way to general recognition that there really is no trade-off in anything other than the short term. The emphasis now virtually everywhere is on 'macroeconomic stability as a necessary condition for sustainable growth'—the mantra not only of central bankers but also of Finance Ministers. Within macroeconomic policy, there is also widespread agreement on the respective roles of fiscal and monetary policies. Fiscal policy is increasingly directed at the longer-term sustainability of the public sector financial position; while monetary policy is directed at maintaining price stability, not simply as an end in itself, but as a measure of the balance between demand and the underlying capacity of the economy to meet that demand—a measure of economic stability in that broader sense.

I do not pretend to you that we have suddenly come across the Holy Grail! The consensus I describe has taken a long time to develop, it is still less than complete, and it is not easy, technically, to apply in any particular situation. We have also learned that, vitally necessary though it is, macroeconomic stability on its own is not sufficient. It was not sufficient to avoid the financial bubble and its continuing, depressing aftermath in Japan, for example. It has not been sufficient to ensure acceptable levels of employment within Europe in the absence of structural, supply-side flexibility, especially in labour markets, and without greater progress on this front, some people in financial markets question whether macroeconomic discipline will in fact be sustained. And it has not been sufficient to ensure financial stability in some countries in Asia, in the absence of more transparent and effective financial structures for allocating capital productively, with dramatic impact on exchange rates, as we have seen.

But if it is not the Holy Grail, the international policy consensus in favour of macroeconomic stability is at least a start. The consistent pursuit of domestic stability, rather than exchange rate stability, has necessarily become the focus of IMF advice to many of its member countries, and it is the benchmark for much of the wider international debate. It has in fact produced unusually low inflation—both actual and prospective—throughout the industrial world and beyond, substantially reducing inflation differentials, which have typically been a principal source of exchange market pressures in the past. Persistently pursued, it holds out the prospect of greater exchange rate stability in the medium and longer term. But given the other potential sources of exchange rate volatility it would nevertheless seem premature to contemplate a return to more structured exchange rate arrangements for the international monetary system as a whole.

Against that background, let me now turn to consider the exchange rate in our own UK policy context.

Apart from a brief flirtation with the European 'snake' in the spring of 1972, we have made two relatively short-lived attempts at managing the exchange rate since the breakdown of the Bretton Woods framework of fixed parities. Neither experience was particularly encouraging.

The first was in 1987/88, when for a period monetary policy was in effect directed primarily at 'shadowing the Deutsche Mark'. The idea essentially was that, just as other major European currencies were successfully aiming to hold inflation down by anchoring their currencies to the Deutsche Mark within the ERM, we too could lock in to Germany's enviable record of sustained low inflation even without actually joining the mechanism. This approach was never formally adopted or announced, but it became clear in practice that the exchange rate for sterling against the Deutsche Mark, which had fallen very sharply from DM 4 in July 1985 to DM 2.74 in early 1987—before the May Election—was not subsequently to be allowed to recover to above DM 3, even though this meant a big increase in our foreign exchange reserves, and cutting interest rates—from 11% to 8½%—during 1987, in order to prevent it. I do not suggest that this was the only influence on policy during this period, which covered the 1987 stock market crash. But it was certainly an important influence. It had the effect of accommodating the inflationary consequences of the earlier depreciation—indeed of aggravating that effect by stimulating domestic demand.

By the time the exchange rate cap was lifted in the spring of 1988, the boom was already entrenched. Interest rates had to be pushed back up—to 15% by the autumn of 1989—to bring the situation back under control, producing the inevitable and very painful bust of the early 1990s.

Our second attempt at managing the exchange rate followed in October 1990, when we formally entered the ERM. An important non-monetary consideration at the time was that the United Kingdom would have little influence on the outcome of the imminent European Inter-Governmental Conference if we were not in the ERM. The monetary question was essentially whether joining the ERM in the circumstances at the time, and necessarily in practice at close to the prevailing market exchange rate, was a reasonable risk.

In fact, at the time of our entry into the ERM, our policy needs appeared to coincide with those of our partners. The economy was responding to the high, though falling, level of interest rates and the rate of inflation was also falling. In principle, it seemed possible that with the enhanced policy credibility that ERM membership was expected to bring, we could hope to complete the domestic economic stabilisation with lower interest rates than otherwise, and so at less cost in terms of loss of output.

That is not how things turned out. In the event, reunification meant that Germany needed to maintain a tight monetary policy, when the domestic situation in a number of other ERM countries, including ourselves, required an easing of monetary policy. The results of this exceptional and unforeseen divergence in the domestic policy needs of countries whose currencies were pegged together through the ERM are certainly familiar to you.

