The exchange rate and economic policy

In its desire to put a stop to deflation and redirect growth, Japan's economic authorities have given their monetary policy a markedly expansionary twist. This has led to a substantial depreciation of the yen (down 20% against the dollar since November 2012) which has aroused criticism, especially among the country's Asian neighbours who may lose external competitiveness. There are some, however, who argue that today's expansionary monetary policy by Japan and other advanced economies is not a competitive devaluation. Ultimately, the essential aim of such policies is to boost domestic demand.

Whether depreciation is deliberate or not, what is true is that the exchange rate plays or should play an important role in economic policy decisions. This role will depend, in the first instance and to a large extent, on the exchange rate regime chosen.

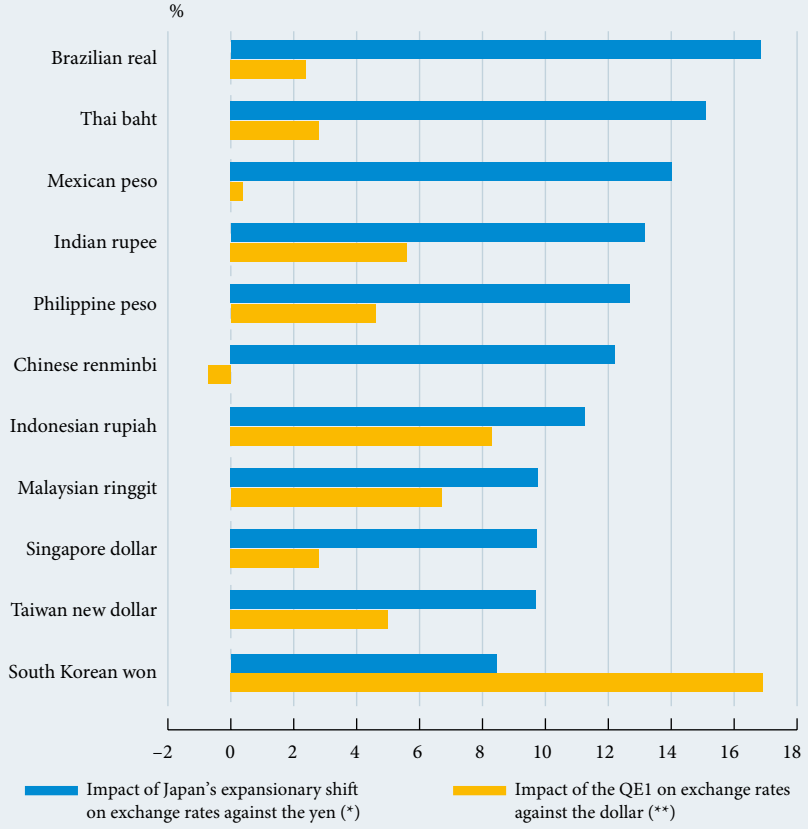
A hard exchange rate peg makes it impossible to use the exchange rate as a routine economic policy tool because it basically fixes its par value. If, moreover, capital flows are allowed to circulate freely, this regime means that monetary policy can no longer act independently to modulate the economic cycle. Hence, a country with a fixed exchange rate that decides to ease its monetary policy (compared with the country of the anchor currency) would lead to capital outflows and, consequently, push down the value of the currency. Under this scenario, the central bank would not be able to counter indefinitely by selling off reserves since these are limited. In the area of economic theory, this incompatibility between a fixed exchange rate, free capital flows and independent monetary policy is known as the trilemma of the open economy or the impossible trinity. We can find present-day examples in the

Saudi Arabian riyal, which pegs its rate against the dollar, or in the Lithuanian litas which, since its inclusion in the Exchange Rate Mechanism II (ERM II), has kept a de facto fixed rate against the euro.[1]

Nonetheless, nowadays a hard exchange rate peg is the exception rather than the rule. Most fixed exchange rate systems maintain a «soft» peg; i.e. a par rate against an anchor currency which is not unalterable (for example, the Central African franc or CAF) or which can be adjusted gradually and periodically in response to changes in a set

THE EXTRAORDINARILY EXPANSIONARY MONETARY POLICIES OF JAPAN AND THE UNITED STATES INFLUENCE THE FOREIGN EXCHANGE MARKET

A positive sign indicates appreciation against the yen or dollar



NOTES: (*) Changes in the exchange rate against the Japanese yen between 16 December 2012 (Abe Shinzo's victory) and March 2013.
(**) By QE1 we mean the Federal Reserve's first round of Quantitative Easing. We have calculated the variation in the exchange rate against the dollar as the cumulative figure throughout the different asset purchases within the programme.
SOURCES: Thomson Reuters Datastream and own calculations.

(1) The ERM II (designed as an antechamber to the euro in European Union countries opting to form part of the euro area) fixes a central exchange rate for the currency in question against the euro, with a normal fluctuation band of ±15%. Although this band can be adjusted downwards (as in the case of Denmark, which narrowed it to ±2.25%), Lithuania did not modify the band but, in practice, maintains zero fluctuation around the central rate fixed at 3.45 litas/euro.

of quantitative indicators (what is known as a «crawling peg», as in the case of the Chinese renminbi) or fluctuate within a more or less narrow band (for example, the Singapore dollar). Under such regimes, economic authorities have room to use the exchange rate as a macroeconomic policy tool. Thus, being able to devalue or revalue their currency according to the circumstances. They also have some room to manoeuvre in monetary policy when a fluctuation band is chosen and even greater room if capital controls are imposed (such as in the Chinese case). In any case, the credibility of both rate peg systems, hard or soft, requires a large enough buffer of international reserves to be able to defend the agreed par value.

