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Saying No To Currency Wars

Swiss National Bank (SNB) surprised the markets with its move to peg Swiss Franc (CHF) to Euro (EUR) on September 6, 2011. The central bank has been worried over the appreciating CHF for a while now and had taken earlier measures to stem the rise. The measures were found to be inadequate prompting SNB to peg the currency. SNB is not alone in the race with Bank of Japan joining occasionally to prevent the appreciation. The other advanced economies' central banks like Fed and Bank of England are also accused of indirectly keeping their currency undervalued by extra easy monetary policies.

In September 2010, Brazil Finance Minister Guido Mantega termed this practice of trying to keep currencies undervalued as 'Currency War'. He again reiterated his point in July-2011 that these wars are not over only to see SNB taking a dramatic step to peg its currency in September-2011.

This paper looks at this issue of Currency Wars and central banks intervention in currency markets. It points how it is another form of trade protectionism and worsens economic outlook. It also sets dangerous precedents as these actions are coming from developed economies which are preachers of keeping currencies flexible. So far the interventions are limited in scope and scale but could easily escalate to more intensified currency wars if other countries join the fight to protect their currencies.

I. Economics of Currency Wars

We call them Currency Wars now but have been known as "Beggar Thy Neighbor" policies for a long time. The term emerged during Great Depression when countries were blamed for keeping their currencies undervalued to support their export sector which in turn led to higher growth. But this leads to other countries becoming poorer and hence the name Beggar Thy Neighbor Policy. If other countries also retort to using the same policies it leads to the whole world economy getting poorer.

During Great Depression, these wars escalated as countries were on Gold Standard exchange rate system. Under this system, the countries fixed their currency to the gold and were expected to maintain the peg. As money supply was fixed to gold there was not much pressure of inflation. Hence, central banks only looked at maintaining the value of the currency.

The central banks were required to play by the "rules of the game" for the gold standard to work. In other words, they were supposed to raise their discount rates - the interest rate at which the central bank lends money to member banks - to speed a gold inflow, and to lower their discount rates to facilitate a gold outflow. Suppose there is a technological innovation in US. As money supply is fixed, it would lead to lower prices in US. The prices of U.S. exports become cheaper leading to balance-of-payments surplus. This then led to gold to flow from the world to the US. The gold inflow increased the U.S. money supply, reversing the initial fall in prices. For the rest of the world, the gold outflow reduced the money supply and, hence, lowered the price level. The net result was balanced prices among countries.

This system came under strain during Great Depression. The countries could not expand money supply to protect their falling economies. Infact in US, Fed raised policy rates to prevent gold outflow to protect the currency. These initial moves by Federal Reserve are seen as one of the key reasons for the Great Depression. The countries were forced to abandon Gold Standard and look at ways to devalue their currency and keep it undervalued to push exports and overall growth. This policy of devaluing currencies led to the term “Beggar Thy Neighbor Policies”. The countries even retorted to numerous protectionism policies and raised trade barriers, worsening the outcome of the crisis and making it a global crisis.

II. Currency Wars in 2007 Crisis

One central and obvious lesson from Great Depression was not to engage in protectionism policies and intervene in exchange rate markets. Only if exchange rates depreciated due to market forces tracking weakness of the economy, it was deemed as fine. In this crisis, these lessons were taken seriously. In G-20 meetings during the crisis, countries pledged not to indulge in protectionism policies. Though, there are some instances of trade protectionism measures but are too few to raise any immediate concerns barring case of China which continues to rely on undervalued Renminbi for its growth.

However, the emergence of currency wars came from different sets of policies. The huge stimulus from developed economies’ central banks flooded the markets with their currencies leading to lower value of their currencies. This concern especially picked up in Sep-10 when it became apparent that Fed would initiate another round of quantitative easing (or QE2). Brazilian Finance Minister made his comment over start of currency wars in Sep-10 and this sentiment picked up after his comments.

Then some countries like Brazil, Korea etc used capital controls to prevent currency appreciation. Usage of Capital controls got a major boost after a controversial paper from IMF economists. They said that capital controls could be a part of the toolkit to prevent asset bubbles due to capital flows but it should be used as the last measure. They also added that countries having capital controls before the crisis were less affected by the 2007 financial crisis. These results from IMF were shocking to say the least as it came from an institution which vehemently opposed capital controls all along since its inception.

