"TRADE RELATIONS UNDER FLEXIBLE EXCHANGE RATES"

Trade Relations under Flexible Exchange Rates¹ is published today by the GATT secretariat as a staff paper in the series "GATT Studies in International Trade".

It is often suggested that the present monetary system of flexible exchange rates has distorted trade patterns and diminished the importance of the international rules governing trade relations, as well as of efforts to reduce trade barriers. The study, by Richard Blackhurst and Jan Tumlir, assesses these arguments. It concludes that these particular claims are unfounded. But the authors, who are senior economists of the GATT secretariat, believe that the world economy has suffered from the absence of an international currency of stable purchasing power.

In 1973, the previous international monetary system, under which the exchange rates between major national currencies were fixed, was replaced by a system of floating rates. These rates have since fluctuated considerably. In assessing the impact of these fluctuations on international trade, the new GATT study seeks to dispel uncertainties which, in the authors' words, "threaten to undermine the steadiness of commercial policy, which is the main objective of international trade agreements and of the continuous diplomatic effort devoted to their interpretation in daily practice".

The study asks, and tries to answer, a number of fundamental questions. These include:

- **Are efforts at trade liberalization still worthwhile in a climate of uncertainty about exchange rates?** The authors answer, "yes". Exchange rate changes, to the extent that they influence trade flows, affect all imports and exports uniformly. The effects of trade liberalization, on the other hand, vary from product to product because existing trade barriers (and the degree of liberalization) are not uniform for all products.

- **Do exchange rate changes affect trade flows between countries?** The study concludes that the effects are only minor. Most shifts in nominal exchange rates reflect differences in national rates of inflation. The evidence of recent years suggest that even changes in real (inflation-adjusted) exchange rates have hardly affected trade balances.

- **Can governments manipulate exchange rates to gain unfair advantage in the world market?** "No", the authors conclude. Under floating rates, with capital moving relatively freely across frontiers, countries cannot maintain an artificially low exchange rate for a long enough period to affect trade flows noticeably, since any attempt to do so will seriously damage the domestic economy.

- **Have countries been "injured" by exchange rate changes?** The study accepts that individual firms have met difficulties when real exchange rates have appreciated. But the source of this damage is seen in the persistent divergence between tight monetary policies in surplus countries and relative monetary ease in the deficit ones. In these circumstances large variations in exchange rates are inevitable.

- **What are the real costs of international monetary instability?** The major cost, the authors conclude, has resulted from the lack of a stable international currency performing the rôle once taken by the pound sterling, and later by the United States dollar. Without such a currency to act as a stable standard of value, medium of exchange, and store of value, the efficiency of all economic activity begins to decline. The same costs and distortions which inflation creates in the domestic economy appear at the world market level, and there ceases to be a stable reference point for monetary policy.

The aim of the series GATT Studies in International Trade is to make publicly available the results of some of the work undertaken by the staff of the GATT secretariat. They are published on the initiative of the secretariat. The views expressed are those of the authors alone and do not necessarily reflect the views of Contracting Parties to the General Agreement on Tariffs and Trade or of the secretariat of GATT. The purpose of the studies is to contribute to the discussion and understanding of current issues in the field of international trade.

The major conclusions of this study are summarized in its introductory chapter, excepts of which are given below.

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Major conclusions of "Trade Relations under Flexible Exchange Rates"

1. Exchange rate changes and trade flows

'The economic value of trade liberalization is not affected by increased variability of nominal exchange rates. There are no points of legitimate comparison between the two. Whatever the ultimate effect of an exchange rate change, it is uniform across all exports and imports of a country, whereas trade barriers are typically selective, differentiating between industries and product groups."

A frequent complaint, the study notes, is that exchange rate uncertainty acts as a deterrent to the expansion of trade. Although this sounds plausible, it is necessary to specify the alternative to be compared with the situation being analyzed. "Given the large and variable differences in national inflation rates, it is clear that an attempt to maintain fixed exchange rates in the 1970's would have had little chance of succeeding without extensive direct controls on trade as well as capital flows. These, however, would have impeded not only trade expansion but also general economic growth much more than did the additional uncertainty created by floating exchange rates." Moreover, the fact that even in the 1970's trade continued to expand more rapidly than production ... suggests that there was no important adverse effect of exchange rate variability on the level of international trade, which remained influenced mainly by the underlying GNP growth.