It can be argued that the problems within the ERM—including our own problem—could have been avoided by timely adjustment of the relevant parities. And so in principle they could. But in practice, it is never as easy as that makes it sound. By the time the developing tension became apparent, the Deutsche Mark anchor was already established as the absolutely key element of the monetary policy framework in other member countries—on which their anti-inflationary credibility crucially depended. To give that up, without a real fight, would have imposed substantial economic costs in the form of loss of anti-inflationary credibility. These costs might have been less if it had been possible to agree upon a unilateral Deutsche Mark revaluation or upward float—making it clear that the root of the problem lay in the exceptional circumstances of German reunification. But that approach could not be agreed.

We were then confronted with a situation in which raising interest rates made no economic sense in terms of our domestic conditions, and so we sought to maintain the parity through intervention, in the hope that the pressures in Germany would ease. In the event, they did not ease soon enough, and after very heavy intervention and a last ditch rise in interest rates, we had no choice but to withdraw from the ERM—on 16 September 1992, Black or White or even Grey Wednesday, depending on your point of view.

These episodes apart, the pound has floated more or less continuously since 1971. But floating has not been without its problems either—in fact it has been a roller-coaster ride—with obvious overshooting on either side.

Against the dollar, sterling fell by nearly 40% from 1972–76; it rose by nearly 50% during the next four years or so; and then fell back again by nearly 60% in the mid 1980s, to close to parity with the dollar. It then trended upwards again—by more than 80%—as the dollar weakened against other currencies generally, before we fell out of the ERM in 1992.

We have not been much more stable against the Deutsche Mark—down 50%, up 25%, down more than 40% in four or five year waves to 1987, although then a good deal steadier through the ERM period until 1992.

After the initial fall of around 20% on leaving the ERM, sterling was in fact remarkably stable against both the dollar and the Deutsche Mark until the autumn of 1996. Since then, it has risen relatively modestly, by around 10% against the generally stronger US dollar, but by about 35% against the Deutsche Mark.

Sterling's strength against the Deutsche Mark and the other core European currencies, in particular, creates a real dilemma for monetary policy.

The UK economy, after six years of relatively steady growth and low inflation, is now operating close to either side of full capacity—nobody knows precisely. Domestic—particularly consumer—demand has, at least until recently, been growing at a rate that cannot plausibly be sustained for long, if inflation is to be kept to our $2\frac{1}{2}$% target rate. The dilemma in this situation is that tightening monetary policy to moderate the growth of domestic demand is liable to put further upward pressure on the exchange rate, when the internationally exposed sectors of the economy are already taking a real battering from the strength of the exchange rate, and now also from the economic effects of Asia's financial crisis.

The situation is all the more difficult because we do not pretend to understand exactly why sterling has appreciated so far against the European currencies. Some part of it is certainly a reflection of our relative interest rates, reflecting our relative cyclical positions. But we cannot explain very much of the appreciation in this way—either its timing or its extent.

Now you all can no doubt explain the rest of it—and I would be happy to receive your answers, on a postcard please, addressed to me at the Bank.

Some of my market contacts tell me that it has to do with perceptions about the euro. The immense efforts that have had to be made nearly everywhere on the Continent to meet the Maastricht budget deficit convergence criterion, have—they say—distorted the fiscal-monetary policy mix. And more fundamentally, there is a nervousness that a broad euro will be a weak euro, because the European Central Bank will somehow be more likely to be subject to political pressures.

If these factors are indeed important, then they seem likely to fade. Activity is now picking up on the Continent. And people will come to appreciate both the strength of the protection of the ECB's independence written into its statutes, and the determination of the ECB's Governing Council to establish the euro from the beginning as a sound and credible currency. This could start to happen quite quickly once the appointments to the ECB Executive Board have been made and the ECB is established.

In the meantime we are left with our dilemma.

In seeking to address it, we take full account of the disinflationary impact of the strengthening exchange rate itself. This includes both its direct effect in reducing the level of retail prices—which has not yet fully come through—and the reduction in aggregate demand resulting from the now rapidly deteriorating external trade balance.

These effects are less than ideal in terms of the balance within the economy. They are nevertheless helpful, in that they give somewhat more time for domestic demand growth to moderate, as we expect that it will—in response to both the fiscal and monetary tightening already in the pipeline, and as the windfall effect from building society demutualisations abates. But it nevertheless remains, at the margin, a fine judgment whether domestic demand will in fact slow soon enough and fast enough to avoid inflation eventually picking up. That is the judgment that the Monetary Policy Committee will examine again next week.

Mr Chairman, the exchange rate is, to my mind, one of the most intractable aspects of monetary policy—as I have tried to explain this evening. There are times when we are damned if we try to manage it and equally damned if we do not. Whether it floats or whether it is fixed, it can at times come into conflict with domestic policy objectives—and now is such a time.

At the end of the day, it cannot make sense to sacrifice our objective of long-term domestic stability. That would expose the whole of the economy to the destructive effects of inflation—including the exposed sectors we were seeking to protect. We have to manage our way as best we can through this uncomfortable period while it lasts, until more sustainable exchange rate relationships are re-established.