Asian Currencies: New global scapegoats

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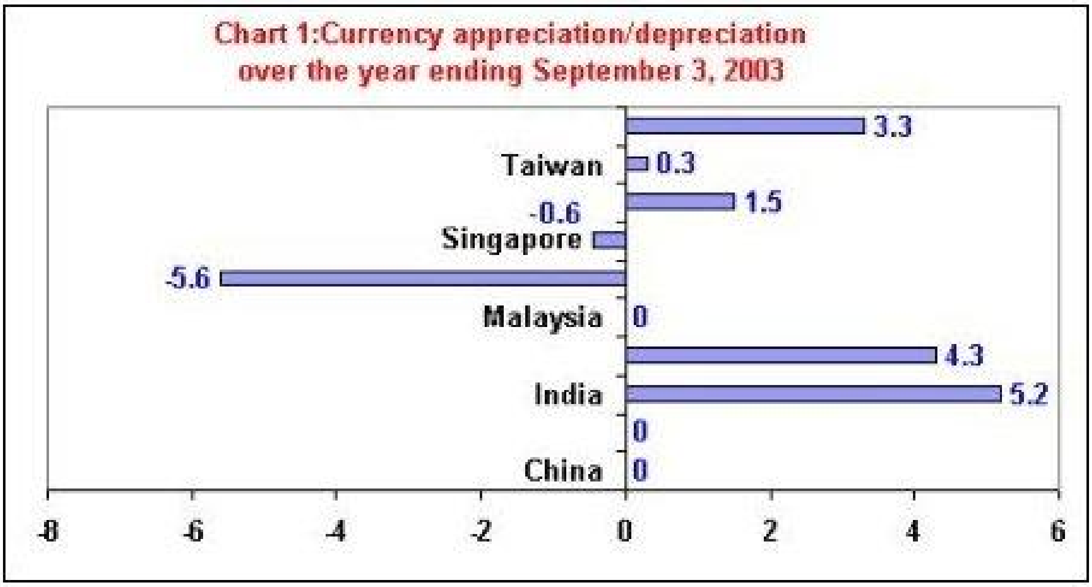
In mid-July, Alan Greenspan, chairman of the US Federal Reserve, while deposing before a congressional committee, warned the Chinese authorities that they could not continue to peg the renminbi to the US dollar, without adversely affecting the functioning of their monetary system. This touching concern for and gratuitous advice to the Chinese had, however, some background. Greenspan was merely echoing the sentiment expressed by a wide circle of conservative economists that the Chinese must float their currency, allow it to appreciate and, hopefully, help remove what is being seen as the principal bottleneck to the smooth adjustment of the unsustainable US balance of payments deficit.

China was, of course, only the front for a wide range of countries in Asia, who were all seen as using a managed and "undervalued" currencies to boost their exports. Around the same time that Greenspan was making his case before the congressional committee, The Economist published an article on the global economic strains being created by Asian governments clinging to the dollar either by pegging their currencies or intervening in markets to shore them up. That article reported the following: "UBS reckons that all Asian currencies, except Indonesia's are undervalued against the dollar … The most undervalued are the yuan, yen, the Indian rupee and the Taiwan Province of China and Singapore dollars; the least undervalued are the ringgit, the Hong Kong dollar and the South Korean won."

The evidence to support this is of course limited. It lies in the fact that while over the year ending September 3rd the euro has appreciated against the dollar by about 9 per cent, many Asian currencies have either been pegged to the dollar, appreciated by a much smaller percentage relative to the dollar or even depreciated vis-à-vis the dollar.



To anyone who has been following the debate on exchange rate regimes and exchange rate levels in developing countries, this perception would appear to be a dramatic reversal of the mainstream, conservative argument that had dominated the development dialogue for the last three to four decades. Till recently, many of these countries were being accused of pursuing inward looking policies, of being too interventionist in their trade, exchange rate and financial sector policies, and, therefore, of being characterized by "overvalued" exchange rates that concealed their balance of payments weaknesses. An "overvalued" rate, by setting the domestic currency equivalent of, say, a dollar at less than what would have been the case in an equilibrium with free trade, is seen as making imports cheaper and exports more expensive. This can be sustained in the short run because trade restrictions do not result in a widening trade and current account deficit. But in the medium term it seen as encouraging investments in areas that do not exploit the comparative advantages of the country concerned, leading to an inefficient and internationally uncompetitive economic structure.

What was required, it was argued, was substantial liberalization of trade, a shift to a more liberalized exchange rate regime, less intervention all-round, and a greater degree of financial sector openness. Partly under pressure from developed county governments and the international institutions representing their interests, many of these countries have since put in place such a regime.

