Currency Wars and the Paradox of Global Thrift
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Especially in Europe but in most of the G20 countries, austerity policies have reduced aggregate demand, therefore stunting gross-domestic-product growth. The primary mode of stimulating these economies has been to pursue quantitative easing (QE), which amounts to printing money. This combination of fiscal austerity and expansionary monetary policy, known as easy-money-tighter-fiscal policy (EMTF), has led to weak currencies as the majority of G20 countries have collectively pursued EMTF. At the same time, Japan’s central bank is now contemplating an antideflationary, currency-weakening policy, threatening a currency war with China and other Asian economies. To stimulate growth and avoid a currency war, G20 governments and central banks need to reform tax systems by closing loopholes and moderate the growth of government retirement and health benefits while employing QE policy as needed to avoid deflation.

The cries of “currency war” that surfaced at the February 15–16 G20 Summit are a byproduct of the political and economic pain that has arisen from government efforts to move away from huge deficits. Fiscal consolidation, austerity measures, and “responsible” deficit reduction efforts—whatever they are called—reduce demand and thereby slow growth. Austerity also increases tax burdens or reduces much loved government largess. The pain is especially intense in Europe outside of Germany, so little wonder that the highest level of sensitivity to exchange rates exists in Europe, excluding Germany. (See figure1.)

The only way to mitigate the slower growth caused by fiscal tightening is to have central banks aggressively pursue easier money. With virtually zero interest rates prevalent in the United States, United Kingdom, European Union, and Japan—which represent well over 50 percent of the global economy—easy money means quantitative easing (QE), which amounts to printing money.

Key points in this Outlook:

- Since the beginning of the recent global economic crisis, G20 economies have combined fiscal austerity measures with expansionary monetary policy, and the austerity measures have made quantitative easing (QE)—the printing of money—the only pro-growth policy.

- The resulting currency weakness amounts to export of deflation pressures, threatening a currency war since every country, by definition, cannot have a weaker currency.

- Finance ministers and central bankers must reduce debt growth by reforming tax systems, moderating growth of government health and retirement programs, and phasing in binding spending cuts over the next decade while pursuing enough quantitative easing to avoid deflation.
The Paradox of Global Thrift

The easy-money-tighter-fiscal policy (EMTF) mix being pursued globally in 2012–13 with increasing intensity is the classic policy mix for a weaker currency. Easy money pushes down interest rates and spills cash abroad in search of higher returns, pushing down the value of the easy-money currency. Tighter fiscal policy reduces growth and weakens demand, including demand for imports, and so the demand for foreign currency is reduced and the easier-money currency weakens. Easier money—in the United States, for example—increases the supply of dollars in global financial markets, while tighter fiscal policy reduces the US demand for foreign currency in global financial markets. This is a clear recipe for a weaker dollar.

If one smaller country, say Brazil or Mexico, pursues EMTF, it “works” in the sense that the resultant weaker currency boosts exports and reduces imports, helping mitigate the drag from tighter fiscal policy. However, if large countries representing the lion’s share of global output all try to pursue EMTF, no one country succeeds, and fiscal consolidation cuts growth without relief being provided by more net exports. Hence the paradox of global thrift emerges.

Governments under the political strain of enacting meaningful tax increases and spending cuts often find their efforts unrewarded because almost all countries are pursuing EMTF, leaving almost no room for government efforts to succeed in sustaining growth while fiscal consolidation is underway. It becomes very tempting for a country like Spain to protest any weakening of the dollar or yen, which by definition strengthens the euro. France has been pushed into a recession by the austerity imposed by deficit reduction and trapped inside the euro system of fixed exchange rates that mandates an overvalued currency for all but Germany. For these reasons, France is among the loudest objectors to Japan’s recent aggressive and successful efforts to push down its currency.

France’s dilemma is being felt even more intensely in Spain and Italy, where political backlash is building. The outcome of Italy’s February 24–25 elections may include a thumbs down on the austerity programs Italy has been forced to follow. Greece, meanwhile, has become the

\[\text{Figure 1}\]

The Eurozone Struggles with Growth: Change in GDP since 2007 (Seasonally Adjusted Real GDP)
poster child for the “pain and political backlash” club of countries trapped inside the eurozone with a politically and economically toxic combination of an overvalued currency, higher taxes, and reduced government spending. The eurozone entered a recession in the fourth quarter of 2012, its “reward” for pursuing deficit reduction with a still-overvalued currency for most of its members. The eurozone is a casualty of the paradox of global thrift. (See figure 1.)

Currency-War Cries Will Grow Louder

The discordant tone of the currency-war rhetoric will intensify.

