

REINING IN EXCHANGE RATES

A better way to stabilize the global economy

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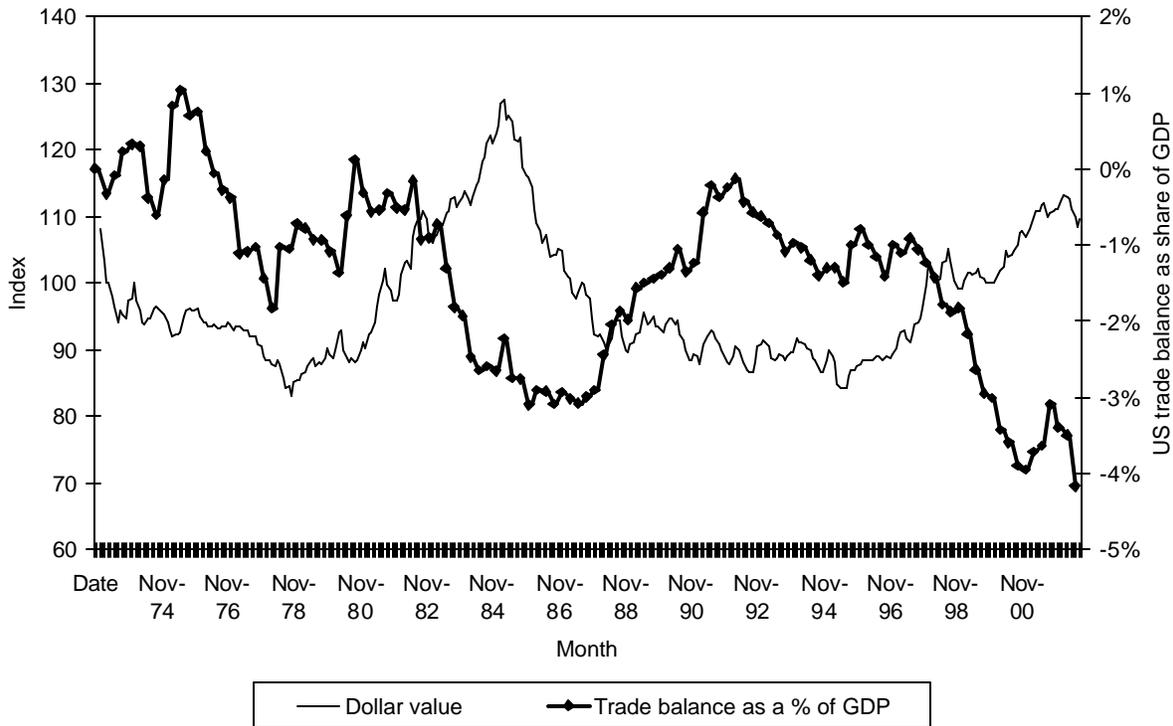
The continued crisis in Argentina that has put other Latin American countries, most notably Brazil, on the verge of an economic crisis will keep the IMF and the World Bank well occupied at their meetings in Washington D.C. in September. Underlying the Argentine crisis was the fact that its local currency has been tied to the U.S. dollar since 1991. This arrangement worked fine as long as the value of the dollar was stable. But beginning in 1995, the dollar—and hence the Argentine peso—became overvalued, so much so in fact that, by late 2001, the dollar's more than 30% overvaluation hurt exporters in Argentina. Following rising trade deficits, Argentina experienced growing demands for overseas debt that ultimately pushed the economy to the breaking point by the end of 2001.

While the economic consequences of the overvalued dollar were more severe in Argentina than elsewhere, there were also serious ramifications for the U.S. economy from the dollar's persistent overvaluation. Due to the high value of the dollar, the U.S. trade deficit rose to record heights (see **Figure A**). As a result, the U.S. has lost more than three million high-paying jobs, mostly in manufacturing industries like aircraft, electronics, steel, and textiles. Moreover, the growing deficits have required increasing amounts of capital inflows, turning the United States into the world's largest debtor, and putting its economic stability at risk.

To stabilize the U.S. and the global economy, the dollar's overvaluation has to be addressed. This requires first and foremost lowering the dollar's value in an orderly fashion. That is, the dollar's decline cannot be too fast, and it has to be significant enough of a decline to counter the dollar's run-up since

FIGURE A

The dollar and the U.S. trade balance



Source: Federal Reserve real broad dollar index (BoG 2002).

