Asset Management

News or Noise: A Race to the Bottom?

By David Fisher

Last week at the World Economic Forum in Davos, Switzerland, George Soros, when asked about risks in the global economy, said, "Any number of things could go wrong. But the biggest danger is potentially a currency war." Coming from one of the great currency traders of all time, this is a meaningful statement.[1] Yet this warning is nothing new, and many analysts and policy makers have been raising concerns about the risk of a currency war since 2008.

In 2010, the Brazilian Finance Minister, Guido Mantega, was the first significant government official to predict that countries could actively pursue policies of weak currencies. But there have been simmering tensions around currencies for some time. For example, for several years, the United States has accused China of artificially holding down the value of the yuan in order to expand exports. To date, the worst fears about a currency war have not materialized. We do seem to be entering a new phase in 2013, however, so it will be important to monitor the risk.

A Currency War Defined

It first may help to define what a currency war is and explain why countries would want to engage in this activity. A currency war happens when a country has an active policy of holding down the relative value of its currency compared to other countries. As a country's currency goes down, the real cost of its exports also goes down while the cost of imports rises. In the case of both exports and imports, this marginally shifts the balance toward additional hiring within the country and expanded production. This extra production comes about due to the greater demand for exports and for a shift to domestic replacement of imported items as those costs rise. It is clear why a country would want to do this in a slow growth world. It is the old story of taking a larger slice of a static global economic pie.

When global economies are growing at a steady pace, the expanding pie allows for all countries to keep unemployment at a manageable level and increase production at a healthy pace. However, when the pie is not growing fast enough, the pressure on politicians to meet their constituents' needs forces them to attempt to steal market share. The paradox lies in the fact that what is good for one country ends up being bad for everyone if it becomes a competitive situation—a race to the bottom. In a world with widespread competitive devaluations, the positive impact to any single country is neutralized and only the negative consequences of volatility, inflation risk and policy uncertainty remain.

The Fading Benefits of Cooperation

After the financial crisis in 2008, large countries agreed to not participate in competitive practices against other countries. Five years on, however, the benefits of cooperation seem to be fading. In reality, a mild version of devaluation has been going on since 2009. The U.S. Federal Reserve, with the dollar as the global reserve currency, has been able to be more aggressive than most central banks. This has caused the dollar to decline by almost 15% against a basket of currencies since 2009. This has helped U.S. manufacturing industries begin to grow again, putting citizens back to work and enhancing personal incomes. During this time, the euro (compared to the dollar) has been mostly flat, though it has been trading in a wide range from €1.20/$1 to €1.50/$1. Given that the actual survival of the euro was in question during much of that time, it is amazing that it has held up so well. The Japanese yen was near $1 to ¥110 at the start of the crisis, and as recently as October was high as $1 to ¥75.

The Japanese have actually been the ones to launch this most recent series of policy actions aimed at dramatic adjustments within their economy. Other countries are now taking note. As recently as October, $1 was fetching ¥75, but since then the value of the yen has tumbled and $1 can now get ¥91. This is a substantial move in foreign exchange markets, which are historically slow and methodical. The Europeans are the most concerned about these policy changes given that Germany and Japan are two of the most export-dependent economies in the world. A weaker yen is a direct threat to Germany's major export industries. This past week, Jens Weidmann, the head of the German Bundesbank, warned that countries like Japan and Hungary are "threatening an end to central bank autonomy."[2]

The Japanese counter that Germany has been the most advantaged country in the world the last 20 years and has used the fixed exchange rate within the eurozone to dramatically boost its export markets, much of it at the expense of the Japanese. In fact, the Japanese policy inconsistencies in the last two decades have in many ways allowed it to be one of the biggest shock absorbers for many other countries in the world. The fact that the yen, even after a 20% move lower, remains more expensive than it was in 2008 shows that a major shift hasn't yet happened. But in a world where every country is fighting against every other country for any hint of growth, the fervent response to the new Japanese policies is not surprising.

Should We Fear a Currency War?

If Japanese policymakers continue to try and push the yen lower and succeed in moving it near to ¥120 to $1, there is likely to be retaliation. That is probably unlikely and thus the current rhetoric will die down as it has done many times before. But if the Japanese are able to push things that far, then the Europeans will have to respond and drive the euro down. At that stage, we would be much more concerned that a total global currency war could be underway.

Clearly, the equity markets are not fearful of the possibility of an imminent problem. So far in January, many global equity indexes have been hitting new multi-year highs. We conclude that currency devaluations remain a risk as they have for the last five years, but it is too early to become overly concerned. As with other economic and political issues, we will continue to monitor this situation and adjust our strategy if need be. But so far, it seems that a race to the bottom does not seem imminent.

Sources

1. Soros rose to fame in 1992 when his hedge fund took huge short positions in the British pound and eventually profited to the tune of $1.1 billion. The trade is often called one of the greatest trades in the history of the markets.

2. Steen, Michael. "Weidmann Warns of Currency War Risk." *Financial Times.* January 21, 2013.