

Buttonwood | Race to the bottom

Countries compete to weaken their currencies

ONCE upon a time, nations took pride in their strong currencies, seeing them as symbols of economic and political power. Nowadays it seems as if the foreign-exchange markets are home to a bunch of Charles Atlas's 97-pound weaklings, all of them eager to have sand kicked in their faces.

First the dollar took a battering in 2009 when the return of risk appetite, and the ability to borrow the currency at very low rates, sent money flowing out of America for use in speculative "carry trade" transactions. Then the euro got pummelled because of concerns about the euro zone's exposure to sovereign-debt problems in southern Europe. Finally sterling hit the canvas this week because of concerns about the British government's deficit and the policy gridlock that may result from a hung parliament after a general election expected in May.

Is there any sign that politicians and central bankers are upset by these depreciations? None at all. Mervyn King, governor of the Bank of England, seems to welcome sterling's weakness as a boost to exporters. European politicians, such as Christine Lagarde, the French finance minister, have revealed their pleasure at the euro's recent decline for similar reasons. The American authorities, while parroting their belief in a strong dollar, have done nothing to shore it up, neither raising interest rates nor cutting the fiscal deficit nor intervening in the markets.

Nor has there been much sign of rejoicing in those countries whose currencies have tended to strengthen. The Swiss have intervened to hold down the franc. And Japan's latest finance minister, Naoto Kan, has called for a weaker yen (although he received a rebuke from the prime minister for doing so).

The one country that most economists

agree should let its currency rise is China (in theory, faster-growing countries should enjoy real appreciation over the long term). But the People's Republic also resists the temptation, intervening to stop the yuan from rising against the dollar.

Why are weak currencies so much in favour these days? The answer seems to be that the interests of exporters are paramount, given the desperate scramble for growth that has followed the credit crunch and the global recession.

Of course, because currencies cannot

depreciate all at once, there seems to be a kind of "Buggins' turn" to be the land of the rising exchange rate. The starring role tends to be brief, either because the government takes action to weaken the currency, or because economic news prompts the markets to drive it down.

At the same time weaker currencies have not been punished in the traditional way—by higher inflation. Consider sterling. Using the currency's 2007 peaks as a guide, the pound has fallen more sharply against the dollar and euro (around 25-30%) than it did after the exit from the Exchange Rate Mechanism in 1992.

In the 1970s that kind of depreciation was accompanied by double-digit inflation. But the year-on-year increase in the British retail-price index was just 3.5% in January and even that number was pushed up by higher rates of value-added tax, a home-grown factor. Nor is Britain paying any great price for losing its European and American creditors more than a quarter of their money in three years. Short-term rates are just 0.5% and ten-year government bonds yield a lowish 4%.

To some, the lesson of all this is clear. If all the issuers of paper money want to see their currencies depreciate, then the only answer is to own an asset that central banks cannot debase—namely, gold. Part of bullion's rise to more than \$1,100 an ounce this year must be attributed to the conviction that governments will inflate away their debts.

But it is hard to see how sustained rises in inflation will be generated in the next couple of years, given the amount of spare capacity in the global economy. It is also far from certain that governments could get away with a deliberate strategy of higher inflation, given the generally short maturity of their debts (less than five years, in America's case). The markets would see them coming and increase bond yields accordingly.

Indeed the current sovereign-debt jitters may be a sign that creditors are starting to assert themselves again, and demanding higher yields from less prudent governments. Where countries depend on foreigners to fund their deficits, they may find that the "easy" option of depreciation carries a much higher cost than in recent years. In time, having a strong currency may once again come to be seen as an advantage, not a handicap.