Currencies Aren't the Problem
Fix Domestic Policy, Not Exchange Rates

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Last November, the U.S. Federal Reserve embarked on a second round of a type of monetary stimulus known as quantitative easing. The central bank declared that it would buy $600 billion in long-term Treasury bonds in an attempt to push down long-term interest rates. Immediately after the move, the rest of the world accused the United States of deliberately attempting to depreciate the dollar.

However, Washington was not alone in apparently trying to influence its currency's value. China has continued to hold the yuan relatively stable against the dollar, even though many economists believe that the fair value of the Chinese currency is considerably higher. Last September, Japan intervened in the exchange markets to prevent the yen from rising too quickly, and many emerging-market countries have used a mix of similar interventions and capital controls to keep their own currencies from appreciating. Intervention is a zero-sum game: for one country's currency to depreciate, some other countries' currencies must appreciate. Are the same type of senseless beggar-thy-neighbor currency depreciations as those of the 1930s, when many countries tried to depreciate in a race to the bottom, just around the corner?

Thankfully, probably not. Today's jockeying over exchange rates has several important differences from that of the Great Depression years. Most countries today are not trying to gain a short-term advantage through currency actions; instead, they are following domestic economic policy strategies that have allowed them to grow easily in the past. For developed countries such as the United States, this has meant an emphasis on consumption; strategies in China and other emerging markets, meanwhile, have emphasized exports.

Taken together, these strategies have led to significant trade imbalances around the world, even
before the recent crisis. Sustained trade imbalances, in turn, seem to lead to financial and political instability, making them quite dangerous in the long run. However, unless the domestic policy strategies change dramatically, these imbalances will likely persist. Global economic stability, therefore, is not dependent on some grand agreement among countries -- if you allow your currency to appreciate, I will rein in my fiscal deficit -- which unfortunately seems to be the focus of recent economic summits.

Instead, stability will emerge when governments move to more sustainable domestic policy agendas, which are typically in their long-term interest. The role of multilateral bodies, such as the G-20 and the International Monetary Fund (IMF), should therefore be not to coordinate policies among countries but to insert the international dimension into each country's domestic policy debate on reforms. It should also be to set reasonable rules of the game on financial regulation, cross-border capital flows, and international bailouts. Multilateral bodies conduct neither of these functions adequately today. But the silver lining in an otherwise dark cloud is that the rethinking prompted by the Great Recession is already altering policy agendas in some key countries. Given all this, with more effort and some luck, the global economy will not repeat the tragic history of the early twentieth century.

EASING AIN'T EASY

A country's exchange rate affects the international price of its goods. By keeping its currency undervalued (economists debate how easy, in fact, this is to do), a country can expand its market share and production by essentially stealing demand from other states. Exchange-rate manipulation can be particularly attractive in a recession, when preserving jobs is politically important. Governments often view this sort of direct manipulation as a particularly unfair form of competition.

Accusations of such unfairness are now being leveled against the U.S. Federal Reserve. Usually, when a central bank cuts interest rates, the country's currency weakens as capital leaves for more attractive shores. However, lower interest rates also tend to increase domestic demand, as households and firms spend more. In the end, monetary easing does not simply take demand from other countries; it also creates demand overall. Monetary easing, of which quantitative easing is just an extreme form, is therefore typically viewed as a perfectly legitimate economic policy. But the circumstances under which the Federal Reserve embarked on the second round of quantitative easing (the first round was the buying of long-term Treasury bonds and asset-backed securities starting in late 2008) made the move questionable. With short-term U.S. interest rates already near zero, and with large firms able to borrow at very low rates, it was unlikely that corporate investment was being held back because firms thought interest rates were too high. Similarly, households were cautious about spending not because they thought interest rates were too high but because their balance sheets were in disarray. Quantitative easing, other countries alleged, would make dollar bonds unattractive, because long-term bond yields
would fall below what investors wanted given their expectations of higher inflation. This, in turn, would cause capital to flee the United States, lower the value of the dollar, and expand U.S. exports at the expense of other countries.

After U.S. Federal Reserve Chair Ben Bernanke announced that he would undertake quantitative easing, U.S. long-term interest rates dropped and the dollar weakened. But worries about sovereign debt in the eurozone economies soon led the dollar to rebound. And better news about the U.S. economy, as well as worries about the United States' long-term fiscal health, led to a sharp increase in U.S. interest rates. In the end, quantitative easing may have had neither the effect the Federal Reserve predicted nor the one its critics feared.

