

## Competitive devaluations in currency wars: financial projections of neo-protectionism\*

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ABSTRACT. The article examines the nature of a currency war as signs of neo-protectionism in terms of global challenges the global monetary system which came in yet another transformation period has faced. We analyze a mechanism of performance of competitive devaluations as a tool for improving the competitiveness of national economies. It is given the author's interpretation of the financial instruments of neo-protectionism through a thorough study of the latter.

KEYWORDS: competitive devaluations, fundamental imbalance, financial protectionism, currency war, exchange rate, quantitative easing.

### Introduction

In the present-day conditions, development of the world system requires a comprehensive rethinking of both its postulates and mechanisms of its functioning. Mechanisms of transformation of the economy of goods in the human economy become fundamental for systemic innovation transformations, a new genotype of economic development and the foundation of a new paradigm for further economic development are formed<sup>2</sup>, modeling approaches to economic development of the world economy are revised as they are unable to fully take into account a human element, the policy, behavior and psychology of an individual which is the common sense of economy as such, the question of defending the geopolitical interests and their financial component, including the monetary one, take center stage. The main object of state intervention in economic processes becomes a sphere of monetary relations, where the Keynesian concept of «managed money» transformed into the

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<sup>2</sup> See details. A. Halchynsky. Political nooeconomy: principles of renewed paradigm of economic knowledge /Anatoliy Halchynsky. — K.: Lybid, 2013. — p. 15—17.

premise by which money is treated as the determinative element of market system and not only as an important factor in economic development. Thus, exchange mechanisms, including the competitive devaluation, becomes more and more effective in the realization of a goal set for defending the national interests.

R.Cooper<sup>3</sup> suggested, as early as half a century ago, that international cooperation as to economic policy in the world where countries infect each other through the mechanisms of trade and financial relations could contribute to improving the welfare. I.Tchakarov<sup>4</sup> inspired with a scientific body of work by P.Masson<sup>5</sup> concluded that placing a focus exclusively on domestic stabilization policy while developing the principles of national monetary policy would run a risk to lead to loss of welfare, which provides additional arguments in favor of coordination of monetary policies. A.Mattoo and A. Subramanian<sup>6</sup> insisted that the country deliberately resorting to manipulation of an exchange rate should be viewed as one that introduces the import tariffs thereby disrupting the binding GATT tariffs or applies export subsidies prohibited by the WTO. R.Dobbs and M.Spence<sup>7</sup> stated on pages of «Financial Times» that imposition of barriers for incoming capital flows began to replace tariffs and quotas in a set of protectionist measures taken by governments with regard to trade. O.Sharov, a Ukrainian scientist, understands a «monetary war» as a heated conflict in the area of monetary and financial relations between countries and/or financial-industrial and political groups, which is based on the actions aimed at a fundamental change in the existing status quo. A monetary war, as interpreted by the researcher, acts as the continuation of monetary policy by other destructive means organized by economic violence which purpose is a recorded achievement of political and economic goals that are impossible to achieve within the existing monetary and financial relations<sup>8</sup>.

<sup>3</sup> Cooper R. The Economics of Interdependence // New York: McGraw-Hill, 1968pp. — 157–58.

<sup>4</sup> Tchakarov I. The Gains from International Monetary Cooperation Revisited [Electronic resource] / I.Tchakarov // IMF Working Paper. — January 2004. WP/04/1. — Mode of access: <http://www.imf.org/external/pubs/ft/wp/2004/wp0401.pdf>

<sup>5</sup> Masson P. Contagion: Monsoonal Effects, Spillovers, and Jumps between Multiple Equilibria [Electronic resource] / P.Masson // WP/98/142. Washington, D.C.: International Monetary Fund. — 1998. — Pp.41. — Mode of access: <http://www.imf.org/external/pubs/ft/wp/wp98142.pdf>

<sup>6</sup> Mattoo A. Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization [Electronic resource] / A.Mattoo, A.Subramanian // The World Economy. — № 32. — 2009. — p.1135–1164. — Mode of access: <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.175.1554&rep=rep1&type=pdf>.

<sup>7</sup> Dobbs R. The Era of Cheap Capital Draws to a Close / R.Dobbs, M.Spence // Financial Times, January 31. — 2011. — Mode of access: [http://www.mckinsey.com/insights/economic\\_studies/the\\_era\\_of\\_cheap\\_capital\\_draws\\_to\\_a\\_close](http://www.mckinsey.com/insights/economic_studies/the_era_of_cheap_capital_draws_to_a_close).

