

Bergsten rejects Rogoff's "straw man" approach

Kenneth S. Rogoff casts "a vote against grandiose schemes" of international economic policy coordination (March 2003). He specifies the coordination problem in such a narrow and virtually irrelevant manner, however, as to preordain the answer and trivialize it. Advocates of coordination see a very different problem that we believe can be addressed by a modest approach that Rogoff ignores. He defines "international economic policy coordination" as "cooperation among the world's major central banks . . . to arbitrate and coordinate interest rate policy." He rightly notes that advocates of such schemes seek primarily to limit exchange rate volatility and, rightly again, that there is little evidence that volatility has a significant impact on trade (or, one might add, on anything else). Noting, too, that monetary policy needs to retain its focus on price stability and that such cooperation among central banks could generate costs of its own, he therefore rejects this particular concept of international coordination. He correctly concludes that it is a non-answer to a non-problem.

There is another property of the present exchange rate regime, however, that represents an extremely serious problem for both individual countries and the global economy: prolonged currency misalignments that stray far from sustainable long-run equilibrium levels for extended periods. The increasingly obvious proliferation of such disequilibria, especially for the dollar and other major currencies, was the main reason the original postwar system of adjustable pegs collapsed. Floating rates were supposed to obviate the prob-

lem. But misalignments have turned out to be at least as pronounced under the regime of managed flexibility in place for over 30 years. By any calculation, the dollar became much more overvalued in the mid-1980s than it ever was under the Bretton Woods system. It has been substantially overvalued again for the last few years. The results have included large, rapidly increasing trade and current account imbalances that distorted entire sectors, especially trade-dependent manufacturing; protectionist pressures that threatened the stability of the trading system; and constant risk of sharp reversals in the currency markets themselves that could generate "hard landings." The misalignments became so costly in the mid-1980s that the major industrial countries adopted the Plaza Agreement to correct them. Market errors have turned out to be even more serious than policy errors.

The Plaza Agreement and numerous subsequent episodes convey another important lesson for the future of policy coordination: that the major countries can frequently engineer substantial changes in exchange rates *without* corresponding modifications in national fiscal or monetary policies. Because of the presence of multiple equilibria in currency markets, extensive research shows that sterilized intervention can often move rates substantially and with lasting effect if it meets several well-documented criteria: consistency with the underlying economic fundamentals, coordinated participation by at least the parties involved in the currency pair in question, and public announcement of the initiative to send a clear

Repeat borrowing from the IMF

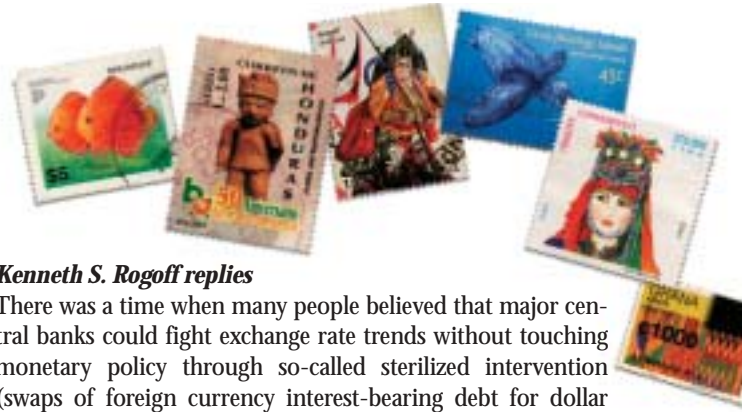
The article "Prolonged Use of IMF Loans: How Much of a Problem Is It?" (December 2002) will probably not be very helpful in promoting understanding of the problems of the borrowing countries. First, a full explanation of prolonged use is not provided. The "deep-seated structural problems" considered one of the factors in prolonged use are not identified. Rather, the article is sprinkled with exotic analyses or terms that are more astonishing than explanatory. For example, the expression "seal of approval," used to mean that a certain form of aid (in fact, debt relief) is linked to programs supported by the IMF, is not likely to please the millions of poor people who have suffered the social costs of repeated programs. Likewise, stating that the IMF has been pressured by governments contradicts all the literature on this topic.

Second, the authors' assertions are all the more surprising in that they are found in a *Finance & Development* issue in which the different "new-style" financial crises and the issue of how much debt is too much are rigorously analyzed. The various articles in this issue should provide an understanding that the prolonged adjustment required of debtor countries results from the fact that, before the HIPC

Initiative, their solvency problems were understood to be liquidity problems.