Nevertheless, the recent debates over currency valuation revealed deeper concerns. The rest of the world worries that policy in the United States, with its two-year electoral cycle, is excessively focused on short-term growth and employment. U.S. politicians neglect the damage their policies do to the rest of the world and, in the long run, to the United States itself. Unlike other countries, whose wayward policies are quickly disciplined by financial markets, the United States is given a long rope because investors value its deep and liquid financial markets -- what in the 1960s Valéry Giscard d'Estaing, then the French minister of finance, described as an "exorbitant privilege."

On the other side, the United States worries that too many countries have become dependent on it to buy their exports and have relied too much on purchasing U.S. financial assets, such as government and corporate bonds, to keep their currencies stable. Although such asset purchases provide the financing the United States needs to fund its imports, they also prevent it from exporting and reducing its trade deficit -- in other words, they encourage U.S. consumption rather than production. The exorbitant privilege may instead be an extraordinary disadvantage.

The symbiotic relationship between the United States and the rest of the world creates very real dangers. U.S. monetary policy is imitated around the world, which means that when the Federal Reserve cuts interest rates, it puts downward pressure on rates everywhere, because no country wants its currency to appreciate strongly against the dollar. Although the Federal Reserve does not recognize it, it sets monetary policy not just for the United States but also for the world. And what is appropriate for a U.S. economy that is recovering slowly from a recession may be overly aggressive for emerging markets that are near full employment, creating inflation and asset bubbles in those economies. Over the medium term, if the United States embraces its role as spender too readily, as it seems to have done in the recent past, it risks jeopardizing its creditworthiness -- not even the United States can borrow forever to fund spending. If the rest of the world suddenly becomes reluctant to fund U.S. spending, the adjustment will be painful, and not just in the United States.

GOLD RUSH

In the years after World War II, the United States had the strongest economy in the world, deep financial markets, and immense reserves of gold. As a result, dollar assets were very liquid and the dollar was easily convertible to gold at the fixed rate of $35 per ounce. Unsurprisingly, these same attributes made the dollar the reserve currency of choice for central banks looking to hold a buffer
against bad times. Many countries also used foreign exchange reserves to back their domestic currency issuances. As national economies around the world grew, their need for reserves increased, and so, therefore, did their demand for dollars.

In the early 1960s, the Belgian economist Robert Triffin warned that the United States would eventually be forced to supply those dollars by running large current account deficits (loosely speaking, the trade deficit, plus aid transfers, minus income earned on financial claims), financed by giving the world dollar-denominated IOUs. Such a scenario would lead to what came to be known as the Triffin dilemma: increased holdings of dollars around the world would erode the faith that the United States would be able to repay gold to anyone who cashed in those dollars. In other words, the willingness to satisfy the demand for a liquid asset -- in this case, dollars -- would eventually erode confidence in its worth.

Triffin was broadly right. The United States initially supplied dollars in the form of grants, loans, and foreign direct investment to capital-short Europe and Japan, which they sent right back by buying U.S. goods. But as U.S. spending on the war in Vietnam increased, its trade surplus shrank, and more dollar claims on the United States accumulated abroad. In the early 1970s, the overhang of dollars outside the United States became so large that the United States had to abandon convertibility and the fixed gold price of $35 an ounce. This triggered the breakdown of the Bretton Woods system of fixed exchange rates.

Much of the language of those criticizing the United States then was similar to the heated rhetoric of today. Many balked at the United States' exorbitant privilege and what some called its "irresponsible" macroeconomic policies. The U.S. response was familiar, too. The United States suggested that French, German, and Japanese currency undervaluation led to shrinking U.S. trade surpluses. (Barry Eichengreen's recent book, *Exorbitant Privilege*, offers a compelling analysis of these debates.)

But unlike today, the United States was not then running a large trade deficit -- in fact, its trade balance and its current account were in surplus throughout the 1960s, albeit shrinking. The world was not dependent on U.S. spending. Also, the fixed nominal exchange rate between the dollar and other currencies was not a choice but required by the Bretton Woods system. And although cross-border private capital flows were already growing at that time, they would be dwarfed by the size of such flows today. For all but the poorest countries, the financing for a country's current account deficit now comes not from other governments or multilateral institutions, such as the IMF or the World Bank, as it used to, but from private sources. These differences are central to understanding why the problem is different today and why, therefore, the solutions must also be different.

**SICK WITH CONSUMPTION**

To see why the United States has come to run such a large trade deficit, it is necessary to understand why U.S. consumption increased so dramatically. In the years before the Great Recession, individual credit, especially for housing, was greatly expanded. Some of this push may have been political; politicians from both parties looked to homeownership as a palliative for people whose incomes had stagnated. Momentum also came from a financial sector running out of control. U.S. consumption
increased from about 67 percent of GDP in the late 1990s to about 70 percent in 2007, financed largely with debt.

