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Christa Randzio-Plath*

Exchange Rates and the Volume of Trade – the Case for Fixed Exchange Rates

Exchange rate volatility and long-term distortions of exchange rate levels have given rise to concern among participants in international trade. Do exchange rate fluctuations have an adverse impact on the volume of trade? What measures could be taken to achieve greater exchange rate stability?

In the light of the EMS crises of 1992 and 1993, and given that world trade has a major impact on national economies and employment in the EU, there is a need to evaluate the impact on trade of exchange rate fluctuations. An analysis of the interactions between the two must be followed up by an estimate of the impact, to determine whether there is a need for political action. If exchange rate fluctuations lead to a decline in trade between the Member States, there must be limits on such fluctuations, as trade promotes growth and hence employment. If it were to transpire that exchange rate fluctuations have no impact, this would put a different complexion on the issue of flexible versus fixed exchange rates, as one of the latter's major advantages would have disappeared, throwing their drawbacks into relief. If fluctuations have only minor effects, the advantages of fixed exchange rates must be weighed up against their drawbacks.

On 15 March 1994 the Subcommittee on Monetary Policy held a public hearing of experts entitled "Fighting against speculation – by means of international monetary cooperation?", with the participation of economists and representatives of the business community.

The growth of world trade slowed down in 1993. World trade in goods, for example, grew by a mere 2.5% in 1993 (4.5% in 1992). The value of world trade in goods, which fell by 2 %, reflects – according to GATT – the buoyancy of the dollar vis-à-vis the European currencies, and declining

oil and primary commodity prices. According to GATT estimates, the value of trade in services rose by only 3% in 1993 (12% in 1992). The countries of South-East Asia are among the nations emerging as competitors. The link between their trade successes and exchange rate policies must be subjected to further scrutiny, as must the link between the market entry successes and the exchange rate policies of a number of Central and Eastern European countries. Trade contributes a great deal to the GDP of the European Union, whose internal and external trade is being assessed here (see Table 1).

In investigating the impact of exchange rate fluctuations on the volume of trade, a distinction must be drawn between short-term fluctuations (such as day-to-day shifts in exchange rates, "volatility") and long-term distortions ("misalignments", such as the nominal rise of approximately 100% in the dollar-deutschmark exchange rate between 1980 and 1985).

Short-term Exchange Rate Fluctuations

A study commissioned by the European Parliament from the Brussels-based Centre for Economic Policy Research (CEPR) notes that there is no consensus among economists as to whether short-term exchange rate fluctuations affect the volume of trade. One possible explanation of this finding is that companies are able to protect their business transactions against exchange rate fluctuations and have increasingly delicate instruments at their disposal for this purpose, including, for instance, derivative financial instruments. Another is that companies refrain from instantly adjusting their prices on

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foreign markets to take account of short-term exchange rate fluctuations, to avoid losing market shares.

An important question is whether it is possible to estimate the *maximum impact* on trade of short-term exchange rate fluctuations. According to the CEPR study, research shows that world trade would have grown by at most 3% more if short-term exchange rate fluctuations had been eliminated in 1990, while trade within the EU could have grown by at most 0.15% more in that year. It is important to stress here that such maximum values are highly improbable. The impact of the 1992 EMS crisis and the widening of EMS margins of fluctuation in 1993 cannot yet be estimated. Initial figures indicate that Italy, Spain and the UK have increased their exports.

The OECD concludes in a contribution for the Subcommittee on Monetary Policy that the EMS has proved its worth, as stabilization of exchange rates within the EU favours trade and has exorcized the risk of competitive devaluations which would destroy the Single Market. On the other hand, fixed exchange rates can make it more difficult to adapt to external shocks which affect Member States in different ways, thereby indirectly jeopardizing the volume of trade within the EU in the medium term. An example here is the period of fixed exchange rates (1987-1992) and the impact of German reunification. This period may have been more damaging than beneficial to EU trade. The OECD is sceptical about a worldwide stabilization of exchange rates; although it would be good for world trade, it would also be difficult to put into practice. The reasons for this lie in differing macroeconomic conditions, particularly varying degrees of dependence on external trade and different political and economic interests.

