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## Currency Cold War is starting to heat up

By Delphine Strauss [Author alerts](#)

The last round of “currency wars” ended a year ago in an uneasy truce, when G20 finance ministers agreed not to target their exchange rates for competitive purposes.

Fears of a round of competitive devaluations evaporated soon afterwards. The US Federal Reserve announced plans to taper its emergency stimulus and many emerging markets have instead been battling to prop up their currencies.

Now, though, central banks are again stepping up the rhetoric on exchange rates. The talk in markets is of a “cold” currency war and of tensions growing beneath the surface of G20 unity.

With the Fed giving no hints as yet on when it might start to tighten monetary policy, a weak dollar has left other major currencies at uncomfortably high levels. Low volatility has stoked a revival of so-called “carry” trades in higher-yielding emerging market currencies.

Policy makers in Australia, Canada and New Zealand have been threatening action to weaken their currencies for some time.

The euro’s strength, already a big political issue, is now a “serious concern” for the European Central Bank, Mario Draghi said last week, signalling that the ECB could ease policy in June to tackle low inflation.

Even the Bank of England is starting to voice concerns that a strong pound, if it persists, could threaten the balance of the UK recovery.

Emerging markets are also entering the fray. Traders believe the Bank of Korea has stepped up dollar purchases to curb strength in the won - the only Asian currency still above its level last May, when the first hints of Fed tapering began to unsettle markets.

Colombia’s finance minister tweeted this week that the government would resume dollar purchases. Among the “fragile five” hit hardest in last year’s EM sell-off, Brazil has already reduced the swaps programme it put in place to prop up the real; Turkey has hinted it could partially reverse January’s emergency rate hikes and traders say India’s central bank has been quietly intervening to limit the rupee’s rise on election fever.

“It is inevitable that we will see a rise in tensions,” says Eswar Prasad, a senior fellow at the Brookings Institution. Central bankers across the developed world are “trying to send a message as clearly as possible that they will design monetary policy to weaken the currency”, while those in emerging markets are “very concerned about being caught in the crossfire”.

Although the US has a higher tolerance for currency appreciation, he added, policy makers there will be “very concerned that actions by other central banks could hurt what is seen as a fragile recovery”.

While some central banks are explicit about their wish for a weaker currency to boost exports, the reason so many are expressing concern is the threat of deflation.

“In a disinflationary environment a weak currency would be advantageous,” says Jane Foley at Rabobank. “The problem is that just about everyone has got disinflation . . . and therefore they all want a weaker currency. Not everybody can be successful.”

“It may not be a currency war, but it increasingly looks like a currency cold war to us,” say analysts at Bank of America Merrill Lynch.

The ECB’s arguments that the euro’s strength exacerbates the risk of deflation “do not cross the line of G20 commitments against beggar-thy-neighbour policies . . . but certainly are not fully consistent with market-driven exchange rates.”

In emerging markets, most currencies have yet to recover fully from last year’s sell-off, and many are at relatively comfortable levels.

“Currency wars are not back,” says Win Thin at Brown Brothers Harriman. But he adds: “If the rally continues . . . we’ll see more people speaking up.”

What is the risk, then, of these skirmishes escalating into a fresh conflict?

If the ECB takes action next month, it could have immediate knock-on effects. There is speculation that the Swiss National Bank could take further action to weaken the franc - whether by raising the minimum exchange rate from the current SFr1.20 per euro, or by cutting interest rates.

Another trigger would be if the Bank of Japan was to ease monetary policy further. The yen has strengthened slightly since the start of the year, after its precipitous fall at the onset of 'Abenomics'. But if policy makers engineer a fresh depreciation, central banks across Asia could feel compelled to retaliate.

Less clear is the extent to which policy makers can achieve their aims. While the SNB has made it clear it will print money as long as necessary to keep the franc in check, investors could swiftly challenge other central banks' determination.

Efforts to talk down the Australian dollar had an effect last year, but with the central bank toning down its language, the Aussie has rallied since January.

Graeme Wheeler, New Zealand's central bank governor, succeeded in talking down the kiwi dollar last week. But trying to keep it in check at the start of a cycle of rate increases would be "as futile as Don Quixote's battle against the windmills", says Tom Levinson at ING.

Some analysts argue that the ECB's expected rate cut in June may be largely priced in and that its effect could be shortlived if it encourages further inflows to the eurozone 'periphery'.

"Is it going to work? It rarely does," says Neil Mellor, strategist at Bank of New York Mellon. "While the dollar is being used as a funding currency because the Fed is refusing to give any guidance on interest rate cycle . . . any drop in other currencies is an opportunity for investors to buy at a subsidised rate."

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