We’re In a Global Currency War … But What Does It Mean?

By Washington's Blog

Theme: Global Economy

Global Research, October 04, 2010
Washington's Blog 3 October 2010

There is a currency war ranging world-wide.

Japan, Brazil, Peru and countries all over the world are trying to beggar thy neighbor (just as happened during the 1930s) and gain a leg up for their exports by cheapening their currencies.

If you take a step back, it really is an odd situation. As Joe Weisenthal writes:

> Just think for a moment about the screwy times we live in when central banks are trying to hurt their rivals by buying up their rivals’ bonds — essentially lending them money.
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> Such is the state of things in a world where every country wants to weaken their currencies to boost their own exporters.

And the House has passed legislation saying China is a currency manipulator and has to raise the value of the Yuan.

What does it mean?

American experts say that the Chinese Yuan is undervalued by 25%, which makes Chinese exports artificially competitive. The U.S. Congress is trying to blame China’s undervalued currency for America’s bad economy and unemployment woes.

But the former U.S. trade representative, Susan Schwab, says that – while there’s a very real problem in terms of China artificially keeping the renminbi low, this isn’t the way to solve anything. Schwab calls it “a signal-sending exercise during an election season”. She says that the bill won’t really do anything, even if the Senate passes it and it is signed into law. Schwab says it “makes no sense”, won’t solve any problems, will escalate tensions, and will only divert attention from the real trade problems between the U.S. and China.

Indeed, Schwab warns that other countries might decide that this U.S. bill means that its open season for addressing currency manipulation, and that other countries believe that the U.S. is manipulating our currency. She says there could be a “boomerang effect” from the legislation.

(Ironically, an anti-sourcing bill – the kind of legislation which might actually keep jobs in the country – was defeated in the same week that the toothless China bill passed.)

Zachary Karabell notes that China is not to blame for all of America's economic woes, and China is in the middle of revaluing its currency:

> The idea is that there is direct line between China, its currency, its exports of lower-cost goods to the United States, and the erosion of middle-class life and now soaring unemployment. But U.S. manufacturing has been bleeding jobs for decades …
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> What's more, the recent loss of millions of jobs since 2008 has everything to do with the collapse of the construction and housing industries along with the near-death of the Big Three American auto makers than with any competitive challenge from China. China has become a large car market for General Motors, but not for export to the United States: for sale in China. It would take a massive leap unsupported by any fact to lay the demise of the U.S. auto industry at the feet of China, or for that matter hold China responsible for the sub-prime and derivative debacles. Those are the cause of recent job loss.
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> Furthermore, China has been revaluing its currency, nearly 20% between 2005 and 2008 and now nearly 3% since June when the government resumed that policy having shelved it during the midst of the global financial crisis. It is in the domestic interest of the Chinese government to raise the value of their currency because they are focused on building up on internal, domestic consumption market. They have no wish to be dependent long-term of the vagaries and whims of American consumers, and higher purchasing power for Chinese consumers is the answer. They are not revaluing quickly enough to suit an America stuck in second gear and looking for someone to blame, but revaluing they are.

Martin Wolf points out that the real problem is global weakness in demand, and China is understandably trying to avoid what happened Japan's ramped-up currency, which led to the Lost Decade:

> "We're in the midst of an international currency war, a general weakening of currency. This threatens us because it takes away our competitiveness." Thiscomplaint by Guido Mantega, Brazil's finance minister, is entirely understandable. In an era of deficient demand, issuers of reserve currencies adopt monetary expansion and non-issuers respond with currency intervention. Those, like Brazil, who are not among the former and prefer not to copy the latter, find their currencies soaring. They fear the results.
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> Here there are three facts, relevant to today's currency wars.
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> First, as a result of the crisis, the developed world is suffering from chronically deficient demand. In none of the six biggest high-income economies – the US, Japan, Germany, France, the UK and Italy – was gross domestic product in the second quarter of this year back to where it was in the first quarter of 2008. These economies are now operating at up to 10 per cent below their past trends. One indication of the excess supply is the decline in core inflation to close to 1 per cent in the US and the eurozone: deflation beckons. These countries hope for export-led growth. This is true both of those with trade deficits (such as the US) and of those with surpluses (such as Germany and Japan). In aggregate, however, this can only happen if emerging economies shift towards current account deficit.
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> China is overwhelmingly the dominant intervener, accounting for 40 per cent of the accumulation since February 2009. By June 2010, its reserves had reached $2,450bn, 30 per cent of the world total and a staggering 50 per cent of its own GDP. This accumulation must be viewed as a huge export subsidy.
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> Never in human history can the government of one superpower have lent so much to that of another.
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> It is not hard to see China's point of view: it is desperate to avoid what it views as the dire fate of Japan after the Plaza accord. With export competitiveness damaged by its soaring currency and pressured by the US to reduce its current account surplus, Japan chose not the needed structural reforms, but a huge monetary expansion, instead. The consequent bubble helped deliver the "lost decade" of the 1990s. Once a world-beater, Japan fell into the doldrums. For China, self-evidently, any such outcome would be a catastrophe.

