DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

ECONOMIC AND MONETARY AFFAIRS

Currency wars

NOTE

Abstract

The expression "currency war" is largely misplaced. The recovery from the Great Crisis is highly uneven, it is therefore only normal that exchange rates move in response to differing economic conditions. It is likewise normal that various central banks react to domestic conditions, but the problem is that events and policies in the largest economies affect the rest of the world through the exchange rate channel. Thus the US Fed' quantitative easing stands to weaken the dollar and to lead to capital outflows that are disruptive. Similarly, China's policy of pegging its exchange rate, which in turn influences monetary policies throughout East Asia, prevents some otherwise normal exchange rates from taking place. In an ideal world, these policies would be coordinated but this is likely to be a highly complicated exercise. As the euro area too is undergoing an apparently feeble recovery and a public debt crisis, the ECB must proceed with extreme caution, possibly delaying its exit strategy.

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Executive Summary

1. While, initially, most countries were hit in broadly similar ways by the financial crisis, the situation around the world is now more varied. This situation is a source of international frictions that tend to focus on exchange rates.

2. The weakening of the recovery in Europe and in the US is creating sharp disagreements at the national level. Policymakers are caught by the need to roll back the very large public debts that have been accumulated, the possible necessity to wait because of weak conditions and the very limited useful of monetary policies now that the interest rates are close to the zero lower bound.

3. The possibility that exchange rates will move sharply has given rise to the fear of a "currency war". At this stage, exchange rates have moved relatively little, with very few exceptions. In fact, where they are free to move, exchange rates play their normal and desirable stabilizing role, depreciating in countries with weak economic conditions and rising in countries that have recovered from the crisis. At this stage, there is no justification for a call to the arms.

4. Likewise, the focus on global imbalances is largely misleading. There is no convincing evidence that these imbalances have caused the crisis. China's surplus has little to do with an undervalued yuan; it is related to very high savings, a consequence of structural inadequacies. Likewise, the US deficits are related to deficiencies in their financial markets. More generally, current account imbalances, even large ones, are not necessarily "wrong"; they mostly reflect deep preferences regarding saving.

5. The Fed's decision to embark on a new wave of quantitative easing is likely to have disappointing effects on the US economy, but its mandate compels the Fed to "do something". The impact on the dollar's exchange rate may be discomforting for other countries but no major central bank can put the exchange rate ahead of domestic objectives.

6. In an ideal world, monetary policies would be coordinated. In practice, there is little that can be done to foster the international coordination of monetary policy. Surveillance by the IMF is probably the best option, one however whose impact is unlikely to be strong enough to defuse tensions.

7. Like the US, the euro area is in a difficult situation, with a weak recovery and a public debt crisis that will no go away any time soon. The ECB should act with considerable caution. Its best course of action is to delay the exist strategy and to le it be known.

1. Painful crisis ending

The policy responses to the onset of the Great Crisis have been fairly harmonious and almost coordinated. The result is that the world has avoided the nearly ten years of misery that followed the Wall Street crash of 1929. That was the easy part for several reasons. First, the lessons from 1929 had been drawn, and we knew at least what *not* to do. That included policy passivity and competitive depreciations or restrictions to international trade. Second, the crisis quickly spread worldwide so that policies were spontaneously oriented in the same direction. Third, central banks had greatly improved their understanding of financial markets and how they act as a channel of transmission for monetary policy. Accordingly they did not hesitate to carry out so-far untried unconventional policies. Fourth, pubic debts, while high in some countries, left enough space for governments to adopt expansionary policies.

Things have now changed considerably. Public debt have reached levels unseen in peace time so that many governments feel constrained and several others are effectively under direct pressure from the very markets that they had kept afloat during the crisis. As a result, the perception is that only central banks can support feeble economies, but interest rates are at or close to the zero lower-bound so that their room for manoeuvre is limited. In addition, the exit from unconventional monetary policies is a new challenge for which there exists no previous experience, which is an additional source of uncertainty. Finally, some countries have recovered and are actually growing fast while the recovery is hesitant in others.

