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Modern Currency Wars: The United States versus Japan

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Abstract

In 2013, through massive quantitative easing by the Bank of Japan (BOJ), the yen depreciated about 25 percent against the dollar and stoked fears of new currency war with return of Japan bashing. But this sharp depreciation simply restored purchasing power parity after the yen had been rising for three years. In June 2013, the PPP for the yen is about 100-103 yen per dollar. And over a longer perspective from 2007, quantitative easing by the BOJ has been similar to that carried out by the Fed itself, the Bank of England, and the European Central Bank. So the BOJ can only be faulted as a currency belligerent if the yen depreciates much more.

This paper looks into the history and the impact of the gold standard and dollar standard. We then discuss in detail the case of Japan. If the United States and Japan can agree (if only implicitly) the right yen per dollar rate, it will make it easier China to keep its currency stable at the current rate—which is also close to PPP. So currency warfare among the big three in Asia can be avoided—no more “Japan bashing” or “China bashing “

Keywords: Japan, dollar standard, exchange rates, quantitative easing.

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In the currency wars of the 1920s and 1930s, various nations fell off the gold standard with deep devaluations. But under the postwar dollar standard, the central position of the United States is key to maintaining the peace—as was true before the Nixon shock of 1971 upset it. Now, without much fear of retaliation, the U.S. can initiate more limited warfare—as with American “Japan bashing” from the late 1970s to mid 1990s to appreciate the yen, or “China bashing” since 2002 to appreciate the renminbi. Japan succumbed to this bashing, and the yen did appreciate too much in 1985 so Japan fell into a zero-interest liquidity trap and economic stagnation for almost two decades.

Led by the United States, now all the mature industrial countries are in near-zero interest liquidity traps for their short rates. Beyond this, their central banks are addicted to surprisingly massive “quantitative easing” to buy Treasury bonds and less liquid securities to drive down long rates down as well. These ultra low interest rates cause lasting damage to financial systems throughout the world—including emerging markets with naturally higher interest rates.

Exiting a liquidity trap for short rates when long rates are near “normal” is technically straightforward in an economic sense; the central bank just lifts its interest rate target for feeding short terms reserves into the interbank market. Of course it may be very difficult politically because no government likes high and rising interest rates. But if long rates are comfortably above zero, increasing short rates does not impair the general health of the financial system.

In Japan, however, long-term interest rates have been near zero (less than one percent) since the mid 1990s. Also, in trying unsuccessfully to escape from economic stagnation, Japan has followed a “Keynesian” strategy of running with very large fiscal deficits so that gross government debt is the world’s largest—about 214 percent of GDP. But Japan’s national saving rate has also been very high, so the debt is virtually all internally held. Japanese banks and other financial institutions are chalk full of Japanese government bonds (JGBs)—most issued in yen with low coupon rates reflecting the low market rates in the neighborhood of 1 percent prevailing at the times they were issued.

The massive holdings of low-yield JGBs by Japanese banks effectively tightens the liquidity trap that Japan faces. Any policy that deliberately or incidentally tends to raise interest rates at long term will cause massive capital losses to bond holders, aka the banks. Most recently, the new government of Shinzo Abe introduced extreme quantitative easing in monetary policy to drive yields to maturity down to less than one percent. This implies even small interest changes when the level of interest rates is very low will lead to quite massive changes in the current capital values of long term bonds.

The Gold Standard and the Great Depression

In the good old days of the 1920s and 1930s, currency wars—although very destructive—were at least easy to identify. Their hallmark was a large devaluation of one nation's currency against gold while its trading partners remained tied to the yellow metal.

After World War I and much debate, in 1925 the British Chancellor of the Exchequer, Winston Churchill tried to restore an international standard by pegging the price of gold at 4.86 pounds sterling per ounce—its pre-1914 parity. Many other nations followed Britain. But then France, which had inflated and depreciated its currency much below its pre-war parity, in late 1926 finally managed to stabilize its currency by sharply raising interest rates: the famous Poincaré Stabilization. This then undervalued the franc against the pound, and together with the higher interest rates in France, began to drain gold from Britain. Despite its depressed economy and high unemployment in the 1920s, Britain kept its own interest rates high to protect its slender gold reserves.

This gold drain then caused a banking panic in Germany forcing it to “accidentally” devalue in July 1931. The British more deliberately abandoned the gold standard in September 1931 with a deep devaluation, and Japan followed in December 1931. The United States had not changed its pre-war gold parity of \$20 per ounce, but as a safe haven it had still accumulated much of the world's gold. In 1933 and after considerable tinkering, President Roosevelt devalued the dollar by raising the official price of an ounce of gold from \$20 to \$35 despite the fact that the U.S. had a trade surplus. This series of “beggar-thy-neighbor” devaluations then came back full circle back to France, and in 1936 it was forced to devalue along with some smaller European countries that were tied to it.

In each case, the threat of a run on the country's gold stock (hot money flows) before it devalued induced governments to cut expenditures (practice austerity in the modern usage of the term) and raise interest rates. The U.S. actually raised interest rates in 1931 even as the Great Depression was unfolding worldwide. So the collective retrenchment in the major countries deepened the worldwide depression, which could be fairly characterized as an *implosion of the international gold standard*.

The world's monetary superstructure, currency and deposits, had become too large for the limited stock of gold—leading to successive runs from domestic currencies into gold. Still these forced devaluations against gold caused neighboring countries to lose their international competitiveness. But this was not planned currency warfare unlike what the term beggar-thy-neighbor seems to imply. Usually, any one country was forced into devaluing by a run on its gold stock, and the devaluation itself was accidental rather than diabolically planned.

The Postwar Dollar Standard

After World War II, gold was dethroned and the dollar was enthroned as definitive international money—but more by accident than design. In 1945, the major industrial countries other than the United States were damaged by the war, had open or repressed inflation, and

controls on foreign exchange transacting. Because only the U.S had an open and stable financial system, foreign banks and corporations naturally began using the dollar as the key vehicle currency for clearing international payments and for invoicing international trade flows. Foreign governments starting holding their reserves in dollars, which had become the official intervention currency even before the 1945 Bretton Woods agreement enjoined them to declare official dollar exchange parities. But with foreign countries all specifying dollar exchange rate parities, this left—and still leaves—the center country without a direct exchange rate policy of its own.