<sup>8</sup> A. Sharov Monetary and currency wars as a factor of threat to national economic security/O.M.Sharov/Strategic Priorities. — No. 3. - 2013

### Historical retrospective of competitive devaluations

Devaluation is a phenomenon not new enough. Its first manifestation was re-minting of coins. The use of money manipulation has been known since ancient times, but it began to draw attention from 1600s (Tulipmania), and as a tool of financial protectionism can be dated from the years of 1716-1720 associated with John Law, a Scotsman well-known in economic circles. But despite the variety and even subtle or not schemes, it is impossible to do without money/currency because a national currency unit, which is the object of devaluation, provides a number of derivative functions besides just economic ones. So, when Benjamin Franklin visited Great Britain in 1763, one of the directors of the Bank of England asked him about the reasons for such rapid economic growth in the American colonies. Franklin replied, «it's very simple: we emit in the colonies their own money called colonial tickets. We print them according to the demands of trade and industry. In this way the products move from the producers to the consumers very well. Thanks to this method, the production of own money immediately guarantees it the purchasing power because the government does not have to pay any interest»<sup>9</sup>.

A considerable amount of time has elapsed since then. The U.S. dollar has become the key currency of the world economic system, global reserve currency, which aims at financing the international trade and exercising (providing) functions of value accumulation for the governments. Before World War II, but rather to the Bretton Woods Conference (1944), those functions were performed by the pound sterling which, for some objective reasons, gave its place to the U.S. dollar. Since then, the U.S. also objectively has had to export dollars — Eurodollars, which already had an imbedded percent of devaluation. In 1967, Jean-Jacques Servan-Schreiber, a newspaper magnate, wrote in the book titled «American Challenge» that as a result of unfair competition with Americans, Europe is exposed to economic colonization. In the late 1960s, the situation gets out of control and the country that was supposed to be a guarantor of stability and steadiness begins to export inflation<sup>10</sup>, resulting in a surplus of dollars abroad, particularly in Europe, and the double price of gold formed by the time in London forced President Nixon to close the «Golden Window» in order to stop the process of outflow of American gold. The epoch of

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<sup>9</sup> Charles G. Binderup. How Benjamin Franklin Made New England Prosperous, 1941 (przemówienie radiowe kongresmana z Nebraski Charlesa G. Binderupa przedrukowane w jego *Unrobing the ghosts of Wall Street*); Song Hongbing. *Wojna o pieniądz: Prawdziwe źródła kryzysów finansowych / Z chińskiego przełożył Tytus Sierakowski* — Kobierzyce: Wektory, 2011. — S. 38.

<sup>10</sup> This is connected with the events of the late 1960s - the Vietnam War, funding of too expensive projects by budget deficit, which caused serious inflation pressure and inflation, that the U.S. had to export.

currency of type A floating ended, and the era of free-floating of (type B) currencies in the world's foreign exchange markets began, which marked the collapse of the Bretton Woods system with the dollar remaining a reserve currency and, the U.S. not willing to give anyone (even SDR proposed as an alternative) found other base which oil – black gold – to maintain the strength and value content of dollar, provided that only dollars should be accepted as payment for oil. That is how petrodollars emerged. In turn, the House of Saud agreed to invest their dollars in the U.S., which in turn contributed to increasing the profitability of transactions. Saudi Arabia controlled OPEC and the dollar was rescued, besides it had yet considerable benefit for the dollar. Excessive issue of the dollar could be afforded for international trade and large-scale over expensive financing without a fear of reducing the gold reserve (Figure 1), which rather contribute to higher prices, economic revival, increase in a demand for energy resources and in the final link of a chain logically entail the demand for dollars with creating the basis for export of devalued, inflationary but still competitive dollars. However, in this scheme, there are periods of «frustrations», lull, a rise in oil prices (sometimes objective, sometimes artificial) to solve the problem of excessively printed dollars<sup>11</sup>.

