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Global Imbalances, Currency Wars and the Euro

NOTE

Abstract

Global current account imbalances tend to create not only bubbles and financial crises but also exchange rate tensions among leading international currencies, and, therefore, among those other currencies that are pegged to them. As the US, UK and Japan, the three more international currencies besides the euro are trying to depreciate their currencies and China is trying to avoid an appreciation of its currency, the result will be that the euro will appreciate making it more difficult for the euro area to exit the crisis.

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Executive Summary

Global current account imbalances tend to create not only bubbles and financial crises but also exchange rate tensions among leading international currencies, and, therefore, among those other currencies that are pegged to them. As the US, UK and Japan, the three more international currencies besides the euro are trying to depreciate their currencies and China is trying to avoid an appreciation of its currency, the result will be that the euro will appreciate making it more difficult for the euro area to exit the crisis.

The short term solution to these tensions is to find some cooperative compromise among those countries which issue the leading currencies, at the G20, because a currency war among them could have devastating effects on trade and capital flows and even reach a situation in which everybody ends as a loser. Such an agreement on exchange rates is necessary but not sufficient, because floating exchange rates are able to reduce the impact of current account imbalances on international trade flows of goods and services but it is more difficult for them to affect the underlying internal saving-investment imbalances which produce the current account imbalances of the countries concerned.

A more definite solution is to have a global institution, as a reinforced IMF, with new governance and increased powers which could be able to maintain a strong surveillance on its member countries macroeconomic policies, interest rates, exchange rates and current account miss-alignments and which can be the lender and liquidity provider of last resort to the countries concerned in order to avoid large reserve accumulations for precautionary motives although most of the building up of reserves has been due to exchange rate intervention.

Finally, the Euro Area needs urgently to regain the present lack of confidence by financial markets which is making very costly the exit from the crisis to many of its members countries as well as to reduce its own internal current account imbalances, which can be only solved through a consensus and agreement between both deficit and surplus member countries.

1. Global Imbalances

There is compelling evidence about the fact that global imbalances, in terms of large current account deficits and surpluses in different countries, tend to produce bubbles, and about that bubbles tend to produce financial crisis which in turn end producing deep and long recessions. Almost 75% of all financial crises have been preceded by external imbalances (although they also have happened in quite closed economies) because the large flows of capital from current account surplus countries into deficit countries tend to eventually to provoke real and financial bubbles and the latter can induce financial crises when these bubbles burst. For instance, the large real estate bubbles recently built in the US, Spain or Ireland could not be financed by domestic savings but only through large foreign capital inflows and loans coming from surplus countries. In order to deal with global imbalances it is important to understand the following three issues:

- First, the world in which we live is a closed economy (we cannot export to Mars) so that, in equilibrium, the net balance of all surpluses and deficits of the account balances of the 181 members of the IMF should be zero (excluding errors and omissions) which means that every surplus in a country is only possible if there is a deficit in another or in several other countries. The way to calculate global imbalances is through the half sum of all deficits and surpluses. In the eighties and nineties imbalances were rather small, reaching 1% of global GDP in 1997. Nevertheless, since 1997 and up to 2009, grew up to just above 3% of global GDP (around $5.5 trillion at current dollars) and as a result, global reserves increased to 4.4% of global GDP, that is, around $6.8 trillion (of which, China is holding $2.6 trillion, (51% of its GDP in 2009). China had in 2008 a current account surplus of 9.6% of GDP ($ 471 billion) while, at the same time, the US had a current account deficit of 4.7% of GDP ($ 670 billion).
- Second, the sum of the net balance of the current account plus the net balance of the capital account of the balance of payments of any country must be zero by definition (excluding errors and omissions). Therefore, a country which receives large capital inflows resulting in a surplus in its capital account must have a deficit in its current account (as it is the case in the US) and vice-versa, a country which is a large exporter and achieves a surplus in its current account must have a deficit in its capital account (as it is the case of China). The reason being that the US needs to finance it excess of imports over exports with capital inflows and China needs to invest its excess of exports over imports receipts through its capital account into other countries.
- Third, a current account balance is defined by a macroeconomic identity derived from the national income accounts: X-M = S-I, that is, exports of goods and services minus imports of goods and services (plus net transfers and net factor income) must equal domestic savings minus domestic investments. Therefore, the current account of a country can be in surplus either because it saves more than it invests or because it exports more goods and services than it imports them and vice-versa in case of a deficit.
- Fourth, given the three previous accounting identities, the result is that the currency appreciation of a large country needs a compensating depreciation of the currency of other countries. This inverse correlation is very high (up to 0.9) in the case of movements among the leading currencies. If the dollar goes up the euro goes down and vice-versa and the same happens with the different currencies pegged to both of them. This is the reason why a way to reduce these imbalances would be through having free floating exchange rates in most countries in the world or at least among the G20 member countries.

