The US as the Leading Currency Manipulator

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For decades, the United States, a self-professed evangelist for free trade, has been paranoid about other nations manipulating the exchange value of their currencies for trade advantage with counterproductive distortions in global free trade. Such apprehension has even been institutionalized into law.

Section 3004 of Public Law 100-418 (22 USC 5304) requires, *inter alia*, the secretary of the Treasury to analyze annually the exchange-rate policies of foreign countries, in consultation with the International Monetary Fund (IMF), and to consider whether countries manipulate the rate of exchange between their currency and the US dollar for purposes of preventing effective balance-of-payments adjustment or gaining unfair competitive advantage in international trade. Section 3004 further requires that if the secretary considers such manipulation occurring in countries, such as Japan and China, that (1) have material global current-account surpluses and (2) have significant bilateral trade surpluses with the US, the secretary of the Treasury shall take action to initiate negotiations with such foreign countries on an expedited basis, in the IMF or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the dollar to permit effective balance of payment adjustments and to eliminate any unfair advantage.

Section 3005 (22 USC 5305) requires, *inter alia*, the secretary of the Treasury to provide each six months a report on international economic policy, including exchange-rate policy. The reports are to contain the results of negotiations conducted pursuant to Section 3004. Each of these reports bears the title "Report to Congress on International Economic and Exchange Rate Policies".

Unfortunately, the underlying implication of the law assumes erroneously that current-account surpluses can be by themselves evidence of currency manipulation by the surplus country. In fact, as trade imbalances are the structural effects of fundamentals in the terms of trade, attempts to correct them with exchange-rate adjustments are by definition currency manipulation.

Exchange-rate policies cannot be substitutes for structural economic adjustments necessary for mutually beneficial trade between two economies. Nor can exchange-rate policies be substitutes for sound domestic monetary or economic policy. When two economies are at uneven stages of development trade, a trade surplus in favor of the less developed economy is natural and just until the less developed economy catches up with the more developed one. Otherwise it would be imperialistic exploitation, not trade.

A protectionist nation in free-trade clothing

That the United States, by its unilateral trade policies, has really been a nation of protectionists in free-trader clothing was again highlighted by a hearing of the Senate Committee on Banking, Housing, and Urban Affair on January 31 headed by its new chairman, Senator Christopher J Dodd, whose Democratic Party won control of the Congress in last year's mid-term elections. The hearing was on the Treasury Department's Report to Congress on International Economic and Exchange Rate Policy and the US-China Strategic Economic Dialogue. Hank Paulson, the 74th treasury secretary of the nation, was the lead witness.

The target of the hearing was China, which has replaced Japan in recent years in the eyes of the US as prime suspect of being the world's leading currency manipulator. Yet as Stanford economist Ronald McKinnon argues in an April 24, 2006, op-ed piece in the Wall Street Journal, China's motivation for pegging the yuan is to secure monetary stability rather than achieve an undue mercantile advantage in world export markets. He pointed out that persistent Chinese trade surpluses and US trade deficits reflect mismatches in saving in China and the US, an imbalance that exchange-rate changes might mask but cannot correct. McKinnon concluded, "China is not a currency manipulator, and the yuan/dollar rate is best left more or less where it is."

The twice-yearly high-level US-China Strategic Economic Dialogue is a brainchild of the new treasury secretary. The first meeting, headed on the US side by Paulson, with the participation of Federal Reserve Board chairman Ben Bernanke and several other cabinet secretaries, and on the China side by State Counselor Wu Yi, supported by Chinese counterparts of US officials, was held in Beijing last December, with the second meeting scheduled to take place in Washington in May.

The Senate Banking Committee, pursuant to statute, annually receives exchange-rate reports from the Treasury, taking testimony from the sitting treasury secretary, and exercises oversight on government exchange-rate policy, which has become of critical concern for US businesses and workers who seek a "level playing field" to compete in global markets. The Treasury Report is the only report to Congress that directly addresses international economics, exchange-rate policy, and currency manipulation by other national governments. Testimony from the treasury secretary to Congress, if requested, is required by law.

In his opening statement as committee chairman at the January 31 hearing, Senator Dodd expressed dissatisfaction with US government policy for its "inability to secure opportunity and prosperity for working Americans". Policies put in place by the administration of President George W Bush well before the appointment of Secretary Paulson have turned record surpluses left by the previous administration of president Bill Clinton into record deficits, leading to under-investment in important national priorities, such as health care, schools, infrastructure and targeted tax relief for threatened businesses and struggling working families, even as the nation fell deeper in debt, while producing growth only to select economic sectors such as financial services and prosperity only to the rich segment of the population.

Median family annual income has declined by nearly US$1,300 over recent years as income disparity widens. More than 3 million US manufacturing jobs have been lost since 2001, the steepest and most prolonged loss since the Great Depression. The current US economic recovery is the first in which manufacturing jobs lost have not returned. Dodd decried the fact that "for millions of Americans, the recession has not ended, but goes on and on", and has done so for more than seven years. The statement was a fair summation of neo-populist sentiments against the adverse domestic effects of two decades of globalization.

Yet the Democratic senator is only half right. While American workers have lost jobs, the US economy has not really lost these jobs, only relocated them. The US economy has merely expanded globally and moved jobs overseas to take advantage of low-wage workers in the employ of US capital, in what economists call cross-border wage arbitrage.

Economic imperialism in the age of industrial capitalism provided employment at the core to produce exports to the colonies to earn gold for the home economy. Neo-imperialism in the age of finance capitalism relocates jobs to the periphery and imports products manufactured by low-wage labor paid for with fiat currency (paper money) issued at the core, the surplus of which can only be reinvestment in the issuing economy. Dollar hegemony emerged as the US dollar, a fiat currency since 1971 when president Richard Nixon took it off gold. The dollar continues to assume the role of prime reserve currency for international trade, anchored by transactions in key commodities such as oil being denominated in dollars. US neo-imperialism is intermediated financially by dollar hegemony.

A selective level playing field

Cross-border wage arbitrage is a subset of financial arbitrage in which investments are made in low-cost countries to produce goods for sale in high-income countries. Interest-rate arbitrage is another subset in which funds are borrowed in low-interest currencies to lend in high-interest currencies, a routine transaction known as “carry trade” in international banking parlance. The complaints about cross-border wage arbitrage by the US, a clear beneficiary of global finance arbitrage, amount to blatant selectivity in its professed commitment for a “level playing field.”

