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BRIEFING ON EXCHANGE RATE DEVELOPMENTS



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Exchange rate movements in the OECD policy scenario for healthy growth and lower imbalances

The policy scenario to achieve strong, sustainable and balanced global economic growth presented in the [OECD Economic Outlook No. 87](#) incorporated substantial exchange-rate realignments. Most OECD currencies were assumed to fall by 10% immediately and by a further 1% per annum over the next ten years. The dollar was assumed to depreciate more, by a further 10%. On the other hand, in addition to the general assumed appreciation of non-OECD currencies, the policy scenario also included a 20% rise in the external value of the renminbi over two years. Together with fiscal consolidation and structural reform, these exchange rate changes helped to generate domestic demand-driven growth in external surplus countries and growth driven in part by foreign demand in deficit countries.

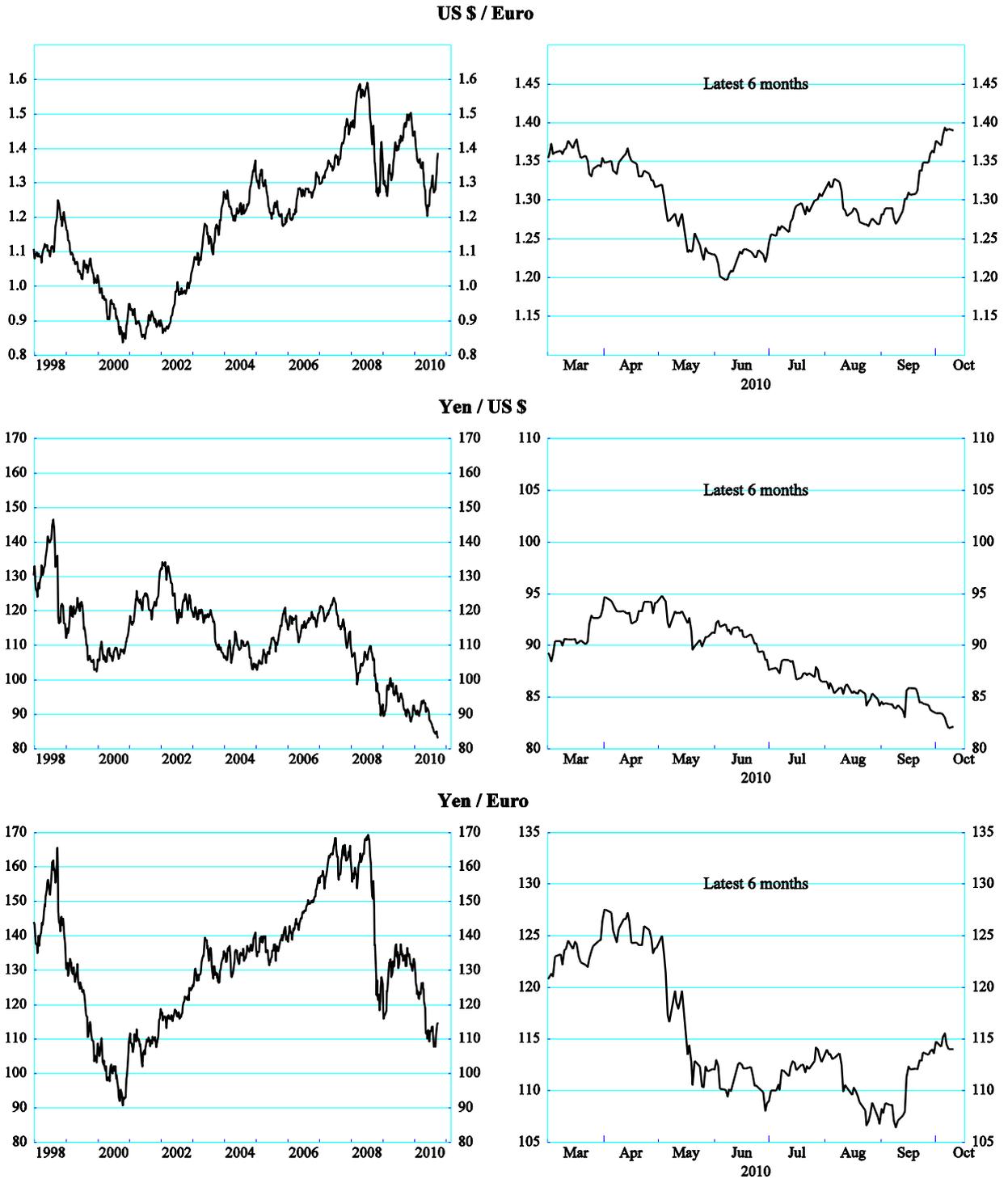
Fundamental drivers of exchange-rate movements

