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Currency Wars?

What is a "currency war" and how does one wage it?

Forget world wars, fought with tanks, bomb and missiles. The new form of global conflict is the currency war, which is fought with increasingly vicious keystrokes. We read in the papers that this or that country is engaged in a currency war with some other set of countries. But what does that really mean? And is the U.S. currently engaged on one of these economic battlefields?

Currency wars are fought over exports and foreign trade—which affects the relative prosperity of one country compared with the people living on the other side of the border. At the heart of the "conflict" is the idea that whenever our dollar can buy more of their euros, yen or yuan (when, in other words, our currency is strong and theirs is weak), their companies are able to sell their manufactured exports at lower prices in the U.S. market and still collect the same number of euros, yen or yuan. This gives those foreign exporters a golden opportunity to increase market share and profits at the same time.

When sales and profits rise, their stock market goes up, and they can pay their workers more. Meanwhile, our companies, whose goods and services suddenly look more expensive, lose top-line sales, profits and stock market value.

Of course, when the dollar is weak, the reverse is true. These same general dynamics hold true for any two countries and their currencies, which helps explain why the Swiss central bank fought for five years to hold the value of the Swiss franc down to 1.2 francs to the euro for a number of years, and why it was so shocking when it abruptly gave up the battle. When the bank let the Swiss franc rise to its fair market level, Swiss manufacturers complained that overnight their products were suddenly 12% more expensive than they had been the day before. Many faced the choice of seeing sales diminish to zero or lose money on everything they sold in the Eurozone. Companies all over the country are cutting jobs, asking workers to work longer or requesting government subsidies.

The short-term "winners" of a currency war weaken their currency compared with others, while the "losers" end up with a strong currency that can buy more imports for less. As with anything economics, there is another side. In this case, the longer-term impacts of a devalued currency may not be desirable (inflation).

But how, exactly, do you wage a currency war? One way is to create or eliminate free currency. The U.S. Federal Reserve can create more dollars by simply keystroking more of them into bank reserve accounts. Or the U.S. Treasury could issue more bonds. Alternatively, the Fed can keep its Fed funds rate at zero, which tends to raise the amount of money that banks loan to their customers and therefore the overall money supply in circulation.

Other countries, meanwhile, can "fight back" by issuing more government debt and using the money to buy Treasuries for their government account, raising the amount of their currency on the market and decreasing the number of dollars. This is how China has managed to keep the yuan on par with the dollar. In fact the Chinese government has been so active in buying up Treasury bonds that the government gave it a direct computer link to Treasury auctions, the only country with such access. The Chinese central banking system owns an estimated $1.25 trillion (face amount) of Treasuries, in an intervention program that has helped make Chinese exports inexpensive in the U.S. Japan, the second-most-active currency warrior, now holds $1.24 trillion worth of Treasuries.

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Meanwhile, the Federal Reserve's various QE programs, which had one arm of the government buying the bonds of another arm of the government, have been described as frontal attacks in the currency wars.

So whenever you read that a central bank has lowered its reserve rate or is buying the bonds of its own country—as the European Central Bank did recently in an effort to revive the euro economies—it is on the attack in the global currency battlefield. Whenever you read about a strong dollar, you know that the U.S. is losing the currency wars. The weaker the dollar, the more competitive U.S. exports will be on the world markets, and the more inclined people in the U.S. will be to purchase products made in America.

But how, exactly, do these wars affect you? When the dollar is strong—as it is now, relatively speaking, against the euro—it means that your trip to Paris or Stockholm will be cheaper, and so will the meals and cab rides you pay for over there. So if you're planning to travel abroad, it isn't so terrible if the U.S. is temporarily losing the currency battles.

In addition, when the dollar is strong, your cost of living tends to be lower, because the cost of foreign products—of which the U.S. bought an estimated $2.6 trillion worth last year—are cheaper. And of course if you buy American, it doesn't really matter to you who happens to be winning this round of the currency wars. Unlike the bloodier kind of war, the impact of winning or losing on the currency battlefield aren't threatening your personal—or financial—survival.