Are currency misalignments an operational policy tool to track down imbalances?

Real equilibrium exchange rates: relevance in open economy macroeconomics and operationality in economic policy making

CEPII Panel discussion

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The real exchange rates inside the euro area

The major issues to address inside the euro area in the next few years:

- Real convergence,
  - Reforms are needed to accelerate the catching up process in the Southern countries
- Persistent imbalances
  - The EC has implemented its macroeconomic imbalance procedure (MIP) since 2011 to tackle imbalances.
  - Among the set of indicators, the 3-year change in real effective exchange rates (REERS).

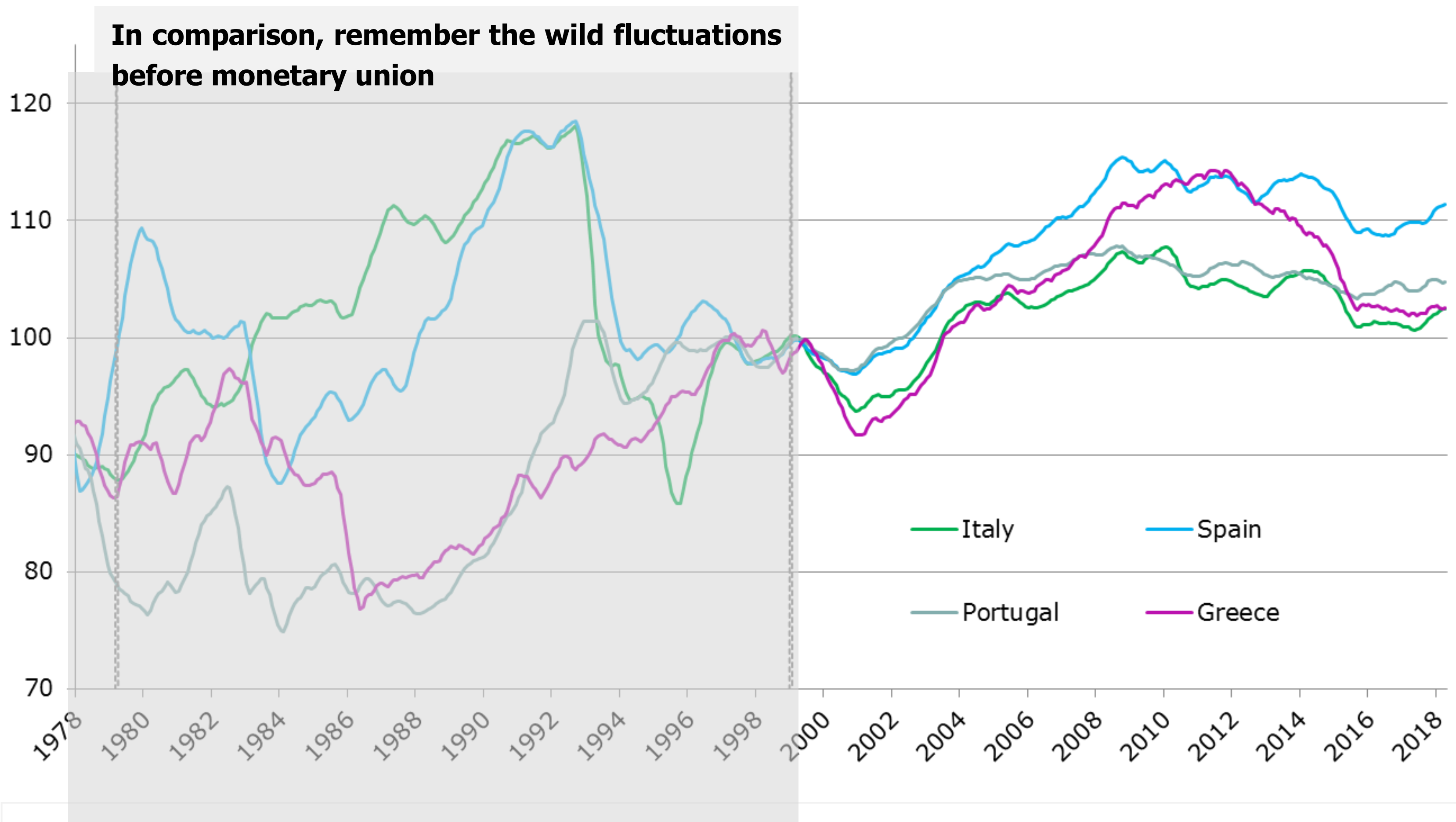
<u>Why should we care about real exchange rates inside a monetary union</u>?