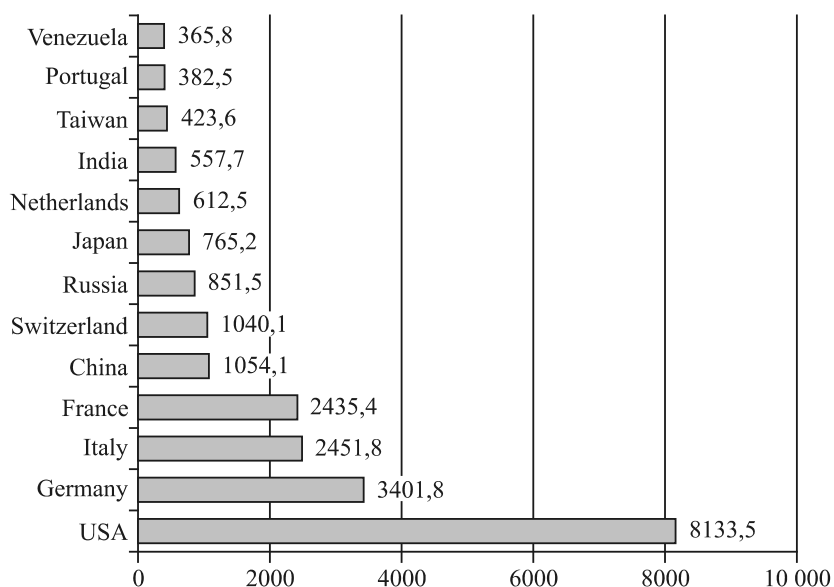
But in the early 21st century, there appeared competitors for the U.S. dollar; first the euro, collective EMS currency, and now China makes steady progress to the yuan secured with gold (Figure 1, however, according to many estimates, China has 7-10 times more gold than the official reserves it reports about<sup>12</sup>) and commodities, which will be a significant power in the global stage. And according to N. Kravchuk, a Ukrainian researcher, who rightly notes that «in the early 21st century the epicenter of uneven development of international monetary relations shifted to currency rivalry between the U.S. dollar and the euro, and then between the «old» (U.S., EU) and the «new centers of gravity» (China, Russia, etc.) which claim not only the geopolitical and geo-economic leadership in the global environment, but also provoke the destabilization of the global monetary system and the need for its restructuring in the direction of reorganization of currency composition of official reserves and international payments»<sup>13</sup>.

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<sup>11</sup> Due to the rising prices, the petroleum market bound the excess dollars which are now needed to pay for oil. As a result, the dollar has remained relatively stable in its value.

<sup>12</sup> See for details. Golden vector of Chinese Policy. Part two. [Electronic resource]. — Access mode: <http://goldenfront.ru/articles/view/zolotoj-vektor-kitajskoj-politiki-chast-vtoraya>

<sup>13</sup> Kravchuk N.Ya. Divergence of global development: contemporary paradigm of formation geo-financial space/Natalia Kravchuk. - K.: Znannia, 2012. - p.431



**Fig. 1 Countries-leaders according to the official gold reserves in 2011 (in tons)**

Source: built on the basis of Zotin A.. Who has the most gold? [Electronic resource] — Access mode: [http://slon.ru/economics/u\\_kogo\\_bolshe\\_vsego\\_zolota\\_13\\_stran\\_liderov-712867.xhtml](http://slon.ru/economics/u_kogo_bolshe_vsego_zolota_13_stran_liderov-712867.xhtml)

D. Strauss- Kahn, a former managing director of IMF,<sup>14</sup> used the term «currency war» in the context of searching for measures to impede deterioration of the situation with regard to currencies, which assumed a threatening form for economic recovery of the global economy. However, he later retracted his statement, noting that the term «war was too high-flown. Indeed, some economists and politicians warn of a danger of deployment of a currency war in which countries understate the value of their currencies in order to improve the conditions of competition in the global market. Obama, in the early days of his presidency, raised the issue of currency manipulation, noting that high unemployment indexes in the U.S. and other countries of Western Europe were partly explained by the failure of the latter to grow the export potential and thus to create new jobs as a result of artificial control of yuan price growth by the government of China. According to A.Bryune and J-P.Guichard<sup>15</sup>, China launched a mercantilist strategy of trade surplus from 1985 with regular devaluations of its currency, which in

<sup>14</sup> Dominique Strauss-Kahn, IMF Managing Director: Probability of currency war break is negligible [Electronic resource]. — Access mode: [http://russian.news.cn/economic/2010-09/29/c\\_13535223.htm](http://russian.news.cn/economic/2010-09/29/c_13535223.htm)

<sup>15</sup> Antoine Brunet, Jean-Paul Guichard. Geopolitics of mercantilism: a new view on the world economy and international relations: translation from French/Jean-Paul Guichard, Antoine Brunet. - M.: New Chronograph, 2012. - 232 p.: pictures - (Series "Social Space").

