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Chairman, Executive Committee
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Years ago I was more directly involved in the minute-to-minute movements of the financial markets than I am today. I got used to screen-scanning. I still switch on the screen first thing in the morning to see what's happening in the markets. And there's always one key price, or one key issue, that puts the markets in focus.

At different times in the past, the price of gold, or the Deutsche mark exchange rate, or even a pending tax bill have provided that focus. For the past few months, it's been oil. The spectacular fall of oil prices -- and the prospect of continued price volatility -- still call the tune for stock, bond and foreign exchange markets around the globe.

The foreign exchange markets have an enduring fascination for me, and I'll get back to them in a minute. But first I'd like to make just a few observations about oil developments.

As you all know, the collapse of oil pries will cause serious strains on important areas: among oil companies and oil-service firms, in states such as Texas and Oklahoma, in oil-producing countries like Mexico that are heavily indebted, and on some financial institutions. But there is a bright side that should not be ignored. This price break has the potential to catalyze strong

economic growth here in the U.S. and abroad. I might note that the Chancellor in his budge comments on oil also seemed inclined toward this optimistic view.

I say "potential" for a reason. The response of industrial countries to the opportunity present by the oil-price fall will determine just how great the benefits turn out to be. Make no mistake: the opportunity is an extraordinary. The disinflationary impact of low oil prices creates a chance for industrial countries -- especially Japan and Germany -- to stimulate economic growth without risking a new bout of inflation.

This growth would go a long way toward correcting the trade and current account imbalances that still plague us -- despite the dollar's dramatic fall of more than 30% against both the yen and the mark since last year. The expansion of demand in the industrial world would also provide a major boost to developing countries. For those countries, exporting more to industrialized nations, in order to restore their own growth, is a political and economic necessity.

Let me emphasize that lower oil prices alone may do surprisingly little to stimulate growth if the key industrial countries do not adopt more expansionary policies. In Germany, France, and Japan, for example, we expect lower oil prices to add just 1½% to economic growth for 1986 and 1987 combined. Without this boost, prospects for growth in those countries would not be good.

All this may seem like the long way round to get to the foreign exchange markets. But I think there are some intriguing connections between what's happening in the oil markets and what has happened in the currency markets -- beyond the obvious effect of oil pushing the yen and the mark up against the dollar.

To begin with, the markets for both oil and the dollar are seeking trading ranges, albeit from very different starting points.

Until January, the price of oil for a decade had been set by a cartel. Another way of putting this is to say that oil producers, through more-or-less coordinated management of oil supply, managed the price of oil. The trouble was that the price got managed away from underlying economic realities: the gap between world demand for oil on the one hand and producers' desired output on the other got wider and wider. Now the law of supply and demand is forcing a correction, and we don't yet know where -- or when -- the oil price will settle.

What's happened in the exchange markets is roughly the opposite. For years, the major central banks -- especially U.S. authorities -- pretty much stayed out of the exchange-rate-management business, letting prices fall where they may. Market forces by last year had pushed the dollar to lofty levels, contributing to record current account imbalances among the industrial countries.

Then in September we had the G-5 meeting here at the Plaza, when policymakers of the major industrial countries agreed that their exchange rates were out of sync. In an historic change of policy, they let it be known that they wanted an orderly depreciation of the dollar, and that they were prepared to intervene in concert to support that view in the foreign exchange markets.

Subsequently, President Reagan in his State of the Union message called upon Secretary Baker to re-examine the merits of proposed reforms of the international monetary system. One of these proposed reforms is target zones.

Now the exchange markets are pretty quick on the uptake. It didn't take long for them to begin thinking about future rate developments in terms of target zones. We at Morgan have done a bit of brainstorming about what the entry levels for such zones might be, and I assume we are not alone in having conducted such an exercise. This doesn't mean we either expect or would want to see formal target zones. It has simply proved a useful analytical tool for understanding and anticipating the movement of exchange rates.

Now let's entertain the question: Should we move all the way to a regime of formal target zones for exchange rates? Exactly what would such a move entail?

The G-5 countries last September agreed that the dollar was at the wrong level. That wasn't so hard; the market was already telling them that. It's a lot harder to agree on the right rate. But let's

suppose that the G-5 countries could agree on the "right" exchange rates for their currencies -- the rates that would be consistent with acceptable trade flows, price levels, and economic growth. Even if they agreed, the market might not -- and then getting the market to trade at those rates would not be easy.

I don't think anyone believes today that intervention alone could do it. At the very least, the markets would have to be convinced that intervention signaled changes in economic policy that would be consistent with these "right" rates. Otherwise, the effect would be similar to OPEC's trying to maintain a price that contradicted the basic trend of supply and demand: it might work for a while, but in the end the fundamentals would win.

The point is that exchange rates depend on the whole international policy framework. The dollar decline of the past year at heart reflects market views that the U.S. policy mix has been changing, or at least is likely to change, in a more appropriate direction. The G-5 statement last September was useful and constructive. But it was constructive mainly because it signaled a new interest on the part of the five nations to work together, perhaps on more than just exchange rate intervention. It gave the markets a nudge at the right time at what I might call the margin of doubt. It confirmed that market's view about the dollar's basic downward trend.

Given the dollar's sharp descent, it's remarkable -- and commendable -- that its decline has been more or less orderly. We're now at the exchange rate levels that we thought a year ago would

constitute a "hard landing," but the hard landing has actually been rather soft. I think this has been achieved precisely because the two factors I've just been talking about have worked together rather neatly. First, the fundamentals are shifting. In particular, there is more optimism that the U.S. budget deficit is on the way down. And second, the authorities have moved with the tide rather than against it.

