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Central bankers and currency conflicts

The ECB, the Fed and the BoJ largely have monetary policy right

This week the European Central Bank left monetary policy unchanged, and the euro barely moved. That is all to the good. Alongside the global trade war started by Donald Trump — the US-EU theatre of which entered an uncertain ceasefire this week — the president has blamed the EU and China for deliberately weakening their currencies. With regard to China, he may have a point; concerning the EU, the accusation is unfair. There are undoubtedly unhealthily high global imbalances, in part reflecting misaligned exchange rates. But it is difficult to blame monetary policy, at least in the advanced economies, for creating them.

As it happens, the ECB, the US Federal Reserve and the Bank of Japan (BoJ) are roughly in the right position as regards to monetary policy, with perhaps only the Fed a little too keen to withdraw stimulus. They are commendably focusing on domestic conditions, including domestically generated inflation and the tightness of their labour markets, much more than on trying to manipulate the external value of their currencies. China is unusual among the big central banks in placing such a big emphasis on exchange rates as part of its monetary policy.

On Thursday, the European Central Bank reiterated the message of its previous meeting in June: it intended to start scaling down quantitative easing in September and halting it by yearend. But it has signalled a sufficiently slow pace of withdrawal that the euro has stayed low. Indeed, at June's meeting, the messaging was sufficiently subtle that the exchange rate actually weakened despite signals of policy tightening to come.

Certainly, the actions of central banks and particularly the adoption of QE by the ECB and the BoJ in recent years seem to have had significant effects on currencies. But as the ECB in particular has painstakingly explained, although the exchange rate was undoubtedly one channel of monetary easing it was by no means the most important or even a necessary one. Before Mr Trump came along, the ECB received only a fraction of the criticism previously (also wrongly) levelled at the US Federal Reserve for using QE to drive down its currency in the years following the global financial crisis.

Earlier this week an IMF assessment of global external imbalances suggested that the euro was on balance undervalued in 2017. But there were huge discrepancies between EU member states. Fund economists reckon the real exchange rate was between 10 and 20 per cent weaker than appropriate in Germany, which continues to run huge trade surpluses, but overvalued by between 3 and 10 per cent for Spain. This is not a problem that a central bank can fix. Mr

Trump should urge Germany to reduce external deficits by encouraging domestic investment, not blame it for a currency valuation it can do little about.

By contrast, the dollar is overvalued because of a combination directly traceable to Mr Trump — looser fiscal policy requiring higher interest rates and pushing bond yields upwards. At the margin, the Fed may have overestimated somewhat the inflationary pressure in the US economy. But in general, the fault with the dollar's overvaluation does not lie with the central bank. If there is currently tension over imbalances and currency misalignments, it is an issue for the politicians, not central bankers, to fix. Monetary policy in the big three advanced economies is currently broadly appropriate. Central banks should continue to take exchange rates as a factor in their decision-making, but emphatically not adopt them as an objective in themselves.