In Europe they worry that the dollar may be too strong. In Japan they worry that the dollar may be too weak. They are both right. The dollar is too strong against the euro and too weak against the yen. More simply put, it is the yen/euro rate that is out of line. The world’s three major central banks, the ECB, Bank of Japan, and Federal Reserve, should intervene jointly in foreign exchange markets, buying euros and selling yen. The goal would be to push the yen down and the euro up, with little effect on the dollar.

The euro has been weak since its debut in 1999. The appreciation of the dollar in the late 1990s was an understandable result of economic performance in the United States, which was stronger than in Europe. But it is surprising how long it has persisted. The current level of the euro does not seem to be justified by fundamentals. On the European side, an appreciated euro would help keep a lid on European CPI inflation. The ECB recognizes that, as a new monetary institution, it needs to build up credibility with financial markets, as did the Bundesbank, Paul Volcker, and Alan Greenspan early in their institutional and personal careers, respectively. This is presumably why the ECB attempted to intervene in the foreign exchange market, an intervention that succeeded in stemming the euro’s slide during the brief interval, in September-October 2000, between the time that the American authorities joined in and the time when the ECB president was quoted as saying there were no more plans to intervene.

On the US side, the current account deficit cannot be sustained indefinitely. But the time is probably not right for a general depreciation of the dollar. The recently determined shift toward US fiscal expansion -- a replay of the early 1980s -- is likely to put upward pressure on US real interest rates, prolonging the capital inflows and strong dollar for the time being.

Meanwhile, the yen should depreciate. Japan has entered its second decade of devastatingly weak economic performance. Economic policy has been caught in a deadlock between the viewpoint of the Bank of Japan, which insists on structural reform, and the rest of the government, which wants easier monetary policy. The right answer, of course, is both structural reform and easy monetary policy, simultaneously. Furthermore, the way for the Bank of Japan to achieve an easing of monetary policy is not just to announce a positive inflation target, or to buy government bonds, or to buy foreign exchange, but rather to try all of the above, simultaneously. At this point, one can no longer be confident exactly what will work, and all tools should be tried.
Some in Japan worry that an attempt to push down the yen might either fail, on the one hand, or succeed all to well, on the other hand. The fear that it might succeed too well is a worry that expectations of future yen depreciation would arise, causing global investors to abandon the now-vulnerable JGB market. The solution is to bring about substantial yen depreciation in the short-term, while announcing the intention to put a floor under the value of the yen in the longer term, so that the depreciation lies in the past rather than the future.

The fear that an official attempt to depreciate the yen might fail arises because conventional wisdom among economists is that central bank intervention in today’s huge international currency markets has little effect, except to the extent it changes money supplies. The Bank of Japan has intervened heavily in the foreign exchange markets in the past, with little overall success.

Research shows that intervention by the world’s major central banks has been more successful than believed. The timing has usually been intelligent. For example, concerted intervention pushed the dollar down in 1985, when it was abnormally high, and pushed it up in 1995, when it was abnormally low. True, intervention operations have not always worked. But they have usually tended to be successful in accomplishing their goals when certain conditions are met, beyond consistency with economic fundamentals. These operations should: (1) be publicly announced, (2) catch private investors by surprise, and (3) be coordinated among central banks, including most importantly the US Federal Reserve. Thus operations to depreciate the yen and appreciate the euro should involve the US authorities. This is true even if the goal is solely to affect the “cross rate” rather than the dollar itself. Aside from the economic arguments, the idea is a fairly costless opportunity for the United States to exhibit a bit of the global leadership that some think has been lacking of late.

The research referenced is by Dominguez and Frankel (1993), Sarno and Taylor (2001), and Ito (2002).