

## Limits to the Effectiveness of Exchange Rate

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### Abstract

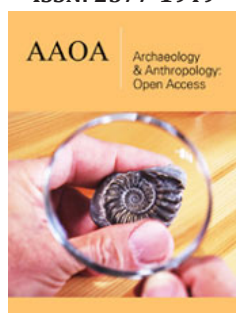
This short paper raised issues on the effectiveness of exchange rate policy within the context of export promotion. Exchange rate was noted to be stable and properly aligned in the long-run implying an incentive deficit for the drive to boost export demand. With expectations defining export growth, strong doubts were cast on the existence of both the J-Curve phenomenon and the long-run trade balance driving capability of the exchange rate. The economics of the effect of currency depreciation/devaluation appeared to support these assertions. However, a liberalized economy could systematically and continuously use exchange rate policy to boost export growth.

**JEL Codes:** A1, A2, E65; F41.

**Keywords:** General economics; Economic education and teaching of economics; Macroeconomics with monetary economics; Open economy macroeconomics

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ISSN: 2577-1949



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**Submission:**  June 10, 2020

**Published:**  June 26, 2020

Volume 3 - Issue 5

**How to cite this article:** Oluremi Ogun. Limits to the Effectiveness of Exchange Rate. Arch & Anthropol Open Acc. 3(5). AAOA. 000592. 2020. DOI: [10.31031/AAOA.2020.03.000592](https://doi.org/10.31031/AAOA.2020.03.000592)

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### Introduction

The efficacy of exchange rate is reflected primarily in its expenditure switching attribute, boosting export production/competitiveness and aggregate demand. Thus, other things being equal, a devaluation that renders the domestic currency less expensive soars export demand while discouraging importation. Optimally, the economically preferred level for all prices is the steady state that in equilibrium context translates to 'a state of rest'. For exchange rate, such an optimal price level may unwittingly limit its effectiveness. In the ensuing discussion of this possibility, exchange rate can be nominal or real without a necessity to modify the analysis. The conclusions follow.

### Implications of Pass-through and Long-run Exchange Rate

Exchange rate pass-through simply describes the degree to which changes in exchange rate are reflected in the prices of traded goods measured in the destination currency. Thus, in the case of exports for example, it refers to the relationship between export price measured in foreign currency and nominal exchange rate. An incomplete exchange rate pass-through describes a short-run state that captures the full trade effect of currency devaluation or depreciation. Some of the reasons informing this development may include, persistence of the exchange rate change, currency of sales' expenses and currency of invoicing, sunk costs, nature of export market, nature of the demand curve and nature of domestic industrial competition. Through such a pricing strategy, a firm may be able to enhance the competitiveness of its export products.

In the long-run, pass-through is expected to be complete as the price level would have risen in full proportion to the exchange rate change. Competitiveness of exports would accordingly be threatened by inflation. The exchange rate being at steady state would offer no further incentive to export production. This would appear to generate an unpleasant outcome for J-Curve: the curve does not appear to exist in the long-run and as a matter of fact, in any run<sup>1</sup>. The economics of the effect of currency depreciation/devaluation appears to support this assertion. So does expectations formation especially, rational expectations that is arguably the most sophisticated expectations formation mechanism ever in history, see e.g.

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<sup>1</sup>The J-Curve phenomenon describes the impact of a currency devaluation on the trade balance, indicating an initial deterioration of the trade balance (short-run) and remarkable improvement as export demand and supply grow (long-run); the combination of both the short-run and long-run impacts produces a "J" like impression.

[1,2]<sup>2</sup>. These assertions also carry the implication that exchange rate devaluation or depreciation cannot be a long-run driver of the trade balance.

Concomitant with the disclosure on J-Curve is the implausibility accompanying an aspect of the conditions for a favorable devaluation under the elasticity approach. A high supply elasticity of export and the existence of unemployed resources are deemed necessary<sup>3</sup>. However, given rational expectations, planning anticipates the policy action and positions the firm accordingly<sup>4</sup>. Besides, there is the likelihood that in the short-run, substitution effect of the policy action could be dominant<sup>5</sup> [3]. The likely incentives generating this outcome can take the form of the size of the expected devaluation or expected sustenance of the exchange rate regime or, commitment to a deliberate use of exchange rate as an instrument of export promotion. The third reason may have in part informed the deliberate policy in some countries e.g. Indonesia and Tanzania, to keep the values of their national currencies at levels below the steady states at different times.

## Conclusion

Firstly, some norms in the economics of effects of exchange rate devaluation or depreciation appeared in need of refining. Secondly, systematic exchange rate policy that consciously incorporated incentive to producers could be an effective export promotion strategy. Finally, real factors unconnected with exchange rate would appear to be more credible determinants of long-run trade balance.

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<sup>2</sup>The recent attention given to heterogeneous expectations in the literature may turn lethargic for the simple reason of inconsistency between the expectations formation mechanism and dynamic adjustments in an educated setting. In the corresponding economy therefore, any seeming heterogeneous expectations would most certainly transform into rational expectations. Besides, heterogeneous expectations could produce divergent economic behaviors of optimism and pessimism, with each most likely taking the form: low, moderate and high. On the average therefore (that is, on a probability distribution basis), such divergent behaviors would cancel out.

<sup>3</sup>Firms in the devaluing country are assumed to be incapable of responding positively to the increase in export demand through for example, utilizing previously unused capacity and extension of new production lines or generally, the existence of previously unutilized resources or spare capacity in the country.

<sup>4</sup>Apparently buoyed by rational anticipations, the response of the textile industry to exchange rate reforms in Nigeria during the late 1980s was immediate and remarkable turning the sector into the leading manufactured export activity until 1991 when policy somersault checked the trend [3].

<sup>5</sup>Such a substitution effect was more likely in less developed countries that are usually considered disadvantaged under the elasticity approach.

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