EXCHANGE RATES

A New Assessment of Floating Exchange Rates

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The switch to floating exchange rates during the 1970s has given economists the first comprehensive opportunity to assess the arguments for and against floating. Much new work has been done on various aspects of floating exchange rate behaviour. This article attempts a limited survey of the evidence concerning two important issues - whether floating exchange rates are inherently unstable and whether they harm international trade.

The new theories of exchange rate determination point to the possibility of greater exchange rate uncertainty and volatility under floating rates; that is, there are special destabilising forces which come into play which may be peculiar to floating exchange rates. Friedman's seminal article entitled "The Case for Flexible Exchange Rates" denies the possibility of destabilising speculation. This assertion stems from the belief that speculators will iron out temporary movements in the exchange rate and will not hinder the permanent changes in the rate. But can speculators differentiate between temporary and permanent changes in the exchange rate? The fact that short-run movements in exchange rates have been far greater than the corresponding movements in domestic price levels, suggests that they cannot.

Neither is this phenomenon compatible with the two traditional theories of exchange rate determination - purchasing power parity theory and what Isard describes as "the popular balance of payments view". Purchasing power parity is not a complete theory of exchange rate determination. It simply emphasises the relationship between relative prices and the exchange rate. There are severe doubts as to whether it now holds in the short run, let alone the medium and long runs. The popular balance of payments view also suffers from short-run deviations in exchange rates. The old notion that a worsening balance of payments on current account is associated with a depreciating exchange rate is accepted by most economists, but not without qualification. The shortcomings of these two major theories led to a situation where Bilson says there was no generally accepted economic theory of the determination of exchange rates.

In recent years, various new theories have been brought forward which have attempted to fill this vacuum. The most important of these are the

- asset market theories and the
- speculative run theories.

These two theories virtually ignore current account positions and maintain that in the short run financial considerations which affect capital account transactions are dominant.

Asset Market Theories

Asset market theories and the popular balance of payments view do not differ to any great extent, so long as the popular view emphasises the capital account. Thus a current account deficit can be associated with a stimulative government budget and a currency depreciation, or buoyant investment expenditure and a currency appreciation.

Asset market theories treat the exchange rate like an asset price, i.e. "the relative price at which the stock of

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money, bonds and other financial and real effects of a country will be willingly held by domestic and foreign asset holders. Therefore, at times of rapidly changing interest rate differentials and exchange rate expectations, the exchange rate is likely to fluctuate violently in the short term.

One of the advantages of the approach is that it allows for the numerous factors that affect exchange rate expectations, e.g. monetary and fiscal policies, official intervention in the exchange market, political uncertainties etc. to, at the same time, determine the exchange rate. Asset holders will continually adjust their portfolios according to the changing circumstances.

**Overshooting Mechanisms**

Within this framework various mechanisms have been identified which could cause the short-run exchange rate to overdepreciate.

Dornbusch, amongst others, has formulated a dynamic model in which an initial overshooting of the exchange rate can take place because of differential speeds of adjustment between prices and exchange rates. Exchange rates overreact when asset markets adjust faster than goods markets. Starting from a monetary expansion, Dornbusch believes that interest rates will fall, together with a simultaneous fall in the exchange rate to a level where the public anticipate an exchange rate appreciation. This fall will be below the short-run purchasing power parity level because real output does not react to a monetary expansion immediately. The result will be that spot rates will depreciate further than forward rates and the expected future increase in real output will cause the forward premium to increase. Therefore spot rates should fluctuate more violently than forward rates.

However, Isard observes that since the advent of floating, this last phenomenon has simply not happened. The differentials between spot and three-month forward rates have not varied significantly. Even so there may still be some truth in Dornbusch's argument if longer term forward rates show greater stability.

Artus and Crockett identify a risk aversion mechanism which could overdepreciate a currency. A devaluing country with a balance of payments deficit will increase the quantity of that country's currency held by traders. The traders will be unwilling to commit themselves to too large a holding of a depreciating currency and would prefer to keep a safe spread of currencies in their portfolio balances.

Friedman himself admitted that when a substantial change in external circumstances occurs followed by a period of relative calm, some overshooting or undershooting may take place before equilibrium may be reached. But he claimed this would only arise if there were intervention by the monetary authorities, otherwise there would seem to be no reason to expect the timing of adjustment to be systematically biased in one direction. However, this may be a "hydra-headed" situation. Official intervention in the market to overcome destabilising mechanisms of one sort may only have encouraged overshooting mechanisms from alternative sources. Mussa tends to agree with this hypothesis. He is of the opinion that government intervention makes it more difficult for speculators to estimate the long-run equilibrium rate and so they have tended to act in a destabilising manner. The ability of speculators to act in a stabilising manner may also have been hampered by imperfections in the international capital markets. Therefore MacKinnon argues that the removal of exchange controls on the number of dealers and the size of the positions they can legally take, would lead to greater exchange rate stability.

**Speculative Run Theories**

The three overshooting mechanisms may not be a sufficient explanation for the exchange rate volatility of recent years. Certainly there is no reason why they should not have been present during the float of, for instance, the 1920s, when prices were more unstable than exchange rates. During the 1970's the reverse has been true. Even so, together with other factors (e.g. variations in interest rate differentials which according to Artus have in certain cases led to large fluctuations in the exchange rate), they can provide the sparks which can set in motion various speculative run theories. These theories were of relevance even under fixed exchange rates.