The Perils of "New Mercantilism"

Arvind Subramanian sees a danger of countries trying to recover economically by competitive devaluation of their currencies and other forms of "new mercantilism."

Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman at the Peterson Institute for International Economics. Our guest is Arvind Subramanian, a senior fellow at the Institute and an expert on the international response to the current global crisis, the recession, and the credit crisis.

Welcome, Arvind.

Arvind Subramanian: Thanks, Steve. Thanks for having me.

Steve Weisman: We are not yet at the bottom, perhaps, of this crisis in January of 2009, but countries are acting.

Arvind Subramanian: Right.

Steve Weisman: Tell me your latest assessment of what countries are doing and whether that's going to be adequate.

Arvind Subramanian: I think at the moment most of the major countries like the United States, China, the United Kingdom, and France have all decided that the way to get the world economy going again is by injecting a lot of public money in government spending, a straightforward change in policies to pump-prime the economy. The United States is trying to sort out the magnitude of the fiscal package. China has announced something already. So, the big question now is whether this will be adequate. First, of course, is the uncertainty about whether many of these things will go through—for example, in the US Congress. Second, once they are implemented, will they be effective enough to stave off a downturn in the world economy?

Steve Weisman: And along with the fiscal package, there has been monetary easing.

Arvind Subramanian: That's true. There is monetary easing globally. But credit markets still are not back to normal. Even though large amounts of money are being pumped in by central banks, it is not really going to the real economy. So that's why we're talking in terms of unconventional responses like, say, the Federal

Reserve buying assets—private-sector assets, troubled assets, and eventually also government bonds, perhaps auto and mortgage assets—to bring down interest rates. So, that's also going to have some impact, certainly.

Steve Weisman: Now, as you just said, we don't know yet whether these steps will work. When will we know?

Arvind Subramanian: Well, I think the expectation of the median forecasters is that in the first two quarters of this year we're going to see negative growth. But then after that, we should start seeing signs of recovery. So, if by the summer we don't see signs of this recovery, I think then we should really start to worry.

Steve Weisman: You are already worried, however, that some of the steps that countries may be taking will actually make things worse. You've written powerfully that, as in the 1930s, this crisis will lead to a round of protectionism. Do you see any signs of that happening yet?

Arvind Subramanian: Right. What we saw in the 1930s was a combination of trade protectionism and competitive devaluations.

Steve Weisman: What is a competitive devaluation?

Arvind Subramanian: A competitive devaluation is when one country forces down its currency in order to increase exports and boost its economy. But that inflicts a negative cost on its trading partner. So, that trading partner then in turn starts depreciating its currency. So, it is competitive because everyone is doing it to stave off the negative effects of their partners doing it.

Steve Weisman: Why does depreciating your currency affect your trade balance?

Arvind Subramanian: Essentially, when you depreciate your currency, your exports become cheaper so you are able to sell more in world markets. That increases exports. Likewise, when you depreciate your currency, the cost of importing goes up and so you buy less from abroad. So, your exports go up and your imports come down, so your balance of trade improves.

Steve Weisman: Now, if everybody jumps in and devalues their currency, what happens? Everyone doing it offsets everybody else.

Arvind Subramanian: Exactly! So for the world as a whole, this cannot be a feasible strategy, because one country's export is another country's import. So, the world as a whole cannot boost the economy through this strategy.

Steve Weisman: Now of course, Arvind, in some cases, at the IMF for example, devaluation is a recommended step for countries in trouble, is it not?

Arvind Subramanian: Yes, it is. But the big difference is that it is recommended usually for a small country when that country alone is in crisis. We have a situation now in which everyone, even the big countries, may try to do it altogether and that cannot work. That's the big difference.

Steve Weisman: Do you see any signs of this race to the bottom happening?

Arvind Subramanian: Well, we're not in the throws, by any means, of a bout of competitive devaluation. But there are some worrying signs. Let me give you two signs. One, on January 13, the government of Ireland accused the UK government of talking down Sterling, and the Sterling depreciation is inflicting a cost on the Irish. The second area or region to watch is that many of these emerging-market countries—Brazil, Mexico, India, Korea—suffered huge declines in their currency because of the crisis. The question now is: Are they going to keep their currencies at these levels or will they allow them to rise back up when the economy turns around? And if they, for example, decide that "no, we want to keep our currencies competitive," then that will also be a sign of competitive depreciation. And of course, the third place to watch out for is what China is going to do.

