

POSSIBLE MEANS AND SOLUTIONS FOR AVOIDING CURRENCY WARS

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Abstract: What is needed is a coordinated plan of action, involving all trading partners to ensure a balanced global recovery. The plan must address three interconnected issues: the exchange rate system, global imbalances and excessive reserve accumulation. Few solutions in response to these issues: - create an emergency markets reserve fund, from which member countries would be able to withdraw with no conditionality; - create a global governance mechanism to prevent countries from running excessive current account imbalances; - give surplus countries greater exchange rate flexibility; - enhance the role of the renminbi as an international currency; - strengthen the capacity of IMF to act as a lender of last resort, allowing it to lend to solvent countries against collaterals.

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1. INTRODUCTION

When recessions are severe and global, like the one triggered by the global financial crisis, they tend to lead to competitive devaluations of currencies. Such interventions raise unnecessary trade tensions, especially if accompanied by protectionist measures. The result could be a large disruption of global trade and further worsening of the global recession. As the experience of the Great Depression clearly shows, the consequences of currency and trade wars would be felt by businesses, consumers and governments around the world.

A conflict over exchange rates is brewing. The burden of adjustment the United States needs to close its trade deficit has fallen mostly upon the euro-dollar exchange rate, to the tune of 30 percent versus eighteen months ago. Meanwhile, the yen-dollar exchange rate has moved only 17 percent in the same period, largely because the yuan-dollar rate has not moved at all. The weak and, in part, export-driven recovery in Europe makes the eurozone governments antsy about further rises in the euro against the dollar. And U.S. presidential candidates are formulating legal challenges to those countries that are seen as blocking the orderly decline of the dollar. Governments and interest groups do not like feeling as if they are being taken advantage of by foreign economic policies.

Outright “management” of exchange rates, however, is not in the offing—none of the major governments are willing to subordinate domestic monetary or fiscal policy to achieve exchange rate goals, and they would have to do so in order to actively manage exchange rates. This external laissez-faire stance is justified economically for

each of the three major currency issuers—the United States, Japan, and the eurozone—since the exchange rate does not have a significant effect on domestic price levels or growth rates until large misalignments are sustained. Politically, though, this is not a sufficient argument to stave off either self-serving arguments from import-competing sectors or more valid government-to-government complaints about burden-sharing and exchange rate manipulation.

The growing threat of trade and currency wars hung in the air at the IMF-World Bank Annual Meetings last weekend. The “global rebalancing” agenda—an initiative led by the United States and a few other countries to induce current account surplus economies to appreciate their currencies and import more goods and services—is having unintended but predictable consequences. The shared purpose that existed two years ago - when G20 economies partnered to stimulate global demand and rescue the financial system – has vanished, replaced by finger-pointing and admonitions.

In arguing so forcefully for “rebalancing,” the United States has always been on shaky ground. Here was the country responsible for the greatest consumption and construction binge in history declaring that things must change; that other countries should mend their ways, relying less on lending to the United States and more on their own spending; that U.S. exports would double in five years, and that the rest of the world’s currencies must appreciate to help out.

Meanwhile, the United States gave no signs of undertaking the painful long-term fiscal reforms—such as instituting consumption and gasoline taxes, ending the mortgage tax credit, and establishing a needs-tested Social Security system—needed to increase its dismal national savings rate. And the difficulties in the three other large trading blocs further complicated things: sovereign debt crisis in Europe; mixed signals from China about its currency flexibility; and Japan’s relapse into deflation.

2. ANALYSES

Recent developments—including the recent U.S. House bill that threatens China with countervailing duties for holding down its currency, the vitriol about exchange rates in the op-ed pages, declarations by various finance ministers that they would not allow their currencies to become uncompetitive, and Japan’s return to intervention after a six-year hiatus—suggest things could turn much uglier.

What can be done to avoid a currency war, and mitigate the threat of eventual protectionism? To answer this question, we first review who has seen the largest appreciation since the outbreak of the crisis and why.

The effective nominal exchange rates of the four largest trading blocs have changed significantly since the outbreak of the financial crisis. The yen in Japan and the yuan in China have appreciated substantially—34 percent and 10 percent, respectively—from their 2006–2007 averages. The euro has changed little from pre-crisis levels, despite its weakness since the outbreak of the sovereign debt crisis. And, frustratingly from the U.S. perspective, the dollar has depreciated only slightly, with devaluation in several U.S. trading partners offsetting the effect of the large yen and yuan appreciation.

Of the 40 largest economies, 25 have seen their currencies depreciate in nominal effective terms from pre-crisis levels. These include several countries that have vocalized the need to curb supposed appreciation, such as South Korea and India.

Only seven countries (including Japan and China) have seen their currencies appreciate by more than 10 percent since the start of the Great Recession. Of these, four

countries—Japan, Switzerland, Israel, and China—have a significant current account surplus. And real exchange rates in the first three countries are roughly in line with their ten-year pre-crisis averages. In China, the real exchange rate has appreciated by 10 percent vis-à-vis its ten-year pre-crisis average.

