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# Unstable Exchange Rates and Trade Policy

## An Impetus for Reforming GATT?

by Hans Mayrzedt, St. Gallen\*

**Floating exchange rates affect two basic principles of GATT, namely: stability of trade policy conditions and reciprocity of trade concessions. What is the relevance of the changes to foreign trade? What possibilities for surmounting the new problems exist in the realm of external economic relations?**

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The foreign trade policy has undergone many changes within the framework of GATT, partly because of policy advances under GATT auspices and partly under the influence of external factors. As long as the import duties of the member states were held at a high level, tariff reductions as well as the trade policy instruments employed to bring them about, such as most-favoured-nation treatment and reciprocity, were matters of major concern. Their importance declined however when following the Kennedy Round the tariffs between the western industrialized states were reduced to a relatively low level, and it will lessen still further after the new tariff cuts agreed upon in the Tokyo Round.

The GATT secretariat has not failed to notice the consequent shift of the main thrust of GATT's future trade policy problems from a North-North to a North-South bias<sup>1</sup>. The real test for GATT is however still to come, and there is also a danger that the trade policy problems encountered in the North-North compass may be neglected in future. The fact that only little attention is being paid to the relevance of unstable exchange rates to trade policy may be regarded as a pointer to such a tendency.

No fundamental problems arose in this respect until 1973 because GATT and the International Monetary

Fund (IMF) had homogeneous rules in regard to trade policy<sup>2</sup>. The situation changed with the departure from stable exchange rates in the spring of 1973. Three questions suggest themselves in this context:

- ☐ How far have the foundations of trade policy been tilted by the floating?
- ☐ What is the relevance of the changes to foreign trade?
- ☐ What possibilities for surmounting the new problems exist in the realm of external economic relations?

### Principle of Stability

To answer the first question we must call to mind two principles of the "old" trade policy which are affected by the floating, namely:

- ☐ Stability of trade policy conditions and
- ☐ Reciprocity of trade concessions.

The characteristic feature of trade policy in the thirties was the lack of stability: Import prohibitions and

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<sup>1</sup> Cf. Olivier Long: Prospects for World Trade and International Trade Policy, in: Außenwirtschaft, June 1976, pp. 155 and 162.

<sup>2</sup> Cf. H. Mayrzedt: Multilaterale Wirtschaftsdiplomatie zwischen westlichen Industriestaaten als Instrument zur Stärkung der multilateralen und liberalen Handelspolitik (Multilateral economic diplomacy between western industrialized states as an instrument for the strengthening of multilateral and liberal trade policy), Veröffentlichungen der Hochschule St. Gallen für Wirtschafts- und Sozialwissenschaften, Schriftenreihe Volkswirtschaft, Vol. 4, Berne 1979, chs. 10 and 11.

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quantitative restrictions on imports as well as foreign currency controls and exchange rate manipulations were prevalent. After the second world war GATT and the IMF led to a gradual return to stable trade policy conditions. The most important instruments under GATT were:

- ☐ Liberalization, i. e. removal of quantitative import restrictions, which curbed arbitrary state interference;
- ☐ Unqualified and permanent most-favoured-nation treatment which ruled out arbitrary tariff differentiation between supplier countries (discrimination) and thus enabled the foreign suppliers with the lowest costs and highest qualities to hold their own against foreign competitors;
- ☐ Fixed tariffs which gave protection against subsequent duty increases.

IMF rules were helping to keep trade policy conditions stable, especially those concerning:

- ☐ Exchange rate stability by means of currency parities,
- ☐ Non-discrimination in the field of payments, and
- ☐ Currency convertibility.

The stability of trade policy conditions lessened the difference between foreign and domestic trade. There is no doubt that it fostered international division of labour.

### Principle of Reciprocity

The principle of reciprocity of trade concessions implies according to GATT that if a country wants to secure trade concessions it must be prepared to offer globally by and large equivalent concessions<sup>3</sup>. This is a fairly old principle of foreign trade policy which, although unpopular in foreign trade theory<sup>4</sup>, has been followed consistently to this very day. The most important instruments for the application of the principle of reciprocity are:

- ☐ The main-supplier rule which means that negotiations should be conducted with the main supplier country, i. e. with the country which will benefit most from the duty concessions in question, and
- ☐ The stipulation of simultaneity of negotiations, which makes any concessions by one country contingent on those by other countries.

To what extent, it must be asked next, has the floating led to changes in regard to the two principles of the "old" trade policy? With fluctuating exchange rates, it has to be noted first of all, the stability of trade policy

conditions from the monetary side can no longer be taken for granted, for:

- ☐ What protection is provided by import duties is no longer known as exchange rate movements cannot be accurately predicted and exchange rates often move out of line with the purchasing power parities.
- ☐ The exporter therefore no longer knows whether he can still count on a certain foreign market for the future although the duties are not altered or even if they are reduced, and what price concessions he will have to make in order to retain the market.

