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Currency Wars: Myth and Reality

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Abstract. This article considers the term "currency war", its meaning and the present situation in the world economy. It also contains research and analysis of HSBC's operations in different countries in the devaluation race grouping them according to the participation in currency wars. Along with the benefits of the devaluation of its own currency the actual disadvantages that may reveal afterwards have been identified. This article highlights the different versions of events put forward by the experts in the global economy and analysts. The authors mention the possible problems of ordinary citizens in case of their country's aggressive policy to reduce their national currency. The behavior of the Russian ruble was also discussed in detail according to which the recommendations were given to depositors of banks about their future action in the circumstances. Devaluation race in any case cannot be completed safely but it is possible to avoid excessive losses if the countries achieve international agreement by establishing a new currency regime.

Keywords: currency wars; devaluation race; participants of currency wars; evaluation of exchange rates; analysis of currency and oil price dynamics; analysts' opinion; economic predictions; currency regime.

Introduction. Improving and strengthening of economic growth is a top priority for any country. Therefore, after the global financial crisis of 2008-2009 you can often hear the phrase "currency wars", the purpose of which is to give a boost to the national economy and increase employment in the country.

The term was coined by the Brazilian finance minister who said that the loose monetary polices in the U.S. and the Europe were hurting the emerging economies as the investors poured money into higher yielding assets and currencies of the emerging countries. Now the term "currency wars" is defined as simultaneous and deliberate actions of a few states directed at the devaluation of their currency against other monetary units [1].

In that way governments expect to provide domestic producers with a competitive advantage on the markets, to revive domestic production and to maintain an export surplus for their own benefit compared with the international partners. In this case, those countries obtain the greatest profit that were the first to join the "devaluation race" and as a result were able to support domestic producers for a longer period of time.

At previous international monetary regimes currency rates of the most monetary units to gold or the major currencies could be changed by directive. Today, in the era of mass free currency floating, it is not easy to achieve this goal and it often requires special unorthodox measures. The examples of such measures are those taken in Switzerland. Preventing the franc from the excessive strengthening it announced the upper limit of its exchange rate against the euro. To protect this achievement it was promised to buy foreign currency at the expense of unlimited emission and even negative interest rates were introduced for deposits in francs (in other words, an investor has to get less in the end than the amount originally invested) [1].

The current arsenal of "currency wars" includes four types of weapons:

1) Rhetoric. For example, the speech of the European Central Bank President, Mario Draghi on February 7 entailed a sharp drop in the rate of the euro.

2) Reduction of rates. Often the currency gets strengthened due to the influx of capital, low bank rates make it less attractive and the price falls. Turkey uses such a policy actively when the lira depreciates against the dollar.

3) Direct intervention. Asian countries, China in particular, sell their own currency in the market and buy foreign ones effectively which leads to a gradual decrease of the yuan.

4) Quantitative Easing (Quantitative easing, QE) in a variety of forms. This is an indirect instrument for fighting in "currency wars" but its implementation is often has a side effect of a currency depreciation which can be seen in the US dollar. However, it is not always efficient – dollar has strengthened after the announcement of the unlimited emission QE3. [2]

At the same time, the policy of "quantitative easing" has led to the release of trillions of unsecured dollars, euros and yens by the central banks which in the absence of any other adequate application poured abroad in large numbers including the financial markets of developing countries thus threatening catastrophic strengthening of their currency. Unwillingly, they have to react and neutralize the flow of funds or monetary units by introducing capital constraints.

In addition to these methods of currency depreciation there are others – for example, a tax on financial transactions in Brazil, raising reserve requirements in the case of a foreigner buying local assets, encouraging domestic investors to spend money abroad, etc.

Recent economic developments. On the basis of how frequently a country uses weapons for fighting in "currency wars" the HSBC bank made a rating of the aggressors. Each country is assigned a score between 0 and 10 according to their "military" activity.