What Senator Dodd leaves unspoken is that the old slogan “what’s good for General Motors is good for America” has been made inoperative by US-engineered financial globalization. For US companies to compete and survive in global markets and to attract global capital, jobs need to be shifted to low-wage locations overseas to reduce labor cost. Instead of foreign governments, such as China’s, being wrongly accused of manipulating the exchange value of their currencies, US big business should be recognized as the real culprit that manipulates global labor markets to gain unfair advantage over labor, both foreign and domestic.

This is a problem that a labor-friendly US government can readily solve, by passing labor regulations that reduce financial incentives for companies to lay off workers and outsource jobs to implement financial machination, as has been done in Germany. Outside of slavery, capital and labor have a symbiotic relationship similar to a marriage. In California, a divorce is settled with an equal split of property held in the marriage plus lifetime alimony sufficient to maintain the non-income-producing spouse in his or her accustomed lifestyle until remarriage. What is needed is a global level playing field between capital and labor where the closing of plants to reduce labor cost is subject to terms similar to an equitable divorce settlement to provide the unemployed worker a living income until re-employed.

National security trumps free trade

Senator Dodd also raised nationalistic concerns by pointing out that more than a million US jobs outsourced have been in critical defense-related industries, dislocating the US manufacturing base and jeopardizing capacity to produce items vitally needed for national security. He gave the example of plants producing special magnets used in smart bombs relocating from Indiana to China, which could expose the US military to interruption of critically needed supply in the event of war.

The senator called for significant changes in trade regulations “to adequately secure America’s future both economically and militarily”. This is of course a call for national security trumping free trade. The military requires not just exotic special magnets. It requires also mundane “dual-use” items such as uniforms and boots, which are mostly made in China now.

Still, such conditions are the results of US “free trade” policy, not created unilaterally by China. Economic nationalism is alive and well in the home of free trade in sectors that are threatened by free trade.

Exchange rates not determined by markets

Reflecting popular misconception, the Senate Banking Committee focused its hearing on exchange-rate policy with a flawed assumption that market-determined exchange rates would solve the problem of US trade deficits. Yet market exchange rates are determined by government interest-rate policies. And the very concept of a government exchange-rate policy is fundamentally opposed to the concept of free markets.

For the global marketplace to be truly free and fair, all currencies must be equally subject to the impartial discipline of market forces. Yet despite neo-liberal rhetoric, no government today or even in history, particularly the US government, leaves the exchange rate of its currency to market forces. In reality, market forces anticipate and respond to government tax and trade policies as well as central-bank deliberations on interest-rate moves. The differences among the exchange-rate policies of different governments reflect the differences in each country’s economic, financial and monetary conditions as well as political ideology, social structure and societal values, but all governments manipulate the currency market to sustain the exchange rates of their currencies at levels best suited to their separate national needs.

The United States maintains an Exchange Stabilization Fund (ESF), which is money available to the Treasury primarily for participating in the foreign-exchange market to maintain currency stability. It holds US dollars, foreign currencies and IMF special drawing rights to intervene in the foreign-exchange market to influence exchange rates, outside the domain of the central bank, without affecting the domestic money supply.

History of exchange rates and currency stabilization

After World War II, as the US emerged as the only country the industrial sector of which had been left not only undamaged but actually strengthened by war, the US dollar by default became the uncontested world reserve currency for international trade.

As early as April 1942, the White Plan, named after Harry Dexter White, US Treasury under secretary and a student of free-trade advocate and Harvard professor Frank W Taussig, proposed a United Nations Stabilization Fund and a Bank for Reconstruction and Development of the United and Associated Nations. The advantages of stable exchange rates that the automatic classical gold standard had provided while it lasted from 1876 to

1914 had proved to be not so automatic after World War I. The classical gold standard was causing deflation around that world that translated into a worldwide depression while mercantilism, the quest by nations for gold through exporting, was causing protectionist reaction in all countries.

The idea of the need for international cooperation in trade and for a new “gold exchange standard” that would make wider use of gold by supplementing it with an anchor currency that would be readily convertible into gold had been developed at a 1920 international conference in Genoa, Italy, but the participating governments failed to reach agreement as not all were ready to accept British sterling hegemony. This idea was incorporated two and a half decades later into the Bretton Woods regime, with a gold-backed US dollar replacing the British pound. The challenge was to devise an operative international finance architecture out of fiat currencies anchored to a gold-backed dollar to accommodate postwar international trade.

One crucial difference between the US plan by White and the British plan by John Maynard Keynes was that the Stabilization Fund (SF) proposed by the United States was to be based on a mixed bag of national currencies, while the Clearing Union (CU) proposed by Britain was to operate with a new international currency to be known as bancor. The CU also had less strict rules than did the SF for its use by countries with balance-of-payments deficits.

Unlike now, when the United States is the world’s largest debtor nation, the US at that time, as the world’s only creditor nation, was concerned about its potential financial exposure to bad credit worldwide and about preserving the rights of creditor countries with balance-of-payments surpluses. The US team voiced serious reservations about the British/Keynes plan, which had liberal liquidity provisions and ready access to liquidity for countries with temporary trade deficits that would encourage moral hazard. Britain anticipated huge wartime deficits as revenue from many parts of the British Empire was suddenly interrupted.

The IMF, dominated by US voting power, closely followed the US/White plan for a contributory fund, although it was slightly larger, at $8.8 billion ($77 billion in 2004 dollars or $463 in relative share of gross domestic product), of which the US put in $2.75 billion ($24 billion in 2004 dollars or $145 in relative share of GDP), and the United Kingdom contributed $1.3 billion. Exchange rates could fluctuate 1% on either side of a par value with the dollar.

The fund was designed to provide members with a cushion of credit to give them the confidence to abandon exchange and trade controls while keeping their exchange rate stable in relation to the dollar. It did not deal with how the transition from war through reconstruction to recovery was to be achieved cross-border finance. The IMF was specifically not to lend for relief or reconstruction arising from the war. Article XIV allowed members to keep exchange controls for three to five years, after which they had to report annually on why controls still remained. This left open the absolute deadline for abandoning exchange controls or trade restrictions, and in fact they were not abandoned for current-account purposes until 1958. The UK only abandoned its final controls on cross-border capital flows in 1979.

