

Currency Wars: A View from the Trenches

Recent weeks have seen much talk about "currency wars". This talk suggests that many countries are seeking the devaluation of their currencies in order to promote their exports, which in turn forces other countries to respond with similar efforts. It harkens back to the disastrous beggar-thy-neighbor policy that was seen between the two world wars. While the foreign exchange market is one of many arenas in which nation states compete for advantage, calling what is happening now a currency war is not only wrong -- it is dangerous.

No Devaluations

It is factually wrong in the sense that there has been no recent currency devaluation in any country that is known or suspected to have intervened. In fact, the emerging Asian currencies (leaving aside the Hong Kong dollar) have all risen against the US dollar this year. The Thai baht is the strongest performer, advancing about 11.3% against the dollar, followed by the 10.8% climb of the Malaysian ringgit. The Taiwanese dollar is 4.2% higher and the Korean won 4.4% higher than they began the year.

Several Latam countries also intervene in the foreign exchange market and, outside of Argentina and Venezuela, their currencies have generally risen. It is the Colombian peso that is the strongest of the followed emerging market currencies, having appreciated by 14.3% against the dollar. Despite the handwringing, the Brazilian real is actually among the weakest of the Latam and East Asian emerging market currencies, gaining just 3.7% against the dollar thus far this year.

The countries that are intervening are doing so to moderate the rise of their currencies. This is fundamentally different than seeking a competitive devaluation. Moreover, one of the take away points from both the large scale intervention by the Swiss National Bank and last month's record sized single day intervention by the Bank of Japan, is that intervention, even when unsterilized, often fails to have much more than a momentary impact in the foreign exchange market.

Not Simply about Exports

There is also a misconception about the motivation behind the intervention. Many observers suggest that export advantage is being sought, but this may exaggerate trade considerations and under-appreciate capital market developments. For example, about 50% of all the foreign purchases of South Korean equities this year took place in the last month. Similarly, while the Jan-Aug period saw foreign investors buy about \$500 mln worth of Taiwanese shares, in September they bought five times that amount (\$2.5 bln).

Central bankers in the advanced developed countries have been criticized for not acting earlier to arrest financial market bubbles. Now it is the emerging market countries that are experiencing strong capital inflows as investors in the US, Europe and Japan diversify their savings. Many emerging markets cannot absorb their own savings, let alone the deluge of money pouring in. They try to neutralize the impact or guide the foreign savings into certain areas. This is not an act of war.

Excessive Fluctuations

The G7 have historically adhered to three principles of foreign exchange. The first is that currencies should reflect fundamentals. This sounds good, but the question is often: which fundamentals? There might be one clearing price for the trade account and another for the capital account. It is difficult to operationalize this principle.

The second, and the one that many are focusing on now, is that currencies should be flexible. The meaning here is clear. The price of foreign exchange, like most prices, should be set by the markets. In practice, few countries have been willing to surrender such an important price solely to market outcomes. The crisis may have weakened the market determinist ideology, but in foreign exchange it remains alive and well.

What many observers seem to miss is the third principle: excessive fluctuations are undesirable. Admittedly these words are often slippery and there is no agreement on how this should be operationalized, but it is a clear recognition that all market outcomes are not necessarily the best. Nor is there a consensus on the prioritization of the three principles.

Japan is experiencing sustained deflation and its economy appears to be faltering. By the OECD's purchasing power parity calculation the yen is nearly 30% over-valued. Over the last six months, the yen has risen by more than 14% on a trade-weighted basis and 11% against the Chinese yuan and 13% against the US dollar, its two largest trading partners. Is there some point at which the yen appreciation should be slowed? If the dollar falls to JPY50 should that be actionable concern? What about JPY70? JPY83? And who should decide; Japanese officials or a committee of officials from other countries?

It is one thing for a country with an over-valued currency to intervene, but it is a horse of a very different color for a country with an under-valued currency to intervene. Intervention to boost one's currency reserves, which might not be (sufficiently) acquired through trade, should not be tarred with the same brush as that used for currency management. No one cried "currency war" when the Swiss National Bank bought several hundred billions of euros as an attempt to arrest deflationary forces. Yet Japan intervenes once and chins are set wagging about a currency war.

What a Real War Would Look Like

To consider what is taking place as "war" is dangerous because it leads to a sense of urgency about retaliation. Note the recent op-ed piece in a leading financial paper by a highly respected economist -- who often testifies before the U.S. Congress -- which proposed that in response to Japan's purchase of around \$22 bln, the US should sell \$22 bln.

The currency war would be only one front of a multi-faceted trade war. And despite some flirtation with nationalist policies in the immediate response to the crisis, significant protectionism has been avoided. The dramatic and abrupt contraction in developed countries and the evaporation of finance saw trade implode during the worst of the crisis, but trade flows have recovered to a great extent.

Just as counter-cyclical government programs, such as employment insurance, helped prevent the levels of unemployment experienced during the Great Depression, so too, the World Trade Organization helps mitigate the likelihood of a trade war. Rights and responsibilities are clearly set out. There is a rule of law and a conflict resolution mechanism.

This is not to say that the mere existence of the WTO prevents trade wars, but it does offer relief short of a trade war. Trade itself is rife with conflict. The US and Canada are the two largest trading partners in the world. A common language is spoken. Their currencies fluctuate freely with each other. They share a large and, for the most part, un-militarized border - but there are often trade tensions in one industry or another. Conflict and tension does not mean war.

Turning Swords into Ploughshares

If you were not watching closely, you probably missed the recent slight-of-hand. The concept of “currency war” has been co-opted. It has become a new club to bludgeon China. On the very eve of the G7/G20/IMF meeting the US argued that China’s undervalued yuan was triggering an international currency war, jeopardizing the global economic recovery. Europe also recently stepped up the pressure on China.

By recognizing what is going on as a currency war, US and Europe can therefore call for a truce. The basis for the truce is some sort of agreement on Asian currency appreciation. Making it a regional issue avoids singling China out. Moreover, given the significance of intra-regional trade, getting an regional agreement may avoid a change in relative competitiveness within Asia. Yet the chances for such an agreement appear slim, and arguably too slim to justify risking the unleashing of protectionist retaliation in the so-called war.

Countries in Asia have not waited for China to move on its currency. Their currencies have appreciated against the dollar, euro and yuan. Rather than the divisive language of war, the real issue is the pace of change - not the direction. The talk of a currency war distracts us from the real threat to the economic recovery, which is not to be found in the pace that Asian, emerging market currencies in general, and the yen are appreciating. After all, the real threat is closer to home: coping with the economic and financial fallout from years of excessive leverage and weak enforcement of lax regulation.