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Currency Wars Yesterday and Today

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An energetic debate on the danger of a global currency war has flared up in recent months, stoked by a renewed move to “quantitative easing” in the United States, resurgent capital flows to developing countries and strong upward pressure on emerging market currencies. This Economic Premise reviews some of the arguments and concludes that the current U.S. monetary easing is a useful insurance policy against the risk of global deflation. But it is increasing pressure on developing countries to move toward greater monetary policy autonomy and exchange rate flexibility, as well as to undertake the institutional and structural policies needed to underpin such flexibility. Such reforms will take time.

An energetic debate on the danger of a global currency war has flared up in recent months, stoked by a renewed move to “quantitative easing” in the United States, resurgent capital flows to developing countries and strong upward pressure on emerging market currencies. At least two schools of thought have emerged on the present exchange rate tensions. One roots these tensions in the problem of global imbalances. Even though current account imbalances in China and the United States have fallen by around half since their precrisis peaks, political tensions over the dollar-renminbi alignment have escalated nonetheless. According to the “global imbalances school,” the aim of quantitative easing by the Federal Reserve is to stimulate the U.S. economy *primarily* by devaluing the dollar, increasing exports, and reducing the U.S. trade deficit. This is a “beggar-thy-neighbor” policy, it is said, because it attempts to switch global aggregate demand away from the rest of the world to the United States. Other countries will resist through competitive devaluations of their own. Such currency wars over global demand will foster protectionism, harming all concerned, similar to the Great Depression of the 1930s.

Another school—call them “deflation hawks”—sees it differently. They think the main problem facing developed economies is weak aggregate demand. Growth remains mediocre and unemployment high, even as the political consensus for fiscal stimulus has dissipated. The monetary easing undertaken by the Federal Reserve aims *primarily* to stimulate stronger domestic consumption and investment and avert the danger of a self-reinforcing deflationary spiral between falling prices and weakening aggregate demand that would lead to a prolonged period of stagnation or recession, as in the Great Depression or in Japan during the last two decades. The weaker dollar is then a side effect of easing. In the deflation hawks’ view, the argument that competitive devaluations led to increased protectionism during the Great Depression is a misreading of history. From the perspective of developing countries today, the U.S. monetary easing has significant benefits in addition to adjustment costs. Developing countries have a number of policy options to facilitate adjustment. Finding the policies best suited to their own needs is one of the important policy challenges facing countries today.¹

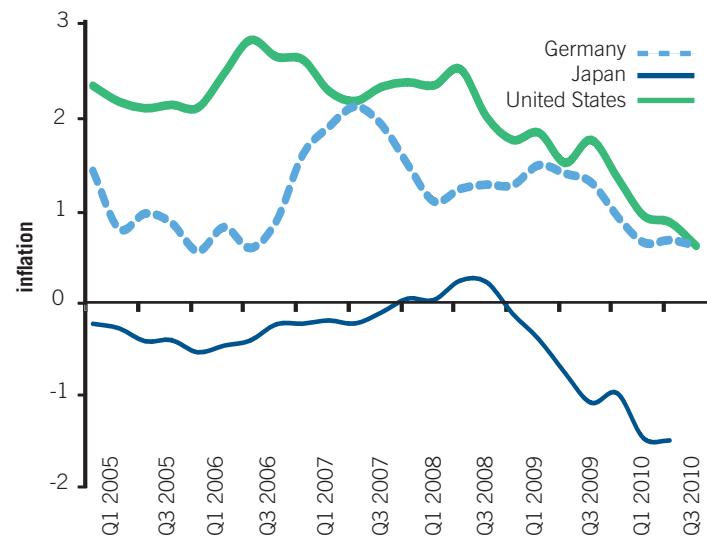
Deflation Risks

The Federal Reserve's decision to loosen was made in light of a stream of data documenting continued deflationary pressures in both the United States and other developed economies over the course of 2010. Core consumer price inflation in the United States fell below 1 percent in the spring and dipped to 0.6 percent in October, the smallest 12 month increase in the history of the index, since 1957. Core inflation has also fallen to less than 1 percent in leading Euro area economies such as Germany and France, while core consumer prices are actually falling at a 1.5 percent pace in Japan (figure 1). Perhaps equally worrying was the sharp fall over the spring and summer in long-term inflation expectations, as measured by the spread between nominal and inflation adjusted yields on U.S. government bonds (figure 2).

