

BRIEFING PAPER

Exchange Rate Policy - Potential Global Imbalances especially with regard to developments in Asia (China, Japan)

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Executive Summary

Exchange Rate Policy - Potential Global Imbalances especially with regard to developments in Asia (China, Japan)

Exchange rate policy is returning to the limelight of the economic policy debate. The reason is the continuing build-up of global imbalances. Looking at different global regions one can indeed detect several that show high surpluses or deficits, but others are not affected at all. The only imbalances in the sense of a non-sustainable situation occur in the US and China. So in the first place it would be the task of the US and China to overcome this potentially harmful situation. From a European perspective, appropriate strategies all have one major drawback, whether they are put into practice or not, neither the ECB nor any other European institution has the power to enforce them. It is for precautionary reasons that the ECB should have an action plan for the worst case. The tremendous advantage of the ECB consists in being the central bank of the appreciating currency. Therefore all actions are credible. Since markets know about this strong position, the ECB should as a first step make a commitment. This could have the form that the ECB would not tolerate any appreciation of the Euro beyond 30 % or 40% within next two years. If markets accept that, no more action is required. In case the markets test that commitment, the ECB should preferably start with open market operations. These can be sterilized domestically so that the supply of money will not rise. In this case there is no reason to assume any inflationary impact.

If open market operations do not produce the desired result, interest rates have to be lowered. Even then the inflationary dangers are low, since the expansionary impact of lower interest rate should offset the adverse effects of an overvalued currency.

Introduction

Exchange rate policy is returning to the limelight of the economic policy debate. The reason is the continuing build-up of global imbalances that according to many observers will sooner or later trigger fundamental exchange rate adjustments. These may occur at the wrong time and in the wrong place given the present global institutional settings and strategies. These may endanger the global upturn especially for those regions that have started to recover after a lengthy period of virtual stagnation like the Euro area and Japan. Therefore it is worth analysing the present situation and considering pre-emptive action in order to avoid such a dismal scenario. Furthermore it should be considered whether fundamental changes are necessary to avoid the emergence of these huge imbalances right from the beginning.

In the following section the imbalances are outlined. After that the role of exchange rates is described and in the final section policy recommendations for monetary policy are derived. The conclusion is that a more active stance of the ECB is required for precautionary reasons.

Global Imbalances

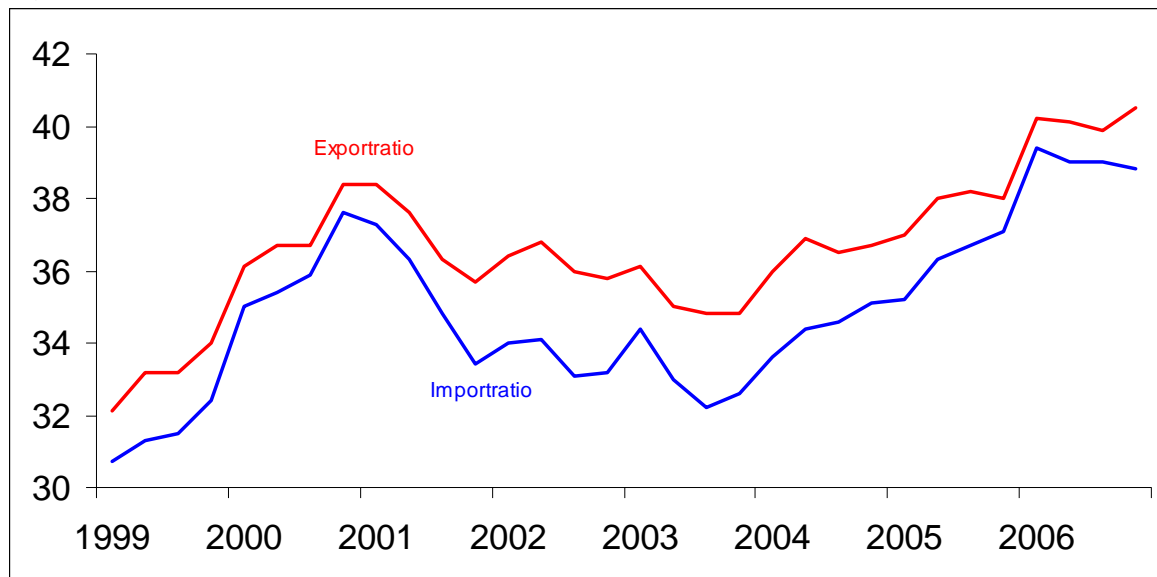
Global imbalances are mainly seen as deficits or surpluses either in net-exports or the current account. So it is trade that determines the imbalance. But one has to keep in mind that neither any surplus nor any deficit necessarily signifies an imbalance. There are good reasons why foreign trade flows are not always balanced. One consists in differing phases of the business cycle. If an economy grows at a relative high pace and domestic demand is the driving force it is likely to import more than another economy that is growing slowly, especially because domestic demand may be weak in the latter. As soon as the situation changes the trade balance will adjust automatically, too. Hence it is problematic to qualify current trade figures as imbalance. But, if there is a clear tendency towards a permanently widening gap, one may conclude that this situation is not sustainable, because for the economy showing a deficit foreign debt would rise indefinitely and for the surplus economy foreign assets would pile up. It can reasonably