An equally important factor in increasing U.S. spending has been the tendency to implement aggressive stimulus policies in downturns. Job growth has been tepid in recent recoveries; it took 38 months, for example, to regain the jobs that were lost in the 2001 recession. Unfortunately, the United States is singularly unprepared for jobless recoveries. Unemployment benefits generally last only six months. Moreover, because health benefits are often tied to jobs, an unemployed worker also risks losing access to medical care. When recoveries are fast and jobs are plentiful, short-duration benefits provide a strong incentive to look for work. But when there are few jobs being created, a positive incentive becomes a source of great uncertainty and anxiety. The political pressure on successive presidential administrations and the Federal Reserve to bring back jobs has been enormous. And they have responded by expanding government spending and keeping interest rates ultralow, thus boosting asset prices and encouraging household spending. In other words, household spending before the Great Recession was fueled not just by expansionary credit policies but also by the aggressive stimulus implemented in response to the 2001 recession.

As the United States increased spending in the years before 2007, many other parts of the world reduced spending, becoming more dependent on the United States and other countries, such as the United Kingdom or Spain, to generate demand. Here again, there were two elements at work: the playing out of long-term economic strategies and a short-term response to financial turmoil.

One of the most successful growth strategies in the second half of the twentieth century was that followed by Germany and Japan, which were looking to rebuild after having been bombed into rubble in World War II. This strategy was later imitated by China and South Korea, which were looking to grow out of abject poverty. In all of these cases, governments (and banks) intervened in the economy to create strong firms and competitive exporters, typically at the expense of household consumption. Such an approach made sense because domestic households were too poor to afford much spending anyway.

Over time, these countries created very efficient export-oriented manufacturing sectors. The need to be competitive in foreign markets kept exporters on their toes. But although global competition limited the deleterious effects of government intervention in the export sector, there were no such restraints on the domestic-oriented production sector. In Japan, for example, banks, retailers, restaurants, and construction companies have managed to limit domestic competition in their respective sectors through their influence over government policies. As a result, these sectors are very inefficient: there are no Japanese banks that rival HSBC in its global reach, no Japanese retailers that approach Walmart in size or cost competitiveness, and no Japanese restaurant chains that rival McDonald's in number of franchises. Domestic services, such as haircuts, are extraordinarily expensive. Low productivity and limited innovation -- and the high prices that follow -- dampen the demand for domestic-oriented production. As a result, economic growth is dependent on foreign, rather than domestic, demand.

This dependence has only been exacerbated by these countries' slowdowns in domestic investment in recent years. For Germany and Japan, the slowdowns were partly a consequence of growing rich again
-- after all, there is a limit to how much capital workers can profitably use -- and partly a consequence of population aging, which has led to shrinking work forces. In addition, during Japan's ongoing two-decade-long economic crisis, Japanese corporations have cut back on their domestic investment so as to pay down their debt.

But perhaps the most dramatic shift in investment took place in the late 1990s among the Asian emerging markets, such as Malaysia, South Korea, and Thailand. With foreign money pouring in during the earlier part of that decade, these countries expanded their investment significantly, financing everything from new airports to state-of-the-art semiconductor plants. They did not, however, have transparent financial markets or strong regulation of corporate disclosure and transactions. Foreign investors who did not understand these countries' murky insider relationships tried to keep their money safe: they offered only short-term loans, denominated payments in foreign currency, and lent through local banks. This last measure gave foreign investors an implicit government guarantee, because governments would likely support domestic banks to avoid widespread economic damage. So although foreign lenders had entrusted their money to opaque domestic borrowers, they had little incentive to screen the quality of the ventures financed.

When boom turned to bust in the late 1990s, a number of Asian governments had to go to the IMF for emergency loans. Governments bailed out foreign creditors as well as domestic banks. The local taxpayer footed the bill, while also suffering a wrenching recession and high unemployment. The lesson was well learned: rather than borrow abroad to finance investment, East Asian governments and corporations decided to abandon grand investment projects and debt-fueled expansion. Moreover, a number of them decided to boost exports by keeping their currencies undervalued, which meant buying foreign currency. In doing so, they built large foreign exchange reserves, which could serve as rainy-day funds if foreign lenders ever panicked again. Thus, in the late 1990s, developing countries cut back on investment and turned from being net importers to becoming net exporters of both goods and capital, adding to the global supply glut.

OUTSOURCING DEMAND

Today, developed countries, hobbled by high levels of household and government debt, are hoping that emerging markets will shoulder the burden of expanding global consumption and investment. Clearly, consumption in poorer countries, such as Brazil, China, and India, as well as in Africa and the Middle East, is far lower than average consumption levels in richer ones, and so is their average physical capital -- houses, roads, sewerages, and so on. There is clearly room for growth here.

