

Le monde dans tous ses États

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The new currency controversy

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Brazilian Finance Minister Guido Mantega aptly captured the spirit of the time in October 2010 when he first spoke of a *currency war* in a context where the US had introduced a second round of quantitative easing and emerging countries were struggling to cope with hot-money inflows. Nine months later, in July 2011, he reiterated his point, saying that there were “struggles between countries” and that the global currency war was “absolutely not over”.²

The expression is reminiscent of the 1930s, when the major currencies relinquished the Gold Standard in an uncoordinated way. It took two years after the crash, from October 1929 to September 1931, for Britain to sever the sterling’s link to gold and pave the way for an all-out currency war. One after the other, countries detached their currencies from gold, in effect trying to export unemployment. But it soon became obvious that not everybody can have a weak currency at the same time. One of the major lessons from the 1930s is that one of the roles of the multilateral system is to prevent futile beggar-thy-neighbour depreciation.

Almost three years have passed since the high point of the financial crisis in September 2008. Is the threat of similar developments a serious one? This note suggests that this reading is too simplistic. The current situation is not one of *beggar-thy-neighbour “war”* between countries all facing similar circumstances. Rather, countries face extremely different challenges and thus the policies carried out to achieve domestic economic goals have to differ. This in turn impacts other countries directly or indirectly through exchange rate developments. But these exchange rate movements can be, and in some important respects are, part of an appropriate response to the asymmetric character of the current challenges. To resist currency adjustments is to attempt to block a necessary response to underlying economic developments.

The existence of asymmetries, however, does not rule out the possibility of *beggar-thy-neighbour* competitive depreciations (or *beggar-thy-neighbour* resistances to appreciation). But it does imply that divergences in policy approaches and the corresponding exchange-rate movements cannot, by themselves, be taken as signs of non-cooperative behaviour. This context renders the surveillance of exchange-rate policies and measures addressing capital inflows particularly delicate.

In this note, I document these asymmetries (section 1), assess their implications for exchange rates (section 2), discuss capital flows (section 3) and conclude with a short overview of the resulting international policy challenges (section 4).

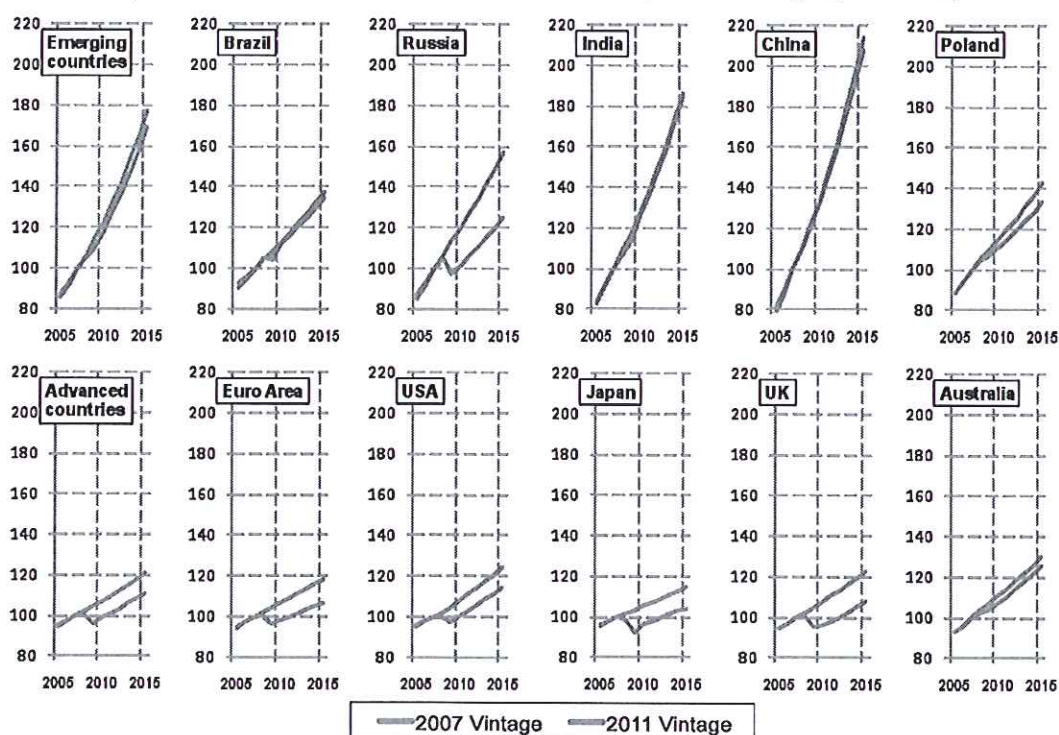
¹ This note draws on, and updates, Darvas and Pisani-Ferry (2010), Gouardo and Pisani-Ferry (2010), Pisani-Ferry and Posen (2010) and Bénassy-Quéré and Pisani-Ferry (2011). I am grateful to Christophe Gouardo for very effective research assistance.

