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# POLICY STAFF COMMENTARY No. 6



## *Not Out of the (Bretton) Woods Yet:*

*Exchange Rate Disequilibria,  
Trade  
and Suggested Reforms*

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**Not Out of the (Bretton) Woods Yet:  
Exchange Rate Disequilibria, Trade and Suggested Reforms**

There are essentially three successive questions concerning the relationships between exchange rate disequilibria and international trade.

- Are exchange rates excessively volatile?
- If exchange rates are excessively volatile, is there any discernible impact on international trade?
- If exchange rates are excessively volatile and there is a distinct negative impact on international trade, what could or should be done about it?

As a means of exemplifying the urgency surrounding the debate on the effects of exchange rate swings on the international economy, consider the following two quotations from proceedings of conferences convened to review the Bretton Woods institutions.

... several participants argued that the present arrangement of floating exchange rates among major industrial countries needs to be reformed to mitigate exchange rate misalignments and instability. Reforms such as exchange rate target zones were proposed to promote fuller international policy coordination.<sup>1</sup>

A glaring weakness in current monetary arrangements ... has been the marked volatility of exchange rates. ... Now, however, limits on excessive volatility and persistent disequilibrium must ... be considered. ... In the near future, the international monetary system must be protected against possible internal breakdowns to reduce the risks to the system as a whole.<sup>2</sup>

It is worthy of note that the first quotation is drawn from a conference held in 1984, while the second is from a conference held by the same institution in 1994.

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<sup>1</sup> J.H. Bergstrand, "Summary", in *The International Monetary System: Forty Years After Bretton Woods*, Proceedings of a Conference Sponsored by the Federal Reserve Bank of Boston, May 1984, p. 1.

<sup>2</sup> R.E. Cononi and R. Hellerstein, "50 Years After Bretton Woods: What is the Future of the International Monetary System? An Overview" in *New England Economic Review*, Federal Reserve Bank of Boston, Boston MA, July/August 1994, pp. 66-71.

Without being too flippant, if exchange rate movements posed such a danger in 1984, how was it that over the next ten years the G-7 economies grew in real terms by an average of 2.8% annually, G-7 export volumes were up about 45%, G-7 import volumes rose about 58%, and the stock of G-7 outward foreign direct investment nearly tripled to \$US1.59 trillion?<sup>3</sup> These data might suggest that the exchange rate worries expressed in 1984 were overstated. Is the same true in 1994? Or, does the increased international integration of business and financial markets instead strengthen the case for a renewal of exchange rate arrangements in order to provide more stable foreign exchange markets?

### **What Has Changed Since Bretton Woods and How Does the Present System Measure Up?**

Within the broader goal of fostering greater international economic well-being, one of the original roles of the IMF was to promote an orderly exchange rate system, in part by ensuring that no member country undertook competitive devaluations.<sup>4</sup> One of the most important changes to have taken place since the Bretton Woods institutions were created was the movement in the early 1970s from an "adjustable peg" to a more flexible "managed float" exchange rate system.<sup>5</sup> Following the collapse of the system of pegged exchange rates in the early 1970s, the IMF Articles of Agreement were changed subtly to reflect a new Fund role. Despite the addition

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<sup>3</sup> See IMF, *International Financial Statistics Yearbook*, IMF, Washington DC, various issues; and OECD, *International Investment Statistics Yearbook*, OECD, Paris, 1994. Foreign direct investment stocks are compared between 1984 and 1992, except for France, which is compared between 1987 and 1991 due to lack of data.

<sup>4</sup> For a discussion of the role of the IMF and how it has changed over time, see N.S. Fieleke, "The International Monetary Fund 50 Years After Bretton Woods", in *New England Economic Review*, Federal Reserve Bank of Boston, Boston MA, September/October 1994, pp. 17-30.