1994 led to a rate of 8.25 yuan to 1 U.S. dollar; this rate remained unchanged until 2005. As a result of gradual unilateral correction by the Chinese government from July 2005 to June 2008, this rate decreased to 6.83 yuan per 1 U.S. dollar, while the World Bank, on the basis of calculations of purchasing power parities, insists that the course which would balance the trade is about 3.4 yuan to 1 U.S. dollar. Thus, due to the exchange rate manipulation, the labor costs in China are 80 times lower than in the U.S., while in some developing countries which could compete with PRC these costs are only 40 times lower than in the U.S. Accordingly, such manipulation is of paramount importance.<sup>16</sup>

Wen Jiabao, the Premier of the State Council of PRC, stated that a rise in the yuan by 20% in a short time will lead to extremely negative consequences for the Chinese economy. «We can not even imagine how many Chinese enterprises will go bankrupt, how many Chinese workers will lose their jobs, how many migrant workers will go back to their villages if China agrees to the requests for revaluation of the yuan by 20-40 %. In this case, China is threatened with huge social disruption», said Jiabao .... «Only one who is not familiar with the economic nature of exchange rates may call for the revaluation of any currency by 40% in a short term», said Glenn Maguire, an economist of Societe Generale. — Such changes should not happen so quickly»<sup>17</sup>. Thus, Wen Jiabao believes that a reason for the negative balance of U.S. in trade with China is not a permanent yuan rate at all, but the structure of trade and investment.

### Financial background of neo-protectionism

Subject to the foregoing, it is reasonable to recall an expression by the authors A.Mattoo and A.Subramanian,<sup>18</sup> who note, inter alia, that «There are solid grounds for the WTO to address the problem of underestimation of exchange rate, because the undervalued exchange rate arises due to import taxes, as well as due to export subsidies and is therefore most pronounced mercantilist policy». It should be admitted that the slow growth in the EU countries and the U.S. led to a rapid inflow of capital into the economies, which show higher growth rates, such as India, Mexico and South Korea, which resulted in an additional raising pressure on their currencies. Japan, Brazil and other countries have already made attempts to limit the apprecia-

<sup>16</sup> Ibid: p.94.

<sup>17</sup> The U.S. launched an attack upon the yuan [Electronic resource] - September 30, 2010. - Access mode: <http://www.newsru.com/finance/30sep2010/yuan.htm/>

<sup>18</sup> Mattoo A. Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization [Electronic resource] / A.Mattoo, A.Subramanian // The World Economy, — №32. — 2009. — p.1135–1164. — Access mode: <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.175.1554&rep=rep1&type=pdf>.

tion of their currencies by introducing or raising the taxes on capital investment. The Chinese news agency Xinhua<sup>19</sup> defines a currency war as a situation in which a country relying on its own economic power strikes his competitors and seizes the wealth of other countries by methods of monetary and exchange rate policies. It is characterized as a special form of economic war by cold calculation, high dedication and extraordinary destructive force.

In O.Sharov's opinion, there are much more various tools and facilities in the arsenal of «currency wars», including «hot» money, fixing rate, floating rate, currency convertibility, currency assignment, currency pools, foreign exchange reserves, monetary monopoly, currency protectionism, currency speculation, foreign exchange control, currency discrimination, monetary blockade etc. (Figure 2) and this arsenal is constantly replenished with new instruments, among which derivatives that U.Baffet, a famous American businessman, generally called «financial weapons of mass destruction» should be specially emphasized<sup>20</sup>.