This combination of diverging situations and uncertainty is becoming a source of controversies. The controversies occur inside countries, where views differ as to what ought to be done. In the developed countries, in particular, some view the high and still growing debts as an urgent threat that should be given policy priority. Others are concerned by the large increases in the size of central bank balance sheets, which they see as a promise of high inflation; they call for a prompt normalization of monetary policy. At the same time, others are primarily concerned with the weak path of the recovery and with lasting high unemployment. They see the risk of a relapse into recession, or simply protracted high unemployment, as socially and politically unacceptable, even dangerous. They consider that, in such circumstances, inflation cannot be treated as an urgent threat and that public debt containment cannot be a priority for policy. These divergences of views are irreconcilable because they are based on a subjective judgement of which is the lesser evil.

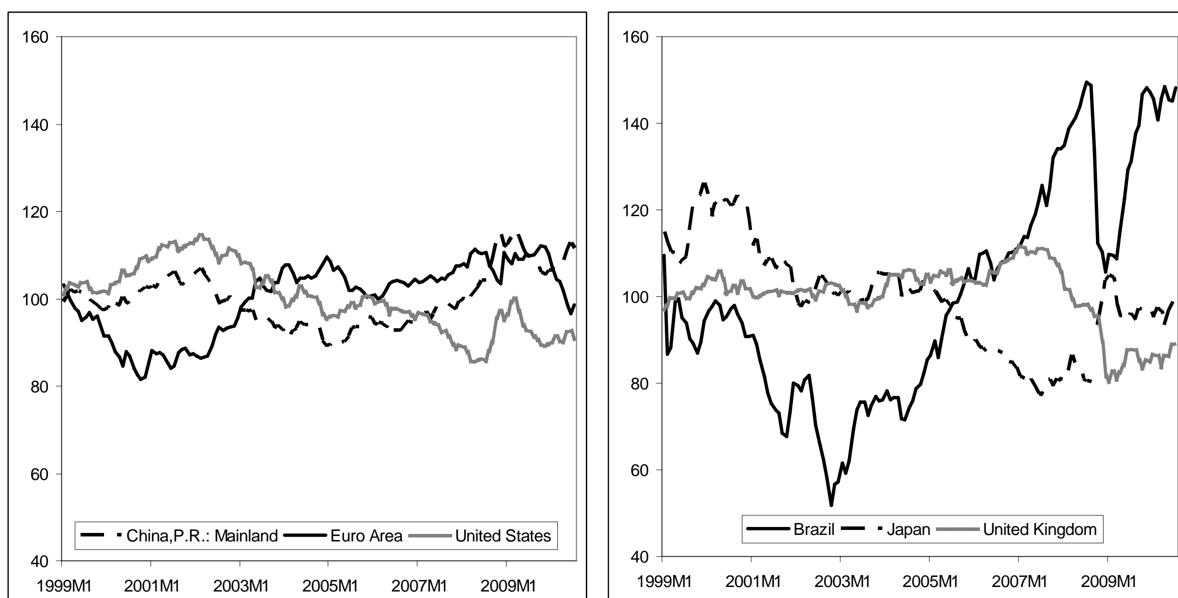
The situation is not any better at the international level. The emerging market countries have quickly recovered, for several reasons. Their banking systems have generally not been involved in the acquisition of toxic assets, so that their banks could quickly resume their normal activity. This stands in sharp contrast with banks in developed countries, which, stress test notwithstanding, seem to be more concerned with completing their deleveraging process than with lending to the economy. In addition, internal markets are quite dynamic in emerging markets and rather subdued throughout the developed world. Finally, public debts are a non-issue when the rate of economic growth exceeds the interest rate, because it implies that debt to GDP ratio is spontaneously declining with the opposite situation is barely-growing developed economies.

