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Session 2. Tensions and New Alliances: the Currency Wars

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Introduction

The concept of "currency war", coined by Brazil's Finance Minister Guido Mantega in September 2010, is indicative of the tensions that pervade the international landscape at the current juncture. Indeed, in the past months, a number of countries have engaged in direct interventions in the foreign exchange markets or adopted some forms of capital controls.

Let me offer a few thoughts on these issues.

If we look back at the developments in the international monetary system over the past 30 years, we see that among advanced economies the era of competitive devaluations has come to an end. By the end of the 1990s, a large body of research had emerged pointing out the conflict between intervention in foreign exchange markets and the commitment of monetary policy to price stability. In the United States, the doubts about the effectiveness of sterilized interventions prompted their abandonment some time after the Mexican crisis. In Europe, the adoption of a single currency put an end to the realignments that had characterized first the "Snake" and then the first two stages of the European Monetary Union.

Currency interventions in these economies are now made only in case of excessively rapid and large fluctuations. In the years from 1981 to 1997 the Federal Reserve intervened 453 times, more than 30 interventions per year on average. In the last 12 years, in contrast, it has intervened only twice, on September 2000, when the euro had reached a record low against the dollar, and on 18 March this year, in the aftermath of the earthquake that hit Japan. The European Central Bank has intervened only four additional times, in September and November 2000. Japan has been somewhat more reluctant to abandon currency interventions, because of the continuing upward pressures on the yen in the face of a troubled slow-growing economy. Yet, after 2004, it has intervened only twice, on September 2010 and this year in the days following the earthquake.

The determination of exchange rates between the dollar, the euro and the yen has been thus left entirely to market forces. Fluctuations have been large: over the past 20 years the ratio between the minimum and the maximum value of the dollar-euro and dollar yen exchange rates was almost 2:1. But the large size and the high level of economic development of these economies make them resilient to currency fluctuations, as the exchange of goods, services, and financial assets mostly occurs within each area, while the presence of deep forward and futures markets facilitates currency hedging.

This situation contrasts with that prevailing in emerging economies, where policy measures to managing the exchange rate have been the norm. The desire to limit the effects of large swings in exchange rates on the real economy, and the difficulty of insuring against them, were certainly an important reason. But there are other reasons as well. Perhaps the most important is that managing exchange rates allowed countries to pursue a strategy of export-led growth. Moreover, especially after the Asian financial crisis, the wish of building up large precautionary reserves has played an important role. These policies, as we know, favored the building up of the large imbalances between surplus and deficit countries, which provided the economic precondition for the international crisis.

In the aftermath of the global crisis timely and internationally coordinated policies were fundamental to avoid a new Great Depression. Crucially, and in sharp contrast with the experience of the 1930's, there was no large-scale recourse to protectionism or to competitive devaluations. To be sure, an underlying demand for protectionist measures has never been muted, as globalization represents a threat for monopolistic rents, and inevitably increased with the crisis. Not surprisingly, during the crisis, 17 of the G20 countries introduced protectionist measures, despite the pledge to avoid them signed in November 2008 by the G20 leaders. However, most of them were very narrow in scope and their impact on the volume of international trade has been negligible.

Fundamentally, countries are now more aware that they are interdependent through supply chains and imported inputs. Moreover, as it often is the case, many protectionist measures, including the so-called "*Buy America*" provision, appear to have been circumvented. Furthermore, WTO agreements now provide greater legal stability for trade relations. The quick recovery of international trade following the end of the Great Recession owes a lot to the fact that the world has avoided currency and commercial wars.

The current situation

Overall, a cooperative environment prevailed. Overtime, however, with the recovery taking ground the situation has somewhat changed. Today the danger that an uncooperative game could gradually gain ground is much more material than only a couple of years ago. A number of features of the present global conditions are behind this risk.

First, the recovery is very uneven. This implies that domestic economic policies are confronting very different conditions at home and are thus moved by different, not necessarily consistent, objectives. With the notable exception of Germany, economic growth remains feeble in the advanced countries, too slow to help redress seriously weakened fiscal balances and unemployment rates. Expansionary policies have exhausted their margins of maneuver. The need to end the exceptional support to the economies provided by fiscal and monetary policies in the last three years is undisputed. Absent action, debt sustainability problems and higher global long term interest rates are a certainty.

