Market Efficiency and Floating Exchange Rates

Earlier this week, the Finance Minister emphasised the need to strengthen the manufacturing sector before entering into more free trade agreements (FTAs). He is right in a broader context as well. No economy has grown fast and consistently, without rapid manufacturing growth achieved by managed, undervalued exchange rates: from Japan and Germany in the post-war decades to China over the last three decades. And, no country has grown fast on imported finance capital. Are we ignoring economic history and faithfully following the International Monetary Fund (IMF) “messages”?

In an article titled *Gyrations in Financial Markets* (Finance and Development, March 2011), IMF researchers identified “*credit volume, house prices and equity prices”* as the underlying variables of financial instability. The fact is that, over the last 20 years, most of the financial crises in the emerging/developing countries are the result of overvalued exchange rates: from Mexico in 94-95, to east Asia in 1997-98, to Brazil, to Argentina, and even Greece and Portugal in the euro zone. This apart, overvalued real exchange rates leading to net negative exports reduce the national income. Is the IMF’s advocacy of freely floating exchange rates and mobility of finance capital a message from Wall Street via US Treasury? After all, floating rates are a boon to traders/speculators, even as their gyrations increase the risks of the tradeables sector in an economy. No wonder, Wall Street lobbied strongly against a tax on short term speculative trades, proposed by Nobel Laureate James Tobin – and is currently doing its best to get around the Volcker Rule banning proprietary trading.

While the efficient market hypothesis was originally propounded in relation to the equity market, in the floating exchange rate era, the belief is that foreign exchange market is also efficient: market rates are supposed to reflect all known and relevant fundamentals. Also, should the rate move significantly away from what is a fair or intrinsic value,

speculators would step in to arbitrage between the market and fair values, bringing the former closer to the latter.

There is only one theory of the fair value of a currency, namely that determined by purchasing power parity (PPP), as propounded by Gustav Cassel, a Swedish economist, back in 1921: the exchange rate between two currencies should be such as to equate the domestic costs/prices of tradable goods and services in the two countries. The corollary is that exchange rates should move to reflect the relative inflation rates. The only modification I have come across is the so-called Samuelson Balassa thesis that, apart from inflation differentials, changes in productivity differentials also need to be reflected in the exchange rate.

Do floating exchange rates reflect prices based on PPP? I quote just two examples:

- ⇒ The most traded currency pair in the world moved from a low of $ 0.8333 to a high of $ 1.364 (64%) per euro between the birth of the single currency in January 1999, and 2006, i.e. before either the mortgage market crisis in the US, or the sovereign debt crisis in the euro zone;
- ⇒ More recently the JPY: USD rate moved from JPY 79 in mid-November to around 100 in less than six months

There was no significant change of any kind between the inflation rates, or productivity, in these countries, which can anywhere near account for the changes. To quote Nobel Laureate Robert Mundell, *"What economic function did the exchange rate changes...fulfil.. except for stuffing gift socks of hedge funds",* and banks' trading desks?

The other tenet of efficient markets is that speculators step in when prices move away from fundamentals to make arbitrage profit. In reality, speculators/traders are trend followers and technical analysis and models often determine their decisions. According to a study published in the Bank for International Settlements Quarterly Review, December 2011, the two most popular trading strategies are "carry trades", and momentum trading. And, the huge trading profits earned by banks are enough evidence

that they work. Were the market efficient in terms of pricing, neither of these strategies should really work!

The relationship between prices and demand is altogether different in the real and financial economies: in the former, a price rise reduces demand; in the latter it increases the demand at least for quite some time, giving birth to so-called feedback loops which lead to prices far away from intrinsic values. Of course, eventually, the appreciated currency crashes, often after a crisis whose costs fall on those least able to bear them. And, in the meantime, an overvalued currency is as deflationary as tight money: Last year, we lost 4.8% of GDP output (and uncounted number of jobs) through net negative exports!

Now that the exchange market is relatively stable, it is time for our policymakers to review the exchange rate policy (or rather lack of it) that we have been following for the last few years, putting our full faith in market efficiency. How well has it served the two basic objectives of our macroeconomic policy, output and employment creation? China's appreciating currency, lower external surplus, and rapid graduation to high technology exports is creating a huge opportunity for labor intensive manufacturing exports, which should ideally suit us – if the exchange rate is competitive and kept stable in real terms. Perhaps a good starting point would be an in-depth review of calculating the real effective exchange rate index relied upon by policymakers.

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