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Effects of Currency Manipulation

This essay was originally published in Muhlenkamp Memorandum *Issue 113, January 2014. Jeff Muhlenkamp wrote this article to explain the ripple effect that could occur when one country devalues its currency. He also looks at who "wins" and who "loses" in the game of currency manipulation.*

At our November 12, 2014 investment seminar, I stated that the devaluation of the Japanese yen may prompt other export-reliant countries to devalue their currencies in turn as they try to keep their exports competitive. A listener asked me later what the impact of such competitive devaluation would be. In short, it would squeeze consumers in the countries that successfully devalue their currency. Let me explain how I arrived at that conclusion.

First an important point: when you talk about devaluing, you have to devalue against something else—it is always relative. So you can devalue the dollar against the yen, the Euro against the dollar, or the won against the yen… but you can't just devalue the dollar. Since the U.S. dollar is the closest thing the world has to a global currency and most commodities are priced in dollars, most countries try to devalue against it. So let's say Country X is interested in growing its economy and employing more of its population by increasing its exports. In order for their export products to be more competitive internationally, they choose to lower the price. Reducing the selling price without reducing the production cost will put their companies out of business, so Country X must also reduce the cost of inputs—typically mostly labor. Workers generally don't like wage cuts very much, so another way to achieve a lower selling price is to manipulate the exchange rate. If the exchange rate falls the international price of the country's exports will drop, but worker's wages will remain unchanged (measured in the currency of Country X). Everyone wins! To execute this plan the central bank prints money and lowers interest rates. (If their exchange rate is pegged, they lower the peg over time.) This combination usually results in a lower exchange rate; i.e. more of Country X's currency equals the same amount of U.S. dollars. Country X's products are cheaper internationally, sales go up, more citizens are employed, etc.

But did everybody really win?

No. Because the exchange rate declined, anything County X imports is more expensive than it had been. Devaluing Country X's currency benefits the exporter (a business with employees) and hurts the importer (another business with employees), along with anyone in Country X who buys imported goods. What really became cheaper from an international perspective is the cost of labor in Country X. Since Country X's labor got cheaper, there is more demand for it and employment goes up. Who benefitted? Consumers outside Country X that buy Country X products at a lower price and newly hired employees inside Country X. Who paid the price? Country X's workers who received less compensation for their labor than they otherwise would have, Country X consumers who pay more for imported goods, and the workers outside Country X who lost their job to cheaper labor in Country X. Everyone can't win, there are always those who benefit and those who are hurt. There is no free lunch.

Growth through exports aided by a cheap currency is called mercantilism. Mercantilism has been tried by a lot of countries, often with a fair degree of success in the short- to medium-term. Japan did it coming out of World War II. You could buy cheap Japanese cars in the U.S. in the '70s because Japanese workers and engineers worked cheaper than their American counterparts, and the exchange rate was a big part of that. China has done it for the last 20 years: they pegged their currency at an artificially low level, so their products were cheap, and cheap Chinese labor attracted a lot of industry to their shores starting with the really labor-intensive stuff like making clothing and assembling electronics.

This method of growth requires at least the tacit cooperation of the foreign trading partners. Generally, after a time, mercantilism reaches its limit and other means of growth are necessary. Notice that the Japanese yen in the 1970s traded at 300yen/dollar; now, it is about 110yen/dollar. Depreciation against the dollar gave way to appreciation against the dollar. The Chinese renminbi is similar. You may recall during the 2008-09 recession there were loud calls in America for China to quit manipulating its currency and allow it to appreciate. America became more interested in the welfare of its exporting workers than its importing consumers and tolerance for a cheap renminbi declined.

Today, Japan is very interested in devaluing its currency against all other world currencies and is printing money at a fantastic rate to do that. Their goal is to spur economic growth through exports. Their problem is they import most of their raw materials and energy. Their exporting companies will benefit, but their consumers will see costs go up. There is both a benefit, and a cost—you never get one without the other.

There are several other countries whose governments are interested in economic growth via exports, including Korea, China, and Germany. Highly engineered German and Korean capital goods compete directly with Japanese capital goods. As Japanese products get cheaper, they should sell more of them—at the expense of their global competitors. Those competitors may decide to fight back, in part, by printing money and lowering their interest rates; i.e. devalue their currency! (against the dollar). Now you have multiple countries simultaneously trying to devalue their currencies in order to maintain market share in their export markets and thus keep their citizens employed.

