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Currency Wars: Between Domestic Politics and International Cooperation (ARI)

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Theme: The incipient currency war could lead to a protectionist escalation that would hinder the global economic recovery. This paper analyses the various angles of the currency war and possible ways of resolving it.

Summary: This ARI compares the currency war that has now begun with that of the 1930s and explains the relationship between competitive devaluations and protectionism. It then examines the domestic political factors that explain the positions of major countries with regard to exchange rates. Finally, it evaluates the various coordination proposals that have been presented, including those aimed at getting China to change its position.

Analysis:

Introduction

The Brazilian Finance Minister Guido Mantega said at the autumn meetings of the International Monetary Fund and the World Bank in early October that the world's major powers have entered into a 'currency war'. Since then, jitters and worry have taken over the front pages of the world's financial press and bellicose language, albeit applied to the economy, has raised tensions to limits not seen since the financial crisis broke out. If these exchange-rate problems mark the beginning of a wave of competitive devaluations that leads to a rise in protectionism of the kind observed in the 1930s, then we should all be worried. Back then, these beggar-thy-neighbour policies did not lead to growth, caused tension in international economic relations and triggered trade wars that only ended after World War II.

However, the international economy is still far from that situation. What is more, it boasts tools of international cooperation that should allow it to avert a scenario of unilateralism, discoordination, nationalism and deglobalisation that would seriously hinder prospects for growth in the world economy. This does not mean the situation can be turned around quickly. It is much more likely that the moves will be gradual and not very spectacular. But, in any case, all of the players in this fledgling battle stand to gain if they lower tensions. This would contribute to finding a cooperative solution at the G-20 summit in Seoul in mid-November. In fact, the exchange rate problem could serve for the G-20 to regain the momentum it had at the outset of the crisis in 2008 and 2009 but has been losing at the last two summits, especially the one held in Toronto last June.

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An ideal outcome from the G-20 summit would look like this: an agreement is reached for China to raise nominally the value of its currency and de-link it from the US dollar; the US, Japan, the euro zone and the UK coordinate a monetary expansion through quantitative easing measures; and the remaining emerging economies specify clearly what kind of capital controls they plan to use in the event their currencies appreciate too much as a result of the expansive US monetary policy. This cooperative solution would allow adjustments in real exchange rates to contribute to restoring balance to the world economy; in order words, increasing demand in countries with current account surpluses and reducing it in those running a deficit. It would also ease the risk of deflation that hangs over wealthy countries and justify the use of certain capital controls in emerging powers such as Brazil and India, which are seeing huge influxes of capital that generate inflation and bubbles in securities markets and could sow the seed for another financial crisis. In fact, the 'Framework for Strong, Sustainable and Balanced Growth' that the G-20 approved at the Pittsburgh summit in September 2009 was designed specifically to facilitate this process of restoring balance to world economic growth under the supervision of the IMF. And the proposals that the countries of the G-20 discussed in preparatory meetings of their economy and finance ministers went in that direction.

However, this coordinated solution, which is already being compared to the Plaza agreement of 1985, which served to drive down the dollar, will be difficult to nail down in an agreement. There are various reasons: (1) China's reluctance to revalue its currency, due to domestic political motives; (2) US officials' mistrust of China and other emerging economies that intervene in currency markets and accumulate reserves in dollars; (3) uncertainty over what the impact will be from a new round of quantitative easing by the Federal Reserve, the Bank of Japan and the Bank of England, which might or might not contribute to the fight against deflation but will affect exchange rates; (4) the indifference with which the European Central Bank (ECB), acting strictly in line with what Germany mandates, is dealing with the problem of exchange rate volatility and the strength of the euro; and (5) the dangerous, widespread feeling that each country will tend to seek solutions to its own problems without taking into consideration the needs of the global economy, something which affects in particular relatively small countries which are unable to avoid adverse effects from unilateral policies adopted by major powers. The latter is applicable to countries as diverse as South Korea, Switzerland, Brazil, Thailand and Indonesia, which are seeing their currencies rise while they are powerless to stop it. But it also affects countries on the periphery of the euro zone, which see how the restraints imposed by sharing a single currency and the conservative attitude of the ECB hinders economic recovery through exports, because of the strength of the euro. In short, domestic political factors are blocking a cooperative solution at the international level.

This paper analyses the different angles of the exchange rate conflict and possible ways to resolve it. It first compares the current situation with that of the 1930s and explains the relationship between competitive devaluations and protectionism. Secondly, it explores the internal political factors that explain the positions of the main countries on exchange rates. Finally, it assesses the viability of the various coordination proposals that have been raised, including those that seek to persuade China to change its stance. Throughout the paper we show that, for now, the world economy is far from an all-out currency war or a wave of competitive devaluations that might lead to protectionism. But that does not mean we can rest easy. It is necessary to address the problem and make gradual progress to avert an escalation of the conflict and instability which could have disastrous consequences for the world economy.

