

ROBERT MADSEN'S BIOGRAPHY

Robert Madsen is a Senior Fellow at MIT's Center for International Studies, where he works on East Asian and global politics and economics. He is also a member of the Executive Council at Unison Capital, Japan's pre-eminent private equity firm; and a frequent consultant to a "super-major" oil company, which he helps with global and regional economic forecasts, commodity markets, fiscal trends, Chinese economics, and the Eurozone troubles.

Over the last two years he was also on retainer with a fund-of-funds and a prominent macroeconomic hedge fund. Previously he was Asia Strategist at Soros Private Funds Management and an advisor to the Robert M. Bass Group on its investments in Japanese real estate.

Dr. Madsen graduated from Harvard University, earned a master's degree and a doctorate at Oxford University, and received a J.D. from Stanford Law School. He is fluent in Japanese and Mandarin Chinese.

Currency Wars

26 May 2011

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Massachusetts Institute of Technology

Outline

A Note on Exchange Rates and Current Accounts

The First Currency War: 1990s Japan

The Second Currency War: The World, 1995-2009

The Third Currency War: The World Today

The Fourth Currency War: Europe 2012-2013

Conclusion

Outline

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The Third Currency War: The World Today

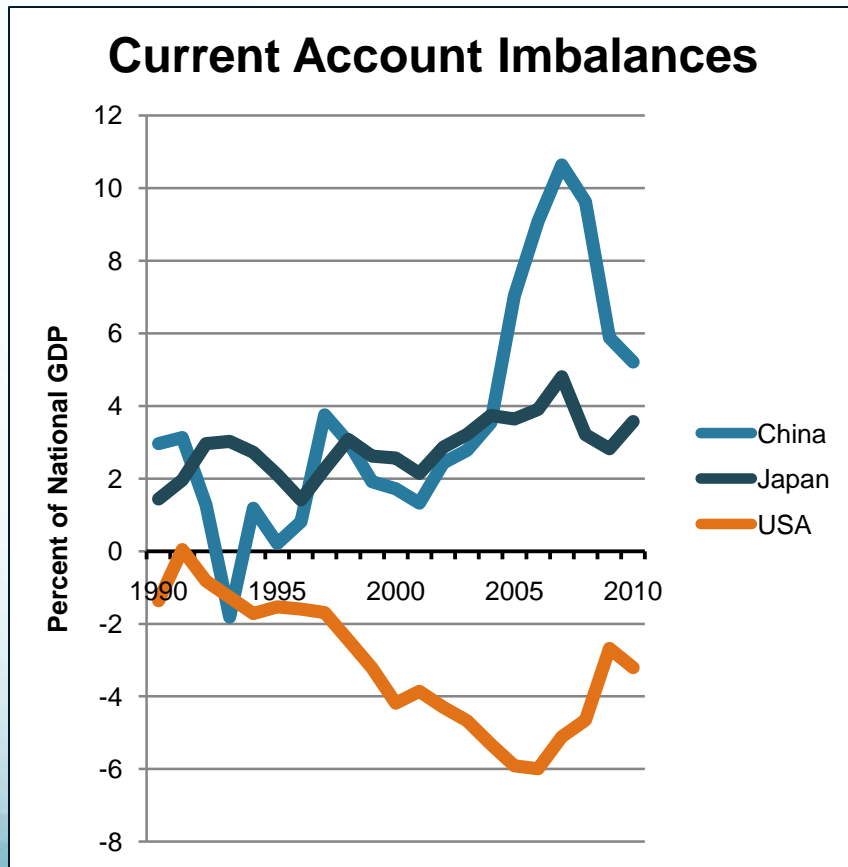
The Fourth Currency War: Europe 2012-2013

Conclusion

Exchange Rates in Economic Theory

- Although variable in the short term, over longer periods of time a country's current account balance should average zero.
- Exchange rates must adjust freely to produce that effect.
- The exception to these rules is that there should be a slight flow of savings from the rich world to the poor, where opportunities for investment are plentiful and living standards need to rise.

Exchange Rates in Practice



Source: EIU Country Data

- Large imbalances are sustained over decades.
- Capital flows voluminosously from poor economies to rich.
- There is a symmetry between the behavior of borrowers and lenders that suggests a common causality.