Bill Bonner notes that the core problem is unhinged fiat currencies which are not backed by anything real, and that a revaluation in the Yuan would hurt the vast majority of Americans when they shop:

> These strange facts incite the following reflection on the whole scammy system. The trouble with today's capitalism is that there is little honest capital left in it. It has been drained away by quackery, debt and fraud. Real capitalism requires solid capital – money you can trust. But real money disappeared nearly 40 years ago. That was when the last traces of gold were removed. Since then, all currencies have been "managed." No longer fixed measures of real wealth, they have become tools…supposedly used by the authorities to promote full employment and growth…but in fact little more than monetary felonies.
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> From the end of the Napoleonic wars until the beginning of World Wars of the 20th century, the world's money system was backed by gold. You couldn't "manage" it. You couldn't devalue it. You couldn't talk it up or talk it down. You couldn't beggar thy neighbor by cheapening it or enrich him by making it more dear. It was what it was. The new experimental money system began in the Year of Richard Nixon, 1971. Thereafter, the supply of money could increase much faster than the supply of goods and services. US money supply (M2) rose 1,314% between 1970 and 2008, from $624 billion to $8.2 trillion. What did all this ersatz new money do? First it flattered…then it corrupted…and finally, it robbed.
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> America's working stiffs were the first to get whacked. Inflation made them feel like they were earning more; but they haven't had a real, hourly raise since the system was put in place 4 decades ago. And now, America is struggling to make sure they get none in the future either. Lowering the dollar against the renminbi increases the cost of probably 90% of the goods in Wal-Mart and Costco – where the working classes shop.
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> But this has been going on ever since the managers began taking liberties with the dollar. In the 1960s, the working man – 90% of the population – got 60% of the income gains of the period. By the end of the bubble years – 2001- 2007 – he got just 11%. This has resulted in a "record income gap," says this week's news. Half the nation's income goes to the top 20% of the population, nearly twice as much, compared to the bottom 20%, as in 1967; it's the biggest gap since they began keeping track.

> Consumer prices rose 5 times over the last 40 years. The stock market went up 15 times – from 800 in January 1970 to over 12,000 in 2008 – roughly in line with the increase in the money supply. But the phony money betrayed the rich too. Investors were misled. Capitalists erred. Trillions of dollars went down rat-holes. Consumers were spent out, but the capitalists kept building shopping malls. Now, stock market prices have gone nowhere for more than a decade. And household net worth – most of it in the hands of the wealthy – has declined $12.3 trillion from the peak. When the mistakes are finally flushed out, they could be down another $12 trillion.
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> The horns have sounded and bells have been rung. It is 1939 in the currency war – just the beginning. When it is over, every managed currency in the world will be dead or wounded. But we will be wiser, too. When the new managed dollar was introduced in the "Nixon Shock" of August, 1971, nobody knew what it was worth. When the end comes, everyone will know.

