The Deceptive Exchange-Rate Debate

Christopher Ragan

With the onset of the Asian economic crisis in 1997, and the feared meltdown of the world economy, it is no surprise that economists and policymakers around the globe intensified their discussions on the need for a new “international financial architecture”. It didn't take long for the debate to turn to the choice between fixed and flexible exchange rates. In Canada, a country with a long history of flexible exchange rates, this debate is familiar ground. But with a 10% currency depreciation in the wake of the Asian crisis, the age-old argument was due for a dusting-off.

The debate over fixed versus flexible exchange rates is deceptive, largely because the typical business manager or consumer instinctively understands only one half of the debate—the one showing the benefits of fixing the exchange rate. But those same people don't even realise the other half of the debate exists. The result is that the media coverage makes the issue seem all too easy. Why would anybody in their right mind not want to fix the exchange rate?

It is crucial to think not only about the benefits of having a stable exchange rate, but also about the benefits of having a flexible exchange rate. The appropriate policy decision then involves assessing the magnitudes and choosing the alternative with the highest net benefits. The advantages of exchange-rate fixity are largely microeconomic, dealing with transaction costs and uncertainty. In contrast, the benefits of a flexible exchange rate are mainly about the process of macroeconomic adjustment.

One Red Herring

Before laying out the debate, however, it is essential to dispense with one important red herring. Many economists argue that an important macroeconomic benefit of a fixed exchange rate is the enhanced credibility of a country’s monetary policy. More correctly, the country gives up whatever monetary policy it currently has and adopts instead the monetary policy—credible or not—of the country to which it fixes its currency. Such fixing does provide monetary credibility to a country like Argentina that for several years was racked by a devastating hyperinflation and needed the anchor of US monetary policy to see its way through the storm of stabilisation. But this argument has no bearing whatsoever for a country like Canada today; nine years of formal inflation targeting has unquestionably established the Bank of Canada’s anti-inflation credentials. In short, given Canada’s record on inflation targeting, we can address the fixed-versus-flexible debate while ignoring the issue of monetary-policy credibility.

The Micro Benefits of Exchange-Rate Fixity

There is one significant benefit that would follow the fixing of the Canada-US exchange rate. If the Bank of Canada were to credibly fix its dollar, buyers and sellers on both sides of the 49th parallel would no longer have to guess about the future path of the exchange rate. This is potentially very important. In a world in which $350 billion in goods and services flows annually in each direction across the border, and in which profit margins are often small, even moderate fluctuations in the exchange rate can wipe out billions of dollars of profits. Fixing the exchange rate would instantly eliminate an important source of uncertainty that buyers and sellers face every day.

With greater certainty, firms would be more willing to engage in long-term contracts, either with foreign consumers or foreign suppliers. The resulting increase in international trade would bring with it greater benefits from international specialisation. Some critics point out that Canada-US trade has mushroomed over the past decade even in the presence of exchange-rate volatility, and this is true. But who knows how much larger those trade flows would have been if the exchange rate had been fixed?

Economists have actually had a tough time identifying any relationship between exchange-rate volatility and the flow of international trade. This doesn't mean that such a relationship doesn't exist, it's just that we can't find evidence of it. But the logic is pretty compelling—a fixed exchange rate ought to lead to more trade and thus more gains from trade.

A further benefit would come if Canada were to go further and formally adopt the US dollar. In this case, there would no longer be any need to convert Canadian dollars into US dollars or vice versa. All currency-conversion costs that we currently incur would be saved. These have been estimated at a few billion dollars per year. But against this benefit must be set the annual loss of seigniorage revenue that the Canadian government would no longer earn...
from the printing of Bank of Canada notes, also a few billion dollars per year. On balance, there is probably a net financial benefit to Canada from adopting the US dollar, as compared with merely fixing the Canada-US exchange rate, but it is small.

The Macro Benefits of Exchange-Rate Flexibility

Central to understanding the benefits of exchange-rate flexibility is the way in which the economy adjusts to various external shocks, especially changes in the world prices of commodities. For the purposes of illustration, consider the Canadian economy in the wake of the Asian economic crisis, and compare what actually happened with what would have happened had Canada been operating under the constraints of a fixed exchange rate.

With the sudden onset of significant recessions in Thailand, Malaysia, Indonesia, South Korea, and the Philippines—all of which are large net importers of raw materials—the world demand for raw materials fell sharply. With the fall in world demand, a decline in world prices was inevitable, by roughly 30% during the first year of the crisis. As Canada is a net exporter of commodities, the Asian recessions meant a reduction in income for Canadian commodity producers and their employees. Many resource-based firms scaled back production and many workers were laid off, especially in resource-heavy British Columbia. This is the obvious sense in which the Asian crisis was a negative shock for the Canadian economy.

The reduction in the world's demand for commodities also led to a decline in the demand for the Canadian dollar on foreign-exchange markets. After all, less desire for Canadian commodities means less need to purchase Canadian dollars. As a result, the Canadian dollar depreciated against the US dollar by over 10%. With this depreciation, the effects of the Asian crisis on the Canadian economy were muted. The commodity-exporting industries were still hard hit—no miracle could prevent that. But Canadian exporters in other regions and other industries benefited directly from the weaker Canadian dollar as the foreign-currency price of their exports fell, making their goods more attractive in foreign markets. Indeed, this was a banner period for the manufacturing industries in Ontario and Quebec, in no small part because of the weaker Canadian dollar.

Now consider what would have transpired had Canada been operating a fixed exchange rate. Obviously, the Asian crisis would still have happened, and the decline in world commodity prices would still have occurred. Moreover, the decline in demand for Canadian commodity exports would still have put Canada's resource sector—especially in British Columbia—through the ringer. The key difference, however, is that the Canadian dollar would not have been permitted to depreciate, and as a result there would have been no weak-dollar-induced manufacturing boom in Ontario and Quebec to offset the economic hard times in British Columbia. The Canadian economy, as a whole, would have been considerably worse off.

The real value of Canada's flexible exchange rate is its ability to cushion the effects of external shocks. In the case of the Asian crisis, Canadian output and employment grew by more (or fell by less) than would have occurred had Canada been operating a fixed exchange rate. In this sense, the flexible exchange rate acted as a "shock absorber".

A Fly in the Ointment?

So that's the exchange-rate debate in a nutshell. It should be clear why it is the relatively straightforward micro benefits of fixed exchange rates, rather than the complex macro benefits of flexible rates that occupy most of the space in the media's coverage of this issue. But the sensible debate must be balanced with appropriate attention paid to both aspects.

This gets us to a final troubling point. The macroeconomic benefits of flexible exchange rates discussed above are based on an important and uncontroversial assumption about the economy—that nominal wages are slow to adjust to excess demands or supplies in the labour market. With such slow adjustment of wages, the level of domestic output does not return immediately to the economy's level of capacity following either a positive or negative shock. This is why the currency depreciation during the Asian crisis was helpful—without it, the effect of the negative shock would have been to keep the Canadian economy below its productive capacity for longer. But what if the amount of wage rigidity in the economy depends on the exchange-rate regime? The Bank of Canada has argued that living through a period of very low inflation will eventually result in workers being more open to accepting wage cuts in industries experiencing hard times, whereas those same workers would be very reluctant to accept cuts in a world of high inflation. So the Bank clearly accepts the argument that the inflation regime will influence labour-market behaviour. Doesn't the same apply here? If there is less need for wage flexibility in a world where the exchange rate can adjust to various shocks, isn't it reasonable to think that the fixing of the exchange rate would eventually force an increase in the amount of wage flexibility?