The recent disinflation is consistent with trends in the real economy. Unemployment remains close to recession highs, running at 9.8 percent in the United States and just over 8 percent in the Euro area. Real gross domestic product (GDP) growth in the United States slipped to a mediocre 2.1 percent (q-on-q) average in the second and third quarters, not enough to make a dent in unemployment. Estimated potential output gaps remain at about 5 percent in the United States and Japan and 3 percent among major European economies (IMF 2010a).

Why is deflation a concern? The worry is not a temporary episode where prices fall for a few quarters; it is when deflation becomes self-sustaining, pushing aggregate demand lower, which in turn causes further deflation. There are several channels for this process:

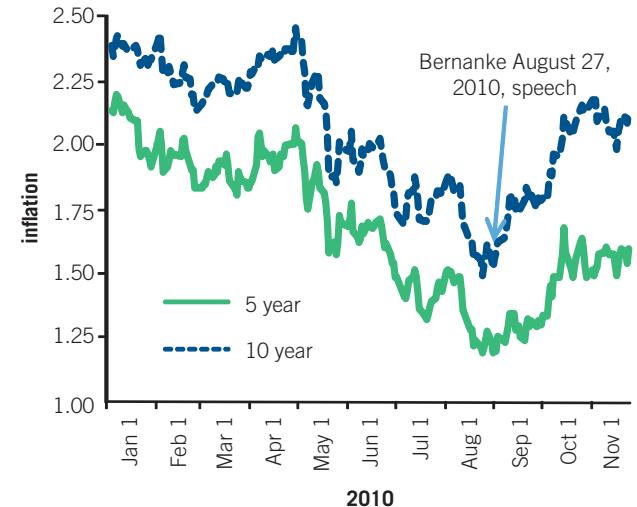
Figure 1. Core CPI Inflation



Source: Organisation for Economic Co-operation and Development (OECD) Main Economic Indicators.

Note: Data are for Q1 2005 to Q4 2010 (Q4 2010 is October only); percent change from a year ago. All items, nonfood, nonenergy.

Figure 2. U.S. Inflation Expectations



Source: Federal Reserve Bank of St. Louis, FRED database.

Note: Spread between nominal and inflation adjusted yields on U.S. Treasury Bonds.

The key concern about deflation arises because nominal interest rates cannot fall below zero. Significant price deflation (even if completely anticipated) means that real interest rates will remain high despite recession, further depressing demand and employment.

Deflation increases the real burden of households' and firms' net nominal debts. *Debt deflation* increases financial distress, causing households to cut consumption and firms to cut investments or go out of business. Financial sector fragility increases as the nominal value of bank collateral and borrowers' debt-servicing capacity falls. Although some creditors may gain from deflation, bankruptcies and restructurings destroy real resources.

Rising fragility worsens asymmetric information problems in financial markets, leading to more severe credit rationing, increases in corporate credit spreads, and further financial fragility among banks and other financial institutions.

Policy Response to Deflation Worries

The Federal Reserve has deployed several instruments in response to the crisis. Special facilities were established to provide low-cost liquidity to banks. The policy interest rate has been close to zero since December 2008. The Federal Reserve also undertook large-scale purchases of long-term government securities between December 2008 and March 2010 to reduce long-term interest rates (the previously mentioned "quantitative easing"). At the end of August, Federal Reserve Chairman Ben Bernanke indicated that the central bank would consider renewed easing of this type because of worries about disinflation and deflation. The new program began in November.

