DEVALUATION, INFLATION, AND POWER: A HISTORICAL LOOK AT CURRENCY WARS

Prerna Upadhyay[*]

ABSTRACT

The strong monetary policy actions undertaken by advanced economies' central banks have led to complaints of "currency wars" by some emerging market economies, and widespread demands for more macroeconomic policy coordination. This paper revisits these issues. It concludes that, while advanced economies' monetary policies have had substantial spillover effects on emerging market economies, there was and still is little room for coordination. It then argues that restrictions on capital flows were and are a more natural instrument for advancing the objectives of both macro and financial stability.

Keywords: Currency War, Economy.

INTRODUCTION – CURRENCY WAR

A currency war, also known as competitive devaluation, occurs when countries design to cheapen their currencies to gain a trade advantage over others. By lowering the value of their currency, a nation's exports become cheaper and more seductive on the global request, while significance becomes more precious, encouraging consumers to buy domestic products. This strategy aims to boost domestic diligence and employment. Still, if multiple countries engage in similar practices contemporaneously, it can lead to profitable insecurity and reduced transnational trade.

SAGA OF CURRENCY WAR

[1]In the 1920s and 1930s currency wars, colourful nations fell off the gold standard with deep devaluations. But under the postwar bone standard, the central position of the United States is

[*]BA LLB, THIRD YEAR, GAUTAM BUDDHA UNIVERSITY.

[1] https://kingcenter.stanford.edu/sites/g/files/sbiybj16611/files/media/file/479wp_0.pdf

crucial to maintaining the peace — as was true before the Nixon shock of 1971 upset it. Now, without important fear of retribution, the U.S. can initiate more limited warfare — as with American "Japan bashing" from the late 1970s to medial 1990s to appreciate the yearning, or "China bashing" since 2002 to appreciate the renminbi. Japan succumbed to this bashing, and the yearning did not appreciate too important in 1985 so Japan fell into a zero-interest liquidity trap and profitable recession for nearly two decades. Led by the United States, now all the mature artificial countries are in near-zero interest liquidity traps for their short rates. Beyond this, their central banks are addicted to unexpectedly massive "quantitative easing" to buy Treasury bonds and lower liquid securities to drive down long rates as well. These ultra-low interest rates beget lasting damage to fiscal systems throughout the world — including rising requests with naturally advanced interest rates. Exiting a liquidity trap for short rates when long rates are near "normal" is technically straightforward in a profitable sense; the central bank just lifts its interest rate target for feeding short-term reserves into the interbank request. Of course, it may be veritably delicate politically because no government likes high and rising interest rates.

But if long rates are comfortably above zero, adding short rates does not vitiate the general health of the fiscal system. In Japan, still, long-term interest rates have been near zero (lower than one percent) since the medial 1990s. Also, in trying unsuccessfully to escape from profitable recession, Japan has followed a "Keynesian" strategy of running with veritably large financial poverties so that gross government debt is the world's largest — about 214 percent of GDP. But Japan's public saving rate has also been veritably grandly, so the debt is nearly all internally held. Japanese banks and other fiscal institutions are chock-full of Japanese government bonds (JGBs) most issued in yearning with low pasteboard rates reflecting the low request rates in the neighbourhood of 1 percent prevailing at times they were issued. The massive effects of low-yield JGBs by Japanese banks effectively tighten the liquidity trap that Japan faces. Any policy that is designed or apropos tends to raise interest rates in the long term and will beget massive capital losses to bondholders, aka the banks. Most recently, the new government of Shinzo Abe introduced extreme quantitative easing in financial policy to drive yields to maturity down to lower than one percent. This implies indeed small interest changes when the position of interest rates is veritably low will lead to relatively massive changes in the current capital values of long-term bonds.

A currency war is a type of economic warfare instead of using planes tanks and guns to damage another country you use financial instruments instead in the past few years you may have heard of trade wars when one country decides to tax goods from a foreign country to either protect a domestic industry or to encourage a foreign country to get rid of their tariffs. Well currency wars are similar to that except instead of manipulating tax rates you're manipulating monetary policy in interest rates currencies from different countries are out in the global economy and they all have value about each other some currencies like the us dollar the euro or the pound are worth more than pesos or yen. Having a weaker currency can encourage foreigners to buy stuff from your country for relatively cheap. A currency war is when multiple countries are trying to devalue their currencies to gain a trade advantage over each other, this phenomenon is rather new because the technological means for it did not exist before the early 20th century. When the first currency war was fought, currency war was triggered by the monetary policies of the First World War. Before the war, the global economy operated on an international gold standard. In the international gold standard, all the participating countries publicly declare their currency to be worth a certain amount of gold this allows paper money from any country on the gold standard to be exchanged for gold in any other country, also on the gold standard when one country's gold supply goes too low their banks would raise their interest rates while banks and countries with higher gold supplies would lower theirs this would result in gold moving from banks with low interest rates to banks with higher interest rates.