² *Financial Times*, 6 July 2011.

Asymmetries

The global crisis of 2008-2009 has resulted in a deep and lasting asymmetry between advanced and emerging countries. In several advanced countries, private deleveraging remains incomplete while public finances consolidation is only starting, and demand is set to remain subdued for years to come. But the developing and emerging countries have no public deleveraging to deal with and for the time being at least, they remain on a strong growth track. *Figure 1* highlights diverging developments by showing GDP, normalised as 2007 = 100, as seen in October 2007 and in April 2011 for the two main country groups and a few selected countries.

Figure 1: GDP forecasts to 2015: October 2007 and April 2011 vintages (2007 = 100)



Updated from Darvas and Pisani-Ferry (2010) with data from the 07/10 and 11/04 IMF *World Economic Outlooks*.

Most emerging countries were barely hit. Those of Eastern Europe, including Russia, have been. But Brazil, Mexico, Turkey, India and China, to name a few, have not been hit at all and the crisis has not led re-evaluate their longer-term growth prospects. For them, the global shock registered as a temporary blip mostly affecting the export sector. Because their financial sectors were almost totally sheltered from contagion and had not developed in the same way as in the United States and in Europe, domestic demand was not directly affected. By contrast, advanced countries have been hit quite hard on average and examples of full rebound are rare. Australia is one, having not suffered too much from the crisis and having one of the best growth prospects among advanced economies: on top of sound policy responses and a healthy banking sector owing to prudent financial regulation, the country benefited from strong demand for commodities (mostly coal and iron ore) from Asian countries.³ Sweden also is doing comparatively well. But they remain exceptions. Even

³ This likely explains its absence from the currency war dispute despite having a strong currency. Glenn Stevens, governor of the Reserve Bank of Australia, has instead welcomed a stronger exchange rate

Germany, whose performance looks stellar in comparison of those of neighbours, has not rebound fully.

In spite of similar fates during the crisis, there are also significant differences within the group of advanced countries between the euro area, the UK and the US (Figure 2)⁴:

- The same pattern of GDP growth can be observed in all three groups, though with differences as regards the depth of the fall and the pace of the recovery.

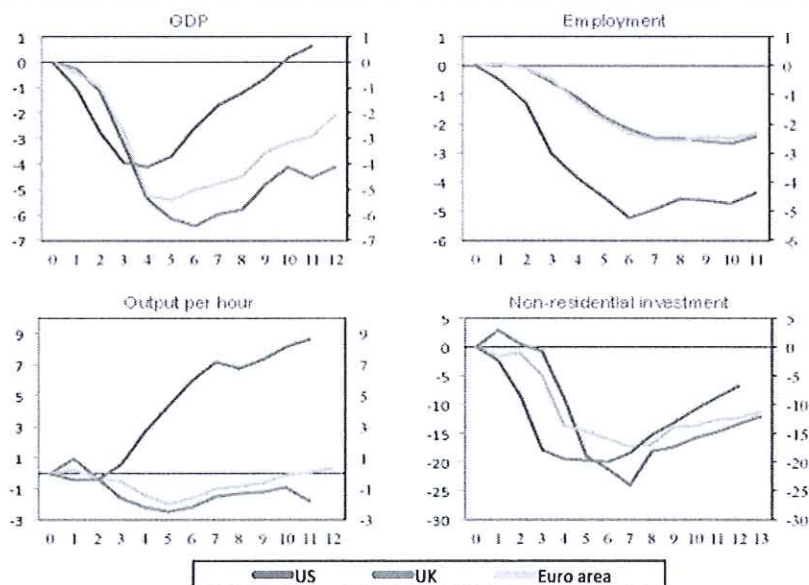
- US employment declined much more than euro-area and UK employment and did not start exhibiting signs of recovery until early 2010. Consequently, the 2008-09 employment decline was exceptionally deep and prolonged in the US whereas in Europe (including the UK) it was not exceptional.

