The Federal Reserve and the currency wars

By José Antonio Ocampo
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The United States Federal Reserve's recent decision to launch a third round of "quantitative easing" has revived accusations by Brazil's finance minister, Guido Mantega, that the US has unleashed a "currency war." In emerging-market countries that are already struggling with the impact of rapid currency appreciation on their competitiveness, expansionary measures announced in recent weeks by the European Central Bank and the Bank of Japan have heightened the sense of alarm at the Fed's decision.

My sense is that both sides are right. The Fed was right to adopt new expansionary monetary measures in the face of a weak US recovery. Furthermore, tying it to improvements in the labor market was a particularly important step – one that other central banks, especially the ECB, should follow.

Of course, monetary expansion should be accompanied by a less contractionary fiscal stance in industrial countries. But the advanced economies' room for fiscal maneuver is more limited than it was in 2007-2008, and America's political gridlock has deepened, all but ruling out further stimulus through budgetary channels. Although the effectiveness of a new round of quantitative easing will be limited, as Mantega argues, the Fed had no choice but to act.

But Mantega is also right. Given the role of the US dollar as the dominant global currency, the Fed's expansionary monetary policy generates significant externalities for the rest of the world – effects that the Fed is certainly not taking into account. The basic problem is that there are essential imperfections in an international monetary system that is based on the use of a national currency as the world's main reserve currency.

This problem was highlighted as far back as the 1960's by the Belgian economist Robert Triffin, and, more recently, by the late Italian economist Tommaso Padoa-Schioppa. "The stability requirements of the system as a whole," Padoa-Schioppa argued, "are inconsistent with the pursuit of economic and monetary policy forged solely on the basis of domestic rationales."

In particular, expansionary monetary policies in the US (indeed, in all advanced countries) are generating high risks for emerging economies. Because interest rates must remain very low in developed countries at least for the next several years, there are now strong incentives to export capital to higher-yielding emerging economies. But such capital inflows threaten exchange-rate overvaluation, rising current-account deficits, and asset-price bubbles, all of which have in the past led to crises in these economies.

In short, the medium-term benefits that emerging economies could receive from faster growth in the US are now being swamped by short-term risks generated by the "capital tsunami," as Brazilian President Dilma Rousseff has called it.

The basic problem is the lack of a broader agenda that would make the Fed's position consistent with that of Mantega and other emerging-country officials. That agenda must include two issues of global monetary reform that remain unaddressed: coordinated global regulation of capital flows in the short term, and a long-term shift toward a new international monetary system based on a true global reserve currency (possibly based on the International Monetary Fund's Special Drawing Rights).

The US could benefit from such policies, as capital-account regulation would force investors to find opportunities at home, while a true global reserve currency would free the US from concerns – and harsh rebukes – about the implications of its monetary policy on the global economy. At the same time, emerging markets would gain the full benefits of expansionary monetary policy in the US, to the extent that it boosts demand for their exports.

IMF Managing Director Christine Lagarde has called for coordinated action to sustain the global recovery. Moreover, in October, the IMF is set to release official "rules of the road" for the use of capital-account regulations. The IMF/World Bank meetings in Tokyo on October 12-13 thus might be the ideal opportunity to begin broadening the international monetary agenda – by giving the green light to coordinated regulation of cross-border capital flows, and launching a discussion about the future of the international monetary system.

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