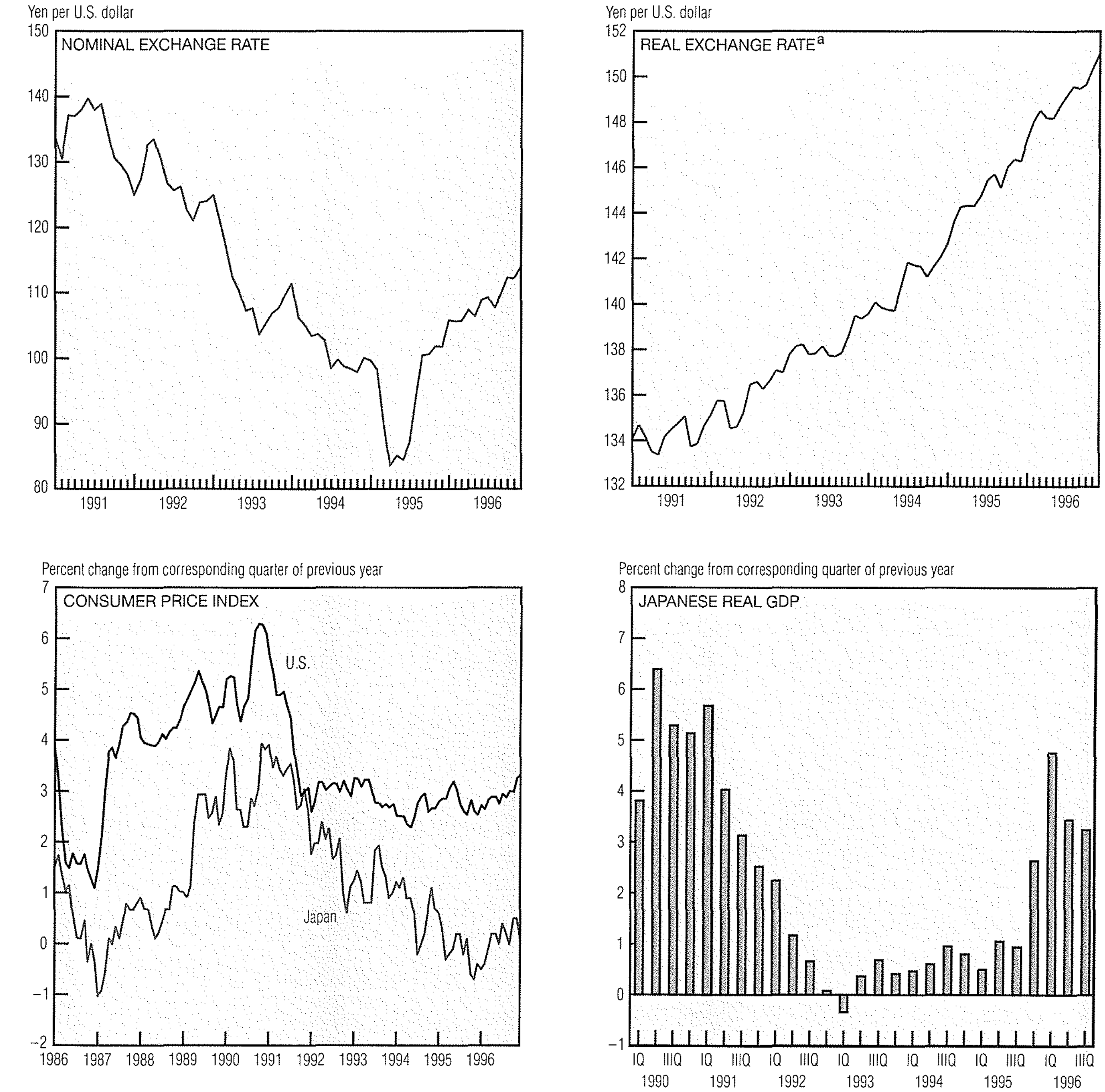
# Monetary Policy and Global Competition




a. The real exchange rate is calculated using consumer prices for both the U.S. and Japan. The base period is November 1991.
SOURCES: Bank of Japan; and the Statistics Bureau of the Japanese Prime Minister's Office.

The dollar's recent sharp rise against the yen has intensified long-held concerns about Japanese manufacturers' competitive edge in U.S. markets. Since March 1995, the dollar has appreciated about 35% against the yen, and many analysts anticipate further advances this year.

When one also weighs the persistent inflation differentials between the two countries, the competitive implications of the dollar's rise seem more challenging. On a real basis, the dollar has appreciated nearly 13% against the yen since 1990. Can policy moves make a difference?

Foreign exchange intervention can send ripples through the market. Much like a rock tossed into a swift river, however, intervention offers no fundamental force with which to alter a market's current. Because success depends on changing traders' perceptions and expectations of events, rather than directly changing fundamentals, intervention's influence is at best fleeting.

Alternatively, the Federal Reserve could ease monetary policy when the Bank of Japan tightened its money supply. This would promote a dollar depreciation at the expense of higher inflation in the U.S. and deflation in Japan. Since exchange rates often respond more quickly than prices, our competitive position might show a temporary improvement that would last only until prices responded fully to monetary pressures. Ultimately, countries cannot improve their competitive position through monetary policy.