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CURRENCIES AND CURRENCY WARS

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ABSTRACT

The purpose of this paper is to examine the global currency wars of the day. Besides that, it explains the major currencies. The fear of currency wars and the ways of dealing with them is discussed. Impact of currency volatility on the Indian economy is also part of the discussion. With low domestic savings, emerging economies like India have to go global to get more funds for investments. Competition was always there in the forex market. Now even wars have become common. Understanding and facing currency wars properly is crucial.

KEYWORDS: *Currency, Forex, Rupee, USD, wars*

JEL CLASSIFICATION: F2, F3, F31

I.INTRODUCTION

"Everybody is fighting their own unique war" – Anon.

In International business one of the important features is the presence of foreign exchange (Forex) or foreign capital, needed for trade and investment. In a narrow sense, Forex means the foreign currencies but in a broad sense the term Forex includes foreign currencies as well as their rates, types and determination in various market situations, forex rate control or management methods etc. The term "Foreign Exchanges" connotes the mechanism or organisation whereby world currencies exchange, the system or the business of exchanging currencies i.e. all those operations which spring from the exchange of different moneys or currencies. Major currencies include the U.S. Dollar, Euro, Canadian Dollar and Swiss Franc.

Forex markets are the most difficult or complex market to trade in as the exchange rates of countries are affected by so many factors like interest rates, liquidity, geo-political factor and so on. One must be thorough with concepts such as currency appreciation/depreciation, currency wars, parity, spread, digital currency exchangers and so on.

International Businesses use forex markets when they have need for money – for payments and investments. For example, a US company that has $10 million it wants to invest for three months. In US suppose the best rate on these funds may be 2% but in South Korea money market account, it may earn 12%. Therefore, the company may change its $10 million into Korean Won and invest it in South Korea. However, the rate of return it earns on this investment depends not only on the Korean interest rate, but also on the changes in the value of Korean Won against the Dollar in the intervening period. We must understand that it is not currencies *per se* that is important in international business but how they get converted, how their values change – appreciation and depreciation – and how currencies are in war (i.e. competitive devaluation) and currency crisis. Thus, currency types, currency buy-sell operations (even swaps), currency speculations are important. Foreign investments are increasingly significant even for the emerging economies like India. This is in-keeping with the trend of international economic integration. As Peter Drucker rightly says, "Increasingly world investment rather than world trade will be driving the international economy". International economics has witnessed currency wars which have led to serious crisis situations globally. Therefore, a study of currency wars is much rewarding both theoretically and practically. This paper examines the phenomenon of currency wars with special reference to the recent trends in this regard.

II.CURRENCIES

Forex is not a homogeneous commodity; it refers to various claims – of currencies, bills of exchange drafts etc. – on foreigners denominated in foreign currencies such as USD, Australian Dollar, Argentina Peso, and so on. There are different 'types; of currencies today – Soft, Hard, Hot and Exotic currencies.

- "Hard currencies" or strong currencies are fully convertible whereas "Soft currencies" (or weak currencies) are not fully convertible. They are typically from developing countries and they float somewhat independently, meaning they are priced by a free market, often close to their true values. Hard currency belongs to strong geo-political nation. It is highly liquid, easily accessible, and its value remains more or less stable over a period of time. It is most preferred currency by traders and investors. Their rates are well visible and accepted as they are under constant market scrutiny. However, compared to soft currencies it is difficult to forecast future rates of hard currencies. Example: US Dollar, Swiss Franc, Japanese Yen, Euro etc.
- "Soft currency" is a currency which is hyper sensitive and fluctuates frequently. Such currencies – also called weak currencies – react very sharply. Soft currencies are usually from countries that are not too stable (politically and economically) nor come in the category of "superpowers". Rates are too sticky (mostly officially cemented!). Investments and trade in such currencies is a high risk proposition. But investors willing to earn more over short-term can definitely go for such currencies, at their own risk. For traders, soft currencies are a big NO-NO. Its convertibility outside the host nation is very less thus no major international deal take place using soft currencies. Example: Zimbabwean Dollar.
- Very soft currencies are known as "Exotic currencies". "Exotic currency" is a foreign exchange term for a thinly traded currency. Exotic currencies are illiquid, lack market depth and trade at low volumes. Trading an exotic currency can be expensive, as the bid-ask spread is usually large. Exotics are not considered major currencies because they are not easily traded in a standard brokerage account. Examples of exotic currencies include the Thai Baht, Uruguay Peso or Iraqi Dinari.
- "Hot currency" or hot money is the flow of funds or capital (e.g. hedge funds) from one country to another in order to earn a short-term profit on interest rate differences and/or anticipated exchange rate shifts. These speculative capital flows are called 'hot money' because they can move very quickly in and out of markets, potentially leading to market instability. This happens in case of selective or top currencies. The top 8 Currencies are European Euro (EUR), British Pound (GBP), U.S. Dollar (USD), Canadian Dollar (CAD), Japanese Yen (JPY), Swiss Franc (CHF), Australian/New Zealand Dollar (AUD/ NZD), and South African Rand (ZAR). Flows of hot money can cause currency wars too.

