Currency Wars, Then and Now
How Policymakers Can Avoid the Perils of the 1930s
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In June 1933, a thousand representatives from 66 countries gathered in London for the World Economic Conference -- the grandest collection of world leaders since the Paris Peace Conference of 1919. Among those attending were a king, eight prime ministers, 20 foreign ministers, and 80 other cabinet ministers and heads of central banks.

The global economy was still mired in a depression that had begun more than three years earlier. In the two countries hardest hit, Germany and the United States, unemployment was above 30 percent. The United Kingdom, the nations of the British Empire, and a handful of other European countries with close commercial ties to London had abandoned the gold standard in late 1931, leaving exchange-rate arrangements in complete disarray. Meanwhile, Germany, after a banking crisis in the summer of 1931, had suspended payments on most of its international debts and imposed severe currency and capital controls.

The purpose of the conference, originally conceived in the last days of U.S. President Herbert Hoover's administration, was to spur a joint effort to repair the severely damaged international financial system. But the new U.S. president, Franklin Roosevelt, made it clear that his first priority was to get the U.S. economy back on its feet; international considerations would have to take second place. In the first month of his administration, after successfully stabilizing the domestic banking system, he had followed the British example by taking the United States off the gold standard. The London summit thus took place against the backdrop of a falling dollar and enormous turmoil in the currency markets.

It appeared as if policies in the two biggest economies in the world, the United States and the United Kingdom, were aimed at getting themselves moving at the expense of the economies in Europe. As the
meeting began, European leaders were desperately trying to negotiate an arrangement to keep currencies stable.

In an ominous hint of his attitude toward the conference, Roosevelt stayed home -- choosing instead to vacation in New England while staffing the U.S. delegation with a singularly unqualified group of isolationists and political hacks. Among them was Key Pittman, the colorful Democratic senator from Nevada, whose drunken carousing provided great fodder for the London tabloids -- culminating one summer night when he shot out all the streetlamps on Upper Brook Street with his pistol. It was left to Roosevelt's key economic aides, who had accompanied the official delegation, to hammer out a pact on currencies with European financial officials and central bankers.

At the last moment, just as an agreement on stabilizing exchange rates seemed imminent, Roosevelt's attitude hardened. He became concerned that economic recovery at home would be stymied if the London agreement prevented the dollar from continuing to fall. Roosevelt dispatched a strongly worded cable for public release in which he torpedoed the agreement that his own advisers had hammered out with the Europeans, dismissing currency stabilization as just one of the "old fetishes of so-called international bankers." The telegram created a storm in London and was universally denounced by foreign leaders as cynical, selfish, and destabilizing. The conference limped to a sad close, leaving a legacy of mistrust and suspicion among the major participants.

Although Roosevelt was maligned at the time, his decision to devalue the dollar in 1933, by allowing the United States to ease credit conditions at home, turned out to be the single most important factor in bringing about the end of the Great Depression in the United States. The London conference has gone down in history as the moment when the United States abandoned any pretense of international cooperation and decided to generate a recovery on its own. The result was a disastrous backlash against globalization. And although the world economy revived during the 1930s, it did so only with countries hunkered down behind high tariff barriers, import controls, and restrictions on capital flows.

FROM LONDON TO SEOUL

After the 2010 G-20 meeting in Seoul came to a close, with overheated talk of a "currency war" in the air, it was hard not to think back to the London conference of 1933. Now, as then, countries are trading accusations of currency manipulation. In both 1933 and 2010, newspapers were full of quotes by foreign officials denouncing Washington for driving the dollar down at their expense, and conservatives in the United States fulminated against their own government for its policy of currency debasement. Now, as then, attempts by officials to find common ground and forge an agreement -- in Seoul it was the initiative to shift the focus away from China's exchange rate by setting limits on current account surpluses -- have foundered under a barrage of recriminations.

Ever since the latest global economic crisis began in the fall of 2007, commentators have been drawing parallels between current events and those surrounding the Great Depression. In both cases, there was a preceding decade of easy credit, overborrowing, and excessive leverage, which eventually led to an asset bubble. Then, it was in the stock market; this time, real estate. In both cases, the bursting bubble and the ensuing economic downturn led to a series of banking and sovereign-debt crises.
At the root of many of the problems of the interwar years was a malfunctioning global financial system. Policymakers then had to contend with misaligned exchange rates, apparently intractable current account imbalances, and the growing threat of protectionism. As the Seoul G-20 meeting so vividly illustrated, their counterparts of today are struggling with very similar challenges.