Quantitative easing coupled with currency interventions & capital controls (albeit limited) again raised concerns over emergence of Currency Wars as seen during Great Depression.

William Cline and John Williamson of Peterson Institute of International Economics (PIIE) in a research paper (Currency Wars? Nov-10) expand on this concept. They say that currency market intervention is justified only if the currency is overvalued and intervention does not really harm its global peers. They look at a list of 30 countries which are in the news for currency related issues against two metrics: the position of the currency vis-à-vis its equilibrium level and whether the country has been reported as intervening to affect the market level of its rate.

They calculate equilibrium value of currencies (called Fundamental Equilibrium Exchange Rate or FEER) looking at balance of payments. If a country is running large current account surpluses its currency should appreciate and depreciate in case it is having current account deficits. The nominal exchange rate is adjusted for inflation, as a country which has higher inflation its currency should depreciate to restore the real position. The list of 30 countries in respective categories is given in Table 1.

Table 1: Country Categorization by Currency Under (over) valuation in October 2010 and Exchange Rate Intervention in Recent Months			
	Undervalued	Approx Equilibrium	Overvalued
Intervened to prevent appreciation	China, Hong Kong, Malaysia, Singapore, Switzerland, Taiwan	Argentina, Indonesia, Israel, Korea, Philippines	Brazil, India, Japan, South Africa, Thailand, Turkey
No apparent intervention		Canada, Mexico, Sweden, United Kingdom, United States	Australia, Chile, Colombia, Czech Republic, Euro area, Hungary, New Zealand, Poland
Intervened to prevent depreciation			
Note: Because Hong Kong's currency board pegs the exchange rate to the dollar, and because Hong Kong has been running large current account surpluses, the economy is automatically considered to be in the category of intervention to prevent appreciation. *Source: Cline and Williamson (2010)*			

- Based on Table 1, following economies should not be allowed to intervene to prevent appreciation as their currencies are already undervalued and deserve to be corrected: China, Hong Kong, Malaysia, Singapore, Switzerland, Taiwan. These economies run large current account surpluses and should allow appreciation to resolve global imbalances.
- Whereas intervention by countries like Brazil, India, Japan, South Africa, Thailand, Turkey should be deemed as benign as they are trying to correct the global imbalances as their currencies are already overvalued.
- Countries like Argentina, Indonesia, Israel, Korea, Philippines have currencies at approximately equilibrium level and are just trying to prevent further appreciation so that it does not harm their trade balances. Even this intervention is likely to be benign.
- Countries in the other boxes are not intervening and hence there is no real problem there. Within them, countries like Australia, Chile, Colombia, Czech Republic, Euro area, Hungary, New Zealand and Poland have overvalued currencies and can intervene to prevent further appreciation.

Overall, the analysis points that intervention in currency markets should depend on the external position of the country. If some economies are running current account surpluses and are still intervening to prevent appreciation, it should not be allowed. There should be some framework to dissuade such economies. Whereas those economies which are running current account deficits and their currencies are appreciating, they should be allowed to intervene to balance their external account.

Now, this paper was written in Oct-10 but still provides a framework to think to think about currency wars issues. In May-2011, Cline and Williamson released an update estimate of fundamental exchange rates. Their analysis shows not much has changed.

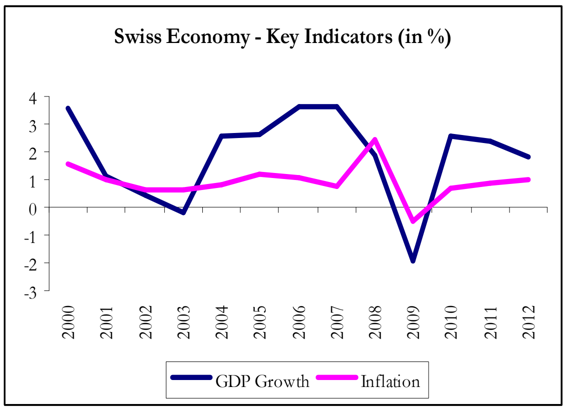
- The countries that need weaker currencies are those with large current account deficits like Australia, South Africa, United States and Brazil. These are countries with floating exchange rates that have been pushed to an overvalued level by (in most cases) capital mobility and the carry trade.
- The countries that need to revalue their effective rates are primarily Asian like China and countries that make it a priority to avoid losing competitiveness versus China like Hong Kong,

Malaysia, Singapore, and Taiwan. The other two undervalued currency countries are with floating exchange rates are Sweden and Switzerland.