One of the arguments raised against the Federal Reserve's new program is that it is a beggar-thy-neighbor policy aimed at

devaluing the dollar. This note has cited reasons to think that the central bank is easing primarily to strengthen U.S. domestic demand and ward off deflation, with a weaker dollar being a side effect. It is also noteworthy that the Federal Reserve is not intervening in the foreign exchange market to weaken the dollar. Box 1 reviews the argument that beggar-thy-neighbor competitive devaluations were a primary factor in the Great Depression.

Another argument is that high unemployment does not reflect lack of aggregate demand, but mostly structural factors such as increased skill and geographical mismatches. In this case monetary easing might only fuel inflation rather than reduce unemployment. However, while these structural factors have undoubtedly had *some* impact on unemployment, recent studies generally find that the cyclical shortfall in aggregate demand accounts for the bulk—two-thirds to three-quarters—of the rise in U.S. unemployment (Loungani 2010; Valletta and Kuang 2010).

A different criticism is that the proposed \$600 billion program of asset purchases will only have a minor impact on long-term interest rates and therefore a minor impact on demand. This overlooks the main channel through which the Federal Reserve aims to affect demand, which is by raising *inflation expectations* so as to achieve low and possibly even negative *real* interest rates for a time. Starting with Mr. Bernanke's August 27, 2010, speech at Jackson Hole, Federal Reserve officials have made it clear they consider current inflation—a mere 0.6 percent core rate in October—too low to be consistent with the Federal Reserve's mandate of full employment and price stability (Bernanke 2010a). For the first time the Federal Reserve has made explicit that its *mandate-consistent inflation rate* is about 2 percent.

Do central banks have the tools to prevent or reverse deflation?

Some observers have concluded that when the central bank's policy rate falls to zero—its practical minimum—monetary policy loses its ability to further stimulate aggregate demand and the economy...this conclusion is clearly mistaken. Indeed, under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero. (Bernanke 2002)

The latest quantitative easing is therefore best seen as a way to underline the Federal Reserve's *credibility* in setting a target for inflation and inflation expectations. Figure 2 provides intriguing circumstantial evidence for the effectiveness of this approach: after falling all year, inflationary expectations (as measured by bond spreads) swung upward right after Mr. Bernanke's August 27 speech. Eggertsson (2008) provides evidence that the U.S. recovery from the Great Depression was driven by a change in expectations, following the Roosevelt ad-

Box 1. “Competitive Devaluation” and the End of the Gold Standard in the Great Depression

In their classic study of U.S. monetary policy, Friedman and Schwartz (1963) put the main blame for the Great Depression of the 1930s on a mistaken, excessively tight stance by the Federal Reserve. As the Depression became worldwide, many countries were forced out of the global fixed exchange rate regime known as the gold standard. A common, traditional interpretation of these competitive devaluations is that they were counterproductive beggar-thy-neighbor policies that only worked by taking international markets away from other countries.

Scholarship over the last several decades has largely corroborated Friedman and Schwartz's emphasis on the importance of monetary factors in the Great Depression, but not the traditional interpretation of competitive devaluation (Bernanke [1993]; Eichengreen and Sachs [1985]; Eichengreen [1992]; Eichengreen and Irwin [2009]). The newer research instead emphasizes the role of the gold standard itself in initiating and propagating the global slump. Faced with an enormous shortfall in aggregate demand and persistent deflation, countries on the gold standard had no independent monetary policy instrument with which to reflate economies. Countries that abandoned the gold standard earliest—that is, devalued—also experienced earlier recovery from recession, not only because of stronger exports, but also because they had more room to expand money supply and cut interest rates. Meanwhile countries that stuck with the gold standard were also the ones that—in desperation—resorted most to protectionism as a way to try and boost demand. The optimal policy response to the Great Depression, in this view, should have been a coordinated, unsterilized devaluation against gold by all countries suffering deflation. In effect, this would have been a coordinated global monetary easing, but without the beggar-thy-neighbor effects on trade.

ministration's 1933 decision to abandon the gold standard and reflate the price level to pre-Depression levels.

