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By Wilson Sy

Is the US-China trade war morphing into a currency war?

In recent weeks, President Trump has become more vocal about the issue that the US dollar's strength is putting the US at a disadvantage. In a tweet last July 3, he said that: *"China and Europe are playing big currency manipulation game and pumping money into their system to compete with the USA. We should MATCH, or continue being the dummies who sit back and politely watch as other countries continue to play their games – as they have for many years!"*

China & EU, currency manipulators?

Trump's complaints about the strong dollar are nothing new. As a presidential candidate, he repeatedly accused China of manipulating its currency. He criticized the dollar as being "too strong" and that China is holding down the yuan just right after his election (see *The US dollar is "too strong" - Trump,* January 23, 2017). However, his recent accusations that China and Europe are playing a "big currency manipulation game" has led many to believe that the Trade War could be morphing into a Currency War.

Trump accuses China and the EU of having an unfair advantage

Even before the G20 meeting, Trump already accused China of having an enormous advantage by weakening its currency, arguing the need to level the playing field. Trump said that China's weaker currency is nullifying the impact of tariffs, adding that President Xi's ability to directly impact monetary policy is an unfair advantage.

Trump also blames the ECB of using its monetary policy to make it easier for the EU to compete with the US after ECB president Mario Draghi announced last month that more stimulus could come. Trump tweeted that Draghi was illegally manipulating the euro, adding that the EU, along with China and others, has been getting away with this for years.

Currency wars & competitive devaluation

In economics, a competitive devaluation occurs when a country deliberately depreciates its domestic currency to stimulate its economy. A currency war happens when countries intentionally seek to weaken their currencies to gain an "unfair" competitive advantage at the expense of other countries. While having a weaker currency can cause higher inflation and lower purchasing power, it is viewed to be beneficial to countries suffering from massive trade deficits and high unemployment.

Currency wars during The Great Depression of the 1930s

During the Great Depression of the 1930s, currency wars were common. Countries tried to weaken their currencies to gain a competitive advantage in trade. However, a series of competitive devaluations and retaliatory tariffs from trading partners meant that no nation benefitted. The resulting sharp decline in international trade ended up exacerbating the global economic depression.

The Plaza Accord of 1985

The Plaza Accord of 1985 was a joint-agreement between US, UK, France, West Germany and Japan to depreciate the US dollar relative to the Japanese yen and the Deutsche Mark. From 1980 to 1985, the strong appreciation of the US dollar put pressure on the US exports, causing major companies like IBM, Caterpillar and Motorola to lobby the US Congress to step in. Following the historic accord, the US dollar depreciated by as much as 50% against the Japanese yen and the Deutsche mark.

Japan and the aftermath of the Plaza Accord

While the US economy benefitted from the Plaza Accord as US manufacturers became profitable, it proved disastrous for the Japanese economy in the long-run. Many economists believe it helped usher Japan's Lost Decade of the 1990s. The agreement to increasingly weaken the US dollar led to the Japanese yen's rapid appreciation. To limit the negative effect on Japanese exports, the BOJ loosened monetary policy which fueled a property and stock market bubble. Ultimately, this led to a prolonged period of deflation when the Japanese bubble economy burst.

A US-China Plaza Accord?

Given the depth of today's global currency market, it would take a multi-lateral agreement similar to the Plaza Accord of 1985 to depreciate the US dollar with lasting effects. But while the US may want to try to orchestrate a modern-day Plaza Accord, it may be difficult given today's circumstances. For one, given the lessons from Japan, China will not succumb to US pressures easily. Secondly, it may be difficult for China and the EU to allow their respective currencies to strengthen, given the slowing growth at home and sluggish global growth.

S&P 500 hits a record high 3000

Stocks hit record highs, and the dollar fell after Fed Chairman Jerome Powell's gave a dovish statement to Congress last week. Powell - himself a frequent target of President Trump's pressure to reduce rates and weaken the dollar - reiterated the readiness of the Fed to cut rates to sustain economic growth. He added that the US-China trade war and slowing global growth continue to pose a risk to its outlook, suggesting the need for a rate cut "in the near term." The S&P 500 index hit 3,000 for the first time, closing at 3,013.77 for the week, following Powell's testimony. The PSE Index likewise closed higher and is seen testing the 15-month resistance level at 8,200.

Trump's concern of a strong dollar and the Fed's indication to cut interest rates has, in a way helped the Philippine peso to appreciate and the Philippine stock market to strengthen. The pause in US dollar strength and Trump's demand for the Chinese yuan to appreciate is actually helping the Philippines (*see Philippines – Unintentional beneficiary of the US-China trade war,* June 24, 2019).

Remaining vigilant

While stocks are at or near record highs and investors taking threats of a brewing currency war in stride, we have to be vigilant. Trade wars could easily morph into currency wars, which can have far-reaching implications and disastrous consequences, especially in today's highly globalized economy. It may lead to greater protectionism and more trade barriers as countries "race to the bottom." It can cause dislocations and destroy economies just like what we saw during the Great Depression and Japan's Lost Decade.

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