Currency Wars and the Emerging Market Countries

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The headlines shout "currency wars". The United States believes China engages in "currency manipulation". It hesitates to declare this to the U.S. Congress, and the secretary of the Treasury says "competitive non-appreciation" instead. China accuses the United States of excessively loose monetary policy, flooding the world with liquidity. There is some truth in both charges, but some exaggeration.

This is one of the key issues facing the G-20. Exchange rate pressures, global imbalances and rebalancing, spillovers and the desirability of policy coordination—these are at the center of the economic interdependence between the developed and emerging market countries (DM and EM). All this is in the context of a weak American recovery from the Great Recession, the risk of deflation, and the likelihood of more quantitative easing by the U.S. Federal Reserve. These domestic issues and the inability to get direct action on exchange rates has led the United States to propose targets for current account imbalances. The wheel goes around, and these proposals bear some resemblance to those of Keynes at Bretton Woods, which the United States then opposed.

Policies such as these cannot be assessed properly without an underlying analytical framework. In the current discussion, the furthest this has gone is evocation of the "trilemma": the impossibility of simultaneously maintaining open capital markets, nominal exchange rate stability and monetary policy autonomy. (We hear little of the "inconsistent quartet", which adds trade openness to these three —but protectionism is indeed a potential weapon in the currency wars, and we must not disregard that threat.)

Policymakers in both DM and EM are aware of the trilemma, but they are not fully conscious of the international repercussions of quantitative easing (QE) by the largest economies when they are at the zero lower bound (ZLB) for interest rates. This note will explore these issues.

The U.S. dollar has in fact already experienced a real effective exchange rate depreciation of over 10 percent since early 2009, almost bringing it back to the low of early 2008. The Federal Reserve Bank of St. Louis has calculated that much of this is due to QE: the Fed's $1.725 trillion asset purchases resulted in a 6.5 percent depreciation of the dollar. The Bank of England has estimated that its QE resulted in a 4 percent depreciation of sterling. So domestic QE does seem to have substantial international implications.

But the October 23, 2010 communiqué by G-20 finance ministers from their meeting in Gyeongju, South Korea, while condemning "competitive devaluations", avoids direct discussion of this spillover of monetary policy—which some might call a "competitive devaluation":

Specifically, we will…

- continue with monetary policy which is appropriate to achieve price stability…
- move towards more market determined exchange rate systems that reflect underlying economic fundamentals and refrain from competitive devaluation of currencies. Advanced economies, including those with reserve currencies, will be vigilant against excess volatility and disorderly movements in exchange rates…

As long as QE does not lead to "disorderly" exchange rate changes, the monetary authorities can ignore its international effects. I will examine whether this view is justified.

What is happening on the ground? The Bank of Japan has intervened to limit appreciation of the yen and may do further QE. The Bank of England is actively considering additional QE beyond the £200 billion asset purchases it has already made. The European Central Bank seems reluctant to expand its balance sheet still further, but it may be forced to buy more Greek, Portuguese, Irish and Spanish bonds if the markets turn against any or all of these sovereign debtors. And if the euro were to appreciate substantially against the dollar, threatening the weak European recovery, the political pressure on the ECB for some form of intervention would be hard to resist. Meanwhile, the only uncertainty about further QE by the Fed is how much and at what speed.

China, for its part, continues to resist both political and market pressures for more rapid nominal appreciation of the yuan. The East Asian countries that have effectively pegged to its currency (or nominally to the U.S. dollar) stand firm. Others have experienced substantial appreciation (Indonesia, Malaysia, Thailand and Korea). Brazil had a massive appreciation in 2009 and imposed a transactions tax on capital inflows, which has just been raised. Since the inflows have continued, intervention has accumulated large reserves, monetary aggregates are rising rapidly, while inflationary pressures have led to interest rate increases. Thailand has also imposed a tax on foreign holders of domestic securities, and Indonesia is considering capital controls. Singapore has widened its exchange rate band. Countries from Israel to India and South Africa are facing similar pressures: capital inflows, exchange-rate appreciation and inflationary risks.

