G20 and Global Imbalances

In mathematics, there is a beautiful concept: the necessary and sufficient condition, in relation to a specific result. The provocation for remembering the concept is the recent criticism by the US of Chinese and German surpluses on the current account. Global imbalances and their correction have occupied the Group of Twenty ever since meetings at the Summit level started in 2009 -- and, rightly so. One solution recommended and reiterated by G20 Summits has been “more” market determined exchange rates. The question is whether this is a necessary, let alone sufficient, condition for a reduction in global imbalances.

It would be interesting to examine the empirical evidence on whether market determined exchange rates reduce global imbalances; remember, we are talking about imbalances, not about surpluses per se:

⇒ China, which continues its policy of managed exchange rate, has reduced its current account surplus from a peak of $ 420 bn in 2008 to $ 193 bn last year. The fall is even sharper in GDP terms, and obviously did not require a market-determined exchange rate.

⇒ Germany, the other country criticized by the US, which, as part of the euro zone, has a floating, fully market-determined exchange rate, has increased its external surplus to $ 238 bn in 2012.

⇒ At home, the current account deficit has grown from $ 29 bn in 2008-09 to $ 88 bn in 2012-13, i.e. since the central bank significantly reduced its market intervention.

All the three cases cited above do not evidence that a market-determined exchange rate is a necessary, let alone sufficient, condition for reduction of global imbalances.

This is not to deny the need for reduction of the imbalances; they have significant costs to both the surplus and deficit countries. The people in the surplus countries consume

less than what they can afford to, given their productivity and output; on the other hand, deficit countries also pay a heavy price in terms of slower growth and employment creation. It is worth emphasizing that our growth rate has halved since we changed the policy on the ground from 2009.

To come back to Germany, it also has a significant surplus within the euro zone, despite all the countries using the common currency. This emphasizes the need to look closely not at the nominal exchange rate (1:1 within the euro zone), but the “real”, i.e. inflation adjusted, exchange rate. Since the so-called “peripheral” countries have had higher domestic inflation than Germany, they had become increasingly uncompetitive even within the single currency area. The huge deficits on current account surely contributed to the sovereign debt crisis of at least two of the peripheral countries.

Clearly, real exchange rates matter to international competitiveness. While there is no single, agreed measure for the under- or over-valuation, persistent deficits, as in our case, are a clear sign of overvaluation of the real exchange rate, which also has a significant impact on growth and employment. As Dani Rodrik has argued (*The Real Exchange Rate and Economic Growth*, Brookings, 2008) real exchange rates exert a significant impact on economic growth; undervaluation not only leads to higher growth but compensates to some extent for institutional weaknesses, so manifest in our case. They are perhaps even more necessary for countries getting large remittance inflows, a form of the “Dutch decease”, an expression coined to describe overvaluation arising from discovery and large exports of natural resources like crude oil. No wonder that Indian industry is lobbying for protectionist measures, which the Governor criticized in a recent speech. The correct solution of course is a real exchange rate which makes the tradeables sector competitive in the global economy.

Can the market be depended upon to correct real overvaluation? To quote from Kenneth Rogoff, Finance and Development, (2002), former Economic Counsellor and Director of IMF's Research Department, “*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."*** Meanwhile**, as** Jeffrey Sachs argued some time back (The Economic Times, July 3, 2002), *"The public should be more aware of the erratic nature of today's financial markets. Exchange rates .... deviate enormously from long-run fundamental values, which can cause major dislocations in the real economy in the jobs, production, and investment."*

What should be the objective of managing the exchange rate? Clearly, managing the exchange rate aimed at a zero external imbalance is not practical. What is possible however is to have an agreed limit, say 1/1.5% of GDP, on the current account balance, whether positive or negative – and, indeed, a zero balance over a cycle; I recall Dr Y V Reddy arguing this in an interview, but am unable to trace the source. When the balance exceeds the limit, there is a clear case for intervention in the currency market (and sterilisation of the effect on money supply) to move the exchange rate in the desired direction. Labour intensive manufacturing, which we need for creating employment, suffers more than capital-intensive industry, under an overvalued exchange rate.

To come back where we started, it would be unrealistic to depend on market-determined exchange rates to reduce global imbalances .

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