Amazingly this dollar based system has persisted from 1945 to the present day³. In 2013, when China trades with Brazil, both countries invoice their exports in dollars and clear interbank payments using the dollar as the intermediary currency. The dollar is now the standard reference currency for determining a currency's international value. But the dollar standard is now under siege from major industrial countries trying to force down their interest rates

In slack economic times, the modern version of a "currency war" takes the form of a country putting downward pressure on its *dollar* exchange rate—either directly through official foreign exchange intervention or, more commonly, indirectly by through capital outflows generated by short-term interest rates close to zero—and with today's quantitative easing (QE) i.e., extreme central bank purchases of longer-term and more illiquid assets. The United States, as the center country under the word dollar standard, has no direct exchange rate policy of its own. But it has put untoward, if inadvertent, pressure on the dollar in the foreign exchanges by keeping domestic interest rates too low.

- (1) Over reacting to the collapse of the high tech bubble in 2001, the Fed cut its overnight funds rate to just 1 percent in late 2002—and then held it down for almost two years so as to create bubbles in property, commodity, and stock markets.
- (2) Over reacting to the subprime mortgage crisis and the collapse in these bubbles in 2008, the Fed cut the interbank rate to virtually zero in December 2008—where it remains today. With short-term interest rates at zero, the Fed initiated various rounds of quantitative easing (QE) by buying long term Treasury Bonds, asset backed mortgage securities, and other long-term instruments so as to reduce long rates as well. We are currently in the third round of massive QE.

Why is QE a potential beggar-thy-neighbor exchange rate policy? Ultra low interest rates in the United States periodically unleash floods of hot money into emerging markets (EM) with higher growth and naturally higher interest rates. Any one EM central bank is then faced with an uncomfortable choice. Either let its exchange rate appreciate against the dollar and thus lose export competitiveness against its neighbors, or intervene heavily to buy dollars to smooth exchange fluctuations and thereby lose monetary control. Since 2002, EM have acquired more than \$6 trillion foreign exchange reserves (Figure 1) and their CPI inflation has been more than 4 percentage points higher than in the United States despite, on net balance, having appreciated against the dollar⁴. From 2002 into 2011, the dollar's effective exchange rate, trade weighted

³ The dollar's traumatic history in this central role is analyzed in the author's new book *The Unloved Dollar Standard: From Bretton Woods to the Rise of China* Oxford University Press, 2013.

⁴ McKinnon, op. cit. Chapter 5.

against all other currencies, depreciated by 30+ percent. Because of higher inflation in EM, the dollar's real exchange rate had depreciated even more.

Low American interest rates have also forced other industrial countries to follow suit. To prevent their currencies from appreciating against the dollar, both the ECB and the Bank of England have expanded their monetary bases and kept interest rates almost as low as in the United States. In both emerging markets and the industrial countries, the result has been *financial repression*. To the disadvantage of savers in the industrial world, bank deposit rates of interest are now less than domestic rates of inflation; and bank lending to small and medium sized firms has been anemic. But with interest rates at rock bottom, such unconventional monetary policy may be able to expand aggregate demand by inducing capital outflows and therefore currency depreciation to stimulate exports: a beggar-thy-neighbor policy by stealth.

Of course, each country claims that it is only responding to domestic deflationary pressure and that it is not trying to devalue or conduct a beggar-thy-neighbor policy by direct devaluation. Indeed, the U.S. Federal Reserve claims that it is better for the rest of the world if QE succeeds in stimulating the American economy. Unfortunately, near zero interest rates so undermine the process of domestic financial intermediation that they may not, on net balance, stimulate the American economy⁵ or other industrial economies. Because interest rates near zero in mature capitalist economies represses their domestic financial systems, exchange depreciation and export expansion may be the only avenue by which quantitative easing can be "stimulating" for any one country. But this comes at the expense of its neighbors.

Japan as Victim

In the postwar period after the Bretton Woods system of fixed dollar exchange parities (the so-called "Nixon Shock" of 1971) fell apart, Japan was an early victim of currency warfare. From the mid 1970s to the mid 1990s, Japan's relatively high saving led to current account surpluses—particularly manifest in the bilateral trade deficits of the saving-deficient United States. But many American economists misinterpreted the root cause of this imbalance. Japan was accused of deliberately undervaluing the yen against the dollar to increase its exports. The result was American "Japan bashing", with threats of tariff and quotas on imports of goods from Japan, unless the yen appreciated.

This resulted in the famous Plaza Accord in 1985, which caused a sharp appreciation of yen. Despite the political accusations, the argument that Japan has manipulated its currency is questionable. According to the Penn World Tables (Alan et al 2012), the yen has been overvalued compared to its purchasing power parity since 1985 (Figure 2). Although purchasing power parity (PPP) is only one factor affecting the exchange rate, bashing yen to a level well above its PPP was an important factor in Japan's continued stagnation through 2012.

This "syndrome of the ever higher yen", from 360 yen to the dollar in August 1971 to touch just 80 in April 1995, was disastrous for the Japanese economy. Initially, the expectation of a higher yen fed a sense of triumphalism leading to massive bubbles in the stock and property

⁵ McKinnon, Ronald "When is a Monetary "Stimulus" Not a Stimulus?" Stanford Center for International Policy Research, *Policy Brief*, February 2013.

markets by 1990. When the bubbles burst in 1991, the yen continued to rise until April 1995. The economy slumped from this double whammy of bursting bubbles and exchange rate overvaluation. Although official exchange intervention was quite frequent in crisis periods (figure 3), the BOJ was not trying to devalue. Rather it was just resisting, although not very successfully, the tendency of the yen to go ever higher—whence its large build up of dollar exchange reserves.

The Bank of Japan (BOJ) reduced interest rates in to curb further increases in the yen. Ahead of the United States, by 1997 the Bank of Japan had set its short term interest rate at virtually zero where it is today—thus constricting domestic financial intermediation over its two “lost decades” of economic stagnation with deflation. Low interest rate, together with the special characteristics of Japan’s economic system, created the famous phenomenon of ‘Zombie lending’-funds provided to low productive firms to keep them ‘ever-greening’. (Ahearne et al 2005, Caballero et al 2006)

To be fair to the Japanese monetary authorities, Japan’s zero-interest liquidity trap was not home grown but externally imposed. American Japan bashing from the late 1970s to the mid-1990s set up the expectation of an ever-higher yen that caused hot money to flood into the economy so that the yen became overvalued (at 80 yen per dollar in 1995) and the price level began to fall for as much as a decade earlier⁶. And the expectation of a higher yen itself pushed interest rates down⁷. By 1997 both market expectations of an ever higher yen and desperate attempts by the BOJ to stimulate the slumping economy by easy money, resulted in a liquidity trap: virtually zero short-term rates and long rates less than one. In spite of the damage to Japan’s economy, the ever-higher yen was unable to correct the chronic trade imbalance between US and Japan. (Figures 4 and 5)

To make things worse, the chronic trade surplus and deflation (Figure 6), together with the low external debt ratio, have made the yen to become a safe-harbor currency during the crisis. This is especially manifested in the 2008 financial crisis. When US struggled with the aftermath of subprime mortgage crisis, and Euro Area suffering unprecedented sovereign debt crisis and banking system crisis, the Japanese yen, together with the Swiss Franc and Gold, become safe havens for international capital inflows. (Habib et al 2012, Ranaldo and Paul 2010)

Data on foreign portfolio investment in Japan confirmed this phenomenon (Figures 7 and 8), The Swiss National Bank stepped in to stabilize Swiss Franc on Sep. 2011; Japan also acted (Figure 3), but wasn’t firm enough to convince the market. The yen rose to its high for decades despite earthquakes and the Tsunami. The overvaluation of yen was recognized internationally. In March 2011, for the first time since 2000, the G7 announced joint intervention to prevent yen from further appreciation. But the Yen still remained at a high level through 2012.

