The role of the exchange rate

*The **Deputy Governor** speaks of dissatisfaction with the exchange rate regime that has prevailed in the last decade.[1] He notes that there has been considerable instability for all currencies—more than adjustments for fundamental factors would suggest—and that unless something is done about it this instability looks set to continue.*

*The costs of instability are considerable: resources are misdirected leading to underinvestment worldwide, wage inflation can be exacerbated, and there may also be increased pressure for protectionism. The **Deputy Governor** concludes that if all countries paid more heed to their exchange rate the world might begin to edge towards greater stability.*

Many people—businessmen, consumers, economists, officials, politicians—in many countries are unhappy about the exchange rate regime which has prevailed for the past ten years. So pervasive is this discontent that there has arisen considerable nostalgia for the fixed parity arrangements of the Bretton Woods system. Indeed there have been suggestions that we should now have a new Bretton Woods conference.

I do not intend to flirt with this idea, which is not I think a helpful approach. There are two difficulties about it. First, before engaging in complicated international negotiations we would need a clear analysis of what the problem was, how serious it was, and whether any solution could be found which did not make matters worse in other ways. Second, we would need a fair measure of prior agreement among the major trading nations about a general approach. Neither of these preconditions exist at present. In their absence it would seem unwise to rely on a conference to provide them. International conferences may be useful to settle practical details; they are certainly not a useful manner of agreeing on basic principles.

Some people in fact believe there is not a problem at all—or if there is, it is only a small one, an inconvenience, the removal of which would produce much worse effects. Personally, I disagree with this view; but I am clear that those who feel sufficiently dissatisfied to seek a solution must find one that can be put in place in a piecemeal and evolutionary way—in which we can learn as we go along. Our initial aims at least should be appropriately modest.

In order to see our way forward from the current state of affairs, it may be advantageous to look at recent experience; to try to define what has been unsatisfactory about it; and to identify some of the factors accounting for this. It may then appear possible to make some relatively marginal changes to the conduct of national policies, which might mitigate, even if only slightly, some of these adverse factors, and reduce the present level of instability.

Recent experience

The first point is that the exchange rate regime since 1973 has shown considerable instability.

Exchange rates between major currencies have behaved in ways erratic enough to have surprised both private and official market participants, and to have defied convincing explanation by economic modellers. Some of this volatility has been comparatively short run in nature, involving movements which are reversed in a matter of days or weeks. But an important part of it has taken the form of long and unpredicted swings, lasting for periods of years.

Many of the advocates of floating rates have been surprised by this high degree of volatility whose extent and especially whose persistence they had not predicted. Initially, they sought to explain it in terms of a settling-down process, as participants learnt how to operate in a less rigid market; as time passed, and greater stability failed to emerge, this explanation became less tenable. Volatility came to be attributed, in differing degrees, to such factors as the uncertainty engendered by oil price shocks; the increasing liquidity, internationalisation and breadth of financial markets; and to divergence of national economic policies and performance.

Now it is certainly true that exchange rates need to adjust to major changes in countries' circumstances, whatever the exchange rate regime. It is also true that in the last decade there have been major changes in countries' situations which made it inevitable and right that there should be exchange rate changes.

For example, the two oil price shocks in 1973–74 and 1979–80 were bound to place unprecedented pressures on exchange rates. Again, the discovery of a major natural resource such as oil or gas is likely to have some effect on relative exchange rates, irrespective of the exchange rate regime.

(1) In a speech at the International Herald Tribune's ninth annual conference on 15 November 1983.

Another source of major changes in the relationships between exchange rates can lie in political perceptions of differing degrees of risk to private wealth: much of the inflow into the dollar in recent months has been ascribed to this 'safe-haven' motive. Then there have been structural changes in exchange control regimes such as occurred in the United Kingdom in 1979 and in Japan more recently.

Major influences of another sort may come from the way monetary policies are directed. The peaks of sterling and the dollar have owed much to the high nominal and real interest rates associated with using monetary discipline to quell inflation. During the period of transition from a high inflation rate to a low and stable one, a rise in the real exchange rate is unavoidable if domestic price inflation is slow to react. And once domestic price inflation has adjusted, it is possible that some correction to the nominal exchange rate may take place as part of the process whereby the real exchange rate adjusts back to a sustainable level. Some at least of past swings in the nominal exchange rates will therefore have been the price to be paid for remedying previous inflation-promoting errors of policy and uneven progress in this respect.

Progress towards reduction and convergence of national inflation rates may well contribute to greater exchange rate stability. In 1976, the annual inflation rates of the United Kingdom, the United States, Japan and Germany spanned a range of thirteen percentage points, from 4% to 17%. This differential has now narrowed to a 4 percentage point range from 1% to 5%.

But will this be enough? Contrary to what many now urge, experience suggests that the convergence of national inflation rates at a low level may not be sufficient to achieve exchange rate stability. In the late 1970s, for example, Germany and Switzerland both had low and stable consumer price inflation; yet between late 1978 and early 1980, the Swiss franc depreciated by 16% against the deutschemark before rising again.

