The Myth of “Currency Manipulation” under the Flexible Exchange Rates

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Recently, the yen exchange rate tends to fluctuate towards a cheaper side toward 125 yen per dollar. As an adviser to government, I would never predict the course of future exchange rates.

As is well known, the exchange rates is anchored to the purchasing power parity level in the long run. In the short run, it can be affected by various factors, notably the relative stance of monetary policies of the relevant countries. The yen tends to be depreciated by Japanese monetary expansion, and appreciated by the U.S. monetary expansion. The present drift towards the depreciation of the yen is not so much from the change of Japan’s monetary policy as from the anticipation of monetary “tapering off” in the United States, that is, a tighter interest rate policy of the Federal Reserve Board.

This relationship between the relative quantity of money and the exchange rate was known as the Soros diagram in the yen traders’ circle, though in person George Soros disclaimed himself as an originator of the diagram. In any case, this relationship remains a basic law in international finance.

In general, two routes exist by which a country can affect the exchange rate. One route is to intervene directly in the exchange market.

There are two problems about this intervention approach. First, since the exchange rate is determined by relative strength of monetary policy as explained above, monetary policies should be consistent to the exchange rate aimed at interventions. Second, Intervention aiming different exchange rates may create a war-like situation: If the US aims at 100 yen per Dollar, and Japan aims at 120 yen per dollar, then how can the market settle at a single exchange rate?

The second route is to influence the exchange rate between the two countries by monetary policies that aim at a proper combination of inflation and employment. By this approach both countries will be able to reach an exchange rate that is satisfactory to both economies. If a country engages in an expansionary monetary

expansion, the currency of that country will depreciate. It has a negative spillover to the other country, by reducing external demand to the other country. Nevertheless, there is a remedy for the other economy. If an expansion of a country gives a negative spillover to the other country, then the other country can also expand monetary policy, halt the appreciation of its own currency and undue the negative effect of foreign monetary policy. In this way, both country can attain monetary objectives simultaneously.

Under the flexible exchange rate system, *laissez faire* is thus the norm to macroeconomic stability of the world. History abounds in examples. Countries that left the golden fetter of the gold standard during the interwar years to adopt independent monetary policy recovered faster.

Some economists and journalists are afraid that this currency war process may lead to the world inflation. A simple game theory analysis shows under normal conditions that the interaction of monetary policy pursuing domestic macro objectives will converge to a state close to the Pareto efficient states in the two countries, unless the two countries take the intervention approaches with contradicting exchange rate goals.

The normal condition here is the condition that monetary policy affects its own economy more strongly than foreign monetary policy--- the condition is obviously satisfied.

When the Lehman crisis hit the world, the United States and the United Kingdom barely escaped the impasse by appealing to extraordinary monetary expansions. The yen appreciated by negative spillovers, and since Japan did not attempt to undue the negative spillover by counteracting expansionary monetary policy. That is the major reason that Japan had to suffer from recession due to the yen appreciation. It is not until Abenomics came to rescue that Japan learned to undue the negative spillover and to start a fresh come back of the economy.

Recently, the issue of currency manipulation appeared in the discussion of the President's fast track Trade Promotion Authority for Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). The freer trade has overall benefits, but indeed some sectors may incur visible losses. TPP or TTIP is a judicious way to show voters a combined pictures of gains and losses across the globe.

As discussed above, the genuine way of handling an exchange rate level under flexible exchange rates is to interact monetary policies that aim at achieving proper levels of inflation and employment. Therefore, introducing intrinsically irrelevant exchange rate issues to trade issues and deterring freer trade benefits is inappropriate.

In another column of the Project Syndicate, Jeffrey Frankel expressed a similar opinion “currency manipulation” as a “chimera.” This piece will hopefully supplement his piece by reminding you of the basic ground rule of flexible exchange rates