In addition, the US/White plan contemplated the forbiddance of exchange-rate intervention, an important feature for the United States, whereas the British/Keynes plan did not put much emphasis on limits on exchange-rate intervention and even advocated the use of capital controls for the weaker economies, of which Britain expected to become one in the course of the war. Britain imposed exchange control soon after World War II began and kept it for four decades until a new Conservative government abolished exchange control in 1979.

The pre-1979 controls on direct investment restricted sterling-financed foreign investment except where it had a positive effect on the balance of payments. With respect to portfolio investment, the controls stipulated that purchase by UK residents of foreign exchange to invest overseas could be made only from the sale of existing foreign securities or from foreign-currency borrowing. A third element of the controls restricted the holding by UK residents of foreign-currency deposits as well as sterling lending to overseas residents. Cross-border flow of funds was considered neither desirable nor necessary for domestic economic growth, if not an outright threat.

China not a currency manipulator

The US Treasury's Report on International Economic and Exchange Rate Policy, required by law to examine whether any US trading partners are manipulating their currencies to gain unfair trade advantage, has determined in its 2006 findings that China does not so manipulate its currency. Still, congressional and media allegations persist that China's continued resistance to US calls to allow its currency to rise to reduce trade imbalances with the United States has distorting effects on global markets and detrimental effects on US companies and workers. Such allegations are misplaced, not supported by either fact or theory. The distortions have been created by US trade and monetary policies and their effects on the exchange value of the dollar rather than by China, which pegged its yuan at 8.28 yuan to $1 within a narrow band of 0.03% for a decade, from 1995-2005, at times above and at other times below market trends.

On July 21, 2005, after repeated pronouncements that no revaluation was economically justifiable or even being officially considered, China announced a surprise 2% appreciation of its currency, putting it at 8.11 yuan to the dollar. It also announced that the yuan would thenceforth be pegged with the same narrow range to a basket of foreign currencies that included the dollar, the euro, the yen and others likely to reflect China's trade relationships with the rest of the world. The components and weight of different currencies within the basket were not disclosed to the market.

China appeared to be following Singapore's managed-float model, keeping both weights and effective bands confidential to allow maximum flexibility within a narrow range tied to a reference peg to the dollar. Many saw it as an obvious diplomatic move to appease misguided US pressure.

Manipulation involves willful, proactive volatile changes to profit from temporary technical market trends against market fundamentals. A stable exchange rate cannot be labeled as manipulative any more than a driver traveling at constant legal speed for long periods apace with the police car next to it can suddenly be accused of speeding merely because the police car slows down from loss of power.

Senator Dodd cited anonymous "credible analysts" who allegedly identify the undervaluation of the yuan by 15-40% as "a very significant cause" of the loss of jobs in the US to outsourcing. By extension, for the US to cure its trade problems that its own permissive monetary and anti-labor policies have created, China must revalue its currency upward by as much as 40%, not because the market demands it, but because the US needs to reduce its trade deficits. What the US is doing is asking China to pay for America's own policy errors.

But the Dodd Committee needs to understand that such a cure would be worse than the malady, as it would cause dollar inflation to skyrocket in the import-dependent US economy, bringing dollar interest rates up with it, and pushing the debt-infested Goldilocks US economy into sharp recession. After all, China alone, at substantial cost to its own economy, kept the yuan's peg to the dollar all through the decade-long Asian financial crisis that began in July 1997, when all other Asian currencies devalued in quick order in a frenzied rush to the bottom.

At both the House Ways and Means Committee and the Senate Finance Committee February 6 hearings on the Bush administration's $2.9 trillion fiscal 2008 budget, Paulson again asserted that the US has reached a "crossover" point in its trade with China, with exports to China rising at a faster rate than imports from China. China trade has remained a sensitive topic with congressional members who, faced with pressure from constituents over jobs lost to outsourcing overseas, are pushing Paulson for action to force China to revalue its currency.

Yet the only sustainable way to increase US export to China is to raise Chinese wages to increase Chinese consumer demand, not by forcing China to revalue its currency upward. Currency revaluation will only produce monetary instability that will cause deflation in the Chinese domestic market, thus dampening demand for imports from the US.

Paulson defends the yen and criticizes the yuan

Testifying before the all-powerful House Ways and Means Committee, Paulson defended the recent fall of the Japanese yen against the euro, claiming the US Treasury saw no evidence that Japanese authorities had intervened in currency markets since 2004 to manipulate the value of the yen. European officials have been unhappy about the weak yen because it makes European exports more expensive and less competitive in Japan and in Asian markets where the yen is a significant benchmark.

"Some people might not like where it's trading, but it's my job to support and fight for free competitive markets, and I believe that the yen is trading in a competitive marketplace based upon underlying economic fundamentals," Paulson said.

The fact remains that the exchange rate of a country's currency is fundamentally affected by the interest rate set by that country's central bank. Whether such intervention is manipulation is a matter of perspective.

European ministers, particularly German Finance Minister Peer Steinbrueck, are of the opinion that the Japanese yen is undervalued as a result of Japanese monetary policy. But the mismatch between European Union and Japanese monetary policies is caused by Germany's historical phobia on inflation, thus preventing euro interest rates to reach parity with near-zero yen interest rates. The low yen interest rate is beneficial to the EU and US economies, allowing carry trade, a financial manipulation to borrow low-interest currencies to lend in high-interest currencies, to provide funds to finance investment the high-interest economy. The tradeoff is payments imbalance from trade.

Currency peg not immune to market forces

A peg of one currency with another is a unilateral regime. It does not require permission from the government of the pegged currency. A currency peg is not sacred or inviolable, nor is it a free lunch for the economy that adopts it.

Any currency peg can broken by the market if the government that adopts it is unwilling or unable to bear the cost of sustaining it, as has happened to many currencies around the world, including the British pound's peg to the German mark, which was broken by hedge-fund speculator George Soros in 1992 with a spectacular profit of more than $2 billion in a matter of days, draining the exchange reserves of the Bank of England and precipitating a collapse of Europe's Exchange Rate Mechanism (ERM).