Remarkably, this trap of exchange rate overvaluation has lasted from 1985 right through 2012 By the PPP criterion (Figure 2). Japan had indeed been a victim of currency warfare.

⁶ This sorry tale of deflation in Japan is spelled out more fully in Ronald McKinnon and Kenichi Ohno in *Dollar and Yen: Resolving Economic Conflict between the United States and Japan*, MIT Press 1997.

⁷ The principle of “open interest parity”.

⁹ <http://www.bloomberg.com/news/2013-01-13/abe-aids-bernanke-as-japan-seen-buying-558-billion-foreign-debt.html>

Japan as Predator?

The early implementation of zero interest rate policy exerted downward pressure on the yen. Along with the United States, Japan was a major funding source before the 2008 financial crisis—as evidenced by the spectacular fund outflow to Caribbean offshore centers with higher interest rates. (Galati et al 2007) Carry return between yen and US Dollar, currencies from the two major advanced economies, is as large as 5% in 2006; Australian Dollar and New Zealand Dollar are also attractive. Even higher return can be obtained with Yen-EM currency pairs, loaded with higher risk. It fostered depreciation of yen in 1995-1997 and 2005-2007. (Figure Z6) But Japanese economic recovery during these periods was disappointing.

In 2013, however, a remarkable change has occurred. In December 2012, Shinzo Abe Prime Minister Abe was elected on a platform of expanding the size of balance sheet of Bank of Japan. As of May 2013 when this article is being written, Bank of Japan has announced Japanese Government Bond (JGB) purchasing program of about 7 trillion Yen per month, and 1.2 Trillion commercial paper purchasing program in May and June respectively. As a comparison, BoJ holdings of JGB has been increasing at about 0.7 trillion Yen per month from 2008 to 2012. (Figure Z6). The inflation target has also been raised from 1% to 2%, which is supposed to impact exchange rate through the channel of inflation expectation.

Figure Z6a shows the sharp expansion in the BOJ's balance sheet (total assets), and Figure Z6b shows the greater balance sheet expansion of the BOJ compared to that of the Fed, the ECB and the Bank of England for their respective GDPs. For 2013, the BOJ's balance sheet has expanded proportionately more than twice as much as the very aggressive expansion by the U.S central bank.

The path of the yen/dollar rate has reflected this relatively more expansionary Japanese monetary policy. The yen appreciated from about 80 to the dollar in December 2012 to more than 100 by May 2013 (See Figure 2) about 25 percent, and depreciated relative to other East Asian currencies—which tend to track the dollar cum Renminbi (the Yuan /Dollar rate remains remarkably stable)

Japan's aggressive monetary policy has led to serious concern from other Asian economies, especially from China and Korea. Unlike other major advanced economies, Japan is directly competing with other export driven Asian economies. If yen depreciation is maintained in reasonable range, and global market recovery is at good pace, the shock on other Asian exporters may also be mitigated by sufficiently large growing demand from the rest of the world, as is evident in 2005-2007 pre-crisis eras.

However, there are reasons to doubt Mr. Abe's plan. It is reported⁹ that Mr. Abe support purchasing foreign bonds to depreciate yen, although it is later backed off. Unlike quantitative easing whose exchange rate impact may be a byproduct, the massive purchases of foreign assets, or other strong signs of linking monetary policy to exchange rate, is nearly a declaration of 'currency warfare', and may incur a true 'currency war'.

That outcome would be against other 'arrows' of 'Abenomics', including building stronger partnership with US. The ultimate goal for Japan is to boost inflation and therefore economic growth, while controlling its size of government debt. Although exchange rate

correction of an overvalued yen in the medium term may facilitate this goal, pushed to an extreme it will prove intolerable to other countries—not only in Asia, but it could bring back “Japan bashing” by the United States itself. So, it is in the interest of Japan to restrict its stimulus package to only domestic monetary instruments, and to respect the concern of its trading partners over the yen/dollar exchange rate.

But how can we calculate a desirable and “fair” yen/ dollar exchange rate? The PPP rate (shown in Figure Z1) is only a slowly moving variable reflecting slow movements in price levels in both Japan and the United States. It can only be calculated with a considerable lag from price levels in the Penn World Tables. In contrast, the floating market-determined rate can move quickly and show jagged large changes—such as the 25 percent appreciation of the yen in 2013. Nevertheless, we can linearly project the PPP rate in Figure Z1, since PPP is highly dependent on inflation differential (Figure Z7). Assuming 2% inflation difference in 2013 (which implies US reaches its 2% target and Japan recover from deflation), the projected PPP in 2013 would be about 100. Thus we can presume that the BOJ has already accomplished its mission of correcting the overvalued yen and further depreciation is unwarranted. PPP’s drifting with inflation difference also reminds BoJ about the imminence of their mission: the longer it takes to boost inflation, the higher yen’s ‘fair value’ will be.