Competitive Devaluations as a First Step Towards Protectionism

The threat hovering over the world economy is that of competitive devaluations, also known as beggar-thy-neighbour policies. The goal of these practices is to promote a country's exports by weakening the national currency through direct intervention in the currency market, the easing of monetary policy or adopting capital controls. They were used in the 1930s and had awful collective consequences because, as an exchange rate is the relationship between two currencies, it is impossible for all of them to depreciate at the same time. Furthermore, keeping exchange rates artificially low tends to be the precursor to protectionism, which in this crisis has for now been kept at bay (the World Bank says only 2% of the reduction in world trade in this crisis has been caused by a rise in protectionism, while in the 1930s the equivalent figure was nearly 50%).

During the Great Depression of the 1930s, the countries that raised their tariffs the most were not the ones which suffered from more severe recession or a greater rise in unemployment. Rather, it was those which, starting in 1931, stuck by the gold standard (a system of fixed exchange rates that allowed them to devaluate). The countries that abandoned the gold standard –in other words, severed their commitment to this rule that Keynes labelled a 'barbarous relic' because of its incompatibility with the autonomy of monetary policy and its deflationary effects– were able to handle the crisis better and did not raise their tariffs so much.

These days there is no global system of fixed exchange rates. But as China has pegged its exchange rate to the dollar since 1995, the US is in the same situation as the countries that could not devaluate their currencies in the 1930s. This explains the increase in protectionist pressures and anti-Chinese rhetoric in the US (within the euro zone there is also some strain between Germany and countries that are running current-account deficits, because of the existence of the single currency and the inability to devaluate). There are few who now doubt that China is manipulating its exchange rate. Its reserves have now reached US$2.6 trillion (about half of its GDP), a level that is too high to be justified with the argument that it is being stored away for a rainy day. And China's reluctance to revalue the yuan means, as Martin Wolf says, that China is trying to do to the US what Germany did with Greece: force it to regain competitiveness through deflation rather than by allowing an adjustment in the nominal exchange rate. But as the US is not Greece, it has tools for freeing itself of the Chinese pressure, and even to hit back, as we shall see in the next section of this paper. For the time being, the US Congress –which with its current Democratic majority is more protectionist than the White House– has approved a bill that would impose tariffs on Chinese products unilaterally. Such a practice is banned by the World Trade Organisation on the grounds that it is discriminatory. But both economic giants know that a trade war would not benefit either of them.

All in all, the lessons of the Great Depression, which have contributed so much in terms of what policies are right for tackling the current crisis, suggest that a currency war could the spark that touches off the protectionism that everyone wants to avoid so dearly. Therefore, it is a priority to seek cooperative solutions to the currency problem so that the US does not raise tariffs and other countries emulate it, which would set off a trade war that would block recovery and undermine the credibility and legitimacy of the WTO.

Domestic Policy: What is Each Country Worried About?

Although there are cooperative solutions on the table, in a context of weak economic growth in rich countries and swift geopolitical changes at the global level, domestic political factors make it hard for countries to arrive at coordinated solutions. For this reason, it is important to understand what concerns the main players and how much scope for manoeuvre they have.

China

China, labelled by the West as 'the problem', has found in exchange rate policy the most effective tool for boosting growth and employment –the basis of the Chinese political regime's legitimacy–. A cheap yuan allows China to strengthen its export sector and attract foreign direct investment, which translates into job creation and a gradual rise in people's living standards. At the same time, promoting the manufacturing export sector is key to raising productivity, which over the long term is the fundamental variable for increasing levels of per capita income. Finally, exchange rate intervention is a more efficient tool than export subsidies, which by their very nature discriminate between sectors and are not legal under the rules China signed on to when it joined the WTO in 2001. Therefore, even though China has allowed a slight appreciation in the yuan (both between 2005 and 2008 and since June 2010) and the position of its central bank on the exchange rate is vague because the currency's weakness produces inflation and heats up the economy, for now it does not seem the government is going to change its policy, especially if it comes under outside pressure.

Furthermore, China's financial system features heavy government intervention and maintains strong capital controls. This allows it to preserve the autonomy of its monetary policy and counter the inflationary effects of intervening in currency markets through sterilisation, credit contraction and raising interest rates. Other developing countries which have liberalised their financial sector and capital account more are not able to do this. In short, because of domestic political considerations, the government prefers to cool down the economy with instruments that do not help restore balance to the world economy (as a revaluation of the yuan would), but allow it to contain inflation and keep creating jobs and growth through its export sector.