The ERM was a multilateral fixed-exchange-rate regime adopted in March 1979 as part of the European Monetary System (EMS), to reduce exchange-rate volatility and to achieve monetary stability in Europe, in preparation for the Economic and Monetary Union and the introduction of a single currency, the euro, on January 1, 1999. The ERM was established by the then European Community to keep member countries' exchange rates within specific bands in relation to one another. The purpose of the ERM was to stabilize exchange rates, control inflation rates through a link with the strong and stable deutschmark, and to nurture intra-Europe trade. It was also designed to enhance European world trade in competition with the US, creating a so-called United States of Europe and as a stepping stone to a single-currency regime in Europe.

Britain joined the ERM in October 1990 at a fixed parity of 2.95 deutschmarks to the pound, an overvalued rate intended to put pressure on the British economy to reduce inflation rather than institutionalizing international competitiveness. British pride might have played a role in insisting on a strong pound. This chosen rate, or any fixed rate required by ERM membership, proved misguided, because it tried to benefit from the effect of a single currency for separate economies without the reality of a single currency within an integrated economy.

During its 23 months of ERM membership, from October 1990 to September 1992, Britain suffered its worst recession in six decades, with GDP shrinking by 3.86%. Unemployment rose more than a third, by 1.2 million, to 2.85 million. The total price of the ERM fixed exchange rate for the United Kingdom was estimated to be as high as 13.3% of 1992 GDP. The number of residential mortgages with negative equity tripled, reaching a peak of 1.25 million, and company insolvency rose above 25,000 a year.

The British government of prime minister John Major sought to balance political and macroeconomic considerations, only to fail in its effort to support the unsupportable to prevent a devaluation of a freely traded pound by market forces. If the UK had not lost some 8.2 billion pounds defending the currency's unsustainable exchange rate, it could have avoided budget deficits, tax hikes, cuts in public spending, and the unpopular value-added tax on fuel. Spending on the National Health Service could have been more than doubled for 12 months.

Withdrawing from the ERM released the UK economy from persistent deflation and provided the foundation for the non-inflationary growth subsequently experienced. It enabled monetary policy to be freed from the sole task of maintaining the exchange rate, thus contributing to economic expansion by a combination of rational monetary measures. While ERM countries were compelled to maintain relatively high real interest rates to prevent their currencies from falling outside the permitted bands, Britain enjoyed the freedom to benefit from lower rates.

Hong Kong, with its freely convertible currency pegged to the US dollar, faced the same problems for a whole decade after the 1997 Asian financial crisis. After a decade-long recession, Hong Kong's economy finally recovered with direct subsidy from Beijing. Its economy is now again booming from the runaway liquidity effects of the dollar debt bubble created under then-chairman Alan Greenspan by the US Federal Reserve's permissive monetary policy of low interest rates, but Hong Kong will face another crisis when the US economy faces the inevitable consequence. Waiting for an improved economy before de-pegging is like waiting for death to cure an infection, or one more high before cold turkey, a sure path to death by overdose.

The appropriate exchange rate of currencies at any particular time is that which enables their economies to combine full employment of productive resources, including labor, with a simultaneous balance-of-payment equilibrium. An excessively high exchange rate causes trade deficits and domestic unemployment, while a low one generates an excessive buildup of foreign-currency reserves and stimulates domestic inflationary pressures that lead to a bubble economy. Thus every nation with a freely convertible currency must retain the ability to adjust the external values of its currency in this unregulated global financial market and an international financial architecture based on US dollar hegemony. To be fixated on a fixed exchange rate within rigid limits is to court economic disaster in the current international finance architecture of freely convertible currencies. This is why China resists full convertibility of the yuan.

The ERM was a transitional regime whose problems were finally removed once the EU moved toward a single currency in the form of the euro. Still, the anti-inflation bias of the European Central Bank continues to create conflict with monetary-policy needs of national economies within Euroland. The current dispute surrounding the exchange rate of the yen to the euro is the result of interest-rate disparity between the two currencies.

In a fast-changing economic environment of unregulated global markets, the value of the exchange rate that facilitates full employment and a foreign-trade balance will frequently fluctuate. Speculative volatility must be countered and the exchange rate managed by the national bank to prevent disruption in the domestic economy and in external trade. However, this does not imply fixed, unchangeable bands as under the ERM. The optimum strategy for cooperation between national central banks on exchange rates requires a combination of maximum short-term stability with maximum long-term flexibility, the opposite of the effects of fixed exchange rates.

Since, under ERM, Britain's interest rate was pegged to that of Germany through the fixed exchange rate, reduction in interest rates was not available to deal with increasing unemployment and declining growth in the UK. The fact that Britain had no control over interest rates, coupled with the questionable independence of the Bundesbank, Germany's central bank, was an important factor in the final decision to withdraw the pound from the ERM fixed-exchange-rate regime.

The reunification of Germany cracked open the structural flaw in the Exchange Rate Mechanism because massive capital injection from West to East Germany had produced inflationary pressure in the newly unified German economy, leading to preemptive increases of interest rates by the Bundesbank. At the same time other economies in Europe, especially that of Britain, were in recession and not prepared for interest-rate hikes dictated by Germany. This interest-rate disparity magnified the overvaluation of the pound in the early 1990s.

Along with the European Currency Unit (ECU, the forerunner of the euro), the ERM was one of the foundation stones of economic and monetary union in Europe. It gave currencies a central exchange rate against the ECU, which in turn gave them central cross-rates against one another. It was hoped that the mechanism would help stabilize exchange rates, encourage trade within Europe and control inflation. The ERM gave national currencies an upper and lower limit on either side of this central rate within which they could fluctuate.

In 1992, the ERM was torn apart when a number of currencies could not keep within these limits without collapsing their economies. On Wednesday, September 16, a culmination of factors led Britain to pull out of the ERM and to let the pound float according to market forces. Black Wednesday became the day on which George Soros, hedge-fund titan, broke the Bank of England, pocketing $1 billion profit in one day and more than $2 billion eventually. The British pound was forced to leave the ERM after the Bank of England spent $40 billion in an unsuccessful effort to defend the currency's fixed value against speculative attack. The Italian lira also left and the Spanish peseta was devalued.