If the United States and Japan can agree (if only implicitly) that 100 yen per dollar is about right, that makes it easier for China to keep its currency stable at the current rate of 6,14 yuan per dollar—which is also close to PPP. So currency warfare among the big three in Asia can be avoided—no more “Japan bashing” or “China bashing “

Appendix: From Japan Bashing to China Bashing

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Figure 1

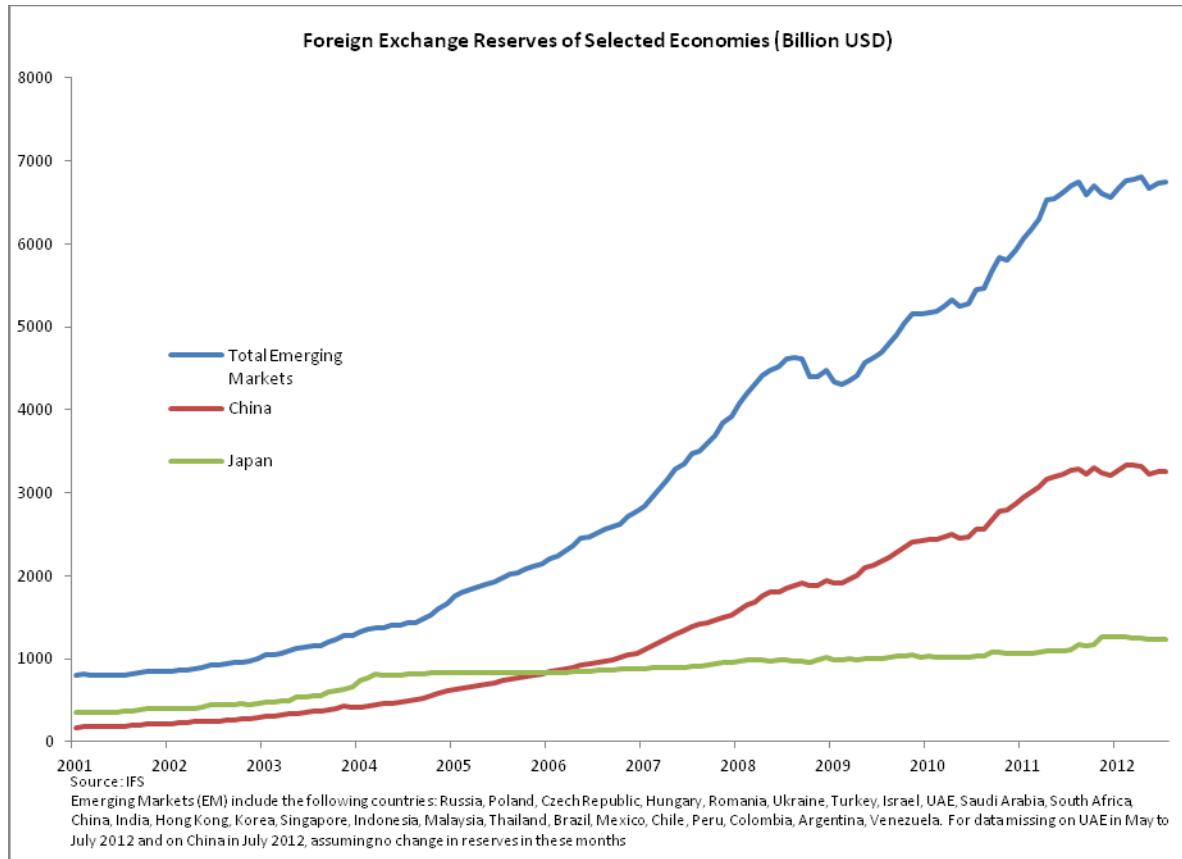


Figure 2

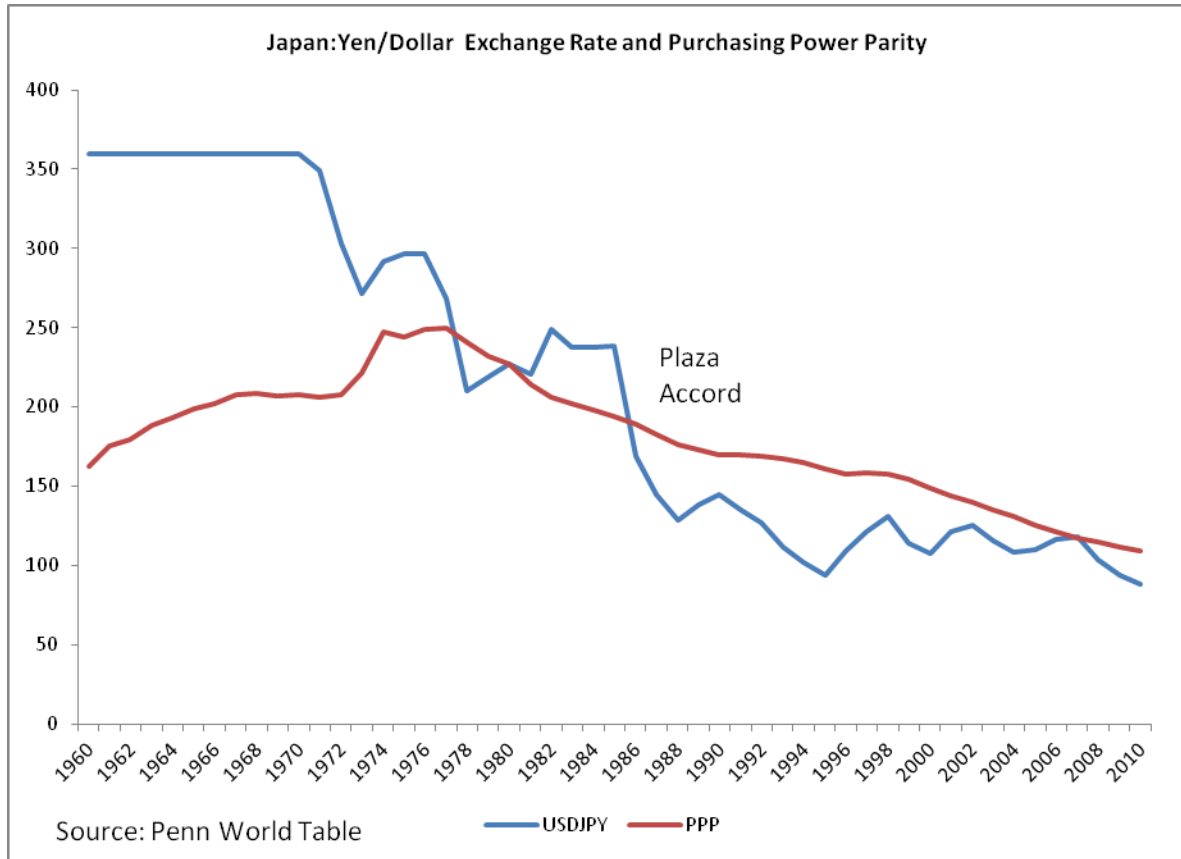


Figure 3

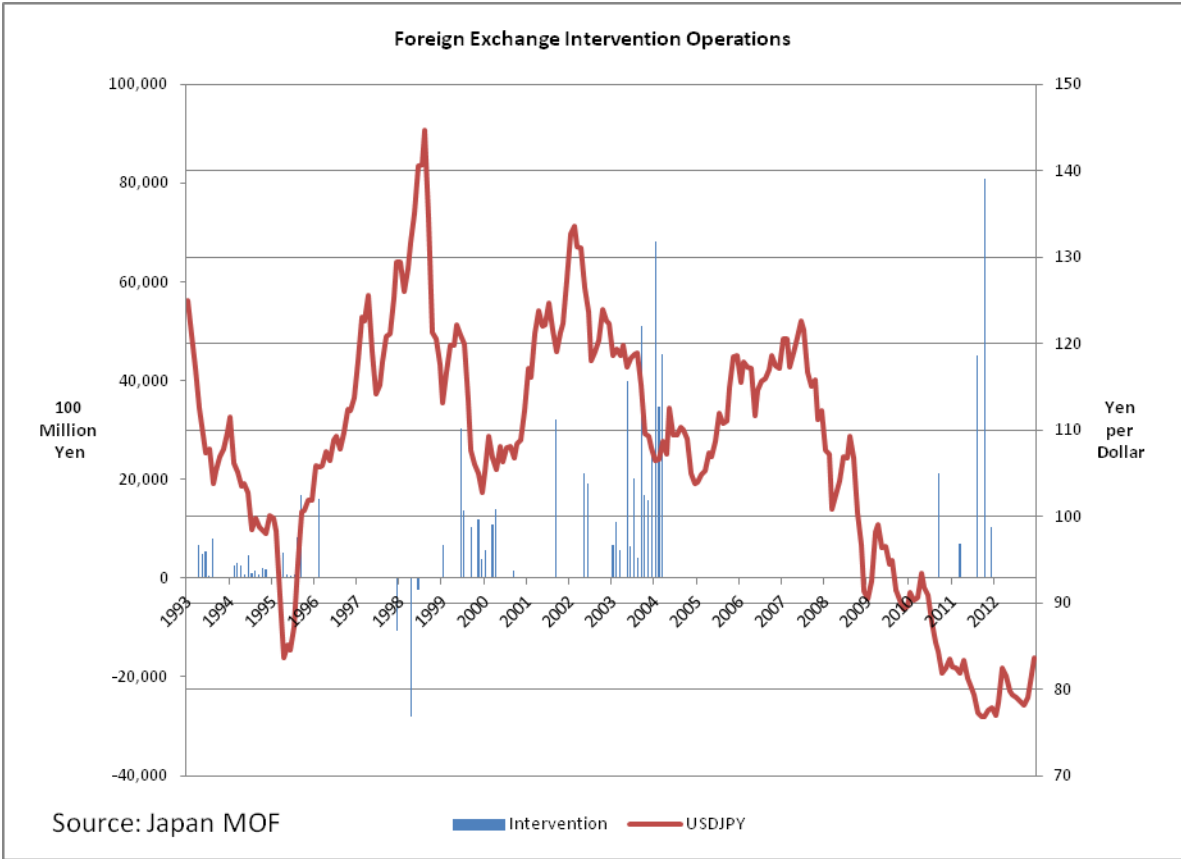


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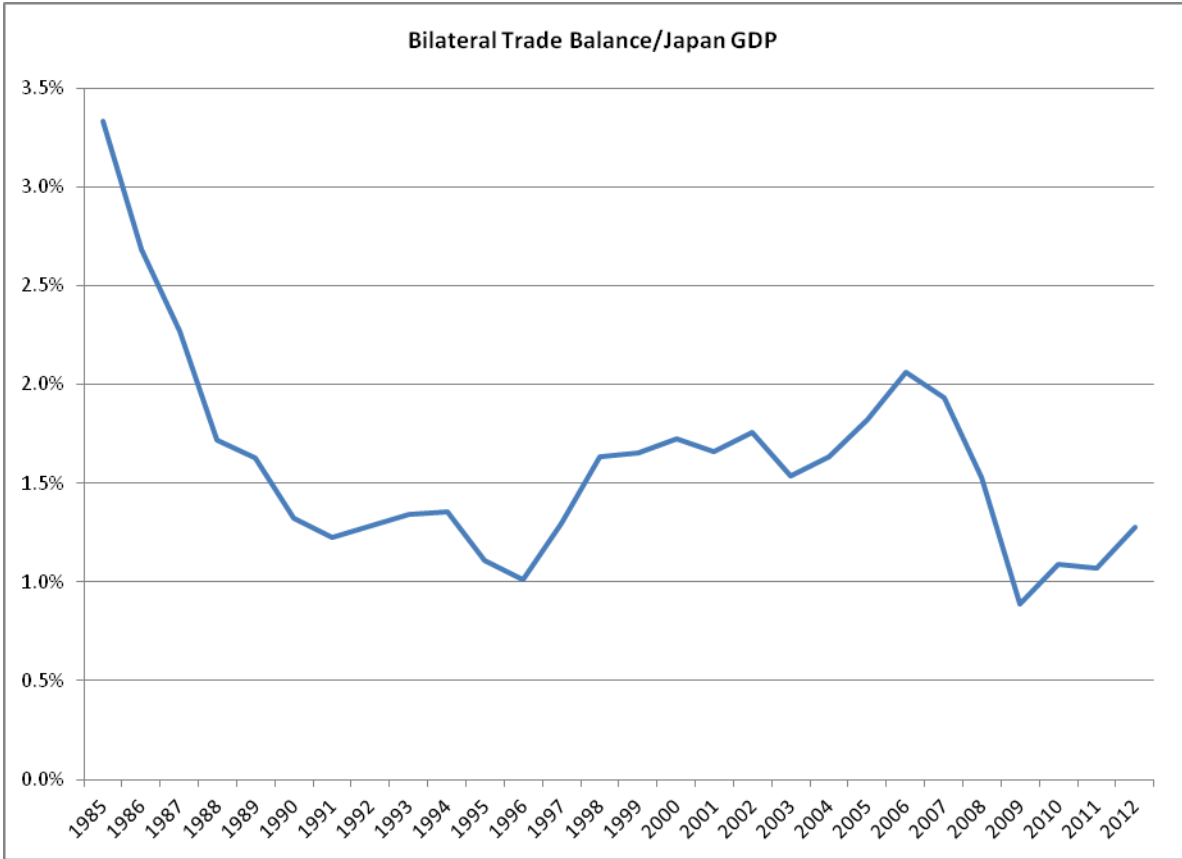