The experience of the interwar years is therefore rich with lessons for today's policymakers and can shed light on a number of crucial questions facing world leaders in 2011. Why have global imbalances been so intractable? What should be done about them, and in light of what happened in 1929, what should not be done? Is all the talk of currency wars overblown, or does it accurately reflect the increased risk of competitive devaluations? And does the recent escalation in tensions over exchange rates and monetary policy foreshadow a spiral of the sort of beggar-thy-neighbor policies that came out of the Great Depression?

A CROSS OF GOLD

World War I caused a seismic shift in capital flows and trade patterns around the world. The major European nations, having spent some 50 percent of their GDPs on the war effort for four full years, were left saddled with gigantic debts and were able to recover only by borrowing from the United States. Washington, meanwhile, emerged from the conflict with a very strong external position, having accumulated over 50 percent of the world's gold reserves.

Prior to the war, under the classical gold standard, countries were supposed to operate according to certain "rules of the game" in dealing with trade imbalances. Because domestic money supplies were rigidly linked to gold reserves, those countries accumulating reserves would automatically experience easy credit, strong demand, and rising prices. Meanwhile, countries with diminishing reserves faced the converse: tight credit and falling prices. So even though currency rates were fixed against one another, trade imbalances were largely self-correcting, without the need for protracted negotiations between countries.

There was always an inherent asymmetry about the whole mechanism. Deficit countries had no choice -- they had to contract credit; otherwise, they would run out of gold. By contrast, the pressure on surplus countries to expand credit was not as strong. Nevertheless, during the nineteenth century, because trade imbalances were small and temporary, the integrity of the system survived.

In the 1920s, the shifts and fluctuations in gold reserves were simply too great, and the system came under considerable strain. The problems created by this skewed distribution of reserves were compounded by the way European countries, which had broken the link with gold when war was declared, returned to the fixed exchange rates of the gold standard. The United Kingdom, in an effort to reclaim its prewar position as the linchpin of the world financial system, went back on gold at an overvalued exchange rate, whereas France very deliberately undervalued the franc. As a result, during the late 1920s, the French accumulated a further 30 percent of the world's gold reserves. The corollary was that Germany and the United Kingdom faced a chronic shortage of gold.

With all their gold, both France and the United States should have experienced an expansion of credit.
Instead, both countries, concerned about inflation, chose to neutralize the monetary impact of their reserves by setting limits on domestic credit growth, in much the same way that China does today. As a result, the gold standard's automatic adjustment mechanism through the credit system was short-circuited.

The full burden fell on the deficit countries. During the 1920s, Germany managed to avoid, or at least postpone, the necessary austerity by borrowing large amounts from the United States -- a policy that would come back to haunt it when the Depression hit. The United Kingdom, on the other hand, tried to confront its problems by forcing wages and prices down through a regimen of chronically tight credit. The ensuing deflation -- roughly a five percent decline in prices every year -- was achieved at the cost of stubbornly high unemployment, long and bitter industrial strikes, and constant social strife. While most other countries were booming during the Roaring Twenties, the British economy limped along.

After the onset of the Depression in 1929, as international financial markets progressively seized up, bankers stopped lending to Germany and the United Kingdom. Without adequate gold reserves to tide them over, the two countries, especially Germany, were forced to cut back their spending abruptly. There was, however, no counteracting force working on France and the United States, the two countries flush with reserves, to increase their spending. The result was a contractionary jolt to a global economy that was already spiraling downward.

In 1931, as fears about the stability of the pound spread, central banks around the world started dumping pounds in favor of gold. In the ensuing scramble for gold, central banks tightened credit by raising interest rates, even though unemployment was well into double digits. More than anything else, these moves turned what was already a severe depression into the Great Depression.

The example of the United Kingdom in the 1920s illustrates how difficult it is to cure external imbalances under fixed exchange rates. Finally, after six years of austerity, battered by the economic collapse, and still no closer to fixing its external imbalance, the United Kingdom abandoned its struggle to maintain a fixed exchange rate and left the gold standard in September 1931.

