

Session 16

Has Europe Lost the Currency War?

Kathryn M. E. Dominguez

University of Michigan and NBER.

Currency wars rarely produce victors. International financial history is replete with examples of countries unsuccessfully attempting to manipulate the value of their currency at the expense of other countries. The interwar period is the classic example; countries abandoned the gold standard and attempted to stimulate their economies by devaluing their currencies. Trading partners quickly retaliated with their own devaluations, leading only to exchange rate volatility and an overall decline in international trade.

When is exchange rate management warranted? Economic theory suggests that when markets function efficiently free-floating exchange rates can serve as global automatic stabilizers. The currencies of countries that experience negative demand or supply shocks will weaken, leading to a fall in export prices and an increase in competitiveness. If just one country or a small group of countries experience the negative shock, the corresponding rise in counter-party currency values will generally be small as it will be spread across a large group of countries. However, if much of the world experiences the negative economic shock, the process of macroeconomic stabilization via unfettered exchange rate movements is less clear-cut. When the negative shock is global, all countries will feel the need for devaluation and no country will want the offsetting appreciation. This is the scenario in which currency wars are most likely to develop, but exchange rate management is least likely to be effective.

Another circumstance in which countries are often tempted to intervene in currency markets is when exchange rates are determined by international capital flows that seem disconnected to macroeconomic fundamentals. Switzerland's recent experience is an example of this dilemma. The Swiss franc appreciated dramatically as a result of safe-haven induced capital inflows, far beyond what most economists would judge as warranted based on Switzerland's economic fundamentals. Concern over the effects of the Swiss franc appreciation on exporters led the Swiss National Bank to engage in massive intervention operations to stabilize the currency and stave off additional appreciation. Countries are also likely to be tempted to intervene in circumstances when they believe other countries are (unfairly) manipulating currency values. China is currently the country most often accused of unfair currency manipulation, though in the past this accusation has also been leveled at Japan and the United States, as well as a number of export-oriented developing countries.

In thinking about the current situation for the Eurozone it is instructive to remember that soon after the introduction of the euro in 1999 there was pressure on the European Central Bank to support the euro using intervention operations. The ECB eventually intervened in the currency market on four days in the fall of 2000. The first ECB operation was coordinated with the U.S. Federal Reserve and the Bank of Japan, along with other central banks. The ECB operations came as the euro was at its weakest against the dollar, and the operations coincided with a substantial (although relatively short-lived) strengthening of the euro.

The question posed to this panel is whether the ECB's mandate should be expanded to include exchange rate policy, and if so, whether a case can be made for euro-weakening interventions. The ECB does not need an extension of its mandate to intervene; it intervened in 2000 and could easily do so again if member countries all agree a weakening of the euro is warranted. In 2000 the Eurozone countries were

able to convince a number of other G7 countries to join them in their effort to strengthen the euro. This time around it is hard to imagine a similar agreement to coordinate interventions to weaken the euro. This would leave the Eurozone with the option to go-it-alone as China and Switzerland have done, though the ramifications of such a strategy in terms of global retaliation are likely to be severe. An alternative, much less risky approach, would be for the ECB to pursue more aggressive monetary expansion similar to policies in place in the US, Britain and Japan. Aggressive expansion would lead to the desired euro depreciation, while at the same time lowering deflationary concerns and supporting domestic demand.

On June 5th the ECB took exactly this approach: it aggressively cut its benchmark rates and launched a new QE-style program. The euro immediately weakened, and there have been no calls for retaliation. Europe has not lost the currency war; the ECB adeptly managed to weaken the euro without a battle.