

BATTLE OF CURRENCIES

M.M.K. Sardana *

Abstract: *A group of countries led by U.S. has been blaming emerging economies like China that they are keeping the exchange rates of their currencies artificially low resulting in price advantage to their manufactures compared to the manufactures of the developed countries. By way of managing the exchange rates of their currencies countries like China are stifling the growth of employment in countries like U.S. Suggestions have been made if the developing countries like China do not revalue their currencies substantially counter measures should be resorted to. Such concerns were not expressed in the past when the world aggregate demand was on the increase even though the developing countries were having huge surpluses over the countries like U.S. Remedy for increasing employment in the developed countries like U.S. cannot be at the cost of employment in the emerging economies. Lasting solution can be worked out by the nation states through negotiation ensuring universal increase in aggregate demand and wages when the significance of exchange rates would be minimal. It should be borne in mind that battle between surplus countries (e.g. China) and deficit countries (e.g. U.S.) is essentially a struggle for power and not a technical one.*

U.S. government has been alleging that China is keeping the value of its currency artificially low and has accumulated huge trade surpluses and large reserves of US\$ with the Fed. This has caused unemployment in US as their products cannot compete with the low priced Chinese products. U.S. has been bringing pressure on China for revaluing its currency to bring about balance in the world trade. The issue has been on the agenda of summit level talks between the two countries and has also been taken up at the multilateral forums like G-20 summit and G-20 meet of Finance Ministers. I.M.F. has also been seized of the matter. However, in the perception of U.S. there has been no significant forward movement in the direction expected by U.S.

Prime Minister Man Mohan Singh has termed the battle between surplus countries (read China) and deficit countries (read the US) essentially a struggle for power and is not a technical issue¹. Following on the observation of the Prime Minister, Finance Minister Pranab Mukherji said that the best course would be to leave it (the battle) to sovereign governments to decide what course of action they will take. Every country has its own

* The author is a Visiting Fellow at the Institute.

¹ US-China Currency War a Power Struggle, Indrani Bagchi, TNN, November 14, 2010.

problems and they will have to address those issues. One cannot sit on value judgement from outside².

The economist Prime Minister as well as his Finance Minister have both termed the accusation of U.S. political rather than these being rooted in economy and economic theory.

If the issues involved were purely economic, in a globalised linked economy exchange rates would be determined by market forces and economic theory formulations such as the conditions arising from the impossible trinity trilemma. In real world situations principle of *ceterius paribus* does not operate. In real world situations, several forces work simultaneously in several directions and are superimposed by the will of the mighty. For several decades, the U.S. has been having huge trade deficits. In other words, the value of goods and services imported by USA is far greater than the value of goods and services exported by USA. On this logic, the value of dollar should have been depreciating vis-à-vis the world currencies which is not borne out by the situation prevailing in the market.

About 70 years ago, when world trade was on the rise and it was pertinent that there should be freedom from the vagaries of currency values of different countries, U.S. was able to establish hegemony of \$ and lure all trading nations to value their goods and services in \$ terms for international trade on assuring the world community that it would redeem their \$ earnings into gold on an exchange rate of \$ 35 to an ounce of gold. Thus \$ came to be recognised as gold in paper form by the world community, Central Banks of different countries and entities spread all over the world kept their reserves with the U.S. Fed which in economic and accounting term would be a debt of the depositors to the US. The concept of denomination of international trade in \$ has got so much enmeshed that it is a difficult proposition to get out of it. If some of the nation states in some region attempted to have some other currency for trade among themselves, the market forces were so manipulated that such group of countries faced adverse consequences and fell in line with the international practice of trading in \$ denominations. Some writers³ have traced the crisis of South Asian Countries in 1997 to their attempt to deal among themselves in yen rather than US \$.

The huge deposits that have been made by the Central Banks and other entities placed enormous funds in the control of U.S. to pursue its goals without any restraint on its

² India not to join currency war, The Statesman, February 19, 2011.

