11 Achieving Exchange Rate Stability in a Tripolar World: A Target-Zone System with a Rotating Anchor

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I. INTRODUCTION

This chapter considers approaches to choosing an anchor in a target zone exchange rate system among the three major currencies: the yen, the DM and the dollar. Though there is as yet no impetus for a world target zone regime, this situation may well change over the next decade. The present G-7 coordination is generally considered to have been successful in reducing exchange market volatility, but the evidence presented in this chapter calls this view into question. The results here also cast doubt on the view that exchange rate volatility would substantially abate if monetary authorities could only succeed in bringing inflation all the way down to zero. For cross-rates between the dollar, yen and DM, the link between inflation rate levels (or differences) and exchange rate volatility appears tenuous at best.

The target zone system I consider for the US, Japan and Germany is similar in many respects to an EMS. One of the most difficult issues to resolve in such a system, and the one I mainly focus on here, is how to pin down world money growth. In the EMS, of course, Germany – more precisely, the Bundesbank – has until now played the role of anti-inflation anchor. I argue that a global system in which a single central bank provides an anchor is inherently more stable and will produce lower inflation than a committee system. One can further argue that Japan, by virtue of its excellent recent inflation record and status as the world's major creditor, is the natural candidate for anti-inflation anchor. If, however, that should prove politically impossible, a system of rotating leadership should be considered.

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The second section of the chapter reviews the empirical evidence on the effects of inflation reduction and G-7 policy coordination on exchange rate stability. The third section looks at current and possible future regional exchange rate arrangements, and also considers their possible effects on global exchange rate stability. The fourth section explores a proposal to have a target zone exchange rate system with a rotating anchor. I should note that throughout, it is implicitly assumed that reducing exchange rate volatility from its present high levels is a valid policy goal. Clearly, the issue of whether reducing exchange rate variability should be a central policy goal is a contentious one; it has been debated extensively in the theoretical and empirical literature without yielding a firm conclusion.

II. GLOBAL INTERNATIONAL POLICY COORDINATION TO REDUCE EXCHANGE RATE VOLATILITY

International policy monetary coordination between the United States, Germany and Japan is hardly as institutionalized as it is within the European Monetary System. Nevertheless, coordination among the biggest three players is generally viewed to be far more coherent today than it was fifteen years ago when the US insisted that all major decisions be made within the 'Group of One' (the United States).

The United States' approach to consultation and coordination changed radically, of course, under Secretary Baker during the mid-1980s. The Plaza Agreement of 22 September 1985 marked a dramatic turning point, with a coordinated statement on appropriate exchange rates. (See, for example, the discussion in Frenkel and Goldstein (1988).) The coordination process that began in Plaza was further negotiated and refined over the ensuing two years, culminating with the famous December 1987 G-7 ministerial communiqué. Now firmly in place for almost four years, the G-7 coordination process is often trumpeted as a clear success in improving exchange market stability:

> we have seen, post-Plaza, the exchange rates settled into (and I use this word advisedly and without prejudice) ranges that have shown over a period of years since 1987 reasonable stability . . . if you look at this in a graph form, you will see an impressive stability compared to the previous 15–20 years experience.