The politics of currencies

by Adam Tooze
September 14, 2020 – *Social Europe*

Adam Tooze argues that worrying about the euro exchange rate and a non-existent inflation enemy in Europe must give way to fiscal and monetary demand boosts.

On September 10th, as they waited for the European Central Bank press conference, market actors and financial commentators held their collective breath. The eurozone sovereign-debt markets were calm, the Pandemic Emergency Purchase Programme has ample headroom and the euro-area economy was showing signs of recovery. Yet the anxious question hanging over the event was whether ECB officials would mention the euro's recent appreciation against the dollar—and, if so, what words would they use?

It may sound odd, but for a central bank to talk about exchange rates is at odds with the prevailing model of central banking in advanced economies. The central focus of that regime is price stability, which is to be achieved by inflation-targeting. Originally, the aim of the central bank was to keep inflation, as measured by a battery of domestic price indices, below 2 per cent per annum. Fear of inflationary overshooting is increasingly obsolete, though it lingers in some parts of Europe. The main concern today is to ensure that inflation stays reasonably close to 2 per cent, so there is not a slide into deflationary territory.

The exchange rate is left to be decided by the daily flux of trillions of dollars in the foreign-exchange markets. If a central bank is doing its job in stabilising domestic prices, it ought to have nothing to fear from the currency markets—or so the theory goes. If all central banks adopt similar price-stability targets, then there should be even less reason for destabilising currency movements.

It is not just unnecessary to target exchange rates. *Not* doing so is a concomitant of the basic logic of central-bank governance since the 1980s—the depoliticisation of money. For national central banks to openly discuss exchange rates risks politicising international financial relations.

By definition, exchange rates are relative. In the fiat-money regime which has prevailed since the collapse of the postwar Bretton Woods system in the early 1970s, exchange rates are summary judgements about the relative attractiveness of holding one country's sovereign currency. If any central bank targets its exchange rate, as does China's for instance, this has implications for all other currencies: any adjustment, up or down, implies an equal and opposite adjustment among counterparts.

This seesaw can generate economic and political tensions. In the days of the European Monetary System in the 1980s and 1990s, Europeans learned this the hard way. The position of the *lira* or the *franc* in relation to the *Deutschmark* became of existential national interest. It was precisely to escape such tensions that Europeans made their leap into the single currency.

Dominant currency

At a global level, currency politics revolves around the dollar, still the dominant currency for commerce and finance. This confers privileges, though not everyone in the United States benefits equally. The value of the dollar is contentious in the US as well. Indeed, different branches of government have different approaches.

For the State Department and the Treasury, with their sanctions regimes, the dollar is a cudgel to be wielded against friend and foe alike. The Office of the US Trade Representative and the Commerce Department view the currency from the angle of competitiveness: when the dollar rises and exporters complain, this is apt to trigger questions about manipulation, and business and the trade unions have vociferous lobbyists in Congress.

The Federal Reserve exercises huge global sway by way of its monetary policy. Its policy on interest rates and credit is governed with regard to the domestic economy and the stability of the US financial system. This is so highly integrated with other major financial centres that the US central bank acts *de facto* as lender of last resort to the global system, with Europe the next most important node. If the Fed is providing liquidity, this weakens the dollar. But if the Fed so much as talks about tightening, as it did between 2013 and 2019, the dollar strengthens.

Exchange rates, asset values, interest rates, competitiveness and sovereignty are scrambled together. Torn between these competing imperatives, the US is an increasingly anxious, prickly and incoherent hegemon.

In this roller-coaster year, we have seen the brutal assertions of US sanctions against Iran—even at the height of the Covid-19 crisis—and threats to cut China's entire banking system out of the dollar clearing system. *Vis-à-vis* Russia, the sanctions against firms assisting Gazprom's Nord Stream 2 gas pipeline into Europe have the force they do ultimately because the US regulates access to its financial system, without which no global business can function.

As the pandemic hit, the imperatives of the global financial system imposed themselves with a huge, panic-stricken run to dollars and a surge in their value. That was offset by massive Fed action, swamping the world with easy dollar credit. And on August 27th its chair, Jerome Powell, initiated a new regime in monetary policy, declaring that in future the Fed would target an average of 2 per cent—not a ceiling—allowing significant overshooting to offset years of low inflation. The upswing in the dollar was comprehensively reversed.

Multilateral order

In an era of more secure US hegemony, these actions and reactions might have been embedded in what we used to call the liberal multilateral order. High points were the G7's Plaza and Louvre accords of 1985 and 1987, which sought co-operatively to guide the dollar's movements. It is hard to imagine any such agreement today.

Today, we have the G20, the members of which have undertaken to refrain from competitive devaluation. Meanwhile the G7 has affirmed the basic common sense of the neoliberal era that fiscal and monetary policies should 'remain oriented towards meeting our respective domestic objectives using domestic instruments', with exchange rates left to themselves. But this leaves the US to act as an unconstrained sovereign. In recent years neither the president, Donald Trump, nor the Fed has held back in commentary about the US exchange rate.

Faced with high-handed American actions, Europeans have increasingly debated the issue of monetary sovereignty. They talk about denominating more of their trade in euro or even creating an independent clearing system. Those ideas rarely go anywhere. When they do, the consequences are often paradoxical.

Europe's breakthrough fiscal deal of July 2020 is a case in point. The optimistic interpretation is that the recovery package marks a step towards a more coherent, federal fiscal policy—a crucial step towards the assertion of sovereignty. Amid domestic crises simmering in the US, investors were looking for a good-news story and the euro appreciated towards $1.20. It was a celebration of Europe's great leap forward—yet a stronger euro pinches exporters and cuts the cost of imported goods, adding to downward pressure on prices.