be expected that global capital markets will not accept this to continue forever. Instead, the adjustment process outlined below will occur.

Looking at different global regions one can indeed detect several that show high surpluses or deficits, but others are not affected at all. Among the latter is the Euro area. Looking at net exports as a percentage of GDP (i.e. the difference between the export and the import ratio, c.f. Figure 1), one realizes that although the export ratio has always exceeded the import ratio since the beginning of the currency union, the difference is rather small and has even been narrowing since 1999. Maximum trade surpluses were seen in 2002 and 2003 when the Euro area showed a very low growth record, especially compared to the United States.

It is difficult to interpret these findings as a trade imbalance. The high numerical values of the respective ratios should not be misleading. These trade figures include the internal Euro area trade. Hence only the difference can be attributed to external trade. The internal imbalances of the Euro area where high surpluses in Germany are matched by huge deficits in e.g. Spain and Italy are not discussed in this paper. The obvious reason is there is no exchange rate mechanism that could adjust in his case.

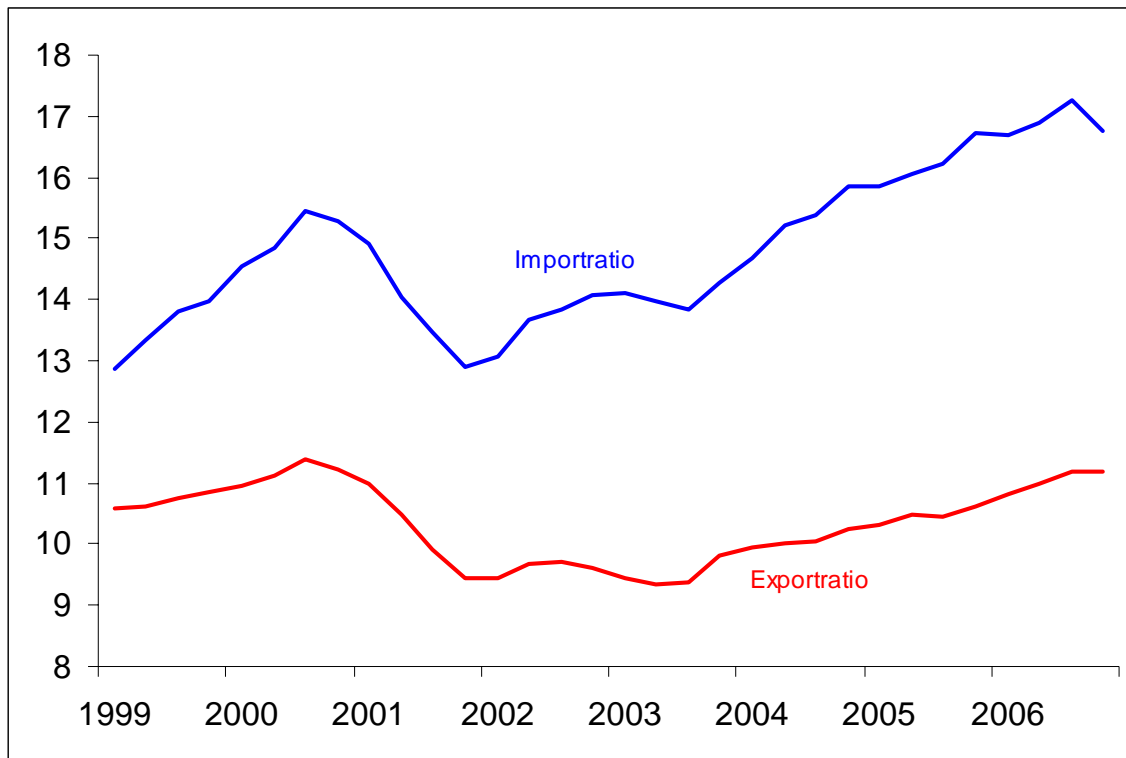
Fig. 1 Export and Import-ratio in % of GDP: Euro-area



