Just as with nominal bilateral exchange rates, there is a technique to convert effective exchange rates to real effective exchange rates to account for inflation differentials. The real effective exchange rate is the single most important exchange rate with respect to trade.

Volatility, Misalignments and Trade

The terms "exchange rate volatility" and "exchange rate misalignment" have distinctly different meanings and implications regarding their effects on trade. Exchange rate volatility is a short-term phenomenon under which the movements of exchange rates are considered excessive when compared to underlying economic fundamentals. An exchange rate misalignment is a longer term phenomenon whereby an exchange rate is persistently either above or below its equilibrium value.

In the literature on the empirical relationship between exchange rate volatility and the volume of trade, there is a broad consensus (although it is not unanimous) that volatility probably reduces the level of trade, but by only a small amount.[16] The availability of financial instruments to insure against exchange rate volatility is at least partially responsible for the modest impact on trade. It is generally agreed that the limited economic welfare effects of a small decrease in trade do not warrant placing exchange rate volatility on the international economic policy agenda.

The trade effects of exchange rate misalignments cannot be dismissed as easily. Misaligned exchange rates imply a misallocation of resources, with either too few (domestic currency overvalued) or too many (domestic currency undervalued) resources devoted to the trade sector, and a suboptimal economic performance in all countries that are affected. To the extent that misalignments cause exporters to lose foreign market shares that they are unable to regain subsequently, trade "hysteresis" is said to occur.[17] In addition, import-sensitive industries that are adversely affected

[16] See, for example, V. Kumar and J.A. Whitt, Jr., "Exchange Rate Variability and Trade", in *Economic Review*, Vol. 77, No. 3, Federal Reserve Bank of Atlanta, Atlanta GA, May/June 1992, pp. 30-1; IMF, "The International Monetary System: Evolution Rather Than Revolution", in *IMF Survey*, IMF, Washington DC, November 28, 1994, p. 370; K.M. Dominguez and J.A. Frankel, *Does Foreign Exchange Intervention Work?*, Institute for International Economics, Washington DC, September 1993, pp. 34-5; and IMF, *Exchange Rate Volatility and World Trade*, IMF Occasional Paper No. 28, IMF, Washington DC, July 1984, p. 36.

[17] For analyses of trade hysteresis in a Canadian context, see R.G. Harris, "Exchange Rates and Hysteresis in Trade", and R. Amano, E. Beaulieu and L. Schembri, "Trade Hysteresis: Theory and Evidence for Canada", in *The Exchange Rate and the Economy*, Proceedings of a Conference held at