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## Currency Wars

### Executive Summary

- Developed market policymakers seem to be indirectly targeting weaker currencies in order to boost their export sectors.
- Weaker currencies can accrue short term benefits but only at the expense of other countries' exporters.
- Macroeconomic fundamentals should have the greatest bearing on long-term currency valuations.
- A risk to global growth prospects from "currency wars," is a rise in protectionism by developing economies seeking to offset the impact of capital inflows fleeing from developed economy currencies.

*"The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists."*

~Ernest Hemingway

### Currency Wars

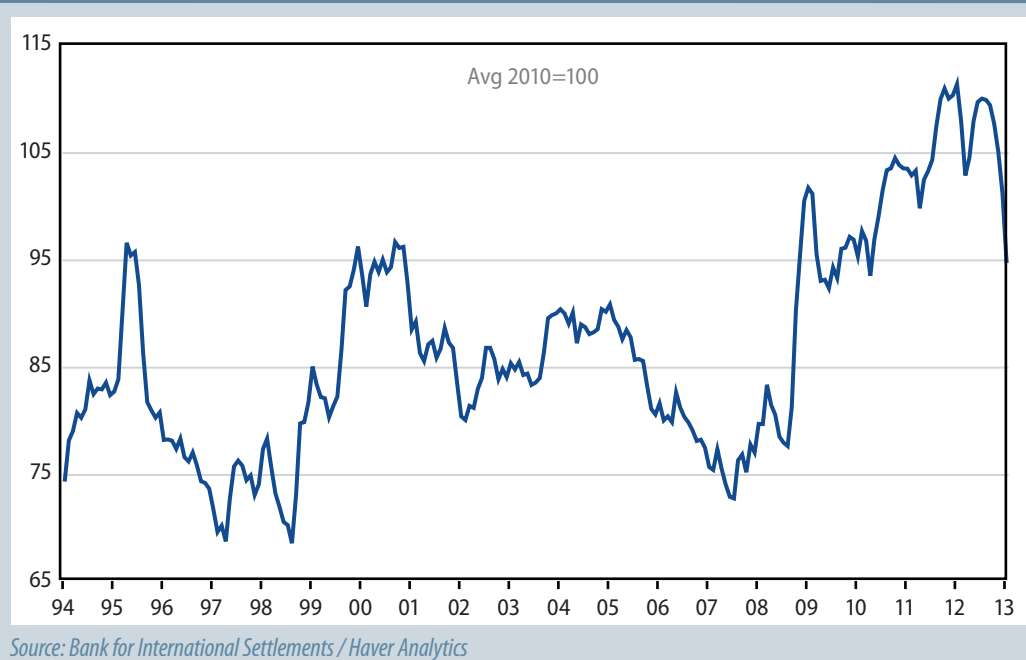
Guido Mantega, the Brazilian Finance Minister, first used the term "currency wars" in September 2010 to describe the process of competitive devaluations, whereby countries try to weaken their currencies so that their exporters gain a price advantage, win international market share and so boost domestic industry and employment. Mantega's comments were aimed at the United States, whereby the Federal Reserve's quantitative easing (QE) policy was seen to be depressing demand for the US dollar and encouraging capital flows out of the US and into emerging market countries in a quest for capital preservation and higher returns. In response to the sharp appreciation pressures on the Brazilian real, the Brazilian authorities responded by intervening directly to weaken the currency and by implementing various macro-prudential policies to discourage capital inflows.

The resurgence of "currency wars" headlines dates to the election of Shinzo Abe as prime minister of Japan in December 2012 and his promise to pursue more aggressive monetary and fiscal policy in an attempt to revive Japan's economy after two decades of stagnation. Specifically, Abe pledged to double the Bank of Japan's inflation target to 2% and committed to buying an unlimited amount of government bonds in order to achieve this. Abe's rhetoric has had a dramatic impact on markets since his taking office, with the yen depreciating by around 10% versus the US dollar and by about 12% versus a broader group of Japan's main trading partners. The sharp fall in the yen has raised tensions among the G20 countries. Some of these countries are expressing concern that the Japanese authorities are deliberately targeting a weaker exchange rate and thus encouraging other countries to follow a similar policy to try and maintain market share for their exports. Japan and its supporters have responded by saying that a weaker currency is not a policy objective in itself but a welcome by-product of pursuing policies that target stronger growth and higher inflation. To date, the G20 has avoided direct criticism of Japan, focusing instead on a pledge to "refrain from competitive devaluation" and "not target our exchange rates for competitive purposes."

### Winners and Losers

While rising equity markets in Japan suggest that there may indeed be a helpful boost from a weaker currency, historical evidence suggests the longer-term benefits of pursuing a weaker currency are questionable. A declining currency makes exports cheaper for foreign buyers, but also puts pressure on domestic importers who face higher import prices. Also, a weaker currency can often hide broader structural problems among some exporters—a longstanding issue in Japan—and is not a substitute for policies aimed at improving productivity growth and competitiveness.