All of that implies that the tail end of the crisis is complicated and a source of conflicts. The risk is that these conflicts exert a negative effect on consumer sentiment and, indeed, abort the recovery. For that reason, it would be desirable not to exaggerate the disagreements that can be a source of anxiety.

2. Currency war! What currency war?

The statement by the Brazilian Finance Minister that we are engaged in a currency war is a good example of how minor problems can become a major irritant. So far at least, there is no such thing as a currency war. This is illustrated in Figure 1, which displays the real effective exchange rate of a few key currencies. These rates account for changes in the price level; they show the evolution of domestic prices relative to prices in each country's trading partners once converted into the same currency, in effect measuring a country's international competitiveness. The left hand-side chart displays the rates of the three major economies, the US, the euro area and China. It shows that over the last two decades, the real exchange rates have moved with great moderation. It is also apparent that the recent evolution is not atypical.[1] It can be argued that a fast-growing country like China should undergo a real appreciation, so that the yuan's stability is a sign of undervaluation. There is some truth in this argument: the 25% real appreciation of the yuan since early 2005 is probably too low, but not necessarily by a wide margin. The right hand-side chart displays three important cases of wider variations. Since early 2007, the Sterling pound has lost 20% in real terms while the yen has appreciated by 23%. Brazil appears as an outlier. Its currency, the real, hit bottom in 2002 at the time of the election of President Lula, it then more than recovered, before plunging at the time of the Lehman Brothers collapse. In the recent past, it has merely returned to its previous peak. Even so, the Brazilian Minister's statement appears as unwarranted.

Figure 1. Real Effective Exchange Rates (Index: 100 = sample average) 1999:1 – 2010:7



Source: IMF
Notes: For comparison purposes, both charts use the same scale. Brazil: bilateral rate vis a vis the US dollar.

[1] The latest observation is July 2010.

Of course, things will change in the future, and there is plenty of room for disagreements. This does not mean that national authorities are manipulating their exchange rates in rude attempts at achieving an unfair competitive advantage, as discussed below.

3. Global imbalances

Long before the crisis started, a number of observers had been voicing concern about the widening current account imbalances in the US and China. Obstfeld and Rogoff (2005) warned that these imbalances were unsustainable and they estimated that the US dollar would have to depreciate by as much as 50%. Such a large change could not happen smoothly, so the implication was that it would take a crisis to rectify the situation. The crisis has now happened, but it does not conform to what was predicted by the global imbalances. In particular, the dollar has depreciated in effective terms by a mere 6% since early 2007. In fact, following the crisis it has fluctuated, depreciating, then appreciating, and now it is depreciating again, but moderately so far. This is one reason why the view that the crisis is due to global imbalances has not caught on. More convincing is the view that the global imbalances were merely a symptom, reflecting other difficulties and specificities of the global financial system.[2]

In order to understand the phenomenon of global imbalances, it is necessary to recognize that a country's current account, the difference between exports and imports broadly defined,[3] fundamentally measures the difference between domestic income and domestic spending; in other words, it is the country's net savings. More precisely, it is the sum of the excess of private savings over corporate spending on productive investment – private net savings – and of the public budget – government's net savings. This simple observation goes a long way invalidating a number of popular but inaccurate stories:

Inaccurate story No.1: the source of the problem is China's exchange rate policy. In order to accept this view, one has to explain how a yuan appreciation would shrink China's external surplus. The view that it would make its exports more expensive and foreign imports more attractive, while correct, must be related to its net savings. The standard story is that income falls when exports decline and imports rise AND that this reduces private savings more than it reduces private investment, without affecting the budget balance. Chinese firms and households save nearly half of GDP for a number of structural reasons (firm ownership, lack of retirement and health programs, a poor domestic financial sector that fails to adequately invest deposits, etc.) so that it would take a considerable decline in incomes to affect the current account. The way to reduce the surplus is not to provoke a deep recession, which would anyway only be temporary, but to deal with these structural weaknesses. Adequate reforms are in China's own best interest but they seem politically difficult. Meanwhile, pounding China's exchange rate policy is unhelpful. It is also useless as an implication of strong demand for Chinese goods is that wages and prices rise, which achieves the same result as a yuan appreciation.