Companies view exchange rate fluctuations as costly, but not especially problematic. The only way, in their view, of responding in the short term to unexpected exchange rate rises against which provision has not been made is to cut prices expressed in the national currency, so as to hold on to market shares; this results in reduced profits or even

losses. They say that it is possible to hedge against the risks of exchange rate fluctuations, though hedging is extremely costly for small and medium-sized companies in particular.

Long-term Distortions

The CEPR study, the OECD and representatives of business believe that misalignment, that is, the long-term deviation of the exchange rate from the prevailing trend or purchasing power parity, has adverse consequences. One extreme example of such long-term distortion is the trajectory of the US dollar exchange rate between 1980 and 1985. The exchange rate of the dollar against the deutschmark reached its lowest point (DM 1.71 per US\$ 1) in early 1980, rising subsequently to a peak of DM 3.47 per US\$ 1 on 26 February 1985. This represents a nominal revaluation of the dollar of approximately 100%. The dollar has now returned to approximately the same level in relation to the deutschmark as in early 1980. The rise of the dollar cannot be accounted for in terms of disparities in inflation rates. On the contrary, these were favourable to a devaluation of the dollar, yet it was revalued by over 100% in real terms. It is impossible to envisage any realistic internal adjustment measure which could have compensated for a revaluation of over 100%. Such a distortion in the level of the exchange rate necessarily leads to an arbitrary distribution of market shares, as the terms of trade no longer reflect the competitiveness of rival national economies in real terms.

Closer to home, another example, on a less extreme scale, of the distortion of real exchange rates is the period of exchange rate stability within the EMS between 1987 and 1992. Whilst the immobility of nominal exchange rates over this period was fully justified by the underlying economic data as far as most currencies were concerned, the Italian lira, the pound sterling and the Spanish peseta had gradually reached a stage at which they needed to be devalued, in view of inflation differentials in relation to the more stable member currencies. The dramatic devaluations of these currencies which took place reflect this imperative fairly accurately. The devaluations of other currencies can also be explained in terms of inflation differentials, while that of the Irish punt may be ascribed to Ireland's close economic links with Britain. It emerged clearly during the hearing that this abrupt change in nominal exchange rates led to serious problems, by contrast with the decision taken in the summer of 1993 to widen EMS fluctuation bands from $\pm 2.25\%$ to $\pm 15\%$.

In the face of exchange rate distortions, firms do have recourse to strategies such as investing in the countries concerned and diversifying their purchasing policy to a greater extent. Unfortunately, there has been little analysis

Table 1
Foreign Trade as a Proportion of EU GDP

| | Intra EU | | Extra EU | |
|------------------------|----------|---------|----------|---------|
| | Export | Import | Export | Import |
| Goods (1992) | | | | |
| million ECU | 696,541 | 715,997 | 435,660 | 487,730 |
| % of GDP | 12.7 | 13.1 | 8.0 | 8.9 |
| Services (1989) | | | | |
| million ECU | 115,235 | 117,007 | 138,697 | 123,129 |
| % of GDP | 2.6 | 2.7 | 3.2 | 2.8 |

Source: EUROSTAT.

of the effects which changes in exchange rates have on cross-border investment.

Impact of Devaluations

“Competitive devaluations” are synonymous with “beggar-thy-neighbour” policies. The impact of devaluations implemented to improve international competitiveness cannot be unambiguously defined, as it depends on the situation of the country concerned. Usually the external position of the country which has devalued deteriorates temporarily, as the quantity of imports remains inflexible initially, whilst higher prices have to be paid in the national currency (J curve effect). It takes a while for international competitiveness to improve as a result of the deterioration in the terms of trade.

Moreover, this enhanced competitiveness only lasts for as long as economic actors retain their “exchange rate illusion”, which is part of the “money illusion”, that is, the illusion that the currency is stable in terms of both its internal and external purchasing power. Once this illusion has been dissipated, adjustment measures are taken which – particularly where permissive monetary policy is involved – can nullify the effects of devaluation. The more open the national economy, the faster the exchange rate illusion is likely to disappear. Subsequent discretionary devaluations of the nominal rate of exchange are pointless, as they have no real impact even in the short term. Not only has the country concerned gained nothing in the medium term, but it may also, at worst, have set off an inflationary wage and price spiral; at all events, it will at the very least have lost credibility as regards economic policy, which will have to be paid for with a risk premium on long-term interest rates.

