A D&B Special Report
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Decide with Confidence

The Impact of Currency Wars

Risk Insights

- A fresh outbreak of 'currency wars' (the manipulation of currencies to boost exports) will significantly increase risks for cross-border trade and investment.
- The key risks will be associated with uncertainty over government policy, currency volatility and supply chain disruption.
- Countries with floating currencies are set to experience better economic conditions than those with pegged currencies, and are less likely to raise cross-border trade and investment barriers.
- Countries that employ capital controls will outperform countries that do not.
- Countries whose currency is appreciating are more likely to adopt capital controls.
- The incidence of trade disputes between countries is set to rise, impacting on supply chains.

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Currency wars increase risks for cross-border trade and investment

Recommendations

'Currency wars' (the manipulation of currencies) have been associated with downturns in the global economy as governments attempt to boost their ailing economies through export growth. Such manipulations require that currencies are kept weak in order to make exports competitive on the global stage. However, if significant numbers of countries adopt these policies, risks for cross-border trade and investment are boosted dramatically as uncertainty over the direction of government policy increases, currency volatility rises and trade protectionism climbs.

A number of high level strategies can be used to mitigate the increase in risk faced by cross-border businesses:

- Hedging against currency volatility.
- Invoicing in your own currency or in a stable currency: if you invoice in a global currency rather than your domestic currency or the currency of your counterparty, risks increase, as three currencies are involved. In times of stability, invoicing in a reserve currency is a sensible option.
- Tightening payment terms in response to changing events (see below).
- Diversifying supply chains to ensure that you are less reliant on a particular business or country.
- Shortening supply chains through product innovation.

We also recommend that customers increase the level of monitoring on individual countries, specifically with regard to the following factors:

- Countries with fixed or pegged currencies. In the 2008-09 recession, the 68 countries with floating currencies (out of the total of 188 currencies) performed better in terms of GDP growth, inflation and export growth than did their fixed-rate counterparts: the worse the economic conditions, the higher the level of bankruptcies and the poorer the quality of payments performance. Moreover, countries with free-floating exchange rates are less likely than those with pegged or fixed currencies to increase trade and investment restrictions (such restrictions are often imposed with little or no warning, critically raising the level of risk involved in dealing with counterparties from the relevant country).
- Countries without capital controls: counter-intuitively, in the 2008-09 recession 83 countries with capital controls outperformed 105 open economies in terms of higher GDP growth, lower inflation and better export-share gain.
- Countries where the currency is appreciating: such countries are more likely to implement barriers to trade; in the recent past Brazil, Indonesia, South Korea, Peru, Thailand and Turkey have all put new measures in place.
- Trade disputes between countries: typical disputes in this context arise over trade 'dumping' (flooding a domestic market with goods or services to force domestic producers out of the market to give the exporting country a monopoly) and countervailing duties (Country A imposing increased tariffs on goods from Country B if it believes Country B is subsiding its exports). In particular, these problems are liable to increase in relation to China for as long as other countries continue to believe it is deliberately keeping its currency under-valued.
- Countries with current account restrictions (i.e. no/low import restrictions) and dual or multiple exchange rates raise the costs of business with counterparties in that country.
- Countries where market sentiment is moving sharply: this will be reflected in the increased volatility of the currency.
- Resource-dependent countries: currency volatility in countries that are reliant on a limited range of products (e.g. minerals or agricultural produce) will be higher than in diversified economies.

A new bout of currency wars threatens supply chains

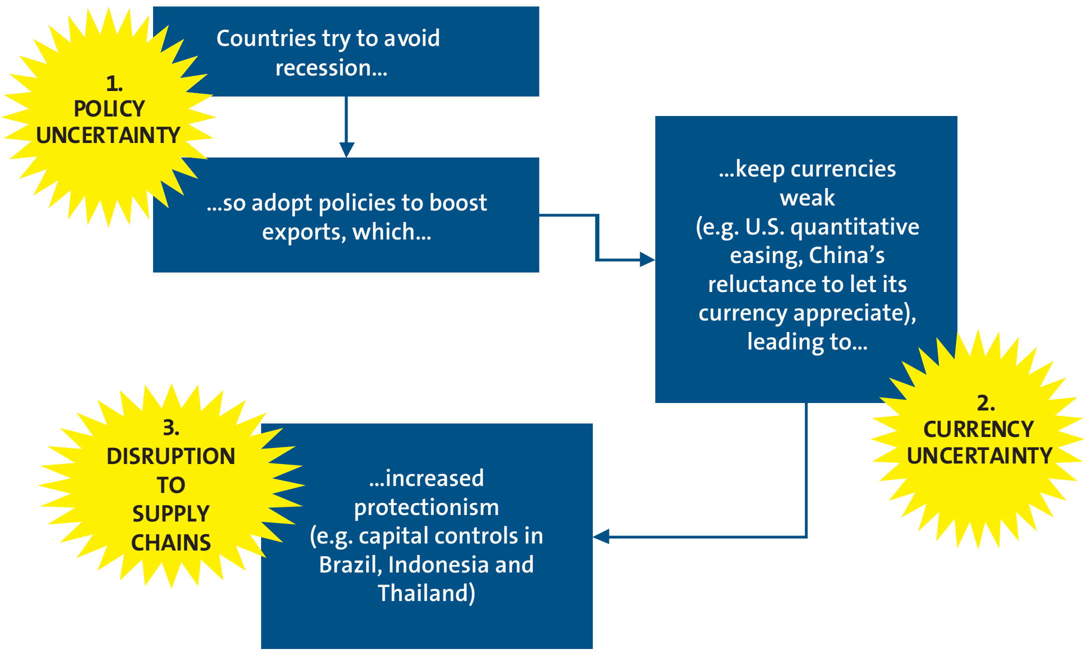
Background: What is Happening and Why?