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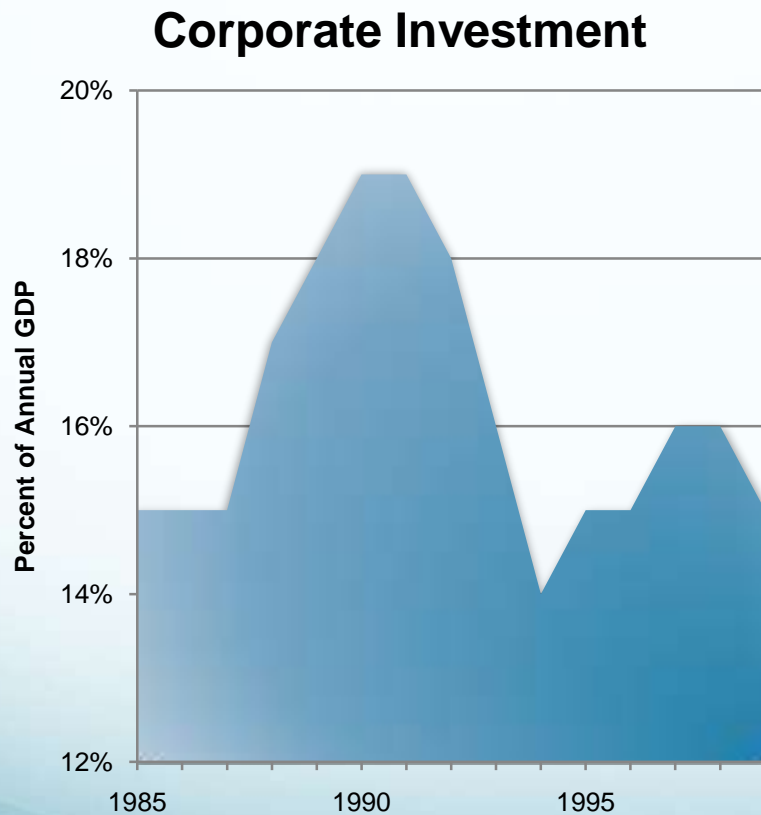
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A Collapse in Demand

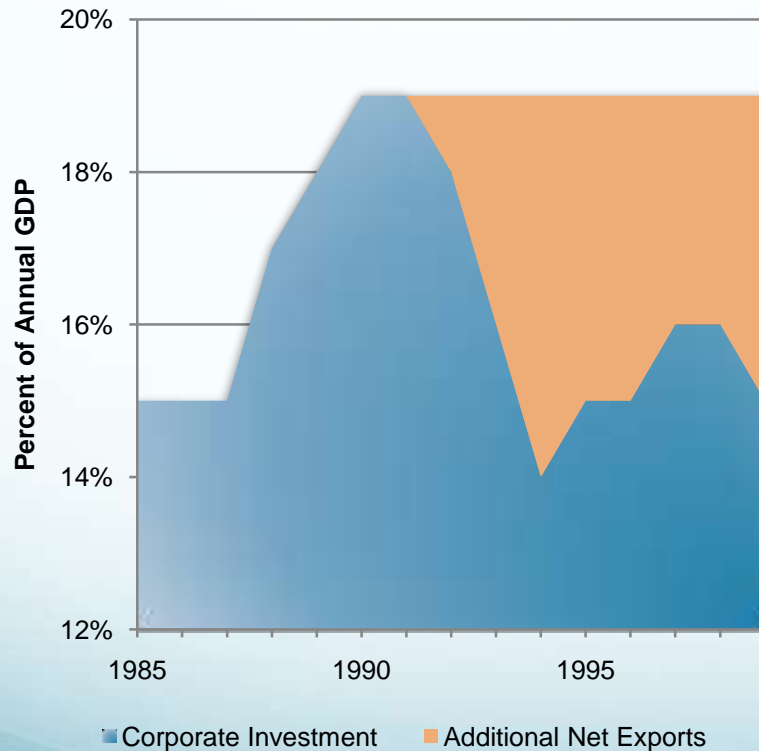


Source: Cabinet Office, SNA

- The collapse of Japan's asset bubble in 1989-1991 caused corporate investment to plummet.
- With consumption already constrained, the fall in capital expenditures made private domestic demand shrink by several percent of GDP.
- Unless counterbalanced by growth in net exports or bigger government deficits, this pattern would produce a depression.

The Ideal Resolution

Investment and Net Exports

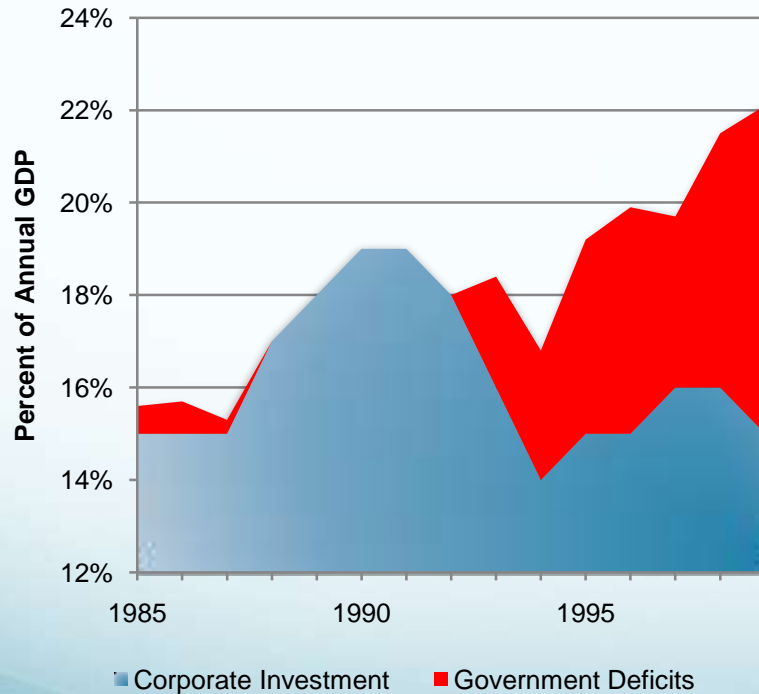


Source: Cabinet Office, SNA

- Ideally the yen would depreciate dramatically, producing a sizeable expansion in net exports.
- GDP could then continue to increase at a reasonable pace of somewhere around 2.5% per annum.