The most active aggressors are Japan, Switzerland and Argentina. Russia having received 3 points was declared a passive country due to the policy of the Central Bank of the Russian Federation that is aimed at making the ruble a flexible currency by 2015.

To wage "currency wars" aggressively each country has different motivations: fighting speculators, dealing with destabilizing volatility of the national currency and responding to the aggression of the other countries, etc. Indeed, the currencies of some countries are greatly overvalued or, on the contrary, undervalued. According to that, the actions taken for currency devaluation could be fair for certain participants of the "currency wars".

To determine the compliance with the measure of participation in the "devaluation race" in the present financial situation on the national currency market the HSBC bank has evaluated currency according to three major indices and calculated the average rating for each:

1) The current real effective exchange rate as compared to its average value over five years;

2) Evaluation of the purchasing power parity by Organization for Economic Cooperation and Development (OECD);

3) The Big Mac index. The graph of the “currency wars” participants was created. It defines where the country is on the coordinate plane in accordance with its currency exchange rate and its activity [2].

Thus, countries were divided into four groups:

1. Not wishing to participate in currency wars (low exchange rate and low propensity for aggression): South Africa, Hungary, Poland and other European countries, the Middle East and Africa (EMEA). These countries have cheap currencies but they are not involved in interventions – it just does not make sense for them to be engaged in wars.

2. Victims of Wars (high rate and low propensity for aggression): primary producing countries. Of course, they notice that their currency is overvalued. But so far no real action is taken – only a small rate cut and a few political statements. The weakness of other currencies will influence them more severely.

3. Just wars (overvalued currency and active aggression): Switzerland, the countries of Latin America.

4. Aggressors (undervalued currency and active aggression): Japan, Taiwan, Turkey, and the USA.

Global worries over competitive devaluation have been on the rise since Japan's freshly installed prime minister, Shinzo Abe, who's determined to stimulate a moribund economy, and has ordered Japan's central bank to be more expansionary. The Bank of Japan has agreed to a two percent inflation target and to make open-ended asset purchases from 2014. The yen has weakened about 14 percent against the dollar in the past three months.

There have been signs of rising capital inflows in China as well. The country's central bank reported on March 5 that companies and individuals sold a record 684 billion yuan ($109 billion) worth of foreign exchange and bought an equivalent amount of Chinese currency in January.

China also holds more than $3 trillion in foreign exchange reserves, the world's largest, making the country particularly vulnerable to depreciation-related losses.

Yi Gang, deputy governor of China's central bank, said last week the country was hopeful a currency war could be avoided, adding, at the same time, it "is fully prepared" for a currency war, Xinhua News Agency reported [3].

However, according to some experts the benefits of participating in the devaluation race are illusory and can later be transformed into:

1) Loss of competitiveness;
2) Social unrest;
3) War.

Loss of competitiveness. When a country subsidizes one's exports with an artificially weak currency, businesses lack an incentive to innovate. Advanced economies cannot compete on price, but must compete on value. European companies have long learned this, as there are rather few low-end consumer goods being exported from Germany. The Chinese have also heeded this lesson, allowing low-end industries to fail and relocate to Vietnam or other lower cost countries: China is rapidly moving up the value chain in goods and services produced. In summary, market pressure to innovate is the most powerful motivation. Governments subsidizing ailing industries through currency debasement do long-term harm to their economies.

Social unrest. Currency debasement is not just bad for the corporate world: it's particularly painful for citizens. Just ask citizens of Venezuela where the government just announced a 32 percent devaluation in the bolívar's official exchange rate to the dollar. An overnight move of that magnitude is immediately noticeable, as are the negative effects on consumers, whereas gradual debasement in currencies of advanced economies are less noticeable, but ultimately have the same effect. The natural consequence of currency debasement is inflation, i.e., loss of real purchasing power; the two forces meet at the gas pump: as a currency loses value, commodities – all else equal – become pricier when valued in that currency.