Figure 5

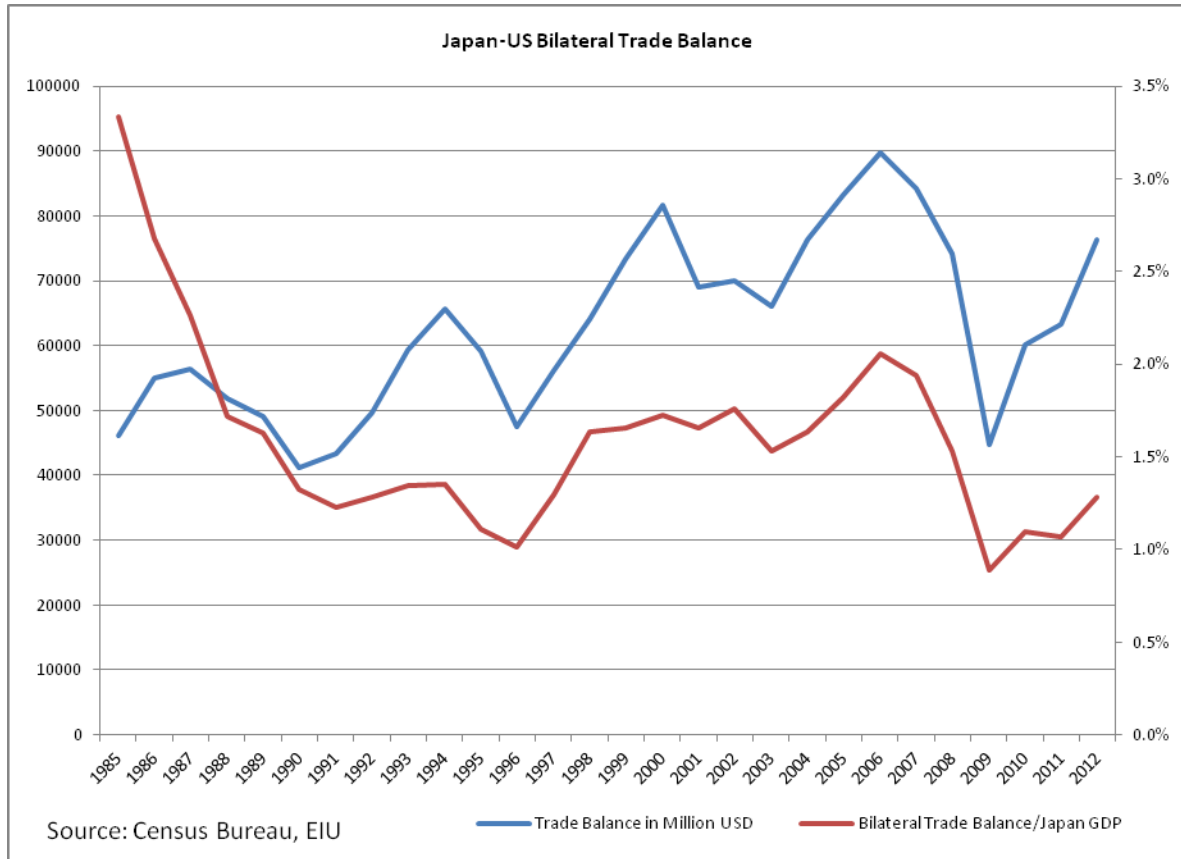


Figure 6

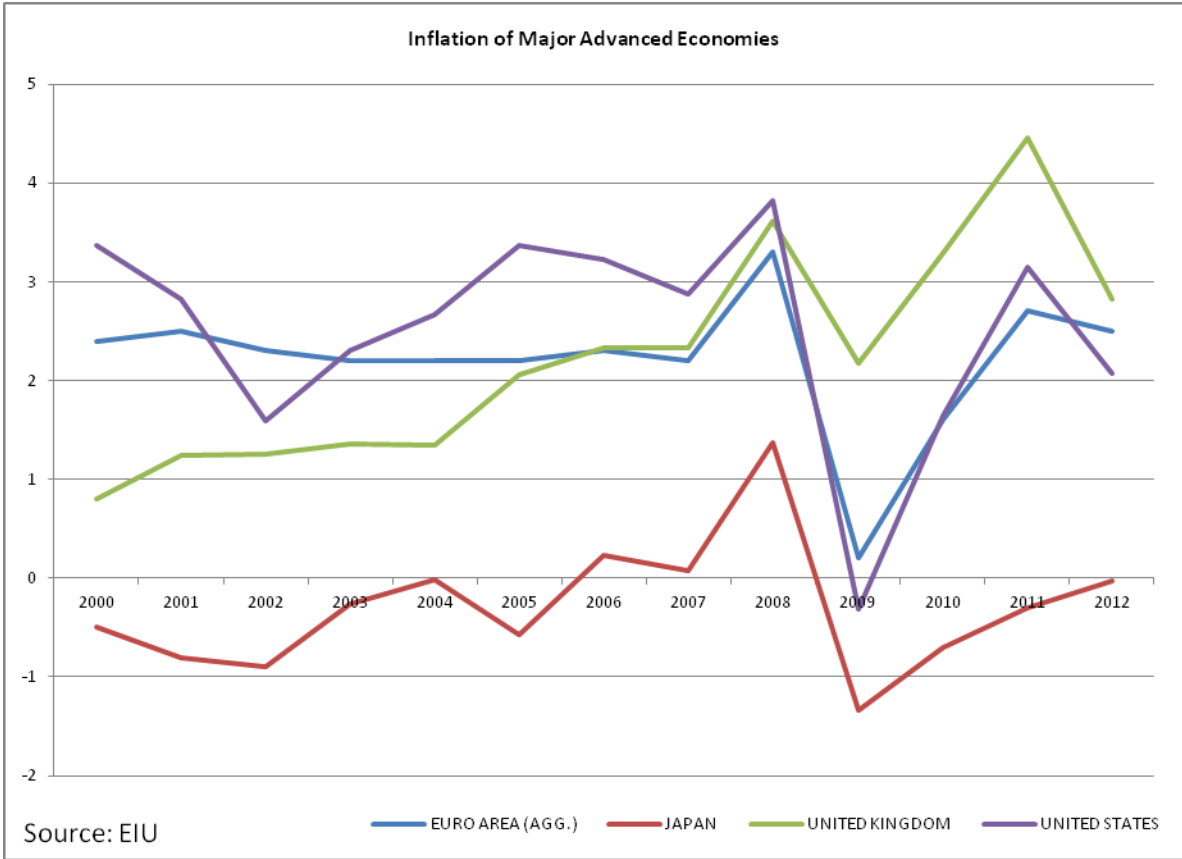