The Actual Adjustment

Investment and Government Deficits



Source: Cabinet Office, SNA

- Foreigners opposed yen depreciation because of the effect a bigger Japanese current account surplus would have on their labor markets.
- Tokyo declined to act unilaterally to lower the exchange rate lest doing so undermine Japan's living standards and international prestige.
- With consumption, investment, and net exports constrained, the government was forced to run ever larger deficits in order to avoid depression.
- The national debt has consequently reached unsustainable dimensions.

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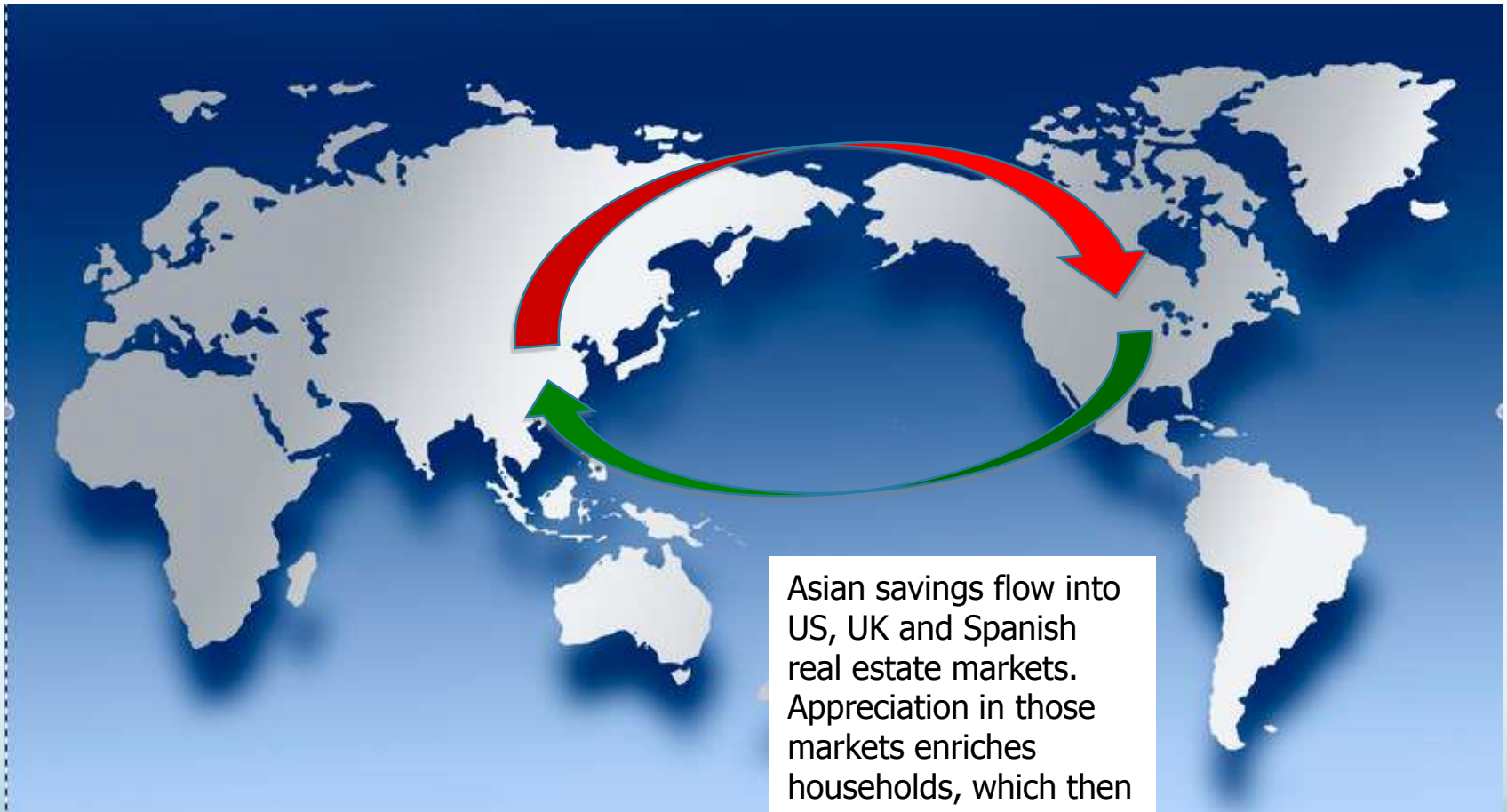
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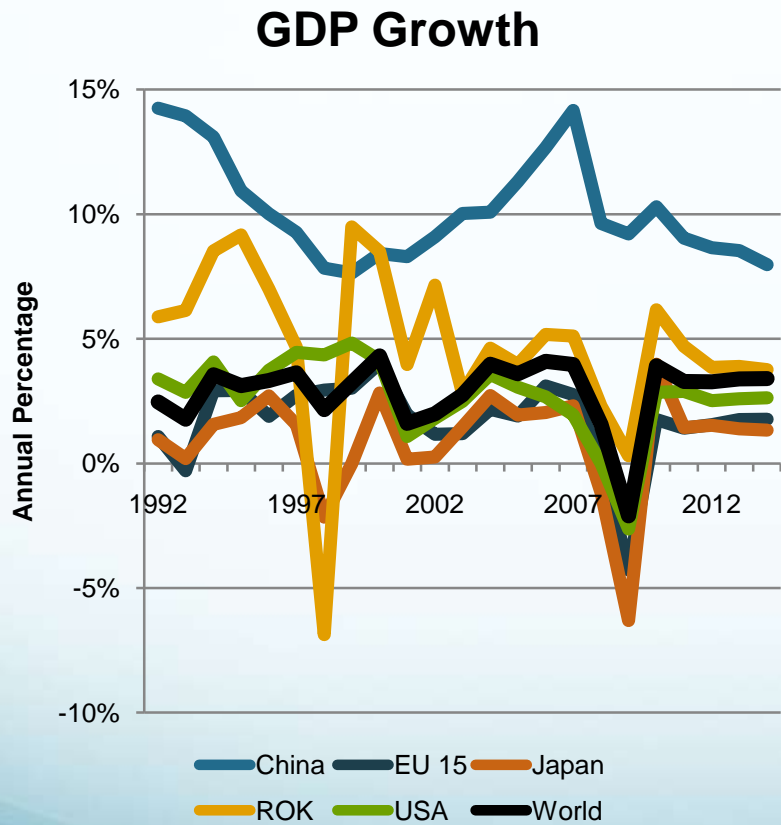
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Recycling Savings



