The US dollar joins the currency wars

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In a world of weak domestic demand in many advanced economies and emerging markets, policymakers have been tempted to boost economic growth and employment by going for export led-growth. This requires a weak currency and conventional and unconventional monetary policies to bring about the required depreciation.

Since the beginning of the year, more than 20 central banks around the world have eased monetary policy, following the lead of the European Central Bank and the Bank of Japan. In the eurozone, countries on the periphery needed currency weakness to reduce their external deficits and jump-start growth. But the euro weakness triggered by quantitative easing has further boosted Germany's current-account surplus, which was already a whopping 8% of GDP last year. With external surpluses also rising in other countries of the eurozone core, the monetary union's overall imbalance is large and growing.

In Japan, quantitative easing was the first "arrow" of Abenomics, Prime Minister Shinzo Abe's reform program. Its launch has sharply weakened the yen and is now leading to rising trade surpluses.

The upward pressure on the US dollar from the embrace of quantitative easing by the ECB and the BOJ has been sharp. The dollar has also strengthened against the currencies of advanced-country commodity exporters, like Australia and Canada, and those of many emerging markets. For these countries, falling oil and commodity prices have triggered currency depreciations that are helping to shield growth and jobs from the effects of lower exports.

The dollar has also risen relative to currencies of emerging markets with economic and financial fragilities - twin fiscal and current-account deficits, rising inflation and slowing growth, large stocks of domestic and foreign debt, and political instability. Even China briefly allowed its currency to weaken against the dollar last year, and slowing output growth may tempt the government to let the renminbi weaken even more. Meanwhile, the trade surplus is rising again, in part because China is dumping its excess supply of goods - such as steel - in global markets.

Until recently, US policymakers were not overly concerned about the dollar's strength, because America's growth prospects were stronger than in Europe and Japan. Indeed, at the beginning of the year, there was hope that US domestic demand would be strong enough this year to support GDP growth of close to 3%, despite the stronger dollar. Lower oil prices and job creation, it was thought, would boost disposable income and consumption. Capital spending (outside the energy sector) and residential investment would strengthen as growth accelerated.

But things look different today and US officials' exchange-rate jitters are becoming increasingly pronounced. The dollar appreciated much faster than anyone expected and, as data for the first quarter of 2015 suggest, the impact on net exports, inflation, and growth has been larger and more rapid than that implied by policymakers' statistical models. Moreover, strong domestic demand has failed to materialise - consumption growth was weak in the first quarter, and capital spending and residential investment were even weaker.

As a result, the US has effectively joined the "currency war" to prevent further dollar appreciation. Fed officials have started to speak explicitly about the dollar as a factor that affects net exports, inflation, and growth. And the US authorities have become increasingly critical of Germany and the eurozone for adopting policies that weaken the euro while avoiding those - for example, temporary fiscal stimulus and faster wage growth - that boost domestic demand.

Moreover, verbal intervention will be followed by policy action, because slower growth and low inflation - partly triggered by a strong dollar - will induce the Fed to exit zero policy rates later and more slowly than expected. That will reverse some of the dollar's recent gains and shield growth and inflation from downside risks.

Currency frictions can lead eventually to trade frictions, and currency wars can lead to trade wars. And that could spell trouble for the US as it tries to conclude the mega-regional Trans-Pacific Partnership. Uncertainty about whether the Obama administration can marshal enough votes in Congress to ratify the TPP has now been compounded by proposed legislation that would impose tariff duties on countries that engage in "currency manipulation." If such a link between trade and currency policy were forced into the TPP, the Asian participants would refuse to join.

The world would be better off if most governments pursued policies that boosted growth through domestic demand, rather than beggar-thy-neighbor export measures. But that would require them to rely less on monetary policy and more on appropriate fiscal policies (such as higher spending on productive infrastructure). Even income policies that lift wages, and hence labor income and consumption, are a better source of domestic growth than currency depreciations (which depress real wages).

The sum of all trade balances in the world is equal to zero, which means that not all countries can be net exporters - and that currency wars end up being zero-sum games. That is why America's entry into the fray was only a matter of time.

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