Source:IMF,IFS

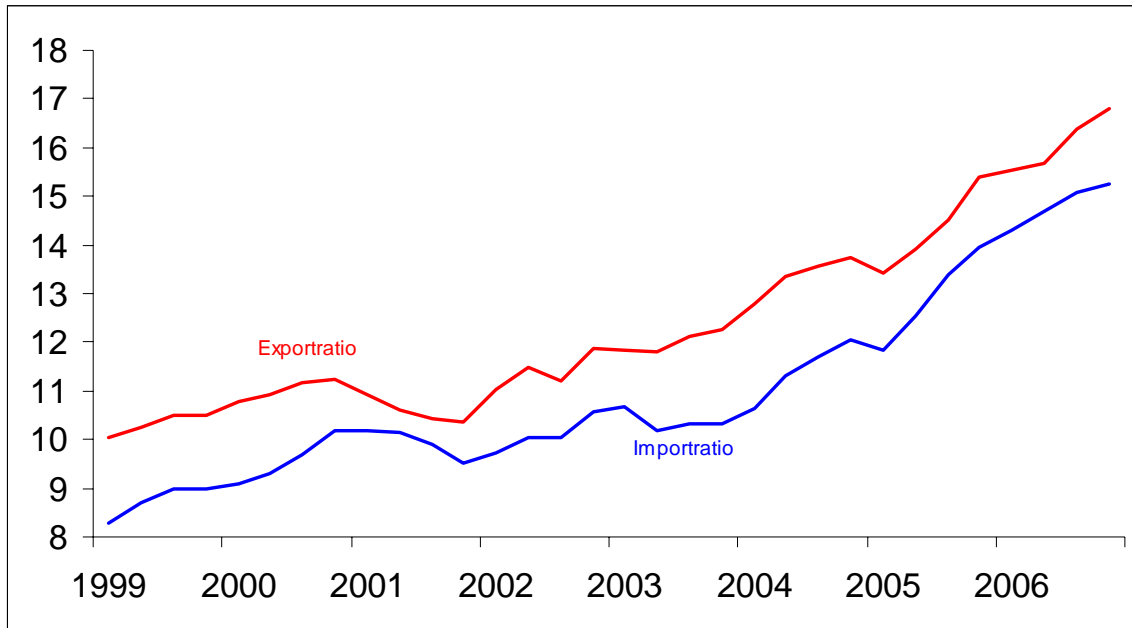
Looking at the same figures in the US, the result is quite different (Figure 2). Here we see a huge deficit of about 6 % of GDP. Until recently the gap was widening by each quarter. But against the backdrop of a moderate slow down in the US imports move more slowly too. The deficits are extreme however by historical standards.

