# Exchange Rate Regimes in the 21st Century: Final Remarks

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## I. Introduction

In my final remarks, I would like to first briefly discuss the proposal that Japan should weaken the yen substantially to turn around its ailing economy. I will then proceed to summarizing some of the salient features of the discussion on exchange rate regimes during the conference.

## II. Exchange Rate Policy as a Remedy for a Liquidity Trap

Several participants recommended that Japan should substantially weaken the yen to stimulate the economy. Let me first emphasize that this is clearly an exchange rate policy, which has been assigned, by law, to the Ministry of Finance (MOF) and not to the Bank of Japan (BOJ). Having said that, I would like to discuss some possible macroeconomic consequences of such an action. First, a weaker yen should raise net exports. But in addition, domestic interest rates would rise, especially if the yen was fixed at a weaker level. As Maurice Obstfeld pointed out, we would be able to get out of the liquidity trap as a result. However, higher interest rates would surely have an adverse effect on borrowers of funds and financial institutions, worsening the bad-loan problem plaguing the economy. It should also be noted that the BOJ would not regain the flexibility to lower interest rates. Under a fixed exchange rate, Japanese interest rates would move in response to the Federal Reserve Board's monetary policy.

In a different vein, Masahiro Kawai argued that the BOJ should stop sterilizing foreign exchange market intervention. Sterilized and non-sterilized interventions are different up to the effects of the BOJ's purchases of treasury bills (TBs) on the economy. The effects of TB purchases, however, would be small under a zero interest rate. And the BOJ has already been buying TBs and other assets massively to expand the monetary base at a growth rate close to 30 percent. In addition, those arguing for "non-sterilization" of foreign exchange market intervention seem to miss a technical point about the monetary operation of the BOJ. Typically, the MOF buys foreign exchange by selling, for example, three-month TBs to the BOJ. If left non-sterilized, the operation increases monetary base for a period of three months. After three months, the MOF will have to raise money in the market to pay back the TBs, at which point monetary base returns to the previous level. The resulting time path of monetary base is very bumpy and does not seem to produce any fruitful results. The

only remaining possibility would be for the BOJ to create a target on monetary base or bank reserves, which and what we currently do, and to move it in response to the MOF's interventions. Such a policy rule, however, would imply subordination of monetary policy to exchange rate policy and does not seem to be prudent behavior on the part of the BOJ.

## III. Discussion on Exchange Rate Regimes

During the conference, I have been trying to determine the degree of support for the bipolar view among the participants. As far as I could see, the support was not as strong as I had expected. But at the same time, the participants addressed the difficulty of intermediate currency regimes much more carefully than in previous conferences with similar topics.

The choice of optimal currency regime seems to depend on a number of factors, and is also not invariant over time. For G-3 countries, many participants supported the idea that free floats were the optimal regime, although some suggested that Japan use an exchange rate-based stabilization technique as discussed above. The case for floating rates among the G-3 economies was most clearly expressed by Obstfeld; flexibility in exchange rates is useful in replicating, in his language, the flexible price equilibrium in the presence of nominal price rigidities. Of course, the conclusion depends greatly on the pricing behavior of companies in response to exchange rate changes as well as on distortions other than nominal price rigidities. Concerning the possible costs of excessive volatility of exchange rates, Roger Ferguson pointed out that such costs were not serious in the G-3 countries, because there were many financial techniques that allowed companies and households to hedge against exchange rate changes.

For smaller countries, some participants recommended hard pegs and others spoke for free floats. Arguments against the bipolar view were also made. Aversion to the bipolar view was strongest among some East Asian participants, including Kawai. The structure of Asian trade is fairly diversified; the memory of the East Asian crises is still fresh. Hence, some participants argued for a soft peg to a basket of currencies, or even argued for a common currency in the region. But it was not clear to me why a peg to a basket was more durable than a peg to a single currency. In addition, some pointed out the need for political integration to precede currency union.

For Latin America, the demand for using a hard peg to impose monetary and/or fiscal discipline seemed very high. Some participants, however, viewed the use of a peg for this purpose as only a temporary remedy. It was intended to buy time for whoever was in charge of economic policy to put their house in order. Some went on to say that a hard peg would be no longer necessary once appropriate macroeconomic policy and political institutions were in place.

This line of argument raised the following points. First, of course, the choice of optimal currency regime depended not only on economic factors but also on political and social factors. In fact, some pointed out that we needed to go beyond the domain of narrow-minded economists to analyze these questions more fully. Second, the

optimal currency regime must change in response to changes in institutions. This point was already illustrated, for example, by the use of a hard peg for inflation stabilization, but possibly for a temporary period. Additionally, the temporal nature of some currency regimes raised the difficult question of how to formulate an exit strategy from them.

In conclusion, people seem to have agreed that we need to analyze more carefully and in dynamic contexts implications of various existing distortions, including political and social factors, for the choice of the optimal currency regime. Hopefully, the new international macroeconomics will offer a nice playground here.