The headlines are full of dire warnings about where the global economy is heading. The sovereign debt crises in the US and Europe have dominated as concerns rise that demand from emerging economies will not be able to prevent a second recession. A further danger lurks behind these alarmist headlines: 'currency wars' and the attendant rise in protectionist policies, both of which threaten the efficiency of supply chains.

Many countries (particularly those in the 'advanced economies' category, such as the US and Europe), are finding economic growth difficult to achieve because of a lack of domestic demand: consumers and businesses are not spending, choosing instead to reduce their debt levels and/or increase their savings. One way in which governments can attempt to drive economic growth is by adopting policies that increase their country's exports. Politicians have a number of options for doing this, but a favored choice is to depreciate the local currency, so that a country's goods/services become relatively cheaper on the global stage.

A weak currency also increases the cost of imports, thus making domestic producers more competitive in the national economy, again driving growth. However, there are problems with maintaining a consistently under-valued currency, not least of which is that it encourages inflation, which is itself detrimental to driving growth.

Key Risks Associated With Currency Wars



Sources: D&B

The Chinese government is keeping the renminbi undervalued...

Who Are the Main Culprits?

Since mid-2008, a number of the large exporting countries have adopted policies that have resulted in their currencies remaining weak. If domestic demand is curtailed by low wages and a propensity for households to save rather than consume, the government has to boost export growth by maintaining an under-valued currency in order to continue growing the economy. The Chinese government is following such a policy and, despite allowing a slow appreciation of the renminbi, the currency remains under-valued.

...while quantitative easing has similar effects for the US dollar and the UK pound...

The US has been particularly critical of the Chinese government, but the US' two bursts of quantitative easing (QE, a third bout of which could follow in the next few months), which were undertaken in an effort to underpin the economy, have impacted on the US currency. The printing of more US dollars (which is essentially what QE does) increases the supply of US dollars, which in turn reduces their value—thus weakening the currency. Consequently, the Chinese administration argues that the US government is also encouraging policies to ensure its own currency remains weak. A similar situation has occurred in the UK, where QE has been implemented in order to support the economy.

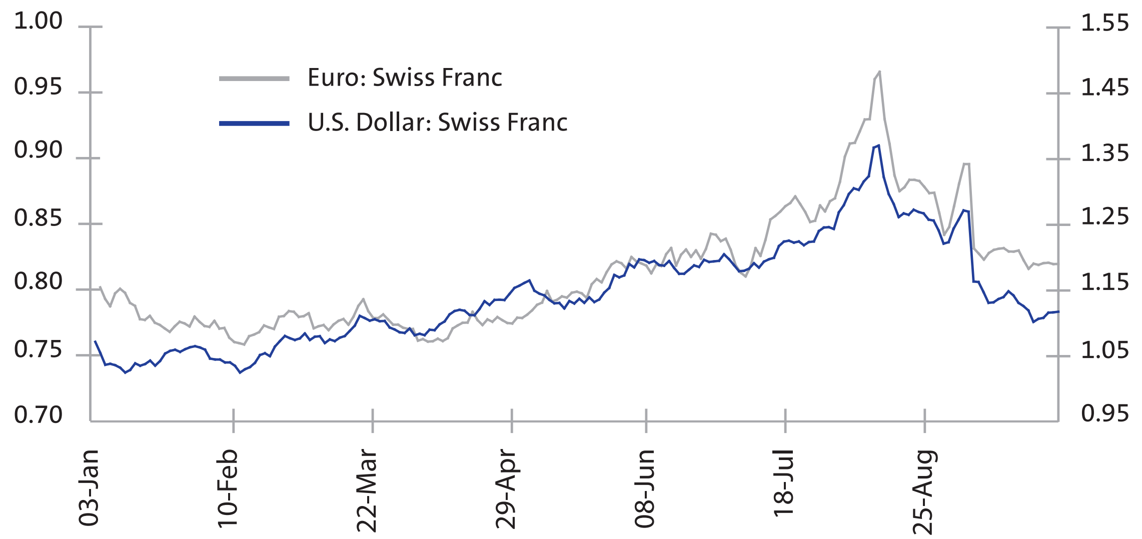
...and the debt crisis means the euro is also weak

