A SYMPOSIUM OF VIEWS

Is a Global Currency War Still Possible?

In 1985, with the U.S. dollar soaring in strength particularly against the yen, industrialized world policymakers saw the elements forming for a dangerous all-out trade war. They agreed on what became known as the Plaza and Louvre Accords, efforts at international cooperation to contain currency pressures. Global financial markets responded positively to this emerging international financial statecraft.

With the Trump Administration's imposition of tariffs, that statecraft has all but collapsed. To complicate matters, tariffs, trade, and the financial policing of international capital flows (backed by the dollar's role as the reserve currency) have all become major weapons in America's foreign policy arsenal.

In this new go-it-alone era, the question is whether the world's major non-U.S. central banks, under pressure from their governments, respond with aggressive monetary policies designed precisely for the purpose of weakening their currencies with the hope of making their exports more competitive. After all, the Bank for International Settlements has just proclaimed that monetary stimulus in and of itself can no longer be the "main engine of economic growth." In a world already experiencing tepid economic growth despite negative or close-to-negative real interest rates, what are the chances that currency devaluation (disguised or otherwise) becomes the preferred policy instrument for growth? And how will U.S. policymakers respond if the dollar strengthens significantly as other nations engage in aggressive global monetary stimulus led by the European Central Bank? Will the end result be a twenty-first century currency war?

And will lowering a currency's value even guarantee greater prosperity? What would be the effect of a currency war on global financial markets? On emerging markets? To what extent has the world's prosperity of the last forty years depended on a successful international economic and financial statecraft, the foundation of which now appears to be at risk?

More than two dozen noted experts offer their analyses.

Globalization and multilateralism are in crisis.

ALEJANDRO DÍAZ DE LEÓN
Governor, Bank of Mexico

Trade tensions have become a major obstacle to global economic growth, with significant effects on manufacturing production, investment, and business confidence. Current purchasing manager surveys show that a contraction in manufacturing may already be underway. Disruptions in global value chains have affected the most globally integrated processes and dampened business investment. These adverse impacts have been more severe in economies more open to trade and with large export volumes to the United States.

Markedly weak investment stands out as one consequence of a highly uncertain environment due to trade and geopolitical tensions. In the last few years, particularly in Mexico, these factors have triggered a strong pushback on investment, directly in manufacturing, but also, indirectly, in services.

The baseline scenarios for global growth have already been affected and large downside risks prevail, as a more hostile environment to trade and investment seems to be more permanent. This is especially so since recent trade tensions are related not only to bilateral trade deficits, but also to technology supremacy and immigration issues, as is the case with Mexico regarding the latter factor.

The multilateral institutions, strategies, and approaches put in place since Bretton Woods seventy-five years ago face deep structural challenges. Arguably, globalization and multilateralism are in crisis, both from the heightened pressure from protectionists and nationalist agendas and from the accumulated costs and tensions derived from global imbalances, associated in part with some countries' use of managed exchange rates and export-led growth strategies.

To attain growth and development, market economies need to engage with each other in a mutually constructive, predictable, and evenhanded way. History and theory show that national interests are best served by international cooperation. Multilateralism seeks to find solutions to global externalities through cooperative approaches that improve both national and global outcomes. This can be considered as an effort to procure much-needed global public goods, not only to address old challenges such as an evenhanded and balanced approach to trade, flexible exchange rates, foreign direct investment, and the international financial architecture, but also new ones, such as climate change and more inclusive growth and development.

An issue that has gained increased attention is the role of monetary policy and its implications, spillovers, and tradeoffs for foreign exchange dynamics, trade performance, and growth. An extreme and narrow view considers competitive devaluations, race-to-the-bottom policies, and even so-called currency wars. These arguments misunderstand currency markets and the role of the exchange rate, and may lead to the confusion that monetary policy should set real exchange rate objectives for competitive purposes.

In this regard, history and theory provide ample evidence that monetary policy should focus on attaining low and stable inflation, hence contributing to output smoothing and financial stability, and not on targeting the exchange rate. To this end, central bank independence is of paramount importance in attaining a well-focused, medium-term–oriented monetary policy, with ample and much-needed distance from political cycles.

We must not forget that on the road to development, at both the national and global levels, we need to reconcile individual (national) interests with the common (global) good. History has taught us that short-sighted approaches lead to mirages at best, or extremely painful lessons at worst.

Exchange rates matter far less than they used to, especially in developed countries.

TADASHI NAKAMAE
President, Nakamae International Economic Research

Currency strength, or weakness, is no longer a bellwether of economic performance for developed economies. The global economy is less dependent on trade than it was forty years ago. Exchange rates matter far less than they used to, especially in developed countries.

Take Japan's automobile industry, its top export industry. In 1985, overseas production by Japanese automakers was almost non-existent. In 1990, they produced 3.3 million units overseas, less than a quarter of the 13.5 million units they produced domestically (16.8 million units in all), while selling around 7.5 million cars at home and exporting 4 million.

By 2018, Japan's automakers were producing 20 million units overseas and only 9.7 million units at home (of which only half, 4.8 million units, were exported).

This means currency matters in different ways now. Today a weaker yen bolsters Japanese automakers' yen-based profits from overseas production. But it does not stimulate an industry's (or country's) exports, raise production, or create lots of new jobs at home as it did in the 1980s.

A weaker yen did lead to higher stock prices and asset inflation, although this did not stimulate consumption or investment the way Shinzo Abe, the prime minister and the leader of the Liberal Democratic Party, had hoped.

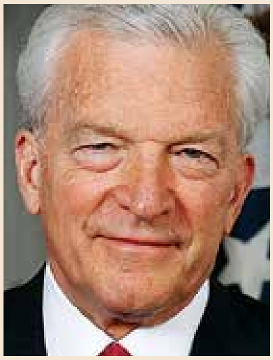
Consider the three years between 2009 to 2011 (inclusive), when the Democratic Party of Japan was at the helm, and the Bank of Japan was run by Masaaki Shirakawa. During this time, the yen strengthened (at an annual rate of -5.2 percent) and prices dropped (the GDP deflator was -1.5 percent). Nominal GDP growth was 0.4 percent, but real GDP growth was much higher at 1.9 percent. Dollar-based GDP grew 5.8 percent (from $5.2 trillion to $6.2 trillion).

By contrast, between 2012 and 2018, after the LDP was back in power, the Bank of Japan, led by Governor Haruhiko Kuroda, loosened monetary policy aggressively as part of "Abenomics." During this period, the yen weakened 5.6 percent. As a result, prices rose 0.6 percent. Nominal GDP grew 1.7 percent but real GDP growth was only 1.1 percent, lower than the preceding years. Dollar-based GDP shrank to $5 trillion from $6.2 trillion in 2012. Meanwhile, per-capita wages and labor productivity stalled.

A weaker currency only works to stimulate or revitalize an economy (at least in any significant way) in emerging countries undergoing rapid industrialization. Even China's dependence on trade has fallen to 18 percent in 2018 from 33 percent in 2007, now that it is near the end of its era of industrialization. These days, China, saddled as it is with cross-border debt, is unlikely to welcome a weaker yuan as it once did.

The real conflict over currency is no longer between countries. In developed countries, a weaker currency no longer helps the economy in the meaningful ways it once did. But the (outdated and inaccurate) perceptions of its benefits still help politically, through promises of raising exports, production, and new jobs. It also helps distract from real, thorny economic issues that are troubling local communities.

There is a growing conflict over weaker currencies, but it is an internal (domestic), and largely invisible one. On one side are the interests of local communities, businesses, and consumers, who, at best, derive little benefit from a weaker currency, or worse, are hurt by currency or trade wars. On the other side are the executives of multinational companies, whose wealth is tied to higher corporate profits and share prices, and thus a weaker currency. The way in which "currency wars" is framed is flawed and distracts from the real and immediate problems of economic polarization, inefficiencies, and inequity within countries today.



The vehicle for a crisis, perhaps deeper than 2008, may be an exchange rate war.

DAVID C. MULFORD

Former U.S. Ambassador to India, and former Under Secretary for International Affairs, U.S. Treasury

The Plaza Accord of September 1985 marked a high point in cooperation and policy coordination between the G5 countries in the evolution of global financial markets. At that time, a consensus was achieved between both surplus and deficit countries in the G5 to cooperate in depreciating the dollar by 40 percent over a period of eighteen months. The G5 decision to cooperate was motivated by fear of a trade war involving the prospect of tariffs and possibly beggar-thy-neighbor exchange rate actions.

Today we face a new situation that could lead to a major international financial crisis. First, unlike in 1985, we already have a trade war which appears to be spreading and deepening tensions.