Implications and Options for Developing Countries

The U.S. policy of renewed monetary easing has both potential benefits and costs for developing countries. Among the benefits would be to help push back the risk of deflation that is stalking much of the advanced world. Averting stagnation or renewed recession in developed economies and in world trade would be a major plus for developing countries, whose economic cycles remain closely correlated with those in the developed world (Canuto 2010; Canuto and Giugale 2010). A second major benefit would be to greatly reduce the threat of protectionism in the advanced world, particularly in the United

States. The most plausible scenario for advanced country protectionism would be precisely a long period of deflation and economic stagnation, as in the 1930s.

The U.S. push for monetary stimulus does create adjustment problems in the rest of the world, however. In principle, the adjustment issue should be relatively easier in other developed economies that are also experiencing high unemployment and are threatened by deflation. In this situation, there could be a rationale not so much for a currency war as for a co-ordinated monetary easing across developed economies to help ward off deflation while also reducing the risk of big exchange rate realignments among the major developed economies (Portes 2010).

The case is more complicated for most developing countries, which are experiencing much stronger growth and *inflationary* rather than deflationary pressures. In this situation, the U.S. easing poses more difficult policy choices by creating added stimulus for capital flows to developing countries, flows that have already been surging in 2010, attracted both by high short-term interest rate spreads and the stronger long-term growth prospects of developing countries.

In pure form, there are three macro policy alternatives available to developing countries.

The first is the option that a growing number of developing countries have been gravitating toward in the aftermath of the emerging market crises of the late 1990s, which is to pursue independent monetary policies that target their own inflation and activity levels, combined with relatively flexible exchange rates and open capital accounts. Given rising inflation pressures, the appropriate monetary policy in many developing economies at present would likely be to tighten, which will however attract even more capital inflows and further appreciate exchange rates. Sustained appreciation raises concerns about loss of competitiveness and the sometimes contentious structural adjustments in the real economy that may then be required. Rodrik (2009) also argues that undervalued real exchange rates have long been a key development strategy because of the implicit subsidy they provide for modern tradable goods industries, which, in Rodrik's view, have unique growth-enhancing properties. So countries may also fear that large appreciations will undercut their long-term growth potential. A standard recommendation for countries in this position is to tighten fiscal policy as a way of reducing upward pressure on local interest rates and the exchange rate.

A second pure option would be to maintain a fixed exchange rate peg and an open capital account while ceding control of monetary policy as an independent policy instrument. This approach tends to suit smaller economies that are highly integrated both economically and institutionally with the larger economy to whose exchange rate they are pegged. It is less appropriate for larger developing countries, such as China, whose domestic cycles may be quite out of sync with the economy to which they

are pegged. In this situation, importing loose U.S. monetary policy will tend to stimulate excessive domestic money growth, inflation in the goods market, and speculative bubbles in asset markets. In this case, adjustment will occur through high inflation (with its attendant efficiency and equity costs) and appreciation of the *real* exchange rate. Countries may attempt to avert some of these consequences by issuing domestic bonds to sterilize balance of payments inflows. But this course also has disadvantages, for example, fiscal costs and a tendency to attract yet more capital inflows by pushing up local bond yields.

Countries may therefore be tempted to adopt a third option and try to combine an independent monetary policy with a fixed exchange rate by closing the capital account through capital controls.² Such controls may sometimes be a useful temporary expedient, but they are not unproblematic, especially in the longer term:

- Capital controls are only likely to be effective in conjunction with other supportive macroeconomic policies to form a consistent policy package.
- Evidence suggests that the effectiveness of capital controls is of limited duration, so they are best used when the surge of capital inflows is deemed to be temporary.
- The effectiveness of controls depends on how extensive they are, whether the country has the necessary administrative enforcement capacity, and on the incentives investors have to circumvent them. Circumvention is usually easiest and most lucrative the more sophisticated financial markets are in the recipient economy.
- Evidence suggests that capital controls may be more effective in changing the composition and the maturity structure of capital flows than in affecting the overall magnitude of the flows.