The degree of variability, not merely in countries' nominal, but in their real exchange rates, has perhaps been one of the more surprising developments of the last decade. In contrast to the Bretton Woods system when many adjustments to fundamental disequilibrium were too slow, giving rise to unnecessary and costly speculation, floating rates, it was argued, would provide an orderly means of adjusting for payments imbalances. Differential rates of inflation and other factors affecting competitiveness would be offset by adjustments to nominal exchange rates. Doubtless there have been many examples when this has occurred. But in some important cases rates have appeared to overshoot, aggravating rather than stabilising countries' competitive position and trade performance.

In the early 1970s, for example, the strength of the German current account and weakness of the US trade position made an adjustment to each country's competitiveness inevitable. An appreciation of the deutschemark relative to the US dollar looked appropriate and duly occurred. But by 1978 it seemed to many observers that it had gone too far, and a very large German current account deficit appeared the following year. The 30% depreciation of the deutschemark against the dollar between the fourth quarter of 1979 and the third quarter of 1981 was surely an overshoot in the other direction. This in turn gave rise to pressures for correction the other way. Similar cycles can be identified for sterling and, especially, the yen.

It is hard to believe that exchange rates have now settled into a more stable configuration, in which either a lesser degree of short-run volatility or less pronounced long-run swings can be looked for with confidence. We must therefore face the possibility that unless something is done about it, we may have to look forward to another ten years as volatile as the past decade. How much would this matter?

Costs of exchange rate instability

In trying to assess the extent of the costs of this volatility, it is necessary to distinguish between short-run instability, where changes in exchange rates are quickly reversed, and major and lasting swings. Short-run instability may give rise to considerable inconvenience to traders and consumers; and it may, because of such obvious arbitrariness in what is for everyone such an important price, bring the system into a sort of disrepute. But it seems unlikely to impose important economic costs, if only because sophisticated and efficient financial markets appear largely to have provided an answer. Forward cover is available in most major currencies at maturities long enough to cover the production process of the great bulk of goods in international trade, and provides insurance against exchange risk at what seems to be a remarkably low cost.

It seems likely, however, that major and more lasting exchange rate movements can impose real costs on national economies. Since wages, reflecting entrenched inflationary expectations, are slow to adjust, sustained movements in nominal exchange rates have generally been reflected in sustained changes in cost competitiveness. In modern conditions of high fixed capital costs and intense price competition, much of the strain is forced on to profit margins. There may follow scrappings of capital stock, lay-offs of labour and failures of firms that go further than required for fundamental adjustment but which, because of rigidities and imperfections, may not be reversed when conditions change.

On the other side of the coin, countries with undervalued exchange rates may undertake investment which later proves not to be viable at more normal levels of competitiveness; and may be subject to inflationary pressures while output is growing at a rapid rate.

Uncertainty of these kinds may thus be a potent factor in reducing investment worldwide, and in shortening investors' horizons. The result may be a failure of capital formation to respond to the usual extent to the current recovery in consumer demand in the world as a whole, even once unused capacity is reduced to more normal levels.

Additional important costs may arise at a global level through the reaction of wages. In most industrial countries real wages probably tend to rise to take account of terms of trade gains, but are less ready to fall when the exchange rate depreciates. As a result, swings in exchange rates are likely to impart an inflationary bias to the world economy. Greater willingness on the part of wage bargainers to discount exchange rate effects, even when sustained, would do much to lessen costs of both kinds; but the relevant learning process does not yet appear to have gone very far.

There is, finally, perhaps the most harmful effect of all. This is the increased pressure for protection by producers in those countries whose exchange rates are currently overvalued in relation to some longer-run norm. This will normally not be fully offset by a greater liberalism in the undervalued country. More important, protectionist measures, once imposed, are hard to get rid of. Certainly they are not likely to be reversed as and when the relative exchange rate distortion is removed or reversed. And of course any such protection measures will themselves tend to perpetuate the overvaluation, by making the current account less weak than it would otherwise have been. Creeping and not always visible protectionism of this sort is, in my view, a serious threat at the present time.

For all these reasons, then, I believe that the substantial and enduring exchange rate swings of recent years are likely to have played a significant part in hampering economic performance and impairing the strength of the present recovery. This makes it important to consider the sources of exchange rate instability, and how far it can be limited.

Factors causing instability

It is not easy to say why exchange rates have been so unstable. It is often asserted, in this connection, that the market knows best. The exchange rate is a price determined in an efficient and free market with well-informed participants; how can it be at any level other than the 'right' one? This is doubtless true in its own terms, but a rather empty tautological point. On the other hand, as I have tried to show, there are occasions when it is clear that in some real economic sense rates are over or undervalued even though it is usually hard to get agreement on the extent of the misalignment. These apparently conflicting perspectives can perhaps be reconciled. The exchange market is dominated, in the short run, by capital movements; and capital flows—even though small in relation to the volume of liquid funds which could potentially move—are often much larger than the flows generated by commercial transactions between countries.