"With these two side issues out of the way, the theoretical core of the first question can be addressed. How does a change in the exchange rate of a particular currency affect that country's trade?"

"The first step is to distinguish between changes in inflation-adjusted 'real' exchange rates and changes in nominal exchange rates which merely offset relative changes in domestic price levels" (and therefore have no influence on trade). Measurements of real exchange rate changes indicate that the changes have been generally moderate, of short duration, and for the most part well within the margin of error which must be posited for exercises of this kind. In short, changes in nominal exchange rates have served in most instances to maintain, not alter, the pattern of international competitiveness".

"The second step involves determining whether estimated changes in real exchange rates have had an impact on trade balances. Empirical evidence ... for eight major countries for the 1970's indicates that the response of trade balances to such real exchange rate changes has been hardly significant, manifest if at all only over periods of such length that the relationship is highly tenuous, many other changes having intervened in the meantime. On the other hand, the relationship between trade balance changes and relative rates of GDP growth - the more rapidly growing country tending to develop a deficit and vice versa - is shown to hold much more closely. Researchers working with statistics for other countries and time periods have reported similar empirical findings."
The authors of the study note that these findings are supported by recent developments in the theory of balance-of-payments adjustment, according to which exchange rate changes are assigned only a small role if any in the correction of current account imbalances, while domestic monetary policy has come to be viewed as the most efficient instrument towards this objective.

2. Can a government manipulate the exchange rate?

Once the general obligation to maintain a given parity has been waived, it does not follow, according to the GATT economists, that the danger of governments manipulating their exchange rates increases. They argue that in a situation in which capital moves relatively freely between countries, the market process by which exchange rates are determined does not allow a single country to maintain a clearly inappropriate exchange rate long enough to produce significant trade results.

"What distinguishes a financial or stock market from a goods market? One of the most important differences is that financial assets are purchased with an eye to their expected future earnings. An increase in the expected future price of an asset will increase its attractiveness. Demand for the asset rises and, consequently, so does its market clearing price. The market for currencies (and their market clearing price, the exchange rate) behaves in a perfectly analogous manner. As with other financial assets, any development that disturbs the market expectations of a currency's future value will have immediate repercussions either for the currency's current value, the nominal rate of return on assets denominated in it, or both."

Thus "the exchange market is an adjunct of the international capital market, and like all markets it averages the opinions of large numbers of individuals strongly motivated to search for information from which relatively reliable expectations about the future may be formed. Under the present system, expectations regarding future exchange rates are guided primarily by two considerations, both of which are well grounded in theory and experience: a belief (i) that over the longer term, exchange rates change so as to offset inflation differentials between countries, and (ii) that if a country has a current account deficit or surplus exceeding what may be considered the stable or normal off-setting flow of long-term capital, its exchange rate will eventually change in a predictable direction. A change in the expected future exchange rate generally causes the current (spot) exchange rate to change as well."

"The fact that the spot exchange rate often changes immediately, whereas the disturbance which triggered the change in expectations affects the inflation differential only with a lag, means that the real exchange rate is affected in the interim. Labelled 'exchange rate overshooting', these inherently temporary changes in real exchange rates are a by-product of the
process whereby expected future changes in nominal exchange rates are capitalized into the current value of financial assets. The only efficient way of reducing such overshooting is to create a more stable economic environment in which expectations are disturbed less frequently. It should be added that qualified observers consider overshooting to have at times stimulated countries to adopt improved macroeconomic policies.

"There is little possibility for countries to deliberately cause their exchange rates to overshoot in the direction of depreciation so as to stimulate output in their export and import-competing industries, since all ways by which a government may try to influence its exchange rate have negative repercussions on the domestic economy which appear more promptly than, and are likely to far exceed in magnitude, the economic benefits of the trade effects envisaged. There are only two or perhaps three ways by which an exchange rate of a currency may be influenced by government policy: direct controls on trade and capital flows, domestic monetary policy and, under certain circumstances, central bank intervention in the exchange market. The third can be considered an independent instrument only in periods of relative stability when the level of intervention is moderate enough for its domestic monetary effects to be offset by other means."