In the other three countries—Brazil, Colombia, and the Czech Republic—currency appreciation may be more problematic. Each of these countries has a modest current account deficit, and their real effective exchange rates have appreciated by 42 percent, 27 percent, and 36 percent, respectively, compared to their ten-year pre-crisis averages. Appreciation in these countries and in many other successful developing economies has been especially sharp in recent months.

However, some of this change is justified: Improved macro fundamentals, better governance, booming commodity exports, and recent oil and gas finds have made Brazil and Colombia more attractive to foreign investors, and the Czech Republic has been one of the more successful transition and EU-accession countries. Nevertheless, whether the large capital inflows into these countries will be sustained is unclear, since the surge in capital flows may only be beginning, and international interest rates will rise once the crisis abates.

The smaller countries play a significant role in trade, but will certainly not set the tone for international currency relations. Instead, the four large blocs will determine the behavior of smaller players through their management of currencies and relations with one another.

The United States should cease pursuing what is increasingly perceived as a policy of currency depreciation vis-à-vis the rest of the world. With negative net exports representing less than 4 percent of U.S. GDP and domestic demand representing 104 percent, policies to stimulate demand should focus on the latter rather than the former. Against a background of slowing growth, the United States needs to resist an early withdrawal of stimulus, but must also reassure investors and trading partners by legislating reforms that reduce spending and increase taxes in the medium term.

In the Euro area, Germany and other core countries must stimulate domestic demand to support the adjustment in the debt-constrained European periphery. Failure to help the adjustment in competitiveness and fiscal balances in the periphery may one day threaten the survival of the Euro area as currently configured.

China has already contributed more to global rebalancing than any other country. Its domestic demand has increased by 41 percent since 2006–2007, its current account surplus has declined by 5 percent of GDP, and its real exchange rate has appreciated by more than that of any other large country compared to its ten-year pre-crisis average. But what can be done for avoiding a US – China currency war? Facts: the US Treasury Department will decide soon whether to label China as “a currency manipulator.” The prospect of a trade war, or even worse a currency war, between the world’s two largest economies risks further destabilizing the shaky recovery of the global economy. Given the extremely complicated nature of the renminbi (RMB) exchange rate in a global economic context, the US should undertake a rational cost-benefit analysis instead of threatening sanctions. Since July 2005, China's RMB has appreciated as much as 21 percent against the dollar. But this has not significantly improved the US trade deficit, nor has it reduced China's trade surplus. The driving forces of today's exchange rate have gone far beyond bilateral trade. To understand what is happening, an analysis of the open global production and trading system is

necessary. It is unlikely that greater RMB appreciation, as demanded by some members of the US Congress, will alter China's status as the "workshop of the world" and substantially boost American exports. While the US could experience limited economic gains if any form of sanctions is enacted, the Chinese economy will suffer serious damage. First of all, a surcharge tariff of 20 percent or more on Chinese imports to the US will drive a large proportion of Chinese exports out of the US market, and will significantly reduce external demand. Second, many workers in China's coastal export processing zones will lose their jobs, resulting in a slowdown of economic growth and social unrest. Finally, as more speculative capital enters China with a bet on RMB appreciation, the problem of an asset bubble in the Chinese economy will worsen and could spiral out of control. Moreover, a Chinese-US trade and currency war would threaten the entire East Asian economy. Goods marked as "Made in China" actually involve a collective division of labor across the region. In the past 15 years, East Asian economies including Japan, South Korea, Taiwan, Hong Kong and Singapore have moved their assembly lines to Mainland China to take advantage of its cheap labor costs, and they continue to target their exports at the US market.

As a result, these economies have greatly reduced their trade surplus with the US, while China is perceived as having the largest trade surplus. A trade and currency war between the US and Asia would therefore trigger significant knock-on effects for the region. As China leads the world out of the recession, the Chinese economy has replaced the US economy as the greatest engine of global economic growth. Consequently, a Chinese-US economic war could undermine the faltering global recovery. For example, panic-induced capital holders could dump dollars and buy euros, resulting in a substantial appreciation of the euro. This is definitely not in Europe's current interests. Among other consequences, it would exacerbate the impact of the Greek debt crisis on the EU economy.

When President Barack Obama took office in early 2009, he sought to strengthen US-China cooperation on issues related to North Korea, Afghanistan and Iran; on global governance reforms such as the International Monetary Fund (IMF) and the Group of 20 (G-20) nations; and on climate change and anti-terrorism policies. Despite quarrels over US arms sales to Taiwan and Obama's meeting with the Dalai Lama, strategic cooperation between the two countries has remained strong. Faced with continuing global challenges, the US needs China's continued cooperation. If unilateral action by the US (i.e., citing China as a "currency manipulator") triggers a trade and currency war, the bilateral relationship will be severely damaged.

Meetings of the G-20 and the multilateral climate change convention, for example, could face immediate barriers because of mishandling by the US of the exchange rate issue.