III. Case of Switzerland

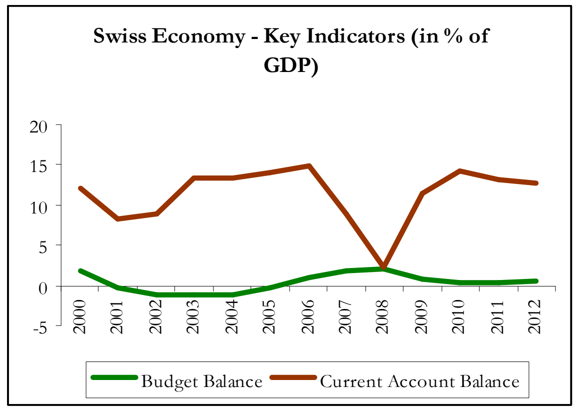
Switzerland is a rare economy with both budget and current account being in surplus especially in the context of developed economies where most have both these accounts in deficit (see our report - India in Twin Deficit Club – Implications and Issues (2-Feb-11) for more details). However, inflation remains low at around 0.9-1% which is leading SNB to maintain zero policy rates. SNB also expresses its concerns that appreciating CHF could depress economic activity and push already low inflation to a deflation. Switzerland also has a well-developed financial system making it easier to invest and deploy capital flows.

Figure 1



Source: IMF

Figure 2

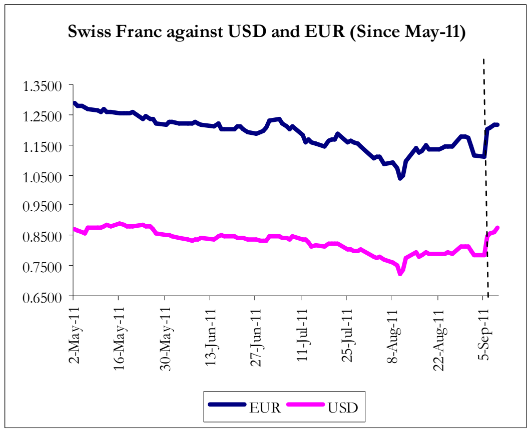


Source: IMF

Based on these indicators, Switzerland is currently placed as a suitable candidate for capital inflows leading to currency appreciation. The world economy is awash with liquidity as most central banks of advanced economies continue to maintain highly stimulating conditions. With bleak economic prospects of advanced economies, investors are looking to invest in stable economies. Switzerland suffered from the global crisis as it had a large financial sector but recovered much faster than other advanced economies. Part of the reason is its exports sector continues to do well. Switzerland is a major exporter of highly sophisticated goods like pharmaceuticals and precision goods whose demand did not decline in this crisis. After the initial shock, the demand for Swiss exports again picked up in 2009. Swiss also started exporting increasingly to Asia before the crisis and as Asia also recovered quickly post-crisis, demand for Swiss exports again rose. Hence, Swiss currency has become a safe haven currency for global investors.

The above quoted study categorises Switzerland as an economy with undervalued currency and should not be intervening to prevent appreciation. The analysis shows Swiss currency is undervalued by 13.3% in Apr-11 (compared to China's 22.2%). However, Swiss authorities think otherwise and have started to intervene in Swiss exchange rate markets since Aug-11. They have argued that CHF should depreciate as they are worried that lower growth in exports could lead to in Swiss economy. Given this background, let us focus on SNB moves in August-2011:

Figure 3



Note: Dotted Line indicates start of the Peg by SNB
Source: Swiss National Bank

- 3-Aug-11: Lowered Policy Rates from target range for the three-month Libor from 0.00–0.75% to 0.00– 0.25%. It also expanded bank deposits at the SNB from CHF 30 billion to CHF 80 billion to expand CHF liquidity.
- 10-Aug-11: As appreciation pressure continued, it led SNB to expand the bank deposits from CHF 80 bn to CHF 120 bn. CNB also decided to conduct foreign exchange swap transactions.
- 17-Aug-11: The bank deposits at SNB were further expanded to CHF 200 bn.
- 6-Sep-11: After some initial depreciation following above action, CHF again appreciated against major currencies. This prompted SNB to peg its currency at 1.2 CHF/EUR followed by a strongly worded statement:

  "The Swiss National Bank (SNB) is therefore aiming for a substantial and sustained weakening of the Swiss franc. With immediate effect, it will no longer tolerate a EUR/CHF exchange rate below the minimum rate of CHF 1.20. The SNB will enforce this minimum rate with the utmost determination and is prepared to buy foreign currency in unlimited quantities."

  SNB chief Philipp Hildebrand explained the need for this extreme action. He said it is a small and very open economy and every second franc is earned abroad. The massive overvaluation of CHF carries the risk of a recession as well as deflationary developments. The costs of such interventions could be very high but they still have to act given the enormity of the appreciating situation.

  SNB has now effectively set a floor for its currency and would ensure that it is not breached. As the figure shows, the EUR/CHF value depreciated within moments of announcing the peg to touch 1.20 levels and has traded around that level since then.

- 15-Sep-11: In its assessment of monetary policy, SNB enforced minimum exchange rate with utmost determination. SNB expects growth to slow in the second half of the year and expects inflation for 2011 and 2012 at 0.4% and -0.3% respectively. Hence, in 2012 it is already expecting deflationary conditions and any further depreciation will only worsen the problems.

The markets had not really digested the fact that SNB was intervening in forex markets as Switzerland belonged to a club of small open economies with highly liberalised markets. Such economies do not intervene in exchange markets and are used as examples for benefits of nonintervention. Now, this pegging of the currency completely surprised the markets despite market rumors that pegging of CHF could be implemented.

There were concerns from several officials regarding this move with Canada Finance Minister Jim Flaherty worried over unilateral forex action and currency wars. There were some initial reports on how hedge funds and other investors might speculate against CHF forcing SNB to break the peg like they did for Bank of England. So far, those risks have not materialised as currency trades at the peg level and it is only a few days old. With huge current account surpluses, CHF will always be a potential target for currency appreciation and SNB could be cornered by speculators in future.

IV. Concluding Thoughts

The above analysis opens up this debate on the issue of currency wars. There are two broad thoughts emerging from the above analysis. One, we need to look at currency wars in a new light. It is not as if all currency market intervention is a necessary bad as for some countries it may be justified. The global economic situations are such that some countries are suffering because of huge speculation and trading in their respective currencies. Hence, there is a need that these economies are allowed to intervene in forex markets and align their currencies in line with the fundamentals.

Second thought is the more traditional one where we look at currency wars with extreme alacrity based on our lessons from the Great Depression. There are concerns that with developed economies like Japan and Switzerland intervening aggressively, others may follow as well. Emerging economies and developed economies have already been using indirect measures like capital controls and monetary easing to support their currencies. Some emerging economies particularly from Asia which depend on export oriented growth have always been criticized for trying to keep their currencies weak. Hence, the moves by Swiss and Japanese authorities could lead the already intervening economies to become more aggressive and direct in their approach leading to an actual currency war as seen during Great Depression. This in turn could worsen the global outlook.

The first one is a more logical way of analysing the situation of currency wars but it is always difficult to justify the fundamental value of exchange rates. In the current economic situation it is the second thought which is likely to prevail and remains a major concern.

Some Economists point that times are different from Great Depression as markets are more advanced and there isn't an international shortage of gold reserves and instead there is an international shortage of monetary demand for goods. Then we could not print gold, but we can print paper money. So, as long as currency wars lead to loosening of global monetary policy, it should be fine. But this stance of easy monetary poliies has already been greatly criticised. Huge monetary accommodation by developed economies is being blamed for sharp surge in commodity prices elevating inflation levels globally. This has been sharply criticized by developing economies who have recovered smartly from the crisis but growth prospects are being hurt by inflation. Hence, any more monetary accommodation via the currency route is not going to be appreciated.

Therefore, global forums like G-7 and G-20 should remain vigilant to these risks and strongly condemn actions that lead to forex market intervention by respective countries. Saying No to Currency wars is critical and important.

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