Scholarly Research Journal for Interdisciplinary Studies,
Online ISSN 2278-8808, SJIF 2021 = 7.380, www.srjis.com
PEER REVIEWED & REFEREED JOURNAL, JULY-AUGUST, 2022, VOL- 10/72

CURRENCY WAR- REASONS AND REPERCUSSIONS

Pranjal Bahri

Paper Received On: 25 AUGUST 2022
Peer Reviewed On: 31 AUGUST 2022
Published On: 01 SEPTEMBER 2022

Abstract

Currency war or competitive devaluation is a situation in which countries try to gain a trade advantage over other countries by causing the exchange rate of the domestic currency to fall in relation to other currencies. Every country would want to prosper, but why does it depreciate its currency? There are 3 reasons: Firstly, to boost the exports. Secondly, to reduce the trade balance deficit and thirdly to reduce the debt burdens. It is a global phenomenon and has various positive and negative impacts. For developing countries, it is a loss situation at the time of implementation of currency and loss of competitiveness as well as removal. It might sound different, but a strong currency necessarily does not serve in a nation's best interests. Today value of one dollar is equal to seventy rupees. If India wants it could bring down the value of dollar in comparison to rupees by tweaking its economic policies, but this will reduce India's profit which it earns from various sources such as IT exports, FDI, Tourism etc. Therefore, India does not appreciate its currency and likewise every country has its system. This paper with through light on why currency war is there and what will be its repercussions on us

Introduction

In the current global economy that is predominantly guided by the market forces, the health of a nation is dependent, to a large extent, on trade and commerce. Countries often strive to achieve a better trade balance by aiming to outdo the volume of imports to the economy with total exports. In certain situations, a nation deliberately depreciates the value of its currency to achieve this end.

Before I go directly to current war and its effects, let's first understand what currency is, its importance and its evolution history.

Currency is a standardization of money in any form, in use or circulation as a **medium of exchange** for goods and services. In short, it's money, in the form of paper or coins, usually issued by a government and generally accepted at its face value as a method of payment.

Currency is the primary medium of exchange in the modern world, having long ago replaced bartering as a means of trading goods and services. Currency in some form has been in use for at least 3,000 years. Under this definition US dollar, euros, Indian Rupee, Japanese yen and British pound are some of the examples of fiat currencies.

Currencies may act as stores of value and be traded between nations in foreign exchange markets, which determine the relative values of the different currencies. Currencies in this sense are either chosen by users or decreed by governments, and each type has limited boundaries of acceptance - i.e legal tender laws may require a particular unit of account for payments to government agencies.

So important characteristics of currency are:

- Currency is a generally accepted form of payment.
- Issued by a government and circulated within its jurisdiction.
- The value of any currency fluctuates constantly in relation to other currencies.
- The currency exchange market exists as a means of profiting from those fluctuations.

In the 21st century, a new form of currency has entered the vocabulary, **the virtual currency**. Virtual currencies such as bitcoins have no physical existence or government backing and are traded and stored in electronic form. Since these currencies are not issue by the Government, so these are not legal currencies.

Evolution of Currencies

Transition from Bartering to Currency

Money, in its modern conception, has been part of society for at least 3,000 years.

First Stage Of Currency Evolution Was Barter System. Historians generally agree that bartering was used before money. Bartering is the direct exchange of goods and services. For example, a farmer might exchange a goat for three pairs of shoes. However, these arrangements are arbitrary and virtually impossible to regulate. They also inhibit the economy from achieving freedom because in order to obtain what you want to buy, you have to find someone equally interested in what you're selling.

Second Stage Of Evolution Was Trading System: Trading systems adopted widely sought-after goods such as animal skins, salt, and weapons to establish a primitive currency system, but for the same reasons as bartering, these systems were riddled with just as many issues. Despite their drawbacks, these early trade systems paved the way for future currency systems. The increase in commerce is largely responsible for this shift because the more merchants and consumers economies needed to support, the more diversified economies became, resulting in less demand for items such as animal skins or weapons.

Third Stage Was Coins: The Chinese moved away from unsystematized bartering around 770 B.C., when they began using miniature replicas of weapons cast in bronze. However, the impracticality of these objects caused a shift to a circular bronze shape, the first coins. In a brief history in currency, coins turn out to be a second stages of evolution of money.

Though China was the first area to adopt what people associate as a coin, the first region to manufacture these coins in an industrial capacity was in Lydia, a town in what is now western Turkey. The manufacturing of these early coins marked the first mint, and the manufacturing process was the first minting.