There is no specific formula or rule which categorizes any particular currency as Hard or Soft. German Deutsche Mark was considered as a strong currency before Euro replaced it. Such incidents show that as an investor or trader you are advised to be sure about the Geo-Political as well as economic outlook of various countries. One must be wary and cautious while making any international deal as they can be indirectly affected by major international events.

III.CURRENCY WARS – DEALING WITH THE DEMON

Most of us have heard of Cold War and War on Terror. But forex market is now worried about another type of war, one fought on the financial battlefield and one most investors know little about: a so-called "Currency War." This we see also as a challenge to globalisation.

Currency war, also known as competitive devaluation, is a condition in international affairs where countries compete against each other to achieve a relatively low exchange rate for their own currency. "Currency wars," James Rickards writes, "are fought globally in all major financial centres at once, 24 hours per day, by bankers, traders, politicians and automated systems – and the fate of economies and their affected citizens hang in the balance." According to Alan Skrainka, chief investment officer at Cornerstone Wealth Management, currency war is "when countries use their currency as a competitive weapon." Simply put, it is when a country "engages in policies" meant to reduce the value of their currency in an effort to boost competitiveness by "stimulating exports and economic growth". Some examples and recent developments:

1. Currency War I erupted from the ashes of World War I in 1921 when Germany began its epic devaluation of the Mark – the one memorialised in pictures of wheelbarrows full of paper money that weren't enough to buy a loaf of bread.
2. The rest of the world race to devalue their own currencies to remain "competitive." France leaped first in 1925, devaluing the Franc. Britain abandoned the gold standard in 1931. The United States infamously devalued the Dollar against gold in 1933 – from $20.67 an ounce to $35. France and England devalued again.
3. Currency War II blew up in 1967 when Great Britain devalued the Pound against the Dollar. Soon the Dollar itself was under pressure – a matter complicated by the fact the Dollar was still tied to gold in international trade.
4. India's devaluation of Rupee – 1966 (Rs.4.76 = $1, after devaluation, Rs.7.50 = $1 i.e. 57.5%), 1991 (devalued by 18-19% from Rs.20.5 to Rs.24.5 against the US greenback).
5. The financial war game was made more intense by the fact it took place amid the market panic in late 2008 and early '09. Team Russia announced it would accept only gold in exchange for its oil and gas – no Dollars. Then Team China made its own move to "tighten the noose around the U.S. dollar's neck." As it happened, on the second and final day of the war game, Russia's Vladimir Putin declared of the Dollar, "The one reserve currency has become a danger to the world economy: that is now obvious to everybody."
6. The real currency war presaged by Putin began in early 2010. "The major economies of the world raced to the bottom, causing massive trade disruption, lost output and wealth destruction along the way." On Jan. 27, 2010, President Obama fired the first volley of Currency War III in his State of the Union speech. He announced the National Export Initiative. Its aim — to double U.S. exports in five years. "The traditional and fastest way to increase exports had always been to cheapen the currency," Rickards writes in his book, *Currency Wars*. And everyone around the world knew it.
7. In August 2015 the Chinese reduced the value of their currency (Yuan) this week in relation to the US Dollar, which should have repercussions in both markets. One, China's move suggests that its economy is in worst shape than believed. Second, a weaker Yuan means a stronger Dollar, and a stronger Dollar means U.S. products sold in China are more expensive, which means fewer sales of Apple iPhones, hotel rooms, and computer chips. Lastly, there is a fear that other nations will respond to China by devaluing their own currencies to stay competitive.

Why currency wars are feared? Currency wars are one of the most destructive and feared outcomes in international economics. At best, they offer the sorry spectacle of countries' stealing growth from their trading partners. At worst, they degenerate into sequential bouts of inflation, recession, retaliation, and sometimes actual violence. Currency wars affect both savings and investments. Exports become cheaper relative to imports but by creating too much supply and not enough demand, it will act as anti-growth and deflationary. Currency crisis can lead to banking crisis and debt crisis. Suppose there is a Dollar crisis, exchange rate devaluation can damage balance sheets if balance sheets (deposits or borrowings) are dollarized. We have seen this in the East Asian Crisis of 1997. Every action has potential for reaction or retaliation. For instance the recent China move to devalue its currency could be the first shot across the bow towards a wider currency war. However, some say that it is a pragmatic move to help a weakening economy. May be the market has incorrectly assumed China is now taking action to depreciate its currency, when in fact it is allowing market forces to determine the value.

