

“A Foreign Exchange
and **Policy**
Retrospective”

**Written Version of Remarks Delivered
at the Twenty-Fifth Anniversary
of the Foreign Exchange Committee**

**John B. Taylor, Under Secretary
of the Treasury for International Affairs**

October 2, 2003



“A Foreign Exchange and **Policy** **Retrospective**”

Good evening. It is a pleasure for me to be here to help mark the twenty-fifth anniversary of the Foreign Exchange Committee. I thank David Puth for his kind introduction and Dino Kos for the invitation to speak. I have benefited greatly from the conversations I have had with both of them and others close to the foreign exchange markets since I have been in my current position at the U.S. Treasury.

We appreciate the work of the Foreign Exchange Committee over the past twenty-five years. You have helped to foster the successful development of one of the largest and most valuable markets in the world. The growth and stability of the world economy depends on a reliable and efficient means of making payments, transferring funds, and determining the rate of exchange between currencies. With around-the-clock trading and turnover of about \$1.2 trillion a day, the foreign exchange markets deliver an essential service to a multitude of corporations, governments, investors, and people on holiday. It is worthy of note on this anniversary occasion that foreign exchange trading is now hundreds of times greater than that at the time of the birth of the Committee.

Good market structure must embrace integrity and transparency. So we applaud the work of the Committee on guidelines for trading and best practices on operations. I examined the Committee’s most recent update of best practices from March of this year. There are sixty best practices in all. I must say that the one that especially attracted my attention was the last one: Best Practice number 60: Develop and Test Contingency Plans. Contingency planning—both the strategic and tactical parts—is something we have been doing a lot of lately in the Treasury.



Contingency Planning: An Important Example

You may have heard about our contingency planning for the currency in Iraq. It was developed well before the start of the military conflict. Its aim was to establish economic stability and prevent economic crisis in the wake of the fall of Saddam's regime. This required that Iraqi workers be paid and that Iraqi pensioners receive payments following Saddam's fall. It also required that the currency remain stable. Our plan was to pay people in U.S. dollars, on an interim basis, using Saddam's dollar assets that were frozen back in 1990. This would both create stability and give the Iraqi people the means of purchasing goods, including consumer goods from abroad. After making these initial dollar payments, we then planned to help the Iraqi people introduce a new Iraqi currency of their own choosing.

I am happy to say that this plan is on track. We have paid millions of Iraqis over a billion dollars in U.S. currency. I am also happy to say that there has been no collapse of the Iraqi currency, that a new national currency has been designed, and that it is ready to be introduced into circulation. We are shipping twenty-seven Boeing 747 planeloads of the new currency to Iraq from printing facilities in England, Spain, Germany, and Sri Lanka. I have a few specimens here if you want to see them.

As this story illustrates, currency markets are an even larger part of our job at the U.S. Treasury than commonly appreciated. And there are other interesting stories I could tell—about the warlords' currencies in Afghanistan, about provincial currencies in Argentina. But tonight I would like to share some perspec-

tives on the more developed currency markets that you are engaged in.

Policy Principles

Our policy on exchange rates is part of our overall international economic strategy. The strategy stems from a deep commitment to economic growth and economic stability. The recent G-7 Agenda for Growth, just agreed to by finance ministers and central bank governors in Dubai, is our latest pro-growth initiative. It is a short one-page attachment to the G-7 statement. It provides a process for benchmarking and reporting, in which each G-7 country takes actions to spur growth and create jobs. It focuses on supply-side policies that increase flexibility and remove structural barriers to economic activity. I think this G-7 Agenda for Growth is a tremendous achievement. It reflects the product of Secretary Snow's hard work in his travels to Europe in July and Asia in September in challenging other financial officials to dedicate themselves to strengthening growth.

We have also been encouraging countries to adopt flexible exchange rate regimes. Flexible exchange rates promote smooth adjustments in the international financial system. They ease the adjustment to changing fundamentals. To work well, however, flexible exchange rate regimes require a monetary policy with a focus on price stability and with a transparent procedure for setting the instruments of policy. In fact, I often refer to this as the *trinity*: 1) a flexible exchange rate, 2) a goal of price stability, and 3) a systematic process for adjusting the policy instruments.



