portfolio construction forum

The return of currency wars

Nouriel Roubini | Roubini Global Economics | 01 December 2014

The recent decision by the Bank of Japan to increase the scope of its quantitative easing is a signal that another round of currency wars may be under way. The BOJ's effort to weaken the yen is a beggar-thy-neighbor approach that is inducing policy reactions throughout Asia and around the world.

Central banks in China, South Korea, Taiwan, Singapore, and Thailand, fearful of losing competitiveness relative to Japan, are easing their own monetary policies - or will soon ease more. The European Central Bank and the central banks of Switzerland, Sweden, Norway, and a few Central European countries are likely to embrace quantitative easing or use other unconventional policies to prevent their currencies from appreciating.

All of this will lead to a strengthening of the US dollar, as growth in the United States is picking up and the Federal Reserve has signaled that it will begin raising interest rates next year. But, if global growth remains weak and the dollar becomes too strong, even the Fed may decide to raise interest rates later and more slowly to avoid excessive dollar appreciation.

The cause of the latest currency turmoil is clear. In an environment of private and public deleveraging from high debts, monetary policy has become the only available tool to boost demand and growth. Fiscal austerity has exacerbated the impact of deleveraging by exerting a direct and indirect drag on growth. Lower public spending reduces aggregate demand, while declining transfers and higher taxes reduce disposable income and thus private consumption.

In the eurozone, a sudden stop of capital flows to the periphery and the fiscal restraints imposed - with Germany's backing - by the European Union, the International Monetary Fund, and the ECB have been a massive impediment to growth. In Japan, an excessively front-loaded, consumption-tax increase killed the recovery achieved this year. In the US, a budget sequester and other tax and spending policies led to a sharp fiscal drag in 2012 to 2014. And, in the United Kingdom, self-imposed fiscal consolidation weakened growth until this year.

Globally, the asymmetric adjustment of creditor and debtor economies has exacerbated this recessionary and deflationary spiral. Countries that were overspending, under-saving, and running current-account deficits have been forced by markets to spend less and save more. Not surprisingly, their trade deficits have been shrinking. But most countries that were over-saving and under-spending have not saved less and spent more - their current-account surpluses have been growing, aggravating the weakness of global demand and thus undermining growth.

As fiscal austerity and asymmetric adjustment have taken their toll on economic performance, monetary policy has borne the burden of supporting faltering growth via weaker currencies and higher net exports. But the resulting currency wars are partly a zero-sum game - if one currency is weaker, another currency must be stronger; and if one country's trade balance improves, another's must worsen.

Of course, monetary easing is not purely zero-sum. Easing can boost growth by lifting asset prices (equities and housing), reducing private and public borrowing costs, and limiting the risk of a fall in actual and expected inflation. Given fiscal drag and private deleveraging, lack of sufficient monetary easing in recent years would have led to double and triple dip recession (as occurred, for example, in the eurozone).

But the overall policy mix has been sub-optimal, with too much front-loaded fiscal consolidation and too much unconventional monetary policy (which has become less effective over time). A better approach in advanced economies would have comprised less fiscal consolidation in the short run and more investment in productive infrastructure, combined with a more credible commitment to medium- and long-term fiscal adjustment - and less aggressive monetary easing.

You can lead a horse to liquidity, but you can't make it drink. In a world where private aggregate demand is weak and unconventional monetary policy eventually becomes like pushing on a string, the case for slower fiscal consolidation and productive public infrastructure spending is compelling.

Such spending offers returns that are certainly higher than the low interest rates that most advanced economies face today, and infrastructure needs are massive in both advanced and emerging economies (with the exception of China, which has overinvested in infrastructure). Moreover, public investment works on both the demand and supply sides. It not only boosts aggregate demand directly, it also expands potential output by increasing the stock of productivity-boosting capital.

Unfortunately, the political economy of austerity has led to sub-optimal outcomes. In a fiscal crunch, the first spending cuts hit productive public investments, because governments prefer to protect current - and often inefficient - spending on public-sector jobs and transfer payments to the private sector. As a result, the global recovery remains anemic in most advanced economies (with the partial exception of the US and the UK) and now also in the major emerging countries, where growth has slowed sharply in the last two years.

The right policies - less fiscal austerity in the short run, more public investment spending, and less reliance on monetary easing - are the opposite of those that have been pursued by the world's major economies. No wonder global growth keeps on disappointing. In a sense, we are all Japanese now.

(c) Project Syndicate

Nouriel Roubini is Chairman of Roubini Global Economics and Professor of Economics at New York University's Stern School of Business.