Thus, a survey by the Federal Reserve Bank of New York suggests that turnover in the US foreign exchange market increased threefold between 1977 and 1980 and may have grown by another 50% since. Perhaps only 5% of this business now represents transactions with final customers. The associated deepening and enhanced flexibility of financial markets has had important economic benefits—such as the provision of forward cover at low cost that I have already mentioned. But, as a corollary, it leaves the market dominated by speculative factors.

The market has intrinsic instability to the extent that it is dominated by short-run operators whose main concern is to guess what other operators are going to do—not to wait for a long-term equilibrium position and put their money on this eventually working out. For lack of solid indications of what is going to happen, the market tends to develop and follow fashions; and the influence of any one fashion can, it seems, last quite a long time. I suggest that this is a phenomenon of which we need to take serious account.

Conclusion

If this is the position, it is arguable that complete withdrawal of the authorities from any role in the exchange markets removes an element that could play, and has played in the past, a stabilising function. Without it, markets may be left too much to their own devices. Since there is no market mechanism capable of taking a long-term view, operators perform as best they can. It is because of this essentially rudderless situation, I suggest, that markets often prove surprisingly receptive to a lead from the authorities. To put it crudely, the proposition I advance is that official indifference toward exchange rate movements may tend to produce anarchy; and that benign neglect does not have benign results but may result rather in disorder.

I would be the first to admit, however, that even if this insight is a valid one, it does not provide an easy recipe to apply in practice. Let me then recognise some qualifications that certainly have to be made. First, it is clear that a return to rigidly fixed parities is not feasible. As long as there are external shocks to the world economy it will prove necessary to allow a degree of exchange rate adjustment as a means of bringing forth an appropriate structural response. To attempt to suppress an exchange rate response might well be to force the instability into other, less satisfactory, areas of the world economy.

It has also to be recognised that the means whereby the authorities can influence the exchange rate have become more circumscribed by the greater depth and breadth of markets. The work of the Jurgenson Group on exchange market intervention has produced greater general agreement on the scope for, and limitations of, official intervention in the exchanges. Intervention remains a useful policy instrument—and may be particularly potent when national authorities are seen to act convincingly in concert—but it cannot be expected to do more than give a lead when markets have become disorderly or when movements differ greatly from those warranted by fundamental factors. And such intervention on its own cannot produce major or lasting effects on exchange rates. Monetary and fiscal policy—most notably the balance between the two—therefore have to provide the primary means of responding to exchange rate pressures.

An example of the way in which, in certain circumstances, a group of governments and central banks can take a lead in

influencing the foreign exchange market is provided by the relative success of the European Monetary System. An important effect of membership has, I submit, been to make evident to markets that EMS governments attach importance to the exchange rate in the conduct of their national policies; and that they look at their exchange rates very much in terms of straightforward competitiveness.

Of course, the success of the EMS has been only partial. There have been more realignments and less economic convergence than many of its original protagonists had hoped for. And such success as it has enjoyed—perhaps even its very survival—may have depended heavily on the nature of its actual membership; and might not have proved extensible to a wider grouping. But it is, I think, an instructive example nonetheless. In any case, participation in EMS or other schemes of international co-operation is not the only means for a country such as ourselves of expressing official concern with the exchange rate.

The exchange rate can be used in the conduct of policy as an indicator of monetary conditions. This is indeed the case in the United Kingdom, where we use it, among other factors, in seeking to interpret the behaviour of the monetary aggregates. In practice this means that if the exchange rate strengthens—implying a more favourable prospect for inflation and greater pressure on the economy—we would be more disposed to be relaxed about monetary growth and more inclined towards policy ease than if the exchange rate were significantly weaker. And of course conversely.

In some circumstances this approach can be similar in its effect to operating with an exchange rate target: significant movements in the rate can be followed by a policy response. And it is perhaps not surprising that some commentators persist in believing that we do in fact have a covert range for the exchange rate. The important distinction is that, used as an indicator, movements in the exchange rate do not imply a mechanical or automatic policy response. That will depend upon our overall interpretation of monetary conditions at the time, and will take account of what we know about the causes of the movement in the exchange rate and not simply the fact of the movement itself.

But I suggest that because we take some account of the exchange rate in the conduct of our domestic policy—and are known to do so—we may be able to exercise some stabilising effect on the exchange market. Moreover, any such stabilisation is likely to be benign, in the sense of furthering, rather than hampering, our ultimate policy aims.

As a practical matter, most governments in the world have no alternative to paying heed, in one way or another, to their exchange rates. Perhaps if all countries did so we could begin to edge towards slightly greater stability worldwide. There should be no illusion as to how much can be achieved, or how quickly. But something is better than nothing.