Currency Wars

A Threat to Global Recovery?

A full-scale global currency war will have no winners. It will not only threaten the global economic recovery but also deepen the geopolitical mistrust and miscalculations in a world in transition.

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The Currency Manipulation Bill has been passed in the House of Representatives with a large majority, targeting China. While many view a full-scale currency war between the US and China as not a very smart idea, with a record-high unemployment rate, depressed blue-collar and even white-collar wages, a struggling economy, and a general perception that American dominance in the world is ebbing away towards a 'Communist' China, chances are that in the run-up to the mid-term elections, the President should like to be seen to be keeping his finger firmly on the Bill's trigger.

The irony is that even if Chinese products were entirely priced out of the world market, this may not succeed in turning the tide for US exports and jobs. Consumers in the US and elsewhere are likely to buy similarly competitively-priced substitutes produced by other developing countries. Moreover, as China's Premier Wen has pointed out, the yuan has appreciated by some 55% since China's first currency reform in 1994. Since then, this magnitude of appreciation has not helped US exports or reduce Chinese imports.

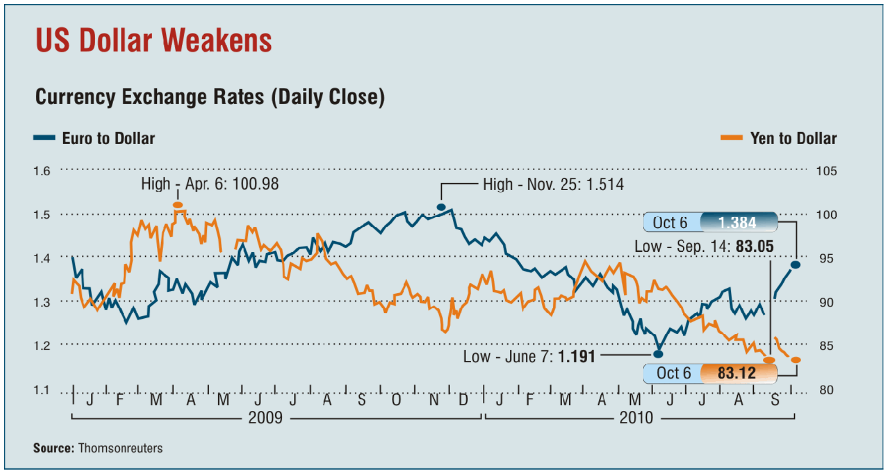
Additionally, net exports account for only 8% of China's GDP, as a great deal of China's export content is represented by imports of parts, components, materials, proprietary technology and services from other countries. Any appreciation of the Chinese yuan will lower the costs of such production inputs to the Chinese manufacturers, offsetting a significant proportion of the impact of a yuan appreciation. So the Chinese yuan would have to appreciate quite drastically to have the intended effect. However, most Chinese products are now trading at very thin margins, often below 5%. A substantial appreciation, as Premier Wen has warned, will drive many of China's manufacturers out of business, resulting in massive unemployment and social instability. This will be a disaster not only for China, but also for the rest of the world.

But that is not all. In the aftermath of the financial crisis, Western countries, especially key reserve-currency issuers, have resorted to Keynesian 'quantitative easing', or turning on the money-printing press, to revive their economies, thereby depressing their exchange rates. Particularly for the US, this is welcome as a boon for exports and diminution of the trade deficit as well as public debt. To safeguard competitiveness, exporting countries from Japan to Brazil have to intervene to keep their currencies from rising too much as a result. Now every country is looking after its own interests and 'beggar thy neighbor' is the name of the game. It is no surprise that the current IMF meeting in Washington DC has failed to reach any consensus on easing global currency tensions.

