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The “magnificent obsession” with devaluation

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This week, the good, bad and ugly of devaluation once again hit newsstands and the internet’s cyber waves. This time it is due to two chapters included in IMF’s yet to be officially released full report: *World Economic Outlook October 2015*, posted on website.

The two chapters with titles, “Exchange Rates and Trade Flows: Disconnected?” and “Where Are Commodity Exporters Headed” show how the “good old remedy” is still continuing to fascinate policy makers, in both rich and poor nations, who are struggling with reform measures, to get out of their economic morass.

China devalued its currency recently. Although it announced its “new normal policy” two years ago, of rebalancing by reversing its two decade old policy of export-led growth, delays in reforms led to resorting to the old remedy by cheapening its exports to rest of the world.

Beggar thy neighbor remedy

It is a remedy resorted to by the biggest economy, US without attracting any attention, ever since the 2008 banking and financial crisis, which spread to the rest of the world as the Great Recession.

While China, the second biggest economy of the world being under fixed exchange rate regime, had to officially announce the devaluation of its currency, the US Federal Reserve under its flexible exchange rate regime, quietly allowed the dollar to depreciate, by buying bad debts of failed financial institutions and pumping in money, enjoys a respected label called quantitative easing (QE).

The objective is by depreciating the currency, a country can “export domestic unemployment to the rest of the world.”

By bringing down sale price by lowering the value of the currency, the devaluing country exports more than before to another country, creates more jobs at the cost of jobs in the importing country by replacing its own exports.

Three years ago, when Japan, the third biggest economy decided to embark upon QE following the US example, Samuel Brittan of Financial Times of London, reminded his readers that it was Professor Robinson, who popularized the term. She explained:

"As soon as one country succeeds in increasing its trade balance at the expense of the rest, others retaliate. Political, strategic and sentimental considerations add fuel to the fire and the flames of economic nationalism blaze higher and higher."

This is the retaliation that policy makers the world over have to worry about.

The contrasting measure, stepping up domestic investment creates more domestic jobs by not destroying jobs in another country. Such a measure "brings about a net increase in employment for the world as a whole."

As conservatives abhor fiscal policy initiatives, the central banks resort to QE and cut interest rates too. The latest to join are India and Norway. Cutting down interest rates will result in capital outflows, leading to depreciation of their currencies.

Abenomics and Draghinomics

Japan's PM Abe under "one of the three arrows," has been successful through QE. The yen has already fallen by 30% in value since 2012. The European Central Bank under President Mario Draghi wants the same: he wants the euro to fall by 10% from its 2014 value. ECB's monthly purchases of public and private debt will rise from around €13 billion to €60 billion by September 2016.

The IMF's World Economy Outlook, while warning of weaker global growth in 2015 and 2016, says currency movements since the financial crisis had been "unusually large."

These movements have "kindled a debate on their likely effects on trade. Some predict strong effects on exports and imports, based on conventional economic models." It is estimated that a 10% fall in the value of a nation's currency can boost exports by an average 1.5% of GDP.

Australian economists have welcomed the finding as it supports their belief that the fall in Aussie dollar will boost the sagging economy which has been hit by fall in export earnings following China's slowdown. Some exporters support a further cut in interest rate to contribute to further fall in exchange rate.

The IMF study refers to increasing phenomenon of fragmentation of production across different countries, the so-called rise of global value chains "which means that exchange rates matter far less than they used to for trade, and may have disconnected altogether."

As long as trade is “traditional” and involves the export and import of finished goods and services that are sensitive to price movements, depreciation is a remedy.

We now know all sides:

- the good: depreciation by QE or devaluation by decree has favourable effects on exports;
- the bad: it shifts domestic unemployment overseas and beggars the neighbors; and
- the ugly: it provokes retaliation and results in currency wars.

Still, the “magnificent obsession” with devaluation continues!

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