Second, the G5 has atrophied significantly since the late 1990s, while the G20 group has increased in size and media prominence, while declining in effectiveness.

Third, there are now three separate players in the world who seek to strengthen their respective power in global monetary, financial, and political affairs: the United States, China, and the European Union. There is no small nucleus of leading world powers that is working together effectively outside the spotlight of the global media to resolve issues related to large imbalances in the global economy.

Fourth, no progress is being made, or even attempted, to reform the world's post-Bretton Woods monetary system, or to re-establish a consultative G5 or G7 group of major nations to rebuild the confidence needed to restore constructive economic dialogue.

Taken together, prospects for an "exchange rate war" have strengthened. If trade tensions continue to build, and we experience a recurrence or worse of the 2008 crisis, it would seem that without some improvement in global economic governance and monetary cooperation, an eventual exchange rate war appears to be inevitable.

China is faced with declining growth, severe demographic constraints, structural reform issues, and the disadvantages of authoritarian rule. Slower economic growth, rising indebtedness, and a weakening of its currency will ultimately produce destructive capital flight.

Europe is facing the economic and political fallout of Brexit, the prospect of declining cohesion among its remaining states, and the widening recognition that the euro has been chiefly to the advantage of Germany versus the European Union's other member states.

The United States is not able to re-establish its former position as the world's preeminent leader in trade and monetary affairs. This weakness implies an inability to manage and hopefully control economic and financial conflicts that can lead to destructive results.

Meanwhile, the world's major central banks continue to believe that cutting interest rates—even to negative levels—will enhance world growth, when the evidence of the last decade tells a different story of slowing growth, weakening currencies, and bloated central bank balance sheets.

The vehicle for a crisis, perhaps for a deeper crisis than 2008, may well turn out to be an international exchange rate war.

There are no winners in currency wars.

CATHERINE L. MANN

Managing Director and Chief Economist, Citi

Few central banks explicitly target the exchange rate, but there are many channels through which exchange rates affect economic objectives of growth, employment, inflation, and financial stability. Because these channels differ for countries, and because "excessive volatility and disorderly movements in exchange rates" muddy the waters in which central banks take policy action and wait for outcomes, it is not surprising that G20 communiqués have, in the past, included this language, as well as the more robust "refrain from competitive devaluations."

But things have changed. Central bank policy and exchange rates are now viewed as extensions of trade, investment, and security skirmishes. The G20 Osaka Summit language of June 2019 could only muster a "reaffirm the exchange rate commitments made by our Finance Ministers and Central Bank Governors" from March 2018 (as above). Summit leaders couldn't bring themselves to make any currency commitments themselves.

What are the objectives of a depreciation campaign—and can those who wield the weapon avoid "friendly fire"? A weaponized exchange rate could improve relative price competitiveness, thereby promoting exports, disadvantaging imports, and bolstering real growth and employment. A depreciated domestic currency could underpin macro inflation, via an increase in the cost/price of imported inputs to pass-through to domestic inflation.

What about "friendly fire"? A domestic depreciation combined with mismatched currency exposure on debt raises financing costs and worsens financial stability, with negative consequences for the real economy. In addition, for countries purchasing commodities denominated in dollars, a domestic depreciation would increase the domestic currency cost of commodities, although exporters would enjoy currency-translation gains.

As first blush, it would appear that the United States has the dominant weapon in the dollar, enjoying dollar-denominated trade prices, dollar-denominated international obligations, and dollar-denominated exports of energy products. But the effectiveness of a dollar depreciation via these theoretical outcomes is weakened by longstanding and complex private sector relationships that internalize and stabilize real flows in response to exchange rate movements.

Emerging markets, in particular, seem to be at risk of friendly fire if they try to depreciate their currencies. Countries whose trade is denominated in the dollar appear to have an asymmetric outcome whereby a domestic currency depreciation doesn't improve price or trade competitiveness but does constrain imports, worsening growth as well as posing financial stability issues via currency mismatches and exposures.

But all policymakers and private sector actors will be shrouded in the fog of the currency war—the volatility in financial markets and the disorderly currency environment precipitated by a depreciation campaign, which surely exacerbates current uncertainties to impinge on business decisions, real investment, and economic activity. There are no winners in the currency wars.

The euro area and Japan may be tempted to intervene to weaken their currencies.

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

Economic expansions do not die of old age, but they do die from other causes. Should a trade war or other shock cause a widespread collapse in consumer or business spending, the textbook response is a rapid easing of monetary and fiscal policies. But actual and perceived limits on monetary and fiscal policies in major economies imply that these policies may not be used sufficiently to foster a strong recovery. Policymakers will be tempted to use foreign exchange intervention and capital controls to weaken their currencies and gain export-led growth at the expense of others. Strong collective leadership is needed to avoid currency conflict. The G20 pledge to avoid targeting exchange rates for competitive purposes is a good place to start, but we need to extend this understanding beyond the G20 and agree on sanctions to be used to deter currency transgressors.

Fiscal expansion, which puts upward pressure on a country's currency, has positive spillovers in the context of a global recession. Monetary expansion, which puts downward pressure on the currency, is sometimes viewed as having negative spillovers. But this view ignores the boost to domestic spending, which bolsters imports and roughly offsets the negative spillover from a weaker currency. The true weapons of currency conflict are sterilized intervention in foreign exchange markets and one-sided capital controls, which redirect aggregate demand from trading partners to the intervening country without any offsetting positive effects.

The policy conundrum in the next recession is most apparent in the euro area and Japan. Policy interest rates (and even long-term government bond yields!) in these economies are already negative and lowering them more than another half of a percentage point is not likely to be useful. There is only modest scope for further stimulus through purchases of peripheral and private bonds. Equity purchases could be effective, and Japan is doing a small amount of them, but it is not clear whether large-scale equity purchases by central banks would be politically feasible. Meanwhile, historically high levels of government debt in Japan and several euro-area countries raise political barriers to using fiscal policy forcefully to restore growth.

Policymakers in the euro area and Japan may be tempted to intervene to weaken their currencies in the event of a new recession. However, the world should not condone aggressive currency policies in these or other economies with significant trade surpluses. Rather, the correct policy mix in the euro area and Japan is to use whatever monetary room is left and to use fiscal policy aggressively. In today's world of ultra-low interest rates, which are expected to persist for many years or even decades, governments can manage much higher debt levels than the old rules of thumb envisioned.

China and the United States have considerably more room to ease monetary policy, and they should do so rapidly in the event of a new recession. They also have substantial fiscal space that might be used. If there is any major economy that might be justified in using currency policy in the next recession, it is the United States, which has an unsustainable trajectory of net international debt owing to chronic trade deficits. Correcting the U.S. trade deficit may require a different monetary-fiscal policy mix along with some intervention in foreign exchange markets. But in the event of a global recession, the United States should refrain from direct currency action provided that its trading partners also refrain. Dealing with the U.S. trade deficit should wait until global recovery is firmly established.

Yes, the western world is flirting with a currency war.

HEINER FLASSBECK
Director, Flassbeck-Economics, and Former Director, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development

Yes, the western world is flirting with a currency war. The reason is simple: Most countries have run out of traditional instruments of monetary policy and they are facing a cyclical slowdown at the same time. More and more countries have to rely on unorthodox measures. Devaluation of the currency seems to be an easy way to stimulate a major macroeconomic price when the interest rate is no longer available and expansionary fiscal policy is taboo.

The dangers inherent to this approach are obvious: competitive devaluations will destabilize the system and no one can benefit. President Trump insists on fair trade—whatever he may mean by that—but the Europeans, led by neo-mercantilist Germany, insist that trade has to be "free." The problem is that "freedom" cannot mean freedom (or absence) of any rules and regulations and definitively not absence of any rules concerning currencies.

The problem is a more general one. A large majority of economists defends "free trade" with tooth and claw. Nothing is as sacred to liberal economists as free trade. But the "theory" is based on a questionable doctrine the English economist David Ricardo postulated two hundred years ago. His famous "principle of comparative advantage," according to which it is not the absolute but rather the comparative advantages that matter in international trade, has dominated the discussion. But the idea is unrealistic. Ricardo assumes that everybody and all economies are full employed in a stationary economy. In the real world, however, no economy is ever working at full capacity and without a possibility to increase its capacity. Every producer or national economy, given absolute advantages and free capacities, will use all available absolute advantages, and will not abstain from producing the products where they have an absolute and a comparative advantage.