Figure 2 Export- and Import-ratio in % of GDP: USA



Source:IMF,IFS

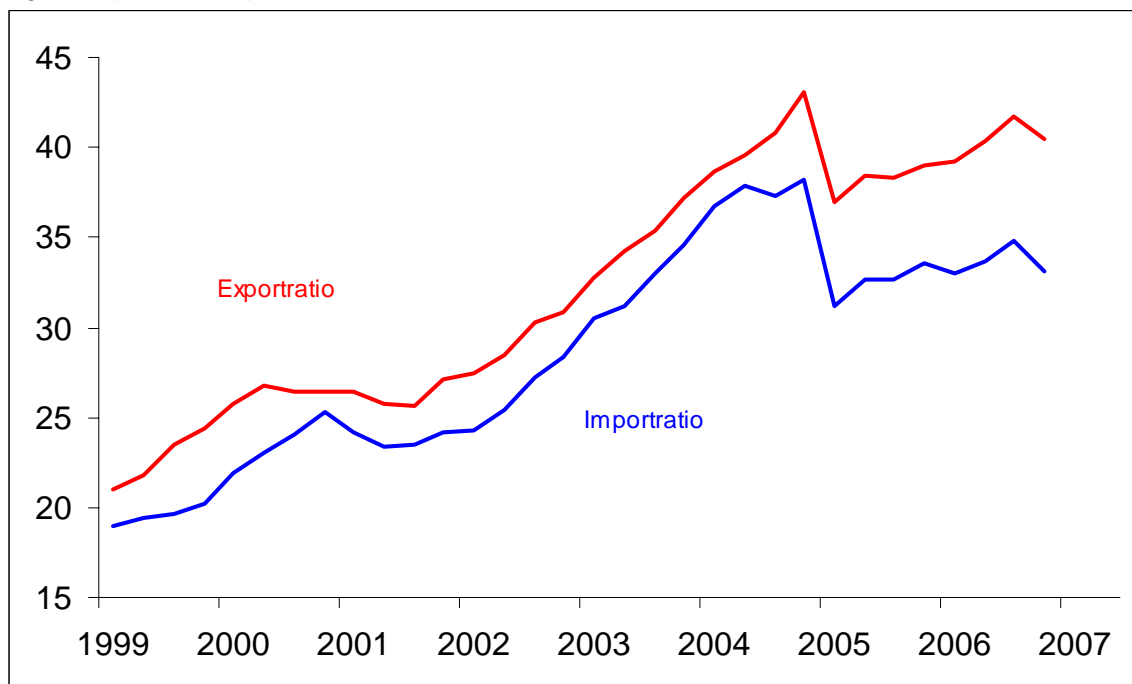
The contrary applies to Japan (Figure 3).
 Fig.3 Export- and Import- ratio in % of GDP: Japan



Source:IMF,IFS

In Japan there is an almost constant trade surplus of around 2 % of GDP. It remains largely unaffected by cyclical fluctuations.

A much more pronounced surplus can be found in China's trade balance (Figure 4).
 Fig. 4 Export an Import –ratio in % of GDP: China

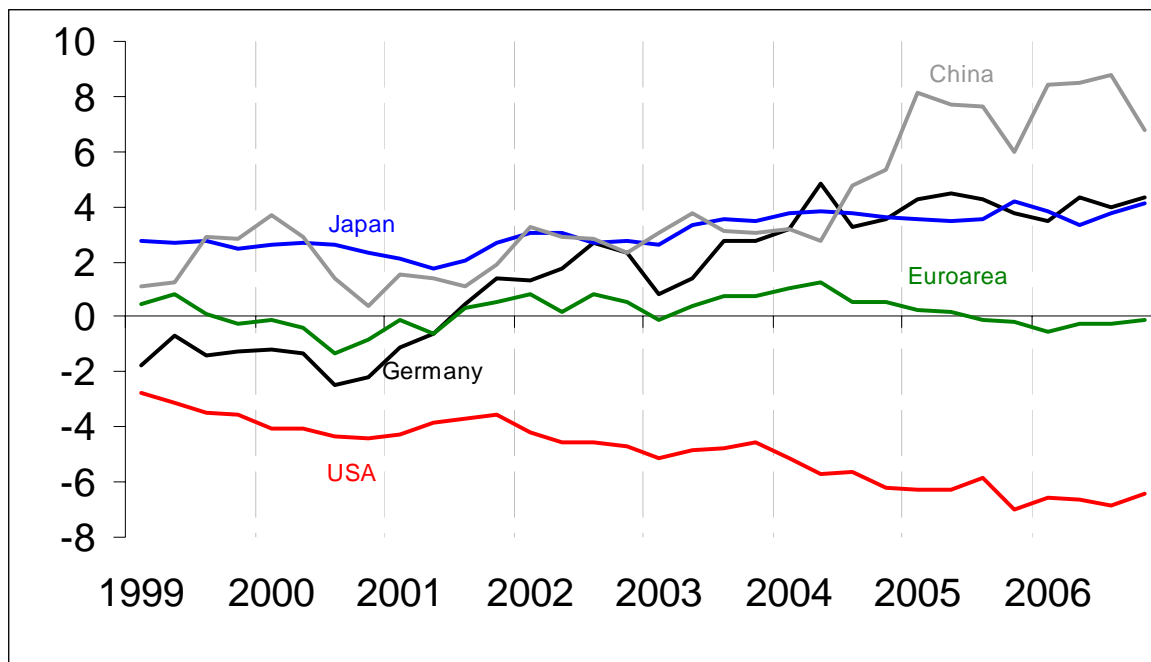


Source:IMF,IFS

Especially during recent years, it has grown significantly amounting to 6 % of GDP at the end of last year. One has to keep in mind that China's growth performance was far better than that of any other big industrial country. Nevertheless, if one wants to find a counterpart of the growing US deficit, it can be detected predominantly in China.

