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Competitiveness

Competitiveness is often narrowly measured by the spot nominal exchange rate. This is wrong for a variety of reasons.

At first glance, the losses from a strong exchange rate are very apparent. It hurts the export sector and there may also be additional country-specific adverse effects (such as on the peso value of remittances in the case of the Philippines). However, stopping there would be grossly incomplete. A strong exchange rate also implies lower inflation and lower interest rates, contribution to incentives for capital formation and job creation. In addition, many firms, including those that export, rely on imported intermediate goods (including commodities), which are less expensive with a stronger exchange rate. Debt service costs are lower as well and consumers have access to global varieties of goods that they desire at less cost. Furthermore, emerging market' currencies tend to be strong during times of low global risk aversion and solid global growth, benefiting exporters. If one takes all these factors into account, a strong currency may not be such a bad thing for the country as a whole, although there are winners and losers, with the latter usually being more vocal than the former. In addition, even if a weaker exchange rate were desirable, there is the whole separate debate on how this should be engineered as going against fundamental market forces comes with significant economic distortions.

Furthermore, most discussions on competitiveness and the currency focus on the spot exchange rate in U.S. dollar terms. Indeed, most trade is invoiced in dollars and the U.S. is an important trading partner. However, what matters more is the real effective exchange rate, which takes into account relative price levels as well as exchange rates compared to trading partners rather than the U.S. dollar only. Incorporating price dynamics is critical as the following example will illustrate. What if the currency depreciates by 10 percent? Is the country now more competitive? Not really if the depreciation leads to higher inflation and therefore makes the country's goods more expensive for foreigners. And indeed, depreciation leads to higher inflation and vice versa although the extent to which this happens depends to a large extent on whether firms pass-on higher costs to consumers as well as institutional features such as wage-bargaining arrangements. Looking beyond the U.S. dollar value is important as well as the U.S. is not the only trading partner, and in most cases not even the main competitor, of a country.

The Real Effective Exchange Rate (REER) tends to be more stable than the nominal exchange rate, which is the focus of much discussion. Indeed, for the Philippines as well as other countries in the region, the REER has appreciated by only about 10 percent since 2000 or about 1 percent on average per year (although the REER has had periodic cycles of larger upswings and declines). What is perhaps more surprising is that there is no clear-cut relationship between export performance and the real effective exchange rate.

Generally speaking, the normal relationship between REER and exports growth is negative, but there are important exceptions. Indeed, if one were to plot exports growth since 2003 against real effective exchange rate appreciation for a large sample of emerging-market countries one actually finds a positive correlation. This not only suggests that the starting point of the REER matters, but also that other factors might be more important for export growth than the REER. The experience of some countries sheds some light on what these other factors might be.

For example, during the past decade, South Korea experienced rapid export growth alongside a continuous REER appreciation. The Samsung Economic Research Institute observed that "external factors like the growing global economy and a weak Korean won after 1997 played a crucial role in accelerating growth in exports… However, internal factors actually had a far greater impact on export growth." These internal factors include a specialization into higher value-added goods, greater product differentiation, both caused by investment in human resources and improvements in proprietary technology. Indeed, exports of high-value added goods were about 25 percent of total exports in early 1990, but had increased to 55 percent in 2005.

In Thailand, before the crisis, the REER appreciated strongly, but export growth accelerated. It has been noted that increased product-market competition encouraged firm efficiency and engendered productivity growth and innovation. Greater competition was achieved by removing regulatory impediments to market operations in Thailand, including by reducing price controls, market entry red tape, rationed operation licenses, and restrictions on foreign ownership.

After the collapse of communism, countries in Central and Eastern Europe were able to quickly gain market share in world exports despite strong REER appreciation. This has been attributed to a shift in product quality and the technological intensity of exports both of which were achieved through structural product and labor market reforms.

These success stories illustrate an important point. Other things equal, competitiveness may be hampered by real effective exchange rate appreciation. However, other things don't have to be equal. Well placed reforms that raise human and physical capital and improve the business environment will lead to productivity gains and overcome the effects of a stronger currency. This requires looking beyond the daily fluctuations in the exchange rate, although this volatility too can be mitigated, for example by making hedging instruments more easily available to small and large exporters alike.

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