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Is There a Global Currency War?

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A B S T R A C T

Objective: The main aim of this article is to identify factors influencing the direction of change in exchange rates and to assess whether it is justifiable to use the term "currency wars" to describe such activities. The main forms of such "currency wars" in contemporary global economy have been characterized and their impact on financial markets and national economies has been analyzed.

Research Design & Methods: The method chosen for verification of the hypothesis is the critical analysis of existing literature regarding currency wars. The article also takes advantage of the experiences connected with exchange rate fluctuations in several developed and developing countries in the years 2000-2014. The cases subjected to analysis include changes in currency markets in the USA, Eurozone, Great Britain, Switzerland, Japan, and China.

Findings: Both parts of the hypothesis have been confirmed. In the conditions of free capital flow, emerging markets and their financial markets are especially vulnerable to the introduction and removal of tools in the framework of a currency war. It is difficult not to notice that China, the biggest trade partner and the regional competitor to Japan, did not protest publicly against the policy of weakening the yen. On the other hand, one should underline that one should not expect protests from the country which pursues a similar strategy, albeit by means of other instruments and tools.

Implications & Recommendations: Only the biggest central banks can afford to participate in a currency war, which might provide transient advantages, whereas emerging markets are on the losing side, both in the period of implementation of currency war tools and in the period of their removal.

Contribution & Value Added: The paper adds to the literature by combining concepts and presenting them as one multidimensional problem.

Article type: conceptual paper

Keywords: currency wars; financial markets; depreciation

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INTRODUCTION

Modern world economy, together with existing economic relations, has become a vast space for free competition. One may, therefore, accept the reality of an intensified international competition, enhanced by changes that have been in operation for decades, connected with globalization, liberalization of capital flow, development of international financial markets and progress in information and communication technology. What is particularly striking is the wide-ranging character of this competition, in which both political and economic factors play their roles.

Among the latter, a particular attention should be paid to foreign currency market. One should point out the fact that the inclusion of foreign currency market into international competition is not exclusively related to conducting unconventional monetary policy in many developed countries, but also to using certain system solutions, which blatantly and permanently affect economic interests of other countries.

In theory, currency devaluations work. Historically, countries like Italy, Spain and Greece used periodic devaluations to pump up their otherwise uncompetitive economies. Currency wars, the term that dominated international financial markets early last year, threatens to make a comeback at the beginning of 2015. Many economists are wondering now if we are facing a global currency war. While analyzing the literature, one may come across arguments both for and against such an occurrence. This question is frequently posed nowadays, as currency wars are not unambiguous and new mechanisms and activities occur on everyday basis. The issues connected with interference determinants in contemporary currency markets are equally important, as well as whether it is a globally coordinated process of anti-crisis measures by means of soft monetary policy, or an attempt to gain trade advantages thanks to cheaper money on international currency markets. Policy makers fear any huge and sudden changes in the value of their currencies. In recent years developing countries like India and Brazil complained that the United States, Eurozone, Japan and other industrialized countries were waging a “currency war” against them by artificially driving down the value of dollar, euro and yen. A rapid appreciation makes their country’s exports less competitive on the world market, while a fast depreciation raises the cost of imported products and makes it harder for governments to repay loans they took out in foreign currencies.

The article tries to provide an answer to the recurring question among economists whether we are witnessing a global currency war; what are the reasons underlying such activities, as well as what are the consequences of this state of affairs for developing and developed countries and the global economy.

MATERIAL AND METHODS

The issues discussed in the article are of paramount importance in ensuring economic stability on a national and international scale, as well as for creating a beneficial macro-economic environment and its predictability, which is crucial for economic activity.

The main aim of this article is to identify factors influencing the direction of change in exchange rates and to assess whether it is justifiable to use the term "currency wars" to describe such activities. The main forms of such "currency wars" in contemporary global economy have been characterized and their impact on financial markets and national economies has been analyzed.

The analyzed literature in the subject and the presented aim of the article led to the formulation of two research hypotheses:

1. Current changes in exchange rates in developed world economies confirm the existence of a certain form of "currency wars", but this phenomenon should not be described as "a global currency war".
2. "Currency wars" destabilize international and local financial markets and increase fluctuations in balances of payments.