Let us continue to use, as an example, the US as the deficit country and China as the surplus country. If both would have floating exchange rates (which is not the case of China, which has a fixed exchange rate system) then the flows of imports and exports of goods and services would tend to adjust in the medium term (depending on the price elasticity for importing and exporting being high enough). The dollar will tend to go down and the renmimbi will tend to go up. The main reason is that floating exchange rates tend to compensate, in the short term, the interest rate differentials among internationally open countries; in the medium term, they tend to compensate the productivity or growth rate differentials among open countries and, in the long term, they tend to compensate the differential among the inflation rates of these open countries (purchasing power parity "PPP" rates).

Moreover, for a developing country like China to be able to catch up with other developed countries, its nominal exchange rate needs slowly to increase up to reaching, in the long term, its purchasing power parity (PPP) rate level, which is much higher than is actual nominal level. Today, China's PPP exchange rate in dollars is two and a half times higher than its current exchange rate to the dollar so that it has needs to appreciate it, in the decades to come, to reach its PPP rate. The way it works is through the Balassa-Samuelson effect by which faster increase in productivity in the tradable sector slowly filters into the non-tradable service sectors and eventually its level of productivity becomes that of a developed country.

Nevertheless, the main problem is that floating exchanges rates may affect both countries trade flows but may not affect enough, at least in the medium or longer term, their domestic savings-investment ratios. It may be that, in the case of the US, its current account deficit its domestic saving-investment relationship may be more structural than its exports-imports rate, given to the fact that the US has a very low saving rate in relation to its investment rate because of its population ageing trend, where its saving age working population is declining and its dis-saving age retired population is growing. In the case of China the high saving rate in relation to its investment rate may also be quite structural, given that the Chinese are saving 50 per cent of their income because they have not achieved yet free access to universal social security and health.

Therefore, floating exchange rates may not be enough or be much less effective to adjust their imports and exports of goods and services, because the S-I ratio can be much more sticky and structural than its X-M ratio. If this is the case, the countries concerned need to take other economic policy actions to change not only their export-import ratios but also their saving-investment ratios, target which may take much longer to achieve because it needs internal fiscal policy incentives.

Fifth, nevertheless, the best way to measure the impact of exchange rates on competitiveness and on trade flows of goods and services is through the trade weighted real exchange rate (TWRER). According to the JP Morgan TWRER index in September 2010, compared to the same index over the long term average (1990-2010), the currencies that have depreciated the most within the G20 countries are: Argentina (-27%), South Korea (-18%), UK (-13%), US (-8%), Canada (-5%), India (-2), Japan (-1,5%) and the Euro Area (-1%). Those which have appreciated the most are: Brazil (+73%), Indonesia (+43%), Russia (+38%), Australia (+30%), China (14%), South Africa (+11%), Turkey (+8%) and Mexico (4%). Therefore, the only two which have been able to maintain their TWRER in equilibrium are the Euro Area and Japan.

In the end, a true reduction of global imbalances needs international cooperation in order to find a collective agreement among leading countries with leading currencies to act all in favor of its reduction. The G20 is a quite well weighted and enough representative institution to achieve such an agreement but it has not been able to agree anything at its recent meeting is Seoul. In order to achieve a successful and sustainable agreement, there must be an independent institution which acts as an agreed referee and which enforces its fulfillment and makes sure that it is fair. This institution exists and it is the IMF. Without an independent and trusted international institution which acts as a referee and supervisor of the fulfillment of an agreement, it is going to be difficult to advance in the right direction.

If no agreement is reached, then individual solutions will eventually end in a currency war in which nobody eventually wins and becomes inefficient and costly for all countries involved. That means, surplus countries which do not appreciate their currencies will be responded by deficit countries by increasing tariffs on all imports coming from these surplus countries and by showing to the WTO that they are currency "manipulators" or furthermore, doing, on their own, competitive devaluations to compensate for the lack of appreciation in the currencies of the surplus countries. This second alternative is even much dangerous that the previous one because the increase in tariffs can be applied country by country but the nominal depreciation punishes the imports from all countries equally, except those which are pegged to the currency of the country that devalues.

At the same time, some countries will tax capital inflows coming from the surplus countries to avoid building up real or financial bubbles, making it more difficult to reduce the imbalances through the recycling of excess reserves by surplus countries. In the end, most countries will end off worse.

