Competitive Devaluations: The new global norm?

Ashima Goyal
Professor

7th Annual International G20 Conference
ICRIER, New Delhi
14-15 September, 2015

Indira Gandhi Institute of Development Research, Mumbai

Current international exchange rate agreements

- Since US ended the gold exchange standard: anything goes!
  - 1976 IMF article IV amended: Cs can follow any exchange rate regime
  - but promote stability and growth, with no manipulation of exchange rates
  - IMF is a monitor with little clout against countries that do not need its loans

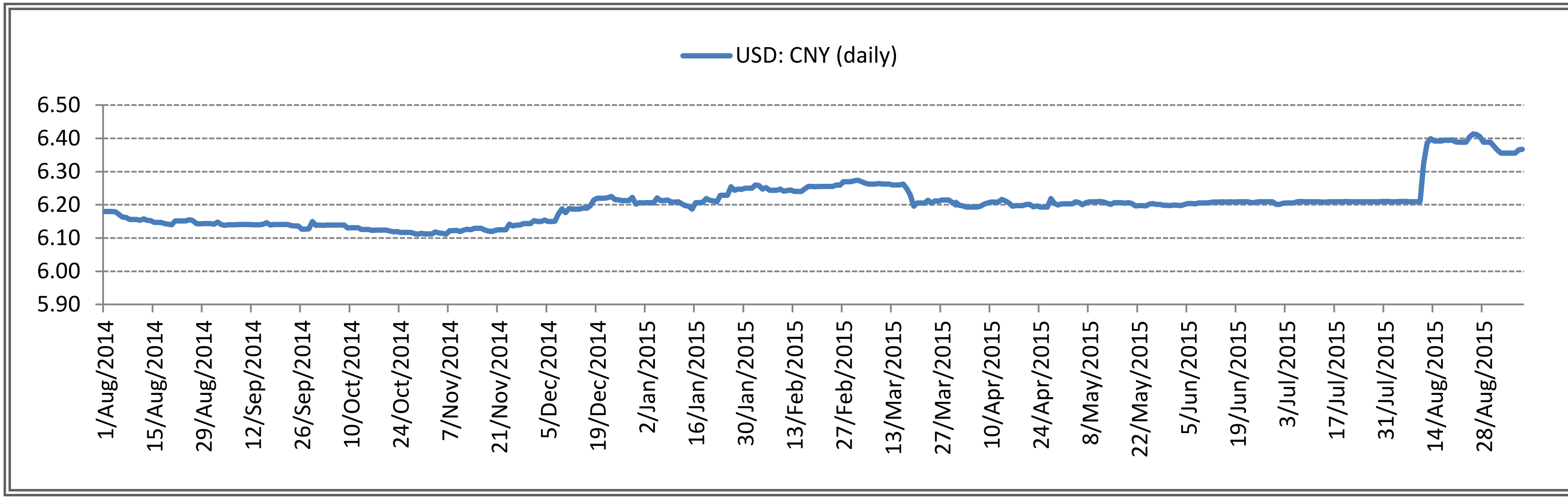
- In practice norm for most EMs: IT and flexible exchange rates
  - Market determined—capital flows make sustained manipulation of levels difficult
  - Inflation targeting as nominal anchor
  - Managed float can't have devaluations: but extent and type of intervention?
    - ✓ **But many AEs large depreciations driven by low interest rates**