In 600 B.C., King Alyattes of Lydia minted the towns and the world's first official currency. These electrum-made coins were a mixture of natural silver and gold and the coins had stamped pictures on them constituting denominations. This formalized system of currency helped increase both its internal and external trading systems, making it one of the richest empires in Asia Minor. When someone uses the saying, "as rich as Croesus," they are referring to the last Lydian king who minted the first gold coin.

Transition to Paper Currency

Fourth And Final Stage Of Evolution Was Paper Currency: Around 700 B.C., the Chinese transitioned from coins to paper money. By the time Marco Polo travelled on the Silk Road between 1271-1295, the emperor of China had a firm grip on the money supply in various denominations. He instituted somewhat draconian measures to respond to the threat of counterfeit by inscribing, "those who are counterfeiting will be decapitated," on the bills.

Parts of Europe were still using metal coins as the sole form of currency up until the 16th century. Their colonial expansion provided the resources necessary for the switch from coins to paper money. The switch enabled them to keep minting a greater quantity of coins. European banks eventually started using paper banknotes for depositors and borrowers to carry instead of coins.

Citizens could take these notes to the bank at any time and exchange them for coin value. They could also be used to purchase goods and services. However, these notes were issued privately and not by government institutions.

The first paper issued by European governments was in colonial governments in North America. Intercontinental shipments took too long and colonist operations frequently ran out of currency as they expanded, necessitating the need to print money. Instead of reverting to a barter system, the colonial government issued IOUs and traded them as currency.

Gold Standard

Paper notes became the norm and eventually coins made of precious metals were discontinued. Despite the end of precious metal coins, paper notes could still be traded for gold or silver. Eventually, the gold standard was adopted by the United States, tying the value of the USD to gold (previously some had used gold and others silver). After the Second World War the USD became the international standard. Currencies in Europe and around the world based their value on the USD, which remained tied to the value of gold.

The rapid economic expansion of the 20th century soon meant that the value of the world's currencies exceeded the amount of gold that was available. In 1971, this led to the US – by then the world's economic powerhouse and currency benchmark – to abandon the gold standard. Leaving the gold standard behind meant that a person could no longer redeem their currency for gold – a practice that had long since ended but which, up to that point, was still technically possible.

Mobile Payments and Digital Currency

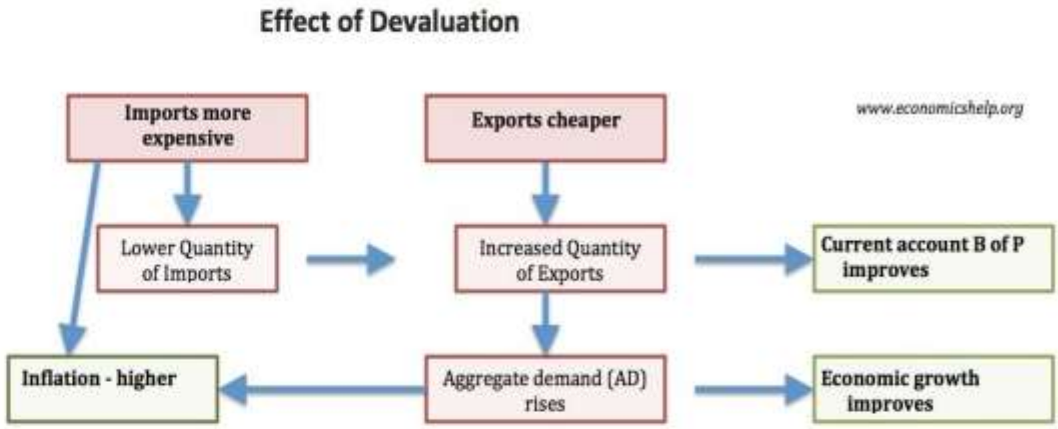
The 21st century in a brief history in currency and paper currency marks a monumental turning point in currency. This is in the form of mobile, virtual, and cryptocurrency. Mobile payment platforms such as PayPal and cryptocurrency such as Bitcoin are ushering in a new era in currency. These are one not controlled by governments, but a decentralized currency freely exchanged between the world's citizens.

What Is Currency War

Currency wars are said to occur when countries seek to devalue their currency to gain a competitive advantage. However, if one country seeks to become more competitive through devaluation, it means other countries become less competitive. Therefore, they may respond by weakening their currency too. Thus, we may get a situation of **COMPETITIVE DEVALUTION** where each country seeks to reduce the value of a currency. This can lead to instability.

