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Policy Coordination: Exchange Rates and Financial Regulations[1]

John Williamson
Senior Fellow
Peterson Institute for International Economics

The purpose of today's meeting is to discuss how one might build a single market for the industrial (OECD) countries, which I understand "trans-Atlantic" to be a shorthand for. In particular, it has been suggested that a target zone system of exchange rates, such as I advocated in the 1980s, might be one of the constituents of an attempt at such market integration. Similarly, one can ask if there is any chance that the attempts to find a common approach to international regulation at the present time might provide the basis for building a common economy of the industrial countries.

Let me first outline these two proposals in somewhat more detail. As I envisaged it when it was first published, a target zone system of exchange rates would have bound together the leading seven or so currencies (in those days, the G7 currencies) through a system of target exchange rates surrounded by wideish (+/- 10%) target zones. The participating countries would have had an obligation to defend the edges of their target zones through intervention backed up by changes in monetary policy, with world monetary policy being determined at the global level by whether or not the world economy was overheating. Had participating currencies been faced with consequential aggregate demand problems, they could have altered their fiscal policies. Target nominal exchange rates would have been adjusted automatically for differential inflation, while the real targets could have been adjusted by international agreement when necessary to achieve reasonable external balance. Other countries could have pegged their currencies to a single participating currency, or to a basket of them, or floated, depending on national choice.

Current proposals for international coordination of regulatory policy seem to envisage some international body being empowered to ensure that each participating country enforces financial regulations that require that financial intermediaries to satisfy certain capital adequacy standards, liquidity requirements, accounting principles, etc. That is what I shall interpret us to be discussing.

I have to say that I regard both proposals as perfectly sensible. Nonetheless, I do not think they would contribute significantly toward the objective of building a single market for the OECD countries. There are two reasons for this assessment.

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[1] Outline of remarks to be made at the Dupont Summit on Dec. 5, 2008.

First, the world has changed since the 1980s, and in a far more fundamental way than the replacement of three G7 currencies by the euro. Specifically, a number of the emerging markets are now central components of the world economy. This is surely true of some, maybe of all, the BRICs (Brazil, Russia, India, and China), even if one recognizes that the right way to spell BRIC is BRICK (i.e. one adds Korea). Imagine a target zone system of exchange rates nowadays in which China was not a participant. On both sides of the Atlantic there is a common view that the biggest exchange rate problem for some years has been the gross undervaluation of the RMB. Accepting this while excluding China from a target zone system would amount to a commitment to tackle the undervaluation of the RMB by lecturing the Chinese, which is a demonstrably ineffective strategy. Making China a partner and asking it to spell out a plausible outcome which does not involve a real revaluation of the RMB seems altogether more likely to be effective. Suppose that one succeeded in stabilizing the real $/€/¥/£ rate, but excluded the EM currencies: Would this not be regarded as the rich world ganging up on the poor? As I see it the moral is that nowadays one has to search for global solutions, not confine solutions to the industrial countries. This does not mean that every country must participate for anything to be agreed: there will always be some nut cases that will exclude themselves, but it has to be open to all.

The situation with regard to financial regulation seems to be the same. It is true that European banks got into trouble in part because they bought securities embodying sub-prime loans from the US, but new rules will have to be worldwide rather than specifically trans-Atlantic for fear of regulatory arbitrage otherwise diverting business outside the trans-Atlantic area. Since we no longer live in a world that is dominated by the trans-Atlantic powers, or even by the industrial countries, effective agreements will have to apply over a wider area than was envisaged in the 1980s.

The right way to model the contemporary world economy is as a number of major currency blocs linked by floating exchange rates. One can even fit the target zone proposal into such a concept. There would still be agreed target exchange rates between the blocs, but not hard margins to the target zones; instead one would require a progressively greater obligation to seek adjustment the greater the deviation of market rate from target. (This is the essence of the reference rate proposal.)

What one cannot have is something that is effectively a single market, with a common money, a single tax system confronting common rules and regulations, and they are certain that these conditions will continue into the future, without also a sacrifice of national sovereignty. Solutions like target zones or reference rates, or for minimum international regulatory standards, are specifically designed so as to minimize the requisite loss of national sovereignty, with the object of making them palatable to the United States and Asian powers which have rather similar attitudes to sovereignty. But as long as integration takes this limited form, firms will not face the same degree of certainty that changes in exchange rates or international differences in regulation would not undermine their competitive position as they now face nationally. There will not be a single market.

Does this mean that it is impossible to envisage agreements among industrial countries that are specific to industrial countries rather than worldwide? I find it difficult to envisage such agreements coming without an explicit limitation of national sovereignty, as in the EU. If there were proposals for such agreements, they would be widely condemned as discriminatory. I therefore judge that we are unlikely to see countries that place a high value on national sovereignty, like the United States, drawn deeper into industrial-country integration. This is not a disaster for the US, or for the EU as a whole, or for Japan, since they are in any event economies that are large enough to support technological developments. It may be problematic for Canada, or the UK if it decides to go it alone. It would surely be problematic for Norway were it not for oil. And we should all be thankful that we are not Icelanders.