Asian savings flow into US, UK and Spanish real estate markets. Appreciation in those markets enriches households, which then spend more money on Asian exports.

A Question of Causation



Source: EIU, Country Data

- If American deficits are driving the international imbalances, a sudden deceleration in US growth would not cause a big decline in global economic activity.
- If Asian savings are the primary cause of the imbalances, by contrast, the loss of US growth would eviscerate global demand and cause world GDP growth to decrease sharply.
- The 2008-2009 crisis demonstrated that excess savings are more important than inordinate US spending as an explanation of the global imbalances.

Why Countries Insist on Running Surpluses

- Older populations tend to save more than younger ones, which explains in part Japanese and Chinese behavior.
- Economies like China, Germany, and much of the developing world keep their exchange rates low to promote employment and social stability.
- Much of the world concluded from recent economic events that they cannot trust the global monetary system and must therefore amass foreign reserves to insure themselves against future crises.
 - 1994-1995 Mexican Peso Crisis
 - 1997 East Asian Financial Crisis
 - 1998 Russian Financial Crisis
 - 2000-2001 Implosion of the Technology Bubble
 - 2008-2009 Global Financial Crisis

The Price of Past Imbalances

- The flow of capital from the developing world to the developed economics depresses GDP growth and living standards in poor countries.
- Anemic GDP growth among poor countries slows the expansion of the international economy.
- The influx of Asian capital to North America, the United Kingdom, Spain and a few other developed countries contributed significantly to the inflation of the real estate bubble in those countries and hence to the Great Recession of 2008-2009.
- If unresolved, the imbalances that produced those disasters will cause more financial and economic debacles.