Inaccurate story No.2: all large current account imbalances are undesirable. This statement means that it is wrong for a country to save or dissave large amounts. Yet, there may be good reasons for the private and/or public sectors to

[2] See Caballero et al. (2008).

[3] The broad definition includes much than trade in goods: trade in services, net income from investment abroad and various transfers.

save or dissave. Rapidly growing poor countries need a lot of public investment, hence large budget deficits. Largely indebted governments need to save. Much the same applies to private saving. Rapidly ageing mature economies need to save to go through their demographic transitions. For instance, Germany's large surplus is perfectly justified on both grounds.

Inaccurate story No.3: the US take advantage of the international role of the dollar to pile up deficits. This ignores the fact that the international role of the dollar is not forced upon the rest of the world by the US. The US has earned its privileged position by building up a dynamic economy supported by a (generally) performing financial system. The privilege is open to challenge, so it is not really a privilege, it is a comparative advantage. The source of the US deficit lies elsewhere, mainly in the (sometime excessive) ability of US firms and consumers to borrow more than they should, and therefore not to save enough. The crisis was the consequence of serious domestic failures within the financial system. A dollar depreciation – or a yuan appreciation – will do nothing to correct the situation. Serious reforms of the financial system and of consumer protection are in order and, in fact, they are already under way. By the way, similar distortions have occurred elsewhere, in countries such as the UK, Spain or Ireland, whose currencies do not enjoy international status.

Inaccurate story No.4: the problem of global imbalances requires a new international monetary system. It should be clear by now that no system will change national preferences towards saving or dissaving; when these are "excessive", they usually reflect domestic distortions, not international monetary failures. A system of fixed exchange rates prevailed during the Bretton Woods era (1945-73) and it collapsed because governments were unwilling to adjust their exchange rates when needed. When capital flows started to be freed, governments could not hold the line any more and the system came to an abrupt end. Still, a number of governments today refuse to let their currencies float freely because truly freely floating exchange rates tend to be too volatile, a consequence of the fundamental volatility of financial markets. Countries that wish to limit the flexibility of their exchange rates every right to do so – and they are often right – but this may require imposing limits on capital mobility. The problem today is not that every country is allowed to do what it fancies with its exchange rate, it is that full capital mobility is incompatible with limited exchange rate stability. Yet, a country's exchange rate has (often exaggerated) implications for its partners, and this is especially true for large countries. This is a very uncomfortable situation, but there exists no magic bullet. Ideally, these policies would be openly and honestly discussed with a view to limiting frictions. This is a task that has been entrusted to the IMF. It is unlikely to have dramatic effects, but there is little else that can be done.

4. QE2 and the euro area

The current situation is quite clear. The US Fed has decided to restart its quantitative easing program because it fears that the recovery could be stalling and its dual mandate requires that it acts when unemployment is unacceptably high. Some argue that the US structural US unemployment rate has increased; this may be the case but no one can deny that a significant portion of US unemployment is currently cyclical. While there are good

reasons to doubt that QE2 will do much to strengthen the recovery,[4] the Fed does not really have much of a choice. It must be seen to be acting to respect its dual mandate (price stability and high employment), its interest rate is at the zero lower bound and its only available instrument is indeed quantitative easing, no matter whether it can be effective or not.

An implication of QE2 is that US banks must rebalance their portfolios. As they sell Treasury bonds, they need to invest the cash that they receive from the Fed. Inevitably some of this cash will be invested abroad, where interest rates are higher. The result is capital inflows into countries which are seen as safe. Safety includes economic prospects. This means that East Asia and Latin America are likely to be primary targets for the recycling of the newly created US dollars. Naturally, these capital inflows are bound to exert pressure towards exchange rate appreciation in the receiving countries.

