

The G-20 and the Currency War

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At their meeting on October 23 in Gyeongju, the G-20 finance ministers agreed to recommit to more market-determined exchange rates and refrain from competitive devaluations. At a time when the “currency war” theme has captured imaginations, this is a welcome pledge. But it does not solve the issue for the G-20.

On the face of it, every country seems to be aiming at a depreciation of its currency—or at least at avoiding an appreciation: Japan with unilateral foreign exchange intervention; the U.S. and the U.K. through large-scale purchase of government bonds; China through keeping an almost fixed link vis-à-vis a depreciating U.S. dollar; and emerging countries all over the world through an array of techniques to discourage capital inflows or to ward off their effects on the exchange rate. Only the euro area seems to be bucking this trend, as the European Central Bank has taken the first steps toward an exit from exceptional crisis measures and has allowed a rise in the short-term interest rate. But even it cannot be indifferent to the risks of appreciation; a persistently strong euro would seriously complicate the economic adjustment under way in countries under stress like Spain, Portugal and Ireland.

This looks familiar. Indeed, it took two years after the crash of the 1930s, from October 1929 to September 1931, for Britain to sever the pound's link to gold and set in motion a currency war. One country after another went off gold, in effect trying to export its unemployment. But it became evident that everybody cannot have a weak currency at the same time and a major lesson from the 1930s is that one of the roles of the multilateral system is to prevent futile beggar-thy-neighbor depreciation.

Two years have passed since the climax of the financial crisis in September 2008. It would seem the same chain of events is being set in motion, with the same delay. This reading is, however, too simple as it ignores two significant asymmetries within the world economy.

The first asymmetry is between the U.S. and the euro area, with the United Kingdom lying appropriately in between. Both have suffered a major financial shock and a major recession. But at this stage of the recovery, policy courses are set to diverge for a series of domestic reasons. The extent of private deleveraging that remains to be done is definitely larger in the United States. In addition as a result of the surprising productivity surge in the U.S. over the last two years, which has not taken place in Europe, the employment situation is much worse, whereas tolerance for unemployment is much lower. The Europeans are more pessimistic about the crisis-induced damages to the supply side, implying a lower perceived amount of slack. Finally, the Greek sovereign debt crisis and tensions over the Irish, Portuguese and Spanish debts have strengthened Europe's concern over public finances, whereas the most likely outlook in the U.S. is a persistent stalemate. In years to come, there will be much more emphasis on supporting the demand side in the U.S. and this is bound to imply a lower U.S. dollar vis-à-vis the euro. The new round of quantitative easing known as QE2 is just part of this broader picture.

The second asymmetry is between the advanced and the emerging worlds. True, both have suffered from the crisis but not at all in the same way. According to the IMF's latest forecast, this year real output in the advanced countries will still be below

the 2007 level, whereas it will be 16 percent higher in emerging and developing countries. Looking ahead, advanced countries are set to continue to struggle with the fallout of the 2008 crisis and the dire state of public finances. The IMF also reckons that the advanced countries need to cut spending or increase taxes by 9 percentage points of GDP on average over the current decade if they want to bring the public debt ratio to 60 percent of GDP by 2030. The emerging countries, however, only need minor consolidation to keep their debt ratio at 40 percent of GDP. This implies that the ability of advanced countries to generate domestic demand is likely to be diminished for several years to come, whereas nothing of this sort applies to emerging and developing countries. Here again, an asymmetry of this magnitude would in any sensible model require a significant adjustment of relative prices. The relative price of the goods produced in the advanced countries—their real exchange rate—needs to depreciate vis-à-vis the emerging countries in order to compensate for the expected shortfall in internal demand.

Thus, there is an unambiguous need for a double real exchange rate rebalancing, both within the advanced countries group and between it and the emerging countries group.

The first one is taking place. There has been significant volatility in the dollar-euro exchange rate; the dollar first appreciated as it played the role of a safe haven, then it depreciated, then it appreciated again at the time of the euro crisis and it has been depreciating for a few months now. But as capital flows freely across the Atlantic, any change in expectations about the future policy course is instantaneously reflected in the dollar-euro rate.

But the second rebalancing is not happening. Compared to July 2007, at the onset of the crisis, exchange rates between advanced and emerging countries have not appreciated. On the contrary, they have depreciated. At first sight, this is not easy to assess because we are used to monitoring exchange rates vis-à-vis the U.S. dollar, which itself is a volatile yardstick. But it is possible to compute an

effective exchange rate between the major emerging economies and the major advanced economies that takes for each emerging country a trade-weighted average of its exchange rates vis-à-vis the main advanced countries, and then averages over emerging countries. In September, this index was down more than 20 percent with respect to July 2007, both in nominal and in real terms. So the adjustment that needs to take place has in fact not happened at all. After the failure of Lehman Brothers in September 2008, most emerging countries suffered from sudden capital outflows that depreciated their exchange rates and this has not been fully corrected. Furthermore, several important emerging countries target their exchange rates vis-à-vis the U.S. dollar, which is now the weakest of the three major currencies.

It is easy to understand why the adjustment is hampered. For each central bank, the question is not what happens to the emerging countries group as a whole but what happens to its own currency vis-à-vis competitors. Brazil does not want to appreciate vis-à-vis other Latin American countries, Thailand does not want to appreciate vis-à-vis other Asian countries and no one wants to appreciate vis-à-vis China. At the same time, China's export regions fear that a yuan appreciation would lead labor-intensive industries to migrate to Vietnam or Bangladesh. So each and every emerging country resists appreciation individually. This is a typical collective action problem, whereby a change that is in the common interest is hampered by lack of coordination among the players.

Ultimately, economic logic is going to prevail and the emerging currencies are going to appreciate in real terms. The difference is that if the nominal exchange rate remains unchanged, advanced countries will have to go through a protracted period of low inflation or even deflation, which will make the debt burden even harder to bear, and emerging countries will have to enter an inflationary period as capital will flow in, drive up reserves, increase money supply and consequently result in a price increase. For both sides, it would be much more desirable to let the adjustment take place through a change in the nominal exchange rate.

What this analysis implies is that the traditional controversy over the Chinese exchange rate policy is by no means a bilateral U.S.-China trade issue but a bigger global macroeconomic problem between the advanced and emerging countries. This is not to say that the yuan issue is second-order because it is not. But its importance does not come from the trade imbalance between the U.S. and China rather it comes from the fact that Beijing holds the key to a global adjustment involving most of the advanced and emerging world.

One of the primary tasks of international organizations is to help solve collective action problems.

The G-20 and the IMF did this at the time of the global recession. The IMF should also take the initiative on the currency front by proposing to the G-20 a conceptual framework for fact-based discussions, by providing an objective assessment of the adjustments that are needed and by facilitating settlement within the multilateral framework. Neither the IMF nor the G-20 can substitute for governments that need to make choices in their national interest. But they can help considerably in the search for a solution.