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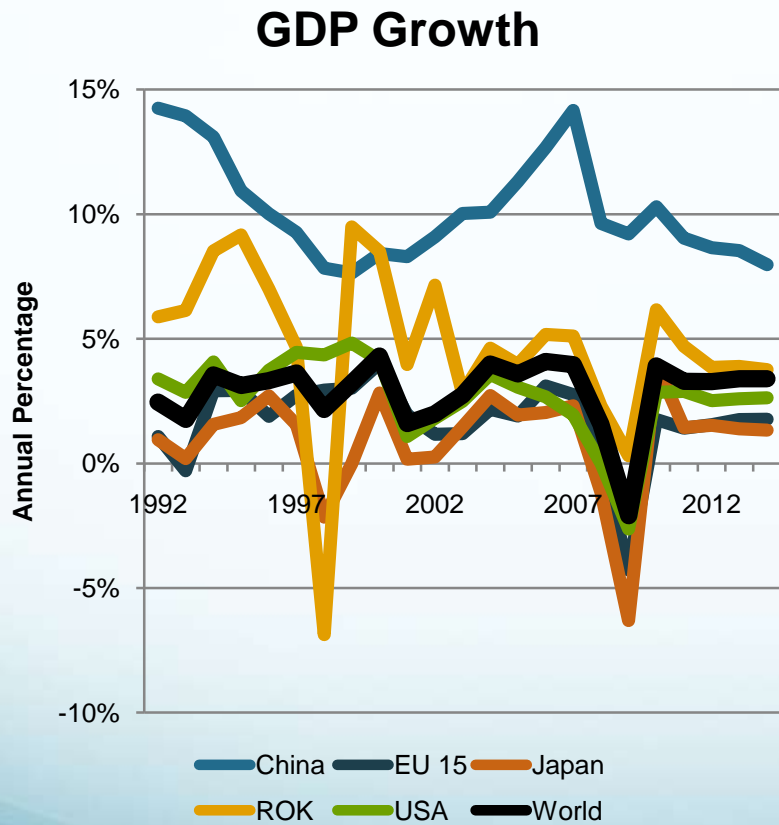
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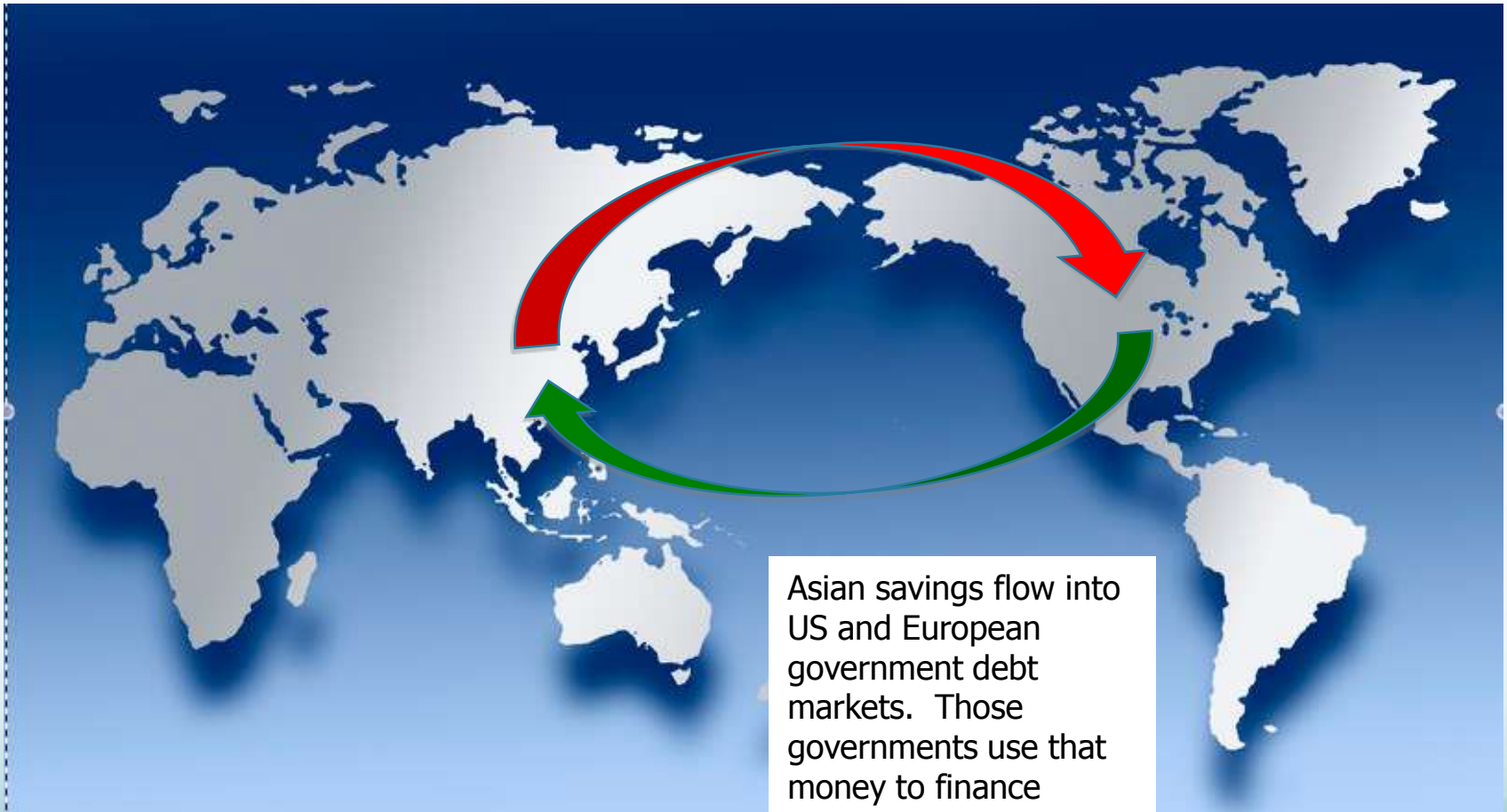
Back to Business as Usual



Source: EIU, Country Data

- The 2008-2009 crisis momentarily redressed the global imbalances by depressing US demand.
- Since the rest of the world failed to increase its demand to compensate for the lost American stimulus, global growth fell markedly.
- The recovery in 2010 and 2011 occurred because the United States returned to its old pattern of excessive borrowing and spending.

