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The Global Currency War Heats Up in Moscow

By Martin Gilman

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Among the finance ministers and central bank governors converging on Moscow at the end of this week, at least some will really wish they could been elsewhere. This has little to do with the fact that Moscow has been pummeled by its heaviest snowfall in a century. Rather, the representatives of the countries that are threatening war, whatever else they may call it, would prefer not to have to confront the likely victims of their aggression.

Of course, no one, for now, is conjuring a fighting war — or even necessarily a trade war. The immediate issue is what the Brazilian finance minister called a "currency war" back in September 2010, and it has sharply intensified since last summer.

Any casual observer in Moscow will have noticed a sharp appreciation of the ruble. Against the dollar, the ruble has appreciated more than 9 percent since mid-July, and against the yen, the ruble has risen an impressive 30 percent.

Certainly these currency movements, if sustained, would make U.S. goods and services — and especially Japanese cars and electronics — more attractive to Russian consumers and importers, and Russian output would face greater price competition in the home market as well as abroad. Since the ruble rate to the euro has been more or less stable since the summer, it means that both the European and Russian central banks share a common concern that their respective currencies have rapidly lost international competitiveness.

Especially for Russians, the recent strengthening of the ruble is all the more curious because, unlike the eurozone, Russia had an inflation rate last year of 6.6 percent. It even accelerated to 7.1 percent in January, although the Central Bank expects it to decline soon. High inflation relative to that of trading partners normally causes an exchange rate to weaken.

Exchange rates in market economies are driven by a multitude of factors, including growth prospects, risk perceptions, interest rates, inflation and confidence, among others. But grumbling about currency movements turns into indignation when there is a perception that the exchange rate is being intentionally manipulated by a country to gain competitive advantage for its exporters and secure more jobs for its workers. Just witness the acrimonious debate in recent years between the U.S. and China concerning Washington's accusations about currency manipulation by Beijing.

The rates for the world's major currencies are determined by markets, unlike Venezuela's pegged currency, which was reportedly devalued 32 percent Friday and is still considered overvalued relative to the black market rate. Brazil, China and India resort to currency controls to insulate their economies from capital flows, whereas Russia, like the advanced economies, has a completely open capital account.

So the rising rhetoric about a new battle in the currency war stems from the presumably unintended consequences of expansionary policies of the advanced economies to address a chronic persistence of lackluster economic growth and stagnant labor markets. A sense of frustration has no doubt pushed central banks into a new zeal for bold monetary experiments to revive their moribund economies. The Keynesian resort to increased government spending has been tried since the 2008 financial crisis. Perhaps it helped blunt the downturn, but stagnating revenue and weak growth has meant continuing deficits, which have translated into an increasing concern about public debt.

The Federal Reserve, Bank of England and Bank of Japan proclaim that their policy of near-zero interest rates and newfound enthusiasm for balance sheet expansion have nothing to do with an intention to depreciate their currencies. But their policies conveniently have the effect of inundating the foreign exchange markets with dollars, pounds and yen, therefore altering the balance between supply and demand — and hence the exchange rates.

Recent exchange rate movements seem to reflect, to some extent, a concern by the markets about excess supply of some currencies relative to demand. It is no coincidence that a weakening of the U.S. dollar occurred as the Federal Reserve announced in September a new policy of unlimited quantitative easing until the unemployment rate drops.

Japan, though, is the most visible example. Its new government is determined to have the Bank of Japan open the monetary spigots to revive the Japanese economy. Not surprisingly, the yen has plummeted, precisely according to the script.

Russia has to be concerned by this development, and not just in its role as Group of 20 host and president this year. Its longer-term strategy to diversify the economy away from oil and gas could be compromised if it is faced with a ruble that strengthens relative to its main trading partners. Of course, South Korea and China are more directly threatened by yen depreciation and are therefore likely to be among the first countries to take measures to maintain competitiveness. Many export-dependent economies may see little choice but to join this game of musical chairs.

Citing Japan's reckless call for monetary expansion and yen depreciation, Alexei Ulyukayev, the first deputy chairman of the Central Bank, said last month that the world was on the verge of a currency war that would be inefficient and self-defeating. That holds true for all forms of protectionism. In the event of a currency war, everyone will suffer in the end as each country tries to leapfrog others in a fruitless and costly effort to maintain employment.

Even the European Central Bank, which has its own preoccupations with internal competitiveness issues, cannot ignore the consequences of a strengthening euro relative to other major currencies. European automakers and other manufacturers have been lobbying their governments about what they deem unfair competition. Apparently, politicians have gotten the message, as French President Francois Hollande made clear in his speech last week in Strasbourg. European Central Bank President Mario Draghi tried to forestall criticism of a strong euro by talking down the currency, but how long before he, too, will turn to an even more innovative monetary policy?

This is the backdrop for the meeting of finance ministers and central bank governors of G20 countries Friday and Saturday, with Russia hosting the cantankerous group under its mandate as G20 president for this year. While its formal agenda focuses on some important long-term issues in preparation for September's summit in St. Petersburg, the one issue that will be on everyone's mind will be sidestepped. And a dangerous game of musical chairs will continue.

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