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**Unconventional wisdom
on exchange rates**
If conventional economic wisdom were valid, the US trade deficit would be shrinking, not exploding, since the dollar has depreciated steadily. Exchange rates do not much influence competitive positions or redress trade imbalances. The West must cultivate other advantages, such as technology, design and after-sales service, to maintain competitiveness with low-cost Asia. - **Joergen Oerstroem Moeller**

Unconventional wisdom on exchange rates

By Joergen Oerstroem Moeller

SINGAPORE - Conventional wisdom has for ages extolled currency depreciations to correct deficits and appreciations to correct surpluses on trade balances.

In 1971, the world, spurred on by the United States, went from fixed to fluctuating rates. The applause was almost universal. Economists may have disagreed about the length of the time lag before exchange-rate changes had worked their way through the economic system and whether better instruments were at hand, but the very principle that eventually they would work was not questioned.

But something strange has happened. Exchange-rate changes no longer affect trade balances, at least not significantly. When mobilized to redress imbalances, they prove without much effect. Conventional wisdom is thrown out of the window.

The US is exercising pressure on China to appreciate the yuan, presumably in the belief that it will work wonders on the US trade balance. But will it?

When Japan was forced to appreciate the yen in 1985, the effect on the Japanese respective US balance of payments was difficult to spot.

In the 1980s, the European Union came to the conclusion that exchange-rate changes were no longer suitable as economic-policy instruments. That was one of the major economic reasons to establish an economic and monetary union.

There is much talk of a dollar slide to turn the US deficit on the trade balance around. The plain fact is that the US dollar has depreciated considerably over recent years, but without much effect on the trade balance. Calculations by the Bank for International Settlements reveal that the nominal effective exchange rate of the dollar fell from the beginning of 2002 to the end of 2005 between 15% and 25% depending on calculation method, the euro has risen about 20%, the yen has been comparatively stable, and the much vilified yuan has fluctuated but ended at the end of 2005 a little more than 10% down compared with the beginning of 2002.

Economic theory says this should improve the US trade balance, but it hasn't. Organization for Economic Cooperation and Development figures show not an improvement but deterioration, actually from a deficit of US$424 billion in 2002 to $716 billion in 2005 and $767 billion in 2006.

As the US and European economies are operating at the same level and broadly speaking are of similar structure, a comparative analysis may be rewarding and may correct an overall picture contradicting what you would expect.

But it doesn't. It gets even worse. From 2000 to 2005, the exchange rate of the euro rose from about $82 to $120 for 100 euro. This is, even by historical standards, a very, very large swing - a 50% depreciation of the dollar. The trade balance between the US and the European Union did not adjust in favor of the US as economic-policy prescription said it would. Quite the contrary. The bilateral deficit went up from about $32 billion in 2000 to $91 billion in 2006.

The fallback position for economic theory is to look at differentials in economic growth. If US growth was higher than in Europe and the growth differential between the EU and US rising, US domestic demand would outpace production, triggering growing imports from abroad, in this case the European Union. But again the figures disappoint. The growth-rate differential rose from 0.7 percentage point in 2002 to 2.1 points in 2004, whereafter it fell to 1.7 points in 2005 and 1.5 points in 2006.

Had exchange-rate movements and economic growth differentials worked in conformity with theory, an improvement, indeed a strong improvement, for the US trade balance vis-a-vis the EU should have materialized, while in fact it has steadily deteriorated.

The inescapable conclusion is that exchange rates do not much influence competitive positions or redress trade imbalances. Looking at the global economy over the past decades, the reason is all too obvious, even if it may be difficult to see the forest for trees.

Global outsourcing has moved most of the cost and price-sensitive production from high-cost producers to low-cost producers. Comparing hourly wage compensation, productivity and potential exchange-rate changes between the US and China or the EU and China, wage differential dwarfs the impact of exchange-rate changes. Even 50% depreciation over five years cannot compare to the long-term advantages of moving most labor-intensive production to China.

The main competitive advantages for developed countries such as the US, the EU nations and Japan have shifted to high tech, quality, design, style, branding, after-sales service and several other factors, which set up a unique position in the market delinked from costs and prices. The most interesting among them are accompanying services such as upgrading, maintenance, and training of staff, all of which are difficult to deliver by a newly industrialized country. But they are in the arsenal of developed nations and are brought into action to shift the competitive game away from prices and costs.

When US Treasury Secretary Henry Paulson cries buckets over the so-called undervalued yuan and President Nicolas Sarkozy of France attacks the European Central Bank for allowing the euro to rise, they are off the mark. It matters very little for the US and

French trade balance and domestic production what the exchange rate is.

In globalization, macroeconomy and exchange-rate changes slip away from the policymakers. What has been labeled labor arbitrage takes over as the fact determining where cost-sensitive production takes place.

What is left for policymakers is a much more difficult and challenging task: to analyze their own competitive, non-price-sensitive advantages and strengthen them. A new paradigm for national economic policy makes established policies obsolete and puts the onus on a much more sophisticated formulation and implementation of policies.

Tomorrow's winners are those intercepting this and adjusting first and fastest. The key ideas: concentrate on what you are best at, skip the rest; do not try to climb the ladder, but focus on maintaining the one or two positions where you are in pole position.

It is likely that a number of Asian countries will start to look in earnest for cooperation about exchange rates. The Chiang Mai Initiative of 2000 must not be underestimated. It aims to create a network of bilateral swap arrangements among the 10 member states of the Association of Southeast Asian Nations plus China, Japan and South Korea to address short-term liquidity difficulties in the region and to supplement existing international financial arrangements.

This is good and commendable. If done in the right way, it will help Asia to weather new storms on the currency markets or a financial crisis like the one we saw in 1997-98. To be successful, however, the Asian countries should take a hard look at how the global economy has changed the effectiveness of exchange rates and the impact of the shift of competitive parameters.

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