Fluctuating exchange rates thus cause uncertainty about the international competitive conditions. We are therefore not in error if we call the uncertainty of the exchange rates – just like other uncertainties bearing on trade – a non-tariff obstacle to trade<sup>5</sup>.

In the light of the disproportion between tariff reductions and real, i. e. inflation-adjusted, exchange rate fluctuations floating exchange rates seem also to bring the importance of the principle of reciprocity in question. While for instance following the Kennedy Round some tariff rates were over a period of five years reduced from 20 % to 12 %, nominal and at times even real exchange rate movements of 20 % and more in one year have been quite a common occurrence in recent years. The result was that despite lower tariff rates product prices often went up.

### Effects of Exchange Rate Instability

Changes of this kind have undeniably taken place. Much more important than this fact itself is the question – which is also more difficult to answer – what importance attaches to such changes for foreign trade. The following three points call for an answer:

- ☐ Have exchange rate fluctuations affected foreign trade in the past? In the absence of a basis of comparison this is in dispute. Besides, the international trade has gone on expanding continually, except in one year. It is probable however that exporters in

<sup>3</sup> Cf. G. and V. Curzon: The Management of Trade Relations in the GATT, in: A. Shonfield (ed.): International Economic Relations of the Western World 1959-1971, Vol. 1, Oxford 1976, p. 156 ff.

<sup>4</sup> Cf. G. Haberler, with the cooperation of St. Verosta: Liberale und planwirtschaftliche Handelspolitik (Liberal and economic-planning trade policy), Berlin 1934, p. 3.

<sup>5</sup> Cf. R. Blackhurst, N. Marian, J. Tuñir: Trade Liberalization, Protectionism and Interdependence, GATT Studies in International Trade, No. 5, GATT, Geneva 1977, p. 9: "... uncertainty is a highly effective non-tariff barrier to international trade, in particular because it discourages long-term investments whose profitability depends on secure access to foreign markets ...".

strong-currency countries have had to accept substantial dents in earnings.

□ To what extent can the problem be solved by a hedge against the exchange rate risk? It can be covered in part only, and for a smaller part at that, namely – disregarding finer points – for the period from the receipt of the order to the time of payment, and the costs are sometimes very high. In other words, foreign trade transactions become more expensive.

□ There is no covering the risk that production in certain locations suddenly cannot be kept going because of currency movements which may take the exchange rates a long way from the purchasing power parities. Rational choice of locations is made more difficult by uncertainty about the trend of the real exchange rates in the next years.

The fact that the differential between foreign and domestic trade has once more widened – because of the higher costs and the greater hazards of foreign trade – carries much more weight today since the international division of labour has taken great strides forward.

#### **Is Reciprocity Unnecessary?**

It has been pointed out that the price-competitiveness of a country may deteriorate despite tariff cuts when goods from hard-currency countries become dearer as a result of exchange rate movements. This phenomenon is akin to tariff differentiation between countries (and thus to discrimination) even if it is not desired by the states concerned but brought about by events in the foreign exchange markets. Is such a development a violation of the principle of reciprocity? In the scientific discussion this question is answered negatively<sup>6</sup>. According to the prevailing opinion the floating has removed the motivation for reciprocity. The need for reciprocity has disappeared, so it is argued, as this principle is applied automatically by an economic mechanism through the working of the flexible exchange rates themselves.

The nature of the problem is shown up clearly by a comparison with the situation as it presented itself with fixed exchange rates when balance of payments and employment considerations seemed to preclude unilateral tariff cuts because they would have impaired the employment and balance of payments position of the unilaterally liberalizing country and other countries

would have had the benefit. With floating rates on the other hand, it is argued<sup>7</sup>, unilateral tariff cuts would pull the exchange rate down by resulting in an import surplus, with the effect that the prospects for exports would improve until the exchange rate advantage was reversed. Overvaluation of a currency which could only be thought of as a temporary phenomenon, would have a similar effect. The current account would quickly turn into deficit because exporting became more difficult and importing easier, so that the currency could be expected to weaken.

How can this train of argument be squared with the practical experience? The largest current account surpluses were recorded last year by the industrialized countries with the strongest currencies – Japan, the Federal Republic of Germany and Switzerland – while the considerable current account deficit of the USA increased further although the dollar took a tumble.

Two conclusions follow from this:

□ As far as price-competitiveness is concerned, currencies can remain overvalued or undervalued for quite long periods.

□ Contrary to the theoretical models, the overvaluation of a currency does not rule out the possibility of the country concerned recording a surplus on current account over a prolonged period.

What does this imply for reciprocity? The possibility of persistent overvaluation of a currency seems to favour violation of the principle of reciprocity by the trading partners. The current account surplus of the country with an overvalued currency however works in the opposite direction, and this is likely to be the decisive effect.

