Currency Wars and Their Implications

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Disclaimer by the Author: The author owns a mutual fund portfolio invested in bonds from emerging markets including from the BRICs.
Currency Wars

When the American banking crisis spread to the rest of the world in 2008, the US dollar depreciated, whereas through the yuan-dollar peg, China maintained its export based growth model against the background of falling global trade and the freeze of short term funding markets.

Exchange rate of the Indian rupee in US dollar since the outburst of the financial crisis

Exchange rate of the euro in US dollar since the outburst of the financial crisis

The US Federal Reserve countered internal deflationary pressure caused by the dislocation of its credit market by lowering its fund rate from 5.25 percent in December 2007 to 0.25% in December 2008, and through quantitative easing. In QE 1, the Federal Reserve gradually purchased $1,350 billion of agency MBS and $300 billion of Treasury securities between December 2008 and March 2010. In QE 2, the Federal Reserve purchased $600 billion of Treasury bonds between November 2010 and June 2011. In QE 3, the Federal Reserve purchased $40 billion for agency MBS per month from September 2012 onward (open ended program). In QE 4, the Federal Reserve was authorized to buy up to $40 billion agency MBS per month and $45 billion long term Treasuries. The supply of US dollars rose considerably, and the US dollar initially depreciated. This policy impacted trade partners such as China and the European Union, but also those emerging countries receiving a much larger quantity of US dollars than their payment balance targets. Perceived as uncooperative in some emerging economies, the expansive policy of the Federal Reserve was emulated by other central banks, excepted the European Central Bank to some extent, as its sole objective is price stability under article 2 of its statute, with no foreign exchange target, although it is empowered to purchase and sell assets in foreign currencies by article 3 of its statute. The Communiqué of the G-20 meeting of finance ministers and central bank governors of April 19, 2013 proscribed currency war in the following terms:

"6. We reiterate our commitments to move more rapidly toward more market-determined exchange rate systems and exchange rate flexibility to reflect underlying fundamentals, and avoid persistent exchange rate misalignments. We will refrain from competitive devaluation and will not target our exchange rates for competitive purposes, and we will resist all forms of protectionism and keep our markets open. [...] Monetary policy should be directed toward domestic price stability and continuing to support economic recovery according to the respective mandates of central banks. We will be mindful of unintended negative side effects stemming from extended periods of monetary easing."

With some "constructive ambiguity", the Communiqué allowed continued monetary easing to the extent that it would not be intended for external devaluation purposes, but for domestic recovery. However, the question of how these two consequences could be dissociated is not answered in the Communiqué. Some market commentators believe that a currency war is already taking place, can no longer be avoided, and needs to be contained. Those countries that devaluated more than others can support exports and internal demand for domestic goods and services through the price effect. Those counties that did not devaluate externally have no other option than internal devaluation, that is wage moderation, and accept its recessionary impact on consumption and investment.
External devaluation through monetary policy

Decrease in interest rates and quantitative easing

Central banks may direct exchange rates by adjusting interest rates as a traditional tool, and when the floor rate has been reached – near 0 percent –, by increasing money supply – quantitative easing. Such a policy may result in higher inflation, once deflation has been averted. Inflation causes a drop in real interest rates, and in the exchange rate as an inflationary currency cannot fulfil its role of storing value over time. Such policies have been illustrated over the past year the 4 Quantitative Easing programs of the US Federal Reserve, the Swiss National Bank's target exchange rate of 1 euro = 1.2 Swiss Franc through the purchase of euro denominated bonds with excess reserves from capital inflows, similar policies of the Bank of England and the Bank of Japan, whose Prime Minister imposed a 2 percent inflation target. As a defensive response, in order to discourage excessive capital inflows, which could create payment imbalances and fuel speculative bubbles or overheating, smaller emerging economies such as Thailand; Malesia, Philippines, Chile, Russia, etc. lowered interest rates and took various steps to limit the appeal of their currencies. So did smaller developed economies in Asia, such as Singapore, Hong Kong, South Korea, etc. Among the most noteworthy developments, the Japanese yen depreciated by 20 percent to the US dollar between November 2012 and February 2013. Likewise, between March 2012 and February 2013, the Brazilian real, the Argentian peso, the Indian rupee depreciated by 15, 13 and 11 percent respectively to the US dollar. Conversely, the euro appreciated by 11 percent to the US dollar.