This mechanism kept the international gold supply in equilibrium and so long as the rules are followed it continues to function properly. However, wars don't just result in the rules of politics and civility following the way they also result in the rules of economics being ignored. World War 1 was expensive and supplies of gold would have run out quickly had they kept to a gold standard so most of the countries involved in the war abandoned the gold standard to prevent all of their gold from flowing out of their banks. The central powers used fiat money printing more as needed to fund the war effort. This radically increased the supply of paper money floating around in their economies but luckily the velocity of money was also high meaning that there were always places for that money to go. But when the war was over the demand for military goods was gone and thus this excess money suddenly had nowhere to go thus inflation occurred.

INFLATION

All the European powers saw this happen but Germany would see the worst of it the treaty of Versailles placed burdensome, reparations on Germany which were required to be paid in gold marks this resulted in whatever gold Germany had left being gradually given to France, Britain and the United States. But there wasn't enough gold left to operate a domestic economy as well so Germany didn't restore the gold standard after the war. The government still needed money to operate so in 1921, the Reichsbank began to buy government bonds paying for them in newly printed Deutsche marks. This money was used to pay government workers which eventually made its way into the private sector thus causing inflation. For people who were in debt, this was beneficial considering that they could pay off their old debt which was nominated in Deutsche marks with the new Deutsche mark that wasn't backed by gold rather than the old one that was. Business owners and banks could initially survive as well considering that they both held on to a lot of non-liquid assets and the value of these non-liquid assets went up as the Deutsche marks were devalued. The wealthy were also initially safe because they could get their money out of German banks and into foreign ones. On top of this people who worked for the government or worked in trade unions were also pretty safe because their salaries by law went up commensurate with inflation which meant that the people who were screwed the most were either those who didn't own property or those who were employed in the private sector.

HYPERINFLATION

In 1922 inflation turned into hyperinflation the Reichsbank continued to print more and more money to meet the demands of government and union workers, but the more they did so the worse the problem got. [2]You have the infamous stories of people needing a wheelbarrow full of money to buy a loaf of bread, and customers offered to pay for meals at restaurants in advance because the price of the meal would go up between having ordered their meal and when they finished eating. By the end, they were printing so much money that they were only printing on one side of the currency to save ink. In 1922 the international community tried to re-establish an international gold standard at the Genoa conference, unlike the original gold standard which involved every currency being backed by its supply of gold the new standard allowed banks to substitute gold with another gold-backed currency. Since the United States was one of the only countries involved in the war to not go off the gold standard its currency

[2] https://www.econlib.org/hyperinflation-in-germany-1921-1923/

was the favored one to substitute gold in most bank reserves. This new gold standard didn't quite have the desired effect because gold continued to accumulate in countries with strong currencies like the United States while weaker countries continued to face gold shortages. Out of fear that Germany's monetary policy was going to their ability to pay their reparations in the future France occupied the Rohr valley in western Germany to secure payments. The Germans didn't like this so union workers in the Rohr responded with slowdown strikes and sabotage the Reichsbank approved of these actions and rewarded the unions by printing them additional money for wages and benefits, which subsequently made the hyperinflation worse.

On November 8th, 1923 the national socialist party led by Adolf Hitler attempted a coup in Bavaria called the beer hall push. The coup was squashed but this was a sign that things had gotten really bad so on November 15th, the Reichsbank introduced a second currency that would circulate alongside the old mark called the Renton mark which was backed by mortgages and property taxes one rented mark was valued at one trillion old Deutsche marks the next year the Reichsbank introduced a new gold back mark leaving the old marks worthless. These years of economic chaos in Germany created high levels of distrust in public institutions. The bankers had wrecked the economy and it was the wealthy who benefited the most all the while foreign powers were either invading their countries or trying to foster revolution.

