The reverse currency war

With the dollar soaring and inflation rates reaching record levels, we may have entered a new era where countries seek to strengthen their currencies rather than weaken them.

Charles-Henry Monchau

Chief Investment Officer

PRIVATE BANKING

The term "currency wars" was originally a metaphor for what economists had long called "competitive devaluations". In the early 1970s, when exchange rates became floating, many countries felt aggrieved that their trading partners were deliberately pursuing policies to weaken their own currency in order to gain an advantage in international trade. As a result, some countries have implemented competitive devaluation policies in order to support their GDP growth and job market.

The currency war took on a new dimension after the 2008/2009 financial crisis. The central banks of most developed countries implemented relatively expansionary monetary policies in order to revive their economic growth and get out of deflation. As a result, their currencies weakened, which helped to stimulate exports and reduce trade deficits.

In Switzerland, our national bank had to make massive efforts to prevent the Swiss franc from becoming too strong. The SNB implemented a negative interest rate policy but also increased the size of its balance sheet by four times in order to make massive purchases of dollars and euros. The strength of the franc threatened our companies' exports and risked reinforcing deflation in Switzerland.

Since 2021, we have seen a paradigm shift. Several countries seem to want to resort to a reverse currency war. In other words, we have entered an era of competitive appreciation.

The world has emerged from deflation and is now facing record inflation rates. A strong currency is one tool among others to fight inflationary pressures. Comparatively more restrictive monetary policies help preserve the relative strength of the domestic currency.

In the United States, the strong dollar is partly responsible for containing inflation, which has reached levels unseen since the 1970s. In Switzerland, the SNB surprised the markets by raising rates earlier than expected and by announcing that the Swiss National Bank's balance sheet could now be used to buy Swiss francs. The stated objective was to contain inflation by lowering the cost of imported goods and services through the appreciation of the franc.

The situation is much more complicated for countries that have not yet entered into a monetary tightening cycle and that are de facto subject to the competitive appreciations of their trading partners.

This is the case, for example, in Japan, which maintains a strategy of controlling the yield curve in order to prevent a rise in 10-year yields, despite the rise in inflation at the local level (see our FOCUS note "Has the Japanese central bank created a monster?"). This monetary policy differential with the United States has resulted in a depreciation of the yen. The weakness of the Japanese currency makes the importation of energy and agricultural commodities even more expensive, further adding to inflationary pressures. Many economists anticipate an imminent change in course by the Japanese monetary authorities to prevent further currency depreciation and control inflation.

An almost comparable scenario can be witnessed in the Eurozone. Despite record inflation rates, the European Central Bank has kept its key rates in negative territory, weakening the single currency. While the old continent is highly dependent on energy imports, the weak euro is raising import costs and exacerbating inflationary pressures. The European central bank therefore faces a complicated choice: raising interest rates would strengthen the currency and bring down inflation. Nevertheless, at the same time, a tightening of monetary policy risks weighing on growth. In a way, the ECB is facing the same dilemma as many emerging countries...

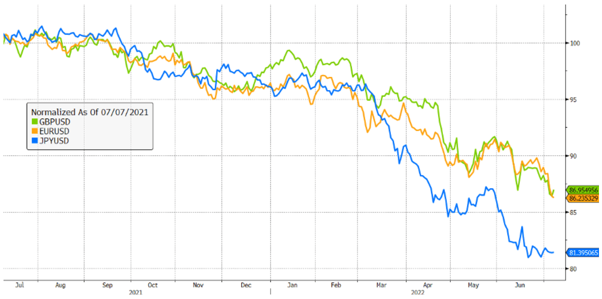
It is important to keep in mind that in both with competitive depreciation and appreciation, it is impossible for all countries to pursue identical strategies simultaneously, as they cannot all move their exchange rate in the same direction at the same time. Competitive depreciation and appreciation are often seen as evidence of a lack of international cooperation in achieving exchange rate stability and an optimized international trade system. It sometimes leads to calls for a new Bretton Woods-type arrangement to promote greater policy coordination.

Fighting inflation through a reverse currency war does not address the root of the problem, but rather creates a vicious cycle where the burden of inflation is passed from one country to the next. Analysts at Goldman Sachs have stated that central banks in influential, developed economies need to raise interest rates by 10 basis points to compensate for a simple 1% devaluation of their currency. If an increasing number of central banks further tighten their policies to preserve the strength of their respective currencies, the impact on global growth could be significant.

Today's economies are deeply intertwined, and sharp changes in the value of a benchmark currency such as the dollar or the euro are bound to have repercussions for all nations, especially those that rely heavily on imports. Moreover, as is often the case, it is the less wealthy countries that are likely to suffer the most. Therefore, not only do emerging markets have to worry about inflationary pressures, but they also have to worry about the risk of a debt crisis. Indeed, many of these emerging markets have dollar-denominated bonds, which increases financial pressure whenever the dollar strengthens. Even before factoring in this year's surge in the dollar, about 60% of all low-income countries were in a position of debt distress.

It would appear the famous adage "our currency, your problem" is more relevant than ever. The dollar still plays a central role at the heart of the global financial system and its strength means that the rest of the world must adjust its monetary policy accordingly. The new currency war could play a significant role in the evolution of the world economy over the coming years.

Strong valuation of the dollar against the euro, yen and pound



Source: Bloomberg

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
Fax +41 58 799 20 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com