At the other end of the spectrum are flexible or floating exchange rate systems where the exchange rate is not determined by decree (with or without a fluctuation band) but is determined by the market. However, this does not mean economic authorities can no longer influence the price of their currency. To begin with, the central bank can intervene directly in the foreign exchange market to limit the volatility of its currency. Although it is not a typical option in large advanced economies, it is not infrequent in emerging economies such as Brazil. Moreover, economic policymakers can also affect the price of their currency indirectly, fundamentally via monetary policy and, to a lesser extent, fiscal policy. For example, easier monetary conditions that increase future inflationary expectations will weaken the currency of the economy in question.

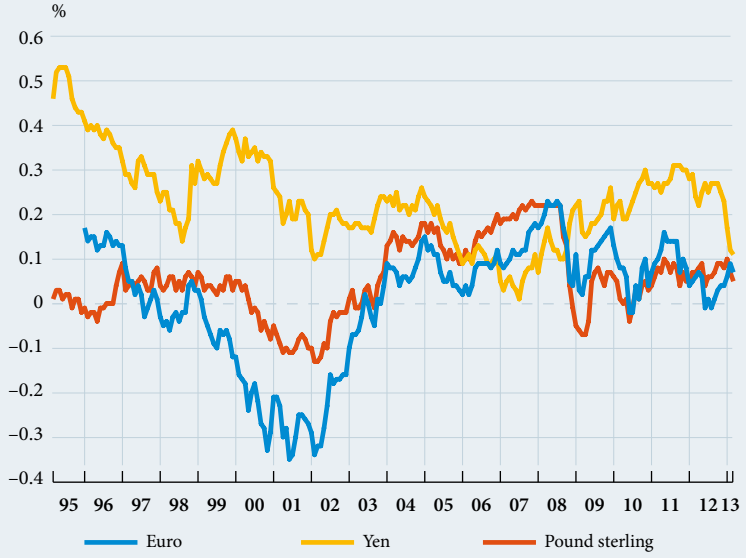
So a flexible exchange rate system also provides economic authorities with the option of bringing about a depreciation or appreciation in their currency via monetary policy. And that is the crux of the issue: although the explicit goal of such a policy may be to stimulate domestic demand, its impact on the exchange rate might be interpreted as deliberate depreciation.

Given the current state of affairs, in which many of the large advanced economies are going through a period of substantial economic weakness and, in some cases, have little room to implement fiscal stimuli, easing monetary conditions is deemed to be inevitable. As inevitable as the fact that the extraordinary scope of the monetary stimuli end up weakening their respective currencies (see the above graph). The problem arises when this depreciation threatens the economic model of other countries and particularly if it is perceived as deliberate. Under such circumstances, the economic authorities whose currencies are being pushed up might undertake measures aimed at weakening their currencies. This would not only restrict the impact of the monetary policies of the large advanced economies on their aggregate demand (ultimately the exchange rate contributes to the adjustment) but, if reprisals escalate, it could clearly lead to a full-blown currency war.

For the time being, however, the reaction of the emerging currencies has been limited to the odd intervention by their central banks in foreign exchange markets or to controls of capital inflows to slow down any excessive appreciation in their currencies. On the other hand, the bulk of the evidence available suggests that the currencies of the advanced economies in question are remaining in line with their equilibrium exchange rate (see the box: «What is the right price for a currency?») and, between them, are not very far from the purchasing power-parity (PPP) exchanges rates. That is, the exchange rate such that we can buy the same bundle of goods in two different countries (see the graph below). Moreover, their recent depreciation does not seem to have contributed to an extraordinary growth in their net exports. In the case of the United States, this might be due to the fact that, considering its size, it is still a relatively closed economy. In the case of Japan, perhaps this is due to the fact that the yen's depreciation, although dramatic, is still very recent. Nevertheless, we might conclude that this movement has

THE EXCHANGE RATES OF THE MAIN CURRENCIES REMAIN IN LINE WITH THEIR LONG-TERM EXCHANGE RATES

Deviation from the PPP exchange rate against the dollar



SOURCES: Bloomberg and own calculations.

aroused mistrust among its neighbours; this comes as no surprise as it would not be the first time Japan has resorted to the exchange rate to boost its economy.

In any case, the high relative weight of Asian trade in Japan's exports means that resorting to depreciating the yen as a macroeconomic policy tool has its limits. If this impairs the competitiveness of its trading partners and neighbours to the point of damaging their growth, the positive effect of the exchange rate on Japan's own activity will also fade.

In short, when Christine Lagarde, Director of the IMF, says that "talking of currency war is overblown", she is most probably right. There are not enough arguments to defend the existence of a currency war. Neither are there enough arguments to believe that the risk of one occurring is well-grounded, at least in the short term. And even less so as long as we all bear in mind, albeit hazily, the ravages caused by the last conflict in this area.

This box was prepared by Clàudia Canals and Marta Noguer
International Unit, Research Department, "la Caixa"