<sup>5</sup> The adjustable peg system was one in which exchange rates were supposed to be changed only periodically in order to correct balance of payments disequilibria. The managed float system, which is still followed, allows monetary authorities to intervene in foreign exchange markets to smooth out short-term fluctuation without attempting to affect the long-term trends in exchange rates. The economic effects of different exchange rate regimes are unclear. Mills and Wood studied the U.K.'s exchange regimes since 1913, and determined that different regimes had no impact on the variability of several macroeconomic variables. See T.C. Mills and G.E. Wood, "Does the Exchange Rate Regime Affect the Economy?", in *Review*, Federal Reserve Bank of St. Louis, St. Louis MO, July/August 1993, pp. 3-20.

of "surveillance over members' exchange rate policies" to its list of responsibilities, the IMF has become marginalized in terms of its influence over the major currencies.<sup>6</sup>

Besides changes in the exchange rate system and the role of the IMF, several new international institutions such as the G-7 and the European Union have emerged alongside the Bretton Woods institutions. In terms of exchange rate management, the G-7 (or the G-5, excluding Canada and Italy) has, at least temporarily, influenced the policies of member governments through such undertakings as the Plaza Agreement of 1985 and the Louvre Accord of 1987.<sup>7</sup> The EU has its own system of exchange rate management, known as the Exchange Rate Mechanism (ERM), which is part of the European Monetary System (EMS). Currency relationships are supposed to be stabilized among those EU members that participate in the ERM.<sup>8</sup>

There have also been several noninstitutional changes in the international economy since the delegates met in Bretton Woods in 1944. Presently, there is a much greater variety of financial services and financial instruments available, and they are provided by several different types of financial institutions whose activities often overlap. Financial markets are now more globally integrated, with large and frequent cross-border capital flows. Sophisticated computer and other communications systems allow large volumes of capital to move almost instantaneously between markets.<sup>9</sup> International trade in both goods and services has grown dramatically over the last fifty years and represents larger shares of national incomes. More recent developments include a substantial increase in foreign direct investment along with the increased importance of multinational corporations.

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<sup>6</sup> See J.J. Polak, "The Role of the Fund", in *The International Monetary System: Forty Years After Bretton Woods*, Proceedings of a Conference Sponsored by the Federal Reserve Bank of Boston, May 1984, p. 246.

<sup>7</sup> For a detailed discussion of the Plaza Agreement and the Louvre Accord, see Y. Funabashi, *Managing the Dollar: From the Plaza to the Louvre*, Institute for International Economics, Washington DC, 1988.

<sup>8</sup> For a discussion on the workings of the EMS, see C.R. Henning, *Currencies and Politics in the United States, Germany and Japan*, Institute for International Economics, Washington DC, 1994, pp. 96-9.

<sup>9</sup> The Bank of Canada estimated that, as of April 1992, transactions in the Canadian foreign exchange market averaged about \$US22 billion per day. On an annual basis, Canadian foreign exchange turnover is more than nine times the level of Canada's Gross Domestic Product. See N. Close and C. Duenwald, "Survey of Canadian Foreign Exchange Market", in *Bank of Canada Review*, Bank of Canada, Ottawa, October 1992, p. 23.

Given the changes in the international economy, the emergence of several new, influential institutions and the relative decline of others (at least in terms of exchange rate management), the perceived strengths of the present system of floating exchange rates include:<sup>10</sup>

- the promotion of external payments balances;
- insulation from inflation abroad;
- the independence and effectiveness of domestic monetary policy; and
- the resilience of the floating rate system in terms of its ability to deal with major international financial strains.

The perceived weaknesses of the floating exchange rate regime are identified as:

- the short-term volatility of exchange rates;
- the existence of large and persistent misalignments of real exchange rates; and
- the system's lack of ability to promote the international coordination of macroeconomic policy.

In line with public attention, this Commentary will focus exclusively on the problems of exchange rate volatility and misalignments.

