Implications of a Currency War

What is the issue?

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- Trade skirmishes have raised fears of a global currency war.
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- In this context, it is important to gauge its possible implications for India and other economies around the world with a historic precedent.
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What did the 2008 Financial Crisis unleash?

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- **Crisis -** Immediately after the collapse of “Lehman Brothers Bank” in the US that kicked off the 2008 financial crisis, economic panic spread globally.
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- The biggest concern of countries then was to avert a sharp slide in their respective economic growth curves and prevent loss of jobs.
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- **Actions -** U.S. and members of the EU embarked on expansionary fiscal and monetary policies (spending more and keeping interest rates low).
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- To secure their growth, some countries turned protectionist in due course by introducing non-tariff barriers and occasionally raising import duties too.
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- Another strategy used by some countries was to either devalue their currencies, or deliberately keep the value suppressed in international markets.
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- Significantly, this helped them to keep their exports cheaper in the world market and thereby sustain international demand for their produce.
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- China, Japan and South Korea were noted to actively suppress their currencies in international markets through central bank interventions at that time.
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- Such interventions of competitive lowering of currency values using monetary and exchange rate instruments was termed “international currency wars”.
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How was this currency trend resolved?

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- Unilateral competitive actions by countries was hindering the effective recovery of the global economy and deepening the trouble.
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- Considering the enormity of the issue, US had called for a summit of top 20 economies (G20) for the 1st time, which met at Washington DC.
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- India, the 13th largest economy then, was a member of the G20, and the grouping accounted for almost four-fifths of the world economy.
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- The single most important decision by the summit leaders in DC was to coordinate efforts and strive for a broad revival of the global economy.
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- In this context, competitive actions to keep currency values low was decried as a malpractice in international trade.
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Why has the talk of currency war revived again?

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- **Trade War -** Global trade skirmishes have intensified lately with the US President Trump threatening to slap comprehensive tariffs on Chinese goods.
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- While tariffs have made Chinese goods costly in the U.S., the recent depreciation of Chinese yuan (almost 8% against USD) has partly offset this.
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- While this is largely due to slower growth in the Chinese economy, it has frustrated Trump, who is mulling more tariffs to contain China.
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- Similarly, trade tensions between the US and Europe too has escalated after both imposed tariffs on each other after Trump started the chaos.
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- **Protectionism -** Trade tensions may tempt counties to use monetary policy instruments to competitively devalue their currencies as a counter to tariffs.
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- This may lead to further chaos and worsen the overall scenario that would already be marred with disrupted supply chains.
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- Such actions might spell doom for all economies and make the whole world poorer by a considerable margin.
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What is scenario in India?

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- **Local Metrics -** In the last 10 years, the Indian economy has grown rapidly, rising from being the 13th largest in 2008 to the 6^{th} largest in 2018.
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- However, the rising crude oil prices has been pressuring India's balance sheets immensely, leading to large "balance of payment" deficits.
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- This is might trigger a macro economic crisis and also lead to flight of foreign and local capital elsewhere, thereby ushering in a self fuelling prophecy.
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- Further, this will adversely impact inflation, interest rates and currency value (Indian rupee has already depreciated 6.8% against the dollar since Jan 2018).
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- RBI recently tightened the money flow by increasing the interest rates further, which might help in curtailing inflation and stemming the outflow of capital.
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- **International Metrics -** India has been increasingly getting integrated more with global markets over the years.
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- Hence, an upswing in the world economy is likely benefit India too.
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- An international currency war due to heightened tariff tensions can hurt the global economy, and in the process hurt India's growth prospects too.
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