Shifting future growth in spending from industrial countries to emerging markets also has a corresponding environmental benefit: since the production of physical goods, such as housing and cars, takes a toll on the environment, it is better for spending to go to moving the slum dweller in Cambodia into a brick house -- a process that will happen sooner or later -- than to moving the suburban American couple into a house with even bigger bedrooms that they will likely never use. Such an outcome may be the environmentally sustainable solution to both global trade imbalances and the incipient currency wars. So how to best bring about this necessary shift in global demand?
Some change is already happening. The lesson China seems to have learned from the Great Recession is that it needs to reduce its dependence on foreign demand. The Chinese know that they cannot continue growing at double-digit rates without encountering protectionist barriers. While much of the world has fixated on China's manipulation of the yuan's value to expand domestic demand, Beijing knows that it is as important to reduce the pro-producer bias in its domestic policy, so as to boost household incomes and consumption. In practice, this means increasing wages, raising interest rates for household bank deposits, and improving the delivery of health and educational services; at the same time, the government is raising corporate taxes and lowering corporate subsidies on inputs such as energy and land. The Chinese government is also encouraging investment in infrastructure to link the poorer, interior western provinces with the richer, coastal ones.

Of course, various economic sectors in China are opposed to change, from China's cash-rich state-owned corporations and banks to foreign firms with production facilities in China that benefit from the low exchange rate. They will fight any loss of their privilege. China will not reform overnight and begin demanding huge amounts of consumer goods. But this could happen over time -- indeed, China's 12th five-year plan, to be implemented beginning in early 2011, emphasizes the expansion of domestic demand.

Other emerging markets, such as Brazil and India, which have historically not repressed consumption as severely as China, are already on a buying binge, buoyed by growing inflows of foreign capital. Trade among emerging-market countries is increasing rapidly. To facilitate this growth in demand, emerging countries will have to allow their real exchange rates to appreciate -- either voluntarily, by accepting revaluations of their currencies, or involuntarily, by having higher inflation. All this, however, raises an important question: Can emerging markets manage to increase their domestic spending in a more stable way than in the past, or will they experience yet another credit boom followed by a bust?

To keep the past from repeating, regulators in both emerging markets and developed economies will have to be more assertive. To ensure that foreign capital inflows do not once again support nonviable investments and irresponsible lending, foreign investors need to be exposed to the full risk of losses. At the same time, domestic financial firms should not have the incentive to expand their balance sheets rapidly when money is cheap. Regulators in a country receiving capital should discourage short-term foreign-currency-denominated loans to their banking system. Instead, they should encourage foreign investors to make long-term direct loans to domestic nonfinancial firms, denominated in the local currency. Government regulators should increase capital requirements, tighten liquidity requirements, and limit leverage for domestic financial firms when credit expands rapidly. Finally, domestic regulators should also improve their national bankruptcy systems so that investors will take a quick and relatively predictable hit when projects fail.

At the same time, regulators in countries with outward capital flows should be careful that their major financial institutions are not overly exposed to any one region, country, or sector. Irish taxpayers should not have to bail out their banks' bondholders simply because these bonds are held by British and German banks. Large cross-border banking firms currently operate with impunity, knowing they are virtually impossible to shut down and will therefore be bailed out when in danger. Reaching an
international accord on how to close these banks when they get into trouble will be difficult but important. Finally, multilateral institutions, such as the IMF, should force investors in a country's debt to take a significant loss if those institutions have to step in to bail the country out -- or else taxpayers will end up having to pay both those institutions and the investors. How best to include clear and transparent triggers for write-downs in debt contracts is not an easy question -- but not an impossible one, either.

All these measures will raise the direct costs to emerging markets of borrowing and will make foreign investors more careful about lending. Higher direct costs will be more than offset by the benefits of more productive and sensible investments, not to mention the decreased likelihood of future busts.

A TRIPLE MANDATE?

The slowdown in spending by the industrial world will give emerging markets strong incentives to shift their growth strategies away from exports -- stronger, in fact, than might emerge from any agreement produced by international summity.

But will "the Great Spender," the United States, cooperate and avoid yet again pumping up demand excessively? U.S. households have certainly increased their savings rates in response to the recession and are trying to pay down their debt. But what is worrying is that many of the efforts of the Federal Reserve and the Obama administration -- whether to keep interest rates very low or offer new tax benefits and government-supported credit for home purchases -- have been meant to encourage household spending. In the meantime, reduced government revenues and increased spending -- the usual effects of a recession -- have been coupled with repeated stimulus packages, which has led to a ballooning of public debt.