And Michael Hudson points out that – with the dollar as the world's reserve currency – every county, including China, must devalue their currencies just to stabilize their economies:

> It is traditional for politicians to blame foreigners for problems that their own policies have caused. And in today's zero-sum economies, it seems that if America is losing leadership position, other nations must be the beneficiaries. Inasmuch as China has avoided the financial overhead that has painted other economies into a corner, nationalistic U.S. politicians and journalists are blaming it for America's declining economic power.
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> For over a century, central banks have managed exchange rates by raising or lowering the interest rate. Countries running trade and payments deficits raise rate to attract foreign funds. The IMF also directs them to impose domestic austerity programs that reduce asset prices for their real estate, stocks and bonds, making them prone to foreign buyouts. Vulture investors and speculators usually have a field day, as they did in the Asian crisis of 1997.
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> Conversely, low interest rates lead bankers and speculators to seek higher returns abroad, borrowing domestic currency to buy foreign securities or make foreign loans. This capital outflow lowers the exchange rate.
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> There is a major exception, of course: the United States. Despite running the world's largest balance-of-payments deficit and also the largest domestic government budget deficit, it has the world's lowest interest rates and easiest credit. The Federal Reserve has depressed the dollar's exchange rate by providing nearly free credit to banks at only 0.25% interest. This "quantitative easing" (making it easier to borrow more) aims at preventing U.S. real estate, stocks and bonds from falling further in price. The idea is to save banks from more defaults as the economy slips deeper into negative equity territory. A byproduct of this easy credit is to lower the dollar's exchange rate – presumably helping U.S. exporters while forcing foreign producers either to raise the dollar price of their goods they sell here or absorb a currency loss.
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> This policy makes the dollar a managed currency. Low U.S. interest rates and easy credit spur investors to lend abroad or buy foreign assets yielding more than 1%. This dollar outflow forces other countries to protect their currencies from being forced up. So their central banks do not throw the excess dollars they receive onto the "free market," but keep them in dollar form by buying U.S. Government bonds. So the "Chinese savings," "yen savings" and "Euro savings" that are spent on U.S. Treasury securities (and earlier, on Fannie Mae

bonds to earn a bit more) are not really what Chinese people save in their local yuan, or what Japanese or Europeans save. The money used to buy U.S. Government securities consists of the excess dollars that the American military, American investors and American consumers spend abroad in excess of U.S. earning power.

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Accusations that Japan, South Korea and Taiwan are “making their currencies cheaper” by recycling their dollar inflows into U.S. Treasury securities simply means that they are trying to maintain their currencies at a stable level.

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It is how most central banks throughout the world are responding to the global dollar glut. They are increasing their international reserves by the amount of surplus free credit” dollars that the U.S. payments deficit is pumping out. To pretend that China is “manipulating its currency” by doing what central banks have done for over a century is [false]. Back in the early 1970s, U.S. officials told OPEC governments that if they did not do this, it would be deemed an act of war. And Congress has refused to let China buy U.S. companies – so China can only recycle its dollar inflows by buying Treasury securities, thereby financing the U.S. federal budget deficit.

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To pretend that exchange rates are determined mainly by international trade is Junk Economics Error #3. International currency speculation and investment is much larger than the volume of commodity trade. The typical currency bet lasts less than a minute, often being computer-driven by arbitrage swap models. This financial fibrillation has dislodged exchange rates from purchasing-power parity or prices for export and imports.

The largest payments imbalances have little to do with “market forces” for imports and exports. They are what economists call price-inelastic – money spent without regard for price. This is true above all for military spending and maintenance of America’s vast network of foreign bases and political maneuverings to control foreign countries. During the 1960s and ‘70s U.S. military spending accounted for the entire balance-of-payments deficit, as private sector trade and investment remained in balance. Escalation of America’s oil war in the Near East and Pipelinistan, and the hundreds of billions of dollars spent to prop up America-friendly regimes, end up in central banks – whose main option, as noted above, is to send them back to the United States in the form of purchases of U.S. Treasury bills – to finance further federal deficit spending!

None of this can be blamed on China.

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U.S. strategists would not mind seeing China’s economy similarly untracked by letting global speculators bid up the renminbi’s exchange rate – by enough to let Wall Street speculators make hundreds of billions of dollars betting on the run-up. “Free capital markets” and “open financial markets” are euphemisms for setting the renminbi’s exchange rate by U.S. and European currency arbitrage and capital flight. The U.S. balance-of-payments outflow would increase rather than shrink, thanks to the ability of American banks to create nearly “free” credit on their keyboards to convert into Chinese or other currencies, gold or other speculative vehicles that look to rise against the dollar.