Monetary expansion in the DM has confronted the EM with the trilemma. If they resist currency appreciation, they lose monetary control and get inflation and asset price bubbles (as well as political pressure over trade competitiveness). The alternatives are equally unpalatable: reverse the trend of the past two decades toward freeing capital markets and thereby encouraging financial development; or accept exchange-rate appreciation and loss of competitiveness. The conventional prescription is to permit the appreciation—after all, it raises real incomes and competitiveness is underpinned by rapid productivity growth—and switch away from export-led growth to more reliance on domestic demand. But many countries, China most vocally, are concerned that significant appreciation will hit marginal exporters, slow growth and create unemployment.

In this context, we now explore the implications of QE, first in a small open economy (SOE), then for a big country, then for a set of big countries. We assume the interest rate is constrained at the zero lower bound, there is a "liquidity trap", economic activity is weak and there is some threat of deflation.

In the SOE, when the central bank brings the interest rate to the ZLB, the exchange rate depreciates. At the ZLB, the monetary authorities can threaten to intervene or actually do so to keep the exchange rate down. In this case, the weak currency is not "competitive devaluation"—it is just a normal part of an easy monetary policy. In any case, for a SOE, there is little effect on the rest of the world (RoW). And if the monetary easing raises domestic demand, including demand for imports, that is good for the RoW. Hence, there is no beggar-thy-neighbor aspect of policy.

Now consider a single large open economy. The analysis is due to McCallum (2000) and Svensson (2001)—the latter proposed the "Foolproof Way" of avoiding deflation and restoring growth in Japan. The authorities need to create inflationary expectations, and they must accept a short-run inflation rate above their long-run target. So they should go to a price level target, with a jump: bring down the exchange rate, if necessary with (unsterilized) intervention. This also expands the monetary base and their holdings of (typically) short-term

foreign government securities (U.K. and Germany). If the exchange rate does not depreciate, then the markets do not expect inflation—the policy has failed, or the extent of intervention has been inadequate and should go up. It is very important to note that this is *not* QE; the authorities are not purchasing domestic long-term assets.

There are spillovers, of course, and they are beneficial. Escaping the liquidity trap at home does not hinder the RoW from achieving their monetary policy objectives, unless they too are in a liquidity trap. And if they are, then expansion in the home country (escape from the liquidity trap) raises the world natural rate of interest and hence alleviates the RoW liquidity trap.

Now move to a world of big countries, all at the ZLB. Ideally, all should inflate in a coordinated fashion, so that exchange rates are not affected. Uncoordinated policies could bring currency volatility. This destabilizes markets, creates a highly uncertain environment for business and raises pressures for trade policy interventions. With simultaneous QE, there might not be first-order effects on the exchange rates between the big countries. And simultaneous QE could achieve simultaneous expansion, which would have first-order effects on the natural rate of interest, helping to restore more normal monetary conditions.

Although simultaneous QE in all big economies might wash out in exchange rates, there are also many SOEs—including the EM countries. What happens in such a world? Some of the additional liquidity in the QE/ZLB economies flows to countries with higher interest rates. Their currencies appreciate, and expected appreciation attracts more capital flows. (Yes, the carry trade is indeed profitable, uncovered interest parity is violated.) Global liquidity goes up, foreign exchange reserves rise in those smaller countries which intervene to try to resist appreciation. The big economies are exporting bubbles to the RoW. But global rebalancing should be achieved by raising consumption in the RoW, rather than investment in financial assets and real estate.

Meanwhile, if one large economy does not participate (*e.g.*, the euro zone), then its currency will also appreciate, with accompanying political and trade tensions. And volatility between exchange rates of large countries is more harmful than if it is confined to small countries.

Here, it is very important to see that simultaneous QE is not the same as simultaneous exchange-rate intervention. In the latter case, central banks will typically hold reserve increments in foreign *short-run* debt (as noted above). If all do this, the net effect is that of domestic open-market operations in short-dated government securities. At the ZLB, these securities are perfectly substitutable for money. There is a liquidity trap, so exchange-rate intervention at the ZLB achieves nothing—whereas QE does seem to have an impact on both interest rates and exchange rates (see *e.g.* Joyce 2010).

If the large DMs do more QE, however, then the flow of liquidity to the EMs may force them to respond. They may try to resist exchange-rate appreciation by intervening in the foreign exchange markets. Here we do have competitive devaluation—the "currency wars". And if the EMs do not sterilize the intervention, or if sterilization is at least partly ineffective, then they experience inflationary pressures. So capital controls look tempting—but experience suggests they may not be very effective.

