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Introduction

Since 1973, the exchange rates of the major industrial countries have been floating against one another, except in isolated instances such as within the European Monetary System. In recent years the move toward floating exchange rates has gained strength, as an increasing number of emerging-market countries have also allowed their currencies to float. Another important recent trend in macroeconomic policy has been to base monetary policy on the pursuit of an inflation target. Some of the major central banks still have not formally adopted inflation targeting, but in practice the achievement of a low rate of inflation is such a high-priority objective of the United States Federal Reserve, the European Central Bank, and the Bank of Japan that formal commitment might not make much difference. These developments seem here to stay. Countries value the freedom of not having to defend an exchange rate objective, while inflation targeting has provided them with an alternative nominal anchor to the traditional one of a fixed exchange rate.

These developments have occurred in an international monetary system defined by the Second Amendment to the International Monetary Fund's Articles of Agreement (adopted in 1976 and formally entered into effect in 1978). This system is essentially a regime of laissez-faire. Anything goes. A nonsystem, as several economists termed the successor to Bretton Woods when it was first announced to the world. There are no rules, except the famous injunction not to "manipulate" exchange rates.[1] Countries may

1. Like the phrase "fundamental disequilibrium," this term has never been officially defined, and in practice it seems that the IMF tolerates anything. My colleague Morris Goldstein (in

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float if they want to, or fix their currencies in terms of anything else they choose (except gold!), or run any intermediate regime they like, no matter if (like the adjustable peg) it has repeatedly proved a disaster in the past. They can run a quasi–currency board if they prefer, even if it promises to bring disaster to their people, and the IMF may underwrite their idiocy in the name of national sovereignty until the crisis hits.

The disadvantages of this regime are becoming ever more evident as the global imbalances grow larger with no sign of reversal, despite a clear enough intellectual understanding of what needs to be done to rein them in (see, for example, Cline 2005). The present arrangements not only lack any disciplines that might avoid the escalation of imbalances but also breed conflicts such as the threat of protectionist legislation by the US Congress aimed at China unless it appreciates the renminbi. One could surely wish for an international system that would pressure countries into seeking and adopting a set of policies that are consistent with a satisfactory global outcome and that would outlaw attempts by individual countries to bully others into acting in accordance with their desires. The recent growth of international imbalances is a predictable result of living in a world without much in the way of rules. It raises yet again the question of whether the set of rules to which countries are subject should be strengthened.

Such a set of rules could be designed in two quite different ways, without asking the impossible by demanding that countries forgo floating exchange rates and de jure or de facto inflation targeting. One set of rules would commit countries to freely floating exchange rates (although presumably allowing an exception for countries that firmly fix their exchange rates). The alternative would be to commit countries to managed floating, with the principles of management clearly enunciated and the parameters publicly announced. Such a commitment could be formulated in two ways. One would involve a commitment that any interventions (or other attempts to influence the exchange rate) should lean against the wind, whichever way the wind is blowing. The alternative would be an obligation that any intervention should be in the direction of a reference exchange rate. This policy analysis develops the latter proposal.

Chapter 2 presents the reference rate proposal and briefly recounts its historical origins. It also considers two other forms that rules might take—rules that would oblige countries to float freely and rules that would limit intervention to that which leans against the wind—and explains why I am not enthused by those proposals. Chapter 3 describes the advantages that I perceive in a reference rate system and considers such supposed disad-

Truman 2006) offered a definition, which labels all protracted intervention in the same direction as "manipulation." This definition at least has the virtue of being specific. But unless one believes that intervention can quickly and reliably cure misalignments, so that a prolonged undervaluation like that of the euro in 2000–2003 need never recur, it would be a mistake to preclude repeated intervention in the same direction. This study suggests an alternative approach.

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vantages as infringement of the ability to pursue an inflation target. Chapter 4 discusses issues that arise in choosing between three alternative versions of the reference rate proposal: the canonical version in which one is prohibited from pushing the rate away from the reference rate, a version that surrounds the reference rate by a band in which intervention can go either way, and an alternative version in which no intervention is allowed in a band around the reference rate. Chapter 5 pursues the most difficult issue the proposal raises: that of selecting and securing agreement on the set of rates to be used as reference rates. Chapter 6 argues the importance of publishing the reference rates and the analysis that underlies them. Chapter 7 discusses how the reference rate proposal might have altered the behavior of countries, and therefore the historical outcomes, in a number of the most difficult cases that have confronted the world economy in recent years (Japan in the 1990s; Thailand, Indonesia, Russia, Brazil, Turkey, and Argentina prior to their crises; and the global economy in the present decade). The concluding chapter traces circumstances in which a reference rate system might be adopted.

As pointed out in chapter 2, the term "reference rates" as used in this study originated in academic work soon after the move to floating in 1973. However, certain officials have used a similar term but with a somewhat different meaning in the interim, as does John Taylor (2007) in his recent book. Specifically, the Group of Seven adopted what looked rather like target zones in the Louvre Agreement in 1987, but they were called "reference ranges." John Taylor recounts on p. 289 of his book how he and Caio Koch-Weser from Germany were urged in 2003 by their Japanese colleague Zembei Mizoguchi to adopt a set of reference ranges (with a similar meaning) around reference rates between the dollar, the euro, and the yen. The proposal was of course rejected unceremoniously, as one would expect of doctrinal floaters like Taylor and Koch-Weser, but they used language suggested by the Louvre rather than in the sense used here, where half the point of calling something a reference rate is to emphasize that it is *not* surrounded by any sort of zone that might oblige intervention.

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