CONGRESS OF THE UNITED STATES

INTERNATIONAL PARLIAMENTARY SUMMIT ON EXCHANGE RATES AND COORDINATION

Zurich, June 28-30, 1986

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Session Four: The Central Bankers

Introductory Remarks by Mr. Dini

1. My brief remarks are meant to provide some common ground for the discussion, but in no way to limit the range of topics which may be raised within the broad subject that has been assigned to us in the Conference program. In my review, I will take the opportunity to express some of my own views.

2. In Tokyo, the seven major industrial countries agreed (i) to pursue better coordination and consistency in their economic policies; and to this end, (ii) to strengthen the mechanisms for international surveillance over national policies; in part by setting up a system of indicators as a basis for policy assessment and consultation.

3. Prior to Tokyo, with the Plaza agreement the Group of Five countries for the first time in several years were agreed that the levels of the main currencies were out of line with "fundamental" economic conditions and inconsistent with the orderly working of the international adjustment mechanism. Accordingly, they decided to undertake coordinated intervention in foreign exchange markets; the decision was publicly announced, contributing to the success of the operation. In the ensuing months the downward trend of the dollar was also maintained by concerted changes in money market interest rates in the three major countries. The Plaza agreement was essentially a one-time action to correct an extreme disequilibrium situation, and not an ongoing arrangement to stabilize or manage with continuity the main currencies' exchange rates; it has shown how effective intervention can be in certain circumstances, but also how it is blunted when domestic policy goals remain divergent and inconsistent.

4. It is worth recalling that both the Plaza and the Tokyo agreements built upon the policy recommendations of the Group of Ten Report, which was published in June 1985. The Report had identified three main requirements for a stronger and more stable system:

(i) sound, stable and <u>internationally consistent</u> policies in the major countries, with strong emphasis on the last condition;

(ii) an effective mechanism of <u>multilateral surveillance</u>, to bring about and then monitor such policies;

(iii) a commitment to give greater weight to exchange rate stability in framing domestic policies, strengthened by willingness to undertake <u>coordinated intervention</u> in foreign exchange markets whenever necessary.

The Plaza agreement laid primary emphasis on the third pillar of these recommendations; the Tokyo Summit rather concentrated on the second by formally endorsing the creation of a system of indicators as a basis for surveillance. The implementation of a system of this kind will inevitably require further study and negotiation. There is a danger that in the meantime attention may be diverted from efforts to correct domestic imbalances and divergences in national policies, which are the principal elements of instability in the current situation. Indeed in recent months the open voicing of conflicting objectives and expectations regarding exchange rates has become itself a direct source of instability and uncertainty in foreign exchange markets. And current trends in payments imbalances, fiscal policies, and domestic demand growth seem to herald more (rather than less) exchange rate instability and protectionist threats in the period ahead. All in all, I wonder whether there is adequate perception of the need to maintain momentum in implementing all the components of the strategy to improve the system that were identified by the G-10 Report, and to make progress toward optimization of world economic performance.

5. Given these considerations, the role of central banks in the Tokyo agreement cannot be overemphasized, for at least three reasons: (i) the key policy coordination problems do not directly concern monetary policy, but other policies; (ii) central banks must continue to give priority to the objective of maintaining price stability in the medium term; a complete subordination of monetary policies to exchange rate considerations could compromise this objective; (iii) linking closely together monetary policies through an exchange rate commitment when fiscal and other policies are divergent could well destabilize the real economy.

6. Bearing these points in mind, I believe the task for central banks within the framework of the Tokyo agreement lies mainly in two areas. First, the generation of large new shocks with monetary policies should be avoided. This may require less rigid adherence to quantitative targets, as indeed is already the case, and the exercise of more discretion in managing monetary policy in the short term, while continuing to pursue a stable course in the medium term. Smoother monetary conditions in the main financial markets may help to reduce destabilizing capital flows. Second, financial innovation and increasing worldwide integration of financial markets entail reduced costs and larger and more flexible availability of financing, accompanied however by greater risk of systemic instability. Supervisory and regulatory systems have to be adapted to reduce this potential threat without discouraging innovation. The need for close international cooperation has become greater. This is an area where central banks can make a valuable contribution.

7. A few remarks on target zones. The attraction of this approach lies in its apparent ability to combine exchange rate stabilization with maintenance of flexibility in domestic policy making.

Achievement in practice of both these objectives is, of course, far from easy. Like any other scheme for limiting exchange rate variability, target zones must either imply a constraint on domestic policies or be bound to fail. The fact that the zone could be larger, and the intervention obligations looser, than those of the Bretton Woods arrangements or the European Monetary System, does not eliminate the basic requirement that the domestic policies of major countries have to be more responsive to external considerations, at some cost to national goals. We are back at the starting point: how can we achieve better coordination and consistency in the major countries' policies? No short-cuts are available around this question.

8. Finally, let me comment briefly on indicators as a basis for strengthened surveillance. No matter how good the set of indicators and how much agreement on its analytical foundations, a great deal of judgment will still be necessary in identifying situations of unsustainable configuration of policies and corrective actions. It is simply not possible to device an automatic response mechanism that would ensure full consistency of national policies. Recognition of this basic truth, however, should not lead us to believe that voluntary compliance and peer's pressure is all that is needed or possible for strengthened surveillance.

My own view is that we need to set up procedures that involve an element of external constraint; that in the trade-off between rules and discretion, the balance cannot be tilted in favor of the latter without putting the target of effective surveillance at serious risk. Clear agreement is needed on what constitutes a situation of policy inconsistency, what the common goals are, and what the minimum requirements for exchange rate stability are. Moreover, when a situation of inconsistency is recognized, there should be an obligation to consult and to agree on remedial action. Countries' international responsibilities should be clearly spelled out on each occasion, as well as any conflicts with their national goals. In other words, the willingness to compromise between international and national goals should be explicitly tested by the surveillance procedures.

9. I will stop here. I realize that I have mainly raised questions. Perhaps the discussion will bring out other problems as well as more precise answers.