This impression is confirmed by the figures in the current account (Figure 5). Besides foreign trade of goods these include trade in services, income flows (such as the repatriation of profits) and transfers (e.g. workers' remittances, contributions to international organisations or aid to other countries). Hence it is a more general measure than the trade balance. Nevertheless, the results are quite similar. Whereas the US shows huge deficits, China and to a much lesser extent Japan run high surpluses¹. The Euro area again shows are more or less balanced current account.

Figure 5 Current Account as % of GDP (USA)



Source:IMF,IFS

In the light of these figures global imbalances with respect to trade are not a general phenomenon. The Euro area definitely shows no sign of an imbalance. Even Japan with its hardly changing surplus is difficult to interpret as an unsustainable situation. The only

¹ Within the Euro area Germany shows the very same surplus.

potential imbalances in the sense of an unsustainable situation occur in the US and in China. Thus, in the first place it would be the task of the US and China to overcome this potentially harmful situation. Unfortunately matters are much more complicated. Trade is a multilateral rather than a bilateral affair.

Trade Deficits and Exchange Rate Adjustments

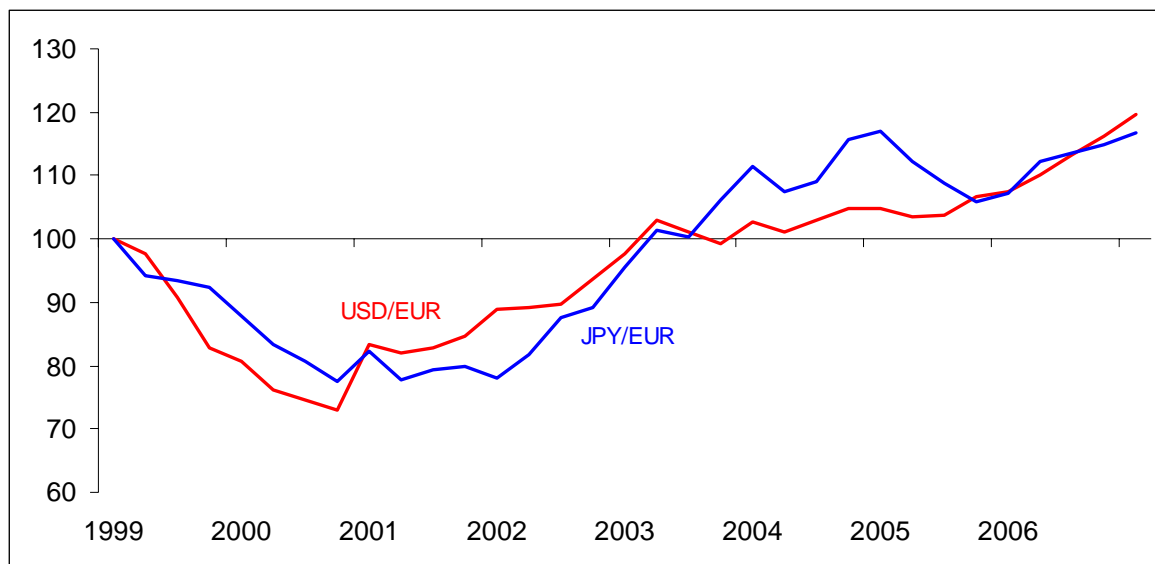
The concerns related to potential imbalances are mainly caused by the hypothesis that high deficits or surpluses in the trade balance will lead to potentially dramatic exchange rate adjustments. This hypothesis is based on the assumption that the currency of a country that accumulates foreign debt will devalue sooner or later since the debt situation will be considered unsustainable at a certain point of time. Creditors will then refuse to provide additional credits and shift their money to other currencies reducing the demand for the currency in question and increasing the demand for other currencies. Thereby an exchange rate adjustment process is triggered. For the present situation that would mean the US-Dollar would depreciate and the Chinese Renminbi would appreciate. In this case only China and the US would be affected. The exchange rate movements would then lead to a lower US-Dollar in relation to the Chinese currency. As a consequence US exports, especially to China, would grow faster and imports (also especially from China) more slowly. China would be affected symmetrically. Therefore such an adjustment would be very benign since it affects only those countries that caused the imbalances. Moreover, they would be affected in the right direction, since the imbalances would gradually be overcome.