To curb German inflation, an increase in German interest rates was necessary, but if the Bundesbank had been completely independent of German political-economic interests as a dominant regional central bank, it would not have adopted this policy, as there were cries from all over Europe for a decrease in interest rates. By adopting tight monetary policies in response to domestic inflationary pressures that followed German reunification in 1990, German short-term interest rates, which had been rising since 1988, continued to rise, reaching nearly 10% by the summer of 1992. So at a time when Britain needed a counter-cyclical reduction in interest rates, the Bundesbank sent the interest rate upward, plunging Britain deeper into recession through the ERM. This kind of cyclical conflict is likely to surface regularly among China, the US, Japan and the EU once the Chinese yuan is freely convertible.

This was the fundamental problem with the ERM – fixed exchange rates conflicted with the interest-rate levels needed by different economic conditions in separate member economies. The British interest rate pegged to that set by the Bundesbank was crippling the British economy because the UK was in a recession and required low interest rates.

Today, the foreign-exchange value of the Japanese yen has been pushed down by low yen interest rates, which the Bank of Japan has been forced to maintain to keep the Japanese economy from falling into deeper recession.

The pros and cons of full convertibility

The key distinction between the Japanese yen and the Chinese yuan is the degree of convertibility. EU officials point to low yen interest rates as the cause of the yen being undervalued, and the US points to the limited convertibility of the yuan as the cause of its being undervalued.

It is true that the yuan's limited convertibility allows China to resist market assaults on its currency. Yet for an economy engaged in international trade, the fact that its currency is not freely convertible is not a free ride, as many experienced traders, including former Goldman Sachs chairman and current US treasury secretary Paulson, have repeatedly pointed out to

Chinese officials. Such currency control incurs a substantial economic cost and can only be sustained if the country in question can afford that cost to preserve monetary stability.

For economies where the currencies are freely convertible, the cost can be massive attacks on their currencies by speculators, such as hedge funds, that would quickly drain the government's foreign-exchange reserves and cause a collapse in the economy's debt market. For economies that practice exchange and capital control, the penalty can be a drain in foreign reserves and a reduction in trade in the case of a deficit. In the case of a trade surplus, the penalty can be a drain of domestic currency capital into growing foreign-exchange reserves.

For a limited-convertibility currency, the cost of a fixed exchange rate is absorbed internally within the domestic economy. On the other hand, a freely convertible currency with a fixed exchange rate is mixing gasoline with fire, as the British pound demonstrated in 1992. Yet a freely convertible currency with a low-interest-rate policy designed to stimulate the domestic economy will enhance a nation's foreign-trade competitiveness. In the case of US-China trade, a freely convertible yuan with a low-interest policy would exacerbate the US-China trade imbalance further against the US, not moderate it in the long run.

In that sense, to say that a currency not freely convertible and tied to a fixed exchange rate pegged to the dollar is unresponsive to market forces, let alone market manipulation, betrays a lack of understanding of how international trade is financed and intermediated in the global economy. Currency pegs are not immune to market forces; they only transmit the effects of market forces through difference economic channels.

All governments participate in money markets to carry out monetary policy, buying and selling government securities to implement their interest-rate policies, and in currency markets to sustain the desired levels of exchange rate. Nowadays most central banks are not even dominant market participants, having been edged out of center stage by hedge funds as major players that regularly move markets with notional values in hundreds of trillions of dollars.

US is the head of the currency-manipulation snake

Fundamentally, a currency peg is merely a different path to the same monetary objective as the setting of the US Fed Funds rate, with the Fed Open Market Committee buying and selling government securities to maintain an announced interest rate target. As the US dollar is the key reserve currency in world trade and finance, the United States, through its interest-rate policy, is the de facto head of the global exchange-rate-manipulation snake and the Fed chairman the chief wizard of exchange-rate manipulation.

For decades, beginning with a collapse of budgetary and monetary discipline during the Vietnam War, the US had been manipulating the exchange rate of the dollar downward, a fact obscured in the past decade by the emergence of dollar hegemony, a regime introduced by Clinton administration treasury secretary Robert Rubin to finance the US trade deficit with its capital-account surplus to deliver borrowed prosperity to the US through a global debt bubble fed by the Federal Reserve's dollar-printing frenzy.

Thus it is irony bordering on disingenuousness when Federal Reserve chairman Bernanke, in China as part of the US-China Strategic Economic Dialogue delegation led by Secretary Paulson, voiced concern for the allegedly undesirable distortions that result from an "effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting". For decades, the real market distortion has come from the Fed's interest-rate policy, liquidity bias and inflation targeting. By law, the Fed is obliged to support the US Treasury's strong-dollar policy in defiance of market forces as a matter of national security. And a strong-dollar policy is a professed example of currency manipulation.

Dollar interest rates have been lower than euro interest rates and higher than yen interest rates because of differing economic conditions and national phobia regarding inflation at home. The US Treasury, while maintaining a strong-dollar policy, has indicated that the dollar should be freer to find its own level. Since most Asian currencies other than the Japanese yen are pegged to the dollar, the only currencies affected by a fall in the dollar will be the yen, the euro and currencies linked to it, British sterling and the Swiss franc, causing a technical movement away from the dollar until the US brings its twin deficits under control. Until then the yen and the euro will bear the brunt of the weakening of the dollar, but not evenly, with the yen falling against the euro while rising against the dollar.

The high cost of bringing the US twin deficits down

If history is any guide, the United States, being an ever-resilient nation, will eventually get its twin deficits under control, albeit the cost this time will far exceed the bloodletting of the Volcker victory over dollar inflation in the late 1990s.

In 1982, impacted by the Federal Reserve under Paul Volcker raising dollar interest rates sharply in 1979-80 to more than 20% to fight runaway inflation in the US, Mexico was put in a position of not being able to meet its obligations to service $80 billion in dollar-denominated short-term debt obligations to foreign, mostly US, banks out of a GDP of $106 billion. Volcker's triumph over domestic inflation was bought with the destabilization of the international financial system, where US banks had acted like loan sharks in the Third World with Fed approval a decade earlier to recycle petrodollars. History will repeat itself before the end of the first decade of the 21st century. Pushing the Chinese yuan upward would accelerate and exacerbate the historical replay.

