The myth of currency war

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Reading the financial media recently leaves one with the impression that the world is on the brink of a 'currency war', i.e. competitive devaluations that could bring misery for everyone in their wake.

However, the perception of an imminent 'currency war' is based on a big fallacy. We know from a standard textbook on macroeconomics that, in a world of free capital movements, it is not possible for a country to control its exchange rate and pursue an independent monetary policy (e.g. under an inflation-targeting regime) at one and the same time. So, central banks are facing a trade-off and, indeed, since the 1970s most countries have chosen to let central banks pursue independent monetary policies, resulting in more or less free-floating exchange rates.

It is fair to ask whether the concept of 'currency war' makes sense at all in a modern world dominated by relatively free-floating currencies. The reason that, not least, the Federal Reserve and the Bank of Japan have chosen to keep policy rates at rock bottom and introduce quantitative monetary easing is their aim of boosting domestic demand and so countering the deflationary trends that have accompanied this crisis. This, in turn, has weakened the US dollar and yen, which some have erroneously construed as an attempt by the central banks to 'steal' competitive advantage.

Monetary easing, which has been the name of the game in the US and Japan, not least, since mid-2012, boosts GDP growth and so is *good* news for the US and Japanese economies. However, it is *also* good news for the global economy. The US and Japan are among the largest importers of goods and services on a global scale, as quite a large share of US and Japanese consumption and investment demand is met by imports. Hence, when demand increases in the US and Japan, it is good news for world trade.

This is also the experience of the 1930s. The countries that were the first to abandon the gold standard and ease monetary policy, such as Denmark in 1931, saw a pickup in domestic demand growth, which was met in part by higher imports. This benefited the world economy at the time, including the countries that maintained the gold standard. So, developments in the 1930s should not be seen as a haunting spectre of what is in store for us – on the contrary. Then, as now, monetary easing led to a recovery in the global economy and stronger growth in world trade.

The euro – and hence the Danish krone – has strengthened in the wake of monetary easing by the Federal Reserve and the Bank of Japan. The perceived wisdom is that, *other things being equal*, this is bad for the Danish economy, as it makes it harder for Danish exporters to sell

their goods abroad. However, this view is based on a faulty analysis, as other things are very rarely equal. As we have shown in a recently published research note, the *reasons* for the strengthening of the euro hide substantial benefits for Danish exports. Indeed, the euro strengthening should merely be viewed as a *side effect* of monetary policy measures that are set to boost global GDP growth. Stronger growth in the world economy is good for both Danish and European exports and should more than offset the short-term competitive losses. As such, we expect monetary easing in the US and Japan to have a net *positive* effect on Danish export growth on a 6M-12M horizon.

Obviously, it is of vital importance that those countries that see their currencies appreciate do not resort to countermeasures in the form of increased protectionism, which would curb world trade. Instead, they should be pleased with the strong contribution that monetary easing by the Federal Reserve and the Bank of Japan has made towards preventing an outright eurozone collapse.

Thus, the view that recent monetary action should be bad for the global economy is a myth. Critics should at least explain what they would put in place of monetary easing during a period of weak demand growth and persistent deflationary trends.

Indeed, investors do not seem overly concerned, with the Danish and German equity markets rising more than 25% since summer 2012. So, if this is ‘war’, one could be tempted to wish for more of the same.