In order to achieve goals set for this article and to verify the assumed hypotheses the method of critical analysis of subject literature and the case analysis have been adopted.

The article also takes advantage of the experiences connected with exchange rate fluctuations in several developed and developing countries in the years 2000-2014. The cases subjected to analysis include changes in currency markets in the USA, Eurozone, Great Britain, Switzerland, Japan, and China.

LITERATURE REVIEW

While dealing with the issue of "currency wars" it is worthwhile to begin with the explanation of the notion itself. The term has been present for some time in newspaper headlines and books on economy and has become the subject for discussion in academic circles (Angeloni *et al.*, 2011; Bergsten, 2013). Currency wars have a global range and take place in all important financial centers in the world simultaneously, 24 hours a day (Rickards, 2012). One should mention here that the term is controversial both among politicians, experts and scientists. Among many attempts to define the notion one should pay attention to several of them. According to the simplest approach these are activities of central banks or some governments whose aim is to satisfy their national interests through currency market. Another view treats it as an intentional devaluation of one's own currency in order to stimulate export and home economy and detrimentally affect importers, directly slowing economies of foreign partners (so-called 'beggar-thy-neighbour' effect). Some treat currency wars as activities of monetary or government authorities of one country aiming at depreciation (or devaluation) of the national currency as a reaction to similar activities of another country – an important trade partner. The term can also be understood as burdening the partner with the costs of coming out of recession by competitive devaluations (depreciations). A. Korinek (2012) finds that in a benchmark case in which national regulators can optimally control domestic externalities, coordination is not indicated. By contrast, J. Bengui (2011) studies the role for coordination between national regulators in a multi-country framework of banking regulation. He shows that liquidity in the global interbank market is a global public good. In the presence of such global externalities, there exists a case for global coordination of liquidity requirements (Korinek, 2012). Persson and Tabellini (1995) show

that coordination of national fiscal and/or monetary policies is desirable if countries have incentives to employ such policies to exert monopoly power over international prices. The most extreme approach in explaining the issue is treating currency wars as the first stage of a series of events leading to a military conflict: currency wars ⇨ overt protectionism ⇨ trade wars ⇨ military conflict.

The term "currency war" was coined by Brazilian Finance Minister Guido Mantega in September 2010 in response to quantitative easing (QE) in the United States. Mantega's implied criticism was that the unconventional monetary policies of the Federal Reserve to ward off deflation and stimulate a depressed economy were "beggar-thy-neighbour" (Eichengreen, 2013).

The most important battlefields are the Pacific Ocean basin, in which American dollar and Chinese renminbi compete, the Atlantic Ocean basin where American dollar and euro confront each other and the Euro-Asian continent pitting euro and Chinese renminbi against each other. The above-mentioned battles are real and do not exclusively take place in the designated geographical locations but also in existing international financial markets (Rickards, 2012).

In many cases, currency war was not associated with a depreciation of the domestic currency but the prevention of appreciation. Normally, the currency of a country with growing productivity would appreciate, reflecting falling production costs in export markets. This situation enables the country to enjoy more imported goods at lower prices. China is the best example of a country that has resisted normal currency appreciation (Darvas & Piasni-Ferry, 2010; Portes, 2012; Gagnon, 2013).

The literature in the subject emphasizes the following factors, among others, which affect the development of currency wars (Brahmbhatt *et al.*, 2010):

- pro-export policy and quickening pace of the development of China,
- the problem of imbalance of payments in many countries (USA; Greece; Ireland; Portugal),
- the elimination of the effects of financial crisis in the years 2007-2009,
- excessive distortion of consumption-production structure on a global scale (China produces and the USA and Western Europe consume),
- the rise in fluctuations of prices of raw materials (oil, copper) on international markets and the resulting change in the distribution structure of capital surplus.

DISCUSSION

Close observation and analysis of contemporary currency wars allows identifying the common mechanism of their origin. It is the result of the occurrence of specific economic relations, based on the globalization and capital flow. The entire mechanism boils down to the fact that the weakening of one's own currency brings the country – in the short term— trade benefits on international markets. The opinion is similar to that voiced almost 90 years ago by J.M. Keynes in exchange of opinions with W. Churchill about the policy towards the pound, with a view to making Britain a global international economic power. J.M. Keynes claimed that the strong currency would lead to economic crisis, thus, in order to steer the country out of recession one should reject the policy of appreciation of the national currency. J.M. Keynes presented his reasoning in the categories of

contemporary currency wars. W. Churchill, in turn was the proponent of the co-existence between a strong currency and strong economy, which, as it later turned out, was an astute move.