On the eve of the meeting of the Group of Seven (G7: the US, Japan, Germany, France, Italy, the UK and Canada) last Saturday in Essen, Germany, the US dollar traded at 121.6 yen and 0.7689 euro (or $1.30 to a euro). While 120 yen to the dollar is where the US likes to see the yen stay, $1.30 to a euro put Europe at a severe exchange-rate disadvantage.

The Chinese yuan traded on the same day at 7.75 to the dollar, down 6.4% from 8.28 on July 21, 2005, when China discontinued the yuan/dollar peg, while the Hong Kong dollar is still pegged at 7.81 to the dollar. If the yuan continues to rise against the Hong Kong dollar, it will force the latter to de-peg from the US dollar to align with the yuan or face very unhappy consequences.

There is visible evidence that the volatility in exchange rates among major currencies has been cause by hedge-fund arbitrage. Contrary to rationalization offered by apologists of the positive role of hedge funds in stabilizing and enhancing efficiency in the market, hedge funds have repeatedly shown themselves as a destabilizing and volatility-generating force that threaten the global financial system.

In this context of the obvious dangers of unregulated currency markets, it is hypocritical for the world's rich nations to urge China to loosen state control of its exchange rate and to move toward full currency convertibility. The G7 powers also addressed the recent slide in the Japanese yen by urging financial markets to take account of Japan's strengthening economy in an attempt to convince currency speculators of the need for caution on carry trades where investors borrow massively in low-yield currencies such as the yen to invest elsewhere for bigger returns, something that is compounding recent yen weakness.

G7 guidance to markets on the ultra-sensitive matter of exchange rates was almost identical to what it said at a meeting last September in Singapore that failed to stem a slide in the yen. With their addictive fixation on the fantasy merits of market fundamentalism, G7 governments are the equivalent of permissive parents warning youngsters on the danger of drugs while they themselves indulge in alcohol abuse.

Paulson dismissed the EU's complaints on the yen, saying the yuan rather than the yen was the problem because the Chinese currency was controlled by the Chinese authorities and remained too weak, whereas Japan's yen was set in freely trading currency markets. He did not address the issue of low yen interest rates set by the Bank of Japan, which cause the yen to fall in the open market and provide profit opportunities for carry trade.

Foreign exchange was a hot topic at the latest G7 meeting in Germany. China was referenced in the final communique: "In emerging economies with large and growing current-account surpluses, especially China, it is desirable that their effective exchange rates move so that necessary adjustments will occur."

In 2006, China's annual trade surplus grew almost 75% to $177.5 billion, while GDP grew 10.7%, the fastest rate in 11 years, as foreign reserves exceeded $1 trillion. Bloomberg reported that the yuan experienced its largest monthly drop (about 0.12% to 7.756 to $1) after a statement by China's central bank governor at the G7 meeting that the pace of its currency gains is "appropriate".

The G7 also discussed potential risks from the burgeoning hedge-fund industry, which is less regulated than banks and other financial institutions and geometrically higher leveraged. Loosely regulated hedge funds have become a powerful market force, initially catering to the risk appetite of the ultra-rich to profit from risk-management needs of business, but concern is mounting about their widespread proliferation to attract individuals and institutional investors with promises of profit but which are not truly qualified to assume such risks.

Instead of spreading risk throughout the financial system to prevent concentrated effects of singular defaults, hedge funds as an industry have become a prominent risk factor themselves in catastrophic systemic failure. Increasing links between hedge funds and commercial banks are also problematic, with banks lending to both sides of the same bet, profiting from handsome fees irrespective of the direction of the market but assuming exposure to counterparty risks in the event of default. Big banks are heavily trading credit derivatives that bet on the risk of bonds or loans default. Many investment banks have become de facto hedge funds with proprietary trading constituting the bulk of their profit.

Hedge funds the real currency manipulators

Hedge-fund assets have doubled globally to more than $1.4 trillion in the past five years, betting on notional values in the hundreds of trillions of dollars.

The Bank of International Settlement (BIS) reports that the volumes outstanding of over-the-counter (OTC) derivatives expanded at a brisk pace in the first half of 2006. OTC contracts are traded directly between counterparties outside of exchanges, which guarantee settlements for their members. Notional amounts of all types of OTC contracts stood at $370 trillion at the end of June, 24% higher than six months before. Growth was particularly strong in the credit segment, where the notional amounts of outstanding credit default swaps (CDS) increased by 46%.

Rapid growth was also recorded in other market segments. Open positions in interest-rate derivatives rose by 24%, while those in foreign exchange (FX) contracts expanded by 22%. Equity and commodity contracts grew at 17% and 18%, respectively. Gross market values, which measure the cost of replacing all existing contracts and thus represent a better measure of market risk at a given point in time than notional amounts, increased by 3% to $10 trillion at the end of June.

The pace of trading on the international derivatives exchanges also quickened in the first quarter of 2006. Combined turnover measured in notional amounts of interest-rate, equity-index and currency contracts increased by one-quarter to $429 trillion between January and March 2006. The combined notional value of all contracts comes to almost $800 trillion. Notional values are not the amount at risk, only the amount on which risk is calculated. But with a notional value of $800 trillion, a 1% shift in value will translate into a profit or loss of $8 trillion, 5.7 times the $1.4 trillion asset value of all hedge funds, or 61% of 2006 US GDP.

The derivatives market has been described as a financial weapon of mass destruction. It makes the issue of China's currency exchange rate seem like a harmless firecracker.

US-China trade imbalance

The Senate Banking Committee also mistook the yuan/dollar peg for a significant contributor to a record US trade deficit, which was more than $750 billion for 2006. On the surface, nearly one-third of that deficit, more than $230 billion, consists of the US bilateral trade deficit with China. For China, its global trade surplus was $250 billion, about 9% of its GDP. US global merchandise trade and current-account deficits rose to between $850 billion and $875 billion in 2006, amounting to 7% of GDP and rising $100 billion annually over the past four years.

Yet when China's trade surplus with the US is viewed in the context of global trade data, leaving out oil, the collective trade surpluses of the oil-exporting countries having become larger than China's surplus. Germany, Japan and the rest of non-China Asia have been large trade-surplus components as shares of the US trade deficit. In contrast, until two years ago, China's trade surplus was minor. US trade imbalances come more from Germany and Japan and less from China.