Consistently, productivity developments have been strikingly divergent. In response to the shock, the US has experience a productivity surge whereas Europe has experienced a productivity holiday.

- Investment is recovering faster in the US.

It is not entirely clear why there is such a divergence in employment and productivity between the US and Europe (where the evolutions in the euro area and the UK are remarkably similar). Part of the explanation is that US companies, which are less constrained by firing restrictions, traditionally adjust their payrolls faster than European counterparts. Part is that they started cutting cost earlier, when commodity prices started rising in 2008. Part can be ascribed to the higher incidence of credit constraints in the United States. Part has to do with specific shocks affecting the real estate and finance sectors, which had grown very large in the US. Part finally results from the fact that in response to the crisis, several European governments introduced or strengthened schemes aimed at encouraging job preservation, such as the German *Kurtzarbeit*. However the extent of the divergence and the UK's behaviour – similar to that of continental Europe, despite being closer to the United States in many respects – still remain puzzling.

Figure 2: Impact of crisis in euro area, the UK and the US (% change per quarter from pre-recession output peak)



Updated from Pisani-Ferry and Posen (2011) using data from OECD and Datastream.

⁴ Japan could be added to the comparison. Evolutions there follow a more European than US pattern.

Lastly, the financial crisis caused the level of government debt in the United States, the United Kingdom and in European countries to surge. The IMF projects that the average gross debt to GDP ratio in advanced countries will reach 107% by 2016, up from 73% in 2007. In emerging countries, in contrast, this ratio is expected to fall to 30% of GDP, down from 36% in 2007 (IMF, 2011). Market pressures and more unfavourable long-term prospects are leading advanced countries to implement austerity measures for the years to come, whilst emerging countries have considerable fiscal space.

In this respect also, there are divergences on the two sides of the Atlantic. The US is markedly less keen on consolidation than Europe. Probably as much as to political economy consideration and the benefits from exorbitant privilege, this difference in attitude can be ascribed to differences in beliefs about the economy's capacity to rebound and the magnitude of the unemployment recession in the United States. US policymakers think that most of the output loss is temporary, and that the primary task of policy is to foster employment and growth, whereas European counterparts consider that a large part, perhaps the largest part of the output loss is permanent.⁵ Accordingly, they put emphasis on monetary normalisation and fiscal consolidation.

Exchange-rate developments

The conclusion from the above observations is that there are stark differences of near-term challenges and policy priorities between emerging and advanced countries, as well as (though to a lesser extent) among advanced countries. In any possible model, asymmetries of such magnitude call for asymmetric policy responses that will need to be accompanied for by some form of adjustment in relative prices. More precisely, a normative prescription would call for:

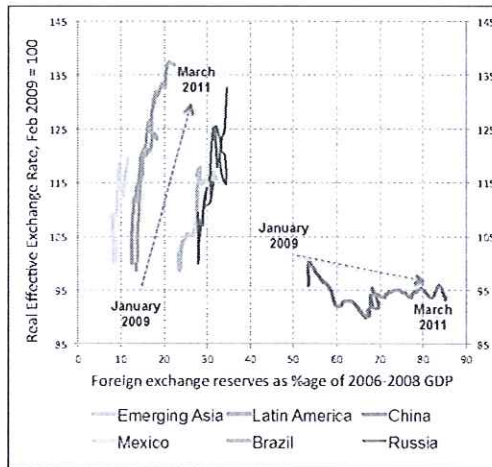
- supportive monetary policies in the advanced countries and a significant tightening in the emerging countries;
- more supportive monetary policy and less aggressive fiscal consolidation in the US than in Europe;
- corresponding exchange rate adjustments, that is, significant appreciation of the emerging currencies *vis-à-vis* advanced countries and, to a lesser extent, appreciation of the euro and the pound *vis-à-vis* the dollar.