War. Currency wars destroy wealth. Currency wars have a disproportionate impact on the poor, as they don't hold assets whose value is inflated in nominal terms and that could buffer some of the fallout. Central banks don't cause real wars. But monetary policy has a profound impact on the social fabric. Abstract theories about how aggressive monetary action are the remedy to depressions ignores the heavy social toll currency wars have on people. For those that argue that the social toll of a depression is greater, we respond that the best short-term policy to address economic ills is a good long-term policy. We cannot see how currency wars can be good long-term policy [4].

As far as Russia and the Russian ruble are concerned, the deputy chairman of the Central Bank Alexei Ulyukayev said at the conference that was held on January 16-19 within the framework of Gaidar forum 2013 that Russia will not participate in "currency wars". The volume of interventions of the Central Bank is on the decrease, trading range is constantly growing, and interest rates will fall in case of a significant slowdown in inflation for a year. However, the oil market also has significant impact on USD/RUR change. The dynamics of oil prices shows their decrease with an alternate and a very slight increase (Figure 1), therefore, the rate of the ruble against the US dollar falls (Figure 2) [5, 6].

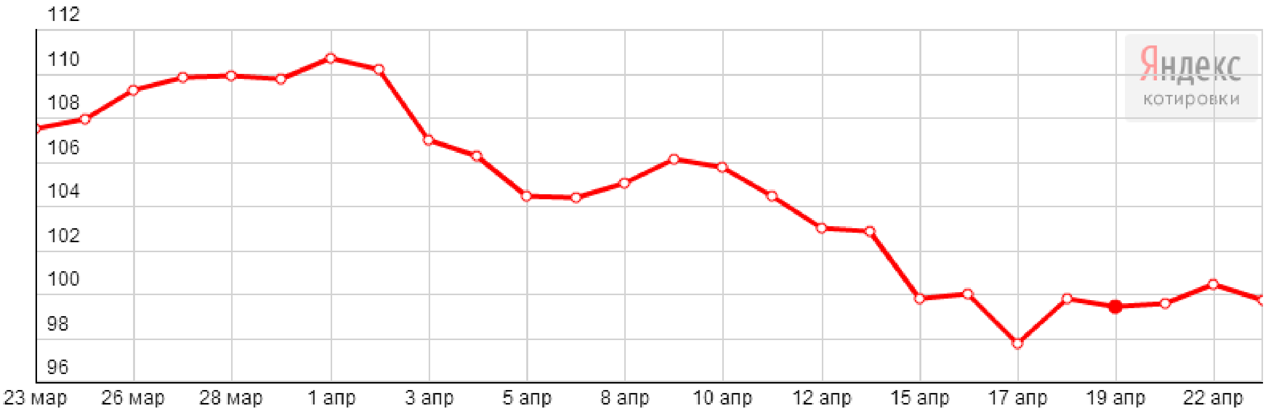

Figure1 – Dynamics of oil prices Brent, USD/barrel (March-April 2013)