Deflation remains the ghost stalking Europe. The August numbers for euro-area inflation were alarmingly low and at a public meeting at the beginning of the month the ECB's chief economist, Philip Lane, acknowledged the connection. The euro-dollar rate 'does matter', he admitted, triggering a flurry of speculation and indignation: was the ECB going to talk the euro down?

Mercifully, the usual right-wing media channels in the US are too distracted to have noticed. We have been spared a Trump Twitter tirade. But few on the other side of the Atlantic have any patience with European complaints. The euro's appreciation in 2020 is tiny—4 per cent against the dollar relative to its pre-pandemic level. The euro area has run annual current-account surpluses of around 3 per cent of gross domestic product for the last five years. Unsurprisingly, therefore, research by the International Monetary Fund finds that the euro is under-, not over-valued.

Europe's problem is inadequate aggregate demand. Exports alone cannot offset the shortfall in consumption and investment, which explains the deflationary pressure and the current-account surplus. A wide range of factors have contributed to this impasse but the ECB bears much responsibility: it has reacted tardily to slowdowns, reflecting deep divisions in the politics of the bank between more and less hawkish impulses.

These came close to causing disaster when the coronavirus hit. The euro plunged against the dollar as Italy faced the epidemic alone and the fear of a sovereign-debt crisis and a breakup of the euro area returned. Since her gaffe on March 12th, when she denied responsibility for Italian spreads, the ECB president, Christine Lagarde, has held the bank behind an expansionary line. But for the ECB to mirror the Fed and to match its latest expansionary announcements would require a political shift on the Governing Council which is far from likely. Conservative voices are far too significant and the *Bundesbank* continues to snipe from the sidelines.

Carefully stage-managed

As it turned out, the press conference on September 10th was carefully stage-managed. In the introductory statement came the words 'the Governing Council will carefully assess incoming information, including developments in the exchange rate'. Far from dramatic, it was as Frederik Ducrozet, one of the most influential ECB watchers, put it, 'at the lower end of the verbal intervention spectrum'. But it was the first mention of the exchange rate in such an introductory statement since 2018.

Questions were inevitable but Lagarde batted them away: 'The Governing Council extensively discussed the appreciation of the euro, but as you know we don't target the exchange rate,' she insisted. The ECB's mandate was to ensure price stability, big swings in exchange rates could affect inflation and the bank would 'have to monitor carefully such matters'.

The more significant news came in the inflation report accompanying the press conference. This signalled a slight upward adjustment of the ECB's inflation expectation for 2021, from 0.8 to 1.0 per cent. In the looking-glass world of modern central banking that decimal-points adjustment was taken to signal a victory within the bank for the more hawkish position. If the inflation outlook is slightly higher, if there is marginally less risk of sliding into deflation, there is marginally less need for further bold actions, which in turn sends a signal to the markets that the gap between the ECB and the Fed's more accommodating position is likely to widen, which implies a further appreciation of the euro—which happened for a few hours until the euro ended the day more or less where it started.

Though it has acted boldly on Covid-19, the ECB has a remarkable record of counterfactual inflation fear. It has been wrongly predicting an acceleration of inflation every quarter since 2010. Hence it has been consistently slow to head off the real risk—deflation.

In large parts of Europe that is already reality. As Positive Money pointed out recently, the ECB should be focusing on the fact that since 2013 not only has inflation been persistently low but it has diverged. Southern Europe is undergoing deflation, the opposite of what a debt-burdened economy, such as Italy's, needs.

Lack of demand

Europe's fundamental problem is not captured by aggregate euro-area inflation rates or, for that matter, the exchange rate with the dollar. The acute problem is the lack of demand, growth and thus also healthy rates of inflation in the weaker parts of the eurozone economy. Without a convergence of growth rates, Europe in its present form will be under constant pressure. The July compromise avoids immediate austerity but it does not solve the problem.

One could, of course, imagine a large-scale reallocation of labour and resources. Unemployed Italians, Spaniards or Portuguese could move to tighter labour markets, as happens within national units. In creeping form that is the reality Europe is accepting. We know it calls into question cohesion and risks exacerbating domestic political tensions, especially in the wake of the coronavirus shock. But if Europe is to avoid that, it needs targeted regional growth policy.

Creating that convergence in growth is clearly not the primary job of the central bank—it is a matter of much broader economic, social and industrial policy. But the ECB has an indispensable role as a supporting actor, enabling borrowing and channelling credit to support whatever fiscal and industrial measures are necessary.

This will require tough and highly political battles about the proper role of the ECB. Given the timeframe on which we must work, it is inseparable from the push for decarbonisation and a green energy transition.

Such a policy probably implies an overall expansion in credit and demand. That might peg back the euro against the dollar—but as an effect, not a cause. And, in any case, it could be outweighed by a desire for euro assets driven by political uncertainty in the US. An overt policy of targeting the exchange rate would thus be misguided. It would be a distraction from the real issues in Europe and it make enemies on all sides in the US.

The neoliberal model of economic governance is however in open dissolution. One of the main faultlines is the politics of money. As progressive voices all over the world are arguing, one of the key challenges of the moment is to articulate a new democratic politics of money. Ultimately, that must extend to the international currency system, the role of the dollar and the relation of other major currencies to it. But if foregrounding the power relations that underpin the currency system is the first move in a new politics of money, one of the basic maxims of political realism is 'pick your fights'—the ones that make sense and the ones you can win. On both counts, debate about the euro's exchange rate should be held at arm's length.

This is one point on which, at least for now, there is no reason for Europe to break with the common sense of the 1990s. Make fiscal- and monetary-policy decisions to restore a healthy balance to the euro area—and let the external value of the currency take care of itself.

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