Why has the US continued to put pressure on China over the RMB? And how likely is it that this pressure will lead to action? These questions can be answered by an analysis of US domestic politics and the recent diplomatic frictions between the two countries. As the US mid-term election approaches, the weakening political support for the Democratic Party and President Obama is evident. Maintaining a majority in Congress will be a difficult challenge for the Democrats. Scapegoating China is always helpful to domestic politics, because it diverts popular dissatisfaction with Obama's economic policies.

Taking action on the Chinese RMB would please American voters who complain about the high unemployment rate in the US. In addition, China's rapid

economic rise is a source of public fear in the US. It is, therefore, good timing to “take on China.” Threatening to impose sanctions on China over the RMB may be regarded as “saving face” in the recent bilateral diplomatic spat over US arms sales to Taiwan and Obama’s meeting with the Dalai Lama. The Chinese government views Taiwan and Tibet as part of the nation’s “core interests” and publicly condemned these moves. In the US, Chinese actions are now interpreted as “arrogant” or “tough,” altering the former perception of China as having a “low profile.” Undoubtedly, the confrontation reflects some change in the relative power position between the two countries following the global financial crisis. The assumption can therefore be made that Americans want to teach the Chinese that the US is still the largest power in the world. This could be a game of “saving face” in response to China’s “overreactions” on Taiwan and Tibet.

3. CONCLUSIONS

My intention in this essay is not to discuss whether the RMB exchange rate should appreciate against the dollar from a theoretical perspective. The economic theories of exchange rates conflict with each other, and there is no easy answer to this issue.

One lesson we can learn from this exchange rate dispute is that we are faced with an increasingly integrated global economy, and the global financial crisis and structurally imbalanced global economy indicate that the macroeconomic authorities of most countries have failed to adapt to this new reality. As a developing country, China has learned from the successful experience of export-led East Asian countries, and has pursued a stable exchange rate policy. But five to 10 years ago, few could have predicted such close interdependence between the Chinese economy and the global economy. We must be extremely prudent about the impact of today’s globalized economy, where China, the US, East Asia and other regions are so closely interlinked. We have to handle the RMB exchange rate with rational analysis. There are signs that the US and China may find a sensible way to solve their dispute and avoid the tremendous negative consequences to the recovering global economy. In the US, domestic political imperatives could eventually give way to a more rational policy making process. A rational decision will benefit all economies, including that of the US.

Within this context, G20 vows to avoid currency war. Finance ministers from the Group of 20 nations promised to refrain from “competitive devaluation” of their currencies, heading off the prospect of a currency war. In a final statement after two days of heated negotiation, the G20 said it would “move towards more market-determined exchange rate systems” and that the International Monetary Fund would “deepen” its supervision of exchange rates. “This language calms everything down and gives us a route map forward,” said George Osborne, the Chancellor of the Exchequer. “Obviously this colourful language about currency wars has got everyone excited,” he added. Mr. Osborne clarified, however, that the statement was not a criticism of China for persistently undervaluing the Japanese yuan. “What people have been nervous about is that the current imbalance would get worse as countries other than China look at the route of competitive devaluation.” He also said that while currencies “tend to grab the headlines”, they are just one part of wider economic imbalances.

While several member countries of the G20 hailed the summit in South Korea as a success, Japan immediately broke ranks to declare that, contrary to the spirit of the “communiqué”, it would continue to devalue the yen if it saw fit. Yoshihiko Noda,

Japan's finance minister, said: "A prolonged appreciation in the yen is not good for Japan's economy. Our stance, that we will take appropriate, bold action if needed, is unchanged." And while Timothy Geithner, the US Treasury Secretary, promised that the US would have a "strong dollar" policy, other countries remained skeptical about whether the US really would refrain from more quantitative easing, increasing its money supply in order to stimulate its economy. "There was a criticism of the American policy of creating more liquidity," said Rainer Breuderle, the German Finance minister. "I tried to make clear that I regard that as the wrong way to go. An excessive, permanent increase in money is, in my view, an indirect manipulation of the (exchange) rate."

Meanwhile, a US plan to set firm trade caps, as a way of rebalancing the global economy, was also shot down by China, Japan, Russia, India and Germany. While the G20 agreed to reduce "excessive" trade imbalances, no firm targets were set. Instead, the final statement from the G20 simply said that "indicative guidelines" would be agreed at a later stage, "recognising the need to take into account national or regional circumstances".

The move to place caps on trade was an attempt to focus on the root issue behind the recent exchange rate clashes. However, Mr. Osborne said that strong exporters had argued that "different countries are in different situations". He said: "Some are natural resource exporters and have a structural issue. Others, like Germany, have a very strong export sector built on competitiveness and not driven by exchange rate." "What a lot of those countries have said is that (the rules) should be a bit more country-specific and just having a single target risks being too broad a tool." He suggested that individual targets for each country, or region, could be drawn up instead. "The important step is that this item is in the "communique" and that the IMF has now been given permission to walk into this space," he said, referring to the decision to give the IMF the power to police the matter.

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