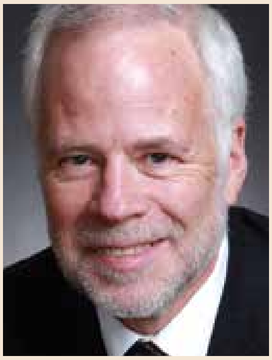
In addition, Ricardo assumes that—at full employment—the remuneration of the workforce precisely reflects the respective scarcity of labor and capital in all participating countries. In reality, however, nominal values are decisive for international trade because, together with currencies (exchange rates), they determine prices. With inflation rates and unit labor costs varying widely between countries, there has to be a functioning mechanism to ensure that widely divergent price and wage dynamics remain closely tied when calculated in an international currency.

However, this is not the case. Currency markets have become the playground of speculators. The relative values of currencies are often driven in the completely wrong direction for years, as speculators "carry currencies" to take advantage of inflation and nominal interest rate differences. In this way, currencies of countries with high inflation appreciate, and those of countries with low inflation depreciate, which is exactly the opposite of what would be necessary to rebalance trade. Brazil is the classical example and it was a Brazilian finance minister who spoke years ago about a currency war.

Trump is also right in insisting that "global imbalances" stand in stark contrast to the free trade doctrine. Surpluses or deficits in trade reflect absolute advantages and should be prohibited. But huge imbalances and huge swings in exchange rates are ignored by many "free traders."

A new world monetary order must regulate monetary relations between the major blocs, and at the same time give smaller countries the opportunity to tie their currency to one of the those blocs. If goods and capital are to move rather freely worldwide, sustainable solutions must be found for rational currency relations between regions, which, for whatever reasons, are not able to achieve rapid convergence in cost and inflation trends.

Without a rational international monetary system, currency wars cannot be avoided. Exchange rate adjustments have to be closely tied to the differences in inflation rates and must not be left to the market. In a reasonable world monetary order, exchange rates must be stable enough to allow rational investment decisions, yet also flexible enough to maintain the international competitiveness of all participating states.



The world's central banks are not gearing up for a currency war.

BARRY EICHENGREEN
George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley

I don't see the "major non-U.S. central banks, under pressure from their governments, respond[ing] with aggressive monetary policies designed precisely for the purpose of weakening their currencies." I see them as loosening conventional and unconventional monetary policies with the goal of bringing inflation up to target, and doing so more aggressively as the economy and inflation rate weaken. The central banks that move fastest and furthest in the direction of loosening will also, more likely than not, see their currencies weaken as a result. But weakening the exchange rate is not their express purpose. It is not their primary objective. Certainly this is not the express purpose or primary objective of the European Central Bank, the central bank at which this criticism has recently been trained.

To the contrary, the danger comes not from non-U.S. central banks but from the United States, and not from the central bank but the Treasury. It is that the U.S. Treasury will use the Exchange Stabilization Fund to push down the dollar, President Trump seeing a strong dollar as frustrating his efforts to enhance the competitiveness of U.S. manufactures and agricultural products on international markets. Trump sees foreign trade in terms of mercantilism. And this use of the Exchange Stabilization Fund would be monetary mercantilism at its worst. Foreign central banks and governments would not regard this favorably; they would see it as an explicit beggar-thy-neighbor policy. Successful international economic and financial statecraft would then be directly at risk—if it isn't at risk already.

I also don't see the warnings of the Bank for International Settlements, mentioned in the editor's query, as particularly pertinent here. Certainly it would be desirable if fiscal policymakers did more of the hard macroeconomic lifting, adjusting fiscal policy in sensible ways to support economic growth and stability. But it makes no sense for central banks to call a sit-down strike, and to refuse to take action to push inflation up toward 2 percent, simply in an effort to get fiscal policymakers to act. We have a technical economic term for such monetary inaction: it's called "cutting off your nose to spite your face."

What should really concern us is not currency wars but the over-reliance on monetary policy.

JASON FURMAN

Professor of the Practice of Economic Policy, Harvard University's Kennedy School, and Nonresident Senior Fellow, Peterson Institute for International Economics

Nothing excites the imagination as much as a war. And for those of us who work in economics where we do not have shooting wars, we have to settle for getting excited about "currency wars." Unfortunately, the term has been stretched so far that it long ago lost any coherent meaning and more often serves to confuse our understanding of macroeconomic policies. More importantly, it distracts us from putting more emphasis on a potentially more fruitful global macroeconomic dialogue around expansionary fiscal policy.

Let's start with the economics. All monetary policy operates through a domestic channel (via wealth effects and the cost of capital) and through an international channel (via exchange rates). Absent capital controls, it is effectively impossible to conduct domestic monetary policy on a sustained basis without affecting exchange rates. Conversely, it is also effectively impossible to affect exchange rates on a sustained basis without changing domestic monetary policy—with the limited and often ephemeral effects of sterilized interventions and cheap talk corroborating this point.

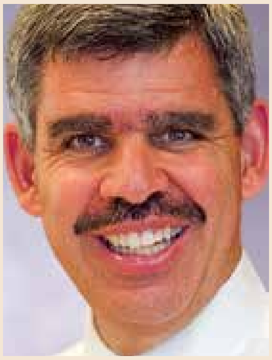
When Brazil in 2010 or the United States today accuses other countries of engaging in a "currency war," they are right in a narrow sense. U.S. policy was weakening the dollar in 2010 and eurozone policy is weakening the euro today. The policies, however, were fully explicable by domestic conditions. In 2010, the United States was in a deep economic hole and inflation was low, and today the eurozone remains below potential with inflation well below its policy ceiling. As a general matter, it would be odd to expect many countries at any time to engage in monetary policies that deviated substantially from their objectives for internal balance.

Moreover, expansionary monetary policy in a home country has countervailing effects on the foreign economy. Specifically, a monetary expansion increases foreign exports through the income effect of stronger demand but reduces them through the substitution effect of a stronger currency. Economists are much less sure of the net sign than are policymakers and politicians levelling charges of "currency wars."

There are limited and very important exceptions to this general logic. Capital controls or reserve accumulation can be used to persistently weaken a currency, driving a wedge between exchange rate policy and monetary policy, as China did for more than a decade after its entry into the World Trade Organization. In this case, international pressure was warranted, possibly even greater than was brought to bear, but ultimately the misalignment of Chinese macroeconomic policy with its domestic considerations, including its desire for stronger domestic demand, was the most important factor bringing about change.

Most of the time, however, the term "currency war" is confused both about the motives of the country that declared war as well as the impact of its actions. This confusion comes at a cost—responding in kind could be feckless (like if the United States had decided to engage in exchange rate intervention) or even counterproductive (like if a country reorients its monetary policy away from domestic goals and toward an exchange rate goal).

Being distracted by imaginary currency wars distracts countries from pushing each other on the more positive-sum macroeconomic policy to combat common shocks: fiscal policy. A fiscal expansion in China in 2005, the United States in 2010, or the eurozone today would strengthen domestic demand in a manner that has unambiguously positive global spillovers. What should really concern us is not currency wars but the over-reliance on monetary policy that has come about, in part, because of exaggerated fears of fiscal expansion.



A "currency war" could be the next stage for a world heading towards greater economic fragmentation.

MOHAMED A. EL-ERIAN
Chief Economic Advisor, Allianz; Chair, President Obama's Global Development Council; and author,* The Only Game in Town: Central Banks, Instability, and Avoiding the Next Collapse *(Random House, 2016)

Absent a change in policy approach by the systemically most important countries, a "currency war" could well be the next stage for a world heading towards greater economic fragmentation, losing economic momentum, and lacking adequate global policy coordination.

The catalyst would be the further depreciation of the floating currencies of open economies, particularly those being negatively impacted by global trade uncertainty. The amplifier—and driver of contagion among countries—would be slowing global growth. And as countries try to offset fragile domestic growth dynamics being aggravated by contractionary trade winds, the tools would involve a mix of unusual monetary policy loosening, competitive devaluations, and perhaps even some explicit market intervention.

As worrisome as all this would be in deepening global economic fragmentation, there's a silver lining associated with this additional cloud hanging over a global economy that already struggles to deliver high and inclusive growth. It's about policy choices.

The big hope is that concern about the spread of beggar-thy-neighbor foreign exchange moves would serve as a catalyst for long-overdue adjustments in domestic policies, as well as for better global policy interactions—both of which would help contain other risks facing the global economy.

The risk is that policies will continue to lag, increasing that dreadful probability of global recession, financial instability, and an erosion in policy flexibility and effectiveness.

There are some worrisome parallels between the 1930s and today.

THOMAS MAYER
Founding Director, Flossbach von Storch Research Institute, and former Chief Economist, Deutsche Bank

There are some worrisome parallels between the 1930s and today. In June 1930, less than a year after the stock market crash of October 1929, the U.S. Congress passed the Smoot-Hawley Tariff Act. U.S. tariffs went up significantly and numerous countries retaliated with tariff increases of their own. In September 1931, the United Kingdom went off the gold standard. Sterling was devalued against gold and the currencies of countries remaining in the gold bloc. Several other European countries followed the United Kingdom only a little later. The gold bloc countries lost competitiveness and their exports weakened, which exacerbated their economic downturn.

