

Playing the blame game

A currency war makes no sense, but it may happen



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Throughout the years and continents, foreign exchange markets have probably been those where the most patent political hypocrisies spread regularly. The latest news is that we are entering a new currency war.

Between the US attacks against the yuan, President Nicolas Sarkozy's indication that he wants to put those markets at the forefront of the G20 French presidency for the first half of 2011, and the comments of the Brazilian finance minister, accusing his counterparts of waging an 'international currency war', one would believe that the future of the world economy lay in the exchange rates of currencies.

What is typical in most of these declarations is that government officials speak as if currencies were the cause of the economic woes of their country. Nothing is more wrong. Even though it makes for great headlines and gives glamorous opportunities to economists (including Nobel Prizes), the reality is more sobre – the price of a currency reflects the relative strengths and weaknesses of the issuing country. Blaming the barometer for a heavy monsoon or drought makes no sense at all. So it is for currencies.

When politicians heat up against currencies, it is generally because they don't like the value of their currency. As an indicator, it is like the mirror of Snow White – it does not reflect the nice image of themselves that they would like to see. The reality is beyond currencies.

Over the past year, we have seen the euro lose 20 per cent of its value; it made headlines without affecting international trade. But that effective devaluation had a cause – the inability of the eurozone to manage its own currency and the lack of budgetary discipline of some of its members; Greece, followed by Spain, Portugal and Ireland, showed weaknesses inherent to their social model. The eurozone was too weak to force them to put their house in order; it was only when all else failed that they accepted the obvious. They needed to put in some money to reassure the markets that their countries would not default. And based on the interest rates of some of those bonds, many investors still believe that Greece will become bankrupt. It is politically better to accuse the foreign exchange market for the demise of the euro

than to admit to one's own political and economic weaknesses.

The US doesn't care about the dollar. And for those who do not live in the US, let's be clear: they never will. What they care about is that the countries with which their companies trade care about their currency so that US companies can remain competitive. They decided that it was all the fault of the yuan. The Chinese told them that they would let the yuan increase at a pace that is compatible with the need to ensure employment and economic activity. They too are facing a 9.5 per cent unemployment rate like the US.

This is only part of the story. By reducing interest rates and injecting liquidity in the US economy, the Federal Reserve tries to stimulate the US economy. That noble objective has several consequences, one of which may not be unintended.

It does impact the international value of the dollar – the US needs to massively borrow abroad to finance its budget deficit and it does so in dollars. Low interest rates make such investments unattractive and the dollar is losing value because its level of interest rates no longer reflects the level of risks of its borrowings. It is not a foreign country's fault; it is the direct result of an otherwise acceptable domestic policy. By following the dollar, the Chinese are simply telling the US that they do not intend to reduce the competitiveness of their economy to please Washington.

In this battle, the losers are the Japanese. Their export companies are suffering because the yen has lost one quarter of its value. On the \$800 billion invested in US treasuries, they lost approximately \$200 billion. This is irresponsible from a country that depends on foreign capital to finance its deficit. So, when the US blames other countries for the turmoil in foreign exchange markets, it needs to first look at its own currency.

However, this does not leave India indifferent. Fairness in foreign exchange requires a level of convertibility that the Reserve Bank of India and the finance minister do not seem to contemplate any time soon.

By deliberately weakening its currency, the US may ignite protectionist policies. This is a dangerous game, not only for the economy, but also for world peace. ♦

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