³ Currency Wars: A Matrix of Concepts, Rashmi Sanghvi, January 24, 2011 rashmisanghvi.com

resources. Even if some countries decide to draw on their reserves, they have to do it with due care as they may run the risk of increase in their money supply and consequently increase in interest rates and finally the dollars with drawn may also travel back to the US Fed.

During the cold war period, there was intense rivalry between the USSR and the USA. Both went on to develop several military bases with nuclear submarines stationed around the world. Reserves with U.S. started dwindling because of the increase in their military expenditure. There was a gold run and savings were being made in gold rather than \$. In 1972, The French sought for the exchange of their millions of accumulated \$s for gold in terms of the commitment of US to exchange \$ for gold. The U.S. government flatly refused and there was no one powerful enough to make US stand by its promise. \$ depreciated by 50% in terms of gold. A regime of floating rates of currencies came into being and there was a final good bye to the gold standard for currencies. Thus, the stage was set for market forces effectively setting the exchange rates of most of the countries though the Central Banks still could intervene by making use of their reserve to determine the value of their currencies and such steps are dictated by the needs of their economy.

The process of globalisation also started at about the same time when \$ delinked itself from gold standard. The developed country economies perceived that it was possible to do cost cuttings by off sourcing some of their activities to regions where labour costs were low⁴. From a purely American perspective, labour intensive textile and manufacturing industries were consequently moved off shore in mass. Capital-intensive industries like steel and aluminium fabrication followed in subsequent decades; accompanied by technology based companies as well. At the turn of the century, service industries have been the focal point. By 1990, real GDP growth in the emerging and developing economies began to materially outpace growth in developed countries of the world over the past two decades. The IMF forecasts that this trend would continue for next five years⁵. In America, the benefits have been lower prices for imported goods, especially from China. However, the price has been the loss of many well paying, middle class jobs in manufacturing and service industries. Census data reflect that average incomes for Americans have declined over the past decade. The beneficiaries of corporate cost cutting have been the wealthy stock holders, of record

⁴ Currency Rates are the Fulcrum among competing Global Economies, The Levin Institute, The State University of New York, June 12, 2010.

⁵ The IMF "World Economic Outlook", April 2010.

with very little “trickle down” noted. According to a recent study, top one per cent of earners commanded 8.9 per cent of the national income in 1976, but this figure rises to 23.5% by 2007. During the same time, the average hourly wages adjusted for inflation declined by more than 7%. Unbridled capitalism tends to favour the wealthy without discretion. For emerging market countries, the effect has been opposite. The prosperity of burgeoning middle classes in China and India has created domestic demand for better living standards, including better homes and automobiles along with better food and clothing. These demands have caused a severe run up in commodity prices in their respective global markets. Energy and raw materials are necessary to fuel the growing industrial engines in both China and India and other emerging economies. Increase in imports would balance many equations, but trade tariffs stand in the way. The countries like China so direct their exchange rates that despite accumulated foreign exchange reserves, the strengthening of their currencies is checked and natural economic forces are not allowed to strengthen Yuan. Both the U.S. and European union are accusing China of intentionally keeping the value of the Chinese Yuan low to boost Chinese exports – a move that impacts jobs and competitiveness in the American and European markets⁶.

Prabhat Patnaik⁷ and a former U.S. diplomat Edward Harrison⁸ perceive that the concern shown by U.S. and other developed countries about the low pricing of Yuan has emerged because the world’s aggregate demand is not increasing and the growth in credit has been sluggish. This is reflective of the inadequacy of measures taken by the developed world to boost demand to take the world economy out of crisis. Yuan was undervalued before the crisis as well yet concerns as being raised now about its undervaluation were not there. In a scenario of decreasing or stagnant demand globally, the increase in employment in U.S. by deprecating Yuan would be at the cost of employment in China which China can ill afford. If threatening voices are made in order to coerce China into submission, Chinese are quite capable of demonstrating their resoluteness. Chinese have many arguments to advance. The emerging economies like third world welcomed off shoring of labour intensive industries from the west by creating huge infrastructure at a considerable cost and deployment of national resources including manpower. All through these decades the local currencies were kept pegged to dollar for some sort of exchange stability. In good times and in bad, local

⁶ Currency War, *wikipedia*, the free online encyclopedia.