In Germany, the depreciation of other European currencies stifled the policy of internal depreciation followed by Chancellor Heinrich Brüning. In 1934, the Roosevelt administration devalued the U.S. dollar against gold, and in 1936 the countries remaining in the gold bloc followed. The 1930s have gone down in history as a period of weak and volatile economic performance with an eventually terrible political fall-out.

Today, we have seen several rounds of tariff increases between the United States and China, and another round between the United States and the European Union could soon follow. President Trump is accusing other countries of trying to weaken their currencies by contemplating an easier monetary policy, and he is putting pressure on the Federal Reserve to counter presumed currency manipulations. If we continue on this path, we may well end up in an environment similar to that of the 1930s, characterized by economic instability, financial fragility, and declining welfare. We can only hope that the political consequences will not be as bad as then.

Consequently, efforts are needed to avoid a repeat of history. If the U.S. administration cannot be persuaded to abandon its 1930s-style trade and currency policies, other countries must create free-trade zones and intensify currency cooperation among them. With the EU countries being the biggest player on the global trading scene, the European

Union needs to take the lead. Earlier this year, the EU-Japan Economic Partnership Agreement entered into force and in July the European Union concluded a trade agreement with the Mercosur countries of South America.

With the European Union having been a long-standing ally and friend of the United States, similar arrangements with China could be seen as taking sides in the U.S.-China battle for global leadership. However, the fact that President Trump regards China—along with Russia and the European Union—as a foe of the United States does not imply that the European Union should also regard China as its foe. Hence, if the U.S. administration intensifies its hostility against the European Union, the European Union may have no other choice than to extend its cooperation pacts also to China. A few southern European countries have already opened the door by embracing China's One Belt, One Road initiative.

I am not convinced that advanced economies are about to enter a currency war.

LORENZO BINI SMAGHI
Former Member of the Executive Board, European Central Bank

I am not convinced that advanced economies are about to enter a currency war for several reasons.

First, experience has shown that it is not that easy for policy authorities to influence exchange rates. Unilateral interventions in the foreign exchange market have very little impact on the relative price of monies. Even when interventions are not sterilized, they hardly succeed in moving markets. The rare episodes of exchange interventions that have had some effect in the past were generally agreed and coordinated between the monetary authorities of the major economies, in particular in the context of the G7, and aimed at correcting some evident mispricing in financial markets. The last time major economies intervened in a coordinated way was in the summer of 2000, to counter a quick and sharp depreciation of the euro against the dollar. The impact was limited and short-lived.

Second, there is currently no evidence of a major exchange rate misalignment with respect to the underlying economic fundamentals of the major economies. Over the last few years, exchange rates have fluctuated within a relatively narrow band, reflecting the different underlying conditions in the major areas. The relative strength of the dollar has been in line with the more robust U.S. recovery and the consequent tighter monetary conditions.

Third, it is not in the interest of the major countries to give the exchange rate a more prominent role within their respective monetary policy framework. This would reduce the degrees of freedom of the central bank and subordinate monetary policy to external conditions. It would dis-anchor market expectations from the national economy and ultimately lead to a higher risk premium on domestic assets.

Fourth, in the current environment, interventions would be interpreted as an attempt to manipulate the external value of the currency. If the U.S. authorities took such an initiative, they would no longer be able to accuse other countries of doing the same, which would undermine the main reason for retaliating through trade measures.

Fifth, intervening in the foreign exchange markets to depreciate the value of the currency would imply accumulating large amounts of foreign exchange reserves, whose value would vary depending on market valuations. This would expose the balance sheet of the central bank to large potential losses, which would lead to a reduction of seignorage, and thus lower fiscal receipts.

Policy authorities do not always act on the basis of a rational analysis of the pros and cons of various measures. It can thus not be excluded that they may at some point be tempted to interfere with market mechanisms and try influencing the external value of their currency. If this were to happen, the sooner they will realize that such an attempt is futile—and possibly even counterproductive—the least damage they will ultimately do.

The world has been in a currency war for about a decade.

WILLIAM R. WHITE
Former Economic Adviser, Bank for International Settlements

Far from "flirting soon" with a currency war, we have been actively involved in such a war for almost a decade. When the U.S. Federal Reserve supplemented lower policy rates with unconventional policy measures in 2010, it led to a reversal of the dollar strength generated by its safe haven status during the crisis. While subsequently continuing in public to advocate a "strong dollar policy," U.S. policymakers actually welcomed this weakness. A lower dollar increases demand for U.S. products and employment and helps raise inflation towards target levels. It also contributes to a lower current account deficit and the associated buildup of external debt. Finally, a lower dollar directly reduces the net value of external debt, since the dollar value of external assets rises as the dollar falls. For the same reasons, the strength of the dollar since 2015 has been found discomforting in Washington.

However, other countries did not welcome the increase in the value of their currencies implied by dollar weakness. Similar to the United States, most also faced problems of inadequate demand, rising unemployment, and below-target inflation. Moreover, increased current account deficits or reduced surpluses constrained export-led growth strategies, pioneered by post-war Germany and Japan and later followed by many others. Finally, the wealth gains generated for the United States by the lower dollar were recorded as losses elsewhere.

Given these concerns, many countries indulged their "fear of floating" by explicit foreign exchange intervention (mainly emerging economies) and/or by mimicking (mainly advanced economies) the policy actions of the Fed. The former was commonly justified by the need to build up foreign exchange reserves, as insurance against future crises, while the latter was justified by continued shortfalls (often decimal point deviations) in meeting domestic inflation targets. Whatever the rhetoric, the end result was global monetary stimulus of unprecedented magnitude.

Given this world of semi-fixed exchange rates, it is also not surprising that the domestic imbalances first seen in the United States subsequently spread out globally. The ratio of global (non-financial) debt to global GDP has actually risen sharply since 2008, with low-quality corporate debt at the forefront. Concerns about future financial stability (and high house prices) now extend to important emerging markets, not least China and India. Evidence of resource misallocations and declining productivity growth is increasingly widespread. These developments might not trigger another global downturn, but they will certainly exacerbate any downturn arising from other sources.

Against this backdrop of potential systemic instability, and the trade war already initiated by the Trump administration, the prospect of explicit foreign exchange intervention by the U.S. authorities might seem relatively unimportant. Indeed, affected countries could always negate its effects by retaliating in kind. Yet it is precisely this prospect of monetary escalation that might finally lead financial markets to start to look for cover from the eventual inflationary implications. While it is impossible to say whether the dollar would rise or fall, many other financial markets seem overstretched. A sudden shift in perceptions could have dangerous implications.

In a sense, a currency war has already taken place.

RICHARD N. COOPER

Maurits C. Boas Professor of International Economics, Harvard University

In a sense, a currency war has already taken place, although I would not call it a "war." As a result of the financial crisis and subsequent recession, the U.S. Federal Reserve lowered the federal funds rate to near zero and pursued three episodes of "quantitative easing," with the aim of lowering long-term interest rates as well. Other central banks emulated the Federal Reserve, which in contrast started raising the federal funds rate by small increments in December 2015. The result has been an appreciation of the U.S. dollar against virtually all currencies during the past five years—influenced also of course by non-monetary developments such as the stronger U.S. economic recovery, the emergence of U.S. production of shale gas and oil, and the desire of investors around the world to put some of their assets into the United States.

The real risk today is not currency war but a tariff war, initiated by Donald Trump, followed by retaliation by U.S. trading partners.

This is the reverse pattern of the disastrous 1930s, where countries first deployed tariffs to generate employment, followed by "competitive devaluation" of currencies, starting with Britain, followed by the United States and others as they left the gold standard and allowed their currencies to depreciate against those still on the gold standard. Germany was an exception: it deployed currency controls to restrict imports, fearful of the impact of currency depreciation on inflation, still a fresh memory from 1923.

There are of course inhibitions to currency depreciation. One, as in Germany of the 1930s, is fear of stimulating inflation and inflationary expectations, particularly in those countries that have finally succeeded in reducing historically high inflation rates during the past decade. A second is fear of bankruptcy of domestic firms with foreign-currency denominated debt, which includes many emerging markets, including China; currency depreciation raises the local currency burden of this debt, without (except for exporting firms) increasing their revenues. Far from increasing growth and employment, such a resulting burden might generate a local recession and unemployment. A third is concern about raising government deficits through the need to service public foreign-currency–denominated debt, possibly creating a balance-of-payments crisis and leading to a need to cut government expenditures and/or raise local taxes, again putting downward pressure on growth and employment rather than stimulating them.