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“An undervalued currency always promotes trade surpluses,” Prof. Krugman explains. But this is only true if trade is “price-elastic,” with other countries able to produce similar goods of their own at only marginally different prices. This is less and less the case as the United States and Europe de-industrialize and as their capital investment shrinks as a result of their expanding financial overhead ends in a wave of negative equity.

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Congress is increasing the drumbeat of accusations that China is violating international trade rules by protecting itself from financialization. “Democrats in Congress are threatening to … slap huge tariffs on Chinese goods to undermine the advantages Beijing has enjoyed from a currency, the renminbi, that experts say is artificially weakened by 20 to 25 percent.” The aim is to make China “lift the strict controls on its currency, which keep Chinese exports competitive and more factory workers employed.” But such legislation is illegal under world trade rules.

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This kind of propaganda does not see the United States as guilty of “managing the dollar” by its quantitative easing that depresses the exchange rate below what would be normal for any other economy suffering so gigantic and chronic s payments deficit. What makes this situation inherently unfair is that while the Washington Consensus directs other countries to impose austerity plans, raise their taxes on consumers and cut vital spending, the Bush-Obama administration blames China, not the U.S. financial system or post-Cold War military expansionism.

The cover story is that foreign exchange controls and purchase of U.S. securities keep the renminbi’s exchange rate low, artificially spurring its exports. The reality is that these controls protect China from U.S. banks creating free “keyboard credit” to buy out its companies or load down its economy with loans to be paid off in renminbi whose value will rise against the deficit-prone dollar.

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It’s the arbitrage opportunity of the century that lobbyists are pressing for, not the welfare of workers.

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Paul Krugman and Robin Wells blame China for Wall Street’s junk mortgage binge. Instead of pointing to criminal behavior by the banks, brokerage companies, bond rating agencies and deceptive underwriters, they take the financial sector off the hook: “Just as global imbalances – the savings glut created by surpluses in China and other countries – played an important part in creating the great real estate bubble, they have an important role in blocking recovery now that the bubble has burst.”

This sounds more like what one would hear from a Wall Street lobbyist than from a liberal Democrat. It is as if the real estate bubble didn’t stem from financial fraud, junk mortgages, NINJA loans or the Federal Reserve flooding the U.S. economy with credit to inflate the real estate bubbles and sending electronic dollars abroad to glut the global economy. It’s China’s fault for running large trade surpluses “at the rest of the world’s expense.”

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> Wall Street's idea of "equilibrium" is for foreign countries to financialize themselves along the lines that the United States is doing, then global equilibrium could be restored.
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> Such suggestions are a cover story for America's own financial mismanagement. The U.S. idea for global equilibrium is to demand that that the rest of the world follow suit in adopting the short-term time frame typical of banks and hedge funds whose business plan is to make money purely from financial maneuvering, not long-term capital investment. Debt creation and the shift of economic planning to Wall Street and similar global financial centers is confused with "wealth creation," as if it were what Adam Smith was talking about.
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> China is trying to help by voluntarily cutting back its rare earth exports. It has almost a monopoly, accounting for 97% of global trade in these 17 metallic elements. These exports are "price inelastic." There is little known replacement cost once existing deposits are depleted. Yet China charges only for the cost of digging these rare metals out of the ground and refining them. They are used in military and other high-technology applications, from guided missile steering systems and computer hard drives to hybrid electric automobile batteries. This has prompted China to recently cut back its exports to save its land from environmental pollution and, incidentally, to build up its own stockpile for future use.
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> So I have a modest suggestion. If and when China starts re-exporting these metals, raise their price from a few dollars a pound to a few hundred dollars. According to theory put forth by Mr. Krugman and the U.S. Congress, this price increase should slow demand for Chinese exports. It also would help promote world peace and demilitarization, because these rare metals are key elements in missile guidance systems. China should build up its national security stockpile of these key minerals for the future – say, the next prospective five years of production. Let this be a test of the junk paradigms at work.

The bottom line is that there really is a trade imbalance with China which needs to be addressed over some reasonable time-frame. But America hasn't addressed itsown fundamental problems (such as rampant speculation and fraud) which led to our financial crisis. And as former trade rep Susan Schwab notes, the Congressional bill is nothing but political theater which might boomerang on us.

Some smart people think that the currency war could eventually lead to a flight from paper money altogether (and see this), or to an outright conflict between nations (and see this)

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