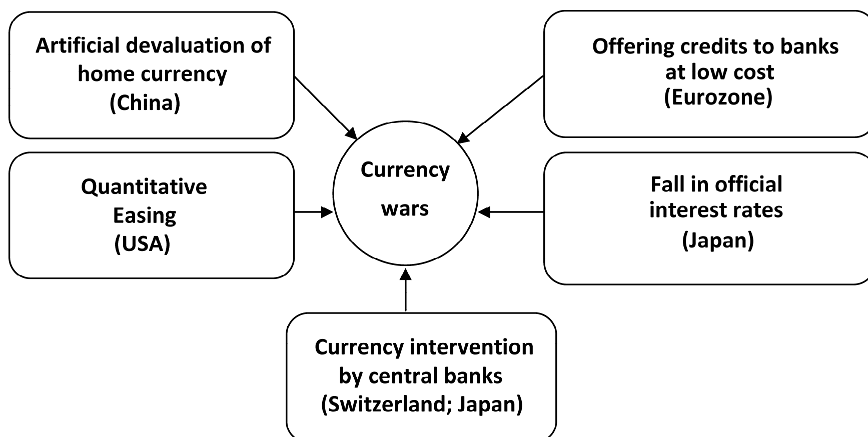

Figure 1. Currency wars mechanisms
Source: own study.

What is called currency wars is thus really a zero-sum game for the world's export markets, a continuation of monetary policy by other means. In the long run the winners may be those who do not try to fight the markets and resist the strength of their currencies even if this may mean a painful adjustment in their export sector in the short run (Gros, 2010).

In the modern global economy, governments and central banks apply different mechanisms, which decide about the essence of currency wars. Among them, one should pay attention to intentional depreciation of home currency, the application of soft monetary policy, giving preferential credits to commercial banks by central banks, intervention of central banks in the form of printing one's own currency (Figure 1).

Since the beginning of the 21st century one may have observed many examples of phenomena on currency markets which are, to a lesser or greater extent, the symptoms of currency wars. The case in point is the activity of the People's Bank of China, which, for several years, has maintained a stable exchange rate of renminbi to USD at the level of depreciation of the home currency reaching 50%. Similarly, American FED has been conducting the policy of quantitative easing since 2007 (till September 2012–2100 milliard USD, and then 85 milliard a month, and 35 milliard USD a month since June 2014). Also, the Bank of England, had bought obligations of the value of 375 milliard pounds by autumn 2012. Similar activities have been implemented by the Bank of Japan since April 2013, which executes the plan of pumping in 7000 milliard yens. The essential aim in this case is to double the money supply in Japanese economy within two years. Similarly, in the Eurozone EBC had given commercial banks 500 milliard euros of loans with low interest rates by December 2011, and since February 2012 further 400 milliard euros. The National Bank of Switzerland, in turn, in September 2011 made a decision of unlimited purchase of foreign currencies at maximum rate of EUR/CHF 1.2 with the

market rate EUR/CHF 1.1. One of the examples of such chain of events, which provide the basis for a currency war, is presented in Figure 2.

The evaluation of the effects of currency wars on particular countries and the global economy constitutes an important component of the scientific debate. The development of currency wars is particularly threatening for emerging markets. It stems from the fact that at the beginning of quantitative easing they had a problem with excessively strong home currencies, whereas now, when the dynamics of quantitative easing has slowed down, they face the problem of sudden depreciation of the national currency. If currency wars are to continue, emerging markets (e.g. Brazil, India) threaten to introduce an import duty as a retaliatory measure.