Again, the real concern today should not be over "currency wars" but over an unraveling of the world trading system through tit-for-tat increases in tariffs along with emulation by other countries less fortunate than the United States in enjoying a robust economy.

Currency manipulation adds nothing to a nation's prosperity.

TIM CONGDON
Chairman, Institute of International Monetary Research, University of Buckingham

If currency depreciation were the key to boosting a nation's international competitiveness, Argentina and Venezuela ought to be models of successful economic policy. After all, the international values of the Argentine peso and the Venezuelan bolivar are fractions of what they were a decade ago, and the devaluations must have given an immense boost to their export industries.

U.S. President Donald Trump complains that the latest easing of eurozone monetary policy—announced by European Central Bank President Mario Draghi on June 18, 2019—reduces the value of the euro against the dollar and so constitutes unfair competition for American companies. But in truth, any easing of monetary policy by any central bank other than the U.S. Federal Reserve could have that effect.

If the world's central bankers were to take any notice of Trump's Twitter rhetoric, they would be in a state of permanent paralysis. As Olli Rehn, the current governor of the Bank of Finland, noted a day later, euroland monetary policy is set in accordance with the state of the eurozone economy and not in order to alter the euro's value on the foreign exchanges.

In theory, the Federal Reserve could retaliate against the European Central Bank by slashing the Fed funds rate and driving the dollar lower. But the Fed—like the European Central Bank—has for decades emphasized the domestic requirements of the American economy in setting interest rates. Coordinated attempts by the leading nations to manage exchange rates, such as the Plaza and Louvre accords in the mid-1980s, have been the exception, not the rule, in high-level policymaking.

Serious students of international economics know that currency manipulation adds nothing to a nation's prosperity. The central banks of Argentina and Venezuela cannot teach the Fed or the European Central Bank about how best to conduct monetary policy. But the Bundesbank—still the intellectual powerhouse in European monetary policy—does have lessons for everyone concerned about taking the best policy decisions.

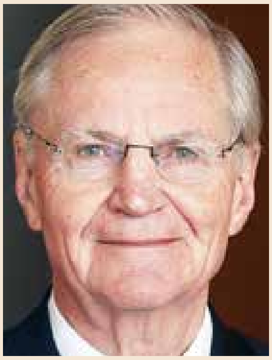
In the post-war decades, Germany belonged, like other industrial countries, to the Bretton Woods system of fixed exchange rates. But in the early 1970s, the Bundesbank became worried that American monetary policy was too loose, particularly after the suspension (actually, the end) of the dollar's convertibility into gold in August 1971. It wanted to keep down the growth of the quantity of money in order to prevent inflation.

The Bundesbank realized that its actions would have an impact on the foreign exchange markets, but gave priority to domestic price stability. In March 1973, it broke the link with the dollar and allowed the deutschemark to find its own value against other currencies. The Bundesbank's decision to let market forces work led to a sharp upward movement in the deutschemark.

German industrialists might have objected that the more expensive deutschemark would handicap them in world markets, but they were relaxed about their international competitiveness and appreciated the value of low inflation to wider economic stability. They continued to produce high-quality goods at acceptable prices, so that German exports grew with little interruption.

Further, German inflation stayed down, whereas inflation in the United States (and Britain and Italy, and far too many other countries, all with falling currencies on the foreign exchanges) accelerated to intolerable levels.

The Bundesbank's commitment—then and later to domestic price stability—made it the world's most admired central bank in the second half of the twentieth century.



Rumors of war? Yes. Actual war? No.

WILLIAM R. CLINE

President, Economics International Inc., and Senior Fellow Emeritus, Peterson Institute for International Economics

The most explicit form of currency warfare is aggressive intervention to prevent appreciation despite a large external surplus. In 2006–2007, the U.S. current account deficit reached 6 percent of GDP, China's surplus reached 10 percent of GDP, and China intervened massively to prevent appreciation of its currency. But China's current account surplus is now only 0.4 percent of GDP, heading toward slight deficit by 2022, and its reserves have fallen from a peak of $4 trillion in 2014 to about $3 trillion.

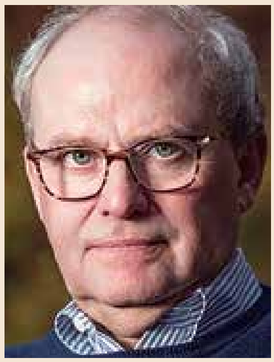
It is much more questionable to charge currency warfare if there is no intervention, but depreciation nonetheless occurs as a consequence of monetary stimulus to an economy with high unemployment. Foreign complaints in 2010 that the United States was conducting a currency war through quantitative easing missed the point that recovery of the U.S. economy would boost U.S. imports from the rest of the world by more than associated easing of the dollar would reduce them.

The U.S. current account deficit is no longer particularly high. A key change is that, thanks to the fracking revolution, the oil trade deficit has fallen from 2 percent of GDP in 2006–2012 and 1 percent in 2013–2015 to only 0.3 percent in 2016–2018. The International Monetary Fund projects the current account deficit at 2.4 percent of GDP this year, virtually identical to the average for 2010–2018 as well as the average projected for 2020–2024.

Nor is the dollar extremely high. The Federal Reserve's broad real index is only 2 percent above the average for October 2016 to May 2019 and only 1 percent above the January-February base used in the IMF's benign projections. Although the real index stands 16 percent above its average 2006–2012 level, the 2 percent of GDP improvement on oil trade warrants a 12 percent appreciation from that period. In part because of the decline in interest rates paid on U.S. debt held by foreigners, the capital income surplus has risen by about 0.4 percent of GDP over the same period, justifying an additional 2 percent rise in the real exchange rate.

President Donald Trump has accused the euro area and China of manipulating their exchange rates lower. Although the European Central Bank is indeed on the verge of further monetary easing, the United States has also reversed its tightening. The gap between the ten-year rate for U.S. Treasury bonds versus German bunds is actually lower now (247 basis points at end-July) than a year ago (252 basis points).

As for China, in the absence of the trade war there would be little prospect of the currency falling below the sensitive threshold of ¥7 yuan per dollar (even though it has fallen from a peak of ¥6.1 in mid-2015 to ¥6.9 in June). China has ample reserves and no incentive to spur capital flight by allowing pronounced depreciation. The trade war raises the risk that China will use depreciation as a form of retaliation, but that circumstance should not be conflated with a generalized currency war.



Currency wars no longer appear likely.

ANDERS ÅSLUND

Senior Fellow, Atlantic Council, and author,* Russia's Crony Capitalism: The Path from Market Economy to Kleptocracy *(2019)

U.S. President Donald Trump is a true mercantilist straight out of the eighteenth century, having as little understanding of modern economics as of the rule of law. His emotional imposition of tariffs on countries and products depending on his latest rage appears to be impeding international trade and thus global growth.

Since the 1980s, however, the global monetary system has changed so much that currency wars no longer appear likely. Two major changes have disarmed the monetary system. The weapons for a currency war are no longer at hand.

The first change is that all major economies now have floating exchange rates. A real currency war presupposes that countries can devalue and set a lower exchange rate.

Today, few countries can do so. The biggest economy with a fixed exchange rate is probably Saudi Arabia. China controls its exchange rate, but it is not fixed. The very weapon for a currency war is missing. Central banks can cut interest rates and pursue quantitative easing to debase a country's exchange rate, but it is so much less palpable than a real devaluation of a currency.

The other big change is the establishment of the eurozone. In the early 1990s, big devaluations in Britain and Italy brought havoc to the European Monetary System. These violent devaluations were major reasons for the establishment of the euro. Thanks to the euro, Italy is firmly imbedded in the euro system and it can no longer devalue, while Britain has adopted a floating exchange rate, as have as all other major economies.

The problem is Trump's inability to understand the reasons for the patently large U.S. current account deficit. The first reason is that the U.S. dollar is the world's dominant reserve currency, accounting for almost two-thirds of international currency reserves. That means that the United States has a chronic current account deficit of perhaps $300 billion each year.

The other reason for the large U.S. current account deficit is the vast U.S. federal budget deficit of nearly $1 trillion, although the United States has effectively full employment. Much of those funds can only flow abroad. Increased tariffs cannot reduce the current account deficit. They can only redistribute that deficit to other countries.

It is time for an "Asian Plaza Accord."

RICHARD C. KOO
Chief Economist, Nomura Research Institute, and author,* The Other Half of Macroeconomics and the Fate of Globalization *(2018).

Economists have long preached that while free trade creates both winners and losers in a country, society as a whole benefits because the winners' gains are far greater than the losers' losses, especially when some of the gains can be redistributed to the losers. What they did not tell us, however, was that a nation's trade account must be largely balanced or in surplus for this conclusion to be valid.