Yet US diplomatic pressure on China to revalue the yuan further continues. This pressure is motivated by the misguided conventional assumption that a lower exchange rate of the dollar will reduce the US trade deficit, despite clear historical data showing that past revaluations of the Japanese yen and the German mark did not reduce US trade deficits with those major trade partners in the long run. All such revaluations did was to lower the domestic cost in local-currency terms more than raise the dollar price of Japanese and German exports. The net effect was deflation in Japan and Germany, with inflation in the US while the US trade deficit continued.

While China has become the largest nominal surplus nation in the global trading system, having surpassed Japan, its foreign-exchange reserve of more than $1 trillion is an enormous drain of wealth from the yuan economy into the dollar economy, leaving China with the world's largest poor population and a large growing economy with a capital shortage. Even if China should stop building up its dollar reserves, it would only mean some other country would add dollar reserves to make up the difference as long as dollar hegemony allows the US to finance its trade deficit with its capital-account surplus.

Under dollar hegemony, dollar reserves are created by the twin US deficits, independent of which foreign country holds them. The solution is for the US to stop printing fiat dollars to fund its deficits, for as long as the Federal Reserve continues its permissive monetary policy, the twin deficits will continue to expand.

Wage disparity and trade balance

Even a substantial increase in the exchange value of the Chinese currency will not reduce US-China trade imbalances if Chinese wages do not converge with US wages.

China has recently let the yuan rise marginally against the dollar while the dollar has fallen against virtually all other currencies, particularly the Japanese yen and the euro. The US has been trying to compensate for its structural loss of competitiveness in manufacturing by forcing the dollar to fall against all other currencies, but the yuan's peg to the dollar stands in the way of this easy way out. In fact, the yuan/dollar peg has a supportive effect on the US strong-dollar policy.

US policymakers should realize that the yuan/dollar peg performs a positive function of forcing the US economy to restructure toward real productive revival, rather than the meaningless path of exchange-rate manipulation. US loss of competitiveness is not caused by its currency being overvalued. It is the opposite: the loss of competitiveness is reflected in the fall of the dollar. The dollar's fall is not caused by the yuan being pegged to it. It is caused by the US seeking productivity gains by having low-wage workers overseas do the producing. Thus increased US global competitiveness is causing the loss of US domestic competitiveness in world trade.

While cross-border wage arbitrage causes the United States to lose jobs, it institutionalizes underemployment in China, keeping Chinese wages too low to support more imports from the US. It takes the export of millions of pairs of shoes to the US to pay for one Boeing airliner. US furniture manufacturers complain about low-price Chinese imports, yet there are no Chinese aircraft manufacturers to complain about the high-price US airliners. That is the true imbalance in US-China trade.

In 2004, China's global trade surplus was only 8% of the US trade deficit, the same as little Netherlands. The whole Euroland global surplus was 27% of the US deficit that year, and the combined global surplus of Japan and the rest of non-China Asia was an even larger share of US deficit. Yet China alone stays in the crosshairs of the United States' trade-deficit complaint because of the large bilateral surplus reported monthly by the US Commerce Department. In the global supply chain, Germany, Japan and the rest of non-China Asia are the surplus giants. This point was insightfully made by Albert Keidel, senior associate at the Carnegie Endowment for International Peace, in his testimony before the Senate Banking Committee.

The bilateral imbalance between the US and China does not itself inform on the real global trade-balance picture. China processes and repackages large volumes of goods from other countries for final shipment to the United States. The Chinese export sector is largely a re-export sector, with labor and environment as main factor inputs. The US has bilateral trade surpluses with many countries, such as the Netherlands and Singapore. Keidel pointed out that the conventional view is that these countries with trade deficits with the US do not contribute to the US trade deficit. But these countries have large global trade surpluses, much of which are with China, sending the bulk of their manufactured components as exports to China for finishing and packaging there, before having them shipped to US market from a Chinese port such as Hong Kong or Shanghai. So China is only the intermediary point for many exports to the US by non-China economies that have deficits with the US and surpluses with China. Further, the Chinese export sector is driven by foreign investment that regularly repatriates earnings even before they reach China. The cost of production by these companies is registered as part of the US deficit with China, but the profit is not registered as a US trade surplus because only capital, not goods, is exported.

The voice of free trade, economist Fred Bergsten, asserts that such global imbalances are unsustainable for both international financial and US domestic political reasons. On the international side, the United States must now attract about $8 billion of capital from the rest of the world every working day to finance the US current-account deficit and US investment outflows in plants that produce the import to the US. Bergsten told the Senate committee that even a modest reduction of this inflow, let alone its cessation or a selloff from the $14 trillion of dollar claims on the US now held by foreigners, could initiate a precipitous decline in the dollar.

Notwithstanding that this simplistic view is not shared by the Federal Reserve or the US Treasury, logic shows that dollar assets can only be sold for dollars, which must then be reinvested in other dollar assets, thus posing no threat to the value of the dollar. When dollars are sold for other currencies, it merely changes the ownership of the dollars, with no reduction in the dollar money supply. Further, Bergsten and his fellow free traders want the dollar to fall. So where is the problem?

NBER declares yuan not undervalued

National Bureau of Economic Research (NBER) Working Paper No 12850 issued last month reported that, relying on conventional statistical methods of inference and a framework built around the relationship between relative price and relative output levels, once sampling uncertainty and serial correlation are accounted for, there is little statistical evidence that the yuan is undervalued.

The NBER is a prestigious and highly respected private, non-profit, non-partisan research organization where Simon Kuznets' pioneering work on national income accounting, Wesley Mitchell's influential study of the business cycle, and Milton Friedman's research on the demand for money and the determinants of consumer spending were among the early studies done. Sixteen of the 31 US Nobel Prize winners in Economics and six of the past chairmen of the President's Council of Economic Advisers have been researchers at the NBER. The more than 600 professors of economics and business now teaching at universities around the US who are NBER researchers are the leading scholars in their fields.