2. Impact of a Potential Currency Wars on the Euro

At present, there are three different versions of macroeconomic policy-mix being implemented by different developed countries in order get sooner out of the recession or to avoid a double dip:

1. First, the US has done a very large fiscal stimulus both to bail out its banks and to avoid the recession to become a depression, while the Federal Reserve (FED) has been helping by doing quantitative easing of very large proportions. Now, fiscal policy has become passive but there is no decision yet to try to reduce or to make any fiscal contraction in the near future, in spite of its mounting level of sovereign debt. On the monetary front, the FED is continuing with a second round of quantitative easing (QE2) to avoid a liquidity trap and deflation, given that it cannot lower its main rate because it is already very close to its zero bound. The US is the only country which can develop this kind of policy mix at present given that it has a high certainty that it is going to continue funding itself at the lowest rates and for a long time, given that it is still the world's "save heaven" of financial investors (together with Germany).

   Its present government, after losing the majority in Congress, is going to try to be reelected in two years time and it is ready to keep, through QE2, printing another $600 billion and even $1 trillion in the future, to increase the price of financial assets and make banks safer and ready to give more loans and provide incentives for companies to invest and, at the same time, to depreciate the value of dollar and create more employment through an increase in exports.

2. Second, the UK, which has already done also a massive fiscal stimulus to bail out its banks and to revive economic activity at the same time that the Bank of England has undertake a large QE. Now, after its recent elections which have brought the opposition to power, is doing a very strong fiscal contraction to reduce its mounting level of debt but with the Bank of England still continues with its lax monetary policy maintaining QE and lowering more the valued of the pound. Both the US and the UK are the two large developed countries (with the exception of Germany) which have higher growth prospects in 2010 and 2011, mainly for pursuing this policy mix.

   These two countries are growing faster and may continue to do so next year thanks to the depreciation of their currencies.

3. Third, the Euro Area (EA) is involved in a quite strong fiscal contraction (except Germany and a few small member countries) and, at the same time, the ECB is sending clear signals about a near end of low interest rates and of purchases of sovereign bonds and other assets from member countries, which means that, in the best case, monetary policy is going to be almost neutral but most probably slightly contractive. If this is the case, its macro-policy mix will have contracting effects on

economic activity and raise the relative value of the euro, affecting external demand and exports as well.

4. Fourth, China seems to be ready not to accelerate the slow pace of appreciation of its currency in spite of the threats by the US and other countries and to continue building foreign currency reserves. Finally, the slow growth in Japan is prompting the new government to intervene in the exchange rate market of the yen in order to achieve its depreciation and gain export competitiveness.

Therefore, the three central banks of the three major international currencies other than the euro, plus that of China, the biggest exporter in the world, are all ready to continue pursuing a policy of depreciating their currencies, while the EA is not doing anything yet to counteract it. Until now, the EA and Japan are the only two of these five countries with leading currencies, which have been able to maintain their trade weighted real exchange rates (TWRER) without deviations from their long-term trend, therefore in equilibrium, but this will be extremely difficult going forward if the three others not appreciate theirs.

As I mentioned at the beginning, if some currencies depreciate, by definition, other currencies need to appreciate. At this moment, the only possible counterpart of a weaker dollar, pound and yen and a not stronger renminbi, is a strong euro. As the only way that the EA can grow, given its large fiscal contraction and its steady monetary policy, which do not allow its internal demand to grow much, is through exports and foreign demand, under a stronger euro, exports will not grow enough to help much needed growth given the present weak recovery of internal demand.

For the time being, the euro is not appreciating for the wrong reasons, that is, because many EA financial assets are, at present, subject to large selling from investors and markets in general (except German bunds), because they receive everyday contradictory news and comments by EA political leaders which create a lot of confusion and show a lack of common view on how to solve the recent sovereign deficit and debt build up in the face of an Stability and Growth Pact that has not fulfilled its duties.

Good and bad ideas are being exchanged, in public, by different EA political leaders, before even being discussed internally, which create a huge uncertainty in financial markets, which react by shorting the bonds of most EA sovereigns and increasing the cost of their debt service, making it even more difficult to achieve their deficit and debt reduction targets and thus reducing their potential economic growth. According to the IMF latest report on the effects of fiscal contractions on the economy, on average, for every percentage point of GDP fiscal contraction, growth falls by 0.5 percentage points after two years and employment falls by 0.3 after two years.

Moreover, the situation of many small and medium size EA banks is still fragile, and Basel III is going to increase their capital ratios and to force them to declare all their underperforming assets and loans and also to make the necessary provisions or to sell them, so that credit growth is going to be curtailed for a while. Finally, most of the EA member countries need to step up structural reforms in the labor and product markets, not only to increase productivity but also to avoid the huge impact of increasing future health and pension spending derived from the ageing of their population.

