Exchange Rates are Not the Issue
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The debate over exchange rates and global imbalances has generated more heat than light. Thus, the United States has rightly abandoned its strong dollar policy in order to address its gaping current account deficit. Or no it hasn't, and it has no reason to do so given Asian central banks' insatiable appetite for dollar reserves. Asia should curtail its intervention and let its currencies float upward in order to help eliminate global imbalances. Or no it shouldn't, since doing so would mean capital losses on its reserves, higher interest rates and weaker demand in its principal export market. Europe should restore fiscal discipline by rebuilding its shattered Stability Pact, and the European Central Bank should cut interest rates in order to prevent the euro's appreciation from getting out of hand. Or no it shouldn't: the continent is better off now that it has put this pro-cyclical engine of fiscal perversity behind it and has a central bank that is serious about price stability.

The reason for this incoherence is that the debate has not focused on fundamentals. Those fundamental problems are the policy mix in all three regions. In most of Asia, monetary policy is too loose while fiscal policy is too tight. The region remains wedded to a strategy of export- and investment-led growth predicated on low exchange rates and low interest rates. This combination encourages inefficient investment and periodic property-market overheating.

In Europe, the problem is the opposite: fiscal policy is too loose while monetary policy is too tight. There the villains are structural reform making for a period of slow growth, pressure for social spending which limits the scope for cutting expenditure, and a new-minted central bank playing a game of chicken with national fiscal authorities.

In the United States, the problem is that fiscal policy is projected to remain loose for so long that if the dollar continues to fall the Fed will have to raise interest rates further and faster than is healthy for the economy. A loose fiscal policy and tight monetary policy would be precisely the opposite of what are appropriate to encourage the private investment needed to exploit the opportunities afforded by the country's surging productivity.

In the U.S., addressing the fiscal problem now would obviate the need for a much tighter monetary policy later. It will moderate how far the dollar has to fall in order to limit the country's current account deficit, thereby relieving the pressure on the Fed to significantly raise rates as the weaker exchange rate began translating into higher prices. It would make for a more investment-friendly environment than the combination of loose fiscal policy and tight monetary policy that will otherwise be inevitable down the road. Given this diagnosis, calls for the Fed to begin tightening now are off base. The underlying imbalance is fiscal. To respond now with monetary tightening would be to address the symptoms rather than the disease.

In Asia, curtailing foreign exchange market intervention would cause exchange rates to rise, but growth will not suffer if fiscal policy is used to support demand. The agreement for fiscal expansion to offset some monetary tightening is strongest in the cases of Korea, Malaysia, Thailand, and Taiwan. The resulting allocation of resources between traded- and nontraded-goods sectors will be more efficient. Threats to the stability of local financial systems due to lending for property-market speculation will be less.

Japan, clearly, is a special case. In our view, calls for Japan to abandon its foreign exchange market intervention are premature. It would be safer to wait for convincing evidence that deflation has been banished once and for all before allowing the yen to rise. The specter of yen weakness of course raises hackles elsewhere in Asia. Fortunately, if Japanese prices rise at the same time the yen falls, which is policy makers' goal, after all, there is no reason for the country's neighbors to fear beggar-thy-neighbor effects.

In Europe, tighter fiscal policy in combination with more relaxed monetary policy would make for a more competitive exchange rate and investment-friendly environment, especially if deficits were cut by curtailing public spending. With more investment in technology and capacity, European growth could get back on track.

While exchange rate fluctuations sometimes take on a life of their own, more commonly they are symptoms rather than causes of underlying problems. This is the case at the moment. It means that the debate over exchange rates would be more productive if it focused more directly on those problems, with in the present context means the policy mix.

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