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Current Account Imbalance and Exchange Rate Flexibility

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The US has been addressing the current account imbalance issue over the past few decades. To tackle this issue, international organizations such as the IMF and the G20 have called for greater exchange rate flexibility. Korea is currently on the monitoring list of currency manipulators, along with China, Japan, Germany, Taiwan and Switzerland based on the Bennet-Hatch-Carper amendment.

Korea's export growth has continued to decline over the past few years, and the contribution of export to economic growth has been going down the same path. If the new US administration intensifies political and economic pressures on exchange rate manipulation issues, this will serve as an additional downward pressure on Korea's export growth rate and economic growth rate. We no longer stall in determining our stance toward exchange rate flexibility, with regard to the global current account imbalance. To that end, we would like to ask: does a flexible exchange rate facilitate current account adjustment?

Kim and Pyun (2016) investigate whether a flexible exchange rate regime closes a current account deficit or surplus. It finds that a flexible exchange rate regime contributes to closing the current account imbalance, from an examination of 59 countries over the period of 1992-2011. Interestingly, this effect is more pronounced in emerging market economies with current account deficits. This could be interpreted as "fear of appreciation", implying that emerging market economies are stingy in the appreciation of their currencies, but generous about devaluation.

We draw three policy implications from this empirical analysis: First, it is important that the real exchange rate moves in a balanced way to adjust the current account surplus or deficit, rather than adopt a flexible exchange rate regime. Second, managing medium or long-term determinants (e.g. fiscal balance, net foreign asset, dependency ratio, etc.) is more important for closing the imbalance. A flexible exchange rate alone cannot solve the global current account imbalance. Third, exchange rate flexibility cannot be determined simply by its role in reducing the current account imbalance. Economic growth, business cycles, and monetary policy independence should be taken into consideration when emerging market economies formulate exchange rate policy.

The problem of the current account imbalance and exchange rate flexibility is expected to enter new territory with the inauguration of Donald Trump. We are now facing a US promoting "America First" with regard to the exchange rate issue, whereas the country previously aimed to correct the global imbalance. Korea is highly likely to be adversely affected, both directly and indirectly, under any scenario presented by the new US administration. We need to closely monitor the global financial market and enhance its resilience against external shocks. At the same time, we must raise export competitiveness internally, and secure economic policy instruments to lay the foundation for enduring an era of ultra-uncertainty. KIEP

Reference:

Kim, K. and Pyun, J. H. 2016. "Fear of Appreciation? Current Account Adjustment and Exchange Rate Regime," mimeo.