Currency Wars: “Beggar Thy Neighbour” Policy

What is a Currency War?

A **currency war is a situation wherein devaluation of currency by one country is retaliated by a competitive devaluation from the other country**. For instance, if the United States were to devalue the dollar against the Pound Sterling and if the British retaliated with their own devaluation then the situation could be accurately described as a currency war. Devaluation is believed to cause growth in the short run. However, this growth comes at the expense of one’s trading partners. Hence currency wars are also known as “beggar thy neighbour” policy!

What Happens When a Currency is Devalued?

The devaluation of a currency has multiple effects. Usually they are considered good for the economy in the short run since they increase chances of growth. However, the growth happens at the expense of other economies. Some benefits that arise due to devaluation are as follows:

- **A cheaper currency makes exports cheaper**. Hence, when countries devalue their currency, they end up pricing their products attractively in the international market and as a result end up giving a major impetus to exports even if other factors such as productivity remain constant.
- A devalued currency also helps to stem imports since the goods produced by other countries tend to become more expensive as compared to domestic goods. Thus, the exports of other nations are negatively affected by currency devaluation.
- Since higher exports means higher production and therefore implies higher employment, currency devaluation seems like an effective mechanism to control unemployment in the nation. However, this ends up being an export of unemployment! This is because goods that will be exported from our country will replace goods being manufactured domestically in that economy and hence cause unemployment there. Therefore, currency devaluations do not create or extinguish unemployment, they just shift it from one country to another
- Lastly, currency devaluations can also positively impact the balance of payments as well as the balance of trade of a nation thereby solving many problems by correcting persistent macro-economic deficits.

Currency Wars: History

The modern world has faced at least two severe bouts of currency wars. They are as follows:

The first instance of a major currency war was witnessed after World War 1. Germany had basically started inflating at an unprecedented rate. They were doing so in order to be able to pay the damages due as a result of losing World War 1. However, other countries like France and Britain also followed suit. Soon these countries were following devaluations by other countries with higher devaluations of

their own. This continued for a long while until Germany ended up in a hyperinflation winning the race to the bottom! Other countries like France and Britain had also inflated significantly. However, their economy did not implode like that of Germany.

The next currency wars were sparked on by the Nixon shock. This is when President Nixon took the world off the gold standard. This was done with the intent to devalue the dollar and promote employment and exports in the United States economy. This would automatically end up promoting unemployment in countries that imported American goods.

The devaluation by the United States was swiftly followed by competitive devaluation by other nations following the dollar standard. The “beggar thy neighbour” policy of currency devaluations quickly became the norm. This round of currency wars ended with speculative attacks on many currencies and raging currency crises in several parts of the world.

The Present-Day Currency War

Some economists argue that we are facing a present-day currency war as well. However, the war is not so blatant and competitive devaluations, if any, are not immediate and there are often diplomatic reasons provided for pursuing them.

At the present moment, over 20 central banks in the world have followed the lead of Bank of Japan and the European Central Bank and have implemented expansionary monetary policies. Countries in the Eurozone as well as Japan were reeling as their economies were not competitive and incapable of exports given their currency valuations. As a result, they inflated their currencies and let the free market devalue it for them! This has led to increased exports from these nations to the United States.

At first the United States was not concerned about these devaluations. This is because the domestic demand was strong enough to absorb the excess goods supplied by these countries without adversely affecting any economic parameters. However, of late, the United States government and the Fed have started being vocal about their concerns.

The United States is now continuing its policy of quantitative easing unabated because it wants to devalue its own currency and remain competitive in a market where German and Japanese imports are becoming cheaper by the day! The modern currency war is not overt. Rather it is a covert operation.

- Japan seems to be devaluing its currency to boost its shattered domestic economy.
- The European Union is following a loose monetary policy which leads to devaluation in order to stave off the Euro crisis
- The United States is devaluing its currency by creating more dollars to protect itself from the effect of the 2008 subprime crisis

Thus, each of these nations has a pretext to inflate more and devalue its currency. However, none of this change the fact that the modern world is in a currency war and economic growth is not happening as a result of a growing domestic economy. Rather it is a result of the beggar thy neighbour policy being followed even by the developed nations.