

CURRENCY WARS

Executive Summary

The Paper in a Nutshell

The real cause of today's currency tensions—including the sinking value of the dollar, the shaky future of the euro, and the persistently undervalued renminbi—lies in the misguided domestic policies of the world's reserve currency economies, and China. The exchange rate system is not perfect, but rather than focus on it, the United States, the European Union, and China must undertake long-overdue internal reforms to reduce currency tensions and return the world economy to balanced, sustainable growth.

Vital Statistics

- The current exchange rate system is a messy blend of floating, managed, and pegged currencies combined with varied approaches to capital controls and reserve accumulation. But the system has proven remarkably resilient during the Great Recession.
- The dollar and the euro serve as the core of the international monetary system, accounting for nearly 90 percent of known reserves. The yen and the pound account for more than half of the remaining 10 percent.
- China is the world's largest exporter and the only major trading nation to maintain a pegged and nonconvertible currency. It remains largely insulated from global financial markets.
- Nearly all of the advanced economies and several of the large developing countries—including Brazil, Mexico, India, and South Africa—have floating exchange rates. Together, they account for almost 80 percent of world GDP and 76 percent of world trade.
- Advanced economies have open capital accounts, as do most large developing economies.
- From 2000 to the start of 2011, developing countries increased their stock of foreign exchange reserves from \$750 billion to nearly \$6.3 trillion.

Recommendations for U.S. Policymakers

Increase household savings: Washington should eliminate a host of tax incentives that encourage excessive consumption of fuel, consumer goods, and housing. Toward that end, Congress should increase the federal gas tax, introduce a value-added tax, and gradually eliminate the costly mortgage interest tax deduction. By incentivizing Americans to export more and import less, such reforms would reduce America's trade deficit and support long-term economic growth.

Reduce the budget deficit: Washington must put its public debt on a long-term sustainable path, in part by reforming government spending. Healthcare and defense, which account for a disproportionate share of the federal budget, are both ripe for efficiencies and cuts.

Recommendations for EU Policymakers

Accelerate fiscal and labor market integration: Despite being one of the most integrated economic regions in the world and a monetary union, the eurozone is far from having coordinated economic policies. If the euro is to survive—much less challenge the dollar—policymakers must create a European fiscal union, issue joint eurobonds, enhance labor market integration to allow workers to move more easily across borders, and introduce basic unemployment insurance provided by the EU to help mitigate diverse shocks.

Undertake structural reforms to help the peripheral economies: Without the ability to devalue or pursue independent monetary policy, Europe's peripheral economies—including Portugal, Ireland, Italy, Greece, and Spain—are suffering from a pronounced loss of competitiveness. To grow their way back to health, structural reforms must be enacted, including a shift in resources toward internationally competing sectors.

Increase consumer demand in the core economies: Germany—with its solid fiscal and external positions—must expand domestic demand. Insofar as German wages and consumption are allowed to rise faster, the deflation needed in the periphery will be shallower and shorter and the need for expensive rescue operations will decrease.

Recommendations for Chinese Policymakers

Allow the renminbi to float more freely: Beijing should steadily increase the flexibility of the renminbi, allowing it to trade within a broader range and appreciate in real terms, thereby increasing the purchasing power of Chinese consumers.

Reduce capital controls: Permanent capital controls restrict China's ability to integrate into world capital markets and establish a modern financial sector. They also limit investment opportunities for citizens and discourage foreign direct investment. Beijing should gradually lift its capital account restrictions and domestic financial controls.

Internationalize the renminbi: China has successfully begun promoting the use of its currency for international trade and investment. Over time, China ought to enact the necessary internal reforms to allow the renminbi to become a major international reserve currency. Such a step would help alleviate international tensions, increase systemic stability, help rebalance China's domestic economy, give its central bank more independence, and shift the country toward a more genuine market economy.

Recommendations for the International Monetary System

Increase International Monetary Fund (IMF) resources: The IMF has played a key role coordinating the response to the Great Recession and serving as an emergency source of liquidity. Its resources should be increased to allow it to respond forcefully, if necessary, to a large financial shock spanning multiple advanced economies.

Encourage developing countries to reduce their reserve levels: To encourage developing countries to shrink their level of foreign exchange reserves, reserve currency economies—including the United States, the European Union, the United Kingdom, and Japan—must regain their footing, lower their fiscal deficits, and raise their interest rates. Until they do so, developing countries will continue to struggle with windfalls of foreign money, and seek insurance against global recessions and sudden stops in capital flows.

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