The Other Side **July 2, 2015**

CAC, Growth and Exchange Rates

In earlier columns, I have commented that the number of financial crises in the global economy has gone up sharply with a liberal capital account; and that capital account convertibility has not helped economic growth. Turning now to "global imbalances" – IMF-speak for Chinese surpluses and US deficits --, these have come down sharply over the last few years, mainly as a result of a sharp, **managed appreciation of the yuan,** though the IMF still prefers market-determined exchange rates.

The pioneering attempt to offer an explanation for exchange rate volatility in the floating rate era was made by Rudiger Dornbusch (1976). To quote from Kenneth Rogoff (2002), former Economic Counsellor and Director of IMF's Research Department, "*Dornbusch's 1976 paper became an instant classic because it seemed to make sense of the chaotic new world of flexible exchange rates, which had only just replaced the serene 'Bretton Woods' system of fixed rates.*

"In Dornbusch's view, excessive exchange rate volatility was the inevitable result of the chaotic monetary policies (and) *inflation differentials…the exchange rate must be volatile because….there has to be a tight link between national inflation differential and exchange rates…"*

As Rogoff went on to point out, however, while Dornbusch's view *"is a landmark theoretical achievement, it is an empirical bust,… monetary policy in the G-3* (the United States, Japan, and Europe) *is far more stable today than it was in the mid-1970s after the first oil crisis…Yet the volatility of G-3 exchange rates has dropped only marginally since the 1970s.... there is some tendency for a country's real exchange rate (the nominal exchange rate adjusted for differences in relative national price levels) to return to its historical value. But* ***the adjustment is very slow indeed. All empirical evidence suggests that one must think in terms of several years, not several months, for the pull of purchasing power parity to kick in."*** (Purchasing power parity in the tradeables sector is the economic fundamental that should determine exchange rates.) Nobel Laureate Robert Mundell, of 'Impossible Trinity' fame, has commented (2010) that "*The whole idea of having a free trade area when you have gyrating exchange rates doesn't make sense at* *all..… What economic function did the exchange rate changes among these islands of stability fulfil? Except for stuffing gift socks of hedge funds* (and bank traders)*, the answer is none."* **And, the cost is borne by the tradeables sector in the real economy.**

The faith in market-determined exchange rates is born out of the efficient market theory, which argues that market prices always fully reflect fundamentals: and for the "true believers" in the IMF, this faith has not been shaken even after the 2008 financial crisis – though even Alan Greenspan, an acolyte of *laissez faire* fundamentalist Ayn Rand, confessed, in October 2008, that *"The whole intellectual edifice* (of market efficiency) *collapsed in the summer of last year.. there was a flaw in the model".* Earlier, Paul Davidson had argued in *Financial Markets, Money and the Real World*, "*There is mounting empirical evidence of both a short-run and long-run nature that* ***behavior in real world financial markets is incompatible with the efficient market theory***." And yet, the ***"Efficient market theory is the backbone of conventional economic wisdom whose mantra is 'the market knows best' how to optimally allocate scarce capital resources and promote maximum economic growth".*** Fischer Black (well-known for the Black Scholes option pricing model), after joining Goldman Sachs, realized that "***Markets look a lot more efficient from the banks of the Charles*** **(Chicago academics)** ***than from the banks of the Hudson*** **(Wall Street, New York).*"*** To George Soros, the spectacular debunking of the credo of efficient markets by the financial crisis of 2008, "*is comparable to the collapse of Marxism as a political system.*" I could go on but the subject requires an essay, if not a book!

The reality is that market-determined exchange rates often differ widely from PPP exchange rates; that as Dani Rodrik has argued in his paper ***"The real exchange rates and economic growth"*** (2008) ***"Tradable economic activities are "special" in developing countries…Sustained real exchange rate depreciations increase the relative profitability of investing in tradeables …That is why episodes of undervaluation are strongly associated with higher economic growth. There is an obvious parallel between the argument I have developed here and the results presented in the recent paper by Prasad, Rajan, and Subramanian (2007). These authors note that fast-growing developing countries have tended***

***to run current account surpluses rather than deficits. This runs counter to the view that developing countries are constrained by external finance, and with the presumption that capital inflows supplement domestic saving and enable more rapid growth. One of the explanations Prasad et al. (2007) advance is that capital inflows appreciate the real exchange rate and hurt growth through reduced investment incentives in manufactures.*"**

In short, if growth is the objective, then the central bank cannot depend on the market to do its job; in other words, it will have to manage the exchange rate. Dr Rajan was one of the co-authors of the paper quoted by Rodrik – or has he changed his views since 2007? Our external account imbalances, both on flow (current account net of remittances) and stock (International Investment Position) accounts need correction, respectively to optimise growth and withstand capital outflows – and **only a managed depreciation of the exchange rate would be able to bring this about.**

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Greece: a victim of fiscal austerity?

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