Why is that so bad?

Remember that Country X's worker was hurt as he received lower compensation than he otherwise would have. Country X's consumer of imported goods was also hurt as import prices rose. Often, currency devaluations are accompanied by domestic inflation (which is a stated goal of Japan's central bank). Inflation hurts the saver and benefits the borrower. Sum that all up and what do we get?

- If Japan, Korea, Europe, and China simultaneously try to devalue their currencies it only has a hope of working if the U.S. doesn't join in. (The U.S. must tacitly allow them to devalue against the dollar.) This implies a strong dollar and lower commodity prices (measured in dollars).
- Who benefits? The only clear beneficiary is the U.S. consumer of imported goods. Japanese, Korean, European, and Chinese exporters don't gain market share, they only succeed in holding what they had. If there is inflation in Japan, Korea, Europe, and China, it will benefit entities that borrowed in those currencies.
- Who loses? Japanese, Korean, European, and Korean consumers of imported goods. All of those countries are big energy importers, so all of their consumers pretty much lose. (For example, the price of crude oil has recently dropped by 45%, from $110 per barrel to $60 per barrel. Since oil is still priced in dollars it has benefited the U.S. consumer, but the Japanese consumer has seen no benefit because the yen has been devalued relative to that same dollar.) Their export workers lose. To the extent they have domestic inflation, all of their savers lose.
- Any foreign entity that borrowed in dollars, but whose income is in a foreign currency, will find it increasingly difficult to make their interest payments; expect defaults. And, of course, one man's debt is another man's bond, so the holders of those bonds lose.
- The drop in commodity prices due to the strong dollar makes it more difficult for the Bank of Japan and the European Central Bank to achieve their stated goals of 2% inflation.

What happens if the United States tries to prevent other currencies from devaluing against the dollar and lowers interest rates and prints money like everybody else? Then, the only beneficiaries are the debtors, as their debts will be denominated in increasingly worthless paper. All savers lose, all consumers lose, and most workers lose. Since the biggest debtors are governments, they win—at the expense of their citizens.

Where are we today? Until October 2014 the U.S. was actively printing money. While the Federal Reserve didn't say it wanted a weaker dollar, that's what happened for the last few years (on a longer time scale, a weaker dollar has been happening for decades). The U.S. has ended Quantitative Easing (QE), and may raise interest rates in the next six months. The dollar has been stronger against most currencies over the last 6 months; commodity prices are falling (measured in dollars), in some cases quite dramatically, creating additional trouble for Russia, Indonesia, and Brazil. Japan is actively devaluing its currency, so far successfully. If the other nations of the world allow Japan to continue to do so the pain will be limited to Korean, U.S., German, and Chinese exporters, and the Japanese consumer. If other countries begin to devalue, the pain spreads as described above.

We pay attention to these types of macroeconomic issues because doing so helps to avoid risk and identify opportunities for investment. As we learn things that are of interest and not well covered or understood by mainstream media we will continue to pass them along.

Glossary:

Currency Peg is when a country or government's exchange-rate policy "pegs" its central bank's rate of exchange to another country's currency. (Currency has sometimes also been pegged to the price of gold.) Also known as a "fixed exchange rate" or "pegged exchange rate," currency pegs allow importers and exporters to know exactly what kind of exchange rate they can expect for their transactions, simplifying trade. In turn, this helps to curb inflation and temper interest rates, allowing for increased trade.

Central Bank is the entity responsible for overseeing the monetary system for a nation (or group of nations).The central banking system in the U.S. is known as the Federal Reserve (commonly referred to "the Fed"), comprising twelve regional Federal Reserve Banks located in major cities throughout the country. The main task of the Fed is to conduct monetary policy that promotes maximum employment and stable prices.

Quantitative Easing is a government monetary policy used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity. Central banks tend to use quantitative easing when interest rates have already been lowered to near 0% levels and have failed to produce the desired effect. The major risk of quantitative easing is that although more money is floating around, there is still a fixed amount of goods for sale. This may eventually lead to higher prices or inflation.