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Currency War Between Giant Economies

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Promoting economic growth through trade does not have to be only through protective tariffs on imports or quota restrictions.

In these days of free trade rhetoric, a country can manipulate its exchange rate and achieve the same objective of promoting exports and discouraging imports, thereby improving the trade balance.

Not every country can afford to play a currency manipulation game.

Only giant economies can do that!

China’s trade with the world, which has been in consumer goods of all kinds, has been successful because of its low wages. Opening the country to the world, through initiatives launched by communist theoretician Deng Xiaoping thirty years ago, has paid rich dividends.

China’s trade surplus

China has built huge trade surpluses over the last 15 year period. Trade surplus is defined as the difference between exports and imports of goods and services. China’s foreign reserves stand at US $1.5 trillion.

America, known for its legendary appetite for consumer goods sold through its nation wide Wal-Mart outlets, contributed to China’s trade success over the period.

Aside from low manufacturing costs, a deliberately kept low exchange rate did the trick. The Chinese renminbi, which was pegged at 8.28 renminbi per US dollar in 1997, remained unchanged for eight years until 2005. Trade surplus rose to US$ 200 billion in 2005 from US$ 50 billion in 1997.

As the US trade deficits increased, annual budget deficits also grew in size, ever since the two wars began in 2001, which only compounded the situation.

Instead of the usual remedies dished out to other nations, which include tightening the belt through fiscal discipline, America chose the easier option: it wanted China to re-value its currency upwards and make their exports to US more expensive and unattractive!

Since the Republican Administration is committed to free trade, imposition of tariffs and quotas was out of question.

As trade surplus and inflows of foreign direct investment grew, the Chinese currency gained in strength. Its pegged exchange rate was not, therefore, in alignment with the natural rate. After considerable plodding by US, China allowed its exchange rate climb up to 6.8 renminbi per US$ in 2005.

China was aware of the benefits of aligning the exchange rate in accordance with fundamentals. Fighting inflationary pressures due to capital inflows was facilitated by appreciation of its exchange rate.

US financial meltdown

Recessionary conditions triggered by the financial meltdown in the US since early 2008 worsened the economic prospects.

It was obvious that China would not be able to keep up its red hot growth rate of 12 percent per annum. A decade-long export driven growth cannot be maintained in the coming years when the industrialized countries are predicted to be slowing down.

Exports of China have fallen in recent months.

It was a clear impact of job losses in the Western world, especially in the US and falling incomes with poor consumer confidence during the ensuing Christmas holiday season and in the months ahead. Thousands of factories in the export regions of China, manufacturing labour intensive goods such as shoes, clothes and toys have already closed.

Added to the closure of cheap export factories, social unrest was spreading. There were news of riots in southern China with violent strikes and protests.

Options before China

China like other countries reduced its interest rate. It also announced a fiscal stimulus package of huge proportions. In addition to the infrastructure programme by provincial governments to the tune of US$1.4 trillion, the central government would be implementing its own, another US$600 billion on development works.

But still the export prospects do not look bright.

Already, the currencies of Asian countries have also weakened against the Chinese currency hurting Chinese exports to the rest of Asia.

So, one option is clear. Against the appreciation of renminbi with respect to Asian currencies, it is to the advantage of China to allow its currency to weaken against the US dollar.

In fact, ten days ago the Chinese President hinted at the possibility of resorting to depreciation. That rattled the American treasury.

Having successfully persuaded China to up–value its currency all these years, any reversal of the trend would only hurt US prospects of growth in the current period of uncertainties.

So, last week during his visit to China, the US Treasury Secretary had to change his tune: He pleaded to his Chinese counterpart not to depreciate the currency, a tune so different from his earlier visits, when he used to plead for appreciation of the renminbi.

Limitations to depreciation as a remedy

If markets expect renminbi depreciation, there would be capital outflows from China. That would only complicate the easy monetary policy change made by the Chinese central bank to help the economy recover. Capital outflows would result in increase in domestic interest rate: a classic case of the trilemma. One cannot achieve monetary independence without sacrificing one of the other two objectives: capital mobility and exchange rate independence.

Any exchange rate depreciation for promoting exports to US would strengthen the President–elect Obama's resolve. During his campaign, Obama indicated that he would press China to re-value its currency.

Furthermore, depreciation of Chinese currency would harden the protectionist sentiments in America.

Above all, it is feared that Chinese currency depreciation would lead to competitive devaluations in Asia, similar to the ones witnessed during the 1997 financial crisis. Such competitive devaluations would only worsen the global instability in exchange markets.

So, China faces a tight situation, as it observes on December 18, the 30th anniversary of the reform initiatives launched by the modern day communist guru, Deng Xiaoping. .

However, for saving communist China's success through capitalist moves in the 21st century, there will no ideological qualms.

As the guru observed, "The colour of the cat does not matter, so long it catches mice!"

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