The United States has moved further down the EMTF road over the past year with more easy money (QE3) and a 2013 deficit reduction equal to well over 2 percent of gross domestic product (GDP). This austerity comes after four years of fiscal stimulus averaging 3 percent of GDP. The United States has so far eschewed the currency-war rhetoric while pursuing with a vengeance the intensified EMTF that caused it.

The United Kingdom boosted its EMTF mix in mid–2012 with an announcement of tighter fiscal policy, while the Bank of England accelerated its QE by purchasing an increasing share of government bonds (see figure 2). The United Kingdom has entered a recession because there has been limited weakening of the currency to offset the additional fiscal drag. The new Bank of England governor, Mark Carney, has clearly signaled his only option: more aggressive QE.

Japan's new government—under Prime Minister Shinzo Abe, who was elected in December 2012—is pursuing a modified EMTF formula that is essentially an easy-money–easy-fiscal policy (EMEF). “Abenomics” is a two-pronged approach to getting Japan out of deflation, which is a currency-strengthening disaster in a world of widespread EMTF. If every country's currency but Japan's is weakening, then the yen becomes very overvalued (see figure 2).

Abenomics combines much easier money—represented by an inflation target of 2 percent and new leadership at the Bank of Japan that will be firmly committed to achieving the higher inflation target—with easier fiscal policy signaled by a new stimulus package worth 2.6 percent of GDP. The easier fiscal stance will not strengthen the yen because the Bank of Japan will purchase the additional supply of government bonds used to finance it—and more—as part of its commitment to exit Japan's 15-year bout of deflation and stagnation.

Prime Minister Abe speaks of future tax increases to contain Japan's huge debt increase that will come on top of Japan's highest ratio of government debt-to-GDP among G7 countries, which stands at more than twice America's much derided 74 percent ratio. Despite huge debt accumulation over the past 15 years, Japan's fiscal consolidation lies distinctly in the future, as it did for the United States from 2009 to 2012.1

As already noted, Japan's hard-to-criticize effort to exit deflation and stagnation after 15 years of weakness has sharply boosted cries from the rest of the G20 that a “currency war” is underway. That pressure was evident before and during the February 15–16 G20 meeting in Moscow. Japan's weaker yen, down by 14 percent against the dollar in just three months, measures its export of deflation since a weaker yen means stronger currencies (more corrosive deflation pressure) elsewhere. The 25 percent rise in the Japanese stock market over the same period signals Japan's success in a zero-sum game that means the EMTF formula in the rest of the G20 has been undercut. Put simply, deficit reduction is even more painful when a currency is getting stronger because it
means simultaneously losing net exports and fiscal stimulus. All of the G7 countries—to varying degrees and excluding Japan—face this dilemma.

**Japan’s Success with EMEF Means More Pain Elsewhere**

Japan’s policy shift to EMEF has succeeded in producing a better outlook for its economy (as manifested by the more than 25 percent increase in the Nikkei since November) because it has removed much of the substantial post-financial-crisis overvaluation of the yen (figure 2). For the sake of G20 harmony, Japan, still the world’s third-largest economy, has decided to do what all other G7 countries—especially the United States, United Kingdom, and eurozone nations—have done from 2009 to 2012 to cushion the huge drag of wealth loss imposed by the 2008 financial crisis: pursue EMEF to spur growth and avoid deflation.

Japan’s passivity during the 2009–12 period gave it an even stronger yen, more deflation, and more stagnation. Now, Japan has sensibly joined the EMEF party, but at a very awkward time for the big G7 economies that have left it and are collectively pursing the zero-sum game of EMTF. In fact, the EMTF game for non-Japan G20 countries has become a negative-sum game to the extent that Japan succeeds with EMEF.

**The Trouble with China**

China and the rest of non-Japan Asia, especially South Korea and Taiwan, are placed in an uncomfortable position by Japan’s EMEF. Weaker stock markets that have emerged in much of Asia are signals of stress in a world of weaker global demand. Even China’s usually buoyant Shenzhen Index, up about 12 percent over the past year, is down 1 percent over the past month, perhaps a sign of skepticism among global investors as to whether China has successfully navigated its transition to new leadership and away from its massive 2008–09 14-percent-of-GDP fiscal stimulus. The weaker Chinese stock market, even with the Hong Kong currency pegged to the dollar, is especially galling to the Chinese in view of the more than 25 percent rise in Japan’s stock market since early November 2012.

China’s currency has been appreciating moderately since mid–2012, but as its external surplus disappears and growth fails to accelerate, the pressure for a weaker Chinese yuan will rise sharply. The same is even more true in South Korea. South Korea’s normally buoyant KOSPI Stock Index has been down by over 2 percent over the past year while the country’s stronger currency has harmed its export growth.

Japan’s successful yen-weakening efforts put it squarely in China’s sights as a problem, a perception that has been exacerbated by the Abe government’s aggressive geopolitical stance in Asia. Other Asian exporters, especially South Korea and Taiwan, are struggling to maintain growth as their currencies strengthen against the Japanese yen (see figure 3).

