Capital Flows and Exchange Rates

Exchange rates are back in the news since the Chinese devaluation of 3%. The rupee has fallen to Rs 66+ after moving in the Rs. 63-64 band for 5/6 months. So have many other emerging market currencies. “Currency wars”, i.e. competitive devaluations, are being talked about. Meanwhile, the Chinese equity prices have once again come under pressure; many other stock markets in both the emerging economies and in advanced industrial countries have fallen; and so have commodity prices in the expectation of lower Chinese demand, thanks to slowing growth.

Interestingly, even as the Chinese devaluation has been characterised as “manipulation” by a few US Congressmen, in a recent policy statement the US Federal Reserve acknowledged that the 20% dollar rise over the last year is having a significant impact on the US tradeables sector. The market turmoil seen over the last couple of weeks was supposed to happen after the Federal Reserve increases interest rates. Or have Chinese markets and economy already become more important to the global economy than the US?

As for the impact of changes in exchange rates on trade, one recent World Bank paper argues that exchange rates have become less important for cross-border trade which is part of global supply chains. One example of the latter is the Apple phone whose parts are manufactured in a dozen countries, assembled in China and exported to the US. (The only parallel in India I can think of is some auto part manufacturers who have long term, fixed price export contracts.) The reason is that it is difficult to modify established supply chains in response to exchange rate changes. The lower relevance of exchange rate changes is also true in the case of the so-called “differentiated products” which are sold on technology, brand name, after sales service, etc. (The exchange rate obviously becomes a far more significant element of trade competitiveness for producers of “commodity” type of goods, sold essentially on price competitiveness.) China is an important contributor to both global supply chains and, increasingly, differentiated, high value added products. On the other hand, Korea’s recent experience evidences the limitations of the World Bank research: many segments of its manufacturing industry, which compete with Japan (consumer electronics, autos, shipbuilding, etc.), are suffering because of the sharp fall of the yen over the last two years.

China's current account is in surplus and yet the market-determined exchange rate in Hong Kong (CNH) depreciated thanks to capital outflows following the stock market crash of June/July. Clearly, "market-determined" has come to mean "capital flow-determined" exchange rates. Is this the optimum regime for global growth? Incidentally, the rupee's fall in the last few days is probably also because of capital outflows.

William White of the OECD has argued that *"hot money, funds that flow from one country to another from investors seeking the highest returns, can wreak havoc on smaller countries – both on the way in and on the way out…..Driven by short –term momentum trading, in which traders buy and sell currencies to cash in on what they anticipate will be continuation of increases or decreases in their value,* ***exchange rates can deviate for years from levels consistent with underlying fundamentals…. What passes for an international monetary system today is not really a system because it has no rules."*** **(Finance and Development, March 2015).**

Coming back to China and its "manipulation" of the exchange rate, advocates of floating/flexible/market determined exchange rates often seem to equate "managed" with "manipulated". Both require intervention by the central bank, but there is a clear distinction between the two. As Jonathan Sanford of the Congressional Research Service argued in a 2010 paper "Currency Manipulation: The IMF and WTO", "*The new language of Article IV* (of the IMF's Articles)*, which went into effect in 1978, said that countries should seek, in their foreign exchange and monetary policies, to promote orderly economic growth and financial stability and they should avoid manipulation of exchange rates or the international monetary system to prevent effective balance of payments adjustment or to gain unfair competitive advantage over other members……The 1977 agreement said that, among other things, 'protracted large-scale intervention in one direction in exchange markets' might be evidence that a country was inappropriately manipulating the value of its currency. The 2007 agreement added a requirement that 'A member should avoid exchange rate policies* *that result in external instability'.* ***When a country's current account (balance of payments) is not in equilibrium, the IMF said in its explanation of the new provision, the exchange rate is 'fundamentally misaligned' and should be corrected.***"

Joseph Gagnon of the Peterson Institute for International Economics in a 2012 paper *"Combating Widespread Currency Manipulation"* has defined "manipulation" more clearly: "*Currency manipulation occurs when a government buys or sells foreign currency to push the exchange rate of its currency away from its equilibrium value or to prevent the exchange rate from moving toward its equilibrium value..... An exchange rate is sustainable if the current account balance is not generating an explosive path for net foreign assets relative to both domestic and foreign wealth. Sustainability generally implies* ***a small value of the current account balance****,* ***but fast-growing economies can maintain moderate current account deficits as long as the associated liabilities do not grow faster than their economic output*****".**

Is it time that our policy-makers need to review the exchange rate policy they have been following for the last seven years?

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