Decrease in interest rates and quantitative easing

To the extent that domestic goods and services can replace imports – which is generally not the case of raw materials, lower exchange rates allow internal demand to shift toward domestic goods and services, which benefits employment and stimulates exports. This virtuous circle holds only when the currency of a given country depreciates more than that of trade partners, which is the root cause of competitive devaluations, i.e. currency wars. Globally, the competitive nature of this policy has the drawback of stimulating inflation while forcing crossborder trade volume down. However, such is not yet the case. In the deflationary context of the 1930s, serial devaluations and related protectionism paved the economic way for World War II, that is by removing shared trade interests. According to data from the League of Nations, the import volume of the main world economies developed as follows between 1928 and 1935:
Currently, the threat of retaliation between the US Congress on the dollar peg and Chinese authorities raise some concerns on the possible repetition of this scenario.

**The renunciation of external devaluation compels internal devaluation**

*The renunciation of external devaluation requires to weaken domestic demand*

Interest rates impact investment level. By refusing to lower real interest rates below those of trade partners and to increase money supply in order to meet the inflation target results in moderating domestic demand, including domestic demand for foreign goods and services. The current account deficit can therefore be reduced by moderating imports with a weakened domestic demand – consumption and investment. Fiscal austerity may result in the same, hence the concept of twin fiscal and trade deficits. Conversely, fiscal austerity – such as that of the eurozone – maintains the exchange rate or helps it relatively appreciate with respect to devaluing currencies, and inasmuch hurts exports.

**Loss in external competitiveness requires wage moderation**

To defend export market shares, those economies that defend their exchange rates in the face of trade partners allowing their currencies to depreciate must offset the relative loss in
competitiveness by lowering labor costs. As a matter of fact, the profitability of the South Korean car maker and exporter Kya dropped by 51 percent in the last three months of 2012, whereas the Korean won had appreciated by 28 percent against the yen over the past 24 months, and requires to look for other cost cuts. Conversely, the depreciation of the Japanese yen is followed by similar inverse movement in nominal wages, with a 6-month lag.

In most advanced economies, consumption makes for two thirds of GDP: wage moderation consequently has an adverse impact on consumption, and on GDP, whereas in China, whose currency is pegged to the US dollar, and which some commentators believe is undervalued by up to 40 percent, wages are regularly raised.

**Conclusion**

External devaluation can be implemented through monetary policy, i.e. by lowering interest rates, and by unconventional policies such as quantitative easing. The goal of external devaluation is to promote exports and replace imports with demand for domestic goods and services. Such policies have been followed by both emerging and advanced economies, and to a lesser extent by the eurozone, which hurt its exports while comforting the status of the euro as a reserve currency in spite of its flaws. Conversely, India’s twin deficits do not make the Indian
rupee a candidate for reserve currency status, unlike China’s yuan, on which there is a consensus that it is bound to revalue upward at some point in time. It may be noted that having an explicit foreign exchange rate target does not preclude a currency from international reserve currency status: the Swiss franc and the Japanese yen continue to be reserve currencies. To the extent that the reduction in payment imbalances depends on rebalancing exchange rates, the pace of convergence is going to be a slow one so long as central banks have differing mandates. Given that central banking must support different goals contingent upon the country’s stage of development (e.g. price stability in the European Union, development in India and other emerging countries), it is unlikely that central banking mandates can be harmonized in the medium term. The challenges to the eurozone show how difficult it is to harmonize central banking mandates when one size clearly does not fit all.

Exchange rate of the US dollar to the Japanese yen since outburst of the financial crisis

![Exchange rate chart](chart.png)
Exchange rate of the euro to the Japanese yen since outburst of the financial crisis

Exchange rate of the euro to the Chinese yuan since outburst of the financial crisis
Exchange rate of the Indian rupee to the Chinese yuan since outburst of the financial crisis

Source: www.oanda.com