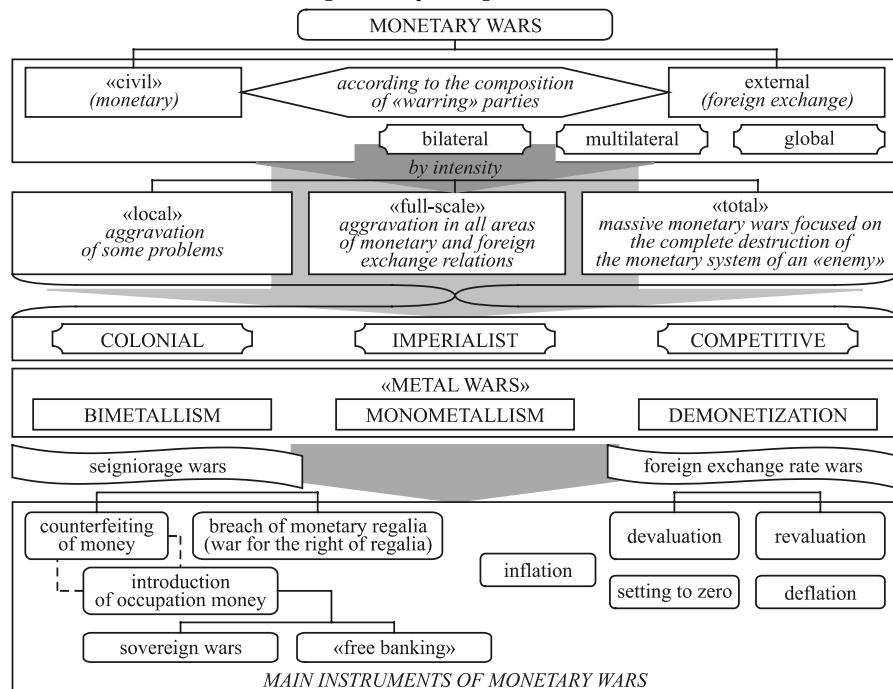


Fig. 2. Characteristics of monetary wars<sup>21</sup>

<sup>19</sup> Shi Xianzhen. «Currency war» may lead to a second round of crisis: Thai economist [Electronic resource] — Access mode: [http://news.xinhuanet.com/english2010/indepth/2010-10/25/c\\_13574787.htm](http://news.xinhuanet.com/english2010/indepth/2010-10/25/c_13574787.htm)

<sup>20</sup> A. Sharov Monetary and currency wars as a factor of threat to national economic security/O.M.Sharov/Strategic Priorities. — No. 3. — 2013.

<sup>21</sup> Developed according to: A. Sharov Monetary and currency wars as a factor of threat to national economic security/O.M.Sharov/Strategic Priorities. — No. 3. — 2013

Exchange rate manipulation to correct a country's export position is not the only tool when political ammunition is used. Therefore, *the adoption of large-scale stabilization packages aimed at refinancing the failed banks, which embodied in the multiple growth of domestic and external debts, or the implementation by Western countries of the policy of low (near zero) interest rates and money supply issue in the framework of the policy of quantitative easing have every reason to be considered the financial instruments of neo-protectionism policy* (Figure 3).

Underreporting of exchange rate of national currency	<b>FINANCIAL INSTRUMENTS OF NEO-PROTECTIONISM</b>	Interest rate policy
The issue of money under the policy of quantitative easing. This mechanism means purchasing by the Central Bank of financial assets from banks and other private companies to issue new electronic money, thus increasing the volume of bank reserves above the required level, raising the prices of purchased financial assets, thereby reducing their profitability.		Implementation of the stabilization programs within which inefficient banking institutions are financed
Restrictive measures with regard the capital movement, based on quantitative indicators (restriction of rates in compliance, setting of a minimum duration of stay, limiting of end-use, claims of unpaid reserves)		Restrictions on the capital movement by price criteria (taxes on capital inflows (Brazil) and capital export (Malaysia), claims of unpaid reserves)
Determination of the optimal level of a foreign exchange component in gold and foreign exchange reserves and the level of savings		Implementation by the country of a mechanism of self-insurance system through the use of large stocks of international reserves

**Fig. 3 Financial instruments of neo-protectionism**

Source: prepared by the authors

The use of such arsenal may be partly explained, inter alia, by the fact that the liberalization of capital markets itself is con-



nected with the economic growth only in the countries that have reached a certain institutional threshold — a threshold which, according to the research team composed of M.Kose, E.Prasad and Ashley D. Taylor<sup>22</sup>, most developing countries still have to achieve.

The foregoing is partly explained by the fact that the obstacle that hinders a trajectory growth of developing countries is not a need for foreign investment, but a lack of investment demand. The latter can be enhanced by the flows of foreign capital able to lead to an increase in the real exchange rate, thereby reducing the competitiveness of goods and reducing the willingness of the private sector to invest.

Certainly, in a situation where there is a high level of unemployment in the country or when it pursues a policy of export-oriented growth, its desire to weaken its own currency is quite justified because when the currency is cheapened, the cost of imports grow, while the price of goods exported to the international market are reduced and hence the demand for them increases. Growth of national production, job creation and GDP growth are considered as potential implications of such policy. Economies of emerging markets may also carry out devaluation in order to increase the gold and foreign exchange reserves to protect themselves from the onset of financial crisis in the future.