These exchange-rate adjustments can be described as being within the mainstream view as to how currency valuations should evolve in the light of economic fundamentals. However, although it is generally agreed that the determinants of exchange rate movements at short horizons (below one year) are poorly understood and that they are driven by purchasing power parities and living standards in the long run (beyond 5 years), there is still considerable disagreement about what drives exchange rates over the medium term. “Fundamental equilibrium exchange rate” (FEER) estimates refer to the level of the exchange rate that is consistent with sustainable external positions. But such estimates can be derived based on very different perspectives: FEERs can be estimated on the basis sustainable current accounts, the “flow approach”, or the net international investment position, the “stock approach.” Although these two perspectives have to converge in the long run, they lead to sometimes quite different results for the medium term. As a result, they provide little guidance for an assessment of the over- or under-valuation of currencies. For instance, in the case of the Chinese renminbi, estimates reported in the [OECD Economic Outlook No. 87](#) range from 60% undervaluation to slight overvaluation with a median value of about 20% undervaluation.

Recent exchange rate movements

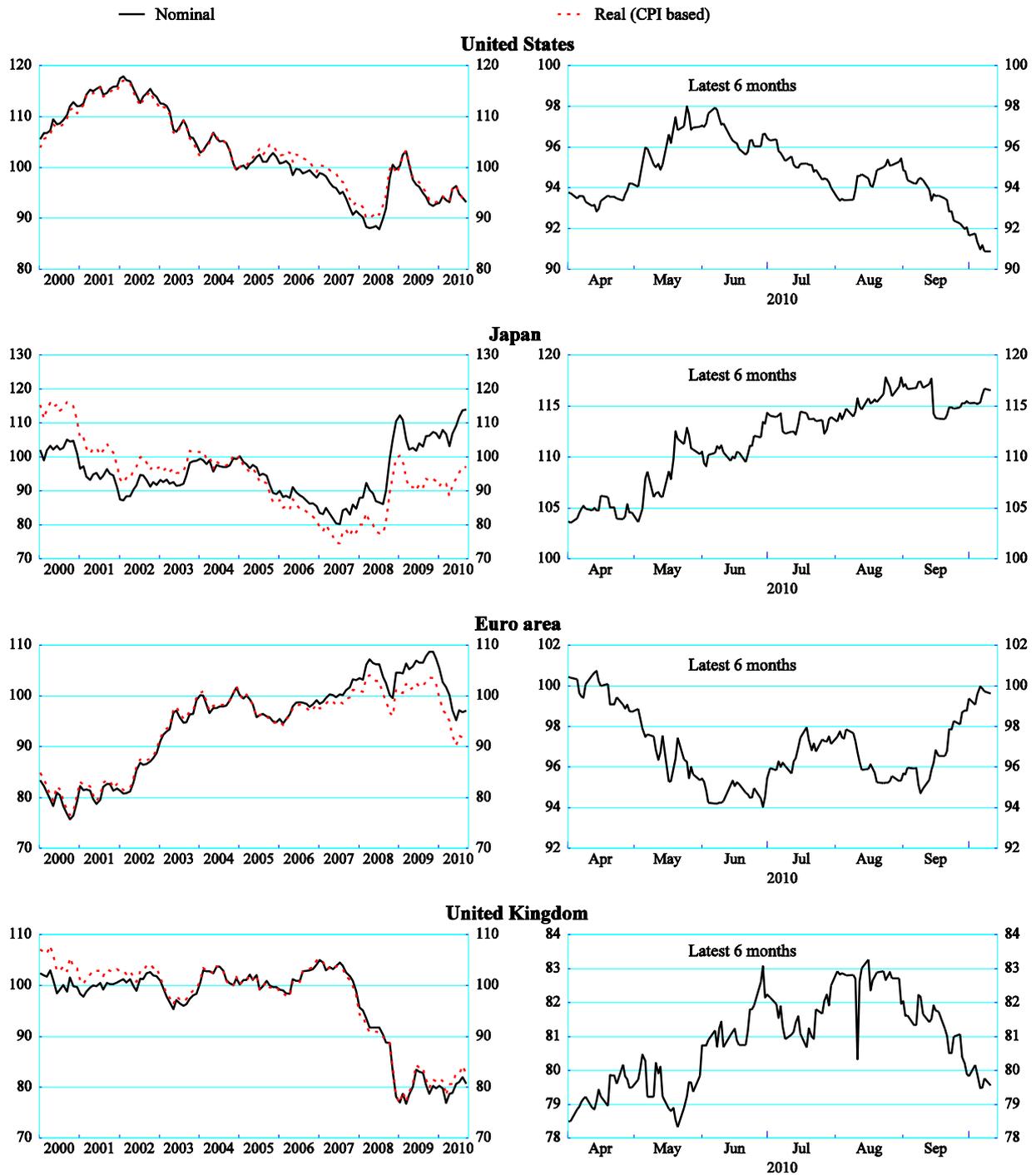
Foreign-exchange markets have experienced considerable volatility in recent weeks with large swings in bilateral rates resulting in often large changes in effective rates (Figures 1 and 2). Some of these movements correspond to the direction of the adjustments in the EO87 policy scenario, provided that these nominal shifts in currency valuations are followed by changes in domestic absorption so that real effective exchange rates adjust lastingly. In the case of the dollar, its depreciation (4.2% since 1 September in nominal effective terms) is supportive of desirable adjustments as it contributes to the rebalancing of US production from internal to external demand and alleviates deflationary risks in the United States. By reducing the need for domestic absorption, the fall in the value of the dollar also facilitates fiscal consolidation in the United States. Similarly, the moderate appreciation that has occurred in emerging market economies such as Brazil and India (1.1% since 1 September in nominal effective terms in both countries) should help them to contain inflationary pressures but may exacerbate their current account deficit unless it is compensated by fiscal tightening. Simulations run with the OECD New Global Model suggest that exchange-rate changes have to be maintained for a prolonged period to have visible effects on real variables. For instance, it takes two years before a change in the external value of the dollar delivers two thirds of its full effect on the US current account.

