Currency war: Biggest threat to Asia and the rest of the world

Never mind about North Korea; the talk in some quarters is that the biggest threat to Asia and the rest of the world today may very well be a "currency war," in which countries race to devalue their currencies in a desperate attempt to stimulate growth.

Yet the reality is much different. It is really a debate about how industrialized countries will grow out of their economic malaise, and even the term "currency war" is being misused.

That catchy phrase was first uttered by Guido Mantega, the Brazilian minister for finance, in 2010. What he was referring to was actually something more complicated than countries racing to depreciate their currencies, which is what most people refer to today when they use the phrase.

Instead, Mantega was really talking about the United States. The huge quantitative easing undertaken by the Federal Reserve has created an environment of low interest rates and put downward pressure on the dollar while pushing the currencies of other countries up.

As they say in physics, every action has an equal and opposite reaction, and the Fed's actions have pushed hot money into countries, mostly emerging markets like Brazil, with higher interest rates. This creates bubblelike asset prices and spurs inflation.

Normally, the response of Brazil or another such country would be to ease its monetary policy and possibly also lower interest rates in an effort to tamp down demand for its currency. The problem is that Brazil has stubbornly high inflation at 6 percent and can't respond the way the United States could.

And that is what is really going on with the world's currencies. Bigger, more mature countries are responding to their own economic downturns by adopting easy money policies. But the problem is that the emerging market economies can't respond with similar effectiveness because of their own economic or political issues.

Nonetheless, the currency war talk has been revived because of an alarming fall in the value of the Japanese yen, which is down more than 20 percent against the dollar since November. The decline has reaped billions of dollars for hedge funds betting against the currency. It's nice for these already rich traders, but there will also be yen losers, with potentially bigger consequences.

The slide in the yen is a product of an effort by Japan's new prime minister, Shinzo Abe, to revive the no-growth, no-inflation Japanese economy that has been mired in stagnation for more than two decades.

Abe is not only openly advocating an inflationary policy with a 2 percent target, and more stimulus, he is talking down the yen. And this week, Japan is expected to appoint a new head of the Bank of Japan. Whoever that may be is expected to be on board with Abe's plan for further stimulus and inflation, a course that is likely to result in further yen depreciation.

As a result, Japanese exports have suddenly become significantly cheaper. And when an exporting powerhouse like Japan devalues its currency that quickly, other nations suddenly find that their goods are much less competitive on the global marketplace.

(Economic Times)