WORLD MONEY October 25, 2010

Real and Financial Economies, and Exchange Rates

As the date of the G20 Summit comes nearer, the rhetoric on the issue of exchange rates is occupying more and more media space. And there is agreement on only one point: trade restrictions and competitive devaluations will only damage the already fragile global economy. The apprehension about trade restrictions and tariff and non-tariff barriers is not fanciful: apart from the enactment of a provision for imposition of a 20% duty on Chinese imports (see last Monday's article) by the U.S. Congress, recently more than half the respondents to a poll in that country voted in favour of the proposition that free trade is hurting the U.S. (Wall Street Journal, October 5). In my view, the problem is not the desirability of free trade *per se*, but of the exchange rate. Successive U.S. treasury secretaries have claimed that the U.S. has a "strong dollar" policy, without ever defining what a "strong dollar" means. But the trade numbers and declining manufacturing jobs clearly evidence an overvalued currency: is it part of a deliberate plan to ensure that the huge mass of people whose real wages have remained stagnant since the "Reagan Revolution", can increase consumption through cheap imports, and a housing bubble facilitating "home equity" loans? The cost of the first is the loss of manufacturing jobs. And the cost of the second is now too will known.

The U.S. has deficits with other countries as well: Europe, Japan, etc. But the currency war, now postponed to the next month's G20 Summit, has China as the principal opponent. The reasons are two:

⇒ Both the euro and the yen have appreciated against the dollar in recent months

⇒ The exchange rates between the euro, the dollar and the yen are, broadly speaking, market-determined and therefore beyond criticism: after all, how can any price determined by the market be wrong?

While on market-determined exchange rates, it is worth recalling that freely floating exchange rates did not come into being as deliberate policy. The fixed exchange rate system collapsed in August 1971 because of the uncertainties following the U.S. withdrawal of the gold convertibility of the dollar. The attempt to bring back fixed rates, notably the Smithsonian Agreement of December 1971, could not be sustained because of free capital movements, and the inflation differentials and global imbalances following the sharp hike in oil prices in 1973.

Many analysts and commentators in both India and abroad have attributed the recent fall of the dollar against the euro and the yen to the loose U.S. monetary policy. This does not stand to reason – surely the Japanese monetary policy is, if anything, looser and the ECB is not far behind! The theory that money supply determines exchange rates through inflation (the good old PPP theory), was advanced first in the 1970s by Rudiger Dornbusch. As Kenneth Rogoff has pointed out, however, *"Whereas the over-shooting model is a landmark theoretical achievement, it is an empirical bust, at least as far as it concerns exchange rates among the United States, Japan, and Europe."* The reason why the Dornbusch theory did not work was simple: with liberal capital accounts, capital flows, not trade flows, became the major determinant of the exchange markets demand supply dynamics. According to the latest BIS survey, presently the global currency markets trade $4 trn of currencies every day, i.e. $ 1,000 trn a year! Just compare that to the global trade which was just $ 15 trn in 2009 as per the WTO. In short, the purchasing power parity theory based on trade flows determining demand and supply of currencies to be exchanged, no longer matters.

Nobel Laureate Robert Mundell has correctly identified the impossible trinity: an independent monetary policy, a liberal capital account and managed exchange rates. The favoured fashion of the last three decades has been to give up the 3rd. The problem is that this has a cost which the real economy has to bear, through lost output and jobs, or consumption. On the other hand, the better off and the financial sector benefit through trading profits in volatile currency markets, and short term capital movements chasing speculative profits.

No wonder in the U.S. (and U.K.) the manufacturing sector and jobs occupy an increasingly smaller portion of the pie, which itself is not growing very fast. No wonder again that while, until the beginning of the 1980s, the financial sector's share of corporate profits was around 15%, it had gone up to 40% just prior to the crisis, even as the manufacturing sector's share of GDP has fallen sharply! And the 40% share of the financial sector still does not include profits made by hedge funds, private equity, trader bonuses (which are often up to 50% of trading profits), and other beneficiaries of financial sector profits outside the corporate sector!

Tailpiece: As for the U.S. China currency war, Martin Wolf says "*America is going to win the global currency battle"* (Financial Times, October 13) while Prof. Yiping Huang says "*The U.S. will Lose a Currency War*" (Wall Street Journal, October 14) Toss a coin!

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