Rising Chinese currency will lead to US inflation

Especially under the present circumstances of nearly zero structural unemployment (below 6%) and near-full-capacity utilization in the US, a rise in import prices caused by a fall of the dollar would sharply increase US inflation and thus interest rates, severely affecting the equity and housing markets and potentially triggering a recession.

Inflation is caused by excess liquidity released by the US central bank, not by the Chinese currency. The same counterproductive effect would come from the Graham-Schumer threat to levy 27.5% tariffs on goods imported in from China it the yuan is not revalued upward by 25%.

The most effective way to reduce the US trade deficit is to reduce US demand by curbing excess dollar liquidity, not by pushing down the dollar. Notwithstanding Bergsten's assertion that "the global imbalances probably represent the single largest current threat to the continued growth and stability of the US and world economies", the real threat is a collapse of the dollar debt bubble, not a selloff of the dollar or dollar assets by foreigners.

Wave of neo-populism

In a wave of neo-populism, free trade is currently under review in US political debate for the uneven effect it has on the US domestic economy. Increasing numbers of industries are seeking government protection from imports and subsidies for exports, threatening the basic thrust of US free-trade policy.

The post-World War II open global trading system was first reversed by the Nixon administration, which imposed surcharges on imports and took the dollar off gold to achieve a cumulative devaluation of more than 20% in 1971, and then by the administration of president Ronald Reagan, which drove the dollar down by more than 50% against the Japanese yen within two years, with a smaller fall against the German mark, via the Plaza Accord in 1985, with more than $10 billion of central-bank intervention in the market. The yen rose from 360 to the dollar in 1971 to top out at less than 80 to the dollar in April 1995. The result for Japan was a bubble in its equity and real-estate markets in the late 1980s that collapsed in 1991 with deflation and a zero-interest liquidity trap. But there was no obvious reduction in Japan's trade surplus as a share of its stagnant GDP.

The Plaza Accord was open government manipulation against market forces to correct the high exchange value of the dollar made buoyant by Volcker's victory over US inflation fought with high dollar interest rates that landed the US economy in deep recession by 1985. Yet coordinated multi-government manipulation of currency markets to push down the dollar did not achieve the primary US objective of alleviating the trade deficit with Japan. This was because the trade imbalance was the result of the structural terms of trade rather than international monetary mismatch.

The recessionary effects of the strengthened yen in Japan's export-dependent economy created a justification for the expansionary monetary policies that led to the Japanese asset bubble of the late 1980s. The decline overshoot of the dollar required the Louvre Accord of 1987 to try in vain to stop it, which promptly brought about the 1987 crash in the US equity market that started the newly installed Fed chairman Alan Greenspan on his way to the greatest joyride in Fed-supported debt financing.

With deep-seated anxieties over globalization surfacing in US political dialogue as the 2008 presidential election approaches, and the impasse at the Doha Round halting further trade liberalization around the world, the distressed global trade system can only be saved by restructuring the injurious terms of trade to provide a level playing field between global labor and global capital.

To restore global imbalance, the US needs to restore monetary and fiscal discipline and cease feeding its insatiable debt appetite with fiat currency. There is much noise from many quarters that the US must reduce its fiscal deficit. Yet the problem is not just the fiscal deficit per se, but that the deficit comes from spending on the wrong things, such as war and tax cuts for the rich, which does not add to constructive economic expansion "on important national priorities, such as infrastructure, health care, schools, and targeted tax relief for threatened businesses and struggling working families", as Senator Dodd lamented.

China needs to wean itself from export addiction

On the other side, China needs to stop neglecting domestic development merely to support export growth and to wean itself from the enslavement of dollar hegemony, freedom from which will allow China to utilize sovereign credit instead of foreign capital denominated in dollars to finance much-needed and currently underfunded domestic construction and economic development.

With a limited-convertibility currency and a shift from export dependency, China can finance with sovereign credit full employment with rising wages through government domestic spending on infrastructure, health care, pensions, education, environmental restoration and other growth-inducing undertakings. Such sovereign credit can be serviced and amortized by rising tax revenue from high-growth economic expansion. China has no need for currency flexibility unless it opens up to freely flowing cross-border short-term capital, commonly known as "hot money", which not even the IMF, the World Bank, or the US Treasury is recommending for China.

If China revalues the yuan upward by 25%, its export-dominated GDP will shrink by 25% or more in local-currency terms, as will the local-currency value of its vast foreign-reserves holdings. China's 2006 GDP totaled 20.9407 trillion yuan or $2.7 trillion at the current exchange rate of 7.76 yuan to a dollar. A 25% rise in the exchange rate of the yuan would have reduced China's export-dominated 2006 GDP to 15.706 trillion yuan. At the current exchange rate, the purchasing power parity (PPP) GDP is $10 trillion, about four times the official exchange rate. With the new exchange rate, the PPP GDP would be $7.5 trillion, all of it due to exchange-rate-induced deflation, with domestic asset value falling by 25%, creating a serious deflation problem.

Urban residents in China still earned only 11,759 yuan ($1,515) in per capita disposable income in 2006, up 12.1% from the year earlier. With the new exchange rate, urban per capita income would fall to 8,819 yuan. Rural residents in China saw their per capita income increase by 10.2% to 3,587 yuan ($462), which with the new exchange rate would fall to 2,690 yuan. US per capita income in 2006 was $43,500, about 28.7 times that of urban Chinese and 92.4 times that of rural Chinese.

The State Council Development Research Center recently told the press that by 2020, China's GDP is projected to reach $4.7 trillion, or $3,200 per capita at the current exchange rate. This is not an impressive goal by any measure, most likely falling behind US per capita growth, and will be further reduced with the periodic rise in the exchange value of the

Chinese currency.

What is more fundamental is that China does not need foreign capital or foreign-exchange reserves if it shifts its economy from export dependency to accelerate domestic development financed by sovereign credit.

China's Customs Bureau reported January import-export data that show the nation's trade surplus grew 65% year over year to $15.9 billion, the fifth-highest growth rate on record, as exports increased 33% to $86.6 billion, the fastest growth rate in 17 months, and growth in imports at 27.5% to $70.7 billion, or double the rate in December. These latest monthly data are not good news for China, as a larger trade surplus denominated in US dollars only mean shipping more real wealth from the yuan economy to the dollar economy.

Both China and the US need a level playing field, but for different reasons.

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