Now the question is where do we go from here?

I would argue that any move towards formal target zones would be a mistake. Formal target zones carry the risk of distracting everyone from the real task at hand. That task is to correct the world's massive trade imbalances. Managing exchange rates cannot solve this problem. The right way to tackle it is through coordinated fiscal and monetary changes by the major trading nations.

It's important to emphasize that the dollar has not fallen enough to even out the enormous U.S. trade deficit and the corresponding surpluses in Japan and Europe. If there were no changes in fiscal and monetary policy here or abroad, the U.S. trade and current account deficits would remain more than $100,000,000,000 a year. The external debt of the U.S. would continue to mount. And, eventually, holders of dollars would begin to lose confidence in the currency. If that happened, we could be faced with a rapid depreciation of the dollar -- one that could be halted, if at all, only by a sharp increase in U.S. interest rates. In other words, we could have our crash landing.

In the U.S., as I said, there is increased political commitment to substantial, phased reduction in the budget deficit. In Japan and Germany, however, there is real resistance to substantial policy changes that would increase domestic demand. But if those policy changes are not made, establishing target zones -- still less maintaining them -- would run into severe problems. The bottom line, ironically, is that formal target zones would work only if they were not necessary.

Now everyone knows that economic policymaking depends at least as much on politics as on economics. Is there an argument that target zones would be an adroit means of making fiscal policy changes politically possible? I think there is such an argument, but whether it is a practical one is another matter.

Germany, for instance, opposes formal target zones, even though it participates in the European Monetary System of more or less fixed exchange rates. The difference is that, within Europe, Germany is the leader: its EMS partners effective must accommodate their actions to German policies. In a global system of target zones, the Germans with reason might expect greater pressure to set just the kind of more expansionary fiscal and monetary policies that they have resisted so far. Germany apparently is not eager to subject itself to such increased pressure. I should add that Germany is not alone in taking this stance: the U.S. has shown similar reluctance to allow external constraints to shape its domestic polices.

Nonetheless, we must recognize that the U.S. trade deficit is not just a U.S. Problem, but a world problem. Further massive dollar devaluation would cure our huge trade imbalances, but that remedy would be hard on everyone -- especially Europe and Japan. The fact remains that continued, substantial dollar depreciation -- in spite of its threat of renewed U.S. inflation -- would be the least painful way out of trade difficulties for this country if other countries refuse to budge.

A more constructive solution would require action by the surplus countries as well as by the U.S. As I mentioned at the outset, low oil prices offer a rare opportunity for such action. I hope that the current round of international economic gatherings, culminating in the Tokyo Summit, will focus attention on the need for coordination of fiscal and monetary policies among the major countries.

If our economic leaders recognize that more convergent polices are in their mutual interest, they will also recognize the political consequences of appearing to change course. It is here, and only here, that I can see a possible reason to put target zones on the agenda. That focus on exchange rates just might allow Japan and Germany to turn around and boost demand -- all in the interest of "exchange rate stability and world economic cooperation," of course!

The target zone question has presented itself in particularly pointed form recently to my fellow speaker. I am referring, of course, to the debate on British participation in the European

Monetary System. Here, too, both timing and political considerations are of great importance. I can't resist a brief digression to contribute my tuppence to the debate.

If Britain decides to go ahead, when should it do so? Obviously, it makes sense to go in at a sustainable level -- one that not only clears the foreign exchange market but also stands a reasonable chance of producing the desire outcome for trade, prices, and economic growth. I think the current Deutsche mark/sterling rate of 3.40 to 3.50 is pretty close to such a level.

This apparently was not the received wisdom last weekend! But unless British entry was to take place in the context of another EMS realignment, I still think that soon would be a better time than most.

The question of when to enter is important, but it is clearly secondary to the question, why enter at all? The usual answer is that it would provide protection against exchange rate instability with Britain's major trading partners.

Now, avoiding instability within the EMS in effect means aligning policies with those of Germany, the leader of the system -- especially policies directed at controlling the medium-term inflation rate.

If the British government wished to commit itself to substantially reduce the inflation rate -- down to the level of 1% that the Bundesbank seems to shoot for -- its actions might cause less pain to the British economy inside the EMS than outside of it. This is precisely because overshooting the exchange rate -- the thing that helped strangle the economy 6 or 7 years ago -- would be avoided.

Nevertheless, the Chancellor's recent budget and the absence of a move last weekend, betray a certain lack of enthusiasm for the EMS course. From the political standpoint, especially with an election looming ahead, the extra unemployment that would be needed to lower the inflation rate significantly would be difficult to accept -- even within the EMS. Perhaps the Chancellor will elaborate on this issue -- but I for one am not surprised by the lack of ardor in Britain's response to its EMS suitors.

Despite all the caveats I've been uttering about the limitations of target zones, I think the kind of exchange rate management that we saw at the Plaza is a good thing. It was useful and timely -- just what such management should be. An even better term for it is "judicious intervention."

My point is simply that attempts to manage exchange rates may serve to focus attention on more critical fiscal and monetary policy initiatives. My fondest hope for the upcoming Tokyo Summit is that it will issue a splendid joint communiqué that reads something like this -- and I hope you'll all appreciate the effort I've made to phrase this in the appropriate bureaucratese!

Quote: "Formalized target zones have little to offer tor exchange rate management or global economic betterment. By contrast, on an informal basis, illustrative zones -- without target status -- could illuminate the interrelationships among the whole range of official policies and encourage appropriate policy changes."