1995. Early in 2002, this trend toward growing overvaluation began to reverse course—albeit only temporarily—and the dollar began to decline rapidly against some major currencies. Although many groups had clamored for a lower dollar value, a rapid decline could have posed serious threats to the long-term growth and stability of the U.S. economy. And even if the dollar’s fall had corrected for its overvaluation, there is no mechanism that will prevent another appreciation in the future.

The rise and limited fall of the dollar reflects a failure of foreign currency markets to properly manage exchange rates because flexible exchange rates are prone to over- and undervaluations. Although governments can and do intervene to influence exchange rates, their resources are limited compared to the size of currency markets. And the interests of many countries are not necessarily aligned, such that the intervention by one country may very well be opposed, or at least not supported by, other countries. The stability of the global economy, however, is in everybody’s interest. To avoid exposing industrialized economies and many emerging economies to rapid, large, and uncontrolled currency fluctuations, a new, more regulated exchange rate regime is needed. This change requires a system of exchange rates whereby participating central banks coordinate their efforts to intervene in order to maintain exchange rate stability, coupled with capital controls to reduce the influence of large financial flows in currency markets.

The dollar's overvaluation and its consequences

Large capital inflows to the United States resulting from the economic developments in the late 1990s led to the appreciation of the dollar after 1995 (Blecker 1999a, 1998).¹ Faster U.S. economic growth after 1995 relative to Europe and Japan helped attract capital to the United States because it was seen as a promising investment. With the demand for dollars increasing, the dollar gained quickly in value. After financial crises roiled Asia and Russia in 1997 and 1998, many investors looked for a safe haven, which they found in the United States; this demand for dollars again increased the currency's value. When the world went into an economic slump and stock prices dropped in 2000, the United States managed to maintain its allure as a safe haven. Amid economic and financial market turmoil, the strong dollar, combined with the U.S. Treasury's policies to keep it that way, seemed a safe bet to investors. By the end of 2001, the dollar reached its highest value since January 1986.

But beginning in early 2002, investors started looking elsewhere. Skepticism about investments in the United States emerged, especially when the robustness of a U.S. economic recovery seemed questionable. Consumer spending was largely stimulated by an increase in consumer debt, and investment spending remained sluggish. Doubts about profit forecasts emerged,² and investors began looking for investment opportunities in Asia and Europe (WSJ 2002). These concerns were exacerbated by uncertainties over corporate accounting practices at U.S. corporations, and the warnings of additional terrorist attacks made investors even more reluctant to invest in U.S. securities (DJN 2002a). When Europe successfully completed the common currency's last step in January 2002, with the introduction of coins and bills, investors now had a viable alternative to the United States.

By August 2002, the decline in the dollar slowed but well before erasing most of the currency's large overvaluation. Largely, the decline in U.S. financial markets seemed to have reached its bottom, instabilities in other parts of the world, especially in Brazil, increased the allure of the United States as a safe haven again, and growth prospects in Europe and Asia remained weak. With the dollar's decline falling far short of erasing most of the currency's gains over the past few years, the main concerns over a persistent overvaluation, in particular with respect to the U.S. and global economic stability, remained intact.

One country that was adversely affected to a large degree by the high value of the dollar was Argentina. The overvalued dollar hampered economic growth and pushed the Argentine economy into a depression at the end of 2001 (Weller 2002a). Demand for Argentine exports abroad slowed due to the rising costs that resulted from an increase in the peso, which has been pegged to the U.S. currency since early 1991. Since the dollar's (and hence the peso's) value rose dramatically against other currencies beginning in 1995, export growth lagged and import growth soared in Argentina, as it did in the United States. From 1991 to 2000, Argentine exports averaged 9% of GDP, down from 9.8% in the early years of the Argentine democracy (1984-90), whereas imports averaged 10.4%, up from 6.1%. Consequently, the trade balance was consistently negative, at an average of 1.4% of GDP (IMF 2002).