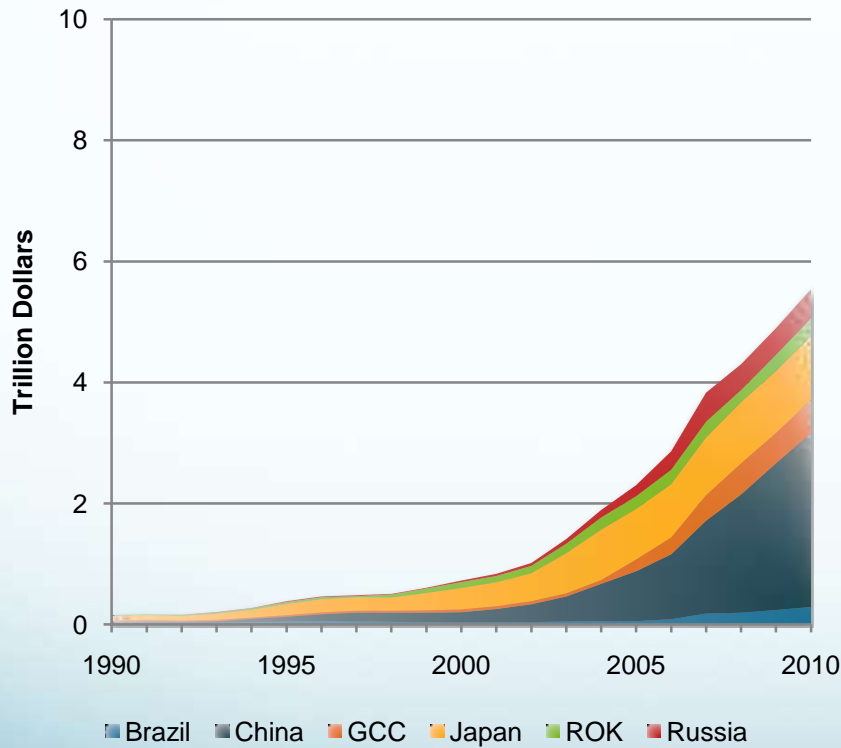
Recycling Savings 2.0



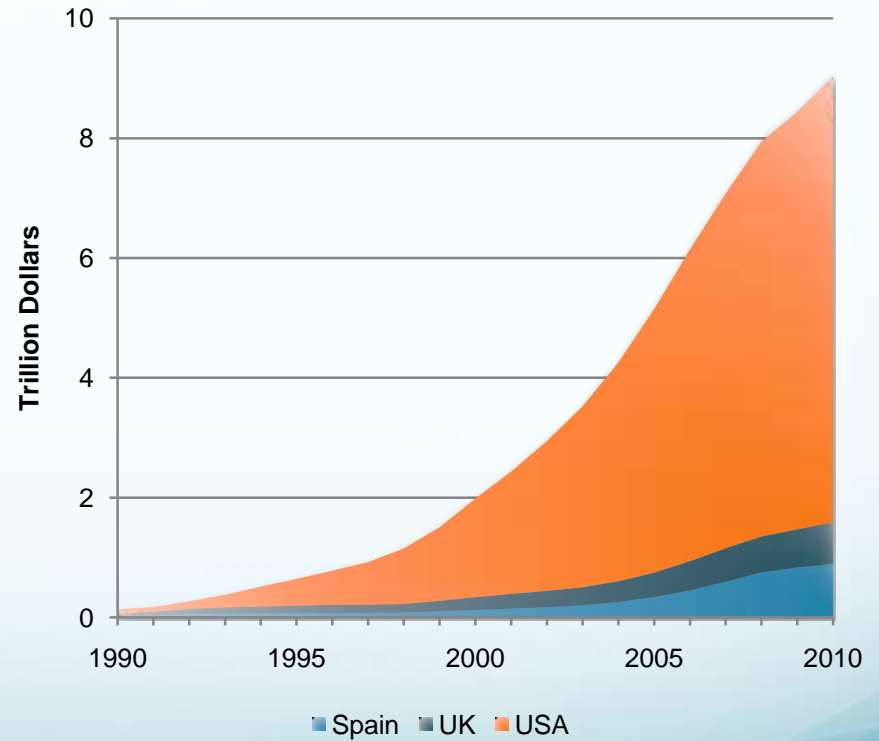
Asian savings flow into US and European government debt markets. Those governments use that money to finance budget deficits, which provide strong demand for Asian exports.

Accumulated Imbalances

Official Foreign Reserves



Cumulative Current Account Deficits



Source: EIU, Country Data

The Necessary Adjustment

- Debt levels in the United States, Japan, the United Kingdom and several other countries are already near the point of unsustainability.
- Those countries must hike taxes and cut spending to eliminate their budget deficits in order to prevent eventual capital flight and financial disaster.
- The household and corporate sectors in those countries must also stop borrowing and begin paying down their debts.
- These dynamics imply that the deficit currencies—particularly the dollar—must depreciate dramatically in order to reestablish balance.
- That exchange-rate realignment will erode the value of much of Asia's dollar reserves.
- If demand among the high-saving economies does not expand to replace the lost American spending, global GDP growth will decline by as much as two or three percentage points per annum.

