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Depreciation: A double edged sword

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Industrialised countries are heading for a currency war, depreciating their exchange rates.

A currency war refers to a country making its currency cheaper so that it can increase its exports, thereby promoting its own growth.

Known as "beggar thy neighbour remedy", it results in exporting unemployment to others. Of course, it works only if others do not retaliate, by paying back "in the same coin".

Depreciation and devaluation

Industrialised countries have a floating exchange rate regime under which exchange rate is determined by a free play of supply and demand forces. If country's expenditure on imports of goods and services from overseas is more than its export earnings, its currency goes down in value. It is known as depreciation.

Under a fixed exchange rate regime, countries such as Fiji do not have to worry about daily outcome interplay of supply and demand. The rate is fixed until changed by authorities. If they reduce the value, it is known as devaluation.

For defending the exchange rate, if out of line with fundamentals, a country must have sufficient foreign reserves. Otherwise, devaluation is the eventual outcome, as it happened in Fiji in 2009.

The falling values of the US dollar, British pound and euro are by-products of money creation by central banks. They have been pumping money into their financial systems ever since 2009.

The objective is to lower the interest rate and encourage investors to borrow and banks to step up lending. Due to perceptions of borrowers and lenders about the future in a contracting economy, credit flows have not increased.

The latest to join them is Bank of Japan (BOJ) in cheapening their currencies, known as quantitative easing (QE). Under this, a central bank buys the government and private debt and injects the money into the banking system. The fear of inflationary potential from money creation is real. However, encouraged by absence of inflation, industrialised countries are on a money creation spree.

Leading central banks have inflation targets.

The idea behind the target is to have a threshold, beyond which any expansionary policies will hurt growth. The target rates of European Central Bank, the US Fed and Bank of England (BOE) are 2 percent.

Based on past trends in Fiji's growth and inflation, a research study by academics, Hong Chen and Markand Bhatt of USP and this author suggests the threshold level of Fiji's inflation as 3.6 percent.

Until recently BOJ's inflation target was 1 percent. Japanese prime minister, Mr. Abe wanted BOJ to raise the inflation target higher and print an "unlimited" amount of yen as a measure to help fight falling prices. The BOJ raised the target rate to 2 percent and is now doing QE.

Unwanted by-product

The QE has debased the world currencies. The US dollar has been declining against all currencies since 2009. After BOE announced further QE on February 20, the British pound plunged to new lows. It fell to $1.5284, and to 1.1450 euros.

The Japanese yen too depreciated by 15 percent against the US dollar in January. The BBC announced the trade data on Thursday.

Japan's exports, which were hurt by the slow recovery in USA and the euro debt crisis, made the first jump in eight months. Due to weakening of the yen, exports to US rose by 11 percent and to China by 3 percent.

Depreciation is a double edged sword.

While exports become more affordable to foreign buyers, a weakened currency renders the imports more expensive.

Fiji's consumers would remember very well the fallout of the 2009 devaluation.

The BBC reports that the biggest jump is in the cost of Japanese imports of liquefied petroleum gas (LPG), which surged more than 28 percent. Since Japan has stopped its nuclear power generation, its dependency on fuel imports for power generation has grown.

The net result of depreciation of the yen is disappointing.

Japan’s trade deficit in January is a record: a rise by 10 percent from a year ago.

The out-going BOE Governor Mervin King’s claim that a depreciating currency would spark an export-led recovery is under scrutiny. The pound has been falling since 2008 but British exports have not performed better. The reason seems to be that British exports have been to slow-growing European economies, rather than emerging economies and Britain is not producing goods which are wanted by Asia.

It is not the price competitiveness of exports that is critical. The quality and design are more important.

As the French saying goes, *plus ça change, plus c’est la même chose*.

“The more things change, the more they stay the same.”