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**Currency co-operation or currency wars?**

The principal topic of hot debate in the previous week-end's IMF World Bank Meetings was the need for realignment of currencies in order to reduce the global imbalances (read "U.S. deficit and unemployment"). No agreement could be reached, with China standing firm on its policy of the last few months, of a more flexible exchange rate for the yuan which, in practice, means a deliberately gradual appreciation of the currency to give time to domestic industry to adjust (the yuan has appreciated around 2.5% against the dollar since June 19, but the day-to-day movements have been in both directions). The problem has now been escalated to the G-20 Summit in Seoul next month.

The fact is that, for some time now, countries have been taking actions to stem the rise of their currencies against the currencies of their major training partners. For example, Switzerland and Japan, both developed economies, have intervened in the exchange market in recent times. But the world's largest exporter, namely China, is at the heart of the dispute. If these are wars, they seem to be "defensive" wars – to protect the domestic real economies which produce 95% of the output and employment, from the exchange rate gyrations that speculative capital flows can lead to. Japan clearly has experienced these, and in spades, in the 1990s. The USD: JPY rate gyrated from JPY 147 at the beginning of the decade to around JPY 80 in 1995, to JPY 146 in 1998 and to JPY 112 in just two months thereafter! There was no significant difference in the inflation rates, or current account balances of the two economies, over the period. (To be sure, Japan did undergo a banking crisis.)

The real reason is the so-called "feedback loops" which exaggerate price trends, sometimes grossly – in either direction. Basic economic theory suggests that the rise in the price of an asset should reduce the demand for it, and a fall make it more attractive. In practice, in financial markets, too often, higher prices of assets attract more buyers, leading to a further rise in the price – until, of course, the music stops one day. The problem is that the cost of rate gyrations has to be borne by the real economy in terms of slow growth/recession, unemployment, etc. The 1990s and the last 10 years have been “lost decades” for the Japanese economy because of the gyrations in its asset prices and the exchange rate, a fact that China, always conscious of the need for social stability, and with a social security net far weaker than Japan’s in the 1990s, is surely aware.

There are two different strands to the issue of managing exchange rates, one philosophical and the other more immediate and political. As for the first, the major Anglo-Saxon economies, namely the U.S. and Britain, have been market fundamentalists for the last 30 years or so. The philosophical/academic underpinning is provided by the Chicago School as also economists like von Hayek. This believes in the efficiency of the markets and how market prices reflect all economic fundamentals. A corollary is that any regulatory intervention to influence the market prices can only distort them and therefore give a less than optimum result. The bankruptcy of the concept of markets being always virtuous, and regulation being always sinful, came out in spades in the recent credit crisis, particularly in the two largest Anglo-Saxon economies, leading to a global recession.

Critics of managed exchange rates describe them as “manipulated” exchange rates: by that logic, I suppose every country in world was “manipulating” exchange rates from 1945 to 1970 (the fixed exchange rate era), and, in any case, is guilty of “manipulating” the domestic value of the currency (inflation) through monetary policy!

Despite all the monetary and fiscal stimuli post-crisis, unemployment in the U.S. remains stubbornly high at near double digit levels, and the ruling Democrats face the prospect of a major setback in the mid-term elections. In such a situation, it is always politically simpler to blame the foreigner: the Chinese exchange rate policy. With China refusing to be hurried, the U.S. Congress has passed legislation authorising the President to impose a duty of 20% on Chinese imports. It has been claimed that this would help create a million jobs. This proposition has several unstated assumptions, as follows:

⇒ That the duty will not merely replace Chinese imports by imports from other countries, but be replaced by increased output and employment;

⇒ Inasmuch as most of the cheap Chinese imports are purchased by the relatively poor, it is acceptable to force them to pay the higher prices of domestic goods; that the rise in domestic cost level (inflation) is needed to create jobs. (Have we not been always told how great lower inflation is?)

20% import duty means, in economic terms, a devaluation of the dollar by that amount against the yuan. The dispute is likely to become hotter ahead of the G20 Summit next month as the U.S.'s August trade data released last Thursday, evidenced a widening of the deficit, mainly because of higher imports from China.

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