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Why the currency-war deniers are wrong

The leaders of the Group of Seven and Group of 20 largest economies have recently tried to talk down the risk of a currency war. This will not necessarily be sufficient to avoid one. The reason is that there is no longer a shared view across leading industrial countries about the role monetary policy should play in the current environment.

The traditional view is that monetary policy should be aimed at stimulating growth and employment as long as price stability is ensured. On the proviso that inflation expectations are well anchored and the central bank's inflation projections are within target, interest rates can be kept as low as possible to foster consumption and investment. The exchange rate is determined by financial markets as a result of the different monetary policy stances across countries, which are in turn determined by different cyclical positions.

In such an environment, currency wars do not exist because the weakness of some countries' exchange rates reflects the weakness of their fundamentals. There would be no point in complaining about the low level of the exchange rates of countries with a relatively depressed economy. It is the task of monetary policy to try redress the situation; the exchange depreciation is only the consequence.

The real world has become a bit more complicated.

First, exchange rates do overshoot compared with the levels that are consistent with underlying fundamentals. This is not only because financial markets adjust faster than goods markets, as the German-born economist Rüdiger Dornbusch explained more than 35 years ago, but also because of the self-fulfilling nature of investors' expectations, and the herd behaviour that influences aggregate market developments. Overshooting is the rule rather

than the exception, and is very difficult to mitigate. Indeed, exchange rate interventions are ineffective unless they are co-ordinated between the monetary authorities of both the appreciating and depreciating countries. Such a co-ordination is very hard to achieve, however, because of the asymmetric benefits that exchange rate movements produce.

Second, and more important, is the fact that monetary policy has become less effective in the current crisis at supporting growth. Despite interest rates at record lows in all advanced countries, economic activity has been disappointing. The reason is that economic agents are burdened by an accumulation of too much debt. Even with low interest rates, they have no incentive, or no possibility, to borrow more. They first need to deleverage and return to more sustainable levels of debt.

In order to restart rapid growth, the amount of debt in the economy should be reduced. This requires a redistribution of wealth from lenders to borrowers. This is not easy to achieve, especially in a democracy. A restructuring of all debts would hurt savers and institutional investors, with potentially destabilising effects on financial stability. It would also fuel moral hazard. An increase in public debt to compensate for the losses of savers and investors, and to avoid market instability, would be as unpopular, even if it were feasible for countries that struggle to issue new debt in the markets. It would be hard for any government to find a parliamentary majority in favour of bailing out those who borrowed excessively at the expense of creditors or of future generations.

A smart idea, which does not require parliamentary approval, is for the central bank to do the job. By intervening directly in the markets, the central bank can reduce the amount of risky assets in the system in exchange for cash, and decrease interest rates with a view to encouraging economic agents to start borrowing again.

If such an intervention is of temporary, to counter portfolio shifts generated by liquidity shortages or fears of major market disruptions, it has no lasting impact on the supply of money nor on the distribution of wealth between borrowers and lenders. If instead the intervention is permanent, accompanied by a commitment to maintain low interest rates for a prolonged period, the policy is very close to what Carmen Reinhart and Kenneth Rogoff have called "financial repression". By holding risky assets and keeping interest rates very low, even lower than the rate of inflation, potential losses are absorbed by the central bank and spread out to future generations, in the expectation that they will be in better shape to absorb the losses. This decision is not the result of an explicit democratic choice but of the central bank being given the task, and accepting, of doing whatever it takes to stimulate growth, even if it entails wealth redistribution. By implementing financial repression, the central bank conducts covert fiscal policy.

The reaction of investors is to try to escape from being financially repressed, including by purchasing foreign assets, especially of countries where such repression is opposed by the political system or prohibited by the central bank statutes. The outflow of capital leads to an excessive depreciation of the currency in the former countries and an appreciation in the latter, compared with underlying fundamentals.

At that point, a currency war can be avoided only if the latter start acting like the former, and also repress holders of financial assets. The most likely outcome of the currency peace which would result from a global attempt by central banks to repress holders of financial assets would be a new bout of risk taking all over the world. And, sooner or later, a new financial crisis.

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