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The Exchange Rate—can we, should we do something about it?

(comment on Stoeckel, Valentine and Higgs)

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A long, long time ago, I used to teach undergraduates. It was my duty to mark their exam papers regularly. I pursued this teaching cum examining activity for some nine years. Over this time I acquired a healthy scepticism of students who wouldn't answer straightforward questions. If one of my students had behaved like Andy Stoeckel who says "So, should the exchange rate be a target variable for government policy?" and then answers his own question as follows: "This seemingly straightforward question turns out to be quite difficult—not so much for conceptual reasons but for what is really meant by the question"; then my old examiner's suspicions are re-aroused. Here, I suspected, was a man who doesn't really want to answer his own question. And so it turned out to be. Three and a half pages later, Andy tells us that "the question really becomes how can we improve the current account . . . etc., etc". This is a question which Andy is really much happier with as he has recently written a very useful pamphlet about it with Sandy Cuthbertson.

Sadly, this is not really the burning question at the moment. This seminar is being held at a time (*i.e.*, 30 September, 1987) of still very high current account deficts, of still growing external indebtedness—to levels which are very, very large by international standards. In spite of this, the $A has suffered a 15 per cent real appreciation over the last twelve months and, if the central bank had not intervened on an unprecedented scale, the real appreciation would probably have been even greater. Given that real appreciations have a pretty detrimental effect on our competitiveness—and hence on our longer term current account outcomes (at least at constant terms of trade)—what can and should be done about this worrying state affairs? Andy Stoeckel does not tell us.

In his paper, my old colleague Professor Valentine is almost equally unwilling to answer straightforward questions—such as are implied

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in his title—*i.e.*, can monetary policy be used to influence the real exchange rate in the short or in the long run? In the paper, Tom Valentine tells us this is a very complex problem and it is best to approach it in a fairly indirect fashion. As far as I can tell, he basically believes that the central bank can only influence the exchange rate in the very short term, and that "an attempt to set a value of the $A which is not justified by fundamentals will result in destabilising speculation which will in the end force the Reserve Bank to give up . . ." Does that mean that we do not worry about the deterioration in our competitiveness resulting from the real appreciation of the last twelve months because (a) we cannot stop it and (b) the market knows best anyway???

In his verbal presentation, Tom Valentine opposed Reserve Bank intervention in the exchange rate market—"except to the extent to which they have intervened recently". Given that the Reserve Bank has intervened more extensively during the last twelve months than at any previous period of the float, this provides us with limited practical guidance.

Our current local debates about the exchange rate and whether we can do something about it—and if we can whether indeed we should—are of course not unique. Similar arguments are going on in many countries. The unfettered, freely floating exchange rates of the early 1980's have led to a good deal of concern about whether the exchange rate fluctuations we are observing really represent optimal responses to externally and domestically induced shocks or whether they are in part the result of currency misalignments generated by speculative forces which can possibly have damaging longer term consequences.

There is no doubt that governments around the world have intervened increasingly in exchange rate markets in recent years—both directly by changing the size of their external reserves (no doubt in part justified as an attempt to "smooth" and "test" the market) and indirectly by "targeting" the exchange rate and by changing domestic policy settings so as to achieve certain exchange rate levels. The fact that governments increasingly intervene does not of course necessarily make it either right or sensible to intervene more heavily. But it does suggest that freely fluctuating rates have not been found to be as beneficial as many governments thought they would be when they adopted them.

Nor is the profession united on whether one should or should not intervene. At a Brookings Conference on Exchange Rates, Trade and Capital flows a couple of years ago, four papers on this matter were presented by Williamson, Branson, Cooper and Dornbusch. Cooper and Williamson favoured managing exchange rates; Tobin and Marris were claimed as allies. Dornbusch and Branson opposed management of exchange rates; Beryl Sprinkel and Samuelson were claimed as allies. Citing the weight of economic authority will obviously not get us very far in resolving this matter.

What are the major judgements at issue between the parties?The two arguments for intervention which seem to have most weight concern, first, whether asset markets (such as exchange rate markets) are so "speculative" that they can detach themselves from fundamentals and go on a bubble for extended periods—with detrimental effects on the "real" economy and on resource allocation. The argument is that an overvalued exchange rate can lead to an unsustainable longer term loss of competitiveness and hence in employment. If internal prices and wages were sufficiently flexible, such a loss of competitiveness would only be very, very, temporary. But in a less than perfectly flexibile internal price and wage environment, there can be permanent job losses as firms close down, move abroad or, at the very least slow their investment.