In the United States, which has been running massive trade and current account deficits since the early 1980s, the number of people counting themselves among the losers from free trade has grown steadily. By November 2016, this group had become large enough to elect the openly protectionist Donald Trump as president. And this was not just a Trump phenomenon: The Democratic Party nominated Hillary Clinton to be its presidential candidate in an arena filled with hundreds of signs saying "No to TPP." A world in which a generous United States helped the global economy by purchasing foreign products and running large trade deficits has proven itself to be no longer sustainable.

In the new and potentially conflict-ridden era we now find ourselves in, how the surplus countries who have benefitted from the U.S.-led free trade system respond is absolutely crucial. If they want to avoid a 1930s-like breakdown in global trade and maintain access to the U.S. market, they must act consciously and decisively to reduce the number of Americans who think they have been hurt by free trade.

To meet this tall order, China, Japan, South Korea, and Taiwan, which account for 60 percent of U.S. trade deficits, should band together and revalue their currencies by 20 percent against the U.S. dollar in what might be described as an "Asian Plaza Accord." By acting together, they can push their currencies much higher than if they acted individually because intra-Asian trade will not be affected. It would be even better if ASEAN countries, which together account for another 13 percent of the U.S. trade deficit, could be brought on board. Such an adjustment should reduce both U.S. trade deficits and the number of Americans who view themselves as losers from free trade. Although these four countries have various political issues among themselves, working together may allow them to solve their trade problems with the United States, which is one thing they have in common and which would be difficult to address individually.

In this forum, *TIE* has reminded its readers how bad protectionist pressures were in the United States just before the Plaza Accord was signed in September 1985, when the exchange rate was 240 yen to the dollar. By the time the Louvre Accord was signed in February 1987, the rate had fallen to 150 yen to the dollar and protectionism was no longer an issue in Washington. Instead of allowing the highly unpredictable and arbitrary "tariff man" to run amok on this trade imbalance problem, it would be far better for the surplus countries to jointly realign their exchange rates and thereby safeguard the free trade system that has benefitted them and the rest of the human race so much since 1945.

Despite close to or full employment in the decade since the crisis, the U.S. current account deficit has halved as a share of GDP—a minor miracle.

JIM O'NEILL
Former Commercial Secretary to the Treasury, United Kingdom, and former Chairman, Asset Management, Goldman Sachs International

I started my career in financial markets about three years before the Plaza Accord. It was extremely clear then that the dollar had become dangerously overvalued against major currencies at the time, so the rationale for the Plaza Accord was exceptionally strong.

I am not at all sure that there are parallels today, not least because, often forgotten amid the politics of the United States having any kind of trade deficit, the U.S. external balance has improved considerably since the 2008 crisis. As many contributors to this magazine know, it has long been believed that due to the relatively superior demographics and growth trend of the United States compared to its traditional rivals and allies, especially Germany and Japan, the United States could run a persistent balance-of-payments current account deficit in the vicinity of 2–3 percent. That is the relatively happy position facing the United States today. To my ongoing surprise, it seems lost to many that despite the United States being close to or at full employment—maybe even through it—in the decade since the crisis, the U.S. current account deficit has halved as a share of GDP. I have been immersed in this issue for thirty-five years, and can say this is not far from being a minor miracle, and should get more attention.

On the flip side, China, which has become the focal point much as Japan was back in the 1980s, might possibly run a current account deficit in 2019 or 2020. They have reduced their current account surplus from close to 10 percent since 2008, and if you believe that the massive imbalances that built up until the crisis especially involving the United States and China were the major source of the crisis, then it is very different today. (Of course it is true that Germany runs a ridiculously unhealthy current account surplus today, but the broader euro area surplus is almost definitely due to insufficient domestic demand in much of the continent including perhaps Germany, and is not a currency issue.)

Turning directly to currencies, I was inspired by the pioneering work of John Williamson with fundamental equilibrium exchange rates, or FEERs, in the 1980s. I constructed my own version of fundamental fair value real exchange rates when I joined Goldman Sachs in 1995, and while I don't do that sort of thing in my post-GS life, I obviously follow exchange rates closely.

It is far from clear to me there is anything like the massive dollar overvaluation of those days. The fair value for the RMB is, give or take, in the vicinity of where the spot RMB exchange rate is, so there might even be a slight overvaluation of the RMB. After clearly being undervalued throughout the 2000s, the euro is perhaps undervalued by 5 percent. The only currency that does seem cheap compared to a FEER- or GSDEER-type valuation is the yen, but that is complicated by Japan's own remarkably weak growth trend and, I suspect more than many realize, a weakening fundamental real exchange rate equilibrium.

Although a tariff spat could in principle remain bilateral, a currency war is almost certain to spread.

MARINA V.N. WHITMAN
Professor, Business Administration & Public Policy, Gerald R. Ford School of Public Policy, University of Michigan, and former member, President's Council of Economic Advisors

Until the first week in August, I thought that an escalation of current trade tensions into widespread currency wars was unlikely. Why such optimism, when the spirit of international cooperation that produced the Plaza and Louvre Accords, through which the G6 countries stabilized currency relationships in the mid-1980s, has given way to a world where the major players have retreated into fortresses of self-serving protectionism? Despite commitments by the Group of 20 in 2013 to avoid currency wars entirely, a pledge reaffirmed by the leaders of the United States and China in 2016, a United Nations report of last February reflected widespread concern that a bilateral trade battle could spiral into more generalized currency wars.

How likely was such an escalation? The U.S. president has accused both China and the European Central Bank of giving themselves "tremendous advantages" by weakening their currencies. And he is said to have urged labeling China as a currency manipulator during the 2016 election cycle.

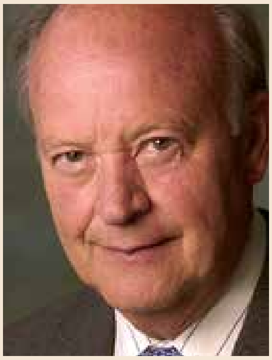
In fact, the U.S. Treasury hadn't declared China a currency manipulator since 1994, despite its unexpectedly sharp devaluation in 2015. More recently, China has actually been propping up its currency, presumably to head off U.S. retaliation against alleged deliberate weakening of the yuan. This behavior led me to believe that other countries would be equally cautious in regard to currency valuations, while the American president had apparently opted for tariffs as the chosen weapon with which to pressure other countries into doing his bidding.

It required only seventy-two hours to prove me wrong. On August 1, President Trump announced that, because U.S.-China trade negotiations had broken down, he would impose a 10 percent tariff on some $300 billion of Chinese goods, in addition to the 25 percent tariffs already placed on some $200 billion of Chinese exports to the United States. On the following Monday, China sent a retaliatory signal by allowing the yen to fall below 7 per dollar, a level that had served as a floor for more than a decade.

The President furiously accused China of gaining an unfair competitive advantage through currency manipulation, and the U.S. Treasury followed suit by formally declaring China a deliberate manipulator, a symbolic but insulting designation. In fact, China gave a credible response that the yen's new value was still higher than market forces alone would dictate, and indicated that it would not be allowed to fall to a market-determined level. This drop in value of less than 1 percent jolted stock markets and signaled that, by adding a currency dimension to an ongoing trade battle, the threat to global growth was gaining strength.

Although a tariff spat could in principle remain bilateral if the participants are willing to ignore trade distortions and GATT/WTO rules, a currency war is almost certain to spread. Countries that compete with China as exporters are bound to find themselves at a new disadvantage unless they allow their currencies to weaken in step with that of their enormous competitor. Many southeast Asian countries are particularly vulnerable, but other BRICS and emerging markets may feel threatened as well.

Countries can use two methods to weaken their currencies. One is through direct intervention in currency markets. The other is by lowering interest rates or quantitative easing. In the latter case, there is no bright line that can distinguish monetary easing in response to domestic economic conditions from using it to gain competitive advantage. In fact, many of the major industrialized nations are already in negative-rate territory, and the United States is uncomfortably close. As for direct intervention in currency markets, I have already noted that most countries will be cautious in fear of U.S. retaliation. As for the United States itself, the press has reported that, in late July, Trump had seriously considered intervening in currency markets to artificially weaken the dollar. After listening to arguments on both sides from his advisers, he apparently decided against it, partly because he likes the sound of "a strong dollar." But, he insisted, "I could do it in two seconds if I wanted. I didn't say I'm not going to do something." If the U.S. economy slows further as the 2020 election draws closer, who knows what he may decide?



The danger of a currency war does not look threatening.