### **The Macroeconomic Role of Floating Exchange Rates**

The precise impact of exchange rate movements on domestic prices, production and employment depends largely upon economic circumstances and government policies at the time. While there are generally accepted principles concerning the trade effects of exchange rate movements (a depreciation increases exports and reduces imports while an appreciation reduces exports and increases imports), it is easy to envision circumstances in which exchange rate changes are followed by seemingly

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<sup>10</sup> See A. Crockett and M. Goldstein, *Strengthening the International Monetary System: Exchange Rates, Surveillance, and Objective Indicators*, IMF Occasional Paper No. 50, IMF, Washington DC, February 1987, pp. 2-10.

unanticipated results, at least in the short term.<sup>11</sup> It is equally possible to imagine situations in which the response of the exchange rate to a change in another economic variable, such as the interest rate, is not what is typically expected.<sup>12</sup>

In an open economy like Canada, one of the primary roles of the exchange rate is that of an automatic price adjustment mechanism to account for differences in domestic and foreign macroeconomic policies and conditions. As an adjustment mechanism, a change in the exchange rate can be preceded, for example, by a disequilibrium in the balance of payments. Short-term balance of payments disequilibria can be offset by an accumulation or a depletion of international reserves and/or international borrowing or lending. Neither solution can be extended indefinitely in the long term. For a long-term balance of payments disequilibrium, an exchange rate revaluation can eventually restore equilibrium.

The body of literature on the determinants of currency supply and demand, and ultimately exchange rates themselves, is enormous, but can be roughly divided into two groups: the economic fundamentals approach and the asset market approach. The balance of payments approach, as outlined above, is a fundamentals approach based on relationships between international flows (as they are recorded in the balance of payments) and exchange rates. The asset market approach discounts the role of international flows and considers the exchange rate to be an asset price that is determined in an efficient financial market -- the foreign exchange market. Like other asset prices, the exchange rate is determined by expectations about the future, and not necessarily by current trade or investment flows.

With neither approach lending itself easily or quickly to practical applications, analysts usually have little indication of the actual shapes or positions of currency supply and demand curves. Instead, one of the most widely used techniques for determining equilibrium exchange rates is the purchasing power parity (PPP) theory. In its most accepted form, the theory postulates that the change in the exchange rate between two countries over a period of time should be proportional to the relative

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<sup>11</sup> For example, the Japanese yen appreciated against the U.S. dollar in the mid 1980s, but Japanese exporters chose to accept lower profit margins rather than allow their U.S. market shares to decline. As a result, despite the appreciating yen, the Japanese trade surplus with the U.S. continued to grow.

<sup>12</sup> For example, in January 1995, the Canadian dollar depreciated against the U.S. dollar even though Canadian interest rates were rising.

change in the price levels of the countries over the same period.<sup>13</sup> This means that if one country's inflation rate over the past year was 5% higher than that of another country, then the currency of the high inflation country should have declined in value by 5%.

That 5% depreciation might lead some observers to conclude that exports should increase, imports should decline and the trade balance should improve. However, the exchange rate change is simply an adjustment mechanism to offset higher domestic prices, and its change will not affect the bilateral trade balance. Such an exchange rate depreciation maintains -- but does not enhance -- the competitiveness of the high inflation country's exports.

Since the nominal (observed) exchange rate can be misleading in terms of its effect on trade, another exchange rate measure is required to account for inflation differentials. The real exchange rate is such a measure; it reflects changes in the nominal rate and changes in the two countries' inflation rates.<sup>14</sup> Continuing with the above example, while the nominal exchange rate reflects a 5% depreciation for the high inflation country, the real exchange rate would show no change since the nominal rate falls by the inflation differential. With respect to trade, the real exchange rate is more relevant than the nominal rate. The real exchange rate determines export profitability since costs (domestic currency) and revenues (foreign currency) are converted to a single currency and price level changes are accounted for.

So far, the discussion of exchange rates has been limited to a bilateral analysis, i.e., exchange rates between only two countries. As a means of expressing a country's exchange rate in terms of a number of other countries' currencies, the concept of effective exchange rates was developed. An effective exchange rate is an index for the local currency price of a basket of foreign currencies. Each foreign currency is assigned a weight according to the foreign country's importance in international trade. The effective exchange rate can be thought of as a country's average cost of foreign exchange, with the average influenced more by the bilateral exchange rates of the country's most important trading partners.<sup>15</sup>

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<sup>13</sup> Although the PPP theory is widely accepted, the empirical evidence supporting this theory is not considered strong.

