What Can We Do About Exchange Rates That Move Too Much?

Pierre Fortin

MOST OBSERVERS, INCLUDING POLITICIANS and journalists, believe that international financial and currency markets are efficient and give the best price signals most of the time. There are two reasons for this. The first one is that humans tend to bow instinctively to power, as all animals do. Those markets indeed wield an enormous amount of money power. The second reason is the irrepressible and uncritical fascination we have for the glitter of advanced technology. The fact that modern computer and communications technologies allow those markets to work around the clock and to transfer hundreds of billions of dollars across the world every day is really impressive.

The widespread belief follows that this enormous, high-tech driven flow of funds cannot be wrong: markets must be right. Yet, we should know from historical experience that wealth and technology in asset markets—stock markets, bond markets, money markets, exchange markets—offer no guarantee that the right economic decisions will be made. Powerful financial and technological means can produce bad as well as good outcomes.

EXCHANGE RATES FLUCTUATE TOO MUCH

In recent years, there has been mounting statistical evidence that asset markets are in many respects quite inefficient. They are prone to systematic errors of predictions, and they are often carried by large and persistent speculative bubbles that do not make any economic sense. As Nobel Laureate Maurice Allais has put it succinctly, they sometimes seem to operate more like global casinos than like sensible resource allocators.

Professor of Economics, Université du Québec à Montréal (UQAM) and Research Associate with the Canadian Institute for Advanced Research, Toronto, Canada.

One popular line of defense for flexible exchange rates is that excessive exchange rate instability is only a reflection of misguided domestic monetary and fiscal policies. If this were true, the prescription for exchange rates would be simple: just get the policies right and exchange rates will find their true stable equilibrium values. However, if financial markets cannot be trusted to determine exchange rates on the basis of economic fundamentals most of the time, then the view that bad exchange rate behavior only reflects bad policies must be logically wrong.

Nominal exchange rates have a marked impact on international competitiveness.

We now have evidence that this view is indeed contrary to fact. Barry Eichengreen, Andrew Rose and Charles Wyplosz have recently analyzed in detail some 160 successful, as well as unsuccessful speculative attacks on the currencies of 20 OECD countries over the period 1959-1993. Their investigation of the causes of turbulence affecting both pegged and floating rates shows that, while some attacks are plausibly motivated by imbalances in macroeconomic fundamentals, many others are of the purely self-fulfilling variety and occur in the absence of any clear imbalances. The stark implication is that governments that in some sense follow the "right" policies cannot be assured of insulation from speculative attacks.

EXCHANGE RATE INSTABILITY IS COSTLY

It is one thing to admit that financial markets cannot be trusted to determine exchange rates efficiently; it is another to argue that excessive exchange rate instability is damaging to real economic performance. If exchange rate fluctuations were just a side show with no consequences for the real economy, there would not be much to complain about. Unfortunately, this is not so. We have every indication that changes in nominal exchange rates have a marked impact on international competitiveness and, consequently, on trade and economic activity. The most striking recent example on a global scale, of course, is the 40% effective appreciation of the U.S. dollar relative to the combined mark-yen zone between 1979 and 1985, followed by the 60% depreciation of 1985-1995.

The Canadian experience of the last decade illustrates these propositions very well. Between 1986 and 1991, the Canadian dollar appreciated over 20%, from 72 cents (US) to 87 cents; it has since returned to 72 cents. According to U.S. Bureau of Labor Statistics calculations, the trade-weighted index of relative unit labor costs for Canadian manufacturing shot up to 128 in 1991 from the base level of 100 in 1986. The exchange rate appreciation was the most important cause of this increase. Canada's merchandise trade competitiveness simply collapsed. Over that period, the country's trade surplus declined to only $4 billion from a starting level of $16 billion.

With the recent depreciation, the relative cost index has returned to its 1986 level of 100. The country is competitive again, and the trade surplus has now been reestablished in the neighborhood of $25 billion. By every account, these gyrations in Canada's trade have played a key role in the mini-depression of 1990-1993.

There is more to say about Canada. The country exports 27% of its output to the United States, and this percentage is on the rise. In addition, the two countries now operate under a free trade agreement. A key question now is whether it is wise from a long-term perspective for Canada to let its currency fluctuate so widely relative to the U.S. dollar. This is in sharp contrast to the strategy followed by members of the European Community relative to the mark.

Large and persistent exchange rate fluctuations translate into unstable Canadian-dollar values of foreign prices. This entails higher transactions costs, miscalculations of costs and profitability, and

inappropriate decisions in terms of location and allocation. Currency hedging can alleviate the problem of exchange risk over the short term, but over the long term its value drops sharply. We are preoccupied here not with very short-term exchange rate volatility, but with the five-year cycles of 20-25% variation experienced by the Canadian-U.S. exchange rate since 1980. Where do you think, in the light of this exchange rate variability, an expanding Canadian firm that already exports 60% of its output to the United States will build or buy its next plant? So far, we do not have more than anecdotal evidence on this matter. However, until we get the verdict, such added cost of producing in Canada for external markets must remain a cause for deep concern.