- They tell us the differences in prices evolution inside the area, also reveal losses or gains of competitiveness.
- They are key variables to determine trade accounts and balance of payments

<u>Why should we care about balance of payments inside a monetary union?</u>

- The financing of persistent deficits is subject to sudden stops, which generates contagion effects.
- When the private sector stops investing in a country, the other members' governments have to step in ==> Monitoring the building up of imbalances is important.

Real effective exchange rates (REER)
for 4 Southern members : Italy, Spain, Portugal and Greece



Source BIS. CPI-based real exchange rate relative to a narrow set of partners.
Base 100= 1999/01 6-month-moving average.

Real effective exchange rates (REER) for 4 Southern members + Germany

1999-2008: Appreciation trend in the 4 Southern countries

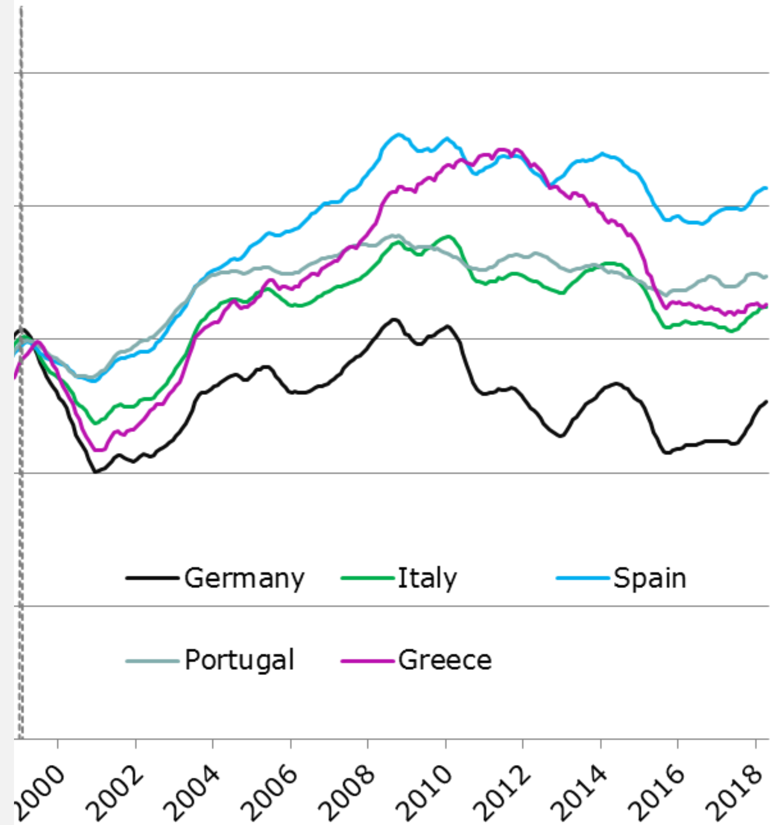
➔ Building-up of imbalances :

demand boom, excessive indebtness, loss of competitiveness….

2009-2017: Adjustment by “internal devaluation”, contraction in demand, austerity programs,

\+ helped by <u>expansive monetary policy</u> and euro depreciation against external partners

For Germany : depreciation trend on the whole period 1999-2017



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Limits of REERs as indicators

The real exchange rate 3-y change is a useful indicator

- It is used in many EWS models of financial crises, like at the IMF.
- In the case of the Southern countries, it could have detected imbalances before the financial crisis in 2008.
- However it is not sufficient

The same level of exchange rate appreciation may come from two very different situations

(i) improvement in the country's fundamentals : growth of productivity in the tradables, growth of wages in the 2 sectors, "Balassa-Samuelson effect", better quality of products… ➔Healthy situation.

(ii) Inflationary pressures and loss of competitiveness ➔ overvaluation → Deficit of current account and risk of balance of payment crisis ➔Policy response is needed.

- The same is true for depreciation. It can come from:

  (i) a degradation in the country's fundamentals, the move in REER helps to restore equilibrium.

  (ii) a rise in productivity without wage increasing in the same proportion, ==> gains in competitiveness => undervaluation => Current account surplus; the trade partners may be affected ➔ a policy response is needed to correct the imbalance.

- The REERs give no clue to distinguish between these 2 situations.
- Only equilibrium real exchange rate calculations can.

Value added by misalignments above REERs

Equilibrium REER calculations are able to separate the 2 situations :

- When the REER are in line with fundamentals : No policy response is needed.
- When they are out of line with fundamentals : Either overvaluation and undervaluation. A policy response is needed to correct imbalances.

For example , the CEPII's estimations make clear :

- that the depreciation in the German REER has led to an undervaluation of about 10%
  - in line with the estimates of the IMF in its country report.
- and some Southern countries like Portugal are still suffering from overvaluation, despite their internal devaluation

This information is important when assessing imbalances and giving country-specific recommendations.