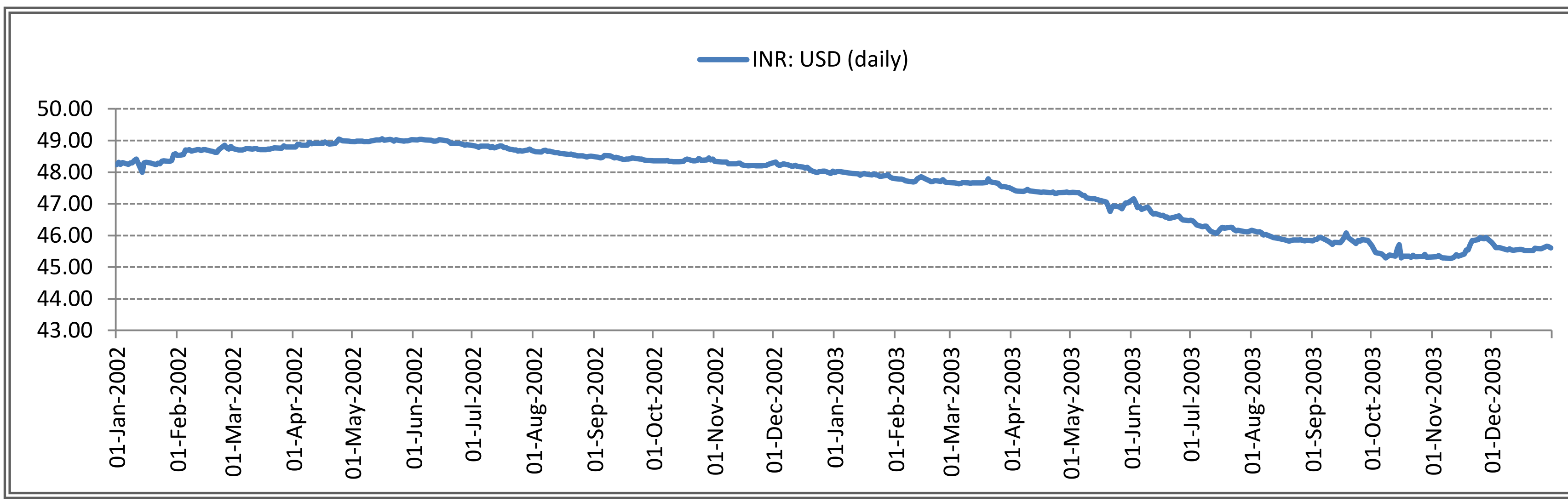
Reform: Greater role for markets

- Markets do not like large unexpected movements even if market-caused
  - Swiss Franc appreciation (↑) after end of SNB cap in 2015
  - China: move to more market determination
    - ✓ **2005 $ peg relaxed narrow daily movements around PBC ref rate; 2015 25% ↑**
    - ✓ **August: reference rate based on last day's trading; more market say; 6.21-6.34 ↓**
    - ✓ **Biggest one day movement since the mid-1990s**
    - ✓ **But using reserves to reduce depreciation: fell ($90b ↓), 200b intervention**

- India: strengthening role of markets as part of reforms
  - 2002 change in earlier trend depreciation; furor in domestic markets

Reversal of trend: India and China graphs



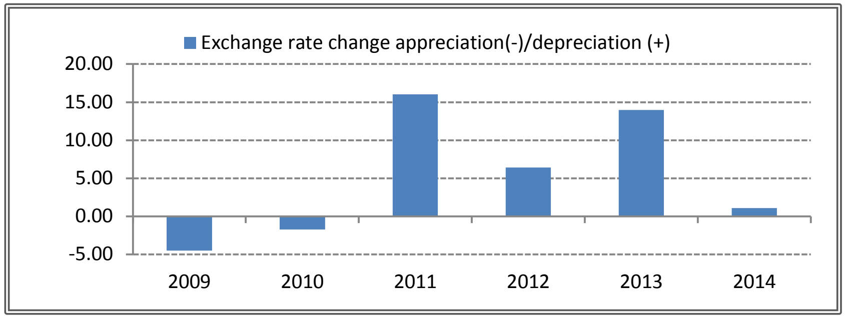


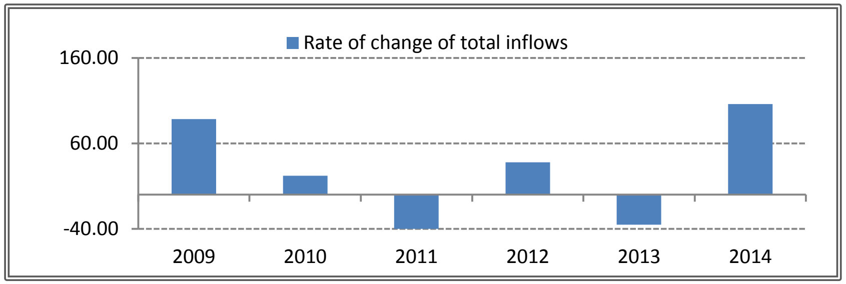
Currency wars or capital flow and market volatility?