The economic preconditions for a successful EMU are simply not there.

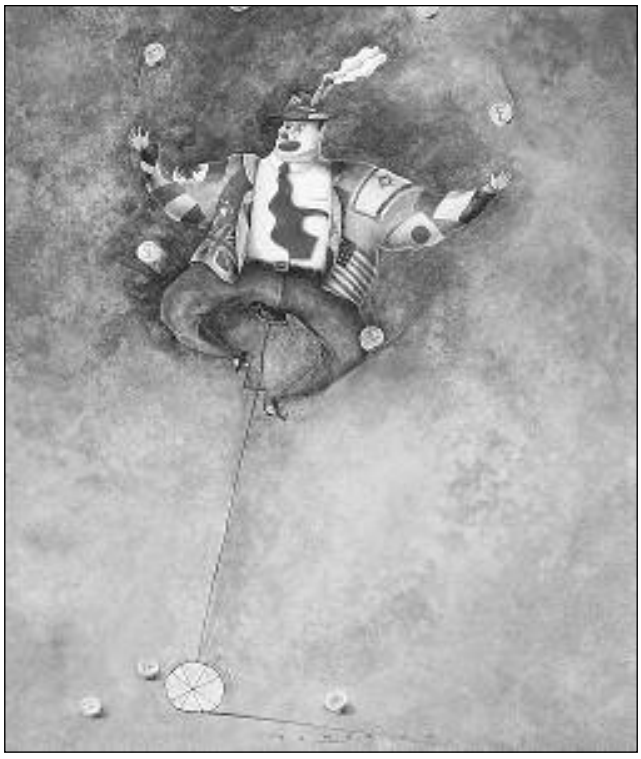
We are led to conclude, first, that the excessively large and protracted exchange rate fluctuations of recent years have often been the result of financial market inefficiencies and, second, that they have been an important contributor to the instability of trade and economic activity in the G-7 group of countries. Third, there is also the lingering concern that the excessive exchange risk imposed on a small open country such as Canada could lead many of its firms to shift production to its large trading partner.

SOME EXCHANGE RATE FLEXIBILITY IS NECESSARY

The statement that exchange rates tend to fluctuate too much does not imply that they should not move at all. The key variable to watch here is the *real* exchange rate, which is the ratio between domestic unit costs and foreign unit costs *expressed in the same currency*. A real exchange rate depreciation means that Canadian unit costs in U.S. dollars decrease relative to foreign unit costs in U.S. dollars, and hence that Canadian producers become more competitive. Conversely, a real appreciation makes Canadian producers less competitive. A real depreciation can arise either from a nominal depreciation or a decline in the ratio of domestic unit costs in home dollars to foreign unit costs in U.S. dollars.

It is crucial to recognize that changing economic circumstances do require fundamental changes in real exchange rates from time to time as a result of permanent modifications in the terms of trade or in capital flows. Examples abound: faster productivity growth in Europe and Asia than in North America, trade and economic expansion in Latin America, the long-term downward trend in the relative world price of commodities, internationally divergent or convergent trade policies, rising capital requirements in Eastern Europe, German reunification, higher real interest rates around the world, a permanent increase in the external debt.

The important observation in this respect is that, if a real exchange rate depreciation has to take place, it is much more easily achieved through nominal depreciation than through a decline in relative unit costs. This is because, in practice, wages and other costs of production adjust only slowly to changing circumstances, particularly in the downward direction, and even more slowly in very low inflation environments. Important reductions in wages and other unit costs require large and costly doses of high unemployment. As we know, the opposite is true for the nominal exchange rate: it moves very easily.



MARC MONGEAU

IDENTIFICATION AND CONTROL PROBLEMS

There is a need for some (nominal) exchange rate flexibility, but not too much. Two problems emerge. First, how to identify how much flexibility should be prudently allowed and around what parity. Second, there is the problem of controlling fluctuations within allowable bounds.

The identification problem concerns the capacity of the monetary authority to determine which exchange rate variations are "fundamentally required", and which are excessive in some sense, at any given point in time. Nobody has a safe rule for that purpose. We know that financial markets cannot be trusted to do the job properly, but we also know that central banks are not a perfect substitute. However, the market situation has gotten so bad that it is likely that any reasonable central bank can improve upon market outcomes on average over time. The available weapons against fuzziness and ignorance are reliance on existing scientific knowledge, continuing fundamental and applied research, openness to new ideas, and a good dose of prudence and pragmatism.

The control problem is about whether there is an effective mechanism whereby sudden speculative attacks by hundreds of billions of dollars of cross-border capital flows can be defeated by countries acting alone or in cooperation. In some circumstances, the cost of defending a currency, measured in reserve losses or interest rate increases, can be so high that markets may not believe the central bank will withstand a successful defense. This may reinforce the attack, make the defense even less credible, harder to counter, and so on. The cases of the British pound in 1992 and of the Mexican peso in 1994 are obvious recent examples. Here again, our approach should be pragmatic. A diversified strategy based on

domestic interest rate policy, cooperation among central banks, and IMF credits is probably the best we can do for a long time to come.