<sup>14</sup> See Annex 1 for an example of how to calculate a real exchange rate.

<sup>15</sup> See Annex 1 for an example of how to calculate an effective exchange rate.

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.<sup>16</sup> 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.<sup>17</sup> In addition, import-sensitive industries that are adversely affected

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<sup>16</sup> 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.

<sup>17</sup> 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



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.<sup>18</sup> 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.<sup>19</sup> It is in this light that some of the calls for reform of the

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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.

<sup>18</sup> 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.

<sup>19</sup> 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.

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.<sup>20</sup> 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

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<sup>20</sup> 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.

to avoid payment. Because of the uncertain effects of financial transaction taxes, there is no widespread support for their introduction.<sup>21</sup>

An area where concerted efforts should continue to be directed is in the regulation of financial institutions, especially nonbanks that are subject to no internationally coordinated supervision and are increasingly engaged in potentially risky international transactions.<sup>22</sup> It is not suggested that any limits be set on the foreign exchange activity of nonbanks, or that their international operations be otherwise curtailed. It is suggested, however, that the creation of a multilateral body similar in character and structure to the Basle Committee on Banking Supervision could be useful in managing the international convergence of prudential rules governing nonbanks. Although the trend is towards an increase in the overlap of products and services offered, it is recognized that the diverse nature of the core activities of nonbanks compared to that of banks requires a quite different regulatory approach. It might be overly ambitious to assume, for example, that a single body would have the expertise to simultaneously coordinate the prudential regulations of banks on the one hand, and securities firms and insurance companies on the other hand. Nevertheless, it is worth pursuing common international prudential regulations, if only to avoid "regulatory arbitrage".<sup>23</sup>

### **Suggested Reforms Related to Exchange Rate Misalignments**

Since exchange rates change in response to international differences in macroeconomic policies, one of the solutions often put forward to deal with both exchange rate volatility and misalignments is an increase in international

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<sup>21</sup> See M. Goldstein, D. Folkerts-Landau, P. Garber, L. Rojas-Suarez and M. Spencer, *International Capital Markets Part 1: Exchange Rate Management and International Capital Flows*, IMF World Economic and Financial Surveys, Washington DC, April 1993, p. 21.

<sup>22</sup> Examples of nonbanks are insurance companies and securities firms. See M. Goldstein, D. Folkerts-Landau, P. Garber, L. Rojas-Suarez and M. Spencer, *op. cit.*, p. 23; and T. Padoa-Schioppa and F. Saccomanni, "Managing a Market-Led Global Financial System", in *Managing the World Economy Fifty Years After Bretton Woods*, Institute for International Economics, Washington DC, September 1994, pp. 257-64.

<sup>23</sup> Firms engage in regulatory arbitrage by switching locations to avoid being subject to certain regulations. Firms might agglomerate in jurisdictions with the fewest, or least intrusive, regulations.

macroeconomic policy coordination.<sup>24</sup> There are at least three problems with the policy coordination solution. First, depending on the degree of coordination, there could be a surrendering of national sovereignty that proves more costly in terms of domestic economic performance than the original exchange rate volatility, especially when it is far from clear whether volatility is in fact a legitimate concern, at least with respect to international trade. Moreover, it is uncertain (and quite possibly doubtful) whether the surrender of this amount of national economic sovereignty would be politically palatable.

Another problem with macroeconomic policy coordination solutions is that they are frequently based on setting and maintaining exchange rate target bands. Although maintaining bands is a key goal of coordinating policy, this Commentary points out that the estimation of equilibrium exchange rates, around which target bands would be set, is not well understood.<sup>25</sup> For the same reasons that exchange rate misalignments are problematic, so too are more managed exchange rates that are not close to their equilibrium values. It is also important to recognize that a system of target bands can lead to an increase instead of a decrease in exchange rate volatility.<sup>26</sup> Thus, ironically, exchange rate bands can actually exacerbate the very problems that they are meant to alleviate.