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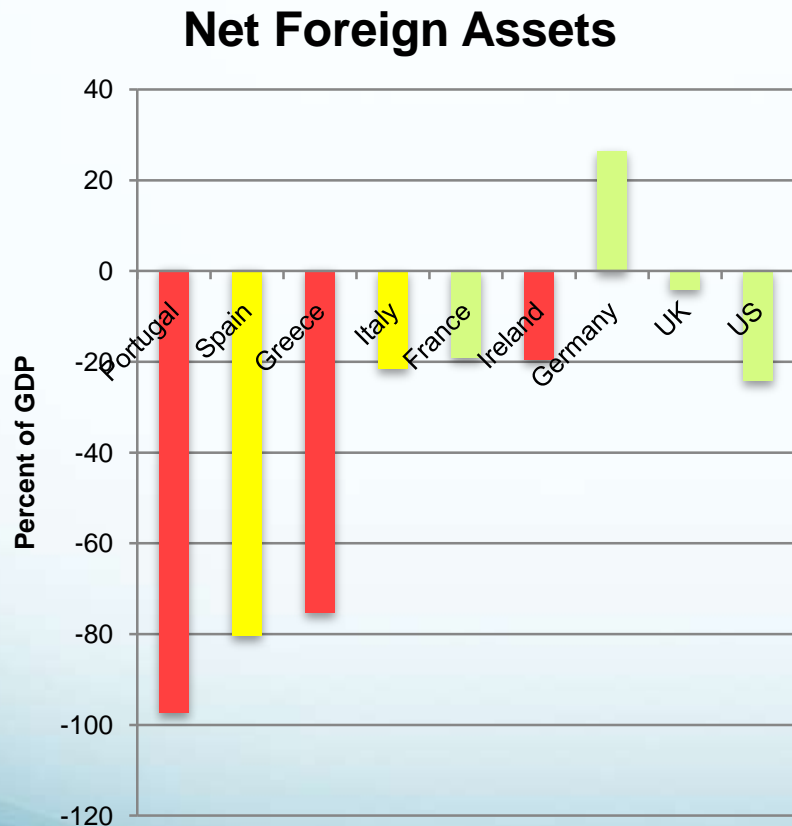
Conclusion

One Economy?



- The Eurozone does not meet the conditions of an “optimal currency area.”
 - A common business cycle
 - Labor mobility
 - Fiscal transfer mechanisms
- Monetary policy is effectively set to meet the needs of Greater Germany, with little regard to the rest of the continent.
- Peripheral Europe suffers from an overvalued exchange rate, which impairs domestic demand and retards GDP growth.
- The governments of those countries are forced to increase their borrowing and spending in order to keep their economies growing.

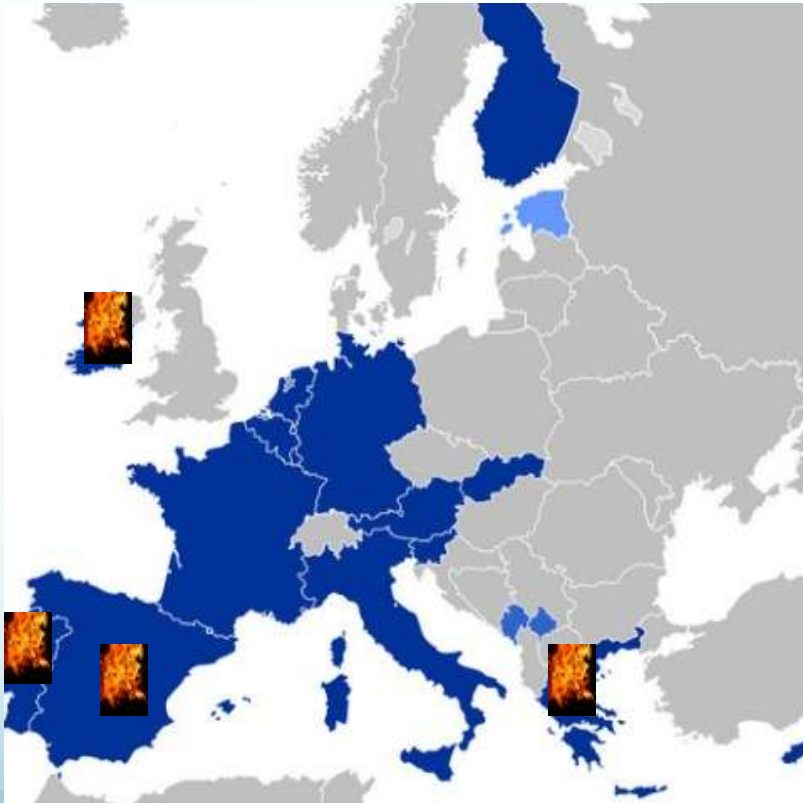
Trouble in the Periphery



Source: EIU, Country Data

- The strong euro contributes directly to deficits and debt in the peripheral economies.
- Onerous external debt translates into financial vulnerability.
- Some countries have already achieved unsustainable debt levels and must default through either voluntary restructuring or market-induced inflation.

Brushfires or Conflagration?



- Several European countries are presently mired in depression.
- Almost certainly Greece, and probably Portugal and Ireland, will default on part of their debts within the next two years.
- Those defaults may destabilize one or more of Europe's major banking systems.
- It is conceivable, if still unlikely, that one or more countries will leave the Eurozone.
- Banking trouble or the partial collapse of the Eurozone would do significant damage to the world economy.