Also, workers, businesses, and the economy suffered, although the strong dollar helped minimize inflation during the 1990s.³ U.S. manufacturers were hit especially hard by competition from overseas producers who enjoyed an advantage simply because of the dollar's high value (Blecker 1999a). Further-

more, U.S. exports were artificially expensive, reducing demand worldwide for U.S. products. As a result, manufacturing growth slowed and a record number of manufacturing plants moved overseas; three million job opportunities were lost after 1994—aided by new trade and investment agreements with low wage countries (Scott 2001). In fact, the 1990s boom was the first time in U.S. history that manufacturing jobs were lost during an economic expansion (Palley 2001). Moreover, these growing deficits required increasing amounts of capital inflows, turning the U.S. into the world's largest debtor and putting its economic stability at risk.

The problems in the U.S. manufacturing sector pose a critical medium- to long-term challenge for maintaining U.S. economic growth and stability during and after a devaluation. Particularly, the strong dollar, which benefited from and fuelled a stock market bubble, resulted in decreased investment growth in the manufacturing sector (Weller and Helppie 2002). The growing trade deficit also led to reduced employment, hitting the manufacturing sector especially hard (Scott 2001). Consequently, the manufacturing sector lost potential physical and human capacity during the dollar's overvaluation. Because manufacturing is the main export sector, to close the trade deficit, manufacturing output would have to grow substantially. Although manufacturing currently operates well below full capacity, capacity constraints could quickly pose a problem if the dollar depreciates over a long period. As a rule of thumb, a trade deficit begins to decline about 12 months after a currency depreciation begins (Dixit 1994). That is, after one to two years, the manufacturing sector may face serious capacity constraints unless businesses invest more. Without a clear indication that the dollar will fall far enough and stay low, businesses have no incentive to undertake these investments. But if the capacity constraints are not addressed, a falling dollar could mean rising prices and slower growth.

Currency markets will not get it right

Initially, many analysts acknowledged the inevitability of the dollar's devaluation in early 2002 (WSJ 2002a), but it was not clear how fast and how far the dollar will fall. By August 2002, it became clear that relying on flexible exchange rates did not produce the desired gradual decline that would erase enough of the currency's overvaluation to close the trade deficit in the medium term.

In fact, despite much talk about the uninhibited workings of exchange rate markets, most governments acknowledge that free-floating exchange rates do not necessarily produce the desired outcomes, and so governments intervene to influence the value of their currencies. Direct intervention is the most likely option to have a predictable effect on exchange rates, with governments buying or selling their currency. To lower the dollar against other currencies, governments could sell dollars in exchange for foreign currency. Selling dollars, though, means expanding the money supply in the United States, which could be offset, or sterilized, by selling bonds in the U.S. local currency.⁴

Governments and central banks can also influence foreign exchange markets through public statements that manipulate the expectations of market participants. However, this approach only works if policy makers can support their statements with actions, such as by intervening in the market directly.

Changing economic fundamentals can also impact exchange rates. For instance, part of the dollar's

rise was caused by the Clinton government's commitment to deficit reduction in the mid-1990s, which gave rise to hopes for lower interest rates and faster growth. But the impact of changes in economic fundamentals on exchange rates is hard to predict (Blecker 1999b). For example, the rapid interest rate cuts by the Fed throughout 2001 should have resulted in a weaker dollar, but continued global uncertainties about growth prospects elsewhere helped to maintain the status of the United States as a safe haven, hence sustaining the high value of the dollar.

The success of government interventions by an individual country or in concert with other countries—as discussed further below—is often limited because interventions still have to rely on currency markets to ultimately get it right. In particular, the tools of governments pale in comparison with the size of foreign exchange transactions. Total foreign exchange market transactions amounted to \$1.4 trillion per day in 2001 (BIS 2002).⁵ The vast majority of this trading, about 90%, was done by foreign exchange dealers and other financial institutions (BIS 2002). In comparison, there are currently \$1.7 trillion held as reserves in central banks worldwide.⁶