### **Mechanisms of competitive devaluations**

Researchers G. Corsetti, P. Pesenti, N. Roubini and C. Tille<sup>23</sup> have proposed a Center-Periphery or multiple-choice model for the policy analysis and empirical assessment of competitive devaluation. To this end, they have developed a general equilibrium model for the monopolistic competition condition and studied the effect of a devaluation by one country on its trading partners. In the opinion of the authors, to differ from the traditional view, a decline in production and the current account deficit in the neighboring countries do not necessarily mean that the devaluation has a negative effect and leads to their impoverishment. On the contrary, they advocate the opinion according to which the neighboring countries can benefit from improvement of the terms of trade in them if the law of one price holds (which provides for a complete shifting of costs through the exchange rate). Moreover, responding with devaluations of their own is not an optimal strategy

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<sup>22</sup> Kose M. Thresholds on the Process of International Financial Integration [Electronic resource] / M.Kose, E. S. Prasad, A.D. Taylor // *Journal of International Money and Finance*. — 2010. — p. 1–33. — Access mode: <http://prasad.dyson.cornell.edu/doc/JIMFProofs.Sept10.pdf>.

<sup>23</sup> Corsetti G. Competitive Devaluations: A Welfare-Based Approach // Giancarlo Corsetti, Paolo Pesenti, Nouriel Roubini, Cedric Tille // *Journal of International Economics*, — 2000. — No. 51 (1, Jun) — pp. 217-241. — Access mode: <http://www.nber.org/papers/w6889>.

for the neighboring countries, as the ensuing deterioration of the terms of trade may be large enough to negate the benefits of protecting their share in the export market. If the law of one price does not hold (there is no shifting of costs through the exchange rate), a devaluation of one country produces unambiguously negative effect on trading partners due to the fall of their export earnings and profits and decrease in efficiency under increased labor productivity for any level of consumption.

The mechanisms of devaluation can, with a high degree of approximation, be summarized as follows:

- Carrying out a currency intervention and devaluation by increasing the supply of the national currency while buying up foreign currencies, as a result of which the national currency exchange rate decreases;

- Implementing a policy of quantitative easing, in which the central bank increases the money supply in the country by buying government securities from commercial banks. The growth in the money supply leads to lower interest rates in the economy and weakening of the currency;

- Depreciating the national currency through the dissemination of information about the taking of appropriate measures in the future, which will diminish any incentives for speculators to be long on exchange.

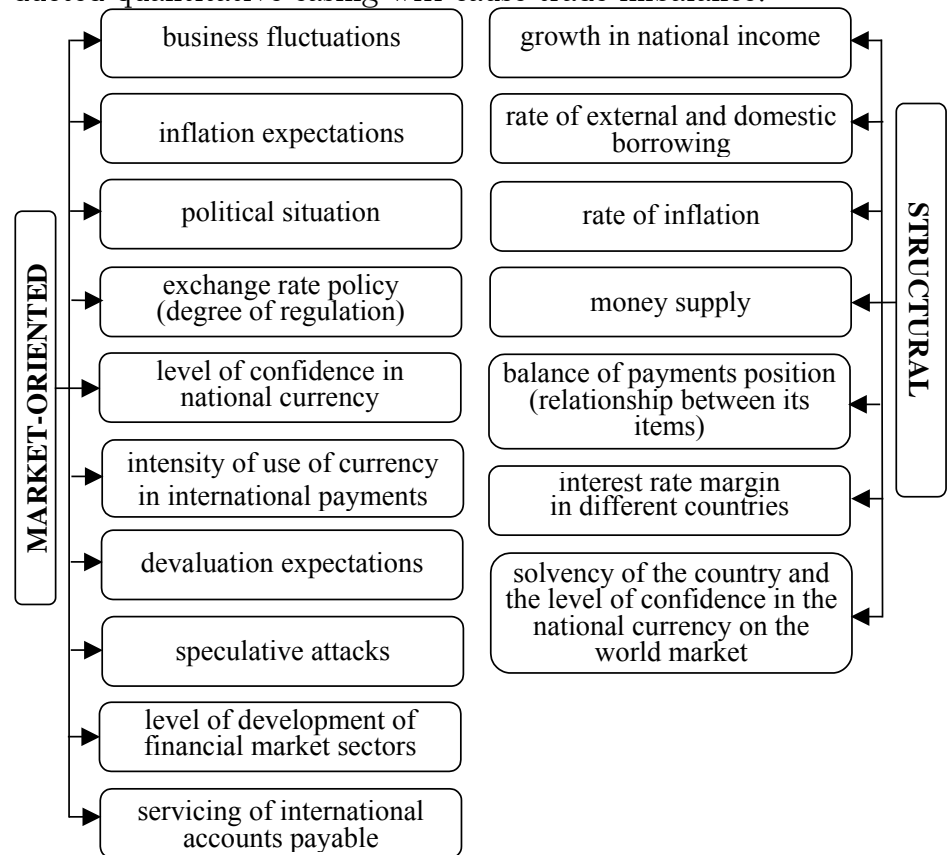
Quantitative easing is a process of infusing money into the system by creating «new money» and, in the long run, buying out financial assets such as bonds and corporate debt from the country's financial institutions. Such transactions of central banks are known as open market operations and consist in providing the system with a sufficient amount of money to reduce interest rates to stimulate consumer demand in the economy. It is assumed that the central bank will have to withdraw the newly created money from circulation as soon as the economy improves to prevent inflation.

