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Free Lunch: Barking up the wrong tree

Martin Sandbu

A curiously old-fashioned obsession with ‘wrong’ exchange rates

Join us over a glass of wine on the evening of February 1 when Martin Sandbu discusses “From textbook to Red Book: does public scrutiny constrain economic policy?” with Stephanie Flanders and Rupert Harrison. Tickets are on sale here.

It’s not quite as simple as that

The market turmoil in China, which started when Beijing changed its currency policy to something nobody has quite understood yet, has also staged a resurgence for the old chestnut of “currency manipulation” and more generally when currencies are overvalued and undervalued. A lot of this debate feels sadly stuck in the past — not just because the facts about exchange rates have changed but because we should have a much more nuanced understanding of what exchange rates do to economies.

In the US, the worry about “unfair currency manipulation” has loudly accompanied the debate around the Trans-Pacific Partnership trade agreement. Fred Bergsten’s testimony to Congress last week is a good example. Bergsten obviously recognises that many currencies have fallen against the dollar, and concludes that “manipulation . . . almost disappeared in 2015. China and many other former manipulators were, in fact, intervening to keep their currencies from falling further rather than from rising.” This, for some reason, does not count as manipulation; in the same breath as citing interventions, and looser monetary policy in Europe and Japan, Bergsten attributes “most of this dramatic behaviour” to “market forces”. The difficulty of defining something as manipulation on the way down but not on the way up is one reason to dislike efforts to hold trade partners to account for their exchange rates.

Apart from the one-sidedness of such complaints, policymakers should also heed the analysis that shows just how complex is the response of international trade patterns to exchange rate movements (not to mention the limited extent to which exchange rate movements are determined by monetary policy). Moaning about (or defences of) "competitive devaluation", "manipulation" and "currency wars" misses the fact that the exchange rate is not a simple lever that you straightforwardly pull and see your net exports improve. For starters, devaluations seem to do less for trade than they once did — though how much less is a matter of dispute.

Moreover, exchange rate movements affect sectors very differently. Paul Bergin and Giancarlo Corsetti argue that whether currency movements help or hurt, macroeconomic stabilisation affects the type of goods and services a country exports. A more stable macroeconomy, they think, favours industries that produce differentiated manufacturing products sectors often thought to offer greater value added and productivity growth. But what matters is how exchange rates — presumably *real* exchange rates, too — move *over time*.

Antoine Berthou and Filippo di Mauro find that small, low-productivity exporting companies respond much more strongly to exchange rates than large, high-productivity firms. This, they suggest, helps resolve the puzzle over whether exchange rates still matter for trade. They also argue that this suggests the exchange rate tool would be useful for the most crisis-hit European economies, which are disproportionately made up of small, relative unproductive companies. But one could retort that the causality may run the other way: if devaluations disproportionately benefit small, unproductive exporters, could not a history of devaluations have made Europe's peripheral economies what they are? And even the one-off gains from selling your goods more cheaply abroad come at a cost.

Meanwhile, Scott Sumner has written a short post on the problems with the notion of "wrong" exchange rates that is both entertaining and illuminating. Sumner compares the Economist magazine's Big Mac index with its recent rival, the Mini Mac index. As readers will no doubt know, the idea of the Big Mac index is the "law of one price" — the idea that with international trade, economic forces should equalise prices of the same goods in different countries when expressed in an international currency measure. The idea behind the rival Mini Mac index is that Big Macs are not actually shipped across borders. So why not use a truly traded good, such as the iPad Mini, for price comparisons?

The two alternatives lead to rather different conclusions about how much various currencies are over- or undervalued — click through the links above for details (the renminbi is 46 per cent undervalued according to one index and only 5 per cent according to the other). But the important point is not what these crude indices say but whether their methodology makes sense at all. Sumner points out that there are plenty of good economic reasons why the law of one price should not hold. Conversely, if you used a perfectly traded good — a commodity such as gold — you would find that prices in different countries are always the same. Does that tell us anything about whether the currency has the "right" value?

