Orderly Global Economic Recovery : Are Exchange Rate Adjustments Effective Any More?*

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When we last met in London in October, I had talked about medium and long-term issues related to globalisation and possible enduring imbalances in the medium- and long-term. I had talked in particular about the consequences of economic demographics and ageing. So I am delighted that this is now a specific subject for discussion in this meeting. Today, I will focus on possible short-term issues that may arise as the current economic imbalances are corrected. Recent data show that the global recovery has gained further momentum with various leading indicators showing a robust turnaround. Financial markets have rallied on the back of higher corporate earnings. Emerging markets debt spreads continue to decline. The latest available data suggest a strong acceleration in world merchandise exports.[1]

Emerging Asia continues to be the fastest growing region in the world. While China is expected to grow by over 9 per cent, India is not far behind with its growth expected to be around 8 per cent in 2003-04. Economic activity in Japan has also picked up, led by exports and business investment. Japan has benefited significantly from expansion in world trade, particularly that with China. In the US, economic activity has turned quite robust. It is significant to note that in both US and Japan there are distinct signs of acceleration in manufacturing activity. In the Euro area, there is also some evidence that activity has begun to pick-up although it is lagging behind significantly in comparison with other regions. On the whole, the sentiment today appears to be much better than it was a year ago when the outlook for the global economy was weighed down by various uncertainties and risks.

Although overall global growth prospects have improved markedly, considerable uncertainties still remain. The main risk facing the global economy today continues to be the persistence of the US external imbalances which, in turn, are reflected in external imbalances in several countries in Asia. The current account deficit in the US at 5.1 per cent of GDP could pose a serious risk to global growth. This, if not corrected in an orderly manner, could seriously harm the health of the global economy. There are different views on this. Most recently, Alan Greenspan, in a lecture at the Bundesbank, expressed the view that economic flexibility in the world is now such that unwinding of this deficit will not cause serious disruption. I hope that he is right.

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* **Intervention by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India at the G-20 Deputies Meeting held at Leipzig, Germany on March 3-4, 2004.**

1 **In the first half of 2003 world merchandise exports rose by 15 per cent in US dollar terms over the corresponding period in 2002. Average annual growth in 2002 was 4 per cent.**

Past experience suggests that the correction of such a high order of external imbalance could be associated with high inflation, rise in interest rates and fall in output. The US ran a current account deficit between 1982 and 1987 when the CAD widened to 3.4 per cent of GDP in 1987 from a surplus of 0.2 per cent of GDP in 1981. A reversal in this trend set in in 1988 and the CAD-GDP ratio reached a near balance position in 1991 - the phase of correction spanning over four years. The correction was facilitated by a narrowing down of the saving-investment gap from 4.2 per cent in 1986 to 1.0 per cent in 1991 and an average annual rate of US dollar deprecation of 6.5 per cent in nominal terms and 5.5 per cent in real terms.

The depreciation of the US dollar fed into inflation in the following years. Nominal exchange rate depreciation passed through into domestic inflation in about 22 months. Even after the exchange rate stopped depreciating, inflation continued to rise for another 12 months.[2] The inflation rate which was 1.8 per cent in 1986 moved up gradually to 5.3 per cent by 1990 before sliding down from 1991. This necessitated monetary tightening in 1988 and 1989 when interest rates had to be raised.[3] GDP growth decelerated sharply during 1989-90 and it turned negative in 1991.[4]

The question, therefore, which all of us need to address is whether we are landing up in same situation as was faced last time. The trade-weighted exchange rate of the US dollar has depreciated by about 13 per cent since February 2002. However, this depreciation of the US dollar is only about one-third of the sharp appreciation of 32.5 per cent in real terms between 1992 and 2001. It is, therefore, widely believed that the dollar would have to depreciate further (by 15 per cent in real terms) to make a significant dent on the current account deficit, regardless of structural factors. Over the medium-term, correction of CAD to the level of the mid-1990s (*i.e.,* 1.5 per cent of GDP) could necessitate an annual average rate of depreciation of about 6.5 per cent spanning over a period of six years. Will this happen and how will it impact the rest of the world ?

