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Theme 229

'CURRENCY WAR' / COMPETITIVE DEVALUATION

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THEME 229 : 'CURRENCY WAR' / COMPETITIVE DEVALUATION

'Currency War' is a term used in the recent economic literature referring to the competitive devaluation of currency values by the leading economies either directly or indirectly so as to promote exports. Such currency disputes, if further escalated, can threaten global co-operation and concerted efforts on economic recovery. This is the observation of the Managing Director of the IMF, Dominique Strauss-Khan, who first used the term 'currency war' because of the possible repercussions that can follow from the competitive devaluation of the currencies by the major trading nations of the world. Economic analysts are also comparing the present situation to the similar predicament that happened after the Great Depression of the 1930s. The 'Competitive Devaluation' or the 'beggar thy neighbor' policies led to contraction of the world trade. Ultimately no nation gains from such policies, resulting in what is known to be a 'zero-sum game'.

What is the objective of the devaluation of currency?

Devaluation is resorted to by the countries when they follow a vigorous export-led growth. The low value of the home currency, as a result of devaluation, reduces the export price of the commodities for the foreign buyers. It also results in higher export value realization for the exporters, thus boosting overall exports form the country resorting to devaluation. Devaluation increases import prices, thus negatively impacting import volume. This will be helpful for the import-competing domestic industries. Thus export-led growth is aimed at boosting domestic production, more domestic employment generation and thereby higher GDP growth rates. The emerging economies may resort to devaluation of home currencies to build up foreign exchange reserves to protect itself from future financial crises.

But currency devaluation has also several adverse consequences for the country. The export –led growth may negatively affect domestic consumption of the goods and this will lower standard of living of the people. There could

be inflationary tendencies reducing purchasing power of the people. Devaluation makes international debt servicing more expensive when the debts are denominated in foreign currency. Frequent devaluations can discourage foreign investment as devaluation is generally seen as a sign of weak governance.

How are exchange rates normally determined?

Exchange rate of a currency is the external value of the home currency, or the 'border price', representing the international purchasing power of the currency. Ideally it represents parity of purchasing power with the foreign currency. It also denotes parity of general prices in the two countries whose currencies are equated. Though long-term exchange rates are determined by the relative purchasing power, the demand-supply factors are predominant in short-term movements of the currency values. When exchange rates are decided by market factors such as inflationary trends, demand-supply, interest rates etc. the external currency values or exchange rates will undergo changes such as appreciation or depreciation of the currencies. In the case of 'managed floating' of exchange rates, currency intervention by the central banks may be required to stabilize the exchange values. Devaluation on the other hand represents artificial setting of exchange rates for realization of certain domestic economic objectives. Intervention by the central bank by buying foreign currencies, easy money policies or quantitative easing, lowering of the policy interest rates of the central bank, giving hints as to the future course of action so as to discourage speculative position taking etc. are some of the mechanisms for devaluation of the currencies.

What is the origin of the present exchange rate controversy?

The exchange rate disputes came to surface in the aftermath of the global economic crisis. It was alleged by the US that China is deliberately manipulating its currency, Yuan, by not allowing it to appreciate in consonance with its huge reserves of foreign exchange and export revenues. China was dubbed as a 'Currency Manipulator' as the Yuan is undervalued by as much as 40 percent. China has been aggressively following a 'mercantilist' route of economic growth by boosting domestic production aiming at higher export revenues. Higher level of exports to the US and other economies adversely affected the domestic industries of the importing countries and this resulted in increased unemployment in those economies. Now, China is being urged to up-value its

currency, or float its currency to market determined prices, so that this will increase exports from the US and other developed economies, resulting in increased employment and faster economic recovery. It is also alleged that the Chinese currency policy resulted in global liquidity imbalances which was one of the factors for the recent financial crisis.

What is the impact of 'quantitative easing' by the US and the developed economies on the currency markets?

