F O C U S: The Impact of Currency Wars

Issue in a Snapshot

A fresh outbreak of 'currency wars' will presage 'trade wars'…

…and significantly increase risks for cross-border trade and investment.

The key risks will be associated with uncertainty over government policy (which may experience sharp changes)…

…currency volatility (which is set to last for at least another 18 months)…

…and supply chain disruption (threatening already fragile profits).

The incidence of trade disputes between countries is set to rise, impacting on supply chains.

'Currency wars' (the manipulation of currencies) have been associated with downturns in the global economy as governments attempt to boost their ailing economies through export growth. If significant numbers of countries adopt these policies, risks for cross-border trade and investment increase dramatically as uncertainty rises. Therefore it is important to appreciate the impact on the global economy – and therefore on cross-border traders and investors – of leading currencies remaining out of balance.

Recent developments: the threat of new currency wars increases

The sovereign debt crises in the US and Europe have dominated the headlines as concerns rise that demand from emerging economies will not prevent a second recession. A further danger lurks behind the headlines: 'currency wars' and the attendant rise in protectionist policies, both of which threaten the efficiency of supply chains.

Many countries (particularly advanced economies such as the US and Europe) are finding economic growth difficult to achieve because of a lack of domestic demand: consumers and businesses are not spending. One way in which governments can try to drive economic growth is by adopting policies that increase their country's exports. There are various options for doing this, but a favoured choice is to depreciate the local currency, so that a country's goods/services become relatively cheaper on the global stage. A weak currency also increases the cost of imports, thus making domestic producers more competitive in the national economy, again driving growth.

Since mid-2008, a number of the large exporting countries have adopted policies that have resulted in their currencies remaining weak. The Chinese government is following such policies, and the renminbi remains under-valued. The US has been very critical of the Chinese government, but the US' own bursts of quantitative easing (QE), which were undertaken in an effort to underpin the economy, have impacted on the US currency, and the Chinese administration in turn argues that the US is also employing policies to ensure its own currency remains weak. Similarly, the UK has implemented QE to support the economy. Meanwhile, the sovereign debt crisis in Europe and politicians' failure to agree a long-term solution to the problems in Greece in particular has weakened the euro.

Outlook, and implications of current policy trends

All this has meant that three of the four reserve currencies (the US dollar, the euro, and the UK pound) are weaker than would be expected (the Japanese yen is the fourth reserve currency). Thus currency traders and investors have sought safe currency havens, which resulted in upward pressure on the Japanese yen and the Swiss franc: both have seen their value increase since the start of 2011, undermining these countries' export bases. Many of the problems stemming from these currency developments could be resolved if the Chinese government were to float the renminbi, but this looks unlikely to happen in the next few years; the renminbi will appreciate, but will continue to be perceived as under-valued by many of its trading partners. The position would also be helped by strong political leadership on the debt crises in Europe and the US; unfortunately, in our view this is unlikely to happen rapidly enough to ease tensions.

Currency wars can seriously affect the risks associated with doing cross-border business. Three key risks exist: policy uncertainty, currency uncertainty, and supply chain disruption. As countries attempt to offset weak currencies, governments can implement policies that affect cross-border business. One example is the pegging of the Swiss franc to the euro, which effectively devalued the Swiss franc overnight by 6%, leaving traders with an unexpected potential loss. Thus policy uncertainty feeds currency uncertainty; although currency volatility can be offset through hedging, this adds further costs to businesses, undermining profits amid already-shrinking margins. Currency volatility will remain a key feature of the global economy for at least the next 18 months. The final element is that countries with stronger currencies implement policies to protect their domestic sector: barriers to trade such as tariffs and import quotas threaten the smooth running of supply chains. In the 2008-09 recession, these policy changes were often imposed overnight, creating further uncertainty for cross-border trade and investment.