Figure 7

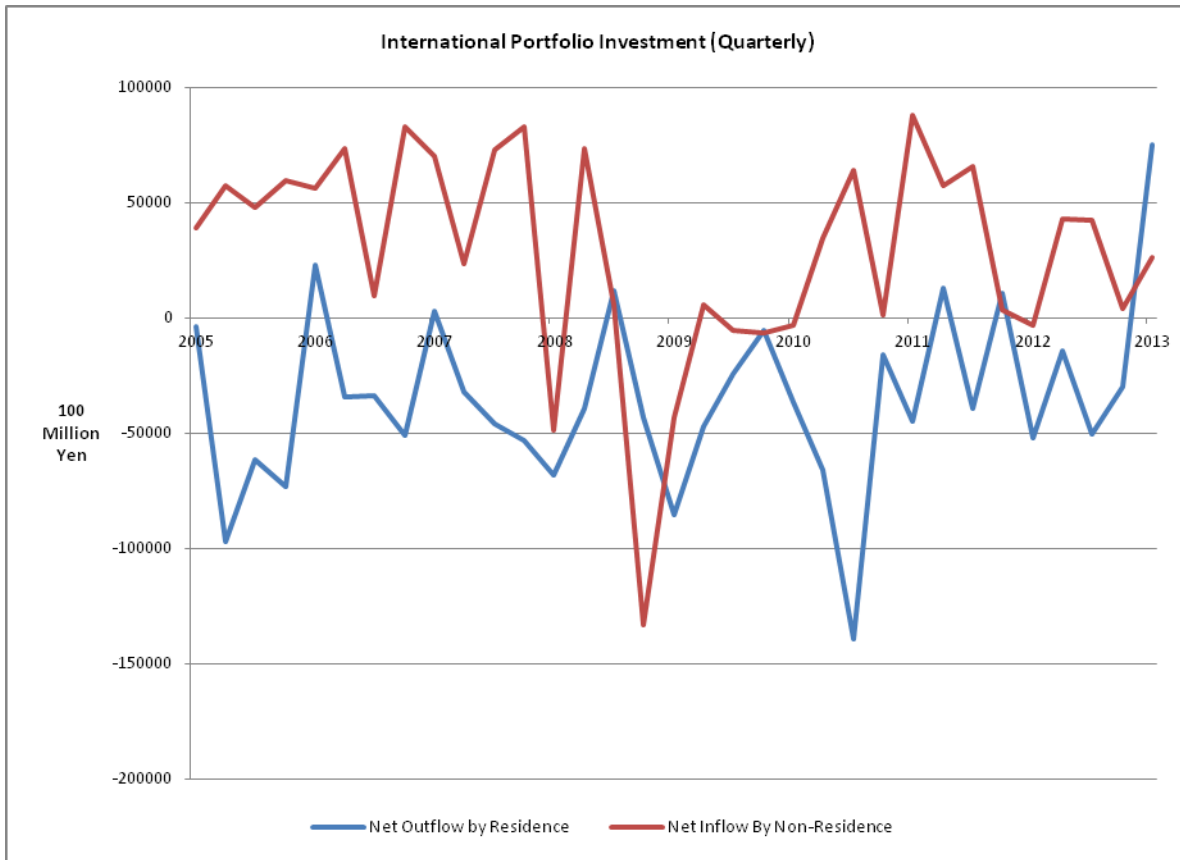


Figure 8

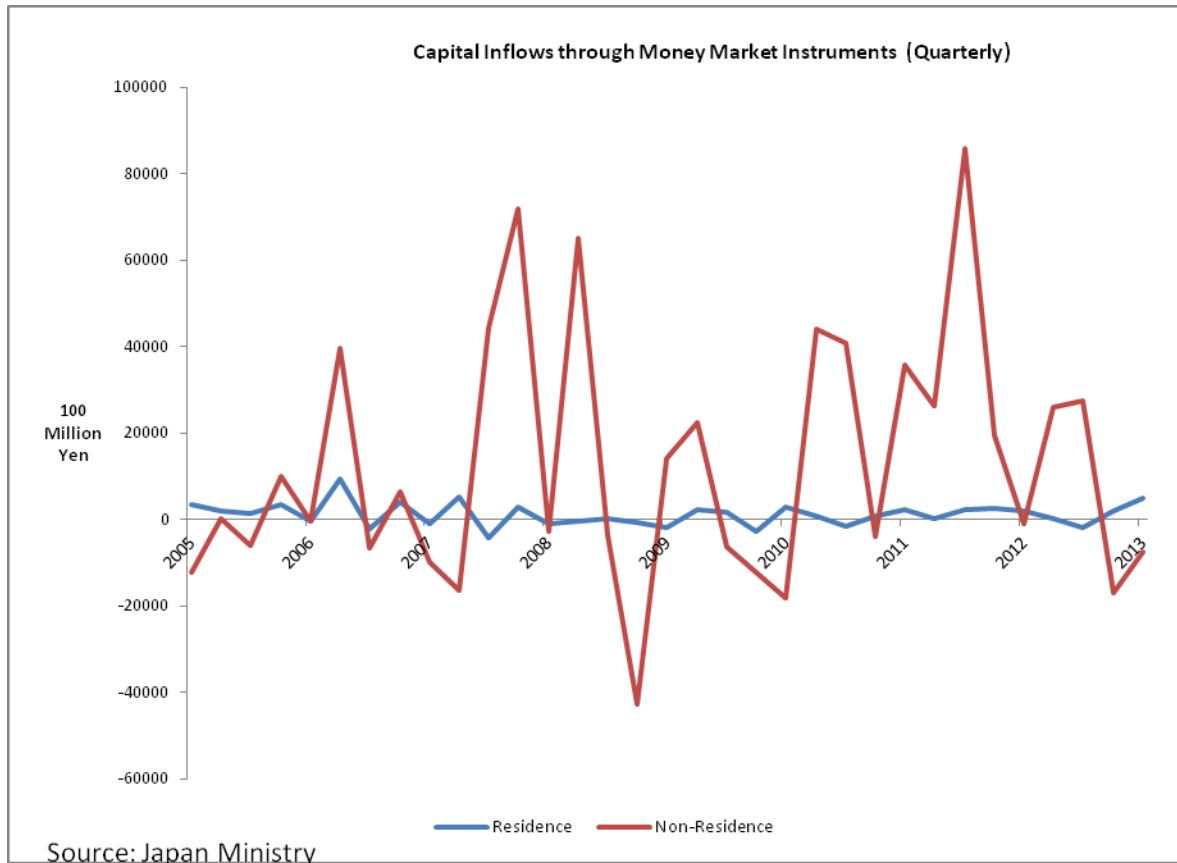


Figure Z6a

