The G-20 Calls a Truce in the Currency War

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A specter of a lost decade is haunting the United States and China. With its core inflation rate eerily tracking the path of Japan's in the 1990s, the U.S. faces the risk of falling into sustained disinflation, if not deflation.[1] Persistently high unemployment, combined with the ongoing financial crisis, makes the situation in the U.S. potentially worse than it was in Japan, which managed to maintain employment and social cohesion during what was often called "a happy recession." China fears that a rapid appreciation of its currency would precipitate mass unemployment and bankruptcies, as Premier Wen Jiabao warned on October 6 at the EU-China Business Summit in Belgium. China is also determined not to fall for "Plaza Accord II" and repeat Japan's mistake—namely, agreeing to a drastic revaluation of its currency, adopting loose monetary policy to buffer the exchange rate shock, turning a blind eye to rapidly rising asset prices, and waiting for firms and financial institutions to grow out of their problems in the wake of the asset price collapse. These fears and anxieties provide the backdrop of the debate on quantitative easing and the undervaluation of the Chinese yuan, two key issues that have framed "the currency war" of the past several weeks.

A two-speed recovery in the increasingly integrated global economy further complicates the picture. While leading emerging economies are currently faced with the risk of overheating, advanced industrial nations, including those with reserve currencies, are concerned about falling back into recession. If leading emerging economies put on the brakes, global aggregate demand would be reduced, with an adverse effect on external demand for advanced industrial nations. On the other hand, if the United States and other reserve-currency countries resort to quantitative easing to fight deflationary pressures, a substantial part of the increased money supply is likely to "leak out" overseas in search of higher yields. As IMF Managing Director Dominique Strauss-Kahn noted in Shanghai on October 18, massive capital flowing into emerging economies could lead to "exchange-rate overshooting, credit booms, asset-price bubbles and financial instability." And emerging economies may have to adopt capital controls to help moderate the vast flows. To manage the two-speed recovery and promote "strong, sustainable and balanced growth" around the globe, macroeconomic policy coordination is more needed than ever before.

As much as international coordination is critical to recovery, however, it is far more important to get domestic policy right by crafting political consensus. Even in this age of globalization, large economies—whether advanced or emerging—still derive most of their aggregate demand domestically, and a country like the U.S. finds it difficult to narrow its output gap (estimated by the Congressional Budget Office to be 6.3 percent of potential GDP in the second quarter) unless its domestic demand recovers. At the same time, due to the liquidity-trap conditions, loose monetary policy is likely to be largely ineffective in generating additional demand. Under these circumstances,

[1] See Mary Daly, "Fed Views," Economic Research Department, Federal Reserve Bank of San Francisco, October 14, 2010, last figure in the article, available at: http://www.frbsf.org/publications/economics/fedviews/fv20101014.pdf.

advanced industrialized nations with high unemployment and underutilized capacity should adopt a greater fiscal stimulus designed to create jobs and improve infrastructure at home, to crowd in private-sector investment after households and firms repair their balance sheets and recover their business confidence.[2] The widely publicized second underwater tunnel connecting New York City and New Jersey may be an example of a productivity-enhancing infrastructure project that would support employment and aggregate demand. Unfortunately, the U.S. and other advanced industrialized nations instituted a rather insufficient fiscal stimulus even though the bond market has been signaling with extremely low interest rates that the U.S. and other advanced economies should undertake much more aggressive fiscal expansion.[3] In particular, advanced industrialized nations should do more to reduce high unemployment, which has such a corrosive effect on consumer confidence and business sentiment. If prolonged, "structural" unemployment will become a self-fulfilling prophecy as workers' skills depreciate.

China and other leading emerging economies must deal with exactly the opposite kinds of problems faced by the U.S. and other advanced industrialized nations. When the global financial crisis of 2008 broke out, many emerging economies saw their currency values plummet as investors took flight to the so-called safe-haven currencies—with some selling their assets in emerging markets to make up for the losses they suffered in advanced industrialized nations. Maintaining capital controls, China put a halt to the appreciation of the yuan, which had risen by 21 percent over a three-year period since the adoption of a currency basket system in July 2005. With the stabilization of global financial markets and faster recovery in emerging economies than in advanced industrialized nations, currency values now have to readjust. Exporters in emerging economies, who have become used to making easy money, may not welcome the prospect of currency revaluation, but emerging economies facing inflationary pressures should take steps to avoid overheating. They should not be afraid of making this adjustment. China suffered no economic catastrophes when the yuan gradually appreciated by 21 percent from 2005 to 2008. If anything, it became an economic powerhouse over this period. Going back further, Korea used the currency revaluation and wage increase in the late 1980s as an opportunity to upgrade its industrial structure. Similar adjustments, in coordination with major economies, could be mutually beneficial.