Seen in this light, consistency and correctness are not requirements it appears when defending the world's only superpower. Nothing illustrates this more than the effort on the part of leading economists, the IMF, developed country governments and the international financial media to hold the exchange rate policy in Asian countries, responsible for stalling the "smooth adjustment" of external imbalances in the world system. The biggest names have joined the fray to make the case: Alan Greenspan, chairman of the US Federal Reserve, John Snow, US treasury secretary, and Kenneth Rogoff, IMF chief economist.

The adoption of a liberalized economic regime in which output growth had to be adjusted downwards to prevent current account difficulties and attract foreign capital had its implications. It required governments to borrow less to finance deficit spending, which often led to lower growth, lower inflation and lower import demand. Combined with or independent of higher export growth, these effects showed up in the form of reduced deficits or surpluses on their external trade and current accounts. Since in many cases the 'chronic' deflation that the regime change implied was accompanied by large capital inflows after liberalization, there was a surplus of foreign exchange in the system, which the central bank had to buy up in order to prevent an appreciation in the value the nation's currency. Currency appreciation, by making exports more expensive and imports cheaper, could have devastating effects on exports in the short run and generate new balance of payments difficulties in the medium term. In fact, among the reasons underlying the East Asian crises of the late 1990s was a process of currency appreciation driven by export success on the one hand and liberalized capital inflows on the other.

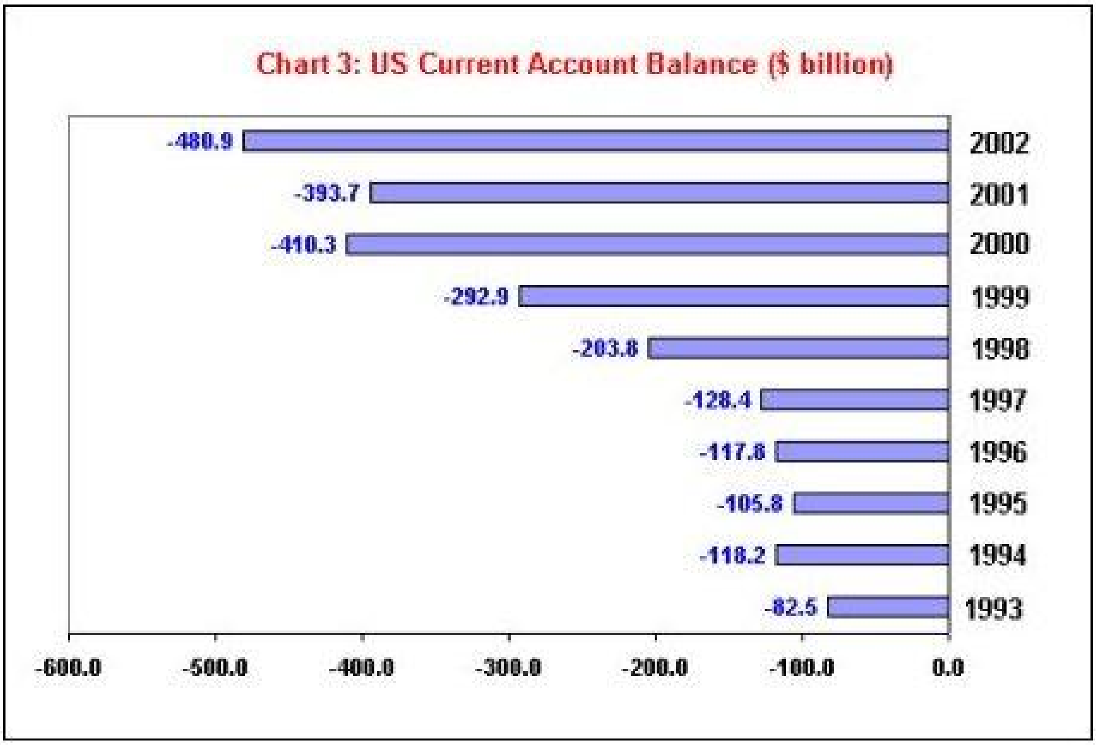
Faced with this prospect countries like China and India chose to adopt a more cautious approach to economic liberalization and, especially with regard to the exchange rate regime and to the liberalization of rules governing capital flows into and out of the country. However, even limited liberalization entailed providing relatively free access to foreign exchange for permitted trade and current account transactions and the creation of a market for foreign exchange in which the supply and demand for foreign currencies did influence the value of the local currency relative to the currencies of major trading partners. This made the task of managing the exchange rate difficult. The larger the flow of foreign exchange because of improved current account receipts (including remittances) and enhanced inflows of capital (consequent to limited capital account liberalization), the greater had to be the demand for foreign exchange if the local currency was to remain stable. But given the context of extremely large flows (China) and/or relatively low demand during the late 1990s due to deflation (India), there was a tendency for supply to exceed demand, even if this did not always reflect a strong trading position. As a result, to stabilize the value of the currency the central banks in these countries were forced to step in, purchase foreign currencies to stabilize the value of the local currency, and build up additional foreign exchange reserves as a consequence.

