exchange rate system, such as those quoted at the start of this Commentary, will be analyzed.

Suggested Reforms Related to Exchange Rate Volatility

Since it is long-term misalignments of the real effective exchange rate that matter most to international trade, any suggested reforms based on the notion that trade is adversely effected by short-term volatility in foreign exchange markets should be very carefully scrutinized. It is not denied that nominal exchange rates can be volatile in the short term, but the effects of that volatility on trade are thought to be small.

Not only is it possible to focus on the wrong exchange rate (the nominal rate as opposed to the real effective rate) and the wrong time frame (short term as opposed to long term), it is also possible to reverse, or at least confuse, the cause and effect of exchange rate movements. Given that one of the macroeconomic roles of exchange rates is that of an adjustment mechanism to account for differences in economic conditions and policies between countries, it is incorrect to consider exchange rates as exogenous variables. As an adjustment mechanism, exchange rates will (and should) change in response to changes in other economic variables.

"Throwing Sand in the Gears" and Prudential Regulations

One of the proposed reforms to address excess volatility in a number of financial markets -- including equity, bond, options, futures and foreign exchange markets -- is the introduction of a transaction tax. It is argued that such a tax would raise the cost of short-term speculative trading, reduce financial market volatility and improve the efficiency of financial markets.[20] There are, however, a number of problems associated with what has become known as "throwing sand in the gears" of financial markets, including uncertainty whether volatility would be reduced, the increased costs that would be borne by all investors (not just speculators) and likely increases in the cost of capital. Further, unless the tax were introduced globally, sophisticated market participants would simply move transactions off-shore in order

[20] For a summary of the pros and cons of securities transaction taxes, see C.S. Hakkio, "Should We Throw Sand in the Gears of Financial Markets?", in *Economic Review,* Vol. 79, No. 2, Federal Reserve Bank of Kansas City, Kansas City MO, Second Quarter 1994, pp. 17-30.