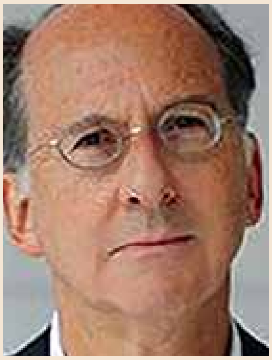
JOHN WILLIAMSON
Senior Fellow (retired), Peterson Institute for International Economics

Now that the European Union has been converted to general belief in the virtues of German economic policy, it looks set for big trade and current account surpluses at anything like current exchange rates. In view of this fact, it would be an act of extreme perversity for the European Central Bank to choose currency depreciation as its preferred instrument for expanding demand.

It would seem far more likely that the ECB would instead seek to expand domestic demand, which has the additional virtue of enabling goodies for domestic agents rather than foreigners. Only if it concluded that it was really boxed in by the liquidity trap, immovable fiscal policy, and lack of monetary alternatives, would it make sense to even contemplate launching a currency war. And assuming one accepts that there is no other body with sufficient power to provoke the United States into retaliation, the danger of a currency war does not look threatening.

The effect of currency depreciation is indeed to steer a greater portion of productive activity to the unit that has depreciated, but this does not necessarily mean that a large country can depreciate its way to prosperity. The reason is that it needs to take into account also the impact of its action on the total level of activity.

If central banks start worrying more about obtaining more of a given level of output than about contributing adequately to prosperity, then we are in for a rough ride. (My own view is that they should worry about both, and that the Fed's tendency to ignore concerns about the distribution of output has also been deeply damaging.)



The Trump team seeks to transform U.S. foreign exchange policy.

MARK SOBEL
U.S. Chair, Official Monetary Financial Institution Forum, and former Deputy Assistant Secretary for International Monetary and Financial Policy, U.S. Treasury

The world faces heightened risks of "currency wars" due to Trump Administration aggression on foreign exchange market policies.

The Trump team seeks to transform U.S. foreign exchange policy.

■ It abandoned almost twenty-five years of bipartisan consensus on the "strong dollar." Instead, the president publicly talks about weakening the dollar. America intervened twice since 2000 as part of concerted G7 operations to support the euro and yen. But intervention to weaken the dollar is now potentially being considered.

■ The Administration is lowering the bar on the current account criterion used in Treasury's "Foreign Exchange Report" in order to possibly drag more countries into its harmful currency "monitoring" list.

■ It is doubling down on bilateral balances—a focus dismissed by almost all economists as irrelevant—to train its sights on China. It points to Chinese currency "manipulation," overlooking the near disappearance of China's current account surplus, the lack of Chinese dollar purchases, and efforts to support the RMB despite a slowing economy.

■ The Administration seeks to include currency provisions in trade deals and subject foreign exchange to dispute resolution, even though currency values are impacted by many forces—such as monetary policy—that go well beyond trade.

■ The U.S. Commerce Department tabled an ill-conceived proposal to treat currency "undervaluation" as a countervailable subsidy—even though "undervaluation" cannot be precisely measured and the proposal is almost surely WTO-inconsistent.

Lately, the president has suggested ECB President Mario Draghi was trying to gain unfair competitive advantage for the euro in pointing to the need for greater ECB monetary policy accommodation. Of course, the European Central Bank isn't the only central bank discussing greater accommodation these days.

Euro-area economic performance is weak, with the Administration's trade wars further clouding the global—and Europe's—outlook. Inflation persistently undershoots. Sovereign yields are often negative. Hence, there are perfectly good reasons for the European Central Bank to adopt greater accommodation.

Will more monetary policy accommodation also weaken the euro? Perhaps. Exchange rates are one channel in monetary policy transmission.

Of course, the European Central Bank's easing burden could be partly relieved if euro-area countries with fiscal space would use it, the union's architecture were strengthened including with a centralized fiscal capacity, and European nations would adopt reforms more quickly, let alone strengthen weak banks.

What's clear, though, is that the European Central Bank's intent is to strengthen the European economy, just as was the case for the United States during the global financial crisis when America swiftly pursued accommodation and the dollar plummeted.

A stronger euro-area economy is in the world's interest.

A currency war would quickly lead to a perilous world economy.

MAKOTO UTSUMI
Former Vice Minister of Finance for International Affairs, Japan

Currency interventions require the explicit or implicit agreement of the G7 countries. This rule of the game seems to have quietly been established among the

G7. With monetary policy now playing a key role in the exchange markets instead, central banks seem to be more mindful of the need to harmonize their policies among themselves. Once the Fed adopted the 2 percent inflation target, the European Central Bank followed, as did the Bank of Japan. These institutions might occasionally be under political pressure, and the risk of being affected by that might not be zero. But it is hard to believe that these central banks dare to adopt a monetary policy which implies the possibility of a currency war.

What then would happen if the U.S. Treasury Department, with the purpose of devaluating the U.S. dollar, decided to intervene on the currency market? It would inevitably invite a currency war which would quickly lead to a perilous world economy. But this would also be hazardous to the U.S. dollar, which would lose the world's key currency status. The American leadership has fully weaponized the U.S. dollar's key currency status to accomplish its international power politics (for example, to effectuate sanctions). It is hence hard to believe that the United States would take steps to lose this powerful weapon.

The probability of a war is miniscule.

EDWIN M. TRUMAN

Non-Resident Senior Fellow, Peterson Institute for International Economics, former Assistant Secretary for International Affairs, U.S. Treasury, and former Director of the Division of International Finance, Federal Reserve Board

We will not be flirting with a currency war over the next two years. Even as, or if, the U.S. and global economy slow down or go into recession, the probability of a war is minuscule.

On average, dollar exchange rates in recent years have been remarkably stable. Since the presidential election in November 2016, the real broad foreign exchange value of the U.S. dollar on the Federal Reserve Board staff's index has fluctuated over a very narrow range of about 10 percent. In June 2019, the dollar's value was essentially unchanged from its level when President Trump was elected and 7 percent above its low in January 2018.

The link between changes in monetary policies and the value of currencies is weak. Nevertheless, if global interest rates decline over the next two years, U.S. dollar rates have further to decline than rates in most other countries; ergo, net monetary pressures are likely to depress the dollar.

If, contrary to what I expect, the dollar should strengthen significantly, action to weaken the dollar through currency intervention would have to be cooperative, as was the case with the Plaza Agreement in 1985. There are two sides to every exchange rate and multiple sides to multiple exchange rates. In light of our current strained relations with leaders of other major countries, I doubt, with one qualification, that cooperation would be readily forthcoming. The qualification is that if the United States were to threaten a further increase in trade protection across the board, as the Congress threatened in 1985 and Nixon imposed in 1971, cooperation might be forthcoming. However, an expansion of the trade war would be more likely as a first phase.

Would significant depreciation of the dollar restore, or enhance, the prosperity of the U.S. economy? No! The central lesson of our history since 1971 is that we cannot devalue our way to prosperity. No other economy has devalued its way to prosperity, in contrast with maintaining an undervalued exchange rate by resisting appreciation.

We may be sleepwalking into a currency war.

DESMOND LACHMAN

Resident Fellow, American Enterprise Institute

Nobody can know with any degree of certainty whether or not we are headed soon to a world currency war.

However, what we can be sure about is that there is increasing cause for concern that we may be sleepwalking towards such an eventuality. This is particularly the case at a time when the benefits of globalization are being increasingly questioned and when the United States is abrogating its leadership role in maintaining an open international economic order.

A principal reason for concern is that the Trump administration's economic policy actions are at uncomfortable odds with its external policy objectives. The clear and present danger is that when its external policy objectives are not met, the administration might double down on its protectionist America First trade policy and might respond in kind to what it perceives to be Chinese and European exchange rate manipulation.

While the Trump administration would like to eliminate the trade deficit and weaken the dollar, its pursuit of an expansionary budget policy at this late stage in the economic cycle highly complicates the attainment of those objectives. By reducing national savings, higher budget deficits are leading to the reemergence of a twin deficit problem. At the same time, the higher budget deficit is putting upward pressure on the dollar by forcing the Federal Reserve to maintain interest rates at a higher level than would otherwise be the case.

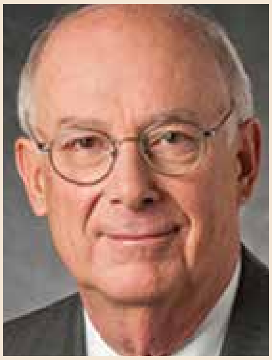
An American First trade policy is also exerting unwelcome upward pressure on the U.S. dollar. It is doing so by heightening investor uncertainty abroad, which is forcing foreign central banks to loosen their monetary policy stance. It is also doing so by unsettling global financial markets, thereby increasing the U.S. dollar's safe haven demand.

