FREE TRADE, ECONOMIC REGIONS AND THE FOREIGN EXCHANGE RATE

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Introduction

In Canada today we are in the midst of a national debate concerning the merits of entering into an agreement with the United States that would liberalize trade flows between the two countries. This debate is reminiscent of the impending reciprocity treaty with the U.S. that contributed to the defeat of the government of Sir Wilfrid Laurier in 1911. The resurfacing of free trade discussions at this time appears to be a result of the philosophical leanings of the current Canadian and U.S. administrations. In Canada, the Mulroney government has clearly strived to be perceived as economically conservative, espousing the virtues of free enterprise. According to this line of reasoning increased trade flows, which are assumed to be the inevitable result of the lessening of market restrictions, should render welfare improvements in both economies. The underlying belief is that the market economy works well as long as it is free from government interference, and that the free market price system will properly coordinate economic activity. Conservative economists assume that any movement towards freer trade would naturally be accompanied by a flexible foreign exchange rate. Canadian politicians, however, appear to have been largely silent on this particular aspect of the free trade issue. It is possible that, because Canada is following an official policy of a flexible exchange rate at this time, the politicians believe that there is no need for discussion in this area.

In Canada there exists a long-standing political objective of balanced growth across the diverse economic regions that make up the

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Canadian political union. It is therefore quite obvious that any economic benefits that would accrue to Canada from free trade would have to be shared by the whole country. This note argues that in the short run, in spite of the apparent political and economic attractiveness of a flexible exchange rate, it is possible that the coexistence of the political objective of balanced economic growth and the economic objective of gains from free trade may be better suited to a fixed exchange rate regime. In the long run, the choice of nominal exchange rate regime is irrelevant and the pursuit of free trade gains could be in conflict with the objective of balanced economic growth.

The Canadian Economy and a Flexible Exchange Rate

In the 1970s the economics profession moved very solidly behind the universal adoption of flexible exchange rates, and the literature contains a great number of papers expounding their virtues. The interested reader is referred to Purvis [2] for a good summary of these arguments. It is widely accepted that a flexible exchange rate insulates the domestic economy from foreign nominal shocks. Thus, for example, a fully flexible exchange rate should be capable of preventing the importation of U.S. inflation. Other economic benefits of a flexible exchange rate arise largely from the degree of domestic autonomy imparted by the freedom from the balance of payments constraint, therefore allowing the most independent use of domestic stabilization policies. There are also political arguments in favour of flexible exchange rates. A flexible exchange rate suits the current conservative mood, in the sense of involving less interference in the economy. A flexible exchange rate may also be viewed politically as a necessary first step in the process of removing barriers to trade such as tariffs, which may help set the economic climate for increased international trade.

The above discussion notwithstanding, there is a compelling argument for the Canadian economy to adopt a fixed exchange rate with free trade. The basis of this argument was put forward, in a slightly different context, by Robert Mundell [1] in 1961. Mundell was actually making a general case for national currencies to be defined by economic regions, rather than political boundaries. However, the logic of his argument applies exactly to the situation that Canada faces today. The essence of this argument is that in a regionally diverse economy, such as that in Canada, a flexible exchange rate may not be capable of performing its prescribed economic task. A fixed exchange rate, on the other hand, has the effect of tying regions together, and booms and busts will be spread across the whole economy.

Mundell's arguments can be readily adapted to a situation of increased trade flows in Canada. Assume, for simplicity, that Canada is made up of two regions: the West, which is abundant in natural resources; and the East, which produces manufactured goods. In order to see some possible effects of free trade and a flexible exchange rate, consider what would happen in a situation of general increased world demand for natural resources due to a movement towards free trade. The western economy would boom and the external value of the Canadian dollar would appreciate. This has the potential to cause unemployment in the East. For the Canadian macro economy to capitalize on the boom, the Ricardian adjustment required in the face of a flexible exchange rate is factor mobility, in this case from East to West. Under a policy of a fixed exchange rate, the appreciation pressure caused by the exogenous increase in demand could be alleviated by the usual monetary expansion. This would have the effect of spreading the boom across both regions, and thus would meet the "balanced growth" criteria of Canada's regionally diverse economy.

In Canada there is a political history of subsidizing industries that might otherwise succumb to economic adjustment. It seems that governments have been very sensitive to lobbies that promote correction of perceived regional disparities. If the goverment were to yield to the temptation to prevent the development of increased unemployment rates in some regions, which would inevitably result during the process of adjustment to free trade, then there would be a policy conflict. The combined policy of a flexible exchange rate and free trade would be sending market signals that would be extinguished by the policy of combatting regional disparity. One method of avoiding this policy conflict is to combine a policy of free trade with a fixed exchange rate regime.

The above discussion argues for a fixed exchange rate to be combined with a movement towards free trade in a regionally diverse economy if there is a lack of factor mobility. The lack of factor mobility itself may be the result of government policy. The fixed exchange rate policy not only spreads the boom over the two regions, but in doing so also extinguishes the signals for factor mobility through a monetary induced expansion. A free trade agreement with the United States clearly involves long run considerations, however, and in the long run this type of expansionary monetary policy is neutral with respect to real variables. Therefore, in the long run the nominal exchange rate regime that is chosen by the monetary authorities should have little effect on the real economic outcomes from free trade.

Long Run Policy and Regions

In the current free trade rhetoric, there is a great diversity of opinion concerning the eventual economic outcome if free trade negotiations are successful. There are predictions that cover the whole spectrum from increased employment to decreased employment. It is possible that some of this disagreement stems from lack of clarity concerning the time frame over which the results are analyzed. Gains from free trade with the U.S. will acrrue to Canada by the process of agents responding to signals for resource reallocation. This action may cause certain industries to cease to exist, which is probably what opponents of free trade have in mind when they claim that free trade will cause a loss of jobs. This contention can only refer to regional pockets of industries lost due to the normal mechanism of economic adjustment, in which sense the loss of jobs scenario is a short run result. Preventing factor migration either by a fixed exchange rate policy or by some regional expansion policy may prevent the loss of jobs in the short run, but may also result in loss of potential gains in the long run.

It may be politically expedient in the short run for the government to yield to pressure to correct regional disparities. Therefore, a fixed exchange rate, free trade, and balanced growth may be viable in the short run. The question naturally arises as to how long the government can prudently pursue this policy. In the long run the exchange rate itself is a nominal variable, and the real economic configurations in an open economy are determined by the real exchange rate, which monetary policy cannot affect. In a regionally diverse economy like Canada's, the response of agents to signals from the real exchange rate in the long run will have effects on the composition of national income. These compositional effects are a source of the free trade gains. They are also the source of possible increased regional disparity in the Canadian economy. Viewed from this perspective, any regional disparities, either existing now or created by a movement towards free trade, should be examined in relation to long run gains. Thus, if free trade gains accrue through factor mobility, then any policy designed to prevent this mobility will nullify these potential gains. Therefore, in the long run it may be the regional policies themselves that are open to question rather than the choice of exchange rate regime.

References

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