MONETARY UNIONS: NOT DESIRABLE OR LIKELY

How, then, are we to proceed toward reform? First, since we want to retain some exchange rate flexibility, we should be skeptical about proposals for new monetary unions or rigidly fixed exchange rates. Second, since we want to attenuate the excessive instability of the present system of floating rates, we have to find some practical means of reducing exchange rate fluctuations.

The notion of one common monetary standard to replace the tripolar system based on the dollar, the mark and the yen still seems too far-fetched economically and politically to be worth discussing. Even the limited guidelines of the Plaza and Louvre Accords are periodically broken by the parties, as the uncontrolled recent depreciation of the US dollar against the yen illustrates. Only two regional monetary unions can be considered seriously within the G-7 group of countries: the current project of a European Monetary Union (EMU) and, eventually, a North American monetary union.

It is not entirely clear why the European Community insists on creating a new monetary union, except for the common political purpose of building a strong and united Europe. The economic preconditions for a successful EMU are simply not there: shocks on equilibrium real exchange rates have repeatedly been shown to vary widely in scope, along with timing and magnitude across member countries. One potentially alleviating factor, international labor mobility, will likely remain weak for many years to come. Moreover, despite the continuing progress of the idea of One Europe, Maastricht enthusiasts seem to grossly underestimate the remaining political difficulty of the project.

EUROPE SHOULD SIMPLY TRY TO IMPROVE THE ERM

Economic welfare in the Community would be better served by the continuation and improvement of the existing Exchange Rate Mechanism (ERM). The ERM appears to be a good compromise. It allows for limited exchange rate fluctuations, and it can be adapted in pragmatic fashion to changing circumstances.

Claims that the dramatic widening of the fluctuation band to a meaningless ±15% (from the original ±2.25%) in 1993 is proof that the ERM is doomed, and completely misses the point. No exchange rate mechanism could have absorbed smoothly the jolt given to equilibrium real exchange rates in Europe by the problems of German reunification. Once the German shock is absorbed and new parities are determined by mutual agreement, the ERM fluctuation band will most likely be narrowed again. What we have witnessed is not the collapse of the ERM, but an interesting learning experience on when and how the system can and should adapt to large real shocks.

A CANADA-US ERM WOULD BE DESIRABLE

For the same economic and political reasons as in Europe, a North American monetary union is neither desirable nor likely. However, an ERM should be very seriously considered between Canada and the United States.

In the last fifteen years, the Canadian-US exchange rate has fluctuated within a ±12.5% band — from 70 to 90 cents. This is much more than justified by economic fundamentals, by any reasonable objective for real economic stability, and by the full exploitation of the benefits of NAFTA. As an alternative, a ±5% fluctuation band could be envisaged initially, and perhaps a ±2.5% band will prove both feasible and useful later, taking due account of the recurring shocks on the real price of Canada's natural resource exports.

North American monetary union is neither desirable nor likely.

Two preconditions for greater exchange rate stability in Canada are more fiscal discipline and greater wage-price flexibility. The first precondition now seems on the way to be fulfilled. The second will be harder to achieve, but maybe the new exchange rate regime will by itself exert enough pressure on wage and price setters to bring about the greater required flexibility. A most helpful additional ingredient would be an explicit agreement for cooperation between the Bank of Canada and the US Federal Reserve in crisis situations.

Under this new regime, Canada would import US inflation on average over time. This is not a bad prospect, since US price objectives and performance have a long tradition of being rather conservative, without falling into the dangerous extreme, recently experienced by Canada, of trying to achieve very low inflation with total disregard for real economic objectives.

A major benefit would be the convergence of Canadian short-term interest rates towards US rates. This convergence occurred under the pegged, but adjustable, exchange rate that Canada had from 1952 to 1973, and also more recently in Austria and the Netherlands, after the schilling and the guilder were pegged to the mark.

The 2-point average differential between Canadian and US interest rates observed over the last decade is one important reason Canada's economic performance relative to the United States has been so dismal. The narrower fluctuation band would eventually rid us of this painful consequence of the recent experience with Canadian monetary independence. Seen in this light, the argument that restrictions to Canadian monetary independence similar to those enforced over 1952-1973 — and perhaps even less binding — would be an infringement of Canadian sovereignty seems absurd. Canadians would be better served by a good monetary policy made in Washington than from a bad monetary policy made in Ottawa.

In the short term, the important and urgent task for Canada is to recover fully from the recent recession, bring its unemployment rate back to 7%, and force its external debt-to-GDP ratio, currently the highest among industrial countries (at 45% of GDP) onto a declining path. With these objectives in mind, it is particularly hazardous to determine with precision what the equilibrium exchange rate is. Two indications are that our current account is still exerting upward pressure on the external debt-to-GDP ratio and that achieving a full recovery will generate a lot more imports. The Canadian-US exchange rate may, accordingly, have to decline further. Or perhaps not, but at any rate, much uncertainty remains. We will see more clearly when the job and debt situations become streamlined. Perhaps 1997 will be the right time to define the allowable fluctuation band around the going parity. ◆