But so far China has refused to let the Renminbi float freely and the Chinese capital markets are still highly restricted. There are some good reasons for that, but the effect on the imbalances is nevertheless detrimental. Investors may shift their assets to another currency, but then the appreciation will occur in the wrong place. One primary candidate for this replacement of China is the Euro area. After all, the Euro is the second most important currency after the US-Dollar. Furthermore, it has acquired a reputation for stability. Hence it seems highly likely that investors choose the Euro as a safe haven,

when the US-Dollar starts to come under pressure. As figure 6 shows there are signs that this is already the case.

Since 2001, when the euro showed its lowest value vis-à-vis the US dollar in recent years, the European currency has appreciated significantly vis-à-vis the US dollar and the Japanese Yen. Compared to its initial value in 1999, the euro has gained about 20 % in value. Compared to the lowest point in 2001, the value of the euro increased by more than 60 %. This is already a significant burden for the euro area, a region that shows no sign of an imbalance. Hence it is the wrong place. But it is also the wrong time, because the euro area has just recovered from a lengthy economic slump. If the export industries have to carry that burden, may be even aggravated by additional appreciation, the upturn will be unnecessarily weaker. Computations by the Brussels-based think tank Bruegel show that if the EU carried the whole burden of adjustment, the process would lead to a 2 % lower GDP in the EU. If one applies these computations to the Euro area the costs would rise to 2.5 % of GDP. In the end, this kind of adjustment would amount to a premature end of the still necessary employment –build–up. In sum the Euro area is an obvious candidate, but the most inappropriate, too.

Fig.6 Exchange rates
Index: 1999=100



Source:IMF,IFS

An appropriate exchange rate policy

Given the facts mentioned above it seems sensible that - for precautionary reasons - the ECB should show a more active approach to exchange rate policy. This is so, because the ECB has to act, if growth and employment are endangered as long as price stability prevails. An exchange rate shock as outlined above will show very detrimental effects on growth and may even trigger deflationary price developments. Therefore the ECB is perfectly legitimated to act.

There are still some ways out of this situation that do not require any intervention by the ECB. If e.g. the US gradually succeeded in getting the balance right without a recession, no serious problems should occur. This could only happen if savings in the US is gradually increased. This could be achieved by slowly raising interest rates and taking a more restrictive stance in fiscal policy. But doing so sliding into a recession has to be avoided, as the global economy would be adversely affected and among other central banks the ECB also would have to react by lowering interest rates. Symmetrically China could foster domestic demand to raise imports strongly. If this were done by raising wages, China would at least appreciate in real terms and record an increasing demand for imports. Both effects will put pressure on the Chinese foreign trade surpluses. These or similar recommendations have already been made by several international institutions including the IMF. From a European perspective, they all have one major drawback, whether they are put into practice or not, neither the ECB nor any other European institution has the power enforce them. Therefore, it would be gambling with growth and employment to assume that the benign scenarios come true and not the worst case outlined above.

It is for precautionary reasons that the ECB should have an action plan for the worst case. The tremendous advantage of the ECB consists in being the central bank of the appreciating currency. Therefore all actions are credible. If the ECB decided to intervene in the market by buying dollars their actions are not limited by a lack of foreign currencies. If interest rates are lowered, no recession threat can be an obstacle. Since

markets know about this strong position, the ECB should as first step make a commitment. This could have the form that the ECB would not tolerate any appreciation of the Euro beyond 30 % or 40% within next two years. If markets accept that, no more action is required. In case the markets test that commitment the measures described above should be taken. Preferably the ECB should start with open market operations. These can be sterilized domestically so that the supply of money will not rise. In this case there is no reason to assume any inflationary impact.

If open market operations do not produce the desired result, interest rates have to be lowered. Even then the inflationary dangers are low, since the expansionary impact of a lower interest rate should offset the adverse effects of an overvalued currency. Nevertheless, a coordinated approach with fiscal policy being more restrictive, and wages that keep on track during this phase, would make business much easier for the ECB. But this is not the reality in the present Euro area.