Conclusions for the European Union

It can be concluded from this analysis that stabilization of exchange rates within the EU is desirable because mutual trade links have increased with the completion of the Single Market and the European Economic Area and will continue to increase. Successful stabilization would make it possible to plan trade, investment and yields in the longer term, thereby having a positive impact on trade and investment and hence on growth to create jobs. This would also help small and medium-sized businesses, which find it particularly costly to hedge against exchange-rate fluctuations for their intra-Community transactions.

There are basically three ways of stabilizing exchange rates within the EU. The ideal solution would be direct transition to the third stage of economic and monetary union. However, this is not a viable option, as none of the Member States fulfils the convergence criteria. In the short

term, an initial attempt can be made to stabilize exchange rates within the framework of the existing system – which has affinities with target zones – of bilateral central rates with fluctuation bands of $\pm 15\%$. A third possible method would be to revert overnight to an exchange rate mechanism with narrow fluctuation margins. This would admittedly be feasible, especially as the remaining member currencies have either remained within or are only just outside the narrow margins. Such a strategy would however be risky. Daily turnover in foreign currency trading on the world’s foreign currency markets, which can be up to US\$ 1 trillion (1 million million), can render all defence of exchange rates illusory. The decision to widen the fluctuation bands to $\pm 15\%$ was not, after all, discretionary; in view of the loss of credibility of the narrow fluctuation bands on the foreign currency markets and the intense pressure for devaluation – speculative and other – on a number of currencies, it looked like the lesser evil.

It is therefore essential, before a return to narrower fluctuation bands, that the Member States coordinate their economic policy better and more rigorously, to make stable exchange rates in the second stage of economic and monetary union credible. Until such time as the Member States have a credible and uncontroversial economic policy aimed at achieving greater convergence, which would automatically lead to the stabilization of the exchange rates, the foreign exchange markets cannot be expected to provide an automatic solution. Monetary and economic policy must be based on the old fluctuation bands. The advantage of such an approach would be that fixed exchange rates would gain in credibility at the same time as the economic policy of the Member States taking part.

In the medium term, however, there is a need for a return to formal exchange rate stability in the EU. While exchange rate stability rests only on consensus between participants, it is more vulnerable than would be the case in a formal system including sanctions such as loss of face and peer pressure. Formalization would prevent erosion of economic discipline. A return to “normal” fluctuation bands, at most two years prior to the beginning of the third stage, is one of the criteria for participation in the final stage of economic and monetary union. The “normal” fluctuation band needs to be clearly defined.

Before the exchange rate mechanism can be restored, however, measures must be taken to ensure that it does not lead to distortions in real exchange rates like those between 1987 and 1992. Decisions to adjust exchange rates must be made independent of purely political decisions prompted by considerations of prestige. In the past, essential adjustments – i.e. devaluations of weak

currencies and/or revaluations of strong currencies—were not made because the governments concerned were afraid of losing face. The following points provide a basis for reform:

The system must be based on joint management and decision-making in future, i.e. the initial exchange rate of a currency entering the exchange rate mechanism and the fluctuation band must be determined jointly, not decided by the individual Member State concerned.

The competitiveness and basic economic data of the Member States must be checked regularly on the basis of

agreed indicators and exchange rates adjusted where necessary.

Political interest in delaying revaluations and devaluations must be avoided through some sort of dialogue procedure between the EU Finance Ministers, in which the European Monetary Institute would play a key role. Such a procedure could enhance the credibility of the decisions taken.

