Is the World on a Binge of Devaluation? Part I

Joseph E. Gagnon and William R. Cline discuss the criteria for judging currency activities by the United States, China, Japan, Switzerland, and others. Tomorrow: The dangers of competitive currency devaluations.

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Steve Weisman: There is widespread concern that we are on the verge of, or have even begun seeing, competitive devaluations of currencies by many countries, and that this could lead be dangerous. I'm here with Joseph Gagnon and William R. Cline at the Peterson Institute for International Economics to assess this phenomenon. This is Steve Weisman.

Joe, you and C. Fred Bergsten, the director emeritus at the institute, have written about this phenomenon and have studied it. What is going on?

Joseph Gagnon: There has been in some sense a vast increase in this kind of behavior over the past decade or so—if anything maybe less now then five years ago.

Steve Weisman: But more countries?

Joseph Gagnon: I think it's more the lingering slow recovery in the wealthy countries that has people searching for things to blame for slow growth or things that could be changed to get faster growth. And policy makers to think about: Can they do something about the exchange rate? I think the immediate precipitating factor here is probably Japan, where the new prime minister made a big deal about monetary policy and about the strength of the yen in his campaign and he won big time.

People are talking about whether he would like to see the yen depreciate, and it has depreciated about 15 percent.

Steve Weisman: Yes, and he is in a tussle with the Bank of Japan over this.

Joseph Gagnon: Yes, he is. And he gets to appoint a new management team and so presumably he'll appoint somebody who will be more expansionary. But I think one thing that's missing from this discussion is what exactly Japan will do, because I think it matters a lot whether they do this—whether they are aggressively easing monetary policy, which I think would be good for Japan or good for the world, or they are going to manipulate their currency, which is a different thing.

Steve Weisman: By?

Joseph Gagnon: By buying dollars and euros, printing yen and buying dollars and euros. That would be a beggar thy neighbor policy, whereas if they print money in Japan to buy things in Japan, such as longer term bonds in Japan, to buy equities in Japan, that kind of thing, just finance the government spending in Japan, that would all be stimulative in Japan and help the world. And it would weaken the yen, but it would help the world overall.

The other thing isn't going to increase spending in Japan. It would just grab spending from some other country and bring it to Japan.

Steve Weisman: Bill, let's pick up on that theme. You have analyzed exchange rate and current account imbalances for many years and Joe's distinction between manipulating your rate by buying foreign currencies, versus having a monetary stimulus for your own economic purposes. Joe drew that distinction. Tell me how you see it.

Bill Cline: I think it's a good starting point. It's useful to step back from this. The way I look at this problem is that we seem to have had an international recession about once every 10 years—'82, '91, 2001. The latest one is the most severe. If you look back at the history, each time a number of industrial countries substantially reduced their interest rates and that's the way you fight a recession.

Well, that was monetary easing, but you didn't hear the outcry about the competitive devaluation. Think about what the difference is. I think one of the qualitative differences is that the shift into quantitative easing—because you're at zero interest rates already—has sort of raised a specter, a bogeyman, and if you think of quantitative easing as just another form of reducing interest rates, then it's not that different from the past.

I would start with that general framework, that there's a lot of angst about this, even though we've used monetary ease to deal with recessions in the past.

Joseph Gagnon: A lot of that angst has been directed against the United States—from Europe, from Brazil. Do they just see it differently or do they have other motives?

Bill Cline: I think that one of the reasons that you are hearing it from a country like Brazil is the world capital markets have become much more integrated. You no longer have the fear of the Latin America debt crisis in the 80's or even the East Asian crisis of the late 90's. You have international investors buying global currency, bonds, stocks. So Brazil does tend to get more of a sloshing of capital when the US is doing monetary expansion.

But it seems to me the US has—with an output gap that according to the IMF is still something like 4 percent of GDP or more—it's perfectly appropriate for the US to be using whatever monetary expansion it can, primarily to get its activity up. That then will cause an income effect that imports go up from the rest of the world.

So yes, I think that the Brazilians got a little too agitated. Their currency has come back down some, so there has been some correction of that.

Steve Weisman: Joe, the phenomenon of currency manipulation, you just said a few minutes ago, has subsided a bit. But still there are a lot of—in your studies—bad actors around the world and there seems to be a fear in the financial sector among analysts that this phenomenon is dangerous. What's your reaction?

Joseph Gagnon: Well, certainly financial market participants are wondering what's going to happen, are worried whether there will be tensions around the world. That may be one reason why they're worried. I think—

Steve Weisman: Let me focus the question in a different way. You do not see a danger to the global economy that some see of this worldwide competitive devaluation?

Joseph Gagnon: No, well, I do. The behavior that Fred Bergsten and I have been upset about is continuing. It's at a lower pace than it was five years ago, but it hasn't gone away and I fear—and in fact we both fear—that it may be coming back. There are hints that China's long decline and its current account balance and its reserve accumulation have bottomed out and may be ticking up a bit. And other countries are looking at what China did and other Asian countries did and may be thinking we'd like to do more of this.

So, I'm worried that the low watermark may have passed and it may come back and countries may say, well, if other countries are doing it, I'll do it, so that sort of mentality gets sort of a self-fulfilling prophesy element.

Steve Weisman: Let me stop there and pick up for part two and ask Bill Cline to comment.