

by an overvalued domestic currency might successfully lobby government for protective barriers that are not easily dismantled when the exchange rate eventually returns to equilibrium.

In terms of observing and commenting on exchange rate misalignments, it is necessary to determine first an equilibrium real effective exchange rate. Then, deviations from that equilibrium -- if they are persistent -- can be interpreted as misalignments and the effects on trade can be evaluated. However, economists have largely been unable to develop a convincing model of real exchange rate fundamentals, and are thus unable to agree (again, unanimously) on long-term equilibrium real exchange rates.¹⁸ Although a number of models have been developed to calculate real exchange rates, none has been able to provide satisfactory results across several bilateral rates.

The inability of economists to agree on equilibrium real effective exchange rates does not preclude a general agreement on whether certain currencies are misaligned in a particular time period, nor does it eliminate misalignments as a potential threat to the expansion of trade.¹⁹ It is in this light that some of the calls for reform of the

the Bank of Canada, 22-3 June, 1992. Harris concludes that it is difficult to separate hysteresis from long lags between exchange rate movements and trade. Amano *et al.* conclude that there is little evidence of trade hysteresis in Canada in relation to the dollar's appreciation in the 1986-91 period.

¹⁸ See, for example, C.C. Coughlin and K. Koedijk, "What Do We Know About the Long-Run Real Exchange Rate?", in *Review*, Vol. 72, No.1, The Federal Reserve Bank of St. Louis, St. Louis MO, January/February 1990, pp. 36-47, which concludes that little is known about real exchange rates in the long-run, and R.G. Harris, *Trade, Money, and Wealth in the Canadian Economy*, C.D. Howe Benefactors Lecture, C.D. Howe Institute, Toronto Ontario, September 1993, p. 30, which states that little is known about exchange rate movements over the short-term. See also J.A. Frankel and A.K. Rose, *A Survey of Empirical Research on Nominal Exchange Rates*, NBER Working Paper No. 4865, NBER, Cambridge, MA, September 1994. Frankel and Rose find that there is no conclusive evidence to account for some large exchange rate shocks and more study is required of the microstructure of the foreign exchange market. A collection of recent works aimed at furthering the understanding of exchange rate equilibria is contained in J. Williamson (ed.), *Estimating Equilibrium Exchange Rates*, Institute for International Economics, Washington DC, September 1994.

¹⁹ Examples of currencies that have been generally regarded as misaligned include the U.S. dollar (overvalued in the early 1980s) and the Canadian dollar (overvalued in the late 1980s). For a discussion of the U.S. dollar, see *The Economic Report of the President*, U.S. Government Printing Office, Washington DC, January 1993, pp. 292-3; for a discussion of the Canadian dollar, see, R.G. Harris, "Exchange Rates and Hysteresis in Trade", in *The Exchange Rate and the Economy*, Proceedings of a Conference held at the Bank of Canada, 22-3 June, 1992, p. 362.