

A Currency War?

A few years back, the Brazilian Finance Minister warned of the possibility of a global currency war, or competitive devaluations in pursuit of domestic growth and employment. The expression has once again started attracting newspaper headlines, thanks to the sharp fall of the Japanese yen in recent months, following the call by Shinzo Abe during the election campaign: the currency has fallen from approximately JPY 79 per dollar to JPY 91, and from JPY 100 per euro to JPY 125, between November 2012 and now. Mr. Abe, who is now the Prime Minister of Japan, thought the fall was needed to counteract an economy in deflation and the trade deficit tripling from JPY 2.5 trn in 2011 to JPY 7 trn in 2012, partly because of an export fall, and also because of larger fuel imports following the closure of all nuclear power plants. Germany, Britain and other countries have expressed concern over the sharp fall of the Japanese currency. And, China wants to put the exchange rates issue on the G20 agenda for the mid-February Finance Minister level meeting.

Meanwhile, South Korea, Thailand, the Philippines, Norway and Russia and other countries have expressed worries about the strength of their respective currencies. Samsung, perhaps the world's most competitive electronics company, recently forecast a drop of \$ 2.8 bn in operating profit this year because of the rise of the won. These concerns are in sharp contrast to the benign neglect of the real appreciation of the rupee, its impact on manufacturing competitiveness, and the external deficit, by our business leaders, and policy makers in Delhi. To be sure, earlier this week, the central bank in its Macroeconomic and Monetary Developments Third Quarter Review 2012-13 stated that, *"Widening CAD (Current Account Deficit), which is at a historically high level, remains a constraint on monetary easing"* and that *"FII investment has flown into T-bills, enhancing the refinancing risks to external debt"*.

Even as the yen has depreciated (and so has the pound), the euro has continued to appreciate despite the fact that the long term problems in the euro zone have hardly been solved. In fact, the euro zone economy is likely to go into recession in the current year and a strong euro is hardly what the falling output needs. Coming on top of fiscal austerity, the exchange rate could strangle output. And, in a globalised economy, this would affect the zone's trading partners as well.

One of the accepted paradigms of exchange markets is that an increase in domestic money supply would depreciate the currency. This follows from the logic of the basic demand: supply curve: higher the supply, lower the price. This logic is largely true in the real economy but does not work well in the financial economy where, too often, falling prices reduce demand for an asset, and vice versa. Another *mantra* often repeated is that a growing economy puts upward pressure on the currency: actually, the yen had moved from JPY 147 in 1998 to below JPY 80 until recently, even when Japan was following loose monetary and fiscal policies, and the economy has been practically stagnant. The euro's strength also does not support either of the accepted paradigms. The fact is that increase in money supply through open market purchases of government or other debt securities, by whatever name, do not seem to affect the exchange rate; the same increase coming from direct purchases of foreign currencies in the market does depreciate the exchange rate. The latest example of the latter is the Swiss franc: in September 2011, the Swiss National Bank put a floor of CHF 1.20 against the euro, and promised to purchase as many euros as may be needed to keep the rate above the floor – and succeeded.

The disconnect between the real economy and financial markets is even stronger in equity prices. Partly because of ultra-low returns on bonds in US, euro zone and Japan, global equity markets have boomed in 2012, even as the IMF has reduced its growth forecasts. One example: the German DAX Index rose almost 30% in 2012, despite an economy in recession, political uncertainties at home, and economic uncertainties in the euro zone.

Are markets really “efficient” in the sense Eugene Fama coined the expression, producing prices fully reflecting all relevant fundamentals? Perhaps Lord Keynes was more correct in his analysis: *“markets can remain irrational far longer than you can remain solvent”*. He also compared market participants’ decision-making to a beauty contest where *“the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole”*. Therefore *“each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors We have (thus) reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be”*. Nowadays, we call this phenomenon the herd instinct.

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