Figure 1. Bilateral exchange rates
 Last observation: 8 October 2010



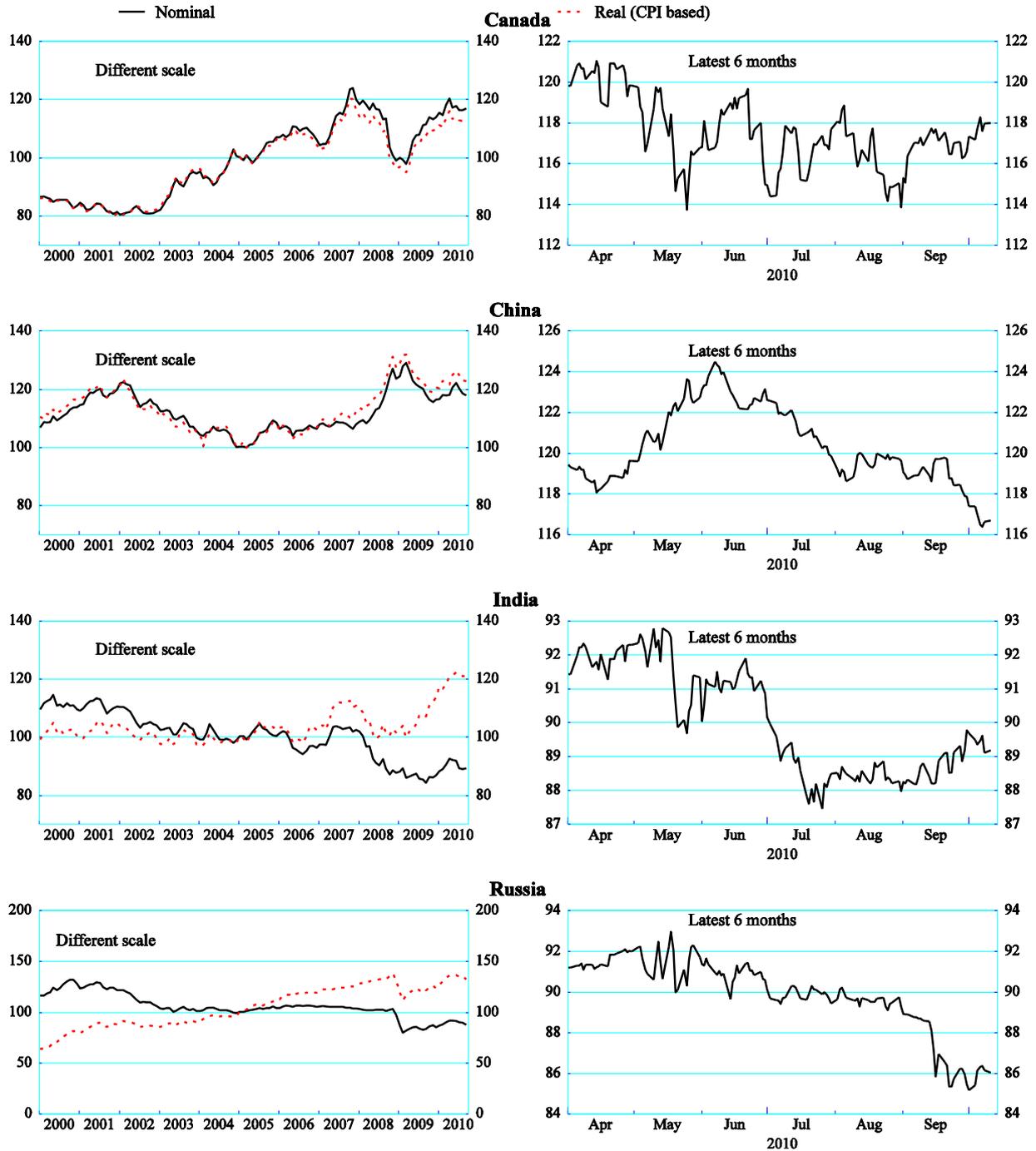
Sources: OECD and International Herald Tribune.

Figure 2. Effective exchange rates
 January 2005 = 100
 Last observation: September 2010 / 11 October 2010



1: Competitiveness-weighted effective exchange rate indices. Competitiveness weights are based on a double-weighting principle, taking into account the structure of competition in both export and import markets of the manufacturing sector of 51 countries. An increase in the index indicates a nominal or, respectively, real effective appreciation and a corresponding deterioration of the competitive position.
 Source : OECD.

Figure 2(cont.) Effective exchange rates
 January 2005 =100
 Last observation: September 2010 / 11 October 2010



1: Competitiveness-weighted effective exchange rate indices. Competitiveness weights are based on a double-weighting principle, taking into account the structure of competition in both export and import markets of the manufacturing sector of 51 countries. An increase in the index indicates a nominal or, respectively, real effective appreciation and a corresponding deterioration of the competitive position.
 Source : OECD.

On the other hand, some other recent exchange-rate movements go against desirable adjustments. The euro area is a case in point, where the substantial appreciation of the euro (4.1% in nominal effective terms since 1 September) will reinforce deflationary risks. In Japan, although the intervention on 15 September reduced the effective external value of the yen to 2.3% below its 1 September level, the currency has since then strengthened by almost as much (2.0%). Further yen appreciation would exacerbate deflation but would help to reduce the current account surplus. In China, the renminbi, which has remained tightly linked to the dollar in spite of the announcement in June of greater flexibility, has depreciated substantially in effective terms (2.3% per cent since 1 September), which works against the rebalancing of the economy toward domestic demand. Furthermore, by adding to general economic uncertainty, increased volatility in foreign exchange markets is bound to dampen growth.

