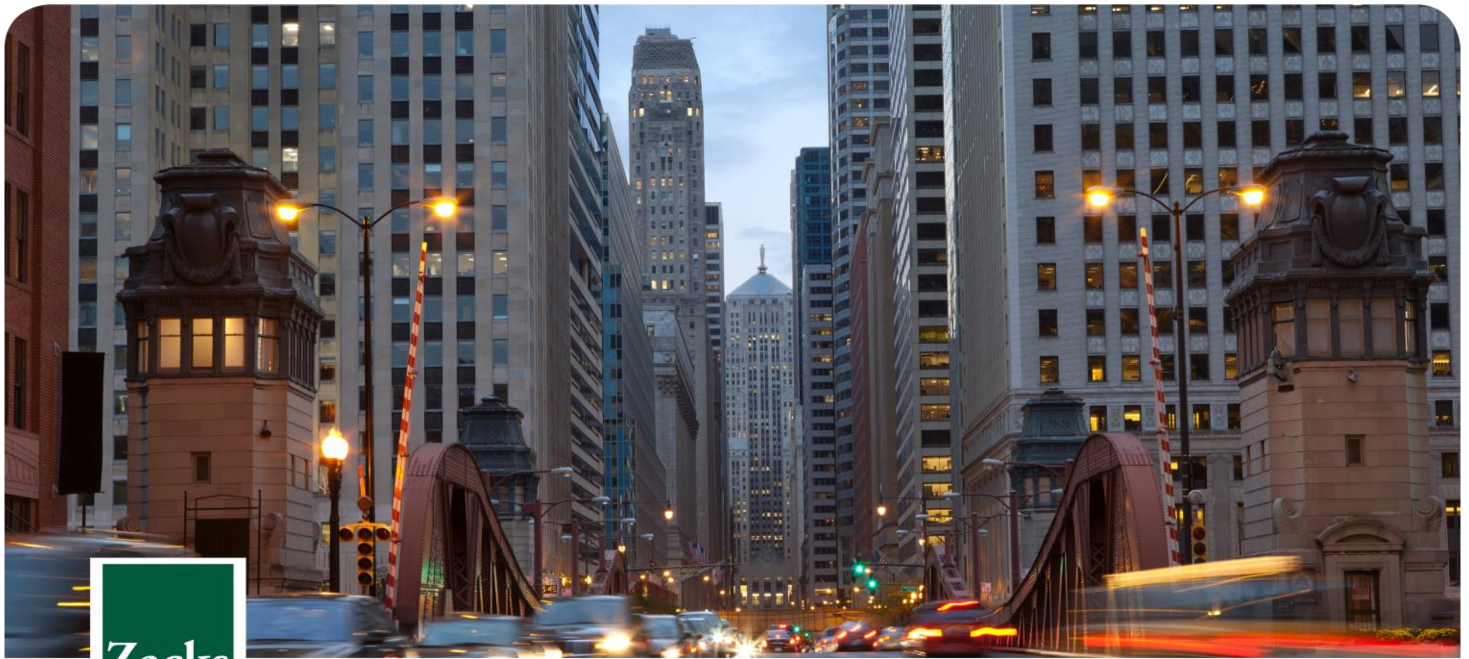

Mitch on the Markets

Are We Headed for a Currency War?

By Mitch Zacks
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Over the past year, mutterings of a "currency war" have become commonplace in the global economic discourse. Suspicions that developed nations are engaging in, or considering, actions to devalue their respective currencies have been growing. As the economic cycle ages, and countries grapple with ways to remain competitive, pressure to devalue ratchets up. When it comes to exports, a weaker currency is certainly one way to support more economic activity.

China is responsible for raising the level of currency war paranoia when, last August, they shocked markets with an unexpected two day devaluation of the yuan by 5%. It was claimed that the devaluation was simply to move the yuan closer to market rates – largely true at the time – but it seems fairly obvious the "angle" was to give the Chinese economy a much needed export boost. China did, after all, devalue the yuan just days after their export figures came in particularly weak. The devaluation also followed several rate cuts earlier in the year and seemed more a continuation of efforts to stimulate the economy than to make it more market-like.

The market loathed the devaluation for its unexpectedness and also because the move created uncertainty over whether other countries would respond similarly.

What is a Currency War and Why is it Dangerous?

A currency war occurs when countries actively attempt to gain a competitive advantage by devaluing their currency. Doing so, theoretically, makes exports more attractive and imports more expensive both of which should serve to increase domestic demand and production.

While these tactics were effective in the 19th century, in a truly global economy as we have today, these measures simply no longer work. Sure, exports may get a boost, but a weaker currency also reduces citizens' purchasing power and often raises input costs for production. This can lead to a general reduction in international trade as countries may seek to offset import costs by producing more goods at home. That may sound good on paper, but it's not in economic terms (costs will almost certainly rise). The global economy benefits from more international trade, not less, and currency wars threaten the status quo.

Are Quantitative Easing Programs Really Aimed at Devaluation?

That's been conjectured of late as Europe and Japan scramble to create growth and bring back inflation with extraordinary monetary policy tactics. The question at hand is: do these QE programs have a secondary motive to devalue the currency and help exports? The hypothesis that they do is essentially based on two factors. First is that the anticipation of more QE can invite speculators to bet the currency will decline in value, which can become a self-fulfilling prophecy. Second is that purchasing bonds in a QE program tends to put downward pressure on long-term interest rates, which can create the means for a carry trade (borrowing in one currency and lending in another) - both put downward pressure on a currency.

Lowering the value of the euro is not part of the QE program's official objectives, but it raised eyebrows last week when Mario Draghi (European Central Bank chief) announced an additional 20 billion euro per month in bond purchases on top of the 60 billion already in place. So pronounced were the rumors that this was an attempt at devaluing the currency that Draghi had to address it in a statement: "The ECB has never ever started [a currency war]. Our measures are entirely addressed to our domestic economy."

Even the U.S. is hedging against the possibility as they made it a key issue in the G20 meeting of finance ministers last month in Shanghai. Assurances were made from all parties present that a currency war was not underway or in the cards, but actions speak louder than words. It's something to keep an eye on.

Bottom Line for Investors

For a 'currency war' to wreak real economic havoc, it has to be deliberate and somewhat malicious in nature – where a country disregards all global economic relations to look out for its own interests. It's arguable whether China took this action in August of last year for this purpose, but they've assured markets that it was a one-time occurrence based on market forces. The market has seemingly let it slide, but it did induce the first real market correction we've seen in over 3 years.

It goes to show how disruptive a large-scale devaluation can be for a big economic player, and it's why the G20 felt it important to discuss the topic at length at its last meeting. I'd say the risk of a currency war at this stage is low – everyone knows what's at stake. But desperation can lead to mistakes, so it's not off the table that further struggles to attain growth won't lead to some misguided action in the future.

- Mitch

About Mitch Zacks

Mitch is a Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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