The Fallacy of the “Currency War” under the Flexible Exchange Rate Regime.

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Before the regime change in monetary policy, initiated by Prime Minister Shinzo Abe and completed by the appointment of the new Bank of Japan governor, Haruhiko Kuroda, the Japanese economy had experienced deflation (BOJ) and continued appreciation of yen for more than fifteen years. The combination of unconventional monetary expansions reacting to the Lehman crisis in other advanced economies and the virtual inaction of the BOJ created a strong wave of yen appreciation, and a resulting large production GDP gap in Japan. Japan’s production record is not only worse than other developed countries, but also worse than most other Asian countries.

During this long deflation the BOJ acted very timidly in worrying about future inflation. It looks as if the BOJ were a golfer who would engages only in patting the ball without using the driver even when the ball was in a bunker. He worries too much that the ball would fall down the imaginary and non-existing cliff (hyper inflation) beyond the green, because he worries so much about over-hitting the ball if he uses the driver.

When developed countries previously attempted to react to the Lehman shock by aggressive, often unconventional monetary expansion, neighboring countries raised the criticism that these actions are triggering a “beggar thy neighbor policy.” Guido Mantega, a Brazilian Finance Minister, criticized the United States and United Kingdom for waging a “currency war” by inducing substantial depreciation of the US dollar and pound sterling. This argument is often raised to criticize the Abenomics.

Contrary to common belief, in this world money game under the flexible exchange rate regime, competitive devaluation no longer leads the world into an undesirable disequilibrium. On the contrary, it can help the recovery of participating countries.

During the Great Depression many countries tried to escape the constraints of the gold standard (golden fetters), and devalued their currencies against gold. As Ben Bernanke shows, during the interwar period, those countries that departed from the gold standard earlier recovered earlier. Countries that stayed on the standard recovered the least and the latest.

Indeed, through the depreciation of the home currency, a country's monetary expansion generally exerts recessionary effects on its neighbors. Other countries, however, are able to *undo* those effects through their own monetary policy under the flexible rates. Each country pursuing its goal by monetary expansion contributes to the total welfare of the world.

In 1984, Barry Eichengreen and Jeffrey Sachs (*Economic letters, Cambridge J. of Economic History)* showed, in theory as well as with historical data, that the sequence of devaluations in the 1930s did not lead to the collapse of economies but rather contributed to their recoveries. Independently, Richard Cooper (*Handbook of International Economics)* found in a Keynesian model that laissez-fair pursuits of inflation targets by monetary policy by nations will lead to a situation that is slightly tighter than the mutually desirable situation.

With the late Yasushi Okada, Koichi Hamada recently analyzed this issue using a more classical model, namely, a model with the monetary approach to exchange rate determination. In this model, the policy message is even strengthened (JJIE 2007). If the objective of each country is a desirable rate of the price change (or a point on the short run Phillips curve), then countries can achieve the objectives of desired inflation (deflation, if any country prefers) as long as each country pursues its price objectives. The flexible exchange rate system has a remarkable advantage that the laissez-faire monetary policy would achieve the Pareto optimum macroeconomic situations for the world as a whole. The flexible exchange rate regime frees countries from the fetter bound by the fixed exchange rate regime.