Target Zones for Exchange Rates?
by Owen F. Humphage and Nicholas V. Karamouzis

in the sense that changes in their domestic demand and supply conditions have virtually no effect on international prices. Often, the sensitivity of their export and import demands to exchange-rate changes is relatively low; consequently, exchange-rate changes may not have the desired effect on their balance of trade. If foreign demand for a country’s goods falls off, the resulting depreciation of its currency might improve its exports, but it also will greatly increase the cost of its imports. Exchange-rate changes often have major effects on prices and on wage negotiations in the small country. Often these countries do not have a very diversified set of industries so that a large segment of the economy is influenced by developments in a single market. Nevertheless, even small countries periodically break their pegs with larger ones when the costs in terms of inflation and competition elsewhere in the world become too great.

The United States does not fall into the small-country category. For a large country like the United States, the role of a small trading sector like the United States, addressing balance of payments problems through exchange-rate changes seems a better approach than using macroeconomic policy. Yet, credible target-zone arrangement could require just the opposite.

Conclusion
Exchange rates are endogenous variables. This means they do not move on their own. Exchange rates respond to other economic factors, such as changes in interest rates and inflation differentials among countries. Ultimately, exchange rates reflect the prevailing package of macroeconomic policies among countries. If current exchange rates appear to be volatile or out of line relative to their equilibrium values, it is because the underlying monetary and fiscal policies are volatile and unsustainable.

Limiting flexibility of exchange rates without the necessary coordination of macroeconomic policies will not provide a solution to macroeconomic imbalances. The imbalances will show up elsewhere in the economic system. For example, the rapid acceleration of the money supply in the United States in the early 1970s under the Bretton Woods fixed exchange-rate system, led to rapid accumulation of dollar reserves by foreign central banks, to the expansion of foreign money supplies, and to higher world inflation. The Bretton Woods Agreement could not guarantee policy coordination.

The maintenance of target zones narrows the uncertainty associated with exchange-rate volatility requires a rather close degree of macroeconomic coordination. Ironically, if countries achieve and maintain a mutually consistent set of monetary, fiscal, and trade policies, a system of rigid target zones becomes unnecessary. Coordination and cooperation itself could maintain exchange-rate stability.

In recent years, growing dissatisfaction with the levels and the volatility of dollar exchange rates has led to calls for greater coordination of economic policies among nations and for an investigation into an alternative exchange-rate system. A number of economists and policymakers, for example, have advocated limiting the fluctuations of the dollar with a target-zone arrangement for exchange rates. Under such a proposal, countries would establish central exchange-rate values for their currencies and keep the actual exchange rates within a specific margin of the central values. For instance, if Germany, Japan, and the United States agree on central rates of 100 yen to the dollar and 2.1 marks to the dollar, and set the permissible bands around the central rate at 10 percent, then these countries would keep the actual yen-dollar exchange rate between 11.25 and 15.75 yen to the dollar and would keep the actual mark-dollar rate between 1.99 and 2.20 marks to the dollar.

Specific proposals about target zones differ with respect to how the central rates are chosen and the degree of flexibility allowed. But as a first approximation it is useful to consider how exchange-rate changes might be determined by central exchange-rate values.

1. The central rates chosen for a target-zone system are fixed and therefore cannot vary. They are determined by the central bank of the country in which the currency is issued. This means that the central bank of the United States cannot change the official dollar exchange rate without changing the central rate. However, the central bank of the United States can change the central rate by buying or selling dollars in the foreign exchange market. When the central bank of the United States buys or sells dollars in the foreign exchange market, it changes the supply and demand for dollars in the foreign exchange market. This changes the exchange rate of the dollar in the foreign exchange market. However, the central bank of the United States cannot change the central rate of the dollar in the foreign exchange market without changing the central rate of the dollar.

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Japan continues to run a huge trade deficit. One of the main factors that contributes to this trade imbalance is the strong yen. The yen has appreciated significantly over the past few years, making Japanese goods cheaper and more competitive in international markets. This has led to a significant increase in the demand for Japanese goods, especially in the United States. As a result, the dollar should depreciate to offset this imbalance. However, the dollar is not expected to depreciate significantly, as it is considered to be overvalued.

Inflation differentials also play a role in determining exchange rates. If the inflation rate in Japan is higher than in the United States, the yen will appreciate relative to the dollar. This is because the yen is expected to lose its purchasing power relative to the dollar. The International Monetary Fund (IMF) has estimated that if the inflation rate in Japan were to increase by 12% per year, the yen would appreciate by 12% to maintain purchasing power parity.

Other factors besides inflation differentials also affect exchange rates. For example, productivity growth, technology changes, and changes in trade policies can all influence exchange rates. In a target-zone system, governments may try to maintain a fixed exchange rate to promote trade and investment. However, this can lead to currency appreciation if the central bank is not willing to adjust the exchange rate.

The exchange rate system is a complex issue, and policymakers have to consider many factors when making decisions about the exchange rate. The goal is to maintain a stable and predictable exchange rate system that promotes economic growth and financial stability. However, the exchange rate system is not always stable, and it can lead to currency appreciate or depreciation depending on the economic conditions.

To summarize, the exchange rate system is a complex issue that requires careful consideration. Policymakers need to consider many factors when making decisions about the exchange rate, including inflation differentials, productivity growth, technology changes, and changes in trade policies. It is essential to balance the interests of different countries and stakeholders to ensure that the exchange rate system is stable and predictable.