We have to note that there has not been any adverse effect of the dollar's decline on the US economy so far. Interest rates are at historically low levels. Inflation is still low due to slack in the US economy, especially in the labour market where weak demand for labour is holding down wage growth. However, depreciation of the US dollar eventually is expected to feed through inflation. Commodity and asset prices have already risen sharply. And going by the past experience, it would

[2] **The depreciation began in February 1985, *i.e.,* after the second inflation episode was almost over and continued till May 1988. Trade-weighted US dollar depreciated by 13.3 per cent over the period. Headline inflation which was falling until December 1986 (trough of 1.2 per cent) began to rise from January 1987 to reach 4 per cent by May 1988. Inflation continued to rise until May 1989 when it touched 5.3 per cent.**

[3] **The Federal Fund Rate, which was 6.66 per cent in 1987, was raised to 7.57 per cent in 1988 and further to 9.22 per cent in 1989.**

[4] **The growth rate of the US GDP decelerated from 3.9 per cent in 1988 to 2.5 per cent in 1989 and 0.8 per cent in 1990. GDP registered a negative growth of 1.2 per cent in 1991.**

not be long before the US dollar's decline starts impacting import prices in particular and inflation in general. With little room to manoeuvre on the fiscal policy front, this may require monetary tightening leading to a rise in interest rates. This would have serious implications for the sustainability of growth not only in the US but in several developing countries.

Correction through Exchange Rate Adjustment

The very significant adjustment in the US dollar exchange rate does not seem to have translated into changes in import prices (excluding fuel), which rose by only about 1.4 per cent in 2003 in the US. Prices of imported non-auto consumer goods rose by only 0.4 per cent. It is then not surprising that there has been little palpable behavioural response in the US to the recent exchange rate adjustment through a lower demand for imports. The general expectation still seems to be that a sliding US dollar will not cause inflation to surge. Similarly, in Europe, currency movements appear to have less impact on inflation than in the past. There are different explanations being given. One is related to globalisation and "Walmartisation". The increased intensity of globalisation and the commodification of many goods have perhaps reduced the pricing power of producers, particularly of low technology goods in developing countries, whereas the pricing power of large retailers like Walmart has risen.

The question that arises then is if the new globalised economy means that exchange rate adjustments as a means of correction of imbalances have become less potent, then the swing in exchange rates to correct emerging imbalances will have to be much larger than before, bringing in their wake greater instability eventually.

According to various commentators, such as The Economist, Business Week, large investment banks and others, the US dollar-Euro rate will have to depreciate to levels such as 1.7 to 1.9 for appropriate external current account adjustments to take place. If such movements take place, and inflation eventually does rise along with interest rates, what will then happen to the world economy? How quickly will this take place? Will this now start happening over the next 12 months and if so will the current world recovery stop in its tracks before it takes off?

Thus, we need to be vigilant of the new risks that would be generated in the process of correction of current macro economic imbalances. To minimise the harmful effects, there is a need for a coordinated and cooperative approach. The current account deficit in the US is, to a large extent, a manifestation of its large saving-investment gap which widened to a high level of 5.3 per cent in 2003. The US, therefore, will have to try to curb household and government borrowings and strengthen national savings. The Euro Area continues to depend largely on external demand. It, therefore, will need to pursue some structural reforms, especially in the labour policies, to boost domestic demand. Japan also needs to continue to take some concrete measures to strengthen its financial system and reduce huge fiscal imbalances. We in India have followed a relatively flexible exchange rate policy to ensure smooth adjustment along with corrections in the world economy. Such flexibility has served us well and we can commend it to other countries.

The world leadership also needs to take appropriate steps to guard against the prospective risks. There are two areas that are particularly important at present and where G-20 leadership can play an important role. One relates to developments on the trade front. Current trends from Cancun onwards are deeply disturbing with industrialised countries slipping into a protectionist posture. This is uncalled for especially because developing countries have at last started to get out of their protectionist mindsets. The industrialised countries (US, Europe and Japan) have a major role to play in reviving the trade talks which involve serious departures from their present positions on agriculture.

Another area relates to international financial architecture, the deficiencies of which were exposed in recent East Asian and subsequent crises. We, therefore, need to ask ourselves whether we have really made progress in developing a sound international financial architecture. In particular, we need to ask whether the access limits are sufficient to deal with the kind of crises countries will face. Or are we assuming that the catalytic role of the international financial institutions is more effective than it really is? The recent experience has amply shown that while large and assured financing (*e.g.,* Mexican bailout) has been successful to keep the markets quiet, limited financing (*e.g.*, Argentina) has not produced good results. It is this ground reality which has led to excessive caution on the part of developing countries in building large reserves.

It is difficult to predict what kind of crises will take place in the near or medium term future. What we know with near certainty is that crises will take place in the future too. Where, how and when they will take place cannot be predicted. As I have indicated, as these exchange rate adjustments in the world's major currencies take place, and inflation and interest rates do rise, they will bring in their wake economic debris in different places. We need to be vigilant on this point and recognise that the magnitude of financing needs that typically arises now is much larger than before. The question I will leave you with is: whether the existing financial architecture is competent for tackling such future crises and, if not, what do we need to do?