Accidental Currency War

The new race to the bottom.

BY MOHAMED A. EL-ERIAN

Six and a half years after the global financial crisis, central banks in emerging and developed economies alike are continuing to pursue unprecedentedly activist—and unpredictable—monetary policy. How much road remains in this extraordinary journey?

In the last month alone, Australia, India, Mexico, and others have cut interest rates. China has reduced reserve requirements on banks. Denmark has taken its official deposit rate into negative territory.

Even the most stability-obsessed countries have made unexpected moves. Beyond cutting interest rates, Switzerland suddenly abandoned its policy of partly pegging the franc's value to that of the euro. A few days later, Singapore unexpectedly altered its exchange rate regime, too.

More consequential, the European Central Bank has committed to a large and relatively open-ended program of large-scale asset purchases. The ECB acted despite a growing chorus of warnings that monetary stimulus is not sufficient to promote durable growth, and that it encourages excessive risk-taking in financial markets, which could ultimately threaten economic stability and prosperity (as it did in 2008).

Even the U.S. Federal Reserve, which is presiding over an economy that is performing far better than its developed-world counterparts, has reiterated the need for "patience" when it comes to raising interest rates. This stance will be difficult to maintain, if continued robust job creation is accompanied by much-needed wage growth.

This new round of central bank activism reflects persistent concerns about economic growth. Despite a once-unthinkable amount of monetary

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stimulus, global output remains well below potential, with the potential itself at risk of being suppressed.

Making matters worse, weak demand and debt overhangs are fueling concerns about deflation in the eurozone and Japan. Anticipating falling prices, households could postpone their consumption decisions, and companies could defer investment, pushing the economy into a downward spiral from which it would be very difficult to escape.

If weak demand and high debt were the only factors in play, the latest round of monetary stimulus would be analytically straightforward. But they are not. Key barriers to economic growth remain largely unaddressed—and central banks cannot tackle them alone.

For starters, central banks cannot deliver the structural components—for example, infrastructure investments, better-functioning labor markets, and pro-growth budget reforms—needed to drive robust and sustained recovery. Nor can they resolve the aggregate demand imbalance—that is, the disparity between the ability and the willingness of households, companies, and governments to spend. And they cannot eliminate pockets of excessive indebtedness that inhibit new investment and growth.

It is little wonder, then, that monetary policy instruments have become increasingly unreliable in generating economic growth, steady inflation, and financial stability. Central banks have been forced onto a policy path that is far from ideal, not least because they increasingly risk inciting some of the zero-sum elements of an undeclared currency war. With the notable exception of the Fed, central banks fear the impact of an appreciating currency on domestic companies' competitiveness too much not to intervene; indeed, an increasing number of them are working actively to weaken their currencies.

The "divergence" of economic performance and monetary policy among three of the world's most systemically important economies—the eurozone, Japan, and the United States—has added another layer of confusion for the rest of the world, with particularly significant implications for small, open economies. Indeed, the surprising actions taken by Singapore and Switzerland were a direct response to this divergence, as was Denmark's decision to halt all sales of government securities, in order to push interest rates lower and counter upward pressure on the krone.

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Of course, not all currencies can depreciate against one another at the same time. But the current wave of efforts, despite being far from optimal, can persist for a while, so long as at least two conditions are met.

The first condition is America's continued willingness to tolerate a sharp appreciation of the dollar's exchange rate. Given warnings from U.S. companies about the impact of a stronger dollar on their earnings, not to mention signs of declining inward tourism and a deteriorating trade balance, this is not guaranteed.

Still, as long as the United States maintains its pace of overall growth and job creation—a feasible outcome, given the relatively small contribution of foreign economic activity to the country's GDP—these developments are unlikely to trigger a political response for quite a while. Indeed, America's intricate trade relations with the rest of the world—which place households and companies on both sides of the production and consumption equation—make it particularly difficult to stimulate significant political support for protectionism there.

The second condition for broad-based currency depreciation is financial markets' willingness to assume and maintain risk postures that are not yet validated by the economy's fundamentals. With central banks—the *de facto* best friend of financial markets these days—pushing for increasingly large financial risk-taking (as a means of stimulating productive economic risk-taking), this is no easy feat. But given the danger that this poses, one hopes that they succeed.

In any case, central banks will have to back off eventually. The question is how hard the global economy's addiction to partial monetary policy fixes will be to break—and whether a slide into a currency war could accelerate the timetable. ◆