We emphasize that the choice of an exchange rate regime is one where country ownership is particularly important. We also recognize that, especially in the case of small open economies, there are benefits from a “hard” exchange rate peg, whether dollarizing, as with El Salvador, joining a currency union, as with Greece, or using a credible currency board, as in Bulgaria or Hong Kong. Of course, these various hard pegs will not prevent the adverse consequences of poor economic policies

The recent G-7 statement also addresses exchange rate issues, as has been much discussed. I know from spending time on trading floors that a lot of trading and price changes take place on the basis of headlines flashing across traders’ screens. So let me read all three sentences on the exchange rate that appeared in the G-7 statement. They are fully consistent with the principles that Secretary Snow has been stressing. It says that:

“We reaffirm that exchange rates should reflect economic fundamentals. We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas to promote smooth and widespread adjustments in the international financial system based on market mechanisms.”

Let me emphasize that there was full agreement about this statement, not just Secretary Snow and Chairman Greenspan, but all the other ministers and central bank governors.

It is also important to note that in Dubai, shortly after the release of the G-7 statement, Secretary Snow reaffirmed the commitment to the strong dollar policy. Talking down a currency is bad economics.

Finally, it should be emphasized that this statement about exchange rates was put forth in the context of the broad G-7 Agenda for Growth, which I already highlighted.

Historical Perspective

This twenty-fifth anniversary of the Foreign Exchange Committee is an opportunity to put these policy principles in historical perspective. The birth of the Committee happens to correspond to the period I would characterize as the peak of the bad old days of high inflation and output instability. Much progress has been made since then.

In the 1970s, monetary policy frequently failed to lean hard enough against the wind. As a result, inflation would rise, bringing pressure on the exchange rate, and eventually leading to a decline in output. These swings in inflation and output resulted in more volatile exchange rates.

Monetary policy has changed since these bad old days as evidenced by much greater price stability and output stability in the United States and many parts of the world. The change for the better is reaffirmed by the relatively resilient global economy in the wake of recent shocks. And the move by Brazil, Korea, Mexico and others to adopt flexible exchange rates, combined with clear price stability goals and a system for adjusting



the policy instruments, is one of the reasons we are seeing fewer crises and greater stability. More generally, it is good news that nearly 100 countries have chosen to abandon pegged exchange rates and have either floated their exchange rate, dollarized, joined a currency union, or created a currency board.

This progress can be attributed to historical developments in three broad areas.

First, recognition that higher inflation would not bring about lower unemployment, a view that was widely held before the 1970s.

A second development—closely related to the first—concerns the procedures used at central banks for setting the instruments of monetary policy. The main change here is that decisions about the instrument of policy—frequently the overnight interest rate—are being approached and analyzed in a more systematic fashion both in research and in practice. And when viewed in this more systematic fashion, one can detect an increased responsiveness of the instruments of policy to inflation and the real economy.

Third, success is infectious. The diffusion of ideas and experience about monetary policy around the world represents another

development behind more stable international prices. The Great Inflation of the late 1960s and 1970s is frequently discussed as if it were solely an American inflation. But this same general inflation pattern—and in particular the end of inflation in the 1980s—can be found in many countries and regions of the world. In recent years the diffusion of ideas and experiences is found in the increasing number of central banks emphasizing price stability, transparency, and independence. In fact, the diffusion of ideas has been a powerful force throughout the industrialized world and—perhaps of even larger impact—in improving stability in many emerging market economies previously plagued by hyperinflation.

Groups like the Foreign Exchange Committee help create the diffusion of good ideas. By continuing to bring together the best practices and promoting them, I am sure that the Committee will continue to contribute significantly. And it is important that it does so, because the next twenty-five years are likely to bring about as many changes as we have seen in the past twenty-five years.

Thank you.

