Is a currency war brewing?

By Brian Milner

January 24, 2013 – *The Globe and Mail*

Talk of stick-it-to-your-neighbour currency wars has intensified dramatically in recent days as a growing number of central banks pursue policies to revive flagging economies that directly affect the value of their currencies. The question is whether this is just a lot of smoke or the first warning shots ahead of open hostilities.

The latest flashpoint involves the Bank of Japan and its setting of a higher inflation target of 2 per cent, backed by open-ended monetary easing. New Prime Minister Shinzo Abe has made no secret of his determination to combat crippling deflation and to bring down an overvalued yen to boost exporters' flagging fortunes. Both are key elements of an economic strategy that also involves a heavy dose of fiscal stimulus.

The Japanese central bank's quick adoption of the new measures has aroused concerns that its cherished independence is being eroded. Bundesbank chief Jens Weidmann bemoaned this dismal prospect the other day, citing "alarming infringements" of central bank autonomy in Hungary and Japan. He warned that such political interference could trigger a destructive round of "competitive devaluations" – which the major industrial and emerging countries have so far managed to avoid since the global financial meltdown of 2008 and the ensuing global recession. "Whether intended or not, one consequence could be the increased politicization of the exchange rate."

Indeed, monetary officials in South Korea, Russia, Sweden, the Czech Republic and several other emerging Asian countries have signalled their readiness to join the devaluation wave. Luxembourg Prime Minister Jean-Claude Juncker, who heads the euro-zone group of finance ministers, declared that the euro was "dangerously high" and Bank of England Governor Mervyn King observed that the British pound needed to be cut by 25 per cent to get the stumbling economy back on the rails.

But Mr. King also made some pointed remarks to a U.S. audience last month about the risk of currency wars that could drive the still recovering global economy into reverse. "You can see, month by month, the addition to the number of countries who feel that active exchange rate management, always to push their exchange rate down, is growing." Charles Plosser, president of the Philadelphia Federal Reserve Bank and a long-time opponent of the Fed's aggressive monetary easing, decried efforts of central banks to control the direction of their currencies, often at the insistence of governments desperate to kick-start growth. "We do not want to get ourselves in a world where you have currency wars. Beggar-thy-neighbour policies … would not be healthy."

No sensible observers are claiming we're about to revisit the vicious trade and currency wars of the 1930s. And some argue that there is no fire smoldering beneath the smoke. "Looking beyond the rhetoric, very little has actually changed in Japan," Capital Economics said in a note. "Elsewhere, an extended period of loose monetary policy in the advanced economies might put upward pressure on some emerging market currencies, prompting intervention and even capital controls. However, this could simply be part of the price that has to be paid for a sustained global recovery."

But the risks of more aggressive global protectionism – including deliberate manipulation of exchange rates – cannot be dismissed out of hand. Royal Bank of Scotland strategists concluded that this could be the year when "currency fracas morph into something more internationally combustible.” Their list of central banks most likely to join any hostilities include Sweden, Thailand, Malaysia and Chile.

Bank of Canada Governor Mark Carney sees no such threat among the leading industrial nations, noting that in the developed world, only Switzerland has deliberately followed a policy to cap the value of its currency. But plenty of other countries, including Canada, the U.S., Japan and the euro nations, would be delighted if their currencies happened to weaken without direct intervention.