The process was made even more protracted and difficult because France and the United States, two of the United Kingdom's main trading partners, refused to play their part by loosening credit and allowing prices of general goods in their countries to rise. The failure to deal with global trade and reserve imbalances during the boom times of the 1920s meant that they became fault lines and a major source of economic instability when the world was hit by the shock of the financial crises after 1929.

THE DOLLAR DILEMMA

The international financial system today is very different and much more flexible. Most major currencies -- the dollar, the euro, the pound, and the yen -- as well as a host of other minor currencies, such as the Swiss franc, the Australian dollar, and the Canadian dollar, float against one another.

There are two exceptions. The economies within the eurozone have given up their national currencies. As a result, countries such as Greece, Ireland, Portugal, and Spain are encountering many of the same
problems of adjustment faced by Germany and the United Kingdom during the early 1930s. They are, however, being given some temporary assistance through the European Central Bank and the European Financial Stability Facility to help them weather the storm.

The other major exception is the so-called dollar bloc. In the wake of the 1997-98 Asian financial crisis, some of the affected countries sought to build up dollar reserves as insurance against future domestic bank runs or downturns in the global economy. At about the same time, China embarked on a program of export-led growth, which depended on selling cheap products to U.S. consumers. To achieve their goals, many Asian countries chose to peg their currencies to the U.S. dollar at artificially low levels. By one estimate, these countries currently account for 40 percent of U.S. trade.

Like France in the 1920s, China has an undervalued exchange rate and to sustain its peg is forced to accumulate enormous quantities of dollar reserves. The country must then neutralize these reserves by limiting credit growth in order to prevent domestic inflation from undermining its competitive advantage. As a result, not only is the dollar prevented from falling against the Chinese currency, but manufactured goods from China continue to remain unusually cheap, disabling two critical mechanisms for reducing the trade imbalance between China and the United States.

Because of the dollar's status as the world's primary reserve asset, such trade imbalances are not as dangerous a source of instability as they were in the 1930s. Unlike Germany and the United Kingdom in 1931, the United States has no risk of running out of international reserves since it can print dollars at will -- in effect, a license to issue international money. It therefore did not face the same pressure to deflate during the recent crisis. Moreover, the sort of global liquidity crunch that brought the world economy crashing down during the rush into gold in 1931 was avoided. When a scramble for dollars did develop in the fall of 2008, the U.S. Federal Reserve lent almost $600 billion to foreign central banks to alleviate the shortage of liquidity. Thus, a major source of short-term instability was eliminated.

Even though two of the levers for curing the trade imbalance between China and the United States -- an appreciation of China's currency and a rise in prices on Chinese goods -- have been disabled, another mechanism is insidiously at work. China has been able to sustain its export push only because the United States has been willing to import Chinese goods and thus run large current account deficits. This, in turn, has required continued borrowing by American households, U.S. companies, and the federal government. However, there are limits, both economic and political, to how much added debt either consumers or the government can take on. At some point, domestic spending will be constrained, and the U.S. current account deficit will automatically decline.

When the recession first hit, it seemed that this mechanism was kicking in. U.S. consumers, drowning in debt, tightened their belts and sharply raised their savings rates. Chinese exports were particularly hard hit by the downturn. For a while, it looked as if China had begun to reconsider the wisdom of relying so much on exports to drive its growth and that it might restructure its economy, focusing more on domestic consumption. But with the recovery, global imbalances are once again emerging, perhaps because the impact of consumer retrenchment in the United States has been cushioned by government borrowing.
Going forward, if China does find it too difficult or politically costly to restructure its economy and, despite the changes in the global market, tries to keep its foot on the export accelerator, it is bound to encounter a shortage of buyers in the United States. By definition, unless the export ambitions of China and other countries can be reconciled with the import capabilities of the rest of the world, the global economy will experience a sharp slowdown in growth and potentially a cycle of trade wars as countries compete for contracting markets.

REEVALUATING DEVALUATION

The lesson of the 1920s is that rigidly fixed exchange rates are dangerous. Conventional wisdom holds that the lesson of the 1930s is the converse -- that the fixed exchange rates of the gold standard were replaced by a disorderly system of floating exchange rates that led to competitive devaluations, which were in turn the catalyst for a disastrous move to protectionism. This narrative only captures part of the story.