Need For Devaluation

1. Overvaluation of currency associated with import substitution for industrialization as opposed to export promotion policies.
2. The risk of losing competitiveness.
3. To relieve an unfavourable balance of trade.
4. Economic stabilization.
5. Correction the price distortions.
6. To gain a comparative advantage in international trade If you devalue your currency, it means your exports are relatively more competitive (cheaper to foreigners). Therefore you will export more.
7. To raise national income per capita.
8. Close the development gaps.
9. Restriction on commodity as well as capital flows.
10. To boost economic growth and reduce unemployment.
11. To encourage investment in the nation's assets. The stock market becomes less expensive for foreign investors. Foreign direct investment increases as the country's businesses become relatively cheaper. Foreign companies may also buy up natural resources.



How It Works

Exchange rates determine the value of a currency when exchanged between countries. A country in a currency war deliberately lowers its currency value. Countries with fixed exchange rates (FIXED RATE is when a country ties the value of its currency to some other widely-used commodity or currency) typically just make an announcement. Other countries fix their rates to the U.S. dollar because it's the global reserve currency.

However, most countries are on a flexible exchange rate. They must increase the money supply to lower their currency's value. When supply is more than demand, the value of the currency drops.

A central bank has many tools to increase the money supply by expanding credit. It does this by lowering interest rates for intra-bank loans, which affect loans to consumers. Central banks can also add credit to the reserves of the nation's banks. This is the concept behind open market operations and quantitative easing.

A country's government can also influence the currency's value with expansionary fiscal policy. It does this by spending more or cutting taxes. However, expansionary fiscal policies are mostly used for political reasons, not to engage in a currency war.

Reasons for Currency War

1. TRADE DISPUTE BETWEEN COUNTRIES: Dispute in this context arise over trade “dumping” (flooding a domestic market with goods and services to force domestic producers out of the market to give exporting country a monopoly) and countervailing duties.
2. Currency Volatility: The sharpest volatility was in countries that was highly reliant on commodity exports: this was primarily down to the significant shifts in global commodity prices.
3. Trade protectionism: National policies could offset global attempt to encourage trade.
4. Global financial institutions such as IMF, world bank and WTO are attempting to encourage trade.

History of Currency War

For a long time before world war I, the world had been on what’s called the classical gold standard. If you had a balance of payment, your deficit, you paid in gold. If you had a balance of payments surplus, you acquired gold. Gold was the regulator of expansion or contraction of individual economies. You had to be productive, pursue your comparative advantage and have a good business environment to actually get some gold in the system — or at least avoid losing the gold you had. It was a very stable system that promoted enormous growth and low inflation.

That system was torn up in 1914 because countries needed to print money to fight World War I. When World War I was over and the world entered the early 1920s, countries wanted to go back to the gold standard but they didn’t quite know how to do it. There was a conference in Genoa, Italy, in 1922 where the problem was discussed.

The world started out before World War I with the parity. There was a certain amount of gold and a certain amount of paper money backed by gold. Then, the paper money supply was doubled. That left only two choices if countries wanted to go back to a gold standard.

They could've doubled the price of gold — basically cut the value of their currency in half — or they could've cut the money supply in half. They could've done either one but they had to get to the parity either at the new level or the old level. The French said, "This is easy. We're going to cut the value of the currency in half." They did that.

The U.K. had the same decision to make but they made it differently than France did. There, instead of doubling the price of gold, they cut their money supply in half. They went back to the pre-World War I parity.

That was a decision made by Winston Churchill who was Chancellor of Exchequer at that time. It was extremely deflationary. The point is, when you've doubled the money supply, you might not like it but you did it and you have to own up to that and recognize that you've trashed your currency. Churchill felt duty-bound to live up to the old value.

He cut the money supply in half and that threw the U.K. into a depression three years ahead of the rest of the world. While the rest of the world ran into the depression in 1929, the U.K. it started in 1926. I mention that story because to go back to gold at a much higher price measured in sterling would have been the right way to do it. Choosing the wrong price was a contributor to the great depression.

In 1930s during The Great Depression when countries dropped the gold standard, which resulted in a loss of intrinsic value and thereafter devaluation of currencies as nothing backed the paper money in circulation. The currency wars of 1930s ended with The Tripartite Agreement in Sept 1936, countries agreed to sell gold to each other in the seller's currencies at an agreed fixed price, which helped to stabilize exchange rate.

The U.S.' Currency War

The United States doesn't deliberately force its currency, the dollar, to devalue. Its use of expansionary fiscal and monetary policy has the same effect.

For example, federal deficit spending increases the debt. That exerts downward pressure on the dollar by making it less attractive to hold. Between 2008 and 2014, the Federal Reserve kept the federal fund rate near zero, which increased credit and the money supply. It also created downward pressure on the dollar.