Assessment and policy implications

In current conditions, and within reasonable bounds, the appreciation of emerging-market currencies is a normal and welcome adjustment to the fact that emerging economies enjoy a better economic outlook than most OECD countries. Appreciation means that some of the tightening in monetary conditions necessary in emerging-market economies will come from the exchange rate so that correspondingly less will be needed from domestic monetary policy.

The downside for emerging-market economies is that, if the exchange rate moves by a large amount, it may lead to a rather uneven distribution of the adjustment burden with the exposed sectors doing most of the adjustment and domestic sectors (and asset markets) being allowed to expand strongly. If the exchange rate movement is seen as a short-lived overshooting, this could be an argument for temporary intervention to smooth the adjustment, but there is always a risk that this line of thinking may be exploited to justify intervention in cases where it does not really apply. Even where intervention may have some basis, its implementation is fraught with difficulties. There is broad convergence in empirical studies on the finding that foreign-exchange intervention is not effective beyond the very short term, except if it is not sterilised. That is to say that intervention works only if domestic monetary policy moves in the same direction. In particular, a country that intervenes to stem currency appreciation would have to make its domestic monetary policy more accommodative, with the risk of adding to consumer and asset price pressures.

An alternative option is to try to curb capital inflows through taxation, deposit requirements and other tools. Such measures may have an effect in the short term but eventually foreign investors usually find a way around them. Controls of this nature are blind: while they may stop some speculative inflows, they are also bound to hurt productive investment. They are more effective and have fewer unintended side-effects when they are targeted at avoiding too large inflows of hot money that can suddenly become an outflow and lead to financial sector problems. There is some empirical evidence that capital controls can effectively shift the composition of inflows from short- to long-term investments. Even so, the first-best policy setting is not to target foreign capital inflows but to put in place regulatory and supervisory arrangements that make sure that the financial sector is resilient to funding shocks independently of their origin.

The recent indications from FOMC members that a new bout of quantitative easing is likely in the United States have contributed to weakening the dollar relative to the currencies that are floating freely against it. The experience of end-2008 and early-2009 has shown that each official announcement of future large-scale asset purchases by the Federal Reserve has been followed by a fall in the effective external value of the dollar, by an average 1.3% two days after the statement. Because of this effect, the prospect of more quantitative easing has fuelled concerns about greater currency tensions (see Box for some issues regarding the complex relationships between quantitative easing and foreign exchange intervention).

Box: Quantitative easing and exchange rate intervention

The links between quantitative easing and exchange rate intervention are complex and differ across countries and conditions. The current situation, with central banks being at the zero floor and undertaking quantitative easing, further complicates the issues. Countries where public debt is low, such as Switzerland, may have difficulty undertaking quantitative easing in the government bond market, in which case the foreign exchange market can be seen as an alternative option. Another alternative solution is to purchase private bonds, but it involves the central bank assuming credit risk and allocating capital to particular firms or sectors, which can threaten its independence. In countries with large stocks of government bonds, such as Japan, the public debt markets are the most effective place where to implement quantitative easing, and there is little case for undertaking monetary expansion directly in the foreign-exchange market. Nevertheless, because it means injecting massive central bank liquidity in the financial system, quantitative easing in the bond market is bound to have some effect on the external value of the currency. Finally, for countries that are not at the zero floor, have not witnessed large appreciation and face inflationary pressures – such as Korea – there would seem to be no case for foreign exchange intervention.

The fact that the largest emerging-market economy is intervening massively to keep its currency from increasing in value considerably increases appreciation forces in other emerging-market economies. This situation creates a risk of prompting series of interventions which would further increase the pressure on countries that have not followed suit. At a general level, foreign exchange intervention is not the most helpful instrument for macro-economic management. It can prompt countervailing intervention abroad and ultimately poses a risk of triggering protectionist responses. Furthermore, foreign-exchange intervention may also just shift pressure points around in economies: for instance, for a given desired degree of overall financial tightness, less tightness from the exchange rate means that more tightness will have to come from other elements of financial conditions. This underscores that considerable benefits are attached to charting a path where the required adjustments for re-balancing occur with some degree of international co-operation.