Global Cooperation

Despite the globalization of the financial and currency markets and the liberalization of capital movements, there is a far less urgent need, in a global context, to limit short-

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term exchange rate fluctuations, given the far smaller degree of economic interpenetration which exists. Abrupt shifts in the exchange rate of the US dollar and the yen can, however, have adverse effects, as the US and Japan account for approximately 28% of the EU's imports from third countries and take approximately 23% of its exports. The US, Japan and the EU together account for 60% of world exports of goods (47% if internal trade is not counted.) The US dollar is *the* key currency used in international transactions; in 1990, approximately 41% of goods exports and 49% of goods imports were invoiced in US dollars.

Distorted exchange rate levels worldwide constitute a far greater problem than exchange rate volatility, as was pointed out at the hearing by both economists and representatives of business. An example of such distortion is the development of the dollar exchange rate between 1980 and 1985, referred to above. A similar contemporary case could be the overvaluation of the yen, resulting from a competitive devaluation of the US dollar (and hence of the ECU).

The undervaluation of currencies can be an important way of stimulating foreign demand and thereby enabling the national economy concerned to catch up in terms of economic development. West Germany and Japan after the Second World War, the countries of South-East Asia and the countries of Central and Eastern Europe currently undertaking reform offer examples. Once the economy in question has successfully integrated into the world market, however, it behoves it to take step-by-step measures to correct undervalued exchange rates, in order to avoid an excessively export-oriented distortion of its economic structure.

The question arises, however, of what can be done at a global level to avoid exchange rate imbalances. Fixed exchange rates, along Bretton Woods lines, for instance, are not a realistic option 50 years after the establishment of the Bretton Woods system and over 20 years after its collapse. Developments in economic conditions since the early 1970s have tended to be even more unfavourable to fixed exchange rate systems. Turnover on the foreign exchange markets has shot up as a result of deregulation and the dismantling of controls on capital movements. Technological advances have made it possible to withdraw these liquid resources in a matter of minutes and also to use them for speculative purposes. The EMS has demonstrated – on a relatively small scale! – what could happen worldwide. However, the present situation in the EMS may provide a starting point for new approaches in considering proposals which have already been discussed repeatedly and at length; the “new” EMS (since 1993) can be viewed as a system of floating exchange

rates with target zones. Similar target zones could also be established between the three leading world currencies, perhaps without formal constraints and on a non-binding basis.

Unsatisfactory Results

A mechanism of this type has already been tried out twice: in September 1985, under the G-5 Plaza Agreement, and in February 1987, under the G-6 Louvre Agreement. The rise of the US dollar exchange rate was reversed following a concerted intervention by the central banks of the G-5 in January 1985. It was sufficient, to prevent the exchange rate from rising again in September, for the G-5 to declare on 22 September 1985 (in the context of the Plaza Agreement) that further revaluation of the main non-dollar currencies within an ordered framework was desirable and that they were prepared to cooperate more closely with one another to promote this aim, for such time as might be helpful. By contrast, the Louvre Agreement of 22 February 1987 aimed to stabilize the exchange rate of the US dollar. It was a success. It was the crisis on the stock exchange in October 1987 which brought this phase to an end.

These two examples show the limits of international monetary cooperation. Although influence was brought to bear on the exchange rates in both cases, one must remember that the overvalued dollar exchange rate in 1985 would have corrected itself sooner or later anyway and that the stabilization introduced in 1987 was merely a fair weather operation which lasted for a quiet six months. Both the Plaza and the Louvre Agreements included a – somewhat vague – undertaking to the effect that economic policies must be geared to one another. The story of the G-7 shows that this failed.

As within the EMS, however, it is scarcely feasible to stabilize exchange rates worldwide unless economic policies are coordinated at the same time. This is done on an orderly and regular basis under the auspices of the International Monetary Fund. In principle, the G-7 offers a more promising framework for economic coordination between the countries concerned, although the results achieved so far have also been unsatisfactory. The utility of global coordination of economic policies is clear; what is at issue is its feasibility. This depends on the willingness of the US, Japan and the EU Member States to coordinate their policies on a binding basis. The worldwide stabilization of exchange rates also entails agreement as to their level which must be credible. On balance, the preliminary conclusion must be that we shall have to trust in flexible exchange rates worldwide fluctuating around purchasing power parities and in long-term distortions being avoided.