#### **Persistent Overvaluation**

Five potential causes of persistent currency overvaluation – not necessarily the only ones – may be mentioned:

□ Some industries require very long adjustment periods. Several years usually elapse in the engineering industry between acceptance of an order (at a lower Swiss franc rate), delivery (recorded in the trade statistics) and receipt of payment.

□ The export products of countries with overvalued currencies are evidently far less price-sensitive than is often assumed (e. g. because of superior quality or marked product differentiation), so that the currency-related price increase has to be borne largely by the importing country. Compared with countries with undervalued currencies their price-sensitivity is probably also smaller.

<sup>7</sup> Cf. F. Roessler, *ibid.*

<sup>6</sup> Cf. B. Nowzad: Fluctuating exchange rates and world trade, in: *Finance and Development*, December 1976, p. 35; F. Roessler: The rationale for reciprocity in trade negotiations under fluctuating currencies, in: *Kyklos*, Vol. 31, 1978, Fasc. 2, p. 261 f.

☐ The attitude of individual firms to possible adjustments shows wide variations. In countries with undervalued currencies they have often desisted from taking advantage of their greater price-competitiveness to increase exports. On the other hand firms, for instance in Switzerland, have apparently often defended export markets even in case of profit margins becoming unattractive there.

☐ Cyclical discrepancies have had a strong impact on current account balances and exchange rates as a result of demand growth differences between foreign and domestic markets.

☐ Exchange rate expectations may have nothing to do with current account movements.

These reflections show that the changes to which trade policy has been subject have lessened the importance of reciprocity. The cut in import tariffs has by now gone so far that they could even be given up altogether in which case the present system of binding tariffs would be replaced by a "binding freedom from duties". The problems inherent in the reciprocity of tariff concessions would thereby be eliminated.

The predominant view in the practice of trade policy however still seems to be that the reciprocity rule still merits its former importance. In the latest round of GATT negotiations the old principle of reciprocity was indeed retained<sup>8</sup>. It cannot therefore be ruled out that governments will react to unwelcome exchange rate movements by resort to non-tariff trade barriers<sup>9</sup>, citing the principle of reciprocity in justification of their actions, although there are weighty arguments against such a policy:

☐ The inflation in the importing country would accelerate.

☐ The international division of labour would be impaired.

☐ The overvaluation of a currency might additionally be aggravated.

☐ There would be a very real danger of retaliatory measures by foreign countries.

In the future the place of reciprocity should be taken by reduction and elimination of non-tariff barriers as well as harmonization of such non-tariff obstacles to trade as differentiative health regulations, standards, etc. To curb non-tariff obstacles to trade and to further the harmonization efforts GATT can draw on

negotiating mechanisms which have proved most successful in regard to tariffs and could probably be applied elsewhere as well. Generalized trade policy principles of equality of treatment and mutual advantage would supersede most-favoured-nation treatment and reciprocity.

### Regional Exchange Rate Stabilization

The difficulties in the way of the practical imposition of curbs on the non-tariff obstacles to trade must not however be underrated since the existence of fluctuating exchange rates has increased the importance of non-tariff measures as potential instruments of trade policy<sup>10</sup>. It must therefore also be considered how the instability of the exchange rates could be checked.

A few initial steps in the right direction have already been taken to this end. There are for instance the dollar support packet and, more especially in western Europe, the efforts for regional exchange rate stabilization. It seems possible, and also sensible, to divide the world economy for purposes of trade and exchange rate policy into regional groupings within which the international division of labour could be carried a long way forward through utilization of both their market potential and their productive capacity. It would be possible to return inside these regions to the security of stable trade policy conditions even though those between the regions would probably still be marked by a low level of security. It was always utopian to believe that it was possible to reach uniform arrangements for trade and monetary policies embracing the whole of the non-communist world apart from a few temporary exceptions. The principal task of world-wide organizations like GATT (and the IMF) would in future consist in regulating the cooperation between the regions and big national markets (USA) so as to complement the work inside the regions where – as is happening in the EC – the cooperation would be intensified.

Having demonstrated that the floating of exchange rates has changed some basic features of the trade policy pursued previously, we should make one point clear: There would probably have been even bigger changes in trade policy had there been no divarication from the system of fixed exchange rates. In that case exchange controls and quantitative import restrictions would probably have become unavoidable. To resort to floating – in an inflationary world – was under the aspects of trade policy a choice of the lesser evil.

<sup>8</sup> Declaration of Ministers Approved at Tokyo on 14 September 1973. Reprinted in: GATT, Basic Instruments and Selected Documents (BISD), 20th Supplement, pp. 19-22.

<sup>9</sup> Cf. B. Nowzad, *op. cit.*, p. 34.

<sup>10</sup> Cf. B. Nowzad, *ibid.*, p. 35.