Commentary on 'Exchange Rate Volatility and Misalignment: Evaluating Some Proposals for Reform'

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This paper is an admirably comprehensive survey of the issues surrounding exchange rate volatility, giving an excellent overview of both theory and some of the practical issues. It is also an extremely judicious paper—or let me be less polite and say an infuriatingly judicious paper. The caution and agnosticism of the discussion seem to me to be extraordinary and unwarranted.

When reading the paper, I found myself engaging in a fantasy. I imagined bringing my automobile in for servicing at Morris and Jacob's Auto Garage, complaining to them about the roughness of the ride. Jacob and Morris examine the car carefully, and then ask to discuss the matter with me. Their remarks go as follows:

First, they ask, "How are you sure your car's ride is rough? We've calculated some measures of its roughness, and it's not exceptional when compared with other kinds of motor vehicles. For example, it's actually a much smoother ride than you get on a dirt bike or a harvester-combine, so that it isn't clear by what standard you should consider roughness to be a special issue in this case."

Second, they make a concession: "It's true that your ride is about five times as rough as it was when you were driving your old Bretton Woods car. But that isn't necessarily due to the car. There are a number of reasons for believing that the environment has changed. For example, Boston streets may be in worse repair than they used to be."

Third, they raise a question, "How do you know you even want a smoother ride? After all, there's a tradeoff. If your ride is too

smooth, you can't feel the road, and that's not good. So there's an optimal degree of roughness in the ride. We don't feel that we have enough information at this point to decide whether your car's ride is actually rougher than this optimum."

Finally, they make a suggestion: "Given the uncertainties, it's hard to propose any particular course of action for your car right now. But we suggest that we have regular consultations. Why don't you bring your car in once a week? That way, we'll have a framework in place should we decide on some action at a future date."

I leave the garage deeply impressed with their intelligence and carefulness, but somehow feeling that I didn't get what I wanted.

So let me look more carefully at the four issues that Morris and Jacob raised at the garage. These were:

(1) ***Is there a special problem of exchange rate volatility?*** The authors point out that the exchange rate is not especially volatile when compared with other financial markets.

(2) ***Is increased volatility due to the exchange regime?*** The authors suggest that larger shocks rather than the shift to floating rates may explain much of the rise in volatility.

(3) Are exchange rates excessively volatile? The authors suggest that the exchange rate volatility of the last 15 years may serve a useful economic function.

(4) ***Do we need policy coordination*** ? The authors question explicit exchange rate arrangements, but are unambiguously for explicit coordination of macroeconomic policy.

My view is that the authors are unjustified in their agnosticism about the first three questions, and oddly convinced about the utility of policy coordination, which actually has a fairly weak case.

Let's start with the volatility of the exchange market. It is true that it is relatively calm as compared, say, with stock markets, but there is a fundamental difference. Why advocate policies to stabilize exchange rates but not stock prices? One answer is to advocate policies for the stock market too—but let's leave that aside, and focus on another answer. The exchange rate, unlike the stock market, is not a price of a "natural" asset: it is the relative price of national monies, which are created assets. Precisely because the division of the world into currency areas is an arbitrary choice by governments, we have no reason to suppose that the behavior of relative currency prices is in any way optimal. Or let's put it differently. If advocates of

floating rates in the 1950s and 1960s had known that exchange rates would behave like stock prices, only a little less so, would they have been so enthusiastic? I doubt it.

Can the changes in the world explain the volatility of exchange rates? A little bit, but surely not a fivefold increase. Oil shocks explain some of what happened to the pound sterling and yen at various times; fiscal divergences explain some more. But the abrupt increase in volatility at the moment that fixed rates were abandoned suggests that the regime, not external shocks, was the cause. Or look at the contrast between the EMS and the rest of the world: fiscally prostrate Italy manages a fairly stable exchange rate with Germany, even as Germany and Japan, with nearly identical net trade patterns, similar fiscal stances, and similar current account performances fluctuate widely against one another.

Are exchange rates too volatile? A reasonable case for not worrying about the exchange rate could be made if financial markets were basing their decisions rationally on the information available, and if we felt that exchange rate volatility were not impairing the ability of firms to make good decisions. However, neither is the case. An extensive literature has now demonstrated, about as convincingly as any literature in economics, that asset markets in general, and the exchange market in particular, move much more than justified by "news"; that market forecasts are consistently biased; that the market neglects long run considerations. On the other side, I would argue strongly that exchange rate volatility does, in fact, degrade the ability of firms to make location and sourcing decisions because they cannot tell fundamental shifts in relative costs apart from transitory shifts due to financial bubbles. Exchange rates ***are*** too volatile.

Finally, what should we do?: The paper is a little cagey on this, but as I read it, it is skeptical about explicit (or at least public) arrangements on exchange rates, but enthusiastic about the process of policy coordination. I am a little puzzled by this. The analytical work on policy coordination that I am aware of always seems to suggest that the potential gains are very modest—not that it's a bad thing, but hardly that it's a priority. Meanwhile, shouldn't we look at history? The crude fact is that fixed exchange rate regimes have, in fact, worked, often for extended periods. That is, while the paper offers many analytical cautions about the feasibility of tying down exchange rates—cautions that I share—fixed rates seem to be one of those things

that work in practice but not in theory. On the other hand, policy coordination has never really happened. Whether this is because of bad economics or bad politics I don't know, but I would be hesitant to place great hopes on something that has no successful precedent.

I suspect that the authors of the paper either have or could develop stronger views than they offer here. Given how much they know, it would have been nice also to hear what they think.