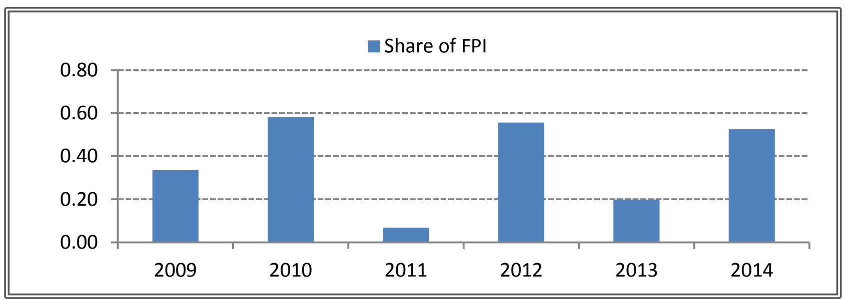
- Post GFC 2008: USD depreciation, EMs appreciation
  - QE: Japan April 2013 QE Yen—33% ↓ by 2015; Euro ↓
  - Guido Mantega ‘currency wars’: Brazilian Real appreciation (24%)
  - Psychological factors: blame others; distorted perceptions; fear

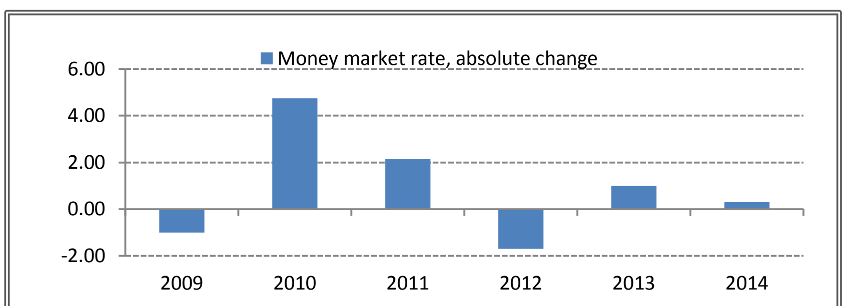
- But 2014-15: USD appreciation, EMs depreciation (Real: 40%)
  - Why would governments want to reverse competitive advantages?
  - Capital flows and markets; and extreme interest rate swings responsible
    - ✓ **19 largest EMs: outflows 2008/09 \$0.5tn; 14/15 \$1tn; inflows July 2009-June 2014 \$2tn**

India

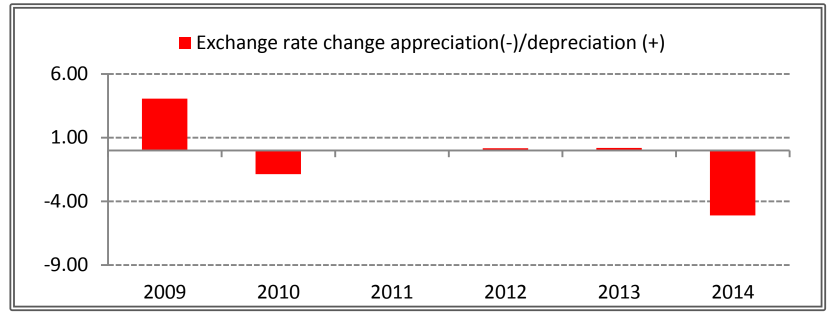

Exchange rate change appreciation(-)/depreciation (+)
20.00
15.00
10.00
5.00
0.00
-5.00
2009
2010
2011
2012
2013
2014

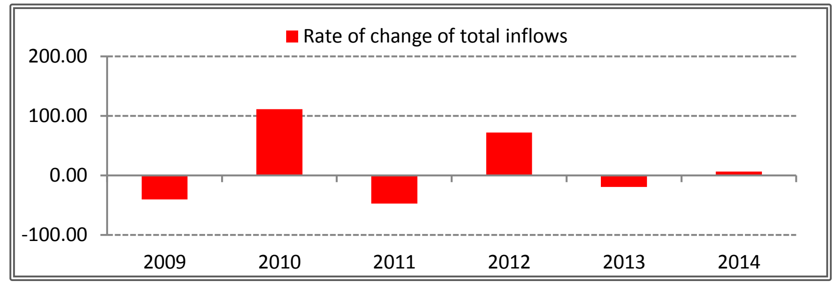

Rate of change of total inflows
160.00
60.00
-40.00
2009
2010
2011
2012
2013
2014

