21st Asian Shadow Financial Regulatory Committee
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The currency war of 2013 – Will it happen?

Serious talk of a currency war resurfaced at the G7 meeting in February 2013. This was followed by Japan's announcement of a major quantitative easing (QE) package in an attempt to pull Japan out of deflation. With Japan joining the United States and the Euro-zone in adopting a strategy of continuing quantitative easing, this view appeared to have some validity but any currency war, at most, is likely to be a cold one. Loose monetary policies are usually aimed at stimulating domestic demand, but their effects spill over into the realm of exchange rates. Since March 2013, the Yen has depreciated significantly against the US dollar and the Euro. Any sustained quantitative easing undertaken by the Bank of Japan could lead to competitive devaluations and reignite beggar-thy-neighbor protectionist policies, especially among the export-led economies of Asia, as well as create the potential for unstable and volatile capital flows. Both are not new issues for Asia.

The impact of quantitative easing of the ECB, the US Fed, and the Bank of Japan differ across the countries of Asia where there is no consistent Asian view on these events. The Euro-zone quantitative easing has, to a large extent, been sterilized; thus, it is not as important an issue for Asian economies, although the lack of European demand in the face of slackening world trade has a significant dampening effect on Asian exports.

On trade, a weak US dollar benefits Asian importers trading in products denominated and settled in US dollars. It also benefits those countries with US dollar-denominated debt but disadvantages countries holding US dollar-denominated assets. The net impact on individual Asian countries varies depending on whether US dollar-denominated assets or liabilities dominate their trading and investment activities. The quantitative easing in the US has also made a large amount of cheap capital available for both foreign direct investment and portfolio capital. Much of this has flowed into Asia, benefiting a number of Asian economies but with the potential for creating conditions for financial instability in some others.

The recent Japanese quantitative easing is within Asia and can have a much larger impact on its economies. For Northeast Asian economies, in particular, the issue is one of competitive advantage, given that inflation remains an area of concern and where inflow of funds could unnecessarily stimulate stock prices and create asset bubbles. For emerging ASEAN countries, the overall view ranges from one of concern to indifference on account of improved long term capital inflows as well as better terms of trade. These views could change rather quickly, however, if any major economy in the region adopts significant competitive devaluation or protectionist policies to upset the status quo.

In this context, it is important for the IMF to continue to maintain and strengthen a stable global monetary system, including stable and appropriate exchange rates. Also, the IMF and the ADB in particular need to more closely monitor and intensify their surveillance of international financial flows, especially short-term capital. If the situation is not well managed, it can offer opportunities for hedge funds and speculators to create market conditions for them to indulge in speculative activities supported by their substantial access to cheap QE money.

The Euro remains overvalued and continuing European austerity fatigue has dampened European growth and is not being helpful in creating jobs. The EU should expand demand, especially economies like Germany, which have the fiscal capacity and can afford to do so. The ECB should refrain from sterilizing its quantitative easing activities to help in this expansion, and, in the process, weaken the Euro. This would ultimately lead to moderate economic growth and job creation. At the same time, this would help promote greater global economic activity.

However, given the already poor prospective global economic sentiment, continuing uncertainty about the intention and intensity of the Bank of Japan's policy to weaken the Yen further would work toward the eventual dampening of the economic outlook and encourage asset bubbles to form in markets. The Bank of Japan needs to provide more certainty and clarity about its intentions on monetary easing and be more sensitive in not creating conditions that could bring about competitive devaluation and other protectionist measures, thus avoiding a currency war.

Recommendations

1. Asian economies, particularly those in Northeast Asia, should refrain from competitive devaluations and protectionist policies, which would have a negative impact on world trade flows.
2. The Bank of Japan should be considerate, cautious and transparent in undertaking any further quantitative easing, by not targeting a weak Yen and taking into account the concerns of others.
3. The IMF and, in particular, the ADB need to closely monitor international financial flows and strengthen its surveillance framework of macroeconomic policies of nations so that it will be more effective in promoting global monetary stability.