So what is at stake is not only the value of the Chinese yuan, but how trade should remain free and fair between countries and the stability of the global currency system. Indeed, the need for a more stable international currency system was earlier highlighted by Zhou Xiaochuan, the Governor of the People's Bank of China, referring to the so-called Triffin Dilemma.[1] Zhou proposed using Special Drawing Rights to replace the US dollar as a primary reserve currency. While this may not be the ideal solution and is unlikely to gain international consensus, in the wake of China overtaking Japan as the world's second largest economy, the momentum for the international acceptability of the Chinese yuan, if not its full and free convertibility, is gathering pace. Already, Hong Kong, as a leading financial center, is being used as an international platform for yuan-based banking settlements and yuan-denominated financial products. The day when the Chinese yuan emerges as one of the world's reserve currencies no longer seems too far away.

The looming currency war also hides another problem. Well before the financial meltdown, the world was already in a huge economic imbalance. Asian exporting countries' mounting surpluses were sterilized and fed into the West's financial system through investment in US Treasuries, making for perennially low interest rates and easy credit, much of it highly-leveraged, feeding unbridled consumption. This in turn pushed up Asian countries' exports and surpluses, with the result that more was invested in US Treasuries to fund even more debt-driven consumption. In short, the West, particularly the US, is overconsuming and China and some other surplus countries are over-saving. When the whole pack of cards collapsed from the financial crisis, rather than curbing consumption (which would have worsened the economic downturn), the West tried to jump-start it again with a massive dose of liquidity. The outcome so far is by no means reassuring.

Meanwhile, the West has been admonishing China for not spending or importing enough (even though, for strategic reasons, continuing to restrict high-technology exports to China). Learning from her external vulnerability in a global financial crisis, China has been putting more and more emphasis on boosting domestic consumption in order to achieve a more balanced economy. Studies by Credit Suisse and McKinsey have highlighted the burgeoning consumer market in China and how it will account for a lion's share of global consumer growth in the coming decades.[2] Indeed, America is already beginning to save more, while Asia is beginning to spend more. So a rebalancing may already be taking place, according to Stephen Roach.[3] Watch out for China's coming 12th Five Year Plan (2011 -2015), due to be announced towards the end of this year.



In another context, these currency wars may be regarded as a proxy between competing forces, as the tide is turning from the West to the East in a more multipolar world. In a report entitled "Global Trends 2025: A Transformed World," the National Intelligence Council concludes that with emerging industrializing economies, the dynamics of energy and other natural resources, new technologies, new non-state actors, and religious fundamentalism with asymmetric powers, a financially and morally weakened US may continue to lead, but her capacity to do so has shrunk. To address the global issues of the 21st century, including international terrorism, nuclear proliferation, regional instability, world trade, energy and resource constraints and Climate Change, the US has to lead by working more closely and cooperatively with other stakeholders, not just with her traditional Western allies.

The rise of the emerging powers during the past two decades has belied Western triumphalism in Francis Fukuyama's *The End of History*. 9/11 and China's rise may have revived the fears of Samuel Huntington's *Clash of Civilizations*. China's prolonged period of impressive economic growth has at least triggered a debate on the relative merits between the so-called Washington Consensus and the Beijing Consensus. But in a multipolar world becoming truly interconnected and interdependent, clash is not preordained, although squabbles and conflicts are inevitable. In this context, a full-scale global currency war would have no winners. It would not only threaten global economic recovery but also deepen the geopolitical mistrust and miscalculations in a world in transition. In particular, the relationship between the US as the only status quo superpower and China as a rising world power calls for more mutual understanding, accommodation and cooperation, if the world is to recover more quickly from the financial and economic crisis, let alone succeed in grappling with the many global challenges of the coming decades.■

Reference # 01M-2010-11-02-01

[1] J F Garner, *The Rise of the Chinese Consumer: Theory and Evidence*, John Wiley & Sons, 2005 and *The Value of China's Emerging Middle Class* in the *McKinsey Quarterly*, 2006.

[2] Stephen Roach, *Next Asia: Opportunities and Challenges for a New Globalization*, Wiley, 2010.

[3] *Global Trends 2025: A Transformed World*, National Intelligence Council, Washington DC, November 2008.