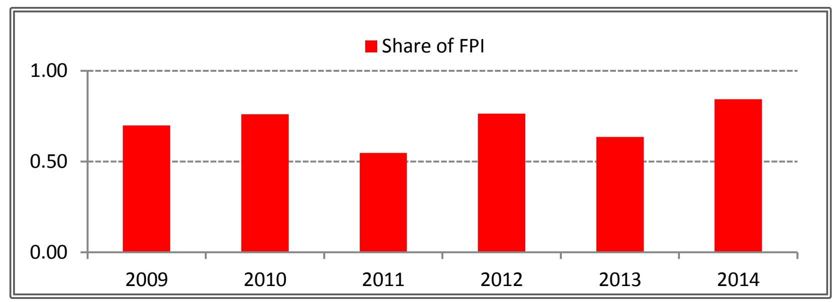

Share of FPI
0.80
0.60
0.40
0.20
0.00
2009
2010
2011
2012
2013
2014

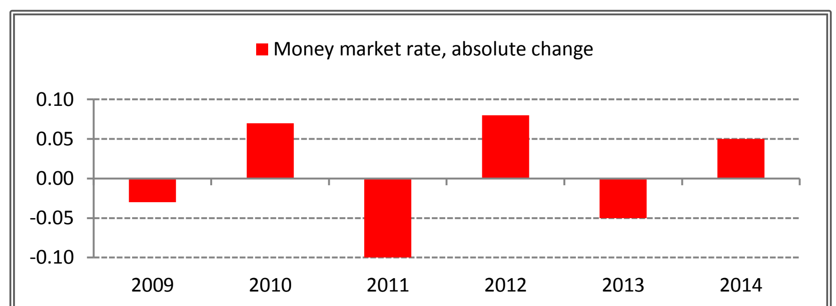

Money market rate, absolute change
6.00
4.00
2.00
0.00
-2.00
2009
2010
2011
2012
2013
2014

U. S


Exchange rate change appreciation(-)/depreciation (+)
6.00
1.00
-4.00
-9.00
2009
2010
2011
2012
2013
2014


Rate of change of total inflows
200.00
100.00
0.00
-100.00
2009
2010
2011
2012
2013
2014


Share of FPI
1.00
0.50
0.00
2009
2010
2011
2012
2013
2014


Money market rate, absolute change
0.10
0.05
0.00
-0.05
-0.10
2009
2010
2011
2012
2013
2014

	Brazil	China, P.R.	Euro	India	Indonesia	Korea	Malaysia	US
2009: EM inflows								
Exchange rate change appreciation(-)/depreciation(+)	**-24.27**	-0.15	**-9.31**	-4.51	-15.39	-13.92	-4.33	4.06
Rate of change of total inflows	**55.44**	0.12	**57.34**	88.58	24.08	488.00	-145.62	-40.32
Share of FPI	0.59	0.15	0.55	0.34	0.68	**0.84**	**0.98**	0.70
Money market rate, absolute change	-4.67	0.00	-1.06	-1.00	-2.62	-0.43	-1.05	-0.03
2011: EM outflows								
Exchange rate change appreciation(-)/depreciation(+)	**9.43**	-4.16	1.37	16.02	0.29	2.58	3.32	-0.04
Rate of change of total inflows	**-25.71**	13.23	26.33	**-40.03**	**-17.56**	**-49.08**	**-9.83**	**-47.30**
Share of FPI	0.21	0.04	0.33	0.07	0.20	0.64	0.49	0.55
Money market rate, absolute change	0.05	0.00	-0.44	2.15	-1.23	0.60	0.26	-0.10
2013: EM outflows								
Exchange rate change appreciation(-)/depreciation(+)	**15.42**	-2.57	-3.04	13.98	24.57	-0.98	6.92	0.19
Rate of change of total inflows	**24.68**	18.28	14.55	**-34.98**	**-1.25**	**-26.9**	**-41.08**	**-19.39**
Share of FPI	0.30	0.16	0.52	0.20	0.34	0.59	0.45	0.64
Money market rate, absolute change	2.79	0.00	0.13	1.00	1.75	-0.26	-0.01	-0.05

Stylized facts

- Capital flows and currency values close association in EMs
- When other currencies weak $ strong
  - During capital outflows FPI share falls
  - Own monetary tightening correlated with outflows in EDEs
  - 2011, 2013: outflows from US&EMs; endogenous liquidity creation
    - **Two sources of capital flows**
    - **Low r and QE; pro-cyclical balance sheets**

Excess volatility affecting AEs also

- US appreciation hurting its recovery
- EMs slowdown ↓ demand for AE imports, AE firms' profits
- Relative size of EMs ↑
  - AEs share of global GDP: 2004—54%; 2015—43%
    - ✓ **So G20 macro adjustments also need to protect EDEs**
    - ✓ **Else negative spillbacks**