But the dollar has retained its value despite these expansionary policies. It has a unique role as the world's reserve currency. Investors tend to buy it during uncertain economic times as a safe haven. As an example, the drastic oil price drop between 2014 and 2016 caused a mini-recession. Investors flocked to the dollar, which caused the dollar value to increase by 25%.

China's Currency War

China manages the value of its currency, the yuan. The People's Bank of China loosely pegged it to the dollar, along with a basket of other currencies. It kept the yuan within a 2% trading range of around 6.25 yuan per dollar.

On August 11, 2015, the Bank startled foreign exchange markets by allowing the yuan to fall to 6.3845 yuan per dollar. On January 6, 2016, it further relaxed its control of the yuan as part of China's economic reform.

In 2017, the yuan had fallen to a nine-year low. But China wasn't in a currency war with the United States. Instead, it was trying to compensate for the rising dollar. The yuan, pegged to the dollar, rose 25% when the dollar did between 2014 and 2016.

China's exports were becoming more expensive than those from countries not tied to the dollar. It had to lower its exchange rate to remain competitive. By the end of the year, as the value of the dollar fell, China allowed the yuan to rise.

Japan's Currency War

Japan stepped onto the currency battlefield in September 2010. That's when Japan's government sold holdings of its currency, the yen, for the first time in six years. The exchange rate value of the yen rose to its highest level since 1995. That threatened the Japanese economy, which relies heavily on exports.

Japan's yen value had been rising because foreign governments were loading up on the relatively safe currency. They moved out of the euro in anticipation of further depreciation from the Greek debt crisis. There was underlying concern about unsustainable U.S. debt, so governments moved away from the dollar at the time.

Most analysts agreed that the yen would continue rising, despite the government's program. This was due to foreign exchange (forex) trading, not supply and demand.

Forex trading has more influence on the value of the yen, dollar, or euro than traditional market forces. Japan can flood the market with yen attempting to devalue the currency—but if forex traders can make a profit from yen, they will keep bidding on it, keeping the value of the currency up.

Before the financial crisis of 2008, forex traders created the opposite problem when they created the yen carry trade. They borrowed yen at a 0% interest rate, then purchased U.S. Treasury bonds with the borrowed currency, which had a higher interest rate.

The yen carries trade disappeared when the Federal Reserve dropped the federal funds rate (the interest rate banks charge each other for overnight loans) to zero.

European Union

The European Union entered the currency wars in 2013. It wanted to boost its exports and fight deflation. The European Central Bank lowered its rate to 0.25% on November 7, 2013.

This action drove the euro to dollar conversion rate to $1.3366. By 2015, the euro could only buy $1.05. Many investors wondered whether the euro would survive as a currency.
In 2016, the euro weakened as a consequence of Brexit, where the residents of the United Kingdom voted to exit the European Union. However, when the dollar weakened in 2017 the euro rallied.

Repercussions of Currency War:

1. A currency devaluation, deliberate or not, can damage a nation's economy by causing inflation. If its imports rise in price. If it cannot replace those imports with locally-sourced products, the country's consumers simply get stuck with the bill for higher-priced products.
2. A currency devaluation becomes a currency war when other countries respond with their own devaluations, or with protectionist policies that have a similar effect on prices. By forcing up prices on imports, each participating country may be worsening their trade imbalances instead of improving them.
3. Currency depreciation is not a *panacea* for all economic problems. Brazil is a case in point. The country's attempts to stave off its economic problems by devaluing the Brazilian real created hyperinflation and destroyed the nation's domestic economy.
4. The degree of currency depreciation may be greater than what is desired, which may cause rising inflation and capital outflows.
5. Devaluation may lead to demands for greater protectionism and the erection of trade barriers, which would impede global trade.
6. Devaluation can increase the currency's volatility in the markets, which in turn leads to higher hedging costs for companies and even a decline in foreign investment.

Are We in a Currency War Now?

In the current era of floating exchange rates, currency values are determined primarily by market forces. However, currency depreciation can be engineered by a nation's central bank through economic policies that have the effect of reducing the currency's value.

Reducing interest rates can be one tactic and **quantitative easing (QE)** be the other. In QE a central bank buys large quantities of bonds or other assets in the markets.

However, others argue the dangers of currency wars are overstated. They argue that in a deep recession, countries facing deflation do the right thing to try and boost the money supply. The US pursuit of quantitative easing is not just to weaken dollar but the pursuit of independent monetary policy. The point to the fact was that despite zero base rates, there was the threat of slow economic recovery and deflation. Thus their policy was aimed at avoiding deflation and they have a right to pursue quantitative easing. Furthermore, the rest of the world will benefit from a strong US economy which buys their exports. A devaluation of the dollar will help rebalance the global economy and reduce imbalances in trade deficits. So these actions are not as overt as currency devaluation but the effects may be the same.

