Currency wars will not have many winners

Steve Hanke

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In 2010, Brazil's Finance Minister, Guido Mantega, coined the phrase "currency war" when he complained about the "cheap" Chinese renminbi (yuan).

Mantega claimed this gave China an unfair trade advantage. As he put it to the "Financial Times", "We're in the midst of an international currency war, a general weakening of currency. This threatens us because it takes away our competitiveness."

That was then. Now the Brazilians are conspicuously silent, because the shoe is on the other foot. The Brazilian real has lost a whopping 25 per cent against the Yuan since January 2015. The currency wars continue and are every bit as intense as they were back in 2010, when Mantega coined the phrase.

But the conventional wisdom about the wonders of weak currencies long predates Mantega — economists and political leaders have been deceiving the public on the advantages of currency devaluations for centuries

The advertised goal of a devaluation is to increase the price of foreign produced goods and services and decrease the price of domestically produced goods and services. These changes in relative prices are supposed to switch domestic and foreign expenditures away from foreign produced goods and services towards those produced domestically.

This is supposed to improve the devaluing country's international trade balance and balance of payments.

For the public, this argument has a certain intuitive appeal. After all, a devaluation is seen as nothing more than a price reduction for domestically produced exports, and price reductions are always seen as a means to increase the quantity of goods sold. When it comes to currency devaluation, the analysis is not that simple, however.

Even if we use a narrow, Marshallian partial equilibrium model (one consistent with the common man's economic intuition) to determine the effects of a devaluation, the analysis becomes quite complicated. Contrary to the common man's conclusion, a devaluation will often result in a reduction of exports and a deterioration in a country's trade balance and balance of payments.

When the models become more general and inclusive, a light shines even more brightly on just how confusing and contradictory the arguments favouring devaluations are. Calls for devaluations, as popular as they might be, are a delusion.

But, without entering the technical weeds of economic analysis, it is clear why a devaluation strategy is a loser's game. In 1947, the famous Cambridge don Joan Robinson penned "Beggar-My-Neighbour Remedies for Unemployment". She not only coined the phrase "beggar-my-neighbour", but concluded that so-called competitive devaluations would be unsuccessful in achieving their advertised objectives.

Among other things, Robinson wrote that a devaluation would prompt a retaliation in the form of a competitive devaluation. Thus, the initiator of a currency war could, and would, always be neutralised — checkmate.

The case against devaluations is even stronger than this. In spite of their continued popularity, both economic theory and evidence fail to support them.

Let's take a look at the evidence. Real devaluations are supposed to lead to export booms. Real devaluations occur when the rate of a nominal devaluation exceeds the rate of inflation.

To grasp the intuition of this relationship, consider the case in which the rate of inflation is allowed to catch up with the rate of the devaluation. In that case, everything after the devaluation would be exactly the same as before it, except the rate of inflation would be higher.

Evidence from Indonesia, for the 1995—2014 period, is typical. When the rupiah depreciated in real terms against the US dollar, lower levels of exports were realised. On the other hand, exports were higher when the rupiah appreciated in real terms.

This is exactly the opposite of the relationship advertised by those who embrace devaluation strategies. They claim that real devaluations will make exports boom, and that currency appreciations will kill them.

The case of China, like that of Indonesia's, runs counter to conventional wisdom. China, from 1995—2014, is of particular interest and importance because the Yuan is at the Centre of the so-called currency wars.

The Yuan, in real terms, has mildly appreciated against the greenback, and Chinese exports have soared. These data not only poke a hole in the layman's notions about the wonders of weak currencies, but also illustrate why most politicians are ignorant of the basic facts, and could be successfully prosecuted for false advertising.

When we move beyond a country's exports to its GDP, we find the same picture: currency devaluations are associated with slower GDP growth. David Ranson studied the relationship between currency devaluations and GDP growth for 19 countries in the 1980—2012 period.

The results are clear: to slow down economic growth, call for a currency devaluation.

So, if devaluations fail to deliver more trade and higher GDP growth rates, what do they deliver? Well, one thing devaluations deliver is inflation.

If we measure the strength of local currencies by the price of gold in those currencies, a virtual one-to-one relationship between the increase in the price of gold in a local currency (a weakening currency value) and a country's annualised inflation rate exists.

In addition, devaluations deliver higher interest rates. When developing countries' currencies are devalued against the US dollar, interest rates in those countries go up.

This results because people with assets denominated in currencies that are depreciating demand higher interest rates to compensate for the local currency's loss in value relative to the US dollar.

The arguments supporting currency devaluations are utterly confused and contradictory supported by neither economic theory nor empirical evidence.

Steve Hanke is a Professor of Applied Economics at The Johns Hopkins University in Baltimore and a Senior Fellow at the Cato Institute in Washington, DC.