"As to direct controls, those on trade cannot be considered an instrument of aggressive exchange rate manipulation. . . . The one thing an import restriction policy is decidedly incapable of achieving is an increase of the restricting country's share in world exports; indeed, it must reduce it. As for official control over capital movements, at the degree of interdependence the world economy has achieved by now, there does not seem to be any reliable, politically feasible method of implementing such controls. Capital movements as such can be controlled only within a comprehensive scheme of direct quantitative controls over all international transactions, merchandise trade in particular. For the time being, at least, no legislature of any advanced industrial country appears even remotely willing to contemplate the delegation to the executive of discretionary economic power of this extent.

"A change in domestic monetary policy has an immediate influence on the exchange rate, but a government would be ill-advised to try to use this influence to undervalue the exchange rate in the hope of an export gain. Only repeated shifts to more expansionary monetary policy could depress the exchange rate for more than a short period. The damage to the domestic economy by the ensuing inflation would far exceed any possible external gain."

3. Have countries been "injured" by exchange rate changes?

"It might seem that, once aggressive manipulation of the exchange rate of a particular currency has been shown impossible, the third question would be superfluous. But the fear of a country being injured by excessive exchange rate changes has been immanent in the history of international
commercial relations, and has been growing again in the last two decades. ...... It thus deserves closer analysis which, moreover, flows easily from that already presented."

According to the study's authors, the contrast between tight monetary policies in the surplus countries and relative monetary ease in the deficit ones suffices to explain the large variations of exchange rates in the 1970s. Given the divergent and unchanging nature of these policies, "the whole adjustment pressure converged on the exchange rates. It is not surprising that at times exchange rates attained what were clearly unrealistic levels from the purchasing-power-parity view, nor that they did not bring about a prompt adjustment. When the really effective policy instruments remain frozen at a contradictory course, the last free element, the exchange rate, will be pushed to large amplitudes but show little effect."

"From the viewpoint of individual firms in the export and import-competing industries in the countries whose real exchange rates appreciated, the exchange rate changes did cause real difficulties. However, this should not be confused with injury resulting from 'mercantilist' competition for market shares by such means as aggressive dumping. Retrenchment of activity in the tradeable goods sector is a necessary part of the balance-of-payments adjustment process in countries with unsustainable current account surpluses. And, because firms react only slowly to exchange rate changes whose duration is uncertain, it is unlikely that there was serious injury in the form of over-adjustment which would have to be reversed later on. It is true that all economies involved suffered costs from the economic turbulence in the late 1970s, but it must be emphasized that these were unintended costs, caused ultimately by the delayed reactions of national monetary policies."

These events, the study notes, led to a revival of the concern, widely debated under the fixed rate system, about the need for symmetry in adjustment. This argument involved two distinct misunderstandings. One was that it is possible for a country to "shift the real burden of adjustment" onto its trading partners. The other reflected the belief, prevalent in the 1960s and early 1970s, in the possibility of a permanent trade-off between inflation and unemployment. Thus it was argued that the surplus countries should ..... follow a more expansionary monetary policy at home, thereby reducing the extent of monetary tightening required in the deficit countries. "It should be obvious that this practice, if consistently followed, could not but impart an inflationary bias to the international monetary system."

4. The real costs of international monetary instability

"The first three questions posed at the beginning of this study have now been answered in a more or less qualified negative. These findings should not, however, be allowed to generate complacency. There are ample reasons for believing that the absence of a stable international currency -
that is, of a national currency of stable purchasing power capable of playing the same rôle as the pound sterling did before 1931, and the United States dollar during the quarter century following World War II - has imposed important costs on the world economy.

"Once a currency's purchasing power begins to erode, it becomes increasingly inefficient at carrying out its crucial functions in the domestic economy (standard of value, medium of exchange, standard of deferred payments, and store of value), with the result that the efficiency of all economic activity begins to decline. Exactly the same functions must be carried out for the world market economy, and when the established (de facto) international currency begins to lose its purchasing power, the same costs and distortions which inflation creates in the domestic economy appear at the world market level. Indeed, in this case there is an additional cost, arising from the fact that the international currency no longer provides a stable reference point against which other countries can gauge their own domestic monetary policies."

"It is not clear how long international monetary instability will continue to burden the world economy with these costs. At this point, the most realistic hope is that the currencies of the large trading countries will acquire the requisite purchasing power stability."

"Given all the economies and advantages of a single currency for the conduct of international transactions, it can safely be predicted that, whatever the final form the international monetary system assumes, the financial processes underlying world trade will remain based on a major national money. Unless that money maintains its purchasing power, no international monetary system will be able to function satisfactorily."