Quantitative easing contributes to the country's currency devaluation in two ways:

- First, it affects speculators' expectations as regards the possibility of currency value depreciation;

- Secondly, a significant increase in the national currency supply leads to lower domestic interest rates compared to the interest rates of countries in which quantitative easing is not applied. This will, in turn, increase the amount of capital in devalued currency that moves to countries with higher interest rates and the benefits of investment and trade, which will lead to a rise in the value of currencies of these countries. Thus, exports of the country which is a recipient of capital will be undermined by its growing exchange

rate, while the growth of imports from the country which has conducted quantitative easing will cause trade imbalance.



Source: compiled by the authors

**Fig. 4. Factors influencing the exchange rate**

An analysis of factors influencing the exchange rate shows that a combination of market-oriented and structural components are used in exchange rate manipulation (Fig. 4).

### Comparative analysis of currency wars

The manipulation of the exchange rate is also one of the causes of currency wars. However, for a currency war to begin, it is necessary that a significant number of major economies decided to make a devaluation of their currencies at once and the same time (Table 1).

*Table 1. Comparative analysis of currency wars*

Historical period	Description
<b><i>Before 1930</i></b>	Before the 18th century the scope of world trade was insignificant, hence exchange rates did not play a role. During this period, devaluation was used to increase the money supply, not to improve conditions of the country's exports or to finance wars or pay debts. Essential was the devaluation carried out during the Napoleonic Wars. After World War I, many countries except the United States went into recession following the return to the gold standard. However, the attempts of Great Britain, then the largest economy in the world, to raise its currency rate to the prewar level did not cause a currency war. Thus, there is no talking about the existence of competitive devaluations prior to 1930.
<b><i>Great Depression of the 1930s</i></b>	At the time of the Great Depression of the 1930s, most of the countries abolished the gold standard, upon which the currencies lost their intrinsic value. Devaluation was widely used by countries which tried to curb the rising of the unemployment level and benefit from this instrument. As a result of competitive devaluation the volume of international trade sharply declined, making a significant impact on all economies of the world. It is generally believed that the currency war of the 1930s began with the abolition by Great Britain of the gold standard in 1931.
<b><i>1940-1971</i></b>	This period of the world economy is better known as the Bretton Woods era that began in 1944 with the signing of the Agreement pursuant to which the United States pledged to pay \$35 per ounce of gold. This semi-fixed exchange rate rendered the use of competitive devaluation impossible. In addition, because of the high growth rate of the world economy at that time the leading economies of the world had neither possibilities nor incentives to devalue their currencies.
<b><i>1971-2000</i></b>	In 1971, after the conduction of an expansionary monetary policy, as a result of which inflation led to excessive revaluation of the U.S. dollar, the U.S. government abandoned its obligation to exchange an ounce of gold for \$35 and appealed to the central banks of various countries to buy and keep with themselves the dollar reserves. This marked the end of the Bretton Woods era of the gold standard. In the mid-1980s, the developed countries such as France, Germany, Japan and the U.S. signed the Plaza Accord to depreciate the U.S. dollar in relation to the Japanese yen and German Deutsche Mark. After the transition to a more liberalized market adjustment of the exchange rates in the 1990s, most of the countries have switched to floating exchange rates and did not resort to interventions even in the event of a significant current account deficit.
<b><i>2000-2008</i></b>	During the Asian crisis of 1997, several Asian countries essentially exhausted their foreign reserves and were forced to adopt stringent IMF conditions on the forced sale of their assets. These events resulted in the loss of confidence in the so-called «free market» and, as of 2000, both developing countries and transition economies have started to make interventions to maintain low rates of their currencies to ensure economic growth supported by exports and increase their gold and foreign currency reserves for protection purposes in the event of new shocks. Because of this, citizens of these countries obtained access to cheap goods and moved to a higher quality of life.