Is India in a Currency War?

The U.S. Treasury Department placed India on its watchlist of currency manipulators in April 2021. It cited India's outsized purchase of U.S. dollars as a possible attempt at currency manipulation.[6]

India's rupee hit a record low of 1 U.S. dollar to 76.67 Indian rupees in March 2020, at the start of the global economic crisis caused by the COVID-19 pandemic.[7]

The rupee has had a tumultuous history since its introduction in 1947 when the nation achieved its independence. The nation moved from a dollar peg to a floating currency in 1991 and, at the same time, devalued the currency to about 1 U.S. dollar to 26 rupees.

The rupee's value remained relatively high through the first years of its remarkable economic growth but faltered during the economic crisis of 2008-2009.[8]

As of Feb. 5, 2022, it remained relatively low at 1 U.S. dollar to 74.64 rupees.

Impact on Other Countries

These wars increased the currency values of Brazil and other emerging market countries. As a result, world commodity prices rose. Oil, copper, and iron are the primary exports of some of these countries—when prices rise for these commodities, demand begins to fall, causing economic slowdowns for the exporting countries.

India’s former central bank governor, Raghuram Rajan, criticized the United States and others involved in currency wars. He claimed that this exports inflation to the emerging market economies. Rajan had to raise India's prime rate (the rate for borrowers with very high credit ratings) to combat the inflation of its currency, risking a reduction in economic growth.

The Bottom Line and Conclusion

It does not appear that the world is currently in the grips of a currency war. Recent rounds of easy money policies by numerous countries represent efforts to combat the challenges of a low-growth, deflationary environment, rather than an attempt to steal a march on the competition through overt or surreptitious currency depreciation.

It is difficult to control and completely eliminate currency wars. Depending on an individual country economic situation, different economies are faced with differing macroeconomic scenarios which must be addressed and managed independently.

A country should make use of its available and appropriate mix of both the monetary and the fiscal tools to manage its macroeconomic environment which might not necessarily appease rival trading partner.

References

Alexandra Esmel (2020) Currency Wars: The Need for International Solutions, Denver Journal of International Law and Policy.vol.23 no 4.

Kimberly Amadeo (2022) Why Global Currency Wars Aren't as Dangerous as They Sound, Currency Wars and How They Work, ***Daily Excelsior***

Prof. D Mukhopadhyay (2022) Currency war-A threat to economic stability. ***Daily Excelsior***

Ahearne, Alan G., and Naoki Shinada. 2005. Zombie firms and economic stagnation in Japan. International Economics and Economic Policy. 2.4. pp. 363-381.

Caballero, Ricardo J., Takeo Hoshi, and . Anil K. Kashyap. 2006. Zombie lending and depressed restructuring in Japan. No. 12129. Cambridge, MA: National Bureau of Economic Research. Galati, Gabriele, Alexandra Heath, and Patrick McGuire. "Evidence of carry trade activity."

BIS Quarterly Review 3 (2007): 27-41. Habib, Maurizio M., and Livio Stracca. 2012. Getting beyond carry trade: What makes a safe haven currency? Journal of International Economics. 87.1. pp. 50-64.

Hattori, Masazumi, and Hyun Song Shin. 2007. The broad yen carry trade. No. 07-E-19. Tokyo: Institute for Monetary and Economic Studies, Bank of Japan, 2007.

Heston, Alan, Robert Summers and Bettina Aten. 2012. Penn World Table Version 7.1, Philadelphia: Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania.

Kwan, C.H. 2001. Yen Bloc: Toward Economic Integration in Asia. Washington, DC: Brookings Institution.

Dollar and Yen: Resolving Economic Conflict Between the US and Japan. Cambridge, MA: MIT Press.

McKinnnon, Ronald I. and Gunther Schnabl. 2003. Synchronized Business Cycles in East Asia and Fluctuations in the Yen/Dollar Exchange Rate. The World Economy.26 August. pp. 1067-1068. Qiao, Hong. 2007. Exchange Rate Changes and Trade Balances under the Dollar Standard. Journal of Policy Modeling, 29. pp. 765-82.

Ranaldo, Angelo, and Paul Söderlind. 2010. Safe Haven Currencies. Review of Finance. 14.3. pp. 385-407. Taylor, John B. 2009. Getting Off Track, Stanford, CA: Hoover Institution, Stanford University.