The second objection to completely freely fluctuating exchange rates which is often used in the United States at present, concerns the non-reversibility of political reactions to widely fluctuating exchange rates. Temporarily overvalued exchange rates, it is argued, generated protectionist trade policies. Such increased protection in countries with temporarily overvalued exchange rates is, unfortunately, not counterbalanced by greater trade liberalisation in countries with undervalued currencies. Temporary exchange rate misalignment could therefore pose an increasing threat to the open multi-lateral trading system which had been one of the major cornerstones of the long post-war boom.

Are there any parallel examples of non-reversible political reactions in Australia? In the first instance, one can perhaps think of that much patched-up, but in my view still valuable, "understanding" between the ACTU leadership and the government which has enabled the ACTU leadership to support government policy and to undermine isolated unions attempting to "break out" of the rather moderate wage policies being pursued. What benefits can the ACTU leadership show for its actions, if a major tangible effect of

such moderation turns out to be the deterioration of our competitive position through the rapid appreciation of the $A?

One might also argue that the unwillingness—or inability—of government to contain the risk of sizeable upside currency movements will have an asymetrically detrimental effect on the risk premiums which will subsequently be built into investment plans. Or, if your want to use Keynesian language, large unexpected appreciations of the $A will adversely affect the animal spirits of the entrepreneurs who are scheduled to be our economic saviours.

All this is not to say there are not also some valid arguments on the other side. For instance, what makes the exchange market different from other asset markets—such as the stock market, or the internal market for loanable funds which determines interest rates? Attempts to fix either interest rates or stock market prices have been largely discredited; why are we likely to make a better job of attempting to fix exchange rates?

I do not think the profession is currently in a position to give a clear and unambiguous answer to the question as to whether we should attempt to manage the value of the $A through central bank purchases and sales of foreign currencies—or through adjustments in the monetary policy parameters partly with an eye to the exchange rate. I suppose my main quarrel with Messrs Stoeckel and Valentine is that they should come clean about our lack of definitive knowledge in these matters.

Personally I think we can expect governments to continue to "lean against the wind" in a variety of ways—so as to prevent (or at the least slow down) the loss of hard won gains in competitiveness—which result from substantial real appreciations of the Australian dollar.

Finally, I would like to make a few comments about Peter Higgs' paper—a paper which really examines different issues from those discussed by Messrs Stoeckel and Valentine. Peter Higgs uses the ORANI model to show how domestic policies can influence the real exchange rate—giving us four different economic policies and their magnitudes which are each expected to give us a 1 per cent depreciation in the real exchange rate. Much as I respect the ORANI model and the ingenuity of the people who construct and manipulate it, I have substantial misgivings as to whether it can capture the dynamics of our foreign exchange markets—driven as they are from time to time by substantial changes in sentiment about this economy and about rival destinations for the funds of international investors. These changes in sentiment may occasionally last for as long as the two-year framework regarded as appropriate for short-run ORANI applications. Certainly the substantial over-valuation of the $US in the early and mid-1980s lasted as long as that.

However, this is not to argue against the usefulness of the Peter Higgs type of exercises for some purposes. Firstly, they can provide us with an idea of the magnitude of the reactions in the "real" world—in as far as we abstract from changes in sentiment of the type referred to earlier. For instance I found it of interest to contrast the size of the absorption and real wage changes which produce a 1 per cent real depreciation—with the size of the across-the-board tariff cut needed.

Secondly, they can trace through the general equilibrium effects of policy changes. Comparing the first three policy changes with identical effects on the real exchange rate, it seems obvious that a cut in real wage costs to employers is the most desirable: (a) it produces the largest increase in real gross domestic product (with a cut in real absorption actually leading to a decline in real GDP; and (b) it increases employment most.

The fourth policy simulation—*i.e.*, the imposition of a consumption tax, balanced by cuts in income tax—is very similar to the third—*i.e.*, the cut in labour costs. This is not surprising since the fourth policy simulation gets most of the action through its reduction in real labour costs to employers. As Higgs makes clear, this simulation depends crucially on certain assumptions about union reaction to the shift in the tax burden.

One facet of the simulations I found surprising were the different balance of trade results produced by three policy simulations which each caused a one per cent depreciation of the real exchange rate. I was under the impression that, in an ORANI world, it would be the change in the balance of trade which would drive the change in the real exchange rate. The interactions are obviously more elaborate.