Things did start to get better in 1924, not only was there the issuance of the new back Deutsche mark but also the United States introduced the dates plan which reduced the amount. The Germans had to pay in reparations as well as opened up lines of credit from us banks to Germany for them to continue paying the reparations they still had to. It also introduced the introduction of a new gold standard from the Genoa conference. However, this new gold standard would be short-lived.

In 1925 the gold standard act was passed in the up which returned the pound sterling to gold, when countries were debating whether to return to the gold standard a sub-question was at what rate? Should they return to the same pound the gold ratio they had before the war, or readjust the value to meet the demands of where the economy was now? When France and Germany returned to the gold standard they chose the latter, choosing to devalue their currency against their current supply of gold. But in 1925 the UK government at the insistence of the chancellor of the ex-checker Winston Churchill decided to return the pound sterling to its pre-war value. This required the UK government to pull millions of pounds out of circulation which caused deflation, this put the UK into a deep recession and weakened its economic growth, especially

in comparison to France and Germany. Winston Churchill later said that this was one of the biggest mistakes of his political career.

The new exchange rate would begin to fall apart in 1927 both, France and the US had high levels of gold reserves while the UK had low reserves. Under the rules of the international gold standard France and the us should have lowered their interest rates and the UK should have raised their own to encourage the movement of gold. However, the UK was refusing to increase their interest rates because doing so during a recession would be politically unpopular, but on top of this the British accused France of intentionally undervaluing their currency to maintain a trade advantage. The United States was the only one of the big three gold countries that was still following the rules of the international gold exchange unfortunately they would be breaking it themselves soon enough.

In 1928 the Federal Reserve began increasing its interest rate out of concern that the stock market had been inflated too much. Stock prices in the US went up because more and more money were being funnelled into it and this was done because there weren't any foreign assets worth investing in because France, Britain and the rest of Europe refused to follow the rules of the gold standard by increasing their interest rates. In 1928 Germany went into a recession which was made worse by the stock market crash of 1929 bad was stacked on top of worse when the us passed the Smoot-Hawley tariff in 1930, which overlaid a trade war on top of a currency war.

Things continued to get worse in [3]1931 when the Bank of Anstalt, Vienna announced its losses which wiped out its capital assets. This triggered bank runs around the continent and resulted in bank holidays being declared in Austria, Germany, Poland, Czechoslovakia, and Yugoslavia. Gold quickly began to flow out of British banks which forced them to abandon the gold standard on September 21st this was shortly followed by commonwealth countries as well as Japan and Scandinavia also abandoning the gold standard. The worsting economy resulted in incumbent US President Herbert Hoover losing the 1932 election to Franklin Delano Roosevelt the most economically illiterate and financially incompetent president to ever hold the office. His first major act was declaring a bank holiday which he did with the Trading with the Enemies Act which had been passed in 1917. It was one of the few pieces of economic

[3] https://www.cambridge.org/9780521365376#:~:text=Austria%20played%20a%20prominent%20role,other%20parts%20of%20the%20world

legislation passed during the Wilson administration that the Republicans didn't later repeal. The banking holiday did restore confidence in the banking system but behind the scenes, not much was done most of the banks that were on the precipice of insolvency still were but the banking holiday at least made it look like something was being done so investor confidence was restored a bit.

FDR'S GOLD POLICIES

Before Roosevelt the us had never done any strategic devaluing of its currency to boost trade, every time it did so was by the rules of the gold standard but for still wanted to increase exports so first, they repealed the Smooth Holly Tariff but that wouldn't be enough. Most of Europe was off the gold standard and were enticing exports with devalued currencies, for wanted the benefits of devaluing the currency without rewarding the people who held gold. For blamed the depression on gold owners hoarding their money if he tried to devalue our dollar this would increase the price of gold benefiting those whom he blamed for the problem. FDR's plan was for the federal government to nationalize as much gold in us as possible. This started with Executive Order 6102 which confiscated all gold held in private hands which were to be exchanged for paper money this was followed by Executive Order 611 which banned the exportation of gold without approval from the US Treasury the last big executive order on gold was order 6261 which forced all gold mines in us to sell their gold to us treasury at a price the treasury determined. This order functionally nationalized the gold mining industry. The purpose was to take the gold out of the hands of private gold holders and replace it with paper money this way the government could feel free to devalue it without increasing the value of gold and thereby rewarding the gold hoarders that way also the gold hoarders would be encouraged to spend their money rather than just holding on to it. FDR once decided that the value of gold should be 21 an ounce. The capstone of FDR's gold policies was the Gold Reserve Act of 1934 which set the new price of gold at 35 an ounce and voided all gold clauses and private contracts it also created the US Treasury's exchange stabilization fund commonly referred to as a slush fund which doesn't require congressional appropriation to spend.