Steve Weisman: What is China doing?

Arvind Subramanian: You see, at the moment, China, over the last year—it's not well recognized—its currency has actually appreciated by nearly 20 percent.

Steve Weisman: And that's what the world wants China to do.

Arvind Subramanian: And that's what the world wants China to do. Exactly! However, if China's growth rate dips below what the Chinese party thinks is acceptable…

Steve Weisman: The communist party.

Arvind Subramanian: The communist party. And if China's government fiscal policy does not bring growth back to that politically acceptable level, then China may also be tempted to say, "we have taken this appreciation for too long, let's try to weaken the currency once again." And if that happens it will be a source of friction in the trading system because the Chinese currency has been a bone of contention between the United States, the European Union, and China for a long period now.

Steve Weisman: We don't know yet how the incoming Obama administration is going to handle the Chinese currency issue. It was a big issue over the last two years with Treasury Secretary Paulson and the Congress. It sounds like you think they achieved a measure of success in jawboning China. Are you recommending that the administration continue that policy or put other pressure on China?

Arvind Subramanian: I think there are two things to note: First, one of the things candidate Obama explicitly said on trade is that he is in favor of a bill on currency manipulation. So, he comes in with a predisposition to be tough on currency matters, I think. Second, on the matter of the Chinese currency itself, I don't know whether it has actually appreciated because of the jawboning. It is a combination of the jawboning plus the fact that the crisis depreciated the currencies of many of China's trading partners. So, that was likely fortuitous and not due to Chinese actions. Going ahead, if the Chinese currency stays at about this level, I think there will be less pressure on the new administration to act. But, I think, the key thing is that if the downturn remains prolonged or the recovery is anemic and the dollar is slightly strong, then there will be a build up of pressure in the United States to take action against trading partners—including those that seem to maintain undervalued currencies. So, there could be one or two triggers that could start this whole thing and we just have to wait and see how this pans out.

Steve Weisman: The next milestone in this will be the G-20's meeting in April in London, I believe.

Arvind Subramanian: That's correct. And, I think, if you look at the G-20 agenda, Steve, what came out of the Washington summit was very weak on this question of imbalances and the whole question of creating an international financial order in which you don't get the kind of global imbalances that we've seen in the past. But, I think, if the currency tensions rise, I think that will and should take center stage in the discussions in April on the international financial system.

Steve Weisman: Before we close, let me ask you about China's reserves. China, to some degree India, and certainly the Gulf countries and oil producers, Russia included, accumulated large reserves over the last several years as the economy grew and oil prices remained high. Now, in the downturn, the reserves of some countries, including Russia and India, have been depleted. What lessons do you think these countries are drawing from the crisis in terms of their future desire to export and build up reserves?

Arvind Subramanian: That is really a key issue, Steve. I think a country like India might well draw the lesson that the fact that they had a lot of reserves actually cushioned the financial impact of the crisis. Now, the model here of course is China. If China comes away from this crisis without a big depression in its growth rate, then I think emerging-market countries might draw the lesson that the Chinese model of maintaining a competitive currency, running huge current account surpluses, and building up reserves is the way forward. If they draw that lesson, we're in for a bout of what one might call the "new mercantilism," where many emerging-market countries say, “this is the way to protect ourselves against future crises.”

Steve Weisman: And are there any alternatives on the agenda for these countries to go on another path besides building up reserves?

Arvind Subramanian: I think the analogy of nuclear armament is relevant here. If, for example, all these countries could be reasonably assured that in the event of a crisis, they will have access to a multilateral pool of liquidity that will be easily available, then the lure of building up this war chest through new mercantilism—competitive exchange rates—might be less tempting. That can only happen if you beef up the IMF, give it a lot more resources, and create the mechanism to reassure countries that in the event of a crisis, they will be able to tap into this pool of resources easily. Then one might say that the incentive to go down this mercantilist route might be diminished a little bit.

Steve Weisman: Arvind Subramanian, thank you very much for sharing your thoughts with us today on Peterson Perspectives.

Arvind Subramanian: Thanks, Steve.