In a world where that much money quickly changes hands, there is a good chance that exchange rates will become over- or undervalued, often for extended periods. An important reason for the failure of free-floating exchange rates is that they are often influenced by large capital movements, which are driven by the expectations of market participants, such as banks. The pattern of rapid capital inflows that lead to currency overvaluations, rising trade deficits, and stock and debt market bubbles seems to be symptomatic of the growing number of financial crises in developing countries (Weller 2001). Even a few smaller industrialized economies—such as Sweden, Finland, or Norway in the early 1990s and Korea in 1997—fell prey to the vagaries of international financial flows. Their stock markets and currencies were first bid up to unrealistic levels and then tumbled in a matter of days and weeks following rapid capital outflows. The United States is not immune to the fallout of large, unregulated international capital flows, either. For example, the U.S. dollar experienced another jolt when investors sought a safe haven for their investments after the Asian financial crisis. The inflow of new capital led to a further overvaluation of the dollar and to the continuation of the stock market and debt bubbles due to the inflow of fresh money. All these trends fuelled each other with the undesirable effect of increasing the U.S. trade deficit. With the trade deficit soaring to record heights amid a weak economy, the chance of a financial crisis in the United States is increasing.

In other words, given that we live in a world of high capital mobility, over- and undervaluations of currency are likely to occur regularly, and appropriate exchange rate valuations are often only of a temporary nature. That is, flexible exchange rates in combination with growing capital mobility are unlikely to be stable. The alternative of fixed exchange rates in combination with capital mobility opens the door too easily for speculators, as the experience in Great Britain in 1993 and in Mexico in 1994 showed. For exchange rates to be more stable they have to become less flexible and capital mobility has to be reduced. But, for the past few decades, the trend has been toward greater exchange rate flexibility and increased capital mobility, and governments have responded to over- or undervaluations through both uncoordinated or coordinated interventions in foreign exchange markets.

Uncoordinated interventions prove unsuccessful

There are examples for uncoordinated interventions in foreign exchange markets to stabilize the dollar's value. For instance, on August 15, 1995, Japan, Germany, and the United States intervened in the foreign exchange markets—without formal agreement to cooperate—by purchasing \$3 billion to boost a sluggish dollar by 3% (Makin 1995).

A similar intervention occurred in early 2002 when many observers considered the decline of the dollar inevitable. When the speed of the adjustment gave rise to concerns, the Japanese government intervened several times to halt the rapid decline of the dollar.

Both Japan and the European Monetary Unit (EMU) theoretically had an incentive to keep the dollar from falling too fast since their recoveries depended upon exports. But only Japan seemed inclined to intervene to slow the dollar's slide against the yen. In the fall of 2001, Japan spent the equivalent of 2.3 trillion yen (approx. \$18 billion) during 10 different interventions, boosting the dollar against the yen and helping its export producers (DJN 2002a). Later, between mid-May and early June 2002, Japan intervened in the foreign exchange markets to slow the dollar's decline (DJN 2002c). The Japanese government employed three methods to influence the dollar's value: verbal threats, pressures on financial institutions, and direct interventions. In mid-May 2002, the government issued statements warning it would take direct action if the yen did not depreciate against the dollar (WSJ 2002c; DJN 2002c). Following the final direct intervention, Tokyo again warned that, if the yen continued to appreciate, the government would purchase additional dollars (DJN 2002d). Concurrently, rumors circulated that the government was pressuring pension funds to buy foreign assets. Moreover, during the week of May 16, 2002 there was speculation that the government-run postal life insurance fund was switching funds to dollar-denominated assets (DJN 2002c). Since threats and pressures on financial institutions did not halt the dollar's decline, the Bank of Japan purchased dollars directly on four separate occasions in late May and early June 2002, totaling as much as \$20 billion (DJN 2002e).⁷ Despite Japan's interventions, the dollar's decline against the yen continued virtually unabated, with the dollar quickly reverting to pre-purchase levels.

Europe did not show the same penchant as Japan to intervene. The dollar's decline poses a dilemma for the European Central Bank (ECB). A low dollar value hurts European exporters and European growth, but lower import prices reduced inflationary risks. Since the ECB's mandate prioritizes inflation over growth, an intervention in favor of a slower dollar decline by the ECB was unlikely (Weller 2002).