In emerging economies, there are instead signs of overheating, with rising inflation and strong credit creation. Some monetary policy tightening has taken place but real interest rates remain very low or even negative in many countries. Capital inflows are for many countries back at the high pre-crisis pushed by global monetary and financial conditions that remain very accommodating. Monetary authorities are refrained from increasing interest rates further by the fear of spurring larger inflows. As a consequence capital controls and other prudential measures are used, which may provide relief in the short term but also generate distortions over longer periods.

Second, the recent experience has confirmed that the world has become multi-polar, with emerging markets representing a new pole of autonomous growth. However, we have not yet moved to a multi-polar monetary system. One important reason is that countries are at very different stages of financial development. The demand for advanced economy assets remains very strong and the dollar is still at the center of the system. Strong capital flows to emerging economies are natural and even desirable as these economies offer the highest perspective returns, but in many countries they continue to be exceeded by capital outflows into advanced-economy debt, especially into the US.

Third, macroeconomic imbalances are increasing again after a temporary retrenchment during the crisis mainly due to a depressed demand in deficit countries. They reflect a continuation of the unbalanced pattern of savings across the globe and make the international landscape much

more vulnerable to the risks of sudden reversal in market sentiment and risk appetite and/or changes in the interest rate cycle.

This situation of the international monetary system is bound to generate suboptimal outcomes and, especially, risks to the global financial stability. The existence of one major reserve currency can make exchange rate fluctuations more abrupt; at the same time it limits the scope for markets to discipline macroeconomic policies in advanced deficit economies (especially the US). Thus far only limited realignment of exchange rates in emerging market economies with large surpluses took place. The pegging of exchange rates to the dollar affects the exchange rate of third countries away from fundamentals. In emerging market economies with flexible exchange rates and open capital accounts, large capital inflows have pushed up their exchange rates, in some cases into overvaluation territory (for example, in Latin America). The insufficient adjustment of exchange rates and of macroeconomic imbalances may lead to disorderly policy reactions and encourage beggar-thy-neighbor policies.

The way forward

The priority for the international community is to avoid that current disequilibria degenerate in a disorderly adjustment. We need determined action in a number of fields.

First and foremost, a rebalancing of global demand is key for a sustainable recovery. Advanced economies need to tackle the debt problem: fiscal consolidation and reduction of leverage in the private sector, must be accompanied by structural reforms aimed at spurring potential growth. In large fast-growing emerging markets, especially in China, excessive saving should be curbed; this implies a gradual shift away from a purely export-led model that must be supported by a correct set of policies, including introducing social safety nets in order to facilitate the reallocation of workers across sectors and reduce precautionary savings. More currency flexibility can support the rebalancing of demand. In large surplus emerging economy, most notably in China, allowing the currency to appreciate gradually by not reinvesting surplus funds into advanced economies' assets would also help to reduce inflationary pressures.

Second, a more sustainable pattern of global demand can be reached only by reinforcing international cooperation and multilateral surveillance. An important step in this direction was made at the 2009 Pittsburgh Summit, where the G20 pledged to work together to set the world economy on a path of strong and sustainable growth. The G20 "Framework for Strong,

Sustainable, and Balanced Growth" and the "mutual assessment process" (MAP), are crucial to identify common objectives and the required actions to reduce imbalances. It is indeed a demanding task as the Seoul Summit last year and the current process within the G20 this year have shown.

Third, even in the most favorable scenario a rebalancing of global demand will take time: macroeconomic imbalances and the associated large capital flows across major economic areas will continue for some time. They must be financed in an orderly manner. The reform of the global financial system remains essential to be able to rely on a more solid and efficient financial sector than we had in the past.

Fourth, while the credibility of the WTO rule-based system has survived the recent global recession, current agreements still leave too many domestic markets (particularly in services) effectively insulated from the beneficial pressures of foreign competition. It must be avoided that the delay of a successful conclusion of the current round of multilateral trade liberalization — the Doha Round — leaves a hole that would be probably filled in by less efficient and less equitable bilateral trade agreements.

Concluding, I do not think there is an explicit currency war, but the risk of diverging and uncoordinated national policies, focused exclusively on an internal dimension and short term objectives, is becoming more worrying. We must make our policies more global, more aware of the need of taking into account the impact they have on each other. The international community has shown to be able to work together to avoid a collapse of the global economy. Now it has to prove that it is able to do the same even at a time when the emergency is behind us, but we are still confronting very serious challenges.