Meanwhile, the sovereign debt crisis in Europe and politicians' failure to agree a long-term solution to the problems in Greece in particular has weakened the euro. Markets will continue to be averse to investing in the euro until the debt problems have been resolved.

The Swiss franc has been pegged to the euro to boost its competitiveness

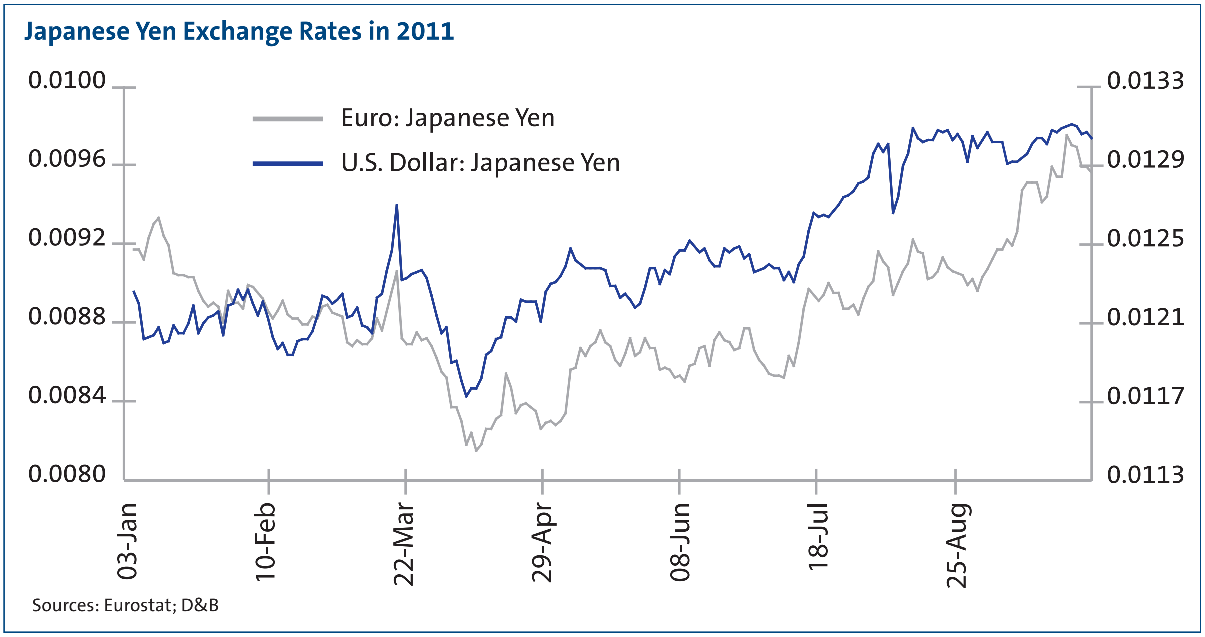
This has meant that three of the four reserve currencies – the US dollar, the euro, and the pound sterling—are weaker than would normally be expected (the Japanese yen is the fourth reserve currency). As a result, currency traders and investors have been looking for safe currency havens, which resulted in upward pressure on the Japanese yen and the Swiss franc: both have seen their value increase since the start of 2011, undermining their export base.

Swiss Franc Exchange Rates in 2011



Sources: Eurostat; D&B

As a result, on 6 September, in a shock move, the Swiss pegged their currency to the euro: this effectively devalued the Swiss franc by 6% and sparked fears of tit-for-tat competitive devaluations, which had already become a hot topic back in September 2010 when the Brazilian finance minister claimed that the world had entered a 'currency war'.



Outlook: The Continued Impact of Current Policies

Key actors are unlikely to shift their positions soon...

Many of the problems stemming from these currency developments could be resolved if the Chinese government were to float their currency: however, barring an unforeseen change in Chinese policy, this will not happen in the next few years; the renminbi will appreciate, but will continue to be perceived as under-valued by many of its trading partners. The position would also be helped by strong political leadership on the debt crises in Europe and the US; unfortunately, in our view this is unlikely to happen rapidly enough to ease tensions.