The G-20 finance ministers and central bank governors met in Korea's ancient capital of Gyeongju in late October to address these policy challenges. They agreed to "move toward more market determined exchange rate systems that reflect underlying economic fundamentals" and "pursue the full range of policies conducive to reducing excessive imbalances and maintaining current account imbalances at sustainable levels." They also agreed that persistently large imbalances would warrant "an assessment of their nature and the root causes of impediments to adjustment as part of the Mutual Assessment Process," in cooperation with the IMF. Although the idea of placing symmetric numerical caps on current account imbalances was floated, the ministers and governors failed to produce specific targets just yet.

[2] Japan offers useful lessons on quantitative easing and fiscal expansion after the collapse of asset prices. Richard C. Koo, chief economist at the Nomura Securities and author of *Balance Sheet Recession*, notes that since the asset prices collapsed in 1990, Japanese households and firms have been deleveraging, despite near-zero nominal interest rates, to repair their balance sheets. Today, the corporate leverage ratio of debt to capital has fallen to 1.78, from 4.05 during the height of the bubble, but "just like the millions of Americans who never borrowed money after the Great Depression, there is tremendous aversion toward debt in Japan, even with zero interest rates." He argues that in the face of deflationary pressures, "Japan has managed to maintain its GDP above the peak of the bubble for the past 20 years because the government stepped in to borrow and spend the surplus savings in the private sector." See Richard C. Koo, "Now Isn't the Time to Privatize Japan Post: Far from crowding out private lending, the bank is crowding in by financing stimulus spending," *The Wall Street Journal*, April 19, 2010.

[3] The target indicator for fiscal consolidation, the debt-GDP ratio, has both a numerator and a denominator, and it does little good for the ratio if GDP rises more slowly than debt in the process.

This agreement represents a major accomplishment in policy coordination as it enables the G-20 to move beyond the narrow focus on the yuan-dollar nominal exchange rate and adopt a fair, gradual and multilateral approach to global imbalances. First, the agreement recognizes that both excessive surpluses and deficits should be fixed, subject to country-specific factors such as natural resource endowment and the asymmetry between reserve-currency and non-reserve-currency countries. In fact, it calls on advanced economies, including those with reserve currencies, to be "vigilant against excess volatility and disorderly movements in exchange rates." Also, the agreement implicitly acknowledges that while the exchange rate is an important variable, it is not the only variable that affects the savings-investment balance. It explicitly recommends "fiscal, monetary, financial sector, structural, exchange rate and other policies" to deal with imbalances. Second, instead of calling for a big-bang adjustment, the agreement has a medium-term framework to deal with persistently large imbalances, "assessed against indicative guidelines to be agreed." Third, the agreement recognizes the danger of politicizing global imbalances as a bilateral problem between the U.S. and China and instead defines it as a multilateral issue to be resolved through the Mutual Assessment Process.

Some critics, however, have argued that the agreement lacks teeth and needs specific numerical targets to be effective. Although the behind-the-scene bargaining over numerical targets is likely to be intense,[4] there is a good chance that the G-20 will agree to indicative guidelines by the time of the Seoul Summit on November 11-12. As for "teeth," the fundamental problem is that you cannot name and shame great powers because they are shameless and powerful. The effectiveness of the IMF surveillance work and the Mutual Assessment Process will be limited to that extent. However, it will be still useful to have a multilateral mechanism that considers both excessive deficits and surpluses as problems, and provides the basis for gradual (not glacial) adjustment. In fact, it is worth noting that one of the major factors that triggered the currency war was the slow adjustment of the yuan in the months following China's announcement to increase its flexibility on June 19, just before the Toronto G-20 Summit. When the yuan appreciated by only 1 percent over the next three months, the economic issue of exchange rate adjustment turned into a much larger problem of *trust* and China had to face increasing pressure from other countries to keep its word as another G-20 Summit approached. Although great powers always have the option of ignoring other countries, the holding of summits and ministerial meetings at regular intervals ensures that the G-20 is far more likely than stand-alone international organizations to follow through on the members' commitments.

The recent G-20 agreement does not force its members to adopt all the necessary macroeconomic policies or resolve their domestic political problems, but at least it helps to shift the policy focus away from the yuan-dollar nominal exchange rate and to larger and more fundamental issues. As such, the agreement qualifies as a step forward. With international coordination taking shape, it is now up to individual nations to craft domestic political consensus to get their policy right.

[4] In its initial discussions with the U.S., China and others, Korea used the standard 5 percent of GDP threshold for current account imbalances. At Gyeongju, U.S. Treasury Secretary Timothy Geithner was reported to be interested in setting the cap at 4 percent. As Gavyn Davies, among others, has noted, a cap of 5 percent catches only Germany among the top 10 economies at the moment, but 4 percent gets China as well as Germany; whereas 3 percent catches the U.S. and Japan as well. Interestingly, it was not China, but rather Germany, Brazil and Japan who led the opposition to numerical targets at Gyeongju. In fact, Yi Gang, deputy governor of China's central bank, stated on October 9 that the Chinese government aimed to reduce the current account surplus to 4 percent of GDP or below over the next three to five years.