The economy 'bail-out' packages adopted by the US and other developed economies resulted in a surge in liquidity which partly moved to other emerging economies causing appreciation of the currencies of other economies, thus affecting the export sectors. The advanced economies followed an aggressive 'easy money policy' by injecting liquidity and by keeping interest rates almost near zero. Injection of liquidity also results in devaluation of the respective currencies. Thus quantitative easing, though primarily aimed at domestic economic recovery, indirectly results in devaluation of the domestic currency also. The surplus liquidity in the advanced economies moved into emerging markets in search of high rate of returns. This short term flow of funds led to fluctuations in currency values and increase in asset values resulting in inflationary trends. Some emerging economies started implementing controls on capital flows by way of imposing tax on such flows called as 'Tobin tax'- named after the economist James Tobin who proposed such tax on short-term capital flows aimed at discouraging cross-border speculative trades and instead encouraging long-term investment.

Thus the US is also blamed for quantitative easing measures which have been followed continuously, driving down the value of the dollar. This has negatively impacted exports from the emerging economies and has inflated asset bubbles. Easy money policies lead to 'currency carry trades' whereby investors can borrow funds at lower cost and invest in higher-yielding assets of the emerging markets.

How does a 'Currency War' originate and what are the implications of a 'Currency War'?

When a large number of major economies simultaneously devalue their currencies, by various methods, then exchange rate is used as means to promote trade. But due to competitive behaviour, this will be detrimental to

global trade. Such behavior from trading countries occurs during the periods of economic recession. During the periods of economic boom, currency manipulations are not taken note of seriously by the trading partners. But in the times of depression or recession, countries may follow protectionist policies and exchange rates will be manipulated overtly or covertly to protect domestic industries. Competitive devaluation during recession will prolong the recovery process. Currency war becomes virtually a trade war with possibly no gains whatsoever to the trading partners in the long term. This may also perpetuate global imbalances.

What are the responses of the leading economies towards the exchange rate disputes?

China has resisted pressures for a sharp appreciation of its currency as it will lead to high unemployment and social unrest. But it is expected that a gradual movement from fixed exchange rate to floating rate will take place. Japan has adopted limited devaluation in the recent periods but the economy is still in the grip of deflation. Among the Eurozone economies, Germany has trade surplus, while other economies such as Greece, Spain, Portugal and Ireland have deficits, and therefore, uniform exchange rate policy that benefits all members cannot be taken. The South American economies such as Brazil, Colombia, Chile and Costa Rica adopted capital controls to check domestic currency appreciation. India has not adopted currency interventions in the recent crisis periods leading to any devaluation of the rupee, despite increase in the current account and trade account deficits.

What are the possible solutions to the exchange rate disputes?

The economies, however powerful, cannot defy market logic and currency manipulation only provides temporary push to exports. The enhancement in domestic productivity should be seen as the key factor to promote trade. There should be international regulations in the matter of exchange rates to be reached by negotiation and consensus. The earlier discussions on the need for a new international financial architecture should be pushed ahead to address issues relating to management of global liquidity and movements in currency rates for orderly growth of global trade and economy.

Currency War & Currency Crises

'Currency War', also known as competitive devaluation, is a situation where countries compete against each other to achieve a relatively low exchange rate for their home currency so as to help domestic industry.

In the present times, this refers to the rhetoric conflict between the US and China over the valuation of the Chinese Yuan Renminbi (RMB). In November 2010 the US launched QE2 – a second round of quantitative easing. There was widespread criticism that the US was using QE2 to devalue its currency. This would also result in capital inflows to emerging economies.

Currency war is distinct from currency crisis, where the value of currency depreciates owing to market forces or external shocks and thereby forex reserves of the country will be depleted, as happened during Asian Crisis of 1997.

History of currency wars / currency crises

Till 1930s devaluation was not resorted to for promotion of exports. World trade was not significant then.

During the Great Depression of 1930s, countries abandoned gold standard affecting intrinsic value of currencies. Competitive devaluation meant 'beggar thy neighbor' policies resulting in contraction of world trade.

The period from 1940 to 1971 is known as Bretton Woods era, when a system of semi-fixed exchange rates was set up which resulted in less volatility in exchange rates. This was a period of less devaluation and high economic growth.

The period from 1972 to 2000 is known for floating or managed floating of currencies according to free market forces. There were trade agreements among leading economies to correct distortions, but no competitive devaluations.

During 2000-2008, after Asian currency crisis, the developing and emerging economies adopted market interventions to keep currency values lower to promote export-led growth and thus build up forex reserves.

During the economic downturn after 2009, leading trading economies started adopting protectionist policies and started keeping currency values lower. This will be a zero-sum game and will adversely affect global trade.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in

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