Although the United States stood to gain the most from an orderly decline of the dollar, the U.S. government showed no concern with the dollar's high value or its decline. In fact, the Bush Administration held firm to the strong value of the dollar throughout 2001 and 2002. Although one of U.S. Treasury Secretary Paul O'Neill's first public statements in 2001 referred to the dollar's overvaluation, he retracted the statement shortly thereafter and has staunchly defended the dollar's value ever since (*USA Today* 2002; Eaker 2001). Lawrence Lindsey, head of the White House's National Economic Council, dismissed the dollar's decline in early 2002, stating that it put the dollar only 3% off peak. He reiterated the administration's support for a strong dollar, as did White House spokesman, Ari Fleischer (WSJ 2002b; DJN 2002b).

A new Plaza Accord is insufficient

Instead of relying on markets to get exchange rates right and on governments to intervene in an uncoordinated fashion, a more coordinated approach could be considered, such as a repeat of the 1985 Plaza Accord. On September 22, 1985 the finance ministers and the central bank governors of France, Germany, Japan, the U.K., and the United States agreed to a gradual devaluation of the dollar. Over the following three years, the dollar was devalued by approximately 25%. The agreement, referred to as the Plaza Accord, acknowledged the precarious situation of a global economy faced with a substantially overvalued dollar and a soaring U.S. trade deficit. Reagan's policies, designed to aid a struggling U.S. economy and low domestic morale, resulted in a 31% appreciation of the dollar between December 1981 and March 1985, the dollar's highest value ever.⁸ To accomplish the devaluation, the five economic giants of the day outlined specific measures their countries would take in a coordinated fashion to intervene in the foreign exchange markets to help the United States lower the dollar without precipitating a domestic or global crisis.

For another such accord to work, the major industrialized economies would have to have enough resources to influence the course of exchange rates, and their interest in lowering the value of the dollar would have to be the same. Both conditions, however, cannot currently be met. For one, central banks do not have sufficient reserves to successfully manipulate foreign exchange markets. Total foreign exchange market transactions amounted to \$1.4 trillion per day in 2001, 90% of which was done by foreign exchange dealers and other financial institutions. In comparison, there are currently \$1.7 trillion held as reserves in central banks worldwide. Not surprisingly, foreign exchange markets are not impressed with the tools available to central banks, as the recent Japanese experience has shown.

Second, another agreement like the Plaza Accord requires the willingness of the major central banks to lower the value of the dollar, and to slow its decline should it fall too quickly. Both conditions are unlikely to be met. In the middle of 2002, when the decline of the dollar stalled, none of the major industrialized economies intervened to ensure a further decline. Since the United States and Europe would most likely accept a further decline, the question is whether the participating central banks would be willing to intervene if the dollar fell too quickly. Here, the ECB may prove to be the biggest obstacle since there does not seem to be any incentive for it to intervene.⁹

Most importantly, a new Plaza Accord to reduce the dollar's value would do very little to prevent a repeat of the current situation. Because Japan, as well as other less-industrialized economies such as China, have a vested interest in a strong dollar to promote domestic growth through increased exports, a similar run-up in the dollar's value as in the late 1990s or a continued overvaluation are likely to happen again.

A better way to manage exchange rates

Relying on markets to get exchange rates right is unlikely to be successful, even when allowing for central bank and government interventions. For one, the resources of central banks and governments pale in comparison to the size of foreign exchange markets. Also, the interest of many major economies are not aligned, such that the intervention by one country is likely to remain unsupported or even opposed by

others. And there is no mechanism in place that would prevent another massive overvaluation. Even more so, the combination of flexible exchange rates and large scale capital mobility is likely to produce regular currency overvaluations all around the world.

Because markets are unlikely to get exchange rates right, the focus should be on a new system of exchange rates for the major industrialized economies and not just on an ad hoc measure to lower the dollar's value. A new system of exchange rates would also offer the advantage that a renewed increase of the dollar's value would become less likely. If a new system of exchange rates can be designed such that a recurrent overvaluation of the dollar, or respectively, undervaluation of the euro, can be avoided, the ECB would have an incentive to participate since it would mean a reduction in long-run inflationary risks. Establishing such a system would also provide a vehicle for the participating countries to engineer the decline of the value of the dollar in such a manner that it is least likely to cause disruptions to growth and stability.

One option to stabilize the exchange rates of industrialized economies would be to establish a system of quasi-fixed exchange rates, similar to the European Monetary System (EMS) (the precursor to the EMU) in combination with some capital controls and an international stabilization fund.¹⁰ The evidence suggests that exchange rates within fixed bands tend to be more stable than floating exchange rates (Williamson 1999).