Table 1 lists some of the main types of capital controls and some evidence on their varying effectiveness. There is some evidence that prudential measures that include some form of capital control (such as a limit on bank external borrowing) may be effective in reducing the volume of capital inflows, though their relevance depends on whether inflows are being channeled through the banking sector, on the prevailing macro-financial conditions, and whether banking sector fragility is a significant concern. Foreign exchange taxes can be somewhat effective in reducing the volume of flows in the short term, and can alter the composition of flows toward longer-term maturities. Unremunerated reserve requirements can also be effective in lengthening the maturity structure of inflows, but their effectiveness diminishes over time.

Few countries follow one of these three regimes in pure form, and there is no regime that is necessarily correct for all countries at all times. In practice, most developing countries combine the three in varying proportions, achieving, for example, some (less-than-perfect) monetary autonomy combined with a "managed" flexible exchange rate.

Table 1. Effectiveness of Capital Control Measures

Types of capital controls	Volume of inflows	Composition of inflows
Foreign exchange tax	Can somewhat reduce the volume in the short term.	Can alter the composition of inflows toward longer-term maturities.
Unremunerated Reserve Requirements (URRs): Typically accompanied by other measures		Have been effectively applied in reducing short-term inflows in overall inflows, but their effect diminishes over time.
Prudential measures with an element of capital control	Some evidence that prudential type controls can be effective in reducing capital inflows.	
Administrative controls: These are sometimes used in conjunction with URRs	Effectiveness depends largely on existence of other controls in the country.	

Source: Ostry et al. (2010); IMF (2010b).

It is interesting to contrast two major developing economies as points on this continuum. China represents a point with limited exchange rate flexibility, backed by heavy exchange market intervention, low domestic interest rates, and some capital controls. China is also experiencing the inflationary pressures in goods and asset markets predicted by theory. By now the potential macro-management benefits of greater exchange rate flexibility and more monetary autonomy are well appreciated by Chinese policy makers. But the macroeconomic regime has also become intertwined with deep structural imbalances—high investment relative to consumption, corporate profits relative to wages, industry relative to services—each buttressed by vested interests and a complex political economy. Policy makers are also concerned about the size and duration of transitional unemployment caused by a downsizing of the tradable goods sectors. Thus the move toward macroeconomic policy reform and more exchange rate flexibility in China, while inevitable, is also likely to be protracted.

Brazil, on the other hand, is an example of flexible exchange rates, autonomous monetary policy and high international financial integration, and is now experiencing a big exchange rate surge and pressure on competitiveness. A rising current account deficit is raising concerns about the risk of a crisis later, in the event of a sudden stop in capital inflows. In this situation it is understandable if the authorities turn to some combination of exchange market intervention, sterilization, and capital controls to try and at least moderate or smooth the pace of appreciation. More fundamentally, Brazil may need to tighten fiscal policy to cool overheating and reduce incentives for capital inflows. Deepening of capital markets and strengthening macro-prudential and financial regulation can help improve the efficiency of capital allocation and reduce the risk of a build-up in financial fragility, while better safety nets will reduce the costs of transitional unemployment. Again, many of these reforms will take time to implement.

Conclusion

The current U.S. monetary easing is a useful insurance policy against the risk of global deflation. But it is increasing pressure on developing countries to move toward greater monetary policy autonomy and exchange rate flexibility, as well as to undertake the institutional and structural policies needed to underpin such flexibility. Such reforms take time. What is needed in global forums such as the G-20 is not necessarily immediate radical action, but rather immediate incremental action, backed by credible commitment to substantial progress over the medium term. This is needed as much from developed as from developing countries, for example, with continued advanced country macroprudential and financial sector regulatory reform that can help reduce the risk and improve the quality of capital flows to developing countries.

Endnotes

- For statements regarding the “global imbalances” perspective, see, for example, Roubini (2010) and Dadush and Eidelman (2010). For the “deflation hawk” perspective, see, for example, Wolf (2010), Eichengreen and Irwin (2010), and Hamilton (2010).
- For further details see Ostry et al. (2010) and IMF (2010b).

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