It is true that during the 1930s, one country after another, faced with mass unemployment and excess capacity at home, adopted a deliberate policy of driving down its currency in an effort to make its goods more competitive so as to export its way out of depression. The spiral began in the fall of 1931, when the pound was forced off the gold standard, and gained its full momentum after the dollar devaluation of 1933. With everyone trying to devalue, no single country was able to gain a competitive advantage for very long, and the whole process became self-defeating. The devaluations occurred in such an uncoordinated and disruptive sequence that states lost confidence in the open global economy's ability to reconcile their conflicting interests and ambitions. Turmoil in the exchange markets continued until the end of 1936, when France, the United Kingdom, and the United States concluded a pact to halt further depreciations.

Despite the chaos of floating exchange rates, the disruptions and costs produced by competitive devaluations have been greatly exaggerated. The dollar devaluation of 1933 did give U.S. goods a competitive edge in world markets and helped the United States recover in part at the expense of other countries. But there were also spillover benefits for Washington's trading partners. By increasing the value of the gold held by the U.S. Treasury and the U.S. Federal Reserve, the devaluation gave U.S. government officials the room to inject liquidity into the banking system and thus loosen credit. The resulting rise in prices reversed the deflationary psychology of the slump and got American households and businesses spending again. As one country after another tried to leapfrog over one another by devaluing further, and as gold prices thus rose, the easing of monetary policy around the world and the resulting global expansion of credit gave the world economy an enormous boost.

With the industrial world having largely moved to floating currencies, exchange rates are no longer a policy instrument under the direct control of governments. There are, however, some superficial resemblances between the intended effects of the "quantitative easing" undertaken in 2010 and those of the dollar's fall in 1933. Both were designed to raise inflationary expectations, boost asset prices, and revive spending behavior. In addition, since any sort of monetary easing, quantitative or otherwise, generally increases the likelihood of a declining dollar, both policies potentially improved the competitiveness of the United States' goods relative to those of its trading partners -- hence the
accusations of currency manipulation from other countries.

NONE OF US WERE KEYNESIANS THEN

For all the parallels, there are numerous reasons why the global economy is unlikely to see a spiral of competitive devaluations similar to that of the 1930s. First, the U.S. external position is now very different. When the dollar was devalued in 1933, the United States, although suffering from high unemployment, was running a large current account surplus and had immense gold reserves. Washington's policy of encouraging its currency to fall at a time when the country had such a strong external position was viewed by other countries as an almost predatory move that instead of curing global imbalances only served to magnify them.

To understand the reaction in the 1930s to the decline of the dollar, imagine the international response if China, with its strong external position, had tried to increase its exports during the downturn in 2008 or 2009 by further devaluing its currency. There would have been an outcry from countries accusing Beijing of acting irresponsibly by trying to steal jobs at a time when employment everywhere was in free fall. By contrast, the United States now has a weak external position, a large current account deficit, and enormous external liabilities. The fact is that if its current account deficit is to be reduced, the United States will have to improve the competitiveness of its goods and gain market share. There is therefore a broad consensus, supported by economic logic, that a fall in the dollar is necessary.

Second, policymakers now have access to a greater number of tools to promote recovery. Even after the major economies had abandoned the gold standard in the 1930s, most officials still continued to espouse the doctrine that budget deficits were always a bad thing. John Maynard Keynes' *General Theory of Employment, Interest, and Money*, which first articulated the benefits of temporary deficit spending, was not published until 1936, and it took many years for his ideas to be accepted. At the time, almost no country -- Germany and Sweden were two exceptions -- was willing to use fiscal policy as an instrument for stimulating demand. Devaluation, with all its attendant negative effects, seemed to be the only tool available for getting the economy moving. This time around, the attitude about the use of fiscal policy has been very different.

Third, unlike in the 1930s, the whole world is not mired in depression. Primarily because of the deft use of fiscal policy in 2008 and 2009, the emerging markets, particularly China and India, have recovered nicely and are now booming. As a result, the potential spillover effects on these countries from U.S. monetary easing are different. The fear is not so much that the United States is trying to steal jobs from them but that its policies will lead to large capital inflows, excessively easy credit conditions in their economies, higher stock and real estate prices, and financial bubbles. Emerging markets have dealt with these possible repercussions with a judicious combination of increases in reserves, capital controls, and currency appreciation -- in effect, the precise opposite of competitive devaluations.