Some of it has indeed happened so far: policy interest rates remain at near-zero levels in advanced countries but they have been rising steadily over the past year. As a consequence, at end-June 2011, three-months interest rates were below 1% in the US, the UK and Japan, and they were below 2% in the euro area, but they exceeded 10% in Brazil and Argentina, 8% in India and Turkey, and 6% in China and Russia. Looking ahead, monetary policy is set to remain accommodative for some time in the United States and to undergo a gradual tightening only in the euro area (the UK being more uncertain). However, the corresponding adjustment in exchange rates is being resisted. *Figure 3*, taken from the IMF's February 2011 surveillance note (but updated), shows that whereas Latin American currencies have appreciated significantly in real terms since 2009, the evolution in Asia has been more

⁵ Pisani-Ferry and Posen (2011) provide evidence on this difference in beliefs.

muted. Especially, China (and other Asian countries, to a lesser extent) has been actively accumulating FX reserves.

Figure 3: Real exchange rate adjustments and reserve accumulation in selected countries, 2009-2011

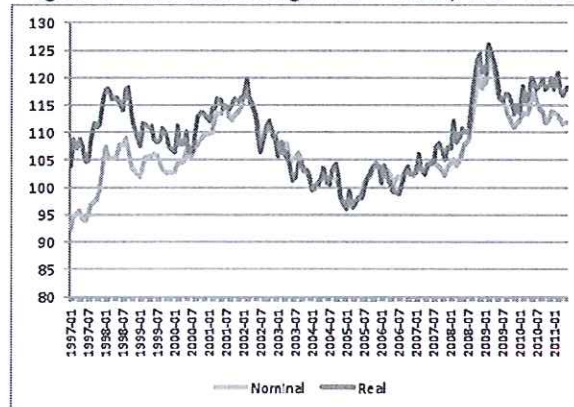


Source: IMF, BIS and authors' calculations

There is collective action problem at the core of this behaviour. For an emerging country, the relevant policy variable is not just the bilateral exchange rate *vis-à-vis* trading partners in the advanced world, but a vector of exchange rates that also includes those of its competitors in the emerging and developing world. Individually, it makes sense for a country to lean against appreciation if it expects its trading partners and competitors to do the same, as similar export structures could lead to lower trade shares. Although the appreciation of emerging countries' currencies might be desirable on an aggregate basis, it requires all of them to appreciate simultaneously and the guarantee that competitors will not deviate. As long as China remains on a quasi-fixed link *vis-à-vis* the dollar, it hampers the overall adjustment of emerging countries' currencies *vis-à-vis* the advanced countries' currencies.

Figure 4 depicts the evolution of China's effective exchange rate as computed by the BIS, from the eve of the Asian crisis to date. The index provides a much better indicator than the usual bilateral USD-RMB exchange rate. It is apparent that effective appreciation has been very limited, both in nominal terms and, importantly, in real terms. Domestic inflation has significantly contributed to real appreciation since 2009 only.

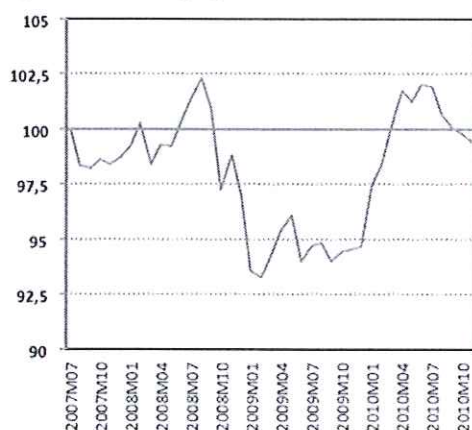
Figure 4: Effective exchange rate of China, 2007-2011



Source: BIS (Broad index – 58 economies)

Empirically, getting a clear picture of the actual extent of actual currency appreciation of emerging currencies as a group and forming a normative judgment are complex, not least because appreciating *vis-à-vis* the dollar – by far the most commonly cited yardstick of a currency's stance – does not signify an across-the-board appreciation with respect to the advanced countries' group. It is, however, possible to construct a simple summary indicator that helps monitor the evolution of exchange rates between the advanced and emerging economies. This indicator is a simple extension of trade-weighted real effective exchange rates for individual countries. To this purpose, Gouardo and Pisani-ferry (2010) have computed a bilateral effective exchange-rate index between advanced and emerging countries (Figure 5).

Figure 5: Effective exchange rate of emerging countries *vis-à-vis* advanced countries, 2007-2010



IMF Internat. Trade Statistics, IMF Internat. Financial Statistics Datastream, National Sources, authors' calculations.