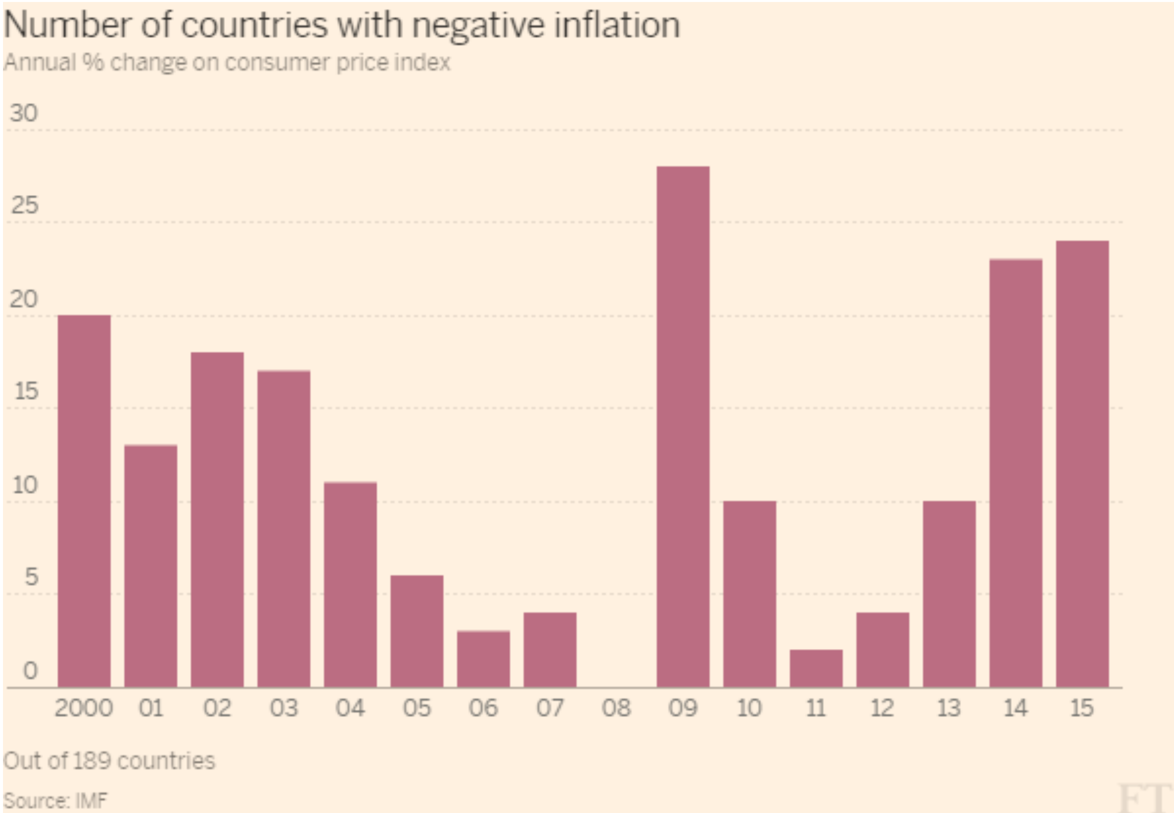
All this makes one think that the very question of a currency's "correct" value is, at best, a very incomplete one. The currency's behaviour over time — and which sectors benefit most from the way it fluctuates — may be much more important.

Other readables

- The FT's Emiko Terazono tells a fascinating tale of two fisheries, comparing the fortunes of Norway's and Chile's salmon industries.
- Dan Davies explains why the *idée fixe* that banks should make double-digit returns for their shareholders makes no sense.

Numbers news

- A lot of countries have falling price levels — but not a lot more than before the crisis, the FT Data blog finds.



- The professor leading the postmortem into the pollsters' disastrous performance at the last UK election — where the Conservatives beat Labour by seven points after most polls put the two parties in a dead heat — blames unrepresentative sampling of the voting population.

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