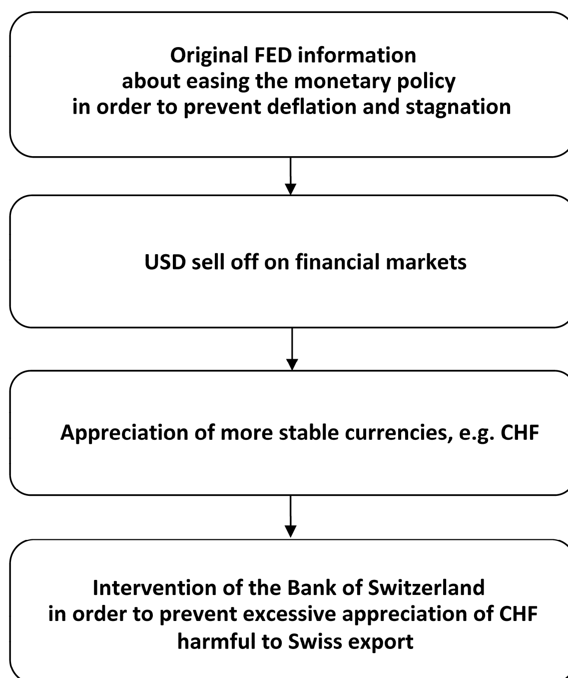

Figure 2. Example of chain of events in a currency war
Source: own study.

The evaluation of the process of evolution of currency wars can generally allow to differentiate both positive and negative effects (Figure 3). The positive effects are as follows:

- Firstly, providing bank systems with additional money, which is especially needed in periods of decrease in solvency, growing pessimism, worsening economic situation, which requires greater activity on the part of commercial banks. One needs to bear in mind that the mechanism of such wars assumes weakening of home currency, so the result is its greater supply.

– Secondly, sometimes it is necessary to have surplus cash at one's disposal in order to distribute it at a relatively lower capital cost. In practice it means a cheaper credit and an opportunity for credit expansion and stimulation of global demand.
– Thirdly, weakening of home currency as a result of currency wars results in the improvement of competitiveness of firms exporting their own products or the ability to lower their prices without diminishing the profit.
– Fourthly, depreciation of the national currency slows down the development of importers, as it means that an importer must pay a larger amount of money or is compelled to raise the price of imported products on the national market, losing the competitive edge; or decides to limit import.

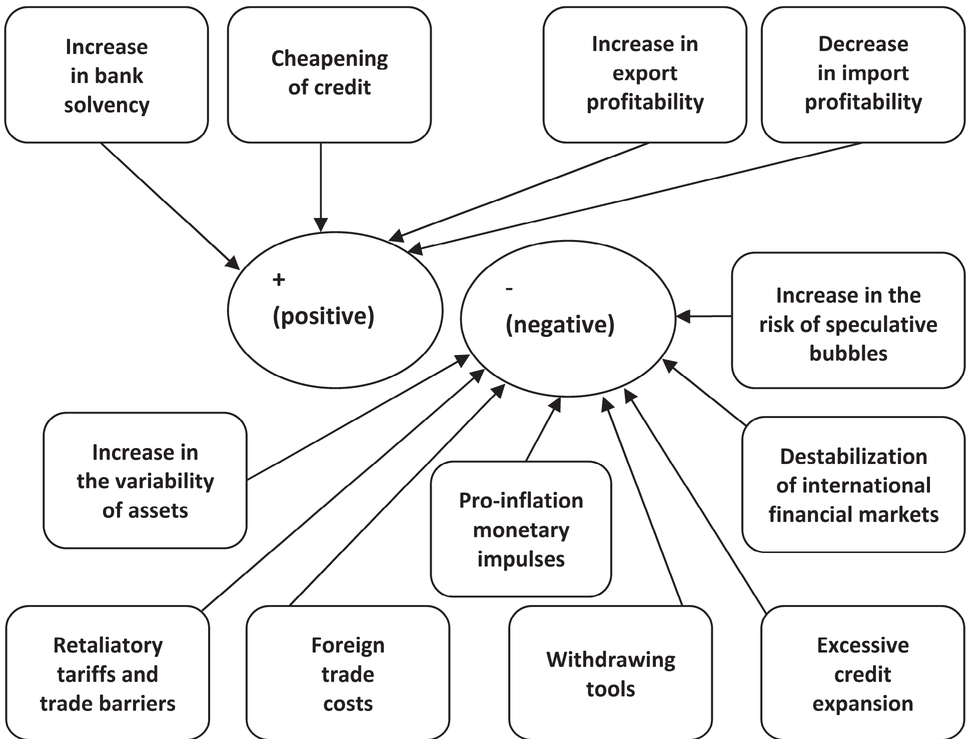

Figure 3. Positive and negative effects of a currency wars
Source: own study.