The currency war, which functionally began in 1921 with the hyperinflation crisis in Germany would be ended in 1936 with the tripartite agreement France, the UK and the US agreed to stabilize their currencies and not retaliate against each other.[4] On the surface, this seemed fine

[4] https://www.britannica.com/event/hyperinflation-in-the-Weimar-Republic

and dandy but the agreement left loopholes that allowed each country to devalue their currency if they needed to promote domestic economic growth, with that provision this agreement was functionally worthless because they were allowed to abandon the terms if domestic concerns outweighed the international ones and they always would. This agreement was followed shortly by World War II in 1939 and a new real gold standard would be set.

US-CHINA TRADE WAR

The trade war took a dangerous turn and is now morphing into what many are calling a currency war. It's all out of economic warfare between the two biggest economies in the world U.S. and China. The Chinese currency weakened passed a significant level that investors were thinking maybe China would defend an indication perhaps, that China was stepping up its fight in the trade war. The U.S., in response, designated China a currency manipulator, something that the U.S. Treasury hasn't done since 1994 and while mostly symbolic, was seen as a big aggressive move to call China out and just escalate this trade tension even further. What makes it difficult is that when you have a currency war, everybody wants a weaker currency. Weaker currencies help your exports stay more competitive on a world stage. But not everybody can have a weaker currency. So, in response to the U.S. and China's moves on currencies, we saw other central banks and economies take action like India, Thailand, and New Zealand, all surprising their markets through monetary policy and weakening their currencies. If everybody races to the bottom, it can be very disruptive to markets and the global economy. When the Treasury formally calls out another country for being a currency manipulator. Not much happens. It's largely symbolic. It's a badge of dishonour. It's considered embarrassing and puts that other country at the top of the G-20 agenda for discussing what it's doing with its currency.

In practice, not much explicitly happens. The Treasury engages the International Monetary Fund and China in negotiations and discussions about what the currency has been doing and how they're going to fix it. Mostly everybody wants a weaker currency. There are benefits to having your currency be weak. Number one, it makes your exports more competitive. If you're in Japan and selling Hondas and Toyotas to Americans, it gives them an edge over companies like GM and Ford. It also makes earnings more competitive. S&P 500 earnings have gotten hit this year because the dollar's been so strong they sell overseas. It's less competitive. They bring the money back home. It's worth less.

We've learned this lesson so many times. And that currency wars and tensions fueled by countries trying to weaken their currencies can have a very destabilizing effect on growth and stock markets. It happened in 2015. China made a surprise decision to let its currency weak and devalue the yuan. Guess what? That led the S&P 500 into a correction, 10 percent off the highs. That's why as soon as we saw China let its currency weaken, it sparked all sorts of concerns, not just about the escalation of the trade fight, but about what's happening beneath the surface in China. When countries devalue their currencies, it leads investors to wonder, is their economy suffering worse than expected? Are they going to have to deal with capital flight, a scary prospect where people take money out of their economy? We're not talking about a small emerging market like Turkey, where we had these concerns. We're talking about China, one of the biggest markets in the world and the second biggest economy in the world. When you have other countries stepping in, then to fight to protect their economies and their currencies, it's this notion of a race to the bottom on interest rates and currencies and that is what spooked markets. The fact that it's going to be unpredictable, it's going to be a source of tension and ultimately, it's going to kill growth because tensions put up walls between countries. Trade slows down. Tensions emerge.

CONCLUSION

Currency wars have long been a strategic tool for nations seeking profitable dominance. From the Gold Standard period to ultramodern- day exchange rate manipulations, history shows that devaluations, trade imbalances, and financial programs can have far-reaching consequences. While some countries profit in the short term, these fiscal conflicts frequently lead to global insecurity, inflationary pressures, and trade pressures. As the economy becomes more connected, the pitfalls of currency manipulation grow, making cooperation and fiscal tactfulness more critical than ever. Whether through central bank interventions, trade programs, or digital currencies, the battle for financial supremacy continues to evolve. The question remains will nations find common ground, or will the coming currency war reshape the global profitable order formerly again?