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Investor Education Centre

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Can anybody win the currency game?

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There is a new game being played around the world. It features high stakes and VIP players and it's not at all obvious who the winner might be. Some refer to the game as "Beggars thy neighbour", some know it as the "Race to the bottom" and others just talk about it as "The Currency War".

It is a game that everyone is being forced to play because every country is suffering from the fallout from the economic recession and wants to fight its way out of it through an export-led recovery.

Finance ministers and central banks are pinning their hopes on export growth. For this to happen, they need a weak currency so that their exports are attractive relative to other countries.

But the problem is that everyone is playing the same game and trying to undercut the currency of everyone else.

Not everybody can be an exporter of goods and services. Somebody has to buy and somebody has to sell. Right now, too many countries are trying to devalue their currencies at the same time.

Traditionally, central banks have managed their exchange rates by raising or lowering interest rates. Those countries with trade deficits (who buy more overseas than they sell) raise interest rates, which attract funds from other countries. Conversely, low interest rates encourage speculators and investors to seek higher returns overseas, and this capital outflow lowers the exchange rate.

Interest rates are not as effective a tool these days given that in many of the larger economies, interest rates are close to zero (in an effort to avoid recession). With interest rates so low, central banks have moved on to the next best thing - quantitative easing - which is pretty much the equivalent of printing money.

Quantitative easing is a term that we last heard in the middle of the global financial crisis. The US Federal Reserve printed money to buy up treasury bonds, mortgage bonds and whatever else needed supporting to stop the financial markets collapsing.

There is now talk of QEII or Quantitative Easing Round Two.

The Federal Reserve is hinting that another easing is imminent, as is the Bank of England. The Bank of Japan started the 'race to the bottom' by selling the Yen on September 15. Other countries reacted immediately and the US began a spat with China suggesting they should revalue their currency - i.e. the opposite of every other country - because they are the strongest economy and do not need an export-led recovery.

China holds all the cards but may not be the winner because the reality is all countries need to work together for the global economy to grow.

One thing is for sure, there will be winners in this game who aren't even sitting at the table.

Already the gold price has gone through the roof as a result of the US dollar weakness. Emerging markets and those economies with higher interest rates should prepare for a wall of cash coming their way! Whatever the outcome, the currency game is a very interesting spectator sport.

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