...so it is important to appreciate the impact of the current trend

Consequently, it is important to appreciate the impact on the global economy—and therefore on cross-border traders and investors – of the leading currencies remaining unbalanced (i.e. the euro, the dollar, the renminbi and the UK pound staying weak, with the Japanese yen appreciating strongly).

What Usually Happens When Currency Wars Break Out?

The most famous currency wars example is from the 1930s, when countries got into a vicious spiral of currency devaluations in order to try to maintain the competitiveness of their exporters. All that was achieved was that these countries' trading partners sank deeper into the mire of recession, further curtailing trade and leading to more depreciations. Thus, the global economy shrank and global trade and investment was devastated, a situation that only ended after the outbreak of the Second World War. Although we are not predicting that the current situation will lead to such a severe outcome, there are some parallels between the significant problems in each historical case.

Risks will increase due to currency volatility, increased protectionism and more numerous trading disputes

As countries rush to protect the competitiveness of their exports, currency wars will prompt a number of problems, such as asset-price volatility (particularly in the currency markets), increased adoption of trade protection policies, and a rise in anti-dumping and countervailing duty disputes. These all raise risks for cross border trade and investment. While it is extremely difficult to predict in detail what will happen in the short to medium term, it is quite possible that the effects seen during the 2008–09 recession will be repeated, such as increases in the three factors mentioned above: currency volatility, protectionism and trading disputes.

Commodity price shifts can have a significant effect

Currency Volatility

According to the Carnegie Institute's Currency Wars publication, in the 2008-09 recession currency volatility exceeded its 2000-08 average in 24 of the 33 largest economies (including in the US, Japan, China and the UK). The sharpest volatility was in countries that were highly reliant on commodity exports: this was primarily down to the significant shifts in global commodity prices during the recession. A second group of countries that experienced high levels of volatility were the transition countries of Russia, Poland, the Czech Republic and Hungary, as a consequence of shifts in market confidence about this type of economy.

Trade Protectionism

National policies could offset global attempts to encourage trade

The corollary to countries maintaining a weak currency is that other countries attempt to protect their domestic sectors when they are threatened by cheaper imported goods and services. They do this by adopting temporary trade protection policies. In the 2008-09 recession the position was exacerbated by flows of speculative capital into the emerging economies, looking for returns that were missing in the advanced countries (due to a combination of low interest rates, low growth potential and high debt).

Global Trade Alert lists 23 types of policy that impact negatively on cross-border trade and investment, including tariff measures, trade defense measures, export subsidies and import bans. Since January 2008, it highlights that almost 1,500 new measures have been adopted that hinder the free flow of trade; this at a time when global financial institutions such as the IMF, World Bank and WTO are attempting to encourage trade. Significantly, it is the advanced countries which are at the forefront of this movement, accounting for over 75% of total measures.

Trading Disputes

The number of trading disputes looks set to rise again

The number of trading disputes recorded by the WTO in 2008 rose by almost 50% compared with 2007 as countries sought to protect their domestic sector against what they perceived to be subsidized goods and services from other countries. After a return to 2007 levels in 2009, the number of disputes is once again growing, threatening the smooth running of global supply chains.

Implications for D&B Customers

The central significance of currency wars is that they can seriously affect the risks associated with doing cross-border business. Three specific risks arise out of currency wars: policy uncertainty, currency uncertainty, and disruption to supply chains:

Risks associated with policy uncertainty...

1. As countries attempt to offset weak currencies, governments can implement (without warning) policies that impact on cross-border business. Recent examples include the pegging of the Swiss franc to the euro, which effectively devalued the Swiss franc overnight by 6%, leaving traders with an unexpected potential loss that could wipe out their profits on the transaction in progress.

...currency volatility...

2. Thus policy uncertainty feeds into currency uncertainty for businesses. This currency volatility can be offset in many cases through hedging, but this adds further costs to businesses, undermining profits at a time when margins are already eroding rapidly. Nevertheless, customers should be aware that currency volatility will remain a key feature of the global economy for at least the next 18 months.

...and protectionism will all rise

3. The final element is that countries with relatively stronger currencies implement policies that protect their domestic sector. Barriers to trade, such as increased tariffs and quotas on imports, threaten the smooth running of supply chains. In the 2008–09 recession, these policy changes were invariably imposed overnight, creating further uncertainty for cross-border trade and investment.

Feedback

We greatly value your feedback on how relevant you find our analysis and focus. To tell us how effectively this special paper addresses the issues facing your business, email us at **CountryRiskServices@dnb.com**. If you have any suggestions for future areas of coverage that would be of use to you, we will be happy to consider them.

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Additional Resources

The information contained in this publication was correct at the time of going to press. For the most up-to-date information on any country covered here, refer to D&B's monthly International Risk & Payment Review. For comprehensive, in-depth coverage, refer to the relevant country's Full Country Report.

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