As in past recessions, Washington's central concern is job creation. Unfortunately, many of the jobs that were lost at the onset of the latest downturn were tied to construction: not only construction workers themselves but many of the supporting workers, such as home improvement contractors or real estate brokers and lenders, lost their jobs, as did those people who worked in manufacturing construction materials. Given the extent of overbuilding during the last decade, it is unlikely that government spending or low interest rates will bring these jobs back. Instead, unemployed construction workers will have to gain new skills or relocate to areas that have jobs. In other words, the jobs recovery will require politicians to have new ideas, time, and patience -- all of which are in short supply given the political pressure.

More generally, Washington must focus more on tailoring the skills and education of the U.S. workforce to the jobs that are being created, rather than hankering after the old jobs eliminated by technology or overseas competition. In this light, the Obama administration's focus on improving educational standards by measuring student performance, evaluating teachers' abilities, and increasing competition between schools is appropriate; indeed, such reform efforts should be pushed with even greater urgency. The United States also needs a better social safety net, not only to reassure workers but also to ensure that slow recoveries do not result in frenetic, and ultimately excessive, stimulus spending.
Finally, a more stable and less aggressive U.S. monetary policy will not only lead to more sustainable U.S. growth; it will also reduce the volatility of capital flows coming into and out of emerging markets. Given the thin safety net, the political pressure on the Federal Reserve to be adventurous with monetary policy when unemployment is high is enormous. But such pressure can be counterproductive if the Fed's aggressive policies have little direct effect on employment but instead generate asset price bubbles and risky lending, which eventually impose high costs on the economy, including greater unemployment.

It is debatable whether Congress should force the Fed to take seriously its de facto role as the rate setter for the world and unlikely that Congress will ever expand the Fed's mandate to do so. At the very least, however, the Fed's mandate should be extended to include financial stability explicitly, on par with its current responsibilities to keep inflation low and maximize employment.

A CHANGE IS GONNA COME?

In sum, governments know what they need to do. Change, however, will not be easy because it involves short-term pain that is likely to be politically difficult. So what role should multilateral bodies, such as the G-20 and the IMF, play in all this? Thus far, they have been trying to broker grand agreements among countries, guided by the assumption that world growth will be more stable if, for example, the United States cuts its spending in exchange for China's expanding its domestic demand.

There are two problems with this assumption. First, even if a grand agreement could be reached and each country carried out its side of the bargain, there is no guarantee that the timing of the reforms and their effects on global demand could be synchronized. Most policy changes have consequences that kick in with variable and uncertain lags, making it a miracle if their effects actually offset one another and smooth growth. Second, it is not clear that policymakers, even heads of state, have the ability to commit their countries to any kind of economic agreement. For instance, the president of the United States can propose adhering to a path of fiscal contraction, but Congress is the final arbiter.

Moreover, it can be counterproductive to raise hopes before every international meeting that there is an agreement that could magically bring down trade imbalances quickly. Publics are disappointed with the same vague communiqués that end nearly all such summits. Politicians, meanwhile, blame other countries for failures. In trying circumstances, such finger-pointing can degenerate into protectionism. Of course, each country knows what actions are necessary. The key will be to give politicians incentives to take those actions despite domestic pressure to maintain the status quo and despite the short-term pain that invariably accompanies reform.

Multilateral organizations, such as the IMF, can help by communicating the international consequences of a country's policies to that country's elite. These organizations have to become more media savvy and should use the Internet, as well as social networking tools, to encourage countries to add their international responsibilities to their domestic policy agendas. Although multilateral organizations rightfully have no domestic vote, an agreement among countries to allow these institutions to speak freely within each country on the international ramifications of its domestic policies may help nudge these policies in the right direction.
The current tension over currencies reflects the unsustainable trade imbalances that developed thanks to long-standing domestic economic strategies. Many economists would place part of the blame for the Great Recession on these imbalances. Interestingly, the consequences of the Great Recession -- the slow growth of industrial economies relative to emerging markets -- may offer a strong impetus for countries to change those strategies.

For the developing countries, the imperative is to become less dependent on industrial-country spending and to spend more themselves; industrial countries such as the United States must start producing and exporting more, even while consuming less. To help these changes along, international capital flows must become less volatile and more risk sensitive. The United States, in particular, can play an important role in the transition, by focusing more on medium-term reforms that will preserve its competitiveness and less on short-term stimulus, which tends to delay change. There is no guarantee that governments will overcome the political pressure to be myopic, but if they do, the collective rewards will be considerable.

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