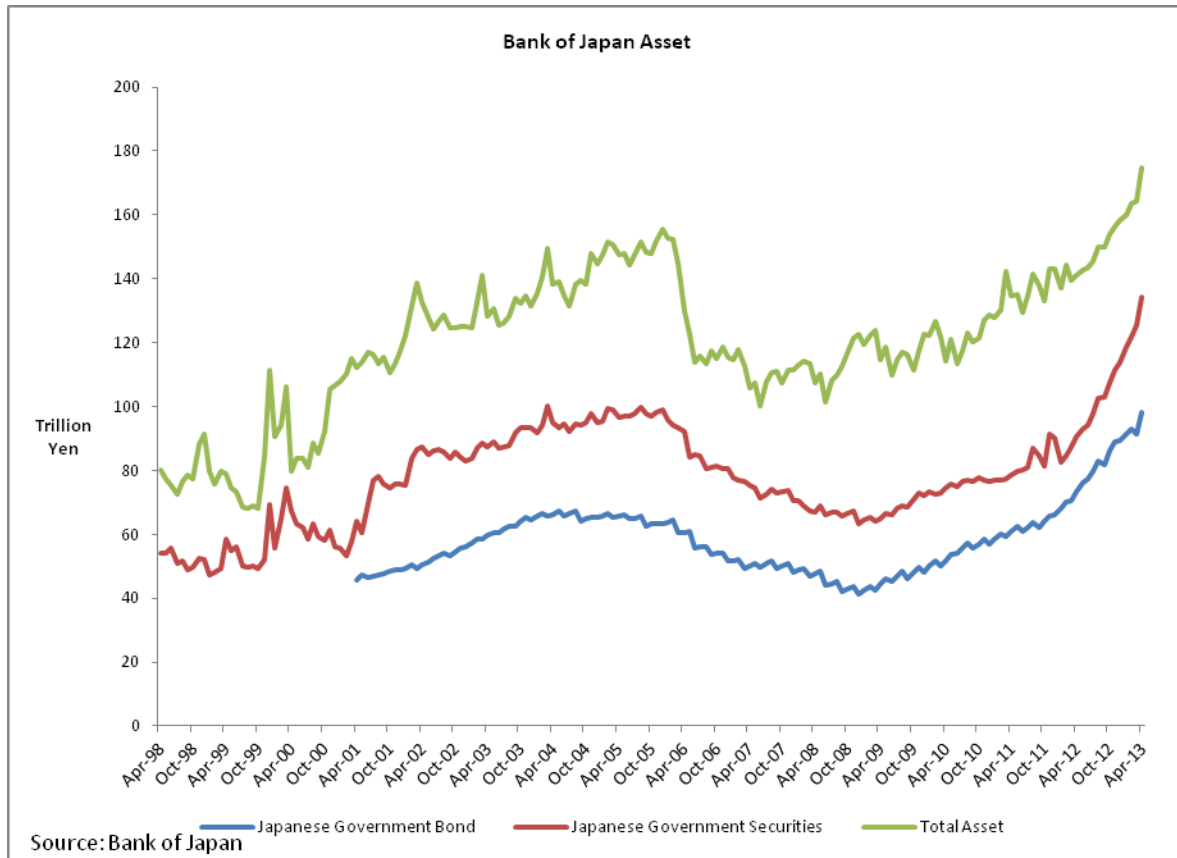


Figure Z6b

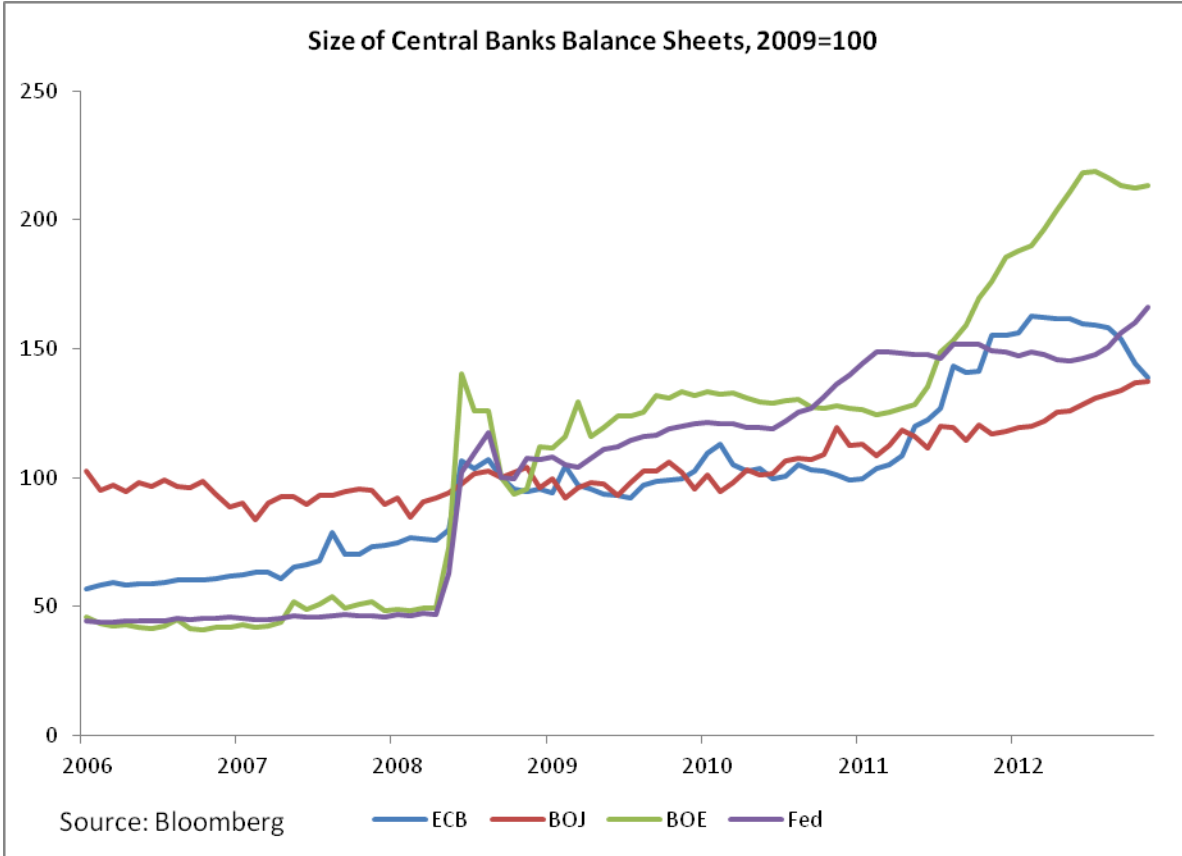


Figure Z7