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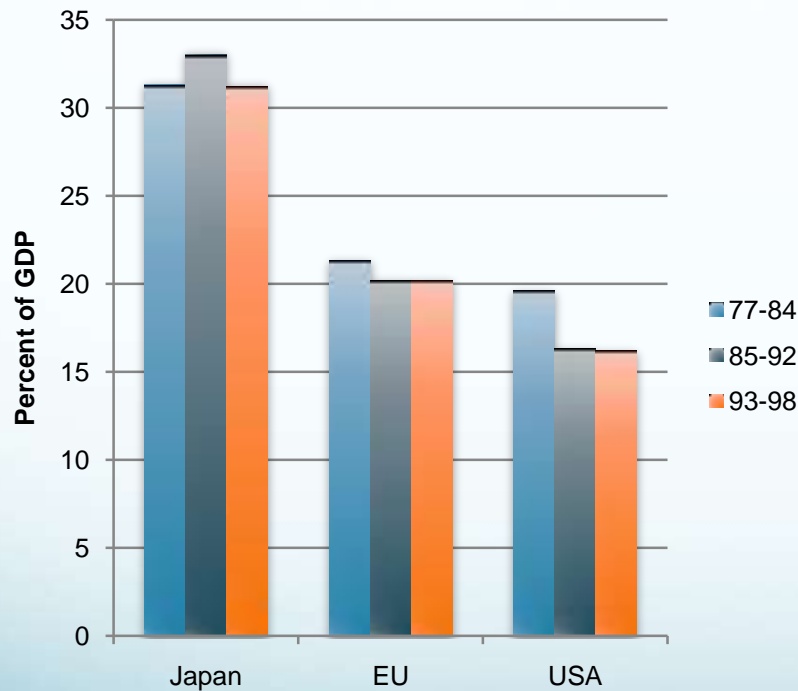
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- The global exchange rate system is broken.
 - Few countries trust the international monetary system.
 - Smaller and poorer economies routinely manipulate their exchange rates to increase employment or self-insure.
 - Japan, the United States, and some other rich economies keep their currencies artificially strong in order to raise living standards and maintain international prestige.
 - No government shows much interest in fixing these increasingly serious problems.
- These distortions have contributed to some of the worst international disasters in recent memory.
 - Japan's "lost decade" — or, more accurately, "lost decades"
 - The implosion of the technology bubble ten years ago
 - The worldwide crisis of 2008-2009
 - The serial debt crises in peripheral Europe
- If governments continue to ignore the underlying distortions, sooner or later market forces will resolve them—perhaps in spectacularly destructive ways.
 - Japan's national finances are growing ever weaker, which means that effective default must eventually occur.
 - US borrowing and spending remain the primary engine of global economic activity despite the fact that that pattern cannot continue indefinitely. A reprise of the 2008-2009 disaster is therefore possible, perhaps even probable.
 - Europe has declined to adopt a systematic approach to its problems and is consequently stumbling from one episode of crisis-and-bailout to another, a process that jeopardizes not only the wellbeing of the peripheral countries but even the viability of the Eurozone itself.

A Problem of Savings

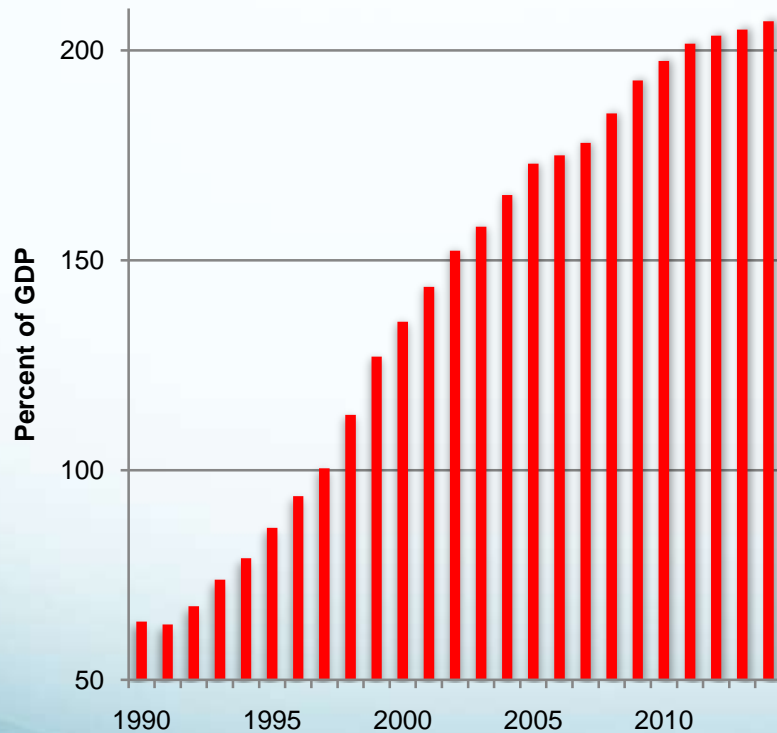
Gross National Savings Rates



- An elevated savings rate implies limited consumption and hence weak private-sector demand.
- The natural solution to such a problem is a big expansion in corporate investment and net exports.
- The yen must depreciate markedly to produce this benign outcome.

The Price of Maladjustment

Gross National Debt



- The deficits kept the Japanese economy growing, albeit at a slow annual pace of some 1%.
- The national debt expanded inexorably, eventually attaining enormous proportions.
- An eventual default, through rescheduling or inflation, is probably already unavoidable.