This is why we see statements like "the U.S. will win this war"; it will either inflate the rest of the world or force their exchange rates up against the dollar (Wolf, 2010). But there is a potential downside for the U.S. Substantial dollar depreciation will weaken the global position of the dollar, as it did in the late 1970s (see Chinn and Frankel, 2007).

Now consider fiscal austerity at the ZLB. Suppose one large economy implements a fiscal contraction with all countries at the ZLB. Normally, Mundell-Fleming would say that fiscal contraction lowers the interest rate, hence brings exchange-rate depreciation, hence contraction abroad (and at home too, where the increase of net exports does not fully compensate for the fall in net government

expenditures). But at the ZLB, there is no effect on the interest rate, so no depreciation through that channel. But there is still a risk premium in the uncovered interest parity condition. Expected depreciation equals the risk premium, then where this is the combined risk premium on the exchange rate and on the interest rate bonds. Then all depends on whether austerity raises confidence: does the risk premium rise or fall with expectations of future economic activity, and how does austerity affect those expectations?

If fiscal consolidation does not raise confidence in the home economy, then the RoW takes a double hit: a fall in activity in the home economy and exchange-rate appreciation against it. How might the RoW respond? Exchange-rate intervention—another salvo in the currency wars!

So what policies may we expect, and what will be their consequences? Bergsten (2010) and Gros (2010) have proposed "unconventional" ways in which the U.S. might try to force China to allow faster appreciation of the yuan. Bergsten suggests "countervailing currency intervention", in which the U.S. would buy yuan in response to Chinese purchases of dollars. But this supposes that China's capital controls can be circumvented—possible for marginal flows, but not for the $1 billion per day that China is currently buying. Gros suggests that the U.S. and Japan, which has complained about Chinese purchases of Japanese government bonds, could "limit sales of their public debt henceforth to only include official institutions from countries in which they themselves are allowed to buy and hold public debt". But this could apply only in the primary market—the secondary market for U.S. government debt is wide-ranging and anonymous, not likely to be controllable in this way. And even if it were feasible, the interest-rate and exchange-rate effects of such a policy, not to mention the response to such "financial protectionism", are sufficiently unclear as to make it highly risky.

The Fed will proceed with QE. It will not accept foreign constraints on its monetary policy. Its decisions will be determined by its view of how best to achieve its mandated goal: maximum employment with price stability, which the chairman has just defined as "about 2 percent or a bit below" (Bernanke, 2010). He also observed that actual inflation was significantly lower. There is nothing in the mandate about effects on the RoW except insofar as these effects might feed back onto economic activity and inflation in the U.S. They might, for example, if Fed policy were to affect the currency composition of EM central bank portfolios. If a major further expansion of the Fed's balance sheet were to provoke a shift out of dollar assets, U.S. Treasuries in particular, that would indeed affect U.S. interest rates and the dollar exchange rate. But so far, the Fed's policymakers, including the chairman, have shown no concern for this possibility.

The markets, however, do respond. "Brazil's benchmark Bovespa stock index hit a new high for the year on Friday as U.S. Fed Chairman Ben Bernanke said current economic conditions warranted further monetary policy easing" (Reuters, October 15, 2010). And if U.S. monetary policy eases further, it will get the exchange rate depreciation that it wants—it will indeed win the currency wars. The U.S. can, after all, devalue the dollar. But there are costs: a wave of trade protectionism is not excluded, although low probability; more likely are capital account protectionism, in the form of EM capital controls; and damaging exchange-rate volatility, including among the large countries, if QE is not coordinated (simultaneous). Moreover, in the longer run, this could substantially weaken the hegemony of the dollar in the international financial system.

John Connally, then U.S. Treasury secretary, famously said the dollar is "our currency, but your problem." Like most aphorisms, the obvious truth in this remark conceals complexities: the "exorbitant privilege" that accrues to the issuer of the major international currency is not to be conceded lightly. And the consequences for EM and the global economy of a shift to multi-polarity in international finance, like the shift of weight toward EM in global growth and economic impact, will be very far-reaching.

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