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Assessing Exchange Rate Performance

Since the turn to Floating more than four years ago exchange rates never have ceased to be used as economic policy variables. On the one hand, authorities in a number of inflation-prone countries are putting much faith into the exchange rate as a tool of stabilisation policy: by pegging their nominal exchange rates to a strong currency or a currency basket they hope not only to shield their economies from external inflationary impulses but also to import (relative) price stability from abroad. On the other hand, some countries have taken recourse to the exchange rate in their struggle for an "adequate" share in world exports and employment. True, in doing so they have avoided the overt Beggar-Thy-Neighbour policies of the Thirties. Today's exchange-rate strategies are more subtle and certainly less damaging to international trade and welfare than the practises used at that time. Yet, the fact alone that currencies are in most cases far away from floating freely should be sufficient to support the IMF's endeavours in supervising its members' exchange-rate policies.

The major task facing the IMF staff is to determine when an exchange rate is out of line with fundamental economic conditions. It is to be hoped that they will take a more balanced and economically better founded view than Mr. Blumenthal did when he singled out the D-Mark (and the Yen) as being undervalued relative to the US dollar. What kind of criteria might be applied?

To begin with it would seem appropriate to focus upon exchange market policy of the monetary authorities. Under this category of criteria both the volume of exchange market interventions (including the raising of official and semi-official credits) and the existence and modification of payments controls ought to be considered. This is what the IMF according to its recently adopted Principles of Fund Surveillance is indeed going to do. Contrary to earlier discussions in the Committee of Twenty in which the reserve indicator played a very prominent rôle this indicator is now but one among many. One reason may be the limited explanatory power of changes in gross reserves, given the range of exchange market instruments available to the authorities. As to Germany, international reserves have remained virtually unchanged since early 1976, the small variations reflecting mainly exchange support operations in the Snake and some low-scale interventions to counter "disorderly conditions" in the exchange markets this summer. They certainly do not indicate a need for exchange rate adjustment.

With respect to restrictions on, and incentives for, current and capital transactions (and related payments) the IMF takes a half-hearted approach: First, it will consider such measures only when they are applied for balance-of-payments purposes — thereby disregarding the fact that any restrictions (and incentives) will affect the exchange rate, irrespective of their prime objectives. Secondly, existing capital restrictions and incentives will not be subject to surveillance, consultations being limited to the introduction or modification of such controls. This "pragmatic" approach appears justified insofar as the Fund is only concerned with preventing any deterioration of the exchange rate structure; however, improvement of exchange relations would require existing exchange controls to be gradually abolished because of the distortions they generate in investment, production and trade decisions.

Under both the stricter theoretical criteria and the more liberal IMF principles German trade and financial policy is coming off rather well. True, foreign trade is not entirely free from restrictions; and the European Community's CAP generates heavy distortions in the international flow of agricultural products. Judged by international standards the effects of the trade measures upon the D-Mark exchange rate are probably negligible, however. The same is true for the few existing restrictions on capital movements; indeed, the small margins between domestic and Euro-DM interest rates demonstrate the limited practical relevance of these restrictions for exchange rate behaviour.

Another set of criteria which might be used in assessing exchange rate performance is linked to the performance of certain trade and monetary variables: developments in binary and effective exchange rates relative to variations in national price levels; inflows and outflows of investment capital; the volume and changes of trade and current surpluses and deficits; changes in world market shares; and others. As to the first criterion, calculations made by the EC Commission indicate that since the Smithsonian Agreement (which was conceptually designed to create an "equilibrium" exchange rate structure) price competitiveness of German manufactured products has deteriorated by five percent. Whereas this figure is indeed rather small, the direction of the change is suggesting that today the D-Mark is more likely to be overvalued than undervalued on an effective basis. This impression is reinforced when the current level of German labour costs is considered even though it has to be admitted that international labour cost comparisons may be subject to considerable errors. As to the bilateral German/US case the disparity between changes in relative prices and the DM/Dollar rate is much more pronounced than in the effective case: since Smithsonian, price competitiveness of German manufactured products has suffered by 15 p.c. relative to US products. Whereas again the precision of the numerical result should not be overrated the general tendency is confirmed.

Flows of direct investment may also give an indication, however crude, of the valuation of a currency: an economy with an undervalued currency is likely to attract capital from abroad, the opposite being true for a country with an overvalued currency. This effect is not only due to the absolute costs of acquiring existing enterprises or setting up new production facilities in the country concerned (relative to abroad). More important appears the rate of return on investments. A low exchange rate is equivalent to a subsidy to export industries and a tariff on import competing productions; the rate of return is therefore likely to be high. On the other hand, with an overvalued currency profits in the tradeable goods sector will be squeezed; domestic producers will be induced to put up new capacities abroad rather than at home.

However, this reaction will not take place at once. For a rather long period of time firms will continue to serve their traditional export markets from their existing production capacities. Therefore, both trade and investment effects of exchange rate changes will make themselves felt only gradually and with considerable time lags. In Germany it appears that the repeated revaluations of the D-Mark in the late Sixties and early Seventies show their effect on investment decisions of domestic as well as foreign enterprises only now. 1975 was the first year in which capital outflows for direct investments outran the annual inflows. Since then the gap has widened. This new trend supports the hypothesis that in a medium-term view the D-Mark is no longer undervalued. For the reason mentioned the continuing trade and current surplus is not necessarily a valid counterargument.

Besides the indicators mentioned others need to be explored if a correct assessment of a currency's exchange rate performance is to be made. Such an assessment is essential as long as governments are not prepared to accept the market's appraisal. In a world of managed, and sometimes dirty, floating the Fund and national monetary authorities will have to take great care that "political" distortions of the exchange rate structure with all their counter-productive effects upon resource allocation and world welfare are being avoided. *Hans-Eckart Scharrer*