The authors do, however, show some lucidity in proposing that the IMF "strengthen the ability of its staff to analyze political economy issues to achieve a better understanding of the forces that are likely to block . . . reforms." Indeed, programs developed using the IMF's old monetary model could end up prolonging the use of IMF resources. This model is an operational version of the monetary approach to the balance of payments, which links the balance of payments and exchange rate directly to the money supply and domestic credit. Empirical research has, on the whole, not validated this approach. Moreover, the model dates back to the time of fixed but adjustable exchange rates. It can be demonstrated that, in a context of floating exchange rates, the model is not determinative. It should also be noted that the IMF has frequently shown that the purchasing power parity principle underlying the monetary approach to the balance of payments is generally not a good guide for short- and medium-term exchange rate behavior.

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signal of official intention to the markets. Sterilized intervention may not always work, and monetary policy may have to change on rare occasions to achieve exchange rate goals, but there is clearly an additional policy instrument to address the additional policy target of external equilibrium.

Despite the recent accumulation of theory and evidence in support of this thesis, it remains extremely controversial in both policy and official circles. Hence, it is worth noting that all three instances of intervention by the United States and the relevant partners in the second half of the 1990s achieved their goals: stopping and then reversing the excessive decline of the dollar (especially against the yen) in 1995, stopping and then reversing the excessive decline of the yen in 1998, and stopping and then reversing the excessive decline of the euro in 2000. None of these cases involved policy changes, simultaneously or sequentially, that could explain the sharp turnaround in exchange rates that subsequently occurred.

Contrary to Rogoff, there appears to be a strong case for at least occasional coordination in the currency markets. Some of us would go further, using the availability of the additional policy tool to try to prevent misalignments *ex ante* by managing the system of flexible rates via some version of target zones, reference ranges (as in the Louvre Accord of 1987), or monitoring zones (as now favored by my colleague John Williamson). There is both theoretical and empirical evidence that maintaining credible ranges promotes mean reversion of floating currencies toward the notional mid-points of those ranges, presumably the equilibrium levels agreed by the participating countries on the basis of calculations that the IMF (under Counsellor Rogoff) already prepares routinely. The huge flows of private capital that officials say they fear so much and use as an excuse not to adopt such a regime would thus, in practice, support the regime's viability and limit the need for intervention, let alone broader policy adjustments.

There is growing recognition that the "corners" consensus of a few years ago—that the only viable currency regimes were unalterably fixed rates or free floats—is inoperable because few countries qualify for the former and fewer still will accept the latter. The real issue is whether to manage flexible rates on a purely *ad hoc* basis, as the G-7 countries have done for over a decade (except, of course, for intra-Euroland rates), or to implement a modest regime of zones or ranges around the floats to avoid the prolonged deviations from equilibrium to which they are now so frequently prone. The debate of recent years over reform of the international financial architecture has ignored this most important of all systemic questions. I hope that Counsellor Rogoff will urge the IMF membership to address it rather than attacking straw men with pejorative rhetoric.

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Kenneth S. Rogoff replies

There was a time when many people believed that major central banks could fight exchange rate trends without touching monetary policy through so-called sterilized intervention (swaps of foreign currency interest-bearing debt for dollar interest-bearing debt). But, nowadays, only a small minority think that even \$10–20 billion of debt redenomination here and there is going to have much impact on the massive euro and dollar debt markets, to which U.S. and European governments alone are adding almost a trillion dollars a year in net new debt. Yes, some minute-to-minute foreign exchange traders might get burned, though most empirical studies find that it is the central banks that consistently lose money trying to tilt against windmills like Don Quixote. My read of the extensive empirical evidence is that sterilized intervention works only when it signals changes about underlying interest rate policy. But for the big three central banks, other communication devices (for example, U.S. Federal Reserve Board Chairman Greenspan's speeches and testimony) have a much greater impact. In fact, contrary to Dr. Bergsten's claim ("a non-problem"), G-3 interest rate policy coordination has potentially far-reaching cross-border effects, and not just on exchange rates. That is why virtually all of the modern academic literature on international monetary policy cooperation focuses on interest rates, not sterilized intervention.

P.S. Yes, sterilized intervention can significantly affect exchange rates in many developing countries today. This was also the case for Europe in the 1950s, and for much the same reasons: relatively thin markets and capital controls. But imposing capital controls just for the sake of being able to implement sterilized intervention does not make any sense for G-3 countries with their mature and reasonably well-regulated financial markets.

Odious debt, odious credit

The IMF deserves credit for the ethical progress it has made in indentifying what has rightly been called "odious debt" (June 2002). There is also a need to identify "odious credit"—the situation created when international lenders lauded a particular finance minister for "successful and paradigmatic" economic policies. That "blessing" made it possible for said minister's country to "happily" continue taking loans (some from those same lenders) and accumulating debt until . . . default. Such was the case of former IMF Managing Director Michel Camdessus, who lavished praise on Argentina's former economy minister Domingo F. Cavallo and kept recommending and approving loans for my country, with the result the world knows. Isn't the IMF obliged to follow the legal Anglo-Saxon principle of accountability?

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