The question is: is there anything wrong with that? To be sure, the Fed decides on its actions without recognizing their impact on other countries, and this cannot be optimal from a collective viewpoint. But this is what all central banks do. Of course, the international role of the dollar means that Fed actions matter more and for more countries than actions by other central banks. This is true, but we need to be precise about what "matter" means.

- It could refer to the role of the dollar as a unit of account, which is used to price most primary commodities and even bilateral trade among third countries. Fluctuations in the US dollar therefore affect "innocent bystanders" around the world. In fact, however, commodity prices tend to systematically offset dollar fluctuations. As for the use of the dollar in trade, insurance is available through hedging techniques, although it is true that only large corporations can use this protection. Still, nothing prevents third countries from invoicing trade in other currencies than the dollar. In fact, China is now encouraging using the yuan for this purpose.
- It could refer to the role of the dollar as a store of value. It is the dominating currency in central bank reserves and it is held by millions of private firms and households. As a result its fluctuations imply capital gains and losses. Yet, it is difficult to conclude that the US should offer an implicit guarantee of the value of its currency. As any financial asset, the dollar is risky and the only possible response is portfolio diversification.
- In theory, exchange rates should change to reflect fundamental economic conditions. If the US economy is weak while the Chinese or Brazilian economies are strong, we should expect the dollar to depreciate vis-à-vis the yuan and the real. The Brazilian Finance Minister, whose currency has considerably appreciated, has injected "currency war" in the current vocabulary but the real's appreciation is not out of logic. By limiting the appreciation of the yuan, the Chinese authorities block a channel of adjustment and impose upon themselves further accumulation of foreign exchange reserves.

The depth of the problem is that if the dollar is to depreciate, there must be some currencies that stand at the other end of the swing and appreciate. The Chinese yuan and most other East Asian currencies are likely to follow the dollar. This leaves the successful countries of Latin America (Brazil, Chile, Uruguay and a few others), Switzerland and a handful of Central and East European countries and the euro area.

[4] The main effect is to lower already low long-term interest rates and to provide banks with cash at a time when they already hold massive excess reserves. It does help banks to make profits (excess reserves now carry interest) and could eventually encourage them to lend more to the economy. But consumer demand for bank credit is being undermined by the still-sick housing market, where prices have not yet reached their floor.

Like in the US, and probably even more so, the recovery is weak in the euro area. A number of smaller countries are forced by the bond markets to tighten very vigorously their fiscal policies. Greece and Ireland are already in recession, and the recession will deepen. The larger countries are also committed to roll back their public debts; if they move soon, as currently announced, the impact on economic growth can only be negative. In the rest of Europe, the British government has announced a very severe spending retrenchment, which will also weigh on its recovery. A weakening of the dollar vis-à-vis the euro would therefore come at a bad time.

What is to be done? The likely deepening of the public debt crisis in Greece, Ireland, Portugal and quite possibly more countries – since a worsening recession is bound to lead to a deterioration of budget balances – will weaken the euro, even relatively to the dollar. This will help the recovery in countries that are immune to the debt crisis. The remaining question concerns monetary policy.

The intentions of the ECB are murky. On one hand, it seems to prepare an exit strategy (it has already allowed the market interest rate to rise a little), which would lead to an ill-timed appreciation of the euro. On the other hand, it is doing its own version of quantitative easing by absorbing public debts under market pressure. Should it continue sterilizing these interventions, however, the impact on the money supply is nil and so is the softening effect on the euro. Like the Fed, the ECB focuses on domestic conditions when making its policy decisions, largely disregarding the consequences for the exchange rate. This is a proper way of operating in normal times. But these are not normal times. Caught in-between the weak dollar and the risk of a weak euro due to the unsettled, and possibly exploding public debt crisis, at the very least the ECB should suspend the implementation of the exit strategy and let it be known. It should also be ready to let the short term interest rate move back towards the end of its feasible range and let it be known.

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