Historical period	Description
<i>After 2009</i>	Due to the sharp economic decline because of the global financial crisis in 2008 and the reduction of the world trade by 12% by the end of 2009, most of the countries, including the developed countries and transition economies, decided to lower their exchange rates, which formed the conditions for the beginning of a currency war. In 2010, the Bank of Japan began to curb the growth of the yen to maintain exports. The United States and other developed countries that had not hitherto conducted interventions also started to devalue their currencies to check the flow of labor to the economies with emerging markets through the mechanisms of business process outsourcing and obtain export advantages. China, India and other economies with emerging markets understated the value of their currencies relative to their levels determined by purchasing power parity. Thus, at the beginning of 2010, all countries began a race of understating the value of their currencies having in mind the «game with zero gain».

Source: compiled on the basis of<sup>24</sup>

During the establishment of the IMF, it was recognized that the use of unilateral interventions in the foreign exchange market may have disturbing consequences for other members. Accordingly, Article IV, among other Articles of Agreement of the IMF, in particular, reads: «...each member shall... avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members». However, the IMF's Articles of Agreement do not contain the definition of either «manipulation» or «unfair competitive advantage», and for decades the Fund has provided little guidance on the content of these concepts.

The IMF's Executive Board<sup>25</sup> has given the interpretation of «manipulation» as policies that are targeted at — and actually affect — the level of exchange rate. Moreover, manipulation may cause the exchange rate to move or may prevent such movement. As for the concept of «unfair competitive advantage», the annex to the IMF decision says that «a member will only be considered to be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that: (A) the member is engaged in these policies for the purpose

<sup>24</sup> Leanne J. Ussher. Global Imbalances and the Key Currency Regime: The Case for a Commodity Reserve Currency [Electronic resource] // Review of Political Economy, Volume 21, Number 3, 403-421, July 2009. — Access mode: [http://blog.global-systems-science.eu/wp-content/uploads/2012/12/ussher\\_commodity\\_reserve\\_currency.pdf](http://blog.global-systems-science.eu/wp-content/uploads/2012/12/ussher_commodity_reserve_currency.pdf). IMF 2012 Spillover Report. — 2012. — Access mode: <http://www.imf.org/external/np/pp/eng/2012/070912.pdf>.

<sup>25</sup> IMF. Surveillance Guidelines: Landmark Framework for IMF Surveillance. [Electronic resource] // IMF Survey Online — 21 June 2007. — Access mode: <http://www.imf.org/external/pubs/ft/survey/so/2007/POL0621B.htm>.

of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate, and (B) the purpose of securing such misalignment is to increase net exports.

Thus, the criterion of manipulation is an attempt to influence the balance of trade. Whether or not a member state had set such a goal is to be determined on the basis of objective assessment of all available evidence, including consultations with representatives of the Central Bank.

### Conclusions

Potentially dangerous effects of devaluation are as follows:

- Deterioration in quality of life of the citizens due to the erosion of their purchasing power (because of higher prices of imports);
- Rise in inflation;
- Increased cost of external debt service;
- Reduced incentives for foreign investment in the country.

Other consequences of competitive devaluation include reduction of employment in some countries and a current account deficit in others. However, an analysis of studies of domestic and Western scholars gives little evidence that devaluation produces negative spillover effects like *beggar-thy-neighbor*, i.e. leads to a reduction in the utility of a typical domestic household in neighboring countries. As for the phenomenon of well-being, the improvement in the terms of trade may significantly outweigh the consequences of layoffs. In particular, when the level of redistribution of costs through the exchange rate is high, the devaluation allows domestic producers to increase their market share in a third country at the expense of other competitors. However, a high level of redistribution also leads to a drop in their relative prices. Because of this, bilateral trade between the two countries that compete in the global economy reduces the incentives to use the exchange rate as a policy tool to enhance competitiveness.

On the other hand, a low level of redistribution of costs increases the likelihood that devaluation will be competitive. Since relative prices in national currencies are isolated from changes in the exchange rates, devaluation will cause an increase in profits of exporters and real domestic income, therefore domestic households can increase their consumption. As foreign manufacturers must meet additional demand at constant consumer prices, they will lose revenue from sales. This kind of devaluation results in *beggar-thy-neighbor* dynamics, as in this case the manufacturers are forced to work harder to satisfy any given level of consumption.

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