The US, Japan and the UK

In the US, the domestic factors are different. The problem is not the value of the dollar in and of itself, but rather the risk of deflation and persistently high unemployment. A cheaper dollar is one tool for tackling these problems, but not the only one. In fact, the Federal Reserve has announced that if inflation continues to go down, it will take a new series of monetary expansion measures. As interest rates are already at 0%, it will launch a new wave of quantitative expansion. In other words, it will print money to buy bonds, which will raise their price, lower their yield and encourage banks to lend more to the private sector. The effect of this measure will be a cheaper dollar and a flow of capital out of the US toward emerging countries (including China), which have higher interest rates. This is usually called 'carry trade'. In this respect, it can be said that, since the US has the world's reserve currency and can print as much money as it wants, through quantitative easing it can 'inflate' the rest of the world and has endless ammunition to do so.

However, as what really worries the Fed's Chairman, Ben Bernanke, is the risk of deflation, quantitative easing should not be considered a competitive devaluation orchestrated to hurt China and other emerging economies. It is a legitimate act by a country with a slim margin for fiscal expansion and which uses monetary policy to avoid deflation, which, if it were to take place, would be catastrophic because it would raise the real value of the already heavy debt loads of US households and companies. But Bernanke, who is among the central bankers that most fear deflation and most advocate establishing a specific inflation goal to instil confidence and anchor expectations, will stop printing money and withdraw liquidity as soon as demand picks up again and prices and employment levels recover. If he did not, inflation would skyrocket, which the Fed is not prepared to stomach, either. The problem is that, since large-scale quantitative easing has never been carried out before this crisis, nobody really knows what effect it is going to have on credit, jobs, prices or growth. What is clear is that it will lead to a flight of capital from the US and enhance the downward trend in the dollar.

Japan (and to a lesser extent the UK) are in situations similar to that of the US, although whatever they do has much less international impact. Japan is considering another round of quantitative easing, is the world's only advanced country besides Switzerland to intervene directly in the currency market so as to weaken its currency and has approved a new fiscal stimulus package. All of these measures are designed to fight against deflation, whose devastating effects Japan already suffered in the 1990s. The UK could once again expand its central bank's balance, especially if the huge spending cuts that the Cameron government has announced end up having deflationary effects.

The Euro Zone

Things are viewed a bit differently in the euro zone. The ECB does not see any risk of deflation (even though the IMF says 66% of the countries with high risk of deflation are in the euro zone). So, to the satisfaction of Germany and to the inconvenience of France and the peripheral countries (including Spain), the ECB has begun its monetary exit strategy by withdrawing some of the extraordinary lines of liquidity it established when the crisis hit. In practice this means that, although interest rates will remain at 1%, a monetary contraction has begun. These measures have caused the euro to shoot up, which reduces the price competitiveness of exports from the euro zone, hinders economic recovery and increases the probability that prices in Europe will in fact fall. In short, the euro is withstanding most of the burden of the global currency adjustment. Furthermore, as the ECB is sitting back and watching the single currency appreciate (and it has full independence to do so), there is no sign that the strength of the euro is going to ease, especially if the rest of the industrialised countries embark on quantitative easing while the European Central Bank restricts its money supply.

In any case, a strong euro is less damaging to Spain than to the average of the euro zone countries for two reasons. First of all this is because more than 55% of Spain's exports go to the euro zone (a proportion which is above the EU average) and these sales are not affected by the rise in the single currency. But they are hurt by the drop in price competitiveness of Spanish products that stems from the positive inflation differential with the euro zone. Secondly, a strong euro makes oil imports cheaper and Spain imports nearly 100% of the oil it consumes, which is far above the euro zone average.

Other Emerging Countries

The last group of important countries in this currency war is made up of emerging countries which, even though they are major exporters, do not intervene so aggressively over their exchange rate as do China and some nations that export energy. These are mainly the countries of Latin America, India, South Korea, Singapore, Indonesia, Malaysia and Thailand (Switzerland should also go into this category, even though it is a wealthy country).

As recovery from the crisis is taking place much faster in the emerging world than in the developed countries, a major capital flow towards the developing countries is under way. These countries offer much higher expected investment yields than do the developed countries, both in bank deposits and higher-risk assets (the Institute of International Finance says the capital flow in 2010 will reach US$825 billion, up from US$581 billion in 2009). And if the advanced countries continue to increase liquidity through quantitative easing, these flows will rise, harming these (innocent) countries for at least two reasons. First, because the flows exert upward pressure on their exchange rates, something which has a negative effect on their exports and can lead them to have a current account deficit (or deepen it if they already have one). Secondly, the flows accelerate inflation and can give rise to bubbles in security markets, which, if expectations shift and capital starts flowing out again (known in academic literature as a 'sudden stop'), can trigger financial crises like these countries already suffered in the 1990s.