Under this Global Monetary System (GMS), the exchange rates of the major industrialized economies would be allowed to float within a certain band around a pre-defined center.¹¹ All currencies would be pegged to one common (hypothetical) currency. The mechanics of this common accounting unit (CAU) would mirror the calculation of the European Currency Unit in the EMS. That is, the CAU would be equal to a basket of the participating currencies, with each currency receiving a weight equal to its respective economy's relative size. Subsequently, each currency would be fixed to the CAU bilaterally and be allowed to fluctuate within certain limits above or below this fixed value. The bandwidth of fluctuation should be defined broadly—by maybe +/-10% around the center—to offer the participating countries maximum macro policy flexibility, to contain speculative pressures, and to account for imprecise measures of the center exchange rate.¹²

The center of the band would be occasionally readjusted to reflect differences in inflation rates between participating countries.¹³ Participating central banks would defend the “hard” bands, i.e., countries would be obligated to defend them, through coordinated interventions, when an exchange rate hit the upper or lower bound of its band. Also, the center of a band could be realigned to respond to real shocks, such as a permanent worsening of trade terms following different productivity growth rates, permanently reduced capital inflows, or external debt increases (Williamson 1999).

To defend bilateral exchange rates against short-term speculative attacks, the GMS should be supported by an International Stabilization Fund. This fund would be financed through the revenue generated from the imposition of financial transaction taxes, or so-called Tobin taxes. For instance, Baker (2000) estimates that a transaction tax for securities transactions in the United States equal to 0.25% of the transaction's value could generate \$120 billion in revenue each year. Similarly, assuming a tax imposed on both sides of a currency transaction equal to 0.01% of the value of the transaction in the four

major currencies (dollar, euro, yen, and pound sterling) would raise more than \$133 million each trading day, or \$33 billion per year, even if trading volume declined by one-third.¹⁴

However, even with the participation of all industrialized economies and the support of the Stabilization Fund, the resources are relatively limited compared to those in the private market in foreign exchange markets, as the experience of the EMS has also shown. Foreign exchange dealers put the narrow-band EMS under pressure in 1992 and 1993 when some exchange rates within the system were believed to be out of synchronicity. As the EMS could no longer maintain its regime of quasi-fixed exchange rates, it replaced the narrow bandwidths with substantially wider ones in August 1993, allowing for fluctuations of +/-15% around the center of the band for each currency.

Although industrialized economies are likely to manage fluctuations within broader bandwidths quite successfully by relying on monetary policy, with some support from fiscal policy,¹⁵ additional tools may be necessary to curb capital flows. This would facilitate the management of the exchange rates by reducing the costs of interventions to the participating governments and by reducing the need for policy coordination between the participants. Already, the volume of foreign exchange transactions may be reduced by the introduction of a Tobin tax. Additionally, obligatory interest-free reserve requirements against short-term foreign loans could be used by the monetary authorities, as done in Chile in the 1990s, as the most effective way to curb capital mobility (Williamson 1999).

The new GMS would combine part of the stability of fixed exchange rates with part of the macro policy flexibility common to flexible exchange rates. Moreover, the GMS would provide governments and monetary authorities with incentives to coordinate macro policies either formally or informally to avoid misalignments and readjustments. In the case of the dollar's recent appreciation, policy makers would have been forced to address the problem of the rising dollar, rather than ignore it. Possible policy responses could have been to pursue new trade and investment agreements more carefully in light of rising trade deficits. Consequently, current account deficits may have been smaller and the dollar's appreciation may have been slower, thereby reducing the need to intervene.

The new GMS would have a reasonable chance of achieving exchange rate stability between the major industrialized countries and other parts of the world. In exchange for participating in a coordinated effort to limit exchange rate fluctuations, the ECB (and other central banks) would essentially receive a promise of limited inflation risks arising from currency markets. Also, many emerging economies tend to tie their currencies to those of their major trading partners, as Argentina did in the early 1990s. Consequently, the stabilization of the exchange rates of the major industrialized economies should also have positive effects on the exchange rates of many emerging economies. For instance, with a more stable value of the dollar, Argentina's trade account would have been more balanced, and the economic crisis that struck in late 2001 would probably not have happened.

