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Cut US. interest rates now

How to support the yen and save U.S. jobs at the same time

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For the last few weeks, treasury officials from the U.S. and other G-7 countries have been scrambling for ways to stop the collapse of the Japanese yen, which they fear could trigger another wave of competitive devaluations and financial crises in Asia, and which also threatens to increase the U.S. trade deficit and cost American jobs. Although the U.S. and Japan briefly intervened to prop up the yen during the third week of June, U.S. Treasury Secretary Robert Rubin had previously told the Senate Finance Committee that yen-dollar exchange rates depend mainly on policy "fundamentals" and that "the whole answer lies in Japan doing what it needs to do."

Secretary Rubin is *half* right. Japan needs to reform its banking system, stimulate its economy, open its markets, and remove its antiquated restrictions on consumer spending. But the United States does not have to wait for Japan to act. There is a policy "fundamental" under U.S. control that strongly influences the yen-dollar exchange rate, and that is the U.S. interest rate.'

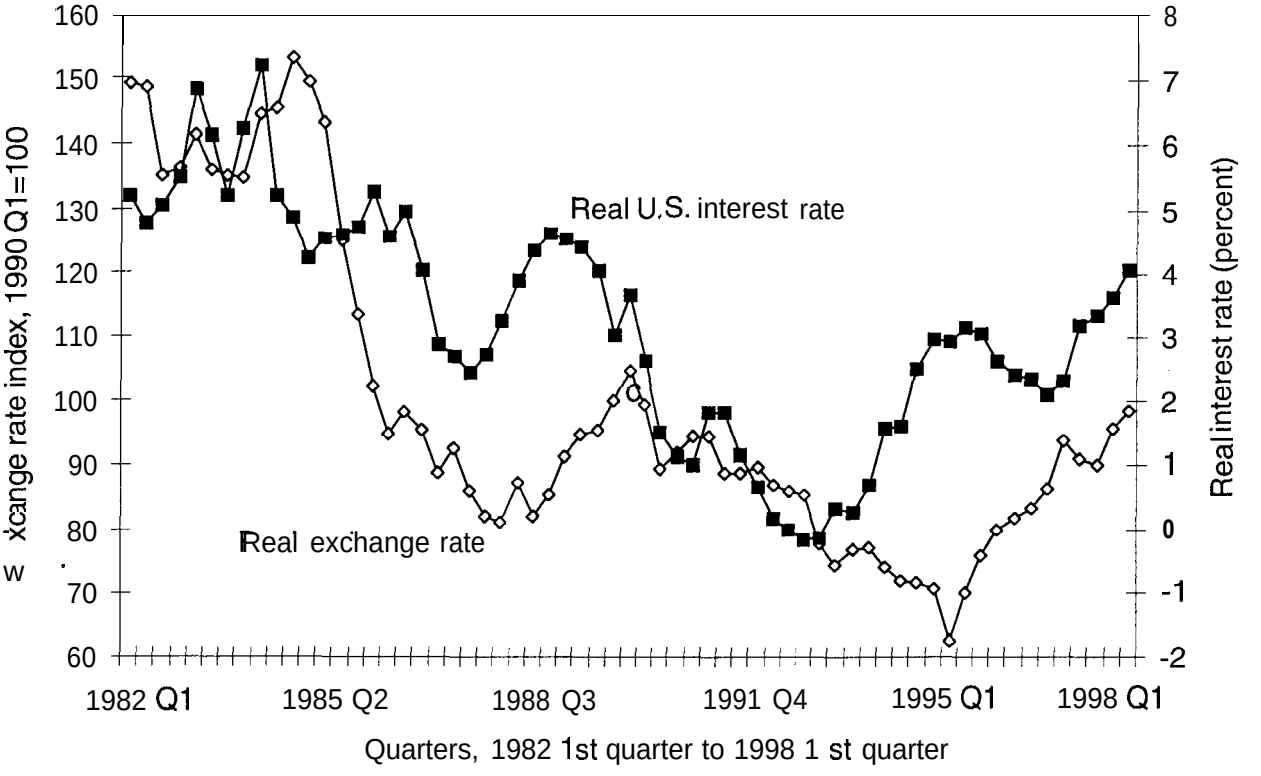
If the United States wants to help Japan contain its erupting financial crisis and prevent the yen from falling to levels that would undermine U.S. competitiveness and threaten American jobs, then the Federal Reserve Open Market Committee, at its next meeting, should reduce its key interest rate target (the "federal funds rate," which is the interest rate on short-term interbank loans) by at least one-half of a percentage point.

The U.S. real interest rate and the real yen-dollar exchange rate are closely correlated (see figure).[2] As the figure shows, the dollar tends to rise when real U.S. interest rates[3] are high and fall when real interest rates are low.[4] This relationship results because high interest rates attract speculative capital into the U.S. from Japan and elsewhere, while low interest rates reduce or eliminate these capital inflows.

Thus, a reduction in the U.S. interest rate should lead to a decline in the value of the dollar relative to other currencies, including the yen. An increase in the yen, relative to the dollar, will help Japan stabilize its economy and restore confidence in its financial system. A higher yen and lower dollar will also help the United States reduce the job losses likely to result from increased trade deficits in the next 12 to 18 months.