Dealing with currency war requires dealing with hot currencies, i.e. short term money flows – by way of (i) zero-interest reserve requirements, (ii) Tobin Tax[1] , (iii) administrative actions, and (iv) keeping forex reserves > imports and debts due for the required period.

The current problem of hot money flows and currency wars is rooted in global imbalance. A coordinated plan by major economies is needed to ensure a balanced global economic growth. Some suggest a return to the Gold Standard, others say SDRs must have increasing role to play. What is needed is a set of prudential not retaliatory policies on the part of each country even if it is inconvenient for the moment.

Notes

[1] *A Tobin tax, suggested by Nobel Memorial Prize in Economic Sciences Laureate economist James Tobin, was originally defined as a tax on all spot conversions of one currency into another. Chinahas for the second time in October, 2015 raised the possibility of taxing foreign-exchange transactions as record capital outflows from the world's second-largest economy put pressure on the Yuan.*

IV. IMPACT ON INDIA

As far as India is concerned, some experts say that with a weak Rupee, India will have a competitive edge in exports and banking (ala Make in India Initiative). Another view is that "as China devalues, India must protect itself from a currency war that it cannot win." For instance, RBI Governor Dr Rajan won't play a ball. Why? He feels that it is good for India not to go for currency war now (i.e. better maintain the forex rate) because –

- India is already battling high inflation, and a weak Rupee will increase the cost of imports, especially the crude oil bill, which in turn will fuel inflation
- It will affect capital inflows badly. A weak rupee impacts their return on capital. For example, a lot of foreigners including private equity players invested in 2007-08 period when the Rupee was 40 against the Dollar. Today, the Rupee is at 64, which means more than 40% loss in terms of currency exchange. So they have to make supernormal profits to make money in India because of currency adjustment or pay a higher cost of hedging.
- India also has had to deal with high cost of capital. Currency is just one element that influences cost favourably if it depreciates or is devalued. Low and stable inflation is a prerequisite for lowering interest rates in the economy.
- India has to first improve the ease of doing business – upscale infrastructural facilities, for instance. Unreliable power supply, too many regulations, archaic labour laws and the bureaucratic system all create hurdles for Indian entrepreneurs and exporters. 'Make in India' campaign won't succeed if there are cracks in its economy.
- India has to focus on innovation. NR Narayana Murthy had hit the nail on the head when he recently remarked that India hadn't done any earth-shattering innovation in the past 60 years. If India becomes a factory to the world, like China, a weak currency is definitely the answer. But letting the rupee fall to support a few products won't help boost India's exports.

May be for the time being, it's better to let the Rupee "find its level" with the central bank stepping in only to curb volatility. Let's work for a level playing field. Meanwhile the good news is that the rupee has advanced in 2015 against 25 of 31 major currencies, and is 23% overvalued according to the RBI's trade-weighted index of exchange rates of India's six largest trade partners. It has strengthened almost 10% relative to a basket of 36 currencies, a central bank's measure of its real-effective exchange rate shows. The Rupee may come under pressure when the Fed hikes rates later this year, enabling the RBI to allow some weakness without damaging its credibility in meeting the disinflationary policy goal.

V.CONCLUSION

International business is growing by leaps and bounds. With a huge, diverse and complex forex market, currency wars cannot be simply wished away. Authorities must find effective ways of dealing with a war or at worse, a crisis. Competitive devaluation is going on even in India's neighbourhood. China has refused to buckle down under U.S. pressures and U.S. has started action. Common man does not see anything happening but economists and finance ministers around the world consider this as currency war and are worried. Not only U.S., other countries too must act wisely to avoid crash. The Rupee has become weak. It may come under pressure when the Fed hikes rates later this year, enabling the RBI to allow some weakness without damaging its credibility in meeting the disinflationary policy goal. Currency wars are not only matrix of concepts but also matter of crisis. There is however, no denying the fact that emerging countries like India need forex stability for economic growth and development. Both inward and outward flows of capital are part of the new growth strategy. Financial markets have become more volatile, and "globalisation" and "contagion" have been a part of the story. In the era of LPG we need, not stumbling blocks but building blocks for smooth flow of international capital. Stability must replace grave volatility and vulnerability. Effective and productive forex management is the need of the hour. Forex Management Act and other devices must be used with that objective in mind.

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