Even if there is no wave of competitive devaluations, will the current tensions over currencies and trade imbalances lead to more restrictions on trade? So far, increases in protection have been relatively minor. In part, that is because the structure and networks of world trade are so different today. Thanks to global supply chains, countries are far more integrated. Companies that produce for the domestic
market and would normally be strong advocates of import restrictions are themselves dependent on imported inputs. Moreover, all the various General Agreement on Tariffs and Trade and World Trade Organization regulations impose severe limits on the trade restrictions permissible under international law.

Recent research by the economists Barry Eichengreen and Douglas Irwin has revealed that the biggest increases in import tariffs and controls in the 1930s did not take place in countries that had abandoned the gold standard early and devalued the most, such as the United Kingdom and the United States. They occurred in France and Germany, which initially refused to devalue because they had experienced high inflation after World War I and were terrified of having no anchor. The lesson of the 1930s, therefore, is that countries are most likely to resort to trade barriers when unemployment is high and all other alternatives for dealing with it -- printing money, lowering exchange rates, or using fiscal stimulus -- have failed or are not an option. Protectionism will become a real threat only if China's peg prevents the dollar from falling and the recent monetary and fiscal stimuli fail to make a sufficient dent in U.S. unemployment.

A LEADERLESS ECONOMY

The economic historian Charles Kindleberger, writing in the 1970s, argued that in a crisis, the centrifugal forces driving countries to adopt beggar-thy-neighbor polices are so strong that the global economy can remain open only if one country is willing to provide leadership -- to be the supplier of capital when others are in a panic, to keep its markets open in the face of protectionist pressure, and to act countercyclically as an economic locomotive for the world. According to Kindleberger, this leader has to have such a stake in the stability of the whole system that it will be willing to do more than its fair share in a crisis, recognizing that smaller countries will freeloader off its efforts.

Before World War I, the global economy operated smoothly only because it was in the interest of the United Kingdom -- as the linchpin of the world financial system -- to assume the role of leader. But after it was almost bankrupted by the war, it was no longer able to fulfill that function. The mantle of leadership should have passed to the United States in 1918. But the men then in charge in Washington were too parochial and insular to seize the opportunity. Thus, during the 1920s and 1930s, London was unable to lead and Washington was unwilling. The Great Depression occurred because of this vacuum of economic leadership on the world stage.

After 1945, the United States, acutely aware that it had failed to step up to the plate between the wars, vigorously embraced the position of the world's economic leader. Whenever a financial crisis hit or the world economy was about to falter, Washington acted as the lender of last resort, kept its markets open, and worked to sustain global aggregate demand.

Today, the global economy has arrived at a similar inflection point. The United States has been sufficiently weakened by its accumulated current account deficits, banking debacle, and foreign policy disasters that it is no longer able to single-handedly assume the role of global economic hegemon. Nor can any other single country take its place. China has the financial muscle to act as the global lender of last resort and has already begun to do so by assisting some of the European countries in trouble.
But its mercantilist approach to trade -- the emphasis on exports rather than imports -- makes it an unlikely candidate to be the market of last resort for other countries in a downturn.

If no single country is in a position to be responsible for stabilizing the global economy when it suffers a shock, is there an alternative mechanism? The hope is that because of the G-20, nations can be goaded by their peers to act in concert to sustain demand and keep markets open without the sort of backsliding and freeload that Kindleberger feared would occur. One year into the crisis, at the G-20 meeting in Washington in the fall of 2008, the process in fact seemed to be working. But the fractures that appeared at the last G-20 meeting, in Seoul, revealed its limits.

The world managed to avoid a repeat of the Great Depression this time because, in contrast to 80 years ago, countries pursued the right macroeconomic policies -- protecting and recapitalizing their banking systems, cutting interest rates to the bone, and letting their budget deficits expand enough to absorb some of the slack in the economy. They were able to do all these things in part because they faced a much more flexible international financial system. In the 1920s, countries were constrained by the imperatives of the gold standard, which straitjacketed economic policies. But in part, countries today pursued the correct policies because they had the example of the Great Depression available to them as a case study of what not to do.

As the recovery has begun to take root, similarities between the period after 1933 and today have begun to surface. Despite the rebound, unemployment remains high, many sectors of manufacturing are suffering from excess capacity, and currency tensions are on the rise. Having so successfully averted the mistakes that made the slump of the 1930s so deep, it would be truly tragic if policymakers were now to repeat the beggar-thy-neighbor policies that made the 1930s a time of the worst sort of populism and nationalism.

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