The correlation between exchange rates and interest rates is not perfect, since many other factors influence exchange rates. In particular, the yen-dollar exchange rate tends to "overshoot," and it also responds to changes in real interest rates with a lag of up to two years. The turning points have often been marked by intervention, most recently in 1995 when the U.S. and Japan intervened to prop up the dollar after it failed to respond to a sharp rise

The real yen-dollar exchange rate and the real U.S. interest rate



Note: The real U.S. interest rate is equal to the federal funds rate minus the percent increase in the CPI; the real exchange rate is yen per dollar adjusted by relative CPIs.

Source: International Monetary Fund, *International Financial Statistics,* and authors' calculations.

in U.S. interest rates in 1994. One important aspect of this successful intervention is that it occurred after a fundamental change in economic policies (interest rates were increased). Thus, successful intervention complemented a shift in monetary policy.

The rise in the real U.S. interest rate since 1996 has been caused by falling inflation rates, not by any explicit change in Fed policy. The nominal federal funds rate has essentially been held constant, but the rate of inflation has fallen from 3.0% in 1996 to 1.7% in May 1998 (on an annual basis). As a result, real short-term interest rates have increased by almost 1.5 percentage points. This increase has contributed to the yen's slide by making U.S. financial assets more attractive to investors from Japan and other countries and stimulating demand for the dollar. Thus, the U.S. must share part of the blame for the decline of the yen.

In addition to adding fuel to the crisis in Asia, the fall of the yen is causing a mammoth increase in the U.S. trade deficit, just as it did in the early 1980s, by making U.S. exports more expensive and imports cheaper. The U.S. goods and services trade deficit increased in April for the fourth consecutive month.[5] If these current rates of growth of imports and exports continue, the annual deficit for 1998 could reach $212 billion, an increase of $102 billion over the 1997 deficit. As has been noted elsewhere (see, for example, the EPI issue brief, *American Jobs*

and the Asian Crisis, by Robert Scott and Jesse Rothstein), a $100 billion increase in the trade deficit can be expected to eliminate 1.1 million jobs in the U.S. economy

Employment in U.S. manufacturing declined in May for the second consecutive month, and at an increasing rate. Trade deficits are beginning to affect the composition of U.S. employment, and could cause an upsurge in unemployment rates in the near future. Manufacturing industries and goods-producing regions in the country will be particularly hard hit.[6]

Therefore, the Fed should act promptly to minimize the damage being done to the domestic economy by the overvalued dollar. The dollar is now as high relative to the yen (in real terms) as it was in the mid- 1980s, the last time that massive U.S. trade deficits destabilized the domestic economy and threatened the global trading system.

Even if the Fed reduces interest rates and the dollar now, the manufacturing sector will still be hard hit by rising imports. Displaced workers will find it difficult to find new jobs and maintain their living standards unless the Fed supports a high level of growth and maintains tight labor markets.

Changes in monetary policy affect the economy slowly, for a variety of reasons. If the Fed cuts interest rates today, the full effects on exchange rates, output, and employment won't be felt for one to two years. Therefore, the Fed must, act now.

Many analysts are concerned that current tight labor markets are putting upward pressure on inflation. However, it is safe to predict that unemployment will increase within a year because of growing trade deficits with Asia, thereby reducing any risk of an increase in inflation rates. If the Asian crisis deepens, its effects could also spread to the U.S. If the Fed *tightens* rates now, it will turn a relatively small increase in unemployment into a much larger problem in 1999.

The time has come for the Fed to step up to the responsibilities of international leadership. A sharp cut in interest rates now will help stabilize currency markets in Asia, reduce the risks that the crisis will spread, and achieve the Fed's legally mandated objectives of maintaining full employment with stable prices. To avoid a cut in rates now risks turning an expected mild increase in unemployment next year into a significant recession, or worse.

Endnotes

[1] Other important forces in currency markets include capital flows, trade balances, relative states of business cycles, inflation, and the search for financial safe havens in times of economic or political turmoil.

[2] An ordinary least squares regression of the real yen-dollar exchange rate on the real U.S. interest rate (with four quarterly lags) explains about two-thirds of the variance in the exchange rate. We have found that this model provides a better explanation of the yen-dollar exchange rate than standard international finance theory, which predicts that nominal exchange rates will depend on the difference between short-term nominal interest rates in the two countries. The reasons for this discrepancy are uncertain, but may have to do with the asymmetrical nature of Japanese capital flows (which tend to go mainly outward, to the U.S. and other locations, rather than flow inward). Other factors also influence this bilateral exchange rate, as discussed later in the text.

[3] The real interest rate shown here is the federal funds rate, which is the interest rate most directly targeted by the Fed, minus the actual rate of inflation in U.S. consumer prices over the preceding four quarters (a good proxy for expected inflation). The real Japanese-US exchange rate shown in the figure also corrects for inflation differentials between the U.S. and Japan.

[4] There is also a strong correlation between the overall, trade-weighted value of the dollar and real interest rates in the U.S. Thus, a cut in interest rates is likely to reduce both the yen-dollar exchange rate and the dollar's value against other major currencies.

[5] Between January and April 1998, the monthly goods and services trade deficit increased from $10.0 billion to $14.5 billion. Imports increased by $2 billion (though declining slightly in April), while exports declined by $2.5 billion, reflecting the deepening of the recession in Asia. In the future, import growth is likely to accelerate because of the lagged effects of the decline of the yen and other Asian currencies against the dollar.

[6] The ***OECD Employment Outlook*** for June 1998 predicts that unemployment will rise in the U.S. in 1999.