**Figure 3**

**Broad Real Effective Exchange Rate, 2008=100**

(Trade-Weighted Based on Bilateral Trade in Manufactured Goods)

![Graph showing exchange rates over time](source: JP Morgan.)

Currency wars in Asia may be the world’s most intense in that they come with a newly aggressive Japanese stance on both economic and geopolitical fronts. The United States will need to support its major ally in the Pacific in both spheres as economic and political conflicts with China intensify. Prime Minister Abe’s February 22–24 discussions with President Obama will hopefully be more
substantive than such perfunctory “get-acquainted” meetings with new Japanese prime ministers have been in the past. One hopes the White House is aware of this urgent reality.

Can Global QE Work?

Can money printing (more QE) rescue the world economy from the paradox of more thrift? Printing more money in a world of weakening demand defined EMTF, so to the extent that money-printing boosts aggregate demand by more than tighter fiscal policy reduces it, the answer is “yes.” But two dangers exist. First, the net outcome of global EMTF will be negative if tighter fiscal policy proceeds too rapidly, as it has done in Europe (see figure 1), since faster tighter fiscal policy reduces the likelihood that easy-money policy can offset tighter fiscal policy’s negative impact on aggregate demand.

Second, if easy-money policy is too successful and is pursued without gradual, steady tighter fiscal policy, overheating and higher inflation will appear as higher aggregate demand eats up excess global capacity. Easy-money policy does nothing to boost aggregate supply, and once full employment is reached, it just creates more demand for a given quantity of goods—a classic recipe for more inflation.

That said, we are a long way from full employment, so EMTF ratios should rise for a time without causing inflation. Reducing EMTF as eurozone nations appear to be contemplating European Central Bank President Mario Draghi’s hints of less easy-money policy and more pressure for tighter fiscal policy among FISH (France, Italy, Spain, and Holland) countries—on top of the extreme tighter fiscal policy already depressing the PIIGS (Portugal, Ireland, Italy, Greece, and Spain) countries—is a dangerous alternative. Italy lies within both the FISH and the PIIGS economic set, raising the uncertainty surrounding its upcoming election.

G20 Weakness

The emergence of currency-war rhetoric among G7 members this year manifests the sharp intensification of the paradox of global thrift in a softening global economy. Europe and the United Kingdom are in recession. America’s fourth-quarter-2012 growth rate was -0.1 percent. Japan’s growth rate during the same period was an even weaker 0.4 percent, which further encourages EMEF policies. China’s recovery is tentative, and other major easy-money policy economies like South Korea, Brazil, and Taiwan are losing momentum while protesting weaker G7 currencies, especially the dollar and the yen.

Against this messy background and following the February 15–16 G20 meeting, the finance ministers and central bankers in attendance promised: “We will refrain from competitive devaluation. We will not target our exchange rates for competitive purposes.” Also, the G20 agreement signatories will “resist all forms of protectionism and keep our markets open.”

These are empty promises. Ministers and central bankers need to immediately start thinking about how to boost growth. Specifically, they need to reform tax systems with lower marginal tax rates financed by loophole closing, keep pursuing QE firmly enough to avoid deflation, and enact new and binding spending reductions that will take effect over the next decade. The trajectory of government spending can only be lowered by entitlement reform that moderates the growth of government-sponsored retirement and medical programs. If they reject these measures, the ministers and central bankers need to prepare for a nasty currency war.

There is hope that the G20 attendees have recognized the seriousness of their predicament. They refrained from ganging up against Japan’s necessary efforts to inflate with Abenomics’ EMEF combination. At least the easy fiscal policy part aims at domestic reflation, taking some pressure off the need to have a weaker currency support growth. A faster-growing Japan with a weaker yen will help the world economy more than a weaker Japanese economy with a stronger yen would.

Underlying Post-Crisis Challenges

More broadly, policymakers need to remember and recognize that the aftermath of a global financial crisis like the one that occurred in 2007–08 is never easy. Wealth losses and resulting consolidation and debt reduction by the private sector make for weak recoveries and stubborn unemployment.

EMEF provides temporary relief, but it ultimately must turn into EMTF as budget deficits and debt quantities get
too high. Added to this is the complication surrounding the fact that the world’s third-largest economy, Japan, has entered the EMEF stage late, complicating efforts in the rest of the world to transition to the EMTF phase. With patience and a clear understanding of the fact that the world economy still faces a difficult period of recovery from the global financial crisis, it should be possible to reach a sustainable path to global recovery by 2015. The trick is not to let the challenges underway result in counterproductive measures that delay progress toward that sustainable recovery.

Notes

3. Ibid.