

7.3 A Discrete Change in Exchange Rates?

At the beginning of stage three it is likely that there will be a discrete jump in exchange rates, when the Council announces the conversion rates for all transactions between currencies participating in EMU on January 1, 1999. Inevitably there will be a discrete change in some exchange rates, just from the fact that bid-offer rates will collapse onto a single conversion factor, but there is the possibility that the Council will decide to use "rounded" rates so as to make the transition to the single currency as easy as possible for the business community and the general public. Giovannini (1991) analyses the last stage of EMU, but in terms of a currency reform. As Giovannini notes, if market rates at the end of 1998 are significantly different from those established by the Council at the beginning of 1999, then there will be macroeconomic effects, and these effects will depend on the degree of price and wage rigidity in each individual Member State. For instance, if prices were perfectly flexible then the discrete change in exchange rates would act like a tax on holders of balances of the depreciating currencies. If, however, prices were not perfectly flexible (due, say, to long-term contracts and adjustment costs) then the exchange rate change would affect the relative valuation of goods and services whose prices do not move freely. The macroeconomic effects would be in terms of the wealth and substitution effects of the changes in the real stock of money, which would give rise to a decrease in spending, a fall in output and the relative price of non-traded goods and an increase in output of traded goods and a trade surplus. The opposite effects would occur in countries whose currencies underwent an appreciation. The point here is that if expectations of economic agents are altered by the changeover, because of long-term contracts and adjustment costs, then it may not be in the interest of the private sector to adopt the official conversion rate, as this would change real payments as contracts are specified in nominal terms. In this sense mandating a changeover at a specified point in time acts like an incomes policy.

In order to eliminate any adverse economic effects of devaluing the currencies of Member States, Giovannini advocates the marking-to-market of contracts at the conversion date and the choice of a conversion rate that induces exactly the same exchange rate depreciation that was expected by wage and price setters (and so gave rise to any relative price distortions in the first place). In reality, this is unlikely to happen, as the calculations involved in such an exercise would be extremely difficult to extract from the economic data available. Nevertheless, it should be acknowledged that certain Member States might seek a discrete jump in exchange rates so as to effectively give them a "final devaluation" as EMU begins. It should also be noted that both Germany and the Netherlands will vigorously resist such a strategy, as it implies a discrete "revaluation" in their currencies, which would have adverse effects on their export sectors.

What would be the effect of this be on Canadian exporters? Canadian exporters will effectively face a discrete jump in exchange rates for their exports to these Member States, and this will likely either make exports less price competitive compared with domestic producers, or shrink profit margins. The opposite would occur for Member States whose currencies revalued. This scenario, although it appears possible, is one which Germany appears most resolutely opposed to, so the likelihood of a significant jump in exchange rates is not high.