Between July 2007 and September 2008 this index did not change much. In the wake of the Lehman collapse, it registered a sharp drop, consistent with the flight-to-quality episode that occurred in the turmoil of the financial crisis. It remained stable throughout 2009, before indicating appreciation of the emerging countries in 2010. Given the extent of the divergences of outlook, it is unlikely, however, that simply returning to the 2007 level is sufficient. The graph provides evidence of the fact that emerging countries *as a group* did not appreciate sufficiently, at least until end-2010.

On the whole the evidence suggests that currency movements since the crisis have not been commensurate to the magnitude of the asymmetric shock experienced by the world economy. Part of the reason is that the appreciation of emerging countries *vis-à-vis* advanced countries raises a collective-action problem within the emerging countries group. Part is also that it is difficult to sort out the capital inflows that should bring about this appreciation from more volatile, shorter-term capital flows that countries increasingly want to resist.

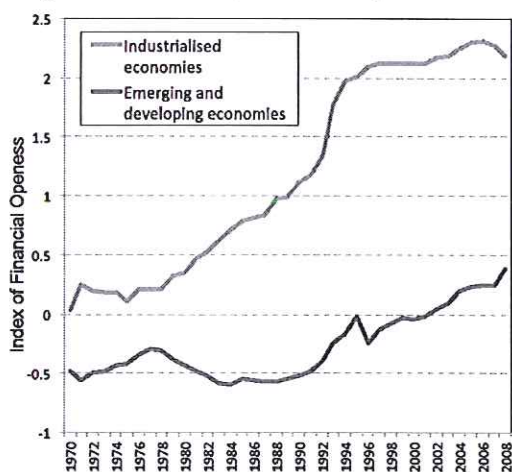
Capital flows

In recent years, emerging economies have been dealing with large-scale, destabilising capital inflows and outflows. Both are problematic:

- *sudden capital inflows* fuel asset price and credit bubbles, and/or trigger appreciation of the country's currency;
- *sudden stops and capital outflows* cause balance of payments crises and sharp currency depreciations, often triggering financial crises.

The liberalisation of international capital flows is relatively recent in emerging countries. Opening dates from the 1990s, a period when it was thought that liberalisation would speed development by giving poor countries greater access to external financing. This pillar of the “Washington Consensus” crumbled after the Asian crisis of 1997-1998, which severely dented support for financial account openness in Asian countries. Although it has significantly increased, it still remains well below what is observed in advanced countries (Figure 6). In East Asia, it has hardly progressed since the end of the 1990s (whereas it has in Eastern Europe and Latin America). The financial crisis has further contributed to the reluctance of emerging countries to open up completely.

Figure 6: Financial Openness Index, 1970-2008



Source : Chinn and Ito (2008), on the basis of IMF notifications.

Admittedly, benefits from financial openness have so far been mixed. It was expected that lower borrowing costs would accelerate capital accumulation and ultimately raise living standards in emerging and developing countries. Benefits have, however, been limited. Private capital flows to emerging economies have been more than offset by official purchases of government debt securities of advanced countries, especially the United States. In the absence of financial openness, these countries would perhaps not have benefited from outside financing but high rates of domestic savings would have preserved investment levels.

Financial openness was also expected to improve domestic portfolio diversification and act as a factor of macroeconomic stability – similar to the role that financial markets play in cushioning regional shocks within the United States. It has on the contrary proven to be a destabilising factor, both economically and financially, even in countries that had carried out reforms of regulation and supervision.

The recent period has once again shown how volatile capital flows between advanced and emerging countries can be. The fall of Lehman Brothers in the fourth quarter of 2008

precipitated large outflows, but capital started flowing back in at a rapid pace because of large interest rate spreads (Figure 7). Many countries have since announced measures to slow the inflow of capital, sparking a debate on whether, and how, capital flows should be managed.

Figure 7: Net capital flows towards emerging economies, 2000-2010 (% of quarterly GDP)



Source: Bénassy-Quéré and Pisani-Ferry (2011), on the basis of IMF data.

Note: positive flows are net capital inflows, excluding central banks.

There are five non-exclusive options for a country facing capital inflows:

- let the interplay of *supply and demand* cause an appreciation of the country's currency;
- *lower interest rates* to reduce the rate of return on domestic assets and halt currency appreciation. Turkey used this response in 2010-2011. It is, however, not entirely straightforward as capital inflows generally nurture credit expansion, which lower interest rates further amplifies;
- *accumulate foreign exchange reserves*. As long as these can be sterilised, this type of intervention has no impact on monetary policy; if they are not, the effect is monetary expansion, with the same effects as if interest rates were lowered;
- *fiscal contraction* may be called upon. In principle, this can be an appropriate course of action but it may not be justifiable from a public finance perspective if requiring sustained budget surpluses;
- *Across-the-board regulatory instruments* may be relied upon to tame the inflow of capital.