A third problem is that, if policy coordination is meant to maintain rigid exchange rate relationships, as is suggested by the Bretton Woods Commission, it could imply, for example, that economies should be kept at the same stage of the business cycle, and that fiscal and monetary policies should be synchronized across

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<sup>24</sup> See, for example, Bretton Woods Commission, *Bretton Woods: Looking to the Future*, Washington DC, July 1994, p. 4; and J. Williamson and C.R. Henning, "Managing the Monetary System", in *Managing the World Economy Fifty Years After Bretton Woods*, Institute for International Economics, Washington DC, September 1994, pp 90-3. Both favour coordinated macroeconomic policies along with, and as a necessary complement to, a system of exchange rate bands.

<sup>25</sup> Williamson and Henning, for example, who themselves propose the adoption of exchange rate bands, state that estimates of equilibrium nominal exchange rates, " ... are unlikely to be wrong by more than 10 per cent". That does not inspire much confidence in their ability to delineate bands within which equilibrium exchange rates are contained. See Williamson and Henning, *op. cit.*, p. 87.

<sup>26</sup> The ERM turmoil in 1992 and 1993 is a case in point. Despite the best efforts of various monetary authorities, intense market pressures pushed several currencies outside their prescribed bands. In a discussion of the ERM crises, the Bank for International Settlements suggests that exchange rate stability might best be achieved in a less constraining, formal exchange rate arrangement. See BIS, *64th Annual Report*, BIS, Basle Switzerland, June 1994, p. 170.

countries.<sup>27</sup> Such a degree of coordination would be very difficult to achieve. A somewhat less ambitious goal than policy coordination would be policy consistency. The difference is more than one of semantics. Sound macroeconomic policies that are consistent over time within a particular country provide critical policy credibility (considered particularly relevant in terms of inflation expectations). Those that are broadly consistent internationally could provide fewer opportunities for currency speculation and/or misalignments. Ideally, the internationally consistent policies would be the same as those put forward by analysts in favour of policy coordination, i.e., policies ultimately leading to internal and external balance, but there would be no formal agreements and no means other than peer pressure and moral suasion to ensure consistency.

Discussions of policy coordination are often accompanied by suggestions that international institutional reform is essential. The IMF has received considerable attention concerning its possible role as a central coordinator of macroeconomic policies, especially as they relate to the stability of the international monetary system in general and exchange rates in particular.<sup>28</sup> Presumably, the IMF would monitor member countries' macroeconomic policies, identify potential imbalances that could lead to exchange rate instability, and prescribe policy corrections.

Yet, if, as noted above, the need is for policy consistency as opposed to policy coordination, it is not clear what new role the IMF would or should have. One could easily argue that it is in each country's own interest to formulate and manage macroeconomic policies that are consistent over time, and that there is no need for an international institution to monitor such developments. As for international consistency, with no formal agreements, there is no obvious reason to believe that an institution such as the IMF would be any better than national authorities at steering countries following inconsistent policies back into line.

Even if policy consistency is found to be insufficient in terms of currency stability, and it is settled that nothing less than policy coordination is required, the

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<sup>27</sup> See OECD, "The Desynchronisation of OECD Business Cycles", in *Economic Outlook*, No. 55, OECD, Paris, June 1994, p. 39. The OECD found that the most significant factor regarding the desynchronisation of business cycles has been the increased relative importance of country- or region-specific economic shocks as opposed to global shocks.

<sup>28</sup> See Bretton Woods Commission, *op. cit.*, pp. 6-7; J. Williamson and C.R. Henning, *op. cit.*, and C.F. Bergsten, "Managing the World Economy of the Future", in *Managing the World Economy Fifty Years After Bretton Woods*, Institute for International Economics, Washington DC, September 1994, pp. 341-74.

need for a new (or renewed) international institution to monitor or manage such coordination is still not clear. The Bretton Woods Commission itself points out that the international monetary system consists of three major currencies -- the dollar, the yen and the deutschmark (or its successor European currency). That implies that volatility and/or misalignments of peripheral currencies, including the Canadian dollar, are simply not as great a threat to the overall stability of the international monetary system. The involvement of an institution such as the IMF, which would likely promote policy coordination across all of its members, might not be necessary when there are really only three currencies that matter.

