The trade wars fomented by the Trump administration are on the cusp of morphing into currency wars.

Currency devaluation might seem a useful element of the policy toolkit for economies suffering from slowing growth or, indeed, dealing with trade disputes, but it carries enormous risks for those countries themselves and for the world economy.

Trade tensions between the US and China, which are on the verge of breaking out into open and all-out economic warfare, constitute the main battle front for the currency wars. For nearly 15 years, from about 2000 to mid-2014, China’s central bank intervened aggressively in foreign exchange markets to prevent the renminbi’s rapid appreciation against the US dollar. By doing so, it gained a competitive advantage for China’s exports. Since mid-2014, the intervention has been in the opposite direction — to prevent the renminbi from depreciating too much or too quickly.
The Trump administration’s designation of China as a currency manipulator is thus a few years late and particularly ill-timed: the recent intervention by the Chinese central bank has mostly favoured US exporters not Chinese ones.

Still, given the arbitrary and retaliatory nature of the currency manipulation designation, China might well be tempted to allow further renminbi depreciation to hit back at the US and, at least partially, to offset US tariffs.

This would be a step with small benefits and enormous risks for China. One risk, which currency speculators are salivating over, is that further renminbi weakness sets off a spiral of currency depreciation and capital outflows as occurred in 2014-15. The government is better prepared this time around to prevent such a destructive spiral — it can use its foreign exchange reserves more aggressively early on and also shut down speculative activity in both onshore and offshore markets. But such measures, along with any tightening of capital controls to reduce capital flow volatility, would unravel the progress Beijing has made in convincing foreign investors that they can count on stable capital account and currency policies and should invest in China’s stock and bond markets.

A few key emerging market economies, such as India and Thailand, have cut interest rates sharply as a defensive action to protect themselves from the collateral damage resulting from rising global trade tensions, amid weakening domestic growth. Major advanced economy central banks such as the Bank of England, the Bank of Japan and the European Central Bank are likely to loosen monetary policy in the coming months to deal with the travails of their own economies. Given the importance of trade to these economies, and whether or not they are explicitly targeting weaker currencies, they are no doubt counting on such a move to provide a boost to growth.

Under Donald Trump, the US administration has taken an aggressive rhetorical approach, threatening to devalue the dollar if the country’s trading partners engage in what it regards as competitive currency devaluations. The US has shown little interest in any fine distinctions between market-driven currency depreciations versus targeted policy-driven devaluations, viewing all currency depreciations relative to the dollar as hostile economic acts.

A currency war would do little to boost US growth prospects. It is much harder for the US to push down the value of the dollar, ironically because of the currency’s dominant presence in global financial markets. It would be difficult to engage in unilateral intervention on a scale sufficiently large materially to affect the dollar’s value against other major currencies — especially if the Federal Reserve stayed on the sidelines in such an endeavour. Besides, such a move would incite a broader currency war, with other countries stepping up their own retaliatory intervention. The resulting turmoil in financial markets could actually firm up the dollar’s value if investors turn to it for safety.

So, for the US, a currency war could have the paradoxical effect of strengthening its currency.
for Mr Trump to bully the Fed into participating directly in a currency war could have longer-lasting consequences for the credibility of the central bank.

There are other costs for the world economy. A stronger dollar would end up creating collateral damage in some emerging market economies, on account of balance-of-payments pressures caused by large amounts of external debt and weakening currencies.

All of these convulsions in currency markets will add to the uncertainty already spawned by global trade tensions. This uncertainty, in addition to the exchange rate volatility triggered by currency wars, will keep business investment weak and continue hurting productivity and employment growth around the world.

A cheaper currency might seem easy to orchestrate and a convenient mechanism to boost domestic growth and retaliate against trade sanctions imposed by other countries. But the actual benefits are likely to be fleeting while the costs in disrupted trade and lost growth could be enormous.

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