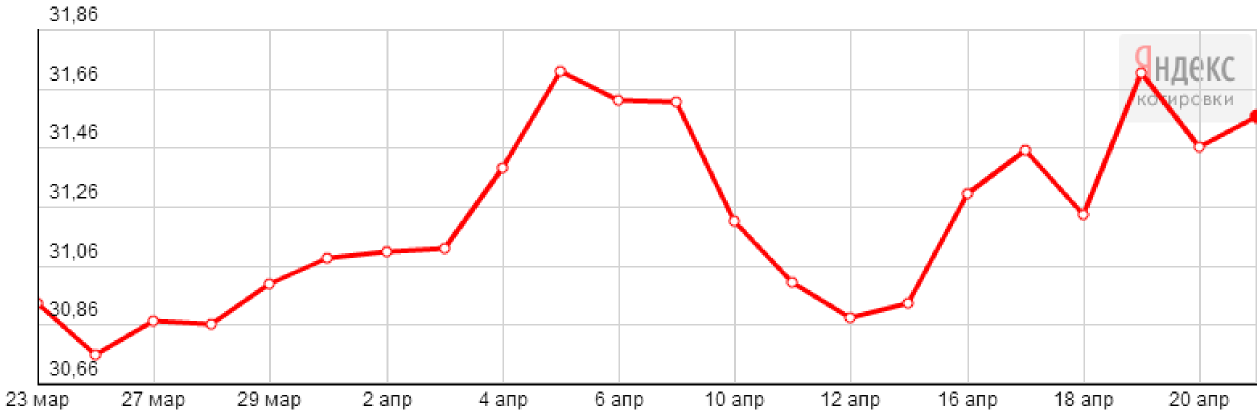

Figure 2 – Dynamical correlation of rates USD/RUR (March-April 2013)

On the other hand, the exchange rates are interdependent, so excessive fluctuations of world currencies may reduce the real value of Russian investments to the securities and cash assets of the other countries. Even more dangerous is the possible destabilization of international finance and, consequently, deepening and intensifying of the crisis in the world economy.

Analysts' predictions about the behavior of the Russian ruble in terms of "currency wars" are different. Most of them believe that Russian economy needs to weaken the ruble, the exchange rate of which may be established at the level of 33-34 rubles/$ in the second half of 2013 [7]. But there is also an opinion about the strengthening of the national currency in the nearest future, which may result in a loss of competitiveness and the country's economic growth, deteriorating the terms of foreign trade [8]. At the same time, Vladimir Putin said that the ruble volatility has an advantage because it curbs the financial speculations [9].

Depositors and ordinary citizens suffer the most in currency wars. When a country tries to devalue its own currency intentionally, extremely large sums of money in bank accounts lose their purchasing power. Gas prices soar. Groceries get more expensive. And the bills are climbing higher every month. "The real victims of this situation are innocent civilians," Aaron DeHoog, Financial Publisher of Newsmax Media, said. "Those who are investing 'safely' can lose as much as 50% of their savings if things get out of control."

Conclusion. Guided by the opinion of analysts and existing dynamics of oil prices and foreign exchange rates, a recommendation can be given to the Russian bank depositors to keep their savings in US dollars and keep an eye on the trends of world currencies taking into consideration the possibility of changes.

As for the global "currency wars", the economists of different countries foresee their end, probably not painless. As all free floating currencies cannot be devalued at the same time, and no one wants to lose this "war", all the participants may come off worst: excess money circulation will entail inflationary outbreak. It will also add volatility to economic development, distort the basic price proportions and inflate the price "bubbles" in the financial markets.

However, the recent data show that the economies of the leading countries are gathering strengths. There has been a gradual improvement of the situation in the euro-zone. If such a "recovery" of the economies continues, then the countries will have no reason to participate in a "devaluation race". In the near future, the countries may even reach an agreement on a new international currency regime, which could be a worthy end of "currency wars".

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Валютные войны: миф и реальность

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Аннотация. В статье рассматривается термин «валютные войны», его значение и настоящая ситуация в мировой экономике. Также приведены исследования банка HSBC и анализ действий различных стран в гонке девальваций с разделением их на группы по справедливости участия в валютных войнах. Вкупе с преимуществами девальвации собственной валюты были обозначены и ее фактические недостатки, которые могут проявиться в долгосрочном периоде. В данной статье освещены различные варианты развития событий, высказанные экспертами в области мировой экономики и аналитиками.

Затронуты возможные проблемы обычных граждан в случае проведения их страной агрессивной политики снижения курса национальной валюты. Кроме того, было подробно рассмотрено поведение российского рубля, в соответствии с которым были даны рекомендации вкладчикам банков по поводу их дальнейших действий в сложившихся обстоятельствах. Гонка девальваций в любом случае не может завершиться безболезненно, но можно и избежать чрезмерных потерь, если страны достигнут международного соглашения путем установления нового валютного режима.

Ключевые слова: валютные войны; гонка девальваций; участники валютных войн; оценка обменных курсов; анализ динамики валютных курсов и цен на нефть; мнения аналитиков; экономические прогнозы; валютный режим.