Further heightening the chances of a world currency war is the very real risk that UK Prime Minister Boris Johnson might carry through on his threat to crash the United Kingdom out of Europe on October 31 without a deal. Were that to occur, sterling would almost certainly suffer a sharp depreciation. That in turn must be expected to drag down the euro and further heighten economic tensions between Europe and the United States.

A more serious, though less imminent, risk for world currency stability would be a recurrence of the Italian sovereign debt crisis in the context of a weakening European economy. Being ten times the size of the Greek economy, Italy would pose an existential threat to the euro that would almost certainly propel the U.S. dollar higher.

Needless to add, it does not help matters that the United States now views China more as a strategic rival rather than as a trustworthy economic partner.

With all of these risks to the global economic order, there has seldom been as much need as there is today for responsible U.S. international economic leadership to prevent a destructive currency war. However, on the basis of the Trump administration's international economic policies to date, I am not holding my breath for that to happen.



The possibility of persistent currency skirmishes that could evolve into a war merits concern and vigilance.

J. ALFRED BROADDUS
Former President, Federal Reserve Bank of Richmond

While the risk of an all-out currency "war" still seems manageable at this point, the possibility of persistent currency skirmishes that could evolve into a war merits concern and vigilance. It may be challenging, however, to distinguish in practice between—on the one hand—justifiable co-movements in major currencies in response to correlated movements in domestic conditions in an ever-more integrated global economy, and—on the other—deliberate efforts by individual central banks to manipulate currencies to favor their respective governments.

To take an obvious current example, the European Central Bank's recent signaling of potential additional stimulus can be seen as an initial eurozone effort to beggar its neighbors, including the United States, and the Fed's late July rate cut can be seen as the U.S. response. But both actions are consistent with recent domestic developments (even allowing for the dissents against the Fed's cuts.) And reported concern in the United States about a potential increase in the spread between the federal funds rate and the ECB's policy rate, if and when the ECB acts, can be understood as driven by Fed attention to its domestic policy mandates rather than an active defense against a perceived currency attack.

The line between these alternative interpretations of events, though, is thin and politically fraught. So while the current consensus interpretation (no deliberate attacks yet) is reasonable for now, it is not hard to imagine a drift toward viewing emerging events as a nascent currency war requiring mobilization for battle.

One source of comfort in this situation is that, at least internally, the Fed and other major central banks recognize the risk to their credibility, and to the effectiveness of their respective policies, of targeting exchange rates or manipulating them for individual country gain. Arguably, this recognition will restrain any drift toward overt currency conflict if key monetary policy decisions around the world are left to these banks.

But assuming that central banks will in fact continue to control these decisions is obviously problematic in today's world. Whether or not there will be a currency war will depend at least in part on whether or not the independence from short-term political pressures many leading central banks have enjoyed in recent decades is sustained. Independence is not a sufficient condition for market-determined exchange rates and an absence of currency wars, but it is arguably a necessary one.

Currency manipulation is a zero-sum game.

JAMES E. GLASSMAN

Managing Director and Head Economist, JPMorgan Chase's Commercial Bank

When central banks are out of step because they face different economic circumstances, as is the case today, currencies respond. That doesn't mean central banks are manipulating their currencies. The dollar fell when the Federal Reserve turned to asset purchases in 2009. It rebounded when others followed suit and the Fed pulled back. In other words, monetary actions aimed at promoting economic recovery shouldn't be interpreted as a disguised effort to cheapen currencies at the expense of trading partners. If other key central banks are able to revive their economies, the United States benefits.

Today's floating exchange rate system gives countries the freedom to address their idiosyncratic challenges without the distraction (straitjacket) of managing currency pegs. For that reason, the post-Bretton Woods system of floating exchange rates has contributed to a better global economic performance, compared with the volatile times in the nineteenth century associated with fixed exchange rate regimes.

In any case, central banks are not likely to abandon their inflation goals in response to political pressure to manipulate currencies.

But is the turn to "go-it-alone" international trade policies likely to tear up this successful script? That's doubtful for several reasons. First, currency manipulation is a zero-sum game. Efforts to cheapen the dollar might benefit a handful of exporters if others do not retaliate. But any modest benefit to exporters would be lost by disrupting the economies of America's trade partners.

Second, unilateral intervention seems no threat. The United States would find little support for a multilateral effort to weaken the dollar, in contrast to the mid-1980s, because the U.S. economy is stronger than most and the (real broad trade-weighted) dollar is close to its average since the 1971 demise of the Bretton Woods system. In 1985, the dollar was 30 percent above current levels as significant fiscal stimulus and the Fed's anti-inflation policy drove real interest rates up. Market participants would correctly assume that any unilateral currency intervention would have little staying power.

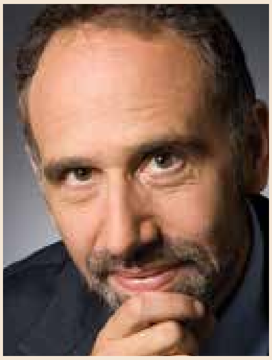
Third, central banks aren't immune to political pressure. But they are unlikely to yield to calls to cheapen their currency, if that detracted from their inflation goals. For more than half a century, the central banking community has worked hard to manage inflation, with great success. Their credibility has enabled them to respond forcefully to economic crises without sacrificing their inflation goals. The credibility the Fed has earned with financial markets, the public, and Congress is an important line of defense against political pressure.

Worries about politics and central banks underscore the value of the Fed's 2 percent inflation target, which other key central banks have embraced. Inflation expectations are a key anchor for bond yields and have hovered close to the Fed's 2 percent inflation target for some time, highlighting investor confidence in the Federal Reserve's management. Should the Fed be diverted from its mission in response to political pressure, its hard-won credibility would be in jeopardy and global bond yields likely would rise.

But isn't the Fed's recent rate cut a response to political pressure? After all, Fed policymakers say the economy is in a good spot: unemployment is at lifetime lows; businesses can't find the workers to fill 7.3 million job postings; the economy is still growing faster than its underlying trend; inflation is creeping back to the Fed's 2 percent longer-run goal; and the Fed's posture is moderately accommodative in the minds of most Fed policymakers. All true. But many believe it is appropriate for the Fed to take out some insurance against the risk that global weakness might slow the U.S. economy more than desired. And bond investors tend to endorse the Fed's action.

Finally, the U.S. economy is in far better shape than most. The case for a more aggressive Fed posture than others would not be very convincing. So monetary actions by the Fed targeted solely to weaken the dollar surely would be countered by more forceful actions by other key central banks.

For sure, U.S. President Donald Trump is responding to legitimate complaints about certain trade practices. But there are far more effective ways to address those than pursuing a currency war.



It is pretty hard to see a scenario in which a currency war can pose a serious economic problem.

DEAN BAKER
Senior Economist, Center for Economic and Policy Research

The world faces many real crises: the prospect of a climate catastrophe, a prolonged slump following the Great Recession, and unstable leaders in the United States and elsewhere threatening wars around the world. In this context, the idea that countries may compete with each other to lower the value of their currencies seems like a really good thing not to worry about.

First, we have to think about what this would actually look like. The idea is that central banks would be lowering their interest rates, not just to provide a boost to domestic demand, but to lower the value of their currency, thereby giving their products a competitive boost in international trade. The expected move towards a larger trade surplus or smaller deficit would then stimulate the domestic economy.

The ostensible problem is that one or more major central banks may follow this path, thereby improving their trade balances at the expense of other countries. The currency war is when other central banks then respond in kind. This can lead to further rate cuts by the original belligerents and then more cuts in response.

Suppose this all happens as described, what exactly is the problem? Are we worried central bankers will get overworked from lowering interest rates?

Ordinarily the problem from having interest rates be too low for too long is that we would be over-stimulating the economy, leading to inflation. But the core assumption in this currency war scenario is that economies are suffering from secular stagnation. Demand is too low, leading to concerns with inflation rates that are lower than desired. In this scenario, excessive inflation is the last thing that we would have to worry about.

Of course the world can change. Maybe we will see some innovation that will lead to a massive surge of investment. Alternatively, maybe the leaders of the eurozone countries will learn introductory economics and discover they can boost their economies with expansionary fiscal policy. In this context, inflation could come to be a problem.

But none of the standard models of inflation show it jumping from near zero to problematic rates overnight. If economies start to pick up speed for unexpected reasons, central banks should have plenty of time to raise interest rates and stop worrying about keeping the value of currencies low.

In short, it is pretty hard to see a scenario in which a currency war can pose a serious economic problem. Let's worry about the world's real problems and not try to invent artificial ones. ◆

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220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com