THE GLOBAL ECONOMY

The Planning Begins—for a Currency War

If there's one thing the world economy has benefited from over the last 70 years, it's the absence of all-out military conflict between the major powers. It should be pretty clear that such events kill trade and destroy wealth.

But while most government and corporate leaders worry about the next move from ISIS or North Korea, a far-less-noticed skirmish is brewing that could disrupt at least the business world in a different way. We're talking here about currency wars.

Although major currency drops in places like South America occasionally heat up, there really has not been a major global currency spat in decades. The two most significant currency wars since President Nixon quit the gold standard have been between the United States and Japan (early 1970s until 1995), followed by the United States and China (starting 2005), said Steve Hanke, professor of economics at Johns Hopkins University. The result of warring with Japan has been massive deflation and stagnation in that country, notes Hanke.

Yet economists are starting to worry about a broader war, and for good reason. We all know that most of the world has been in a growth rut for years, and that many countries, including the U.S., have tried everything to change that. Keep interests rates low. Change trade laws. Play with taxes. Start stimulus packages. And yet here we are.

Clearly, the public is losing patience—just ask anyone at a U.S. presidential rally lately. So as economists see it, what choice do countries have but to go the last-ditch route—and start cheapening their money?

"It's a process by which countries who see each other as competition try to cheapen their exports artificially by currency manipulation," said David Ranson, director of research at HCWE Worldwide Economics. Then once the country devalues its currency against the other, there's usually a retaliation—leaving both countries where they were in the first place in exchange rates, but with much weaker money. (Interestingly, the one piece of good news has been Brexit; the U.K. didn't cut interest rates despite the sharp drop in the pound. But no one can predict the future there.)

Naturally, the domino effect of weak money begins to have implications everywhere, especially in the corporate world. CFOs at multinationals are used to employing hedging tactics, but it gets tough, for

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example, when a retailer has bought its inventory for the Christmas season with one set of expectations and then finds things have changed dramatically.

Lower currencies also change the corporate rhythm in a host of other ways. Top management must be involved if the operations of the company require rejigging. Marketing gets involved if the product mix has to change because of shifting raw material costs. Airlines are a good example of an industry that gets whacked when one country devalues its money in the midst of a fare war, forcing the airline to reduce its flights there.

Surviving currency wars are, of course, a good measure of a company's agility. We all got a good taste of that ability to react fast when China last year surprised the world by devaluating the yuan, in an ill-fated effort to boost its economy and improve trade. Companies with large operations there had to adjust when the yuan shift increased the value of their goods in local markets. Firms with big exports to China were suddenly charging their customers more. For instance, smartphone components or pharmaceuticals from Japan would cost a lot more in yuan post-devaluation.

Meanwhile, the plan didn't boost the Chinese economy in the long run anyway. In 2015, that country, the second-largest economy in the world, suffered net outflows of capital. In other words, investors took their money out of China and stashed it elsewhere, like the United States. The total amount of cash that left totaled an estimated $674 billion, followed by a further $166 billion in the first quarter of 2016, according to the Institute for International Finance.

"Less capital means slower growth," said Ranson. It also means higher inflation because the lower currency value means higher raw materials costs. This is also known as stagflation—stagnation plus inflation.

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The question now is whether the U.S. might even get into this game in a huge way. The last explicit global devaluation of the dollar on purpose was in 1971, but both U.S. presidential candidates are clearly under pressure to find some ways to improve the economy and trade. "When the U.S. devalues it's a global event," said John Tamny, author of "Who Needs the Fed?" and a senior fellow in economics at the Los Angeles-based Reason Foundation. The dollar is, after all, the foundation of the international monetary system.

To be sure, we are still a long way from knowing if a World War in currency will become a reality, and whether the U.S. will jump into the fray. Neither candidate for the White House has expressed a positive attitude toward free trade. Business strategists would be wise to keep their ears open to exactly what each says about trade and currency.

But whether they are based in New Delhi or New London, firms with large foreign operations will have the luxury on Nov. 8th of knowing many months in advance who will occupy the Oval Office. Still, currency traders will likely anticipate the winner and push the dollar around. Circle the date—and let the hedging games begin. ●