Currency devaluation has its ups and downs

In theory, things will balance out in the world of supply and demand

Brazil gave the market a shove

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A trader on the floor of the stock exchange in Sao Paulo, Brazil, nervously watches quotations on monitors shortly after the market opened Thursday. By the end of the day, the market had dropped 10 percent.

When Brazil devalued its currency this week, stock markets around the world got the jitters.

But the average American just got confused. What *is* devaluation, anyway, and what does it mean?

Here's a primer, put together with help from Larry Kirschner, who's in charge of currency trading at Mercantile Bank.

Barter and Buicks

We use currency for convenience. Currency makes life easier than the old barter system. Imagine having to swap 2,000 of the pizzas that you bake for a new car.

Instead, you simply pay the car dealer $20,000 in the currency you got for selling your pizzas.

Currency puts a specific value on things: one pizza equals $10, one car equals $20,000.

Among the things on which currency puts a value is another currency. Just as 2,000 pizzas equal one car, 1,535.95 Colombian pesos equal one dollar.

At least, that's how much a dollar cost in Colombia this week. The price of one currency against another — its value — floats up and down, like the price of a bushel of corn.

Mostly, a currency's value is set by that vague and shadowy "market." In real life, "the market" is shorthand for supply and demand.

When something is in hot demand (or short supply, or both), the price goes up. Let demand fall (or inventories bulge, or both), and the price goes down. Ask anybody who runs a gas station.

Around the world and around the clock, people like Mercantile's Kirschner buy and sell currencies. Their millions of daily trades put a price on a peso, or a dollar.

Deutschemark uber alles

In valuing (or shunning) a currency, the market tends to ask itself:

- What's this country's balance of payments? In other words, does it sell more to other countries than it buys from them? Or does it buy more than it sells?
- What's the interest rate in this country? How much does that country's government have to pay for the money it borrows?
- What's the economic outlook for this country? Is it purring along with low inflation? Do businesspeople there play by the rules? Or is it a sinkhole of corruption and inflation?

If a country scores well in two or three categories, its currency will be in demand. Traders call such hot-demand money a "strong" currency. Take the German mark. Throughout much of Europe, hotels and restaurants will willingly take marks instead of the local currency. (Indeed, in Bosnia, merchants *prefer* the mark to their own, "weak" currency.)

So we'd rather have a strong dollar than a weak dollar, right?

Not necessarily.

Things balance out

Want to feel rich? Take your next vacation in Canada.

Time was when a Canadian dollar cost one American dollar, or maybe a few pennies more. But over the years, the market lost a bit of confidence in Canada.

Now, a Canadian dollar costs only 65 cents. That makes Canada a bargain for American tourists. And if you're a merchant who imports something made in Canada — hockey sticks, say — you get a great deal.

Trouble is, currencies work both ways. If you're trying to *sell* something to Canadians, you're in a bind. That's because fewer Canadians can afford to buy the dollars they need to buy your widgets, or whatever.

That's how the balance of payments works. In theory, anyway, it evens out prosperity. If a country buys more than it sells, its currency weakens. Sounds bad. But the weaker currency means that suddenly, that country's products are cheaper abroad, like those Canadian hockey sticks here.

At the same time, the stuff that Canada buys from abroad becomes more expensive, like an American computer.

Gradually, a spendthrift country turns things around. Thanks to its weaker currency, it sells more and buys less. Finally, its balance of payments comes into balance, and its currency gets stronger.

That's how the market works. In theory, anyway. In practice, some countries give the market a shove, which is what Brazil did this week.

And that's what we mean by "devaluation."

What Brazil did

Most of the world values currencies against the American dollar. In other words, most people price a currency according to how many dollars it'll buy, or how much it costs in dollars.

Normal market activity pushes these prices up and down. But when push comes to shove — when trading weakens a currency beyond what that nation thinks is prudent — the central bank will step in.

A central bank normally sets a floor on its currency: "We think the Taconian peso is worth at least a dime."

Should the market price of a peso fall to 9 cents, Taco's central bank will spend its own reserves of dollars to buy pesos on the open market.

This is supply and demand at work. With Taco buying, demand for the peso is up. And with Taco soaking up all those pesos, supply is down.

Any student in Economics 101 can tell you what happens next: The price of a peso rises.

Brazil's central bank went the other way. The bank said, in effect, "We're *lowering* the floor by 7.6 percent." That means the Brazilian currency — it's called the real — can fall by an additional 7.6 percent before the central bank will step in.

In other words, Brazil devalued the real. As a result, Brazilians will now pay 7.6 percent more for an American bulldozer or a German car or a Japanese VCR.

On the flip side, Americans, Germans and Japanese will pay 7.6 percent less for Brazilian coffee, or shoes, or steel. This should help Brazil to buy less and sell more. That in turn should help the balance of payments. And helping the balance makes devaluation a good thing, right?

Not necessarily.

Devaluation's downside

Harry Truman once longed for one-armed economic advisers. That way, he said, the advisers could no longer preface their advice by saying, "On the one hand . . ."

But economists show more than a sense of humor when they call economics "the dismal science." It's complicated. Take devaluation.

On the one hand, a country that devalues its currency will (or should) improve its balance of payments.

On the other hand, a country with a devalued currency will pay much more to borrow money from abroad and will attract fewer foreign investors.

Look again at Germany with its strong mark. The German government pays about 3 percent interest a year to borrow money.

The dollar is strong, although not so strong as the mark. So the U.S. Treasury pays about 5 percent a year.

A few years back, Mexico devalued its peso. Mexico pays about 33 *percent* a year in interest — more than six times what the United States pays, more than 10 times what Germany pays.

And the American taxpayer can only sigh at Japan. There, the interest rate for money borrowed by the government is only 0.18 percent.