To this toolbox should also be added the specific measures a country can put in place to limit the destabilising effects of capital inflows on the domestic economy. The idea that emerging economies - where the rate of return on capital is structurally higher than in advanced countries - could in some case be brought to protect themselves against capital inflows was initially greeted with protest and it is still opposed by some emerging countries, not least Mexico. It has, however, since then gained acceptance even at the IMF (Ostry *et al.*, 2010, 2011) and found an echo in the G-20.

The main difficulty is to define the conditions under which capital controls may legitimately be relied upon. They can indeed be used for other purposes than safeguarding macroeconomic stability: to maintain an undervalued exchange rate, or to preserve an inefficient financial sector from foreign competition, for instance. This means that non-cooperative policies need to be identified and assessed.

One possible approach could be to determine the response to capital inflows lexicographically: first, an appreciation of the nominal exchange rate; then, if the adjustment is too abrupt, reserves may be accumulated within reasonable limits. Lastly, if these interventions are not sufficient, targeted capital controls can be put in place. Macprudential instruments could be considered during each stage to accompany the necessary measures. The implementation of these principles and international consistency would be monitored by the IMF, in cooperation with regional bodies where appropriate.

In recent G20 and IMF discussions, however, emerging countries opposed the adoption of a code of conduct, because it would have treated disciplines for emerging and advanced countries asymmetrically. They maintain that the source countries bear responsibility in capital outflows also and that no code of conduct can be agreed upon if discipline isn't imposed on advanced countries too.

It is difficult, however, to determine which policies are acceptable because they only constitute a –possibly unconventional– response to domestic developments from those whose international consequences are too damaging to be accepted. In normal times, consequences for domestic inflation are a rough but useful yardstick: policies that remain compatible with domestic price stability are likely to be broadly compatible with international stability. This yardstick however becomes less meaningful, and less useful, in times of crisis.

The upshot is that the delicate task of filtering out volatile capital inflows that justify an array of policy should be allowed to result in an appreciation of the exchange rate, is a difficult one on which there is no consensus yet.

International policy challenges

The first message from the above analysis is, again, that the analogy with beggar-thy-neighbour devaluations is misguided. What the world economy is facing is, instead, a major rebalancing which is bound to have implications for exchange rates. An emancipation of the emerging countries' monetary policies and a major appreciation of their currencies vis-à-vis the advanced-countries currencies are unambiguously called for. Also, if the policymakers' beliefs about the impact of the crisis are correct, the appreciation of the euro and the pound vis-à-vis the dollar are also natural responses to the asymmetric character of the crisis. These adjustments should not be resisted. At the same time, however, there are several problems that cannot be ignored.

– It is justified for US monetary policy to remain supportive, and to be more supportive than monetary policies in Europe, but this does not imply that the US can simply overlook destabilising consequences of its policies for the rest of the world.

– In continuing to exhibit reluctance to appreciation, China fails to recognise that the world situation today is fundamentally different from what it was pre-2008 and hampers global adjustment. Its behaviour is creating problems for other emerging economies rather than primarily for the US.

The appreciation of emerging-countries currencies vis-à-vis advanced-countries currencies raises collective-action problems. Overcoming them is likely to require coordination.

– As they are confronted to capital flows volatility, it is legitimate for emerging countries to have recourse to capital controls and/or currency markets intervention when traditional macroeconomic and prudential responses prove ineffective, but international monitoring is advisable as capital controls and interventions can also be used for mercantilist or protectionist purposes.

The challenge for the international community is to design a framework for dealing with the associated discipline and coordination problems. This is a major task that raises many more difficulties than regulatory coordination or the orchestration of a simultaneous stimulus in 2008-2009. The G20's Mutual Assessment Process, which recently resulted in the adoption of an indicators-based approach, and the launch by the IMF of spillover reports for the major economies are significant steps in the right direction. Acquiescence to international oversight however remains low in the world, especially in the US and large parts of the emerging world, and trust in the other partners' intentions and ability to deliver on commitments is in short supply.