subsidizing their production) and so produces a trade surplus. Other countries must therefore be willing to run the counterpart deficits on their trade account. Before the financial crisis, the United States and some other industrial countries were willing to do so. But as demonstrated by the debate over "global imbalances," the effects may not have been entirely benign, and the advanced countries may no longer be happy to resume their traditional role.

This also points to a distinction between small and large countries. A small country that seeks to maintain an undervalued exchange rate can do so without significant implications for global imbalances and the associated financial risks. Its policies will also have only minor implications for the competitiveness of its emerging market neighbors. For a large country, this kind of active use of exchange rate policy is more problematic on both grounds. This distinction also points to a potential fallacy of composition: what could work for an individual country may become problematic for the world when pursued by countries as a group.

One alternative to using monetary-cum-exchange-rate policy to promote growth-friendly structural change in the direction of producing exportables is of course to subsidize tradables directly or reduce input costs. Such policies can in principle be effective in promoting structural change, and if they are combined with macroeconomic policies that maintain external balance, they need not be associated with trade surpluses.[27] However, such policies run afoul of World Trade Organization (WTO) rules and the Agreement on Subsidies, in particular, which prevent emerging market economies from utilizing explicit or implicit export subsidies. Tax exemptions, directed credit, payroll subsidies, investment subsidies, domestic content requirements, and export processing zones are all potentially actionable under WTO rules.[28]

Such policies also face well-known difficulties of implementation. Interventions may be poorly targeted and subject to political capture and rent-seeking. Currency policy, because it works across the board, is less prone to capture by specific industrial lobbies. For all these reasons, it is an inescapable reality that governments have tried to maintain an undervalued currency as a key element of their growth strategy.

The pressure on central banks to keep an eye on competitiveness can be intense. Inflation targeting that pays little attention to the level or volatility of the exchange rate becomes harder to practice. Central banks are more likely to safeguard their independence by acknowledging such concerns and pressing for non-monetary policy measures that achieve similar aims than by playing the game "who, me?" That means, in turn, greater cooperation and coordination with fiscal and regulatory authorities to create the conditions for a more competitive real exchange rate. Fiscal policy needs to be tight enough to allow the currency to settle on a lower trajectory. Regulators need to be willing to tighten prudential liquidity requirements and capital-account measures when too much money is flowing in. Central banks can signal their willingness to watch (if not "target") the exchange rate, as long as other parts of the economic-policy machinery are doing their respective bits.

The point that not all countries can simultaneously run trade surpluses obviously still stands. From a systemic standpoint, while policies designed to prevent currency overvaluation are not objectionable, those targeting large undervaluations and trade surpluses certainly are. Similarly, there is an element of externality in capital controls in that one country's success in evading capital inflows only increases the difficulty of other countries doing the same. This is certainly a problem at the level of emerging markets as a group.

[27] A production subsidy on tradables produces an incipient trade surplus, which can be eliminated by allowing the currency to appreciate. The appreciation does not remove the production stimulus on tradables entirely as long as tradables *consumption* is sensitive to the exchange rate. See Rodrik (2010).

[28] Least developed countries are exempt from these rules.