Conclusion

In the era of global deregulation (and increasingly independent central banks), proposals to generate greater coordination between governments and monetary authorities and more financial market regula-

tions may seem anachronistic. However, the proposal for a new Global Monetary System would allow governments to take more control of their economic destinies within the context, and under consideration, of a global economy. Absent significant changes in the way we deal with exchange rates between the major industrialized economies, advocates of free-floating exchange rates are effectively saying that we will have to rely on our luck to get it right. Considering past experience and the high costs of getting it wrong, this is too great a risk to not reevaluate the benefits of prudent coordination and regulation. The experience in Argentina as well as in the United States has shown that a prolonged overvaluation of the dollar can put individual economies, and possibly global economic growth, in jeopardy. In particular, large financial instabilities both in industrialized and emerging economies will remain, thus putting the weak U.S. recovery of the last few months and the stability and growth of the world economy in jeopardy.

—*September 2002*

Endnotes

1. The low dollar in the early 1990s was often lamented by the Clinton Administration since it raised investment costs for U.S. businesses overseas according to a senior administration official on July 07, 1994, and made the financing of government deficits more expensive (NA, 1994, 1995). But the strong dollar policy of the Clinton and Bush governments is usually associated with denying that the dollar became overvalued.
2. The dollar's high value compounded the problem, as U.S. multinationals were forced to repatriate foreign earnings at unfavorable exchange rates.
3. Inflation was kept in check due to an onslaught of imports that were artificially more competitive than U.S. products due to the dollar's overvaluation.
4. Theoretically, the U.S. could increase the money supply enough to erase the dollar's entire overvaluation. While some of the additional money supply will simply lead to increased reserve holdings overseas, an extensive increase in the money supply may ultimately lead to inflationary worries in the United States. The Federal Reserve, which has demonstrated its anti-inflationary zeal, may raise interest rates, thereby increasing demand for dollars, and erasing the effects of the greater dollar supply on foreign exchange markets.
5. This figure includes cross-border inter-dealer double counting. Excluding this figure lowers the total transaction volume to \$1.1 trillion per day.
6. Many central banks also maintain reciprocal foreign exchange swap agreements that increase the potential stock of reserves. In the private sector, daily transactions for swaps are \$933 billion compared to \$520 trillion in the spot market. However, even if swap agreements led to a tripling of reserves, total reserves would only equal about one week's worth of foreign exchange transactions.
7. There are several reasons for the relative ineffectiveness of the more recent currency interventions as compared to the ones in 1995. First, the 1995 intervention supported the dollar on its upward trajectory, whereas the 2002 interventions were meant to alter its downward trajectory. Second, economic fundamentals supported each trajectory, making currency interventions less justified. Third, international investors now have an option to invest in with the arrival of the euro, thereby making successful interventions harder to achieve.
8. The figure is based on the Federal Reserve's real broad dollar index (BoG 2002).
9. This assumes that the euro will not rise enough to turn growth negative in the EMU.
10. See John Williamson (1999) for a discussion of "crawling bands" in emerging markets and John Grieve Smith (1997) for a proposal target zones in combination with an International Stabilization Fund to stabilize exchange rates regionally.
11. To maximize resources of all the largest industrialized economies, the EMU, Japan, the U.K., and the United States should participate to ensure a stable system of exchange rates. China is also a major holder of foreign reserves and one of the largest emerging countries with a vested interest in maintaining a high value of the dollar. But China's participation in the GMS, or similar arrangements, seems unlikely for political reasons.
12. Williamson (1999) suggests a band width of +/-15% for crawling bands for less industrialized economies, but Grieve Smith (1997) proposes a narrower band width of +/-5-10%. Also, the EMS broadened its bandwidth to +/-15% in response to speculative attacks, thereby ending the attacks.
13. Because inflation rates do not vary much across the large industrialized countries, such adjustments could be undertaken rather infrequently, say once a year.
14. These calculations are based on foreign exchange trading volume figures for 2001 in the EMU, Japan, the U.K., and the United States (BIS, 2002).
15. The goal should be to limit excessive fiscal deficits—often precipitated by large tax cuts—as was the case for the U.S. during the late 1980s, to limit the need of a country to borrow overseas to a sustainable path.

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