Is the World on a Binge of Devaluation? Part II

Joseph E. Gagnon and William R. Cline says that judging by the past several years, the dangers of currency manipulation are not widespread at the moment.

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Steve Weisman: This is Steve Weisman with William Cline and Joseph Gagnon at the Peterson Institute for International Economics. We’re talking about the phenomenon of currency manipulation and exchange rate fluctuations. Bill, Joe just said that he sees a danger of countries engaging in this kind of activity again, even after a pause of the last couple of years.

How do you see it?

Bill Cline: Of course the country that has caused some concerns lately is Japan, and its substantial depreciation. The irony is that they have not been intervening. This has been a phenomenon that has reflected market expectations because of the policies of the new government. The remarkable fact about the other sort of principal player in this drama, China, has been that about a year ago they stopped building up these massive reserves, and it seemed to be that there’s more capital somehow leaking out these days.

There too, it’s not the smoking gun intervention. Ironically, the big culprit these days is Switzerland, which has been piling up reserves. Not your most usual candidates. I would single out three factors I think should be smoking guns for bad behavior. One is having a huge current account surplus. Two is actively intervening to keep your currency from appreciating or to drive it down.

And third is doing this kind of stuff even though you don’t have a Keynesian demand gap. Your output gap is basically close to zero. If you have a country that’s in that situation, it seems it’s a very good candidate for being criticized by the G20. Once you don’t have all of those then it starts to be a little more ambiguous.

Suppose that you’ve got a country that has its currency declining, but it’s not running a huge surplus. As you know, the threshold that I like to use—and the stuff I’ve done with John Williamson—is plus or minus 3 percent of GDP [for the current account deficit or surplus]. It turns out that Japan’s currency was 78, 79 [yen to the dollar]. It could’ve gone up to—or weakened to 84 and still stayed within its 3 percent surplus over the medium term.

It’s gone to 94. That’s too far. But it seems to me that the— it’s the coexistence of a huge surplus, Switzerland’s in that category, with aggressive intervention to keep the market from making a corrective appreciation of the currency that you worry about it, especially if there’s no justification.
Steve Weisman: So just to be clear, by the three criteria that you mentioned, how do we assess what China is doing today?

Bill Cline: As I say, and sort of the surprise, is that in broad terms China seems to have desisted in intervention. That was sort of the smoking gun for so long. On that criterion, no problem, unless there’s recent information that might suggest the other, which there may be.

Second, what’s their current account? Actually their current account is less than 3 percent of GDP surplus, although the IMF projects it will go back up to 4.5 or something over the next five years. But what you see is below the 3 percent. Unemployment is sort of a different category for them that’s not as directly relevant, but since the other two are not being engaged in as obviously as in the past, that’s kind of aside from the point.

Steve Weisman: Joe, do you go along with those as the three best criteria for making a judgment. Are you more concerned that China is headed in the wrong direction?

Joseph Gagnon: Yes. On the three criteria, I would share two of them. I’m not sure I would want to make unemployment or cyclical—the stage of the cycle—I’m a little bit worried about that because countries disagree a lot as to where they are. We always think we are below capacity even when we’re in a boom, so I don’t know.

But I like the first two that Bill mentioned. I am a bit worried that 3 percent is a little bit too large of a criterion for a current account.

Steve Weisman: Too much latitude for misbehavior?

Joseph Gagnon: It’s a bit on the big side for me, but the principal I think I agree with — that if you have a current account that’s more than the negligible current account surplus and you are accumulating reserves aggressively, and you have an excess amount of reserves already, bonds on some standard—then those are the criteria I would apply.

Steve Weisman: Finally on Japan, you give them a pass a little bit or are you concerned?

Joseph Gagnon: One thing is on China, I think there’s a huge improvement in what China is doing. But they continue to intervene this past year. It stopped for some months of the past year, but as the year as a whole in 2012, they did accumulate reserves. I’m worried—although it’s hard to tell because these things are volatile and the data come with a lag—I’m worried that the trend may have bottomed out and be rising. On Japan, I’d give them a pass for now as long as they make it clear they don’t intend to intervene. And I think if that’s the case, the yen probably will strengthen a bit when the market realizes that they’re not going to intervene.

Steve Weisman: Gentlemen, thank you both very much.