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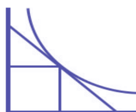

"THE OPTIMAL BUNDLE"

SPRING SEMESTER 2014: VOLUME ONE
WEEK OF FEBRUARY 10, 2015

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Special Report on the Currency Wars

What are the currency wars? In general, a currency war is the condition where countries devalue their currencies to compete against each other to achieve relatively low exchange rates. Lowering the exchange rate makes a country's exports cheaper and imports more expensive, thereby having a positive effect on its trade balance and current account. Several central banks have lowered interest rates over the past year to stimulate their economies, consequently creating conditions resembling currency wars.

The Far East Races South

There is a race to the bottom happening in East Asia. Export-heavy countries like Japan, Singapore, and Taiwan have watched their currencies depreciate over the past few years. Japan has taken charge in this race to the bottom as the Yen has shed 54% of its value against the U.S. dollar since February 2012. The drop has been exacerbated by the Bank of Japan's quantitative easing, which has put pressure on other export-heavy countries to copycat and depress their currencies. Since the announcement of Japanese QE in April 2013, the Singapore dollar and New Taiwan dollar have lost 10.5% and 7% respectively relative to the U.S. dollar. The depreciation is due to a cocktail of the recent strengthening of the U.S. dollar and Asian central bank intervention. If natural strengthening of the USD does not satisfy the export desires of Asian central bankers, FX traders could see an Asian currency print-off and the race to the bottom would accelerate.—GM

Bank of Japan Haruhiko Kuroda has presided over the devaluation of the Yen.

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Petróleo Brasileiro SA is subject to an investigation by Federal Police of an alleged bribery and kick-back scheme.

The Currency Wars Reach Latin America

Whether or not it wants to be, Latin America is now officially included in the global currency war. This past week, Peru's new sol fell 0.4% to 3.015 per USD hitting its lowest point in six years. *Bloomberg Businessweek* writer John Quigley argues these sudden cuts are a consequence of a low demand for copper, which accounts for almost a quarter of Peru's exports. While Peru is purposefully signed on to the currency war, other countries like Brazil have become casualties. In a *Bloomberg* report of 31 countries, the Brazilian real decreased the most since the beginning of the year, weakening 2.8% to 2.679 per USD. This happened after Moody's Investors Service, a bond credit rating business, cut state-owned Petróleo Brasileiro SA's credit rating to junk status due to corruption allegations. The currency war has engulfed the entire region, and while Brazil will have its chance to bounce back from the battle, Peru will be able to further engage in the war...if it dares.—CM

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Switzerland: A Tenuous Frontier

Of all of the countries engaged in a "currency war," Switzerland is the one furthest out on the front lines. In mid-January, the country shocked investors by removing the franc's peg on the euro in an unannounced decision. To weaken the franc and make its exports cheaper, the Swiss National Bank cut short term interest rates below -1%. As a response to the European Central Bank's implementation of quantitative easing, the process may have worked too well. The benchmark index of manufacturing activity dipped to 48.2 last month, around 2.5 points below the expectations of many economists. An index under 50 signals an economic contraction. However, Switzerland may target a corridor rate for the franc at 1.05 to 1.10 per euro, in comparison to its value at 1.20 in mid-January. Considering the worldwide race to the bottom, it seems that the Swiss is once again entering a battle it cannot win without hurting itself further.—RG

Swiss National Bank Vice President Jean-Pierre Danthine said the franc's peg to the euro "must remain the pillar of our monetary policy" just three days before it was removed.

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Will the Currency Wars Do More Harm than Good?

Pro: War, what is it good for?

When the Greek king Pyrrhus suffered heavy casualties in a victorious battle, he remarked, "If we are victorious in one more battle with the Romans, we shall be utterly ruined." Similarly, as central banks in Europe, Australia, Japan, India, Vietnam, and other economies weaken their currencies against other nations, the economic costs could be disastrous. It is in each central bank's self-interest to lower interest rates to stimulate domestic growth through a more favorable trade balance. Yet, Bank of America Merrill Lynch strategist David Woo warns of the danger of this currency war: "if everyone is playing the same game, all we will end up with is more and higher [foreign exchange] volatility." Thus, the only gains from this war will be Pyrrhic victories.

The risks of FX volatility arising from depreciating currencies have grim implications for international trade in goods and capital. Higher FX volatility increases the riskiness and cost of cross-border transactions, along with the costs for investors who hedge currency exposure. Uncertainty gives firms an incentive to focus on their home countries, resulting in weaker international trade and slower global economic growth. According to Woo and fellow BAML strategist Vadam Iaralov, this chain of events is foreseeable because current FX volatility is at its highest level since the financial crisis in 2008. Incidentally, uncertainty in the aftermath of the financial crisis produced the steepest global trade decline since World War II. The looming economic threat lies in the irony that humans are averse to risk amidst uncertainty that produces the outcome they wanted to avoid.

A major pitfall of a currency war is that an economy is susceptible to lose even if it does not participate in it. U.S. corporate earnings have taken a hit, as nearly every currency depreciated against the dollar in 2014. American companies like Procter & Gamble, Johnson & Johnson, and Pfizer reported hits in their earnings because foreign revenue translated to fewer dollars. This predicament could worsen if the Federal Reserve raises interest rates later this year, as Barclays Capital economist Michael Gapen predicts. The trap of currency wars has been laid for combatants and bystanders alike. Onward, march!—JK

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Con: (Not) Absolutely Nothing!

Loud denunciations of "currency wars" and "competitive devaluation" nowadays are just that: loud. They produce an awful lot of sound, but not a lot of substance. Finance commentator and author Jim Rickards' 2011 book *Currency Wars* absurdly suggests the Federal Reserve's quantitative easing program is part of a dollar-crashing currency war as a result of devaluation—even calling it "the greatest gamble in the history of finance." Rickards' claim that QE is a gamble that could bring catastrophe distorts reality. Devaluing currencies, particularly through QE programs, can avert economic stagnation in its home region and abroad.

Economists like Ben Bernanke and others have shown Rickards' monetary policy prescription is misguided at best and dangerous at worst. Cutting interest rates to zero and engaging in massive bond-buying programs has not caused the crash-and-burn devaluation that Rickards predicted. Research from the San Francisco Fed also shows that QE2 alone boosted real GDP by over 0.5% per year for two years. In contrast, research from Goldman Sachs economists confirms that Europe's economic woes have been spreading due to too-passive monetary policy. Recent announcements of monetary stimulus from the European Central Bank not only help its member nations, but this boost also helps countries pegged to the euro. For example, 182 million Africans who use a currency pegged to the euro will now experience greater export growth due to this policy shift. Even if currency devaluation truly was a gamble, it would be a gamble worth making.

Devaluation too does not last forever, and no one suggests it should. Eventually, currencies like the U.S. dollar strengthen again and added strength often means more growth for other countries who likely need a boost. Adopting currency devaluation is meant to turn a downturn into an upswing, and failures to manage it do not discredit the policy itself. The proclamations that it would all quickly lead to a worthless dollar are wrong too. All of that is just sound and fury.—CL

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