Even though these countries have accumulated major reserves as a self-protection measure against the crisis, they are opting to intervene directly to push their currencies down or impose capital controls to limit the entry of capital (Brazil has raised from 2% to 4% the tax on the entry of non-productive capital and Thailand has announced a 15% tax for foreign investors who purchase bonds). In fact, the IMF itself, which has been so critical of capital controls over the past decade, seems now to welcome such practices as a preventive measure for these countries to protect against their economies overheating. But if the controls become widespread there would be a process of financial deglobalisation with negative consequences for the developing world over the long term.

Through no fault of their own, these countries are bearing the brunt of the negative externalities of the policies of China and the US. So they are justified in imposing taxes and controls on entries of capital. But it would be better if they did not have to do it and this requires a coordinated solution at the international level.

Conclusion

Moving Towards a Cooperative Solution at the G-20
Despite the divergence of short-term interests between the different countries and the fact that their internal political problems make it difficult to forge an international accord, they all understand that a deepening of the incipient currency war would not benefit anyone. In fact, all the countries (including China) have admitted that long-term growth in the world economy depends on resolving global macroeconomic imbalances and this requires, among other things, settling the exchange rate problem. So it is quite possible that the G-20 will be able to take measures that, little by little, leave behind the current aggressive rhetoric in the interest of a compromise solution. The question is what measures to take.

For now, all efforts are centred on persuading China to change its position. In order to achieve this there appear to be two strategies: one involving confrontation, which has been led by the US and will probably not yield results; and another based on persuasion by a broad coalition led by the US, in which the revaluation of yuan is part of a larger package of negotiations.

The first option, that of confrontation, consists of the US imposing various policies on China to force it to revalue the yuan. There have been proposals to impose unilateral tariffs, bar China from buying US government bonds, or having the Fed intervene to buy yuans. Although these ideas are welcomed by the most conservative sectors of US society, it is unlikely they would work. Tariffs would eat into the profits of US companies, make consumer goods more expensive in the US and trigger a trade war; barring China from buying US bonds would leave the US without the main financier of its current account deficit; and as the yuan is not a convertible currency, it is unthinkable for the Fed to acquire large quantities of them. For this reason, the Obama Administration is not supporting the confrontational strategy. It understands (and rightly so) that it has to persuade China to change its policy because threats will not work.

Enter the second strategy, in which the G-20 is key because the idea is to forge a multilateral 'everybody against China' coalition, in such a way that isolation prompts the Asian giant to change its mind in a context in which some in China are already warning about the dangers of keeping the yuan so low indefinitely. Essential to this strategy are the other emerging nations, which, for the first time, are openly criticising China's exchange rate policy –both because it harms the price competitiveness of their own exports and because it could force the US to undertake a monetary expansion that would cause problems for them–. This tough-minded position on the part of countries such as Brazil, India and South Korea is important because it breaks up the bloc of the emerging countries, which in recent years have stuck together tightly as they dealt with the US and the EU in international economic forums.

The second key factor to get China to change its position is to take the negotiations beyond the issue of exchange rates, linking it to current account imbalances, reform of the IMF, the search for a replacement to the dollar as the international reserve currency, and even other non-economic issues in which China wants something from the industrialised countries. This strategy began to take shape at the summit of Ministers of Finance and Economy of the G-20 countries in late October in South Korea. At this meeting to prepare for the summit of heads of state and government in Seoul in mid-November, it was agreed to increase the quotas of (and therefore give more votes to) developing countries within the IMF, allowing that institution to be more representative of the global economy and thus more legitimate (the change will take China from sixth to third place, behind only the US and Japan in number of votes). Also, in a historic decision, European countries decided to grant definitively two of their eight seats on the IMF's Executive Board (out of a total of 24) to the developing countries. Although the details of this accord will not be hammered out until 2012, it is possible that another 'gesture' might be that industrialised countries will let someone from China be the next Managing Director of the IMF, ending the unwritten rule under which this post always goes to a European.

Finally, the US has proposed limiting the current account deficit or surplus of any country to 4% so as to reduce global macroeconomic imbalances. Although the proposal was rejected by Germany, Japan and Brazil, it allowed the opening up of a multilateral debate on China's exchange rate policy, rather than treat it as a bilateral conflict between the US and China (China's current account surplus is 5% and rising, so limiting it to 4% would force China to revalue the yuan or increase domestic demand).

In this context, it is worth noting that Germany's reluctance to accept this proposal could lead the countries of the euro zone with current account deficits, such as Spain, to argue with the Eurogroup that Germany's persistent current account surpluses are as dangerous for the euro zone as China's are for the global economy in general. Germany's resistance to boosting its domestic demand makes it as hard to resolve the euro zone's internal imbalances as does the dilatoriness of the peripheral countries in enacting more structural reforms. Therefore, now that the debate on macroeconomic imbalances at the global level is singling out China as the culprit, it would be a good idea for Spain to lead a euro zone coalition that makes the same case about Germany.

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