# 11 Exchange rates to support global rebalancing

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*What exchange rates are appropriate for global rebalancing? This chapter suggests that an "immaculate adjustment" to the locus of expenditure requires a change in the pattern of exchange rates. By using a model developed with William R. Cline, the author notes that the the major disequilibrium in the world remains the overvaluation of the dollar and the undervaluation of the renminbi. Also, the depreciation of the euro has undoubtedly strengthened European trade prospects, the yen is still overvalued relative to the dollar; and the Swiss franc, which is monetarily important, is almost as undervalued as the renminbi.*[1]

The objective of global rebalancing is widely endorsed. Everyone knows that in order to be achieved without global deflation it will be necessary to expand domestic spending in the countries that have had payments surpluses in the past and to expand saving in the countries that have had payments deficits in the past. Unless one is content to see such an adjustment accompanied by inflation in the countries, like Germany, that have had past surpluses and falling prices in countries like the US that had past deficits (or believes in a process of what I have termed "immaculate adjustment"), such a reorientation in the locus of expenditure needs to be accompanied by a change in the pattern of exchange rates. The question is what exchange rates are appropriate.

It happens that in association with William R. Cline I have been studying exactly this topic (Cline and Williamson 2010). In our latest (just-published) iteration aiming to identify the set of "fundamental equilibrium exchange rates" implied by the latest IMF forecasts, we give every country an objective of achieving a current account that is at most 3% of GDP away from balance, taking the actual forecast as the target in the event that it is within +/- 3% of equilibrium. (In earlier studies we allowed countries with large net foreign asset positions, positive or negative, relative to GDP the possibility of a larger imbalance, but in view of the G20's decision to call for global rebalancing this latest study has abolished such possibilities.) We then asked Cline's model what set of exchange rates would be needed to achieve the current account targets given the forecasts for real growth and commodity prices in the latest IMF World Economic Outlook. The model applies export price elasticities to estimate the needed changes in effective exchange rates, and then uses a matrix inversion method to translate

changes in effective rates into changes in bilateral rates against the dollar. The figures in the IMF's World Economic Outlook were based on a period largely in March, but we adjusted to a May base by using Cline's estimates of the impact of exchange rates on trade flows. (It is assumed throughout that all countries pursue fiscal-monetary policies to maintain full employment).

We got results for the G20 countries (plus Switzerland) presented in Table 1. Several comments seem in order.

Table 1. Estimates of the Disequilibrium of the G-20 Currencies, May 2010

| | Desirable change in REER | Desirable change in dollar rate |
|---|---|---|
| Argentina | 0 | +2 |
| Australia | -13 | -6 |
| Brazil | -3 | 0 |
| Canada | 0 | +2 |
| China | +15 | +24 |
| Euro | 0 | +5 |
| India | 0 | +8 |
| Indonesia | 0 | +15 |
| Japan | 0 | +9 |
| Korea | 0 | +10 |
| Mexico | 0 | +1 |
| Russia | n.a. | +5 |
| Saudi Arabia | n.a. | +7 |
| South Africa | -14 | -9 |
| United Kingdom | 0 | +5 |
| United States | -8 | 0 |
| Memo Item: Switzerland | +13 | +17 |

Notes: A plus sign before the figures indicates that the currency needed to appreciate (i.e. was undervalued), while a minus figure indicates that it needed to depreciate (i.e. was overvalued). N.a. = not applicable; no attempt was made to calculate desirable targets for oil exporters. The dollar changes given are those which would leave the REERs unaffected. Source. Cline and Williamson (2010, Table 2, columns 3 and 6).

First, there is no question that the major disequilibrium in the world remains the overvaluation of the dollar and the undervaluation of the renminbi. Because of the convention that exchange rates are quoted in terms of a national currency, the US dollar, it is up to the Chinese authorities to take action to remedy this disequilibrium, and in the absence of any action on their part the disequilibrium will persist. If and when China does correct its exchange rate, a number of other Asian currencies will need to appreciate too (India, Indonesia, Japan, and Korea among the G-20 currencies, although there would be several of the currencies of

smaller countries which would need to appreciate much more against the dollar) in order to avoid becoming undervalued.

Second, the depreciation of the euro has undoubtedly strengthened European trade prospects, but it has not yet become so extreme as to push the euro area into the prospect of large surplus. We allow for a swing of +/- 3% of GDP in the current account balance before we judge it would be appropriate for international pressures to adjust to be brought into play, and the euro area still falls comfortably within that range.

Third, the yen is still overvalued relative to the dollar, but this is now entirely a reflection of misvaluation elsewhere in Asia and no longer reflects a yen that is overvalued in REER terms resulting in a surplus above the acceptable range.

Finally, one may remark about the non-G20 currency in the table. I have included Switzerland because the Swiss franc is monetarily important. It is almost as undervalued as the Renminbi, and even after allowing for the fact that Swiss statistics probably overstate the magnitude of Switzerland's economically-relevant current account surplus by as much as 4 percent of GDP. (Swiss statistics attribute the whole retained earnings of Swiss-owned MNEs to Switzerland even though many of the owners are foreigners, and in the Swiss case this produces a strong bias.) Any reasonably-symmetrical effort to achieve rebalancing is going to have to include Switzerland and not simply Asians as those who need to adjust away excessive surpluses.

## Reference

Cline, William R., and John Williamson. 2010. *Estimates of Fundamental Equilibrium Exchange Rates, May 2010*. (Washington: Peterson Institute for International Economics Policy Brief 10-_.)

## About the Author

**John Williamson** is a senior fellow at the Peterson Institute of International Economics. He was project director for the UN High-Level Panel on Financing for Development (the Zedillo Report) in 2001; on leave as chief economist for South Asia at the World Bank during 1996–99; economics professor at Pontifica Universidade Católica do Rio de Janeiro (1978–81), University of Warwick (1970–77), Massachusetts Institute of Technology (1967, 1980), University of York (1963–68), and Princeton University (1962–63); adviser to the International Monetary Fund (1972–74); and economic consultant to the UK Treasury (1968–70). He is author, coauthor, editor, or coeditor of numerous studies on international monetary and development issues.

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