FROM THE
FOUNDER

A GATT for Currencies?

Despite mind-boggling levels of fiscal and monetary stimulus in response to the 2008 financial crisis, the world economy has grown by a surprisingly meager 1.2 percent annual rate. True, the U.S. economy is starting to exhibit some modest signs of life, but the going will still be rough. The American people continue to shoulder $50 trillion in debt—roughly 350 percent of GDP. Moreover, a fiscal contraction is inevitable. Last year thirty-five states raised taxes and they are scheduled to hike again. Many federal fiscal stimulus measures, including the 100 percent accelerated depreciation, are going away.

And then there is the fact that the U.S. economy is part of a global system. Public and private global debt is also well above 300 percent of GDP and most major banks are undercapitalized and fragile. If the eurozone's financial system implodes, this picture will turn darker. The world is at risk of a further collapse in asset prices and none of this factors in the potential for problems arising as a result of China's dubious shadow financial system.

Governments and central banks may have kept us out of a depression, but full global recovery will only come after a long, hard slog with significant risk.

During this global deleveraging, a major risk is political—that a currency and trade war erupts as governments face public anger resulting from declining incomes and rising joblessness. A behind-the-curtain currency war is not as far-fetched as it sounds. Today, large parts of the world have become dangerously dependent on exports at a time of rising global overcapacity, particularly in manufacturing. Currency devaluation—making exports cheaper—is increasingly seen as a tool for prosperity. In today's economy, trade protectionists are still perceived as enemies to global prosperity. Yet attempted protectionism through the back door via the foreign exchange rate system is inadequately addressed by the rules of the World Trade Organization.

And China is hardly the world's only "currency manipulator." Large parts of the globe are beginning to game the foreign exchange system. More and more, countries are making up their own rules regardless of the level and status of their current accounts. Such attempted free-lancing may have been acceptable during past periods of brisk global growth, when the U.S. economy and the dollar dominated the world. With American dominance fading, today's currency system has the potential to become a dangerous, mercantilist tripwire for misunderstanding, resentment, and potentially destructive reactions.

Every country, it seems, wants a relatively weak currency. In 2011, for example, as the eurozone's sovereign debt crisis was building, the Swiss franc began to soar. Fearful investors saw a safe haven in the Swiss currency.

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The swiftly rising franc was threatening to hollow out Switzerland's export sector, though, so the Swiss pegged their currency to the euro for trade purposes—just as the Chinese regularly peg the yuan to the dollar to gain trade advantage.

Or consider the Japanese, who historically have been masters at using their foreign exchange reserves, through central bank intervention, to keep the yen from strengthening too much. Lately, however, officials in Tokyo have been struggling to keep pace with a deliberate tidal wave of yen-buying by Chinese government-directed funds. Economist Tadashi Nakamae argues that China, which competes directly with Japan in the export of capital goods (high-speed rail systems, for example), has been ruthless in its efforts to engineer a yen rise to make Japanese goods less competitive.

At the same time, European policymakers are in the fight of their lives to save their monetary union. Because of the uncertain outcome, the eurozone is flirting with recession in 2012. But you'd never know that given the relative strength of Europe's currency, which while having weakened some continues to remain above its level with the dollar at the time monetary union was begun. Why hasn't the euro weakened more? One reason is that the crisis has forced European banks to bring a great deal of their overseas capital back home. But another important reason, again, is China. The eurozone is China's largest export market, and a weaker euro would make Chinese goods less competitive. Thus the Chinese this year bought the debt of countries such as Greece, Portugal, and Spain in part as a means of helping to keep the euro from weakening too much. But lately that foreign exchange game entails significantly more risk. The European Central Bank's new three-year repo operation appears to be a potential back-door means of massive amounts of quantitative easing. China's recently acquired European holdings are suddenly facing exchange rate-related losses.

Ultimately, nothing about today's foreign exchange system appears to operate under any concrete rules. Last April, the International Monetary Fund reversed a position it had held for decades. It now deems capital controls (which allow governments, not the market, to set the level of exchange rates) as appropriate in some cases for developing economies. Immediately, the Germans announced that they too would retain the right to institute capital controls. This means that in the event the eurozone breaks up, Germany will almost certainly try to make it more difficult for weaker countries to devalue their currencies for competitive advantage. If Germany leaves the eurozone, it will take steps in the currency markets to make sure its mighty export industry is not put in serious jeopardy.

In short, in today's slow-growth global environment, where disinflation appears for now to be a greater risk than inflation, nearly everyone sees no downside to gaming the system for a weaker currency. Normally, the fear is that aggressive currency depreciation raises import prices and opens the door for a broader increase in inflationary expectations. But this new environment is different, which has added dangerous uncertainty to financial markets.

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The next eighteen months will be particularly telling. Global capital is flooding into the United States in a flight to safety. This phenomenon is helping keep long-term U.S. interest rates at record low levels. But this trend is also precisely the environment in which U.S. policymakers will be tempted to play their own games to try to weaken the dollar for trade purposes. Republican presidential candidate Mitt Romney has already made the U.S.-Chinese currency relationship a central focus of his campaign. With Chinese capital outflows increasing, as China's political transition approaches and the uncertainty puts further downward pressure on the yuan, the situation has become a perfect breeding ground for a coming Washington-Beijing currency stand-down.

That is why a more rational foreign exchange system, one involving a transparent, negotiated agreement on currency intervention, and structural changes including capital controls, is essential if the world is to achieve a sustained recovery and avoid another crisis. Global trade operates under negotiated, concrete rules, creating a climate of certainty for all. It's time our currency system did the same.

Three years ago, the current G-20 policy crowd completely missed the danger inherent in the world's large banks loading their balance sheets with dubious mortgage-backed securities, backed by a blizzard of questionable credit default swaps. On the issue of today's currency arrangements, policymakers need to wake up. It's no time to again be caught asleep at the switch.

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