Apart from the advantages from the activities undertaken within the framework of currency wars, the literature on the subject points at numerous negative effects, such as the increase in fluctuation of asset prices resulting in greater instability on international markets, the increase in the risk of speculative bubbles on various asset markets, the intensification of monetary and credit expansion and thus, increased risk of the occurrence of monetary impulses, slow-down in the development of foreign trade as a result of the risk of introduction of numerous trade limits, such as duties.

CONCLUSIONS

Contemporary forms of currency attacks are becoming more and more frequent and concern mainly so-called emerging markets. Recently, it was Thailand that has been hit, whose currency, bhat, has become inordinately strong. Earlier, Brazil and India faced a similar problem. Such phenomena constitute grave problems for entrepreneurs who target at foreign markets, as the appreciation of the home currency results in the decrease in the competitiveness of exporters, and also the entire economy.

According to some scientists, economists and experts, currency wars have become a fact of life, and currencies of lesser international stature, including PLN, will undoubtedly suffer harmful effects. Doubtless to say, the negative element is the fact that emerging markets do not have much influence on those devaluation or revaluation process. Only economically powerful countries such as China or Japan are able to create the value of their currencies, artificially regulating the competitiveness. According to economists, it is because nowadays, practically everything is manufactured in the Middle Kingdom.

There are also contrary opinions, which claim that there is no hard evidence that something unusual is happening on currency markets. According to this interpretation the risk of genuine currency war is rather low, as the latest currency conflicts have been rhetorical and are not essentially different from earlier events from the period of domination of changeable currency rates. Those currency movements can therefore be justified by a coordinated effort to counteract the financial crisis and the resulting recession, which is accompanied by a strong synchronization of soft monetary policy in main world economies. This approach can be explained by the fact that economically important countries understandably want their currencies to support the economic growth. Moreover, it must be noted that rate fluctuations do not always yield expected results. In spite of the damage to Japan's economy, the ever-higher yen was unable to correct the chronic trade imbalance between the US and Japan. A chronic trade surplus and deflation, together with Japan's low external debt ratio, made the yen a safe-harbor currency during the 2008 crisis (Qiao, 2007; McKinnon & Liu, 2013). Some of the currencies, including the most important ones, sometimes moved in the wrong direction. When the USA was struggling from the aftermath of subprime mortgage crisis, and the Eurozone suffering unprecedented sovereign debt and banking crises, the Japanese yen, together with the Swiss franc and gold, become the safe haven for international capital inflows (Ranaldo & Söderlind, 2010).

Some of these opinions, however, are contrary to facts. It is difficult not to notice that China, the biggest trade partner and the regional competitor to Japan, did not protest publicly against the policy of weakening the yen. On the other hand, one should underline that one should not expect protests from the country which pursues a similar strategy, albeit by means of other instruments and tools.

The analysis of the literature, opinions from experts and politicians show that in contemporary global economy there are characteristics of a currency war. These activities do not exhibit features of a typical military conflict and none of the countries using such tools confirm such actions officially, citing pretexts, such as the

protection of one's own economy against deflation, recession budget deficit or excessive unemployment.

Contemporary currency wars, apart from central banks and politicians, also involve bankers, traders, automatic systems, global financial institutions, hedging funds, corporations and multimillionaires. The present form of a currency war, especially when USD is excessively weakened, wreaks havoc to raw resources markets (oil, copper, gold), and this, in turn, affects financial markets. Depreciation, so favored in currency wars, being a remedy for economic problems in one country, might harm the economies of other countries, bringing about feedback reactions. In the conditions of free capital flow, emerging markets and their financial markets are especially vulnerable to the introduction and removal of tools in the framework of a currency war.

Only the biggest central banks can afford to participate in a currency war, which might provide transient advantages, whereas emerging markets are on the losing side, both in the period of implementation of currency war tools (influx of speculative capital, strong appreciation and a temporary loss of competitiveness) and in the period of their removal (outflow of speculative capital, strong depreciation of currency and a fall in asset prices).

The debate in the newspapers seems to re-emerge in 2014 and 2015, because Europe, China and others join Japan in actively weakening their currency.

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