Aggregate demand versus own demand

- QE potentially increases demand for all countries
  - Exchange rate changes, capital controls: own demand
  - Reduce other counties demand or divert more capital flows to them
  - $\Rightarrow$ negative spillovers for others
- But M policy; procyclical markets also $\Rightarrow$ negative spillovers
  - Since raise risks and reduce aggregate demand overtime
  - Original source of spillovers, others created in self-defense
  - First best policy to moderate at source

Rethinking on mechanisms to protect from market excesses

- ✓IMF capital flow management: onus on recipient
  - Last resort: after other adjustments tried; macroeconomic policies
    - ✓ **Reduce G if capital inflows**
    - ✓ **Imply shift EDE investment from public goods to real estate**
- ✗Internalize spillovers: moderate QE; regulate to damp liquidity multiplication
  - Countercyclical features; global and regional safety nets
    - ✓ **Post GFC US Fed swaps only to inner circle; EM stab funds; infrastructure**
  - Distinguish between excess-correcting and market-distorting interventions

G20 communiques

- Finance ministers and CBGs (Ankara, Turkey Sept 2015); and most communiques
  - We reiterate our commitment to move toward more *market-determined exchange rate systems* and *exchange rate flexibility* to reflect underlying fundamentals, and *avoid persistent exchange rate misalignments*. We will *refrain from competitive devaluations*, and resist all forms of protectionism.
  - But nothing on capital flows; emphasis selected at a time of major EM outflows
- G20 coherent conclusions on capital flow management 2011
  - For EMs: Not as a substitute for macro adjustment; transparent, properly communicated, targeted to specific risks, reviewed and adjusted as appropriate, subject to even-handed multilateral surveillance to assess impact and spillovers
  - For AE reserve currency issuers : sound and sustainable macroeconomic policy

Asymmetric adjustment

- Asymmetric: not enough done to moderate or compensate spillovers on EDEs
  - 2011, 2013, 2015 larger shocks for EMs than 2008
  - EMs cooperated post GFC : China, India excessive macro-stimulus
    - **But had to handle spillovers from QE themselves**
  - G20 AEs: QE and r effect on exchange rates OK; FD consolidation deferred
    - **EDEs market determined rates; improve BOP, domestic demand**
  - Assume AE recovery benefits EDEs; but now clear EDE slowdown hurts AEs
  - Therefore the ↓ in demand for AEs due to spillovers has to be factored in

Types of intervention

- AEs: QE and interest rates affect capital flows and exchange rates
  - G20 does not regard these as market manipulation
- EMs: Thin markets
  - Capital flows: Large asset price movements; market development process
  - Growth and global risk on off affects capital flows more than interest rate
  - Residency based controls, taxes, limits, caps: Beggar-thy-neighbour
- Space for intervention to establish fundamentals: reduce excess volatility
  - Overshooting, trend following, rational bubbles

G20 capital flow management guidelines

- Capital surges create systemic risk so macroprudential measures included
  - Currency based: tax on non-core FX liabilities; cap on FX derivatives
  - But should be applied in AEs also- to reduce pro-cyclicality
  - Margins and position limits–US CFMA (2000) reduced the latter
    - ✓ **Large oil price volatility that has hurt global growth followed this**
  - Follows OECD code on financial liberalization; 34 OECD, 152 EDEs
  - Bank focused; do not discriminate on residency; market making obligation
    - ✓ **Show why intervention necessary**
  - But market development more relevant in EDEs: different criteria
  - Shadow banks neglected; large cross border flows now hedge funds, FPI

Directions set at Post WWII Bretton Woods Conference

- Vision or power affecting vision?: Loss of 'development stages'

  - *Negotiated draft*: To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the sources of productive power in the territories of *all members whatever the stages of their economic development* as primary objectives of economic policy (US State Department 1945: 697).

  - *Final draft*: To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to *the development of the productive resources of all member countries* as primary objectives of economic policy (Schuler and Rosenberg 2012: 130, 190-91).

- License to assume same macroeconomic framework for all countries; uneven weight for countries?

Currency volatility more than currency wars

- Excess volatility, capital flows and currencies
  - markets, AEs would also welcome less volatility
  - Group think (IEO-IMF) hurting AEs also; genuine diversity of ideas required

- Coordination failure
  - Because of differential shocks on AEs and EDEs
    - ✓ **Perceptions of unequal impact on global demand of AEs and EDEs**
  - Changes to improve stability of IFS required
    - ✓ **G20 action: excess correcting mechanisms, more evenly applied**