If, in the middle of this serious fiscal situation, the euro continues appreciating, then, there is a high probability for the EA as a whole to grow at lower rates than expected for some more years. In that case, the ECB may be forced to continue with its program of bond purchases and to delay any interest rate increase to avoid a potential deflation. A recent research by the IMF shows that the EA members represent 66% of the total number of countries with a high risk of deflation.

Finally, the ECB by using harmonized weighted headline inflation instead of core inflation (as does the US Federal Reserve) should refrain from increasing rates, as it did in 2008, in the middle of a recession, as soon as commodity prices increase due to a fall in the value of the US dollar. Maybe, the ECB thinks that a strong euro is good for its monetary policy target given the inverse correlation that exists between the value of the US dollar and the value of most of the commodities which are denominated in US dollars. Each time that the dollar falls prices of commodities go up, so that a strong euro may help to soften their negative cost impact on the EA harmonized CPI, given it is heavily dependent on importing most of these commodities.

Nevertheless, at this moment the most urgent is that EA political leaders make rational and commonly agreed decisions about how to regain the confidence of markets and avoid new runs on the debt of some of its members and reduce their contagion to other weaker members, otherwise, the next response by markets may be even stronger putting at risk the future of the EA. The second most urgent decision is to reach an agreement to try to avoid a currency war at the next G20 in Paris in 2011, given the absolute impossibility of US, Japan and the UK to achieve a depreciation of their currencies, unless it is at the expense of a stronger floating euro.

Looking further into the future, the best way to solve the present current account imbalances and a potential currency war is to have a global institution, such as the IMF, to be given more powers in order to fulfill its duties of being a true global watcher or supervisor, surveying very closely the macroeconomic monetary and fiscal policies of its different member countries, their net debts, interest rates and exchange rates to avoid currency miss-alignments and increasing current account imbalances. For that, a further change in the governance system of the IMF is needed with the right weight of each member according to its relative GDP and its relative international openness. Moreover, the IMF should become the lender and liquidity provider of last resort to countries in difficulties or with higher exposure to financing reversals in order to avoid too large building of reserves for precautionary motives. To achieve that aim the IMF should issue SDR in exchange of actual currency reserves held by most countries so that the SDR becomes the currency of the last instance.

3. Euro Area Imbalances and Real Exchange Rate Changes

Similar imbalances are affecting the current account balances of the member countries of the EA and given that they share the same currency, the solution to these imbalances is even more difficult and needs a stronger cooperation among its member countries. In 2010, the EA will be very close to equilibrium in terms of current account balance versus the rest of the world (+0.2% of GDP) so that it can also be considered as a closed economy, as it is the case of the world as a whole. According to the IMF forecasts for 2010, the current account surplus of Germany (+6.1% of GDP) and the Netherlands (+5.7% of GDP) in the EA need that other EA members show a deficit, as it is the case of France (-1.8% of GDP), Italy (-2.9% of GDP) and Spain (-5.1% of GDP) just to consider its largest members.

The only way to reduce these imbalances is by these three deficit member countries to operate a real devaluation of their exchange rate, because there is not a nominal exchange rate to depreciate. This can be achieved by having a faster productivity growth than Germany and the Netherlands for several years and by achieving a lower wage growth than Germany and the Netherlands for several years, but this achievement in isolation will not be able to close the current account imbalances if Germany and the Netherlands, at the same time, do not reduce its surplus by doing a real appreciation of their exchange rate by increasing their wages, their consumption and their internal demand. It also needs to be a common effort by both the surplus and the deficit countries at the same time, not by the deficit countries alone, because the imbalance is as much due to the large surplus that to the large deficit in the current accounts of member countries. German internal demand average growth has been 0.3% per annum for the decade 2001-2010, while the other three member countries have had a faster growth of their internal demand: France average internal demand growth has been 1.7% per annum, Italy 0.9% and Spain 2.9%.

Germany exports of goods and services account for 50% of its GDP, of which, 43% of its GDP only of goods (86% of the total). In terms of goods it exports 26.9% of its GDP to the rest of the EU and 16.1% of its GDP to the rest of the world. That is, Germany exports of goods account for 43% of its GDP, of which, 62.6% of the total to the EU. Germany imports 21.5% of GDP in goods coming from other EU member countries and imports 12.8% of its GDP from the rest of the world. Thus, it imports of goods are 34.3% of its GDP, of which, 62.6% of the total from the rest of the EU. Therefore, the EU is, by far, its main client both for exports and imports.

For these reasons, the reduction of imbalances in the EA without the existence of a nominal exchange rate needs to be done by deficit member countries producing a real devaluation of its internal exchange and surplus member countries producing a real revaluation of their internal exchange rate. In order to achieve it there is a need for a cooperative solution among both types of member countries.