

EXCHANGE RATE PROTECTIONISM: A HARMFUL DIVERSION FOR TRADE AND DEVELOPMENT POLICY

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Exchange rate protectionism usually refers to the idea that a country's exchange rate might be undervalued, causing the country to import less and export more than it would with a stronger exchange rate. I would like to discuss exchange rate protectionism in a different context.

The Primary Meaning of Exchange Rate Protectionism

I think most of the trade impact of an exchange rate policy is overwhelmed by the policy's impact on economic development. In practice, therefore, the primary meaning of exchange rate protectionism is that an unstable currency tends to cause underdevelopment, limiting a country's imports and exports. The converse also holds: countries with stable exchange rates have seen imports and exports grow rapidly, with China a clear example.

Needed: A Stable Dollar Policy

In my address at Cato's 1999 monetary conference, entitled "Replacing the Vacuum in International Economic Policy," I presented the view that exchange rates, rather than reflecting economic fundamentals, cause them. An extract follows:

In recent years [as of October 1999], the United States has seemed to build its entire exchange rate view on the sound bite that "a

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strong dollar is in the national interest.” Yet it has declined to explain how a currency’s strength should be measured or whether unlimited strength is good.

Clearly, a “stable” currency, not strong or weak, is appropriate during most of a country’s economic life. A “strong dollar” policy made good sense after a period of currency weakness and inflation as the United States experienced in 1993 and 1994. President Clinton and Secretaries Rubin and Summers deserve credit for this constructive 1994 shift in U.S. policy. *By continuing the policy into 1997 and 1998, however, the administration has created a giant momentum play into the U.S. dollar, adding to our asset values and our growth rate, but subtracting from those abroad and increasing the difficulty of the transition to currency stability.*

Meanwhile, the jingoistic “strong dollar” policy of the United States confused foreign countries. Since 1997, the world has suffered from a global competition to see who could have the strongest currency. The Japanese played the game, deepening their deflation spiral and prolonging their economic stagnation. Germany let the mark get too strong in 1998, setting the stage for a “euro crisis” earlier this year as the euro moved back to an appropriate value.

The confusion sown by the United States in international economic policy has resulted in a world of momentum-based volatility in which exchange rates drastically overshoot a stable norm. At the core of the economic confusion is the prevailing, and harmful, view that the value of a currency should change with the business cycle to reflect economic fundamentals. When an economy slumps, the argument is that the currency should weaken, and vice versa. This was the market logic that pushed the euro to extreme weakness in early July when there was talk of it breaking par with the dollar. The same logic pushed the yen to 147 yen per dollar in May 1998 and has now strengthened it to 106 yen per dollar, so strong that it will choke off Japan’s recovery. These wild swings in exchange rates are anti-growth and are the responsibility of government.

Businesses don’t devalue their accounting unit when they lose money. Nor do they increase their unit of account when their profits rise. Suppose auditors advised companies to report earnings in frequent flyer miles if profit growth slowed. Not only would investors have to analyze the earnings slowdown, they would also have to analyze the uncertainty caused by a new unit of account. The United States and the IMF actively promote this illogic, causing economic decline across Latin America, Africa, Russia, and parts of Asia.

To reduce the confusion, the U.S. government should transition to a robust “strong and stable dollar” policy. It should provide a means for financial markets to evaluate the stability of the dollar in absolute terms. A policy of dollar stability would be a pro-growth, pro-investment improvement in U.S. policy and would help world growth.

Exchange Rate Volatility Harms Economic Development

In my view, a country's exchange rate affects its imports and exports primarily as a subset of the exchange rate's role in the country's broader economic health.

- If the value of a currency is weak and weakening, it discourages investment, causes higher inflation and interest rates, lowers living standards, and invites a brain drain. This reduces both imports and high-value-added exports. In effect, the economy shrinks as does trade. Low-value-added exports may increase in the short-run, but the economic deterioration usually harms the infrastructure, the rule of law, and the political process, soon curtailing even low-value-added exports. (Mexico is a notable exception due to the positive trade-effect of NAFTA.)
- A strong and strengthening currency, another form of harmful currency instability, encourages investment in the short run, but quickly leads to deflation. This undermines banks and the debtor/creditor relationship, leading to economic decline and a reduction in imports and exports. Japan's experience in the 1990s is an example. Its monthly exports stagnated at \$30 billion from 1993–2002. Imports grew from \$17 billion monthly from 1989–93 to \$25 billion monthly late in the decade, simply not much growth.

The quest to use exchange rates to modify a country's trade balance is as old as floating exchange rate theory itself. But it has not worked. Japan's trade surplus expanded in the early 1990s to a steady \$12 billion per month, even as its currency strengthened. Waves of currency weakness in Brazil in the 1980s and 1990s left exports stagnant at \$4–5 billion per month. The recent combination of currency stability (gold has been steady at 1,200 Reais since late 2002) and faster global growth has allowed exports to surge to \$9 billion per month.

Currency stability is often, and perhaps purposely, labeled *exchange rate manipulation*. I think it would be clearer to also label government-set interest rates as *interest rate manipulation*. Central banks are usually manipulating one or the other. If one is a form of protectionism, the other is too. In my view, though, neither practice should be confused with trade protectionism. The United States pegged or manipulated its interest rate to 1 percent in June 2003, causing the dollar to float weaker in value. The gold price rose from \$345 per ounce in June 2003 to \$422 now. Real interest rates remain pegged in negative territory. Is this exchange rate protectionism or

interest rate protectionism? Since the practices did not lead to a narrower trade deficit, it is probably confusing to label either practice as protectionism. That term should be used the old-fashioned way—the clearly harmful application of quotas, tariffs, and differential subsidies.

This leaves the key development question of whether pegged interest rates and momentum-based currency instability—also known as freely floating exchange rates—work as well as currency stability and market-based interest rates. The answer is clearly no. A monetary policy aimed at long periods in which the value of money is stable is likely to lead to more growth, investment, exports, and imports than the alternative.

Conclusion

The concept of exchange rate protectionism is a harmful diversion for trade and development policy. Most of the trade impact of an exchange rate policy is overwhelmed by the policy's impact on economic development. It would be better to reserve the term "protectionism" to its normal meaning and treat exchange rate and interest rate policy in the context of economic development rather than trade policy.