⁷ The Currency War, Prabhat Patnaik, India Current Affairs, October 19, 2010.

⁸ Bashing China and going to currency war is wrong and risky: Former U.S. Diplomat, Edward Harrison, Daily News Analysis, October 11, 2010.

currencies like Yuan stuck with U.S. dollar irrespective of its performance against other major currencies.

Any measure which restricts employment in China is bound to trigger unrest in China and to contain such a situation, Chinese would be required to take baby steps and not any considerable leap in line with the expectation of US. Chinese Yuan has been allowed to rise by about 3.5% against dollar from June 2010 to January 2011. That is far too short of the 20% or more than that some American officials are demanding to help US manufacturers. It has been argued that currency policies of China have caused inflationary trends in the domestic market. The nation's rapid growth and huge trade surpluses continue to attract massive amounts of foreign currency into the Chinese economy. China's central bank buys it and replaces it with Yuan to ensure the exchange rate remains favourable to domestic producers. In fact China has allowed an increase of 50% in money supply during the last two years. This has boosted investment in economy resulting in increased growth and has enabled the country to surpass Japan to become world's second largest economy. The trade off has been a flow of easy money into investments such as real estate. Soaring property prices have stoked fears of a bust and created a housing affordability crisis. Wages and prices of everyday necessity are being stoked.

It is being suggested that a stronger Yuan would help tame inflation by showing flow of foreign currency into the country. A stronger Yuan would make imported food and foreign made goods less expensive for Chinese buyers, helping to curb inflation. Loud voices made by U.S. has made the task of Chinese leadership in revaluing the Yuan in domestic political culture difficult as even an economic decision to revalue Yuan would be perceived as if Chinese leadership has caved in under U.S. pressure. At the same time, the extent of appreciation of Yuan has to be gradual so as not to send shockwaves in the export oriented economy of China. The shockwaves, if not within manageable limits, would also not leave the region's and world's interconnected economy immune from unforeseen results.

The recent triple tragedy in Japan and the unrest in middle east countries has brought in worrisome factors in regard to inflationary trends in the emerging economies including China. The requirement of oil in Japan is likely to increase as long as its nuclear energy set back subsists. China is now the second largest user of petroleum products and is importing 55% of its consumption requirement. Even if the crisis in middle east is resolved, the estimates are that the price of oil will hover around not less than US \$ 110 per barrel.

The reality of the situation is that Chinese economy is too large and is supported by a resolute leadership, no quick fix solutions can be expected on lines being advocated by U.S. If China is in a situation of surpluses and is pegging its Yuan to an administered exchange rate, it is supported in its endeavour by historical factors of which it has taken advantage of at a considerable cost and curbing its consumption for several decades. On the other hand, the very fact that U.S. has huge accumulated trade deficits is demonstrative of the fact that it has been living beyond its means and has been extra-ordinarily extravagant. Further, accumulation in Fed. Reserves have also been because of the clout it has been enjoying since 1930 through its device of \$ becoming the international currency on a promise, though broken, with impunity. It has been able to maintain increase in purchasing power vis a vis other currencies against the usual perception in a scenario of perpetual deficit. Whenever, in this being journey of dominance it experiences certain hick ups, instead of understanding the concern of others it overblows its own concern and wants to have quick fix remedies at the cost of others. If overtures do not yield results, punitive actions are contemplated. However, present juncture is somewhat different. Economies, industries and markets are twinned with one another in such a manner that no solution of sustained efficacy can be found without accommodating the concerns of all the players so that everyone has a feeling of win-win situation. Such a solution can be through negotiations only and fair negotiations at that to place in position mutually sustained stimulus packages towards increasing demands and increasing wages to sustain increased demands. Technicalities have little role to play in a real world situations as has been rightly ascribed by Prime Minister Manmohan Singh.