Exhibit 1  
Japan: Nominal Broad Effective Exchange Rate



The obvious corollary of weaker currencies in some countries is currency strength in others. One of the most interesting features about the current global situation is that currency weakness has primarily been seen in rich developed countries that are undertaking QE. These countries generally argue that QE was not specifically intended to lower exchange rates but that a weaker currency has been a useful side-effect of QE.

One of the main losers from the yen's recent weakness, at least in the short term, could be Germany. Germany and Japan target similar export markets, with China being the third most important trading partner for both countries, and although Japan's share of exports to China is much larger than Germany's, exports to China have been a significant driver of Germany's growth since the global crisis. Any loss of market share to a key export partner at a time when the recovery is already weak could remove a key growth engine at a time when the economy most needs it.

### It's Fundamentals That Count

In an era of paper money and (mostly) floating exchange rates, and with daily trading volumes in the global FX market of US\$4 to US\$5 trillion, the concept of competitive devaluations is not realistic. Absent capital controls and/or sustained, concerted and credible central bank intervention, the ability of any country's policymakers to influence exchange rates unilaterally is limited. Even where this is successful over short periods of time, trends in relative macroeconomic and demographic fundamentals will ultimately drive currency valuations.

Economic theory supports the view that faster growing emerging market countries where productivity levels are catching up with developed countries should see their currencies strengthen over the longer term. However, this is currently happening through weakness in developed market currencies rather than strength in emerging market currencies.

One of the best known theories is the "Balassa-Samuelson" effect, which states that a country with higher productivity in the tradable sector (e.g. manufactured goods) will have higher wages in that sector than

will a country with lower productivity. This can put upward pressure on wages in the non-tradable sector (e.g. local services) by more than the tradable sector where prices are kept constant through international competition. That can raise the overall price level relative to the country with lower productivity, resulting in an appreciation in the real exchange rate<sup>1</sup>.

There are many examples of a country's per capita GDP rising as a result of higher productivity. Between 1961 and 1995 Japan saw a 300% appreciation in its real effective exchange rate. However, history suggests that this is not a one-way trend and that real currency appreciation is unlikely to happen in a straight line. In Japan, 30-plus years of real exchange rate appreciation was followed by over 20 years of real currency depreciation, suggesting that, in addition to valuation measures, it is also important to focus on country-specific factors and imbalances. For example, a common feature of countries with overvalued exchange rates is that they often run current account deficits (a country's net position in trade, services and income). If this deficit is funded by long-term foreign direct investment, then this overvaluation can be sustained. However, if the deficit is funded by short-term portfolio flows, then it is questionable whether exchange rate appreciation is sustainable in the long term.

Exhibit 2  
Japan: Real Narrow Effective Exchange Rate



Source: Bank for International Settlements / Haver Analytics

While the yen's current decline is attributed to the recent political pledges, Japan's economic and fiscal fundamentals have been worsening significantly in recent years. For example, the country posted trade deficits in both 2011 and 2012 and has seen its current account surplus decline markedly. The increased reliance on imported fuel in the wake of the suspension of its nuclear fuel industry will exacerbate this trend should the yen weaken further.

Ultimately, countries that want to weaken their currencies either directly (through intervention) or indirectly (through QE) and that are not worried about generating inflation can do so by printing money until they achieve

<sup>1</sup> Changes in the value of a currency's nominal exchange rate do not reflect changes in the value of a currency's purchasing power and have no significant economic impact. Therefore, economists adjust the nominal exchange rate for differences in inflation and this is referred to as the real exchange rate.

their goal (without undertaking any form of sterilization). By contrast, countries that want to strengthen their currencies (or stop them depreciating) have to do this by spending their finite foreign currency reserves and be willing to accept higher interest rates.

### Protectionism on the Rise?

The issue facing many emerging countries is that printing money to weaken their currencies in response to monetary easing by the major developed countries is not an attractive option, given generally stronger growth and higher inflation pressures. Instead, despite assurances from the G20 that “we will resist all forms of protectionism and keep our markets open,” a valid concern is that, in order to try and protect their export sectors, some of these countries might adopt restrictive trade policies through implementing subsidies and tariffs<sup>2</sup>. While developed markets’ central banks continue to adopt extraordinary and unconventional monetary policies that can manifest themselves in weaker or more volatile exchange rates, the challenge for emerging markets’ policymakers will be to calibrate their policies such that they maximise their countries’ growth potential without compromising their inflation credibility.

<sup>2</sup> The World Trade Organization’s 2012 annual report raises this fear, stating that it had witnessed an increase in “trade-restrictive measures. . . . The difficulties and concerns generated by the persistence of the global economic crisis, with its many facets, are fuelling the political and economic pressures put on governments to raise trade barriers. This is not the time to succumb to these pressures. . . . trade frictions seem to be increasing at a time of continuous economic difficulties. These tensions are reflected. . . . through decisions affecting foreign investment.” (Annual Report by the Director General (October 2011-October 2012): Overview of developments in the international trading environment)

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