### Central Bankers and the G-7 Process

Despite desires to streamline the G-7 Summit process, it could be extended to include central bankers when discussions involve exchange rate misalignments and the possible reform of international institutions to oversee and perhaps coordinate macroeconomic policies.<sup>29</sup> Although central bank authorities are the principal agents in implementing countries' exchange rate policies, it is not certain whether they would welcome the opportunity to participate in the Summit's highly politicized economic diplomacy. As noted above, credibility is coveted by domestic economic policy makers, and especially by central bankers. It might be more appropriate from the central banks' perspective to become involved in the Summit only at arms length, and thus maintain their ability to distance themselves, if necessary, from any international commitments that they view as inconsistent with their own domestic policy priorities.

### The Upshot: Will We Be Reviewing Bretton Woods at Sixty?

In 1984 and 1994, it was, after forty and fifty years respectively, a convenient and sensible time to review the workings of the Bretton Woods institutions, especially since the international economy had changed so much since their inception. Many of the reforms suggested in 1984 have resurfaced in the present debate with few changes. Without belittling legitimate concerns over international financial stability, or discounting the macroeconomic policy challenges that accompany increased international economic integration, there is some evidence to suggest that certain problems, such as those associated with exchange rate volatility, are neither as new, nor likely as imminent, as some analysts would lead us to believe. Indeed, some

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<sup>29</sup> See K.M. Dominguez and J.A. Frankel, *op. cit.*, p. 52; and W. Dobson, *Economic Policy Coordination: Requiem or Prologue?*, Policy Analyses in International Economics No. 30, Institute for International Economics, Washington DC, April 1991, pp. 137-41.

proposed solutions, such as exchange rate target bands, introduce their own problems and could themselves lead to the very outcome that they were meant to help avoid.

Despite some of the rhetoric of those espousing immediate and aggressive reforms to usurp the foreign exchange markets and assign an institution (the IMF) to oversee international policy coordination in order to restore stability, there is still much uncertainty surrounding the determination of exchange rates and their effects on trade. Few, if any, of the most basic relationships are without controversy.

So where do we go from here? A two-step process is proposed. To begin, it is necessary to focus research efforts on developing a better understanding of fundamental issues such as exchange rate movements, their causes and their effects on international trade, foreign direct investment and the activities of multinational corporations. Only then (in the year 2004?) might a second step be taken to decide whether an international institution should be charged with somehow managing exchange rates, and, if so, whether that institution should be the IMF.



**Annex 1:  
The Calculation of Real Exchange Rates and Effective Exchange Rates**

**The Real Exchange Rate**

As an example of how to calculate a real exchange rate, consider the Canadian dollar - U.S. dollar exchange rate between 1980 and 1990. In nominal terms, the Canadian dollar was worth \$US 0.85 in both years. Yet, over the ten year period consumer price inflation rose by 78% in Canada and only 58% in the U.S.. The real exchange rate adjusts the nominal rate by the difference in the two countries inflation rates. The real exchange rate in 1990 was thus  $0.85 * (178/158) = 0.96$ , reflecting a real appreciation of the Canadian dollar of 11 U.S. cents between 1980 and 1990.

**The Effective Exchange Rate**

As an example of how to calculate an effective exchange rate, consider the Canadian dollar's effective exchange rate between 1980 and 1990 based on the simplifying assumption that Canada trades 70% with the U.S. and 30% with the U.K.. 1980 is the base year, when the effective exchange rate index equals 100.

|      | U.K. Pound/\$C | \$US/\$C   | effective exchange rate index |
|------|----------------|------------|-------------------------------|
| 1980 | 0.37 = 100     | 0.85 = 100 | $100 * 0.3 + 100 * 0.7 = 100$ |
| 1990 | 0.48 = 130     | 0.85 = 100 | $130 * 0.3 + 100 * 0.7 = 109$ |

Even though the Canadian dollar did not change against the U.S. dollar, its appreciation against the U.K. pound raised the effective exchange rate by 9% to 109 by 1990.



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: exchange rate disequilibria,

trade and suggested reforms

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