

**October 25, 2010**

## ***The Anatomy of the Currency War***

*G20 Summit next  
month critical*

The Seoul Summit of G20 nations to be held in November this year is going to be critical from the point of view of the global economy as it will hopefully move forward to resolve the currency crisis that has enveloped the world for some time now.

*What exactly is happening?*

*The problem with  
too many goodies*

Presently, there is a large flow of funds from the developed world to the developing countries in the form of both debt and portfolio investment. These funds are leading to large balance of payments surpluses for these nations in the form of enlarged foreign exchange reserves. When foreign exchange reserves of any country increases, it leads to an appreciation of the currency. Now, when the currency appreciates, there is an inherent bias against the exports of this nation as its exports become less competitive and expensive in global markets. In order to ensure that this does not happen, countries are ensuring that their currencies do not appreciate which tantamounts to an implicit depreciation of a currency. When one country does it, its trading partners are forced to follow suit thus leading to a currency war wherein all countries are lowering or depreciating their currencies. This has meant a breakdown in the rules of global trade where the market forces are being violated. Currency protection is now pandemic from Japan and Switzerland to Turkey and Colombia.

Besides the issue of currency appreciation, countries also fear that such funds could leave their shores at any point of time when interest rates start to move up in the west. Such funds are hence termed as being hot money. Hence, there is a dual worry out here.

*Who is responsible for what is happening?*

*The First view*

*China needs to be  
controlled*

Advanced nations aver that with countries like China are artificially holding on to their currencies, renminbi in case of China, leading to a serious distortion in trade flows as it should ideally be adjusting through appreciation to ensure that they are smooth. This has created problems for the western nations which face uneven competition in the export markets. The worry is that if such currency manipulation continues, it could wreak havoc on international trade.

Some countries have taken direct action in the form of restrictive practices on capital flows such as Brazil and Thailand. Brazil for example has raised taxes on foreign investments in fixed-income securities for the second time in a month in a bid to defend exports. This is another sign of the currency war. The tax on foreign inflows will climb to 6% from 4%. The government will also close a loophole that allowed investors to avoid the tax on some margin deposits for transactions in futures markets. These moves aim to curb foreigners' appetite for short-term investments and curb the dollar inflows that have contributed to the real's 7.1% gain in the past three months.

*Back to Tobin tax*

Thailand imposed a 15% withholding tax on capital gains and interest payments for government and state-owned company bonds, a clear signal that it would take tough measures to curb inflows of "hot money".

Curiously, capital controls have been recently endorsed by the IMF as a legitimate short-term weapon for reducing the impact of volatile capital flows, though many economists remain sceptical about their effectiveness

*The IMF may also be agreeing*

#### *The other View*

While the US accuses China of undervaluing the renminbi, China blames loose US monetary policy for driving money into emerging markets that threatens to destabilize their economies. USA is trying to propel its economy out of the recession of 2009 and is following an ultra-liberal monetary policy with interest rates close to zero. This throws the burden of adjustment on the emerging markets. They have to tackle inflows as they have repercussions on the domestic economy in the form of monetary policy and inflation. Also the dollar has been falling sharply in the \$ 1.35-40/Euro range thus putting pressure on its trading partners. China's problem is that in case it lets its currency appreciate, then its exports would fall and given that it is an exports oriented economy, will impact the employment situation. It has already raised interest rates which will only enhance capital flows.

*It finally goes back to the USA*

It is true that investors are putting money into developing countries such as China, India, and Brazil amid near-zero interest rates in the U.S., Japan and the Euro region, which have fueled demand for higher-yielding assets. This is the case of 'carry-trade' which means that investors borrow money from countries where interest rates are low and invest the in emerging market hence earning high returns on capital. To top it all, the Fed's Chairman Ben Bernanke has made a statement that additional monetary stimulus may be warranted to boost the world's biggest economy, which means that this situation may be expected to persist for some more time.

*There can be no end to monetary easing*

This in turn has fueled speculation the Fed will embark on a second round of easing next month. Therefore, these nations feel there is a strong case for tackling these inflows through capital controls as well as exchange rate intervention through central bank action.

*What can happen?*

*How to beat China at its game?*

There are some smart sounds being made in the USA for imposing tariffs on goods coming from countries which have artificially low exchange rates. This means the imposition of tariffs on Chinese exports. The second route could be trade sanctions against China while the third could be retaliatory measures such as not allowing China to buy US bonds. While these are possibilities, it is expected that such disputes will be settled through negotiation and these options are more theoretical than practical.

*Whose fault is it anyway?*

*Both dollar and renminbi are falling*

On account of the ongoing tussle, the dollar is falling sharply while the renminbi is being stopped from appreciating thus creating a problem for the world economy. Also countries that are buying up dollars to prevent appreciation run the challenge of controlling growth of money supply and hence inflation. Direct capital controls on the other hand are relatively less messy for those imposing them.

*How about India?*

*The Indian options*

India has received almost \$ 20 bn in the first 6 months of the financial year. While a tax is being spoken of, it is unlikely that it will be imposed. However, the RBI is more likely to mop up excess dollars from the system and sterilize the same to ensure that there are no monetary policy implications since inflation, which is high on its agenda, is still high at around 8.5% per annum.

*What is the G20 Summit all about?*

*More discussions to come*

The Leaders of the G20 group of leading economies will seek to agree on specific guidelines on reducing global trade imbalances, in a fresh attempt to head off a potential 'currency war'. Finance ministers and central bank governors met in the South Korea, and agreed on a policy framework to contain large current account surpluses and deficits, but a proposal to set specific targets ran into opposition. The meeting also announced significant progress in reforming the IMF, shifting power away from Europe and towards emerging nations like China and Brazil.

The meeting however produced little pressure for the US to back away from its accommodative stance which fuelled dollar depreciation. Nor did it provide enhanced flexibility in Asia to pursue intervention or capital controls. A clear warning was sounded to the US that loose monetary policy could continue to push volatile capital flows into emerging economies.

The US and South Korea had also sought to forge consensus on a numerical target for surpluses and deficits at this weekend's meeting, suggesting a cap of 4% of GDP. But the idea of a specific target ran into stern opposition from Germany, Brazil and Japan. Nor has the US persuaded the rest of the G20, many of whom are probably intimidated by China's diplomatic and military clout, to get together on Beijing. Washington's latest plan, to set targets for current account surpluses and deficits, has received a mixed reception.

*And hopefully a solution*

*A consensus for the time being*

The G-20 ministers however concluded that they would move towards more market determined exchange rate systems that reflect underlying economic fundamentals and refrain from competitive devaluation of currencies. Also they would continue to resist all forms of protectionist measures and seek to make significant progress to further reduce barriers to trade.

*A silver lining exists...*

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