Different countries adopted different objectives with regard to the exchange rate. China, for example, chose to make a stable exchange rate a prime objective of policy and has frozen its exchange rate vis-à-vis the dollar at renminbi 8.28 to the dollar since 1995. To its credit, it stuck by this policy even during the Asian currency crisis, when the value of currencies of its competitors like Thailand and Korea depreciated sharply. This helped the effort to stabilize the currency collapse in those countries, even if in the immediate short run it affected China’s trade adversely. India too had adopted a relatively stable exchange rate regime right through this period, allowing the rupee to move within a relatively narrow band relative to a basket of currencies, and not just the dollar.

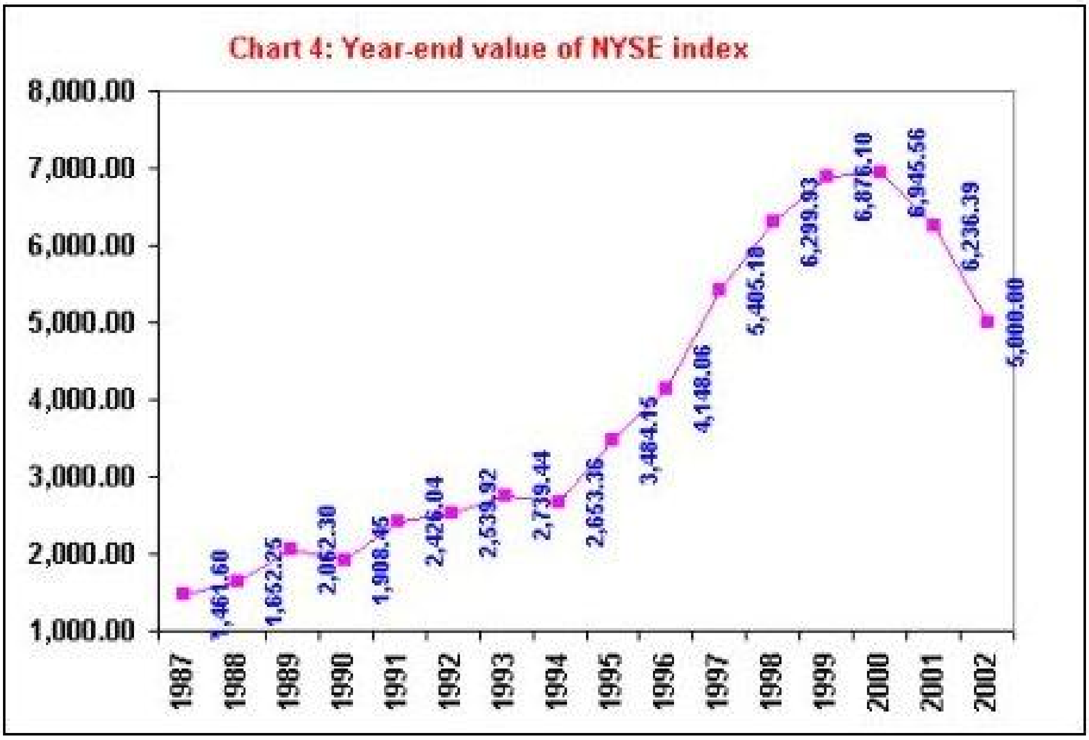
The net result is that most Asian countries – some that fell victim to the late 1990s financial crises, like Korea, and those that did not, like China and India – have accumulated large foreign exchange reserves (Chart 2). According to one estimate, Asia as a whole is sitting on a reserve pile of more than $1600 billion. This was the inevitable consequence of wanting to prevent autonomous capital flows that came in after liberalization of foreign direct and portfolio investment rules from increasing exchange rate volatility and threatening currency disruption due to a loss of investor confidence. These reserves are indeed a drain on these systems, since they involve substantial costs in the form of interest, dividend and repatriated capital gains but had to be invested in secure and relatively liquid assets which offered low returns. But that cost was the inevitable consequence of opting for the deflation and the capital inflow that resulted from the stabilization and adjustment strategy so assiduously promoted by the US, the G-7, the IMF and the World Bank in developing countries the world over. Unfortunately, the current account surpluses and the large reserves that this sequence of events resulted in have now become the “tell-tale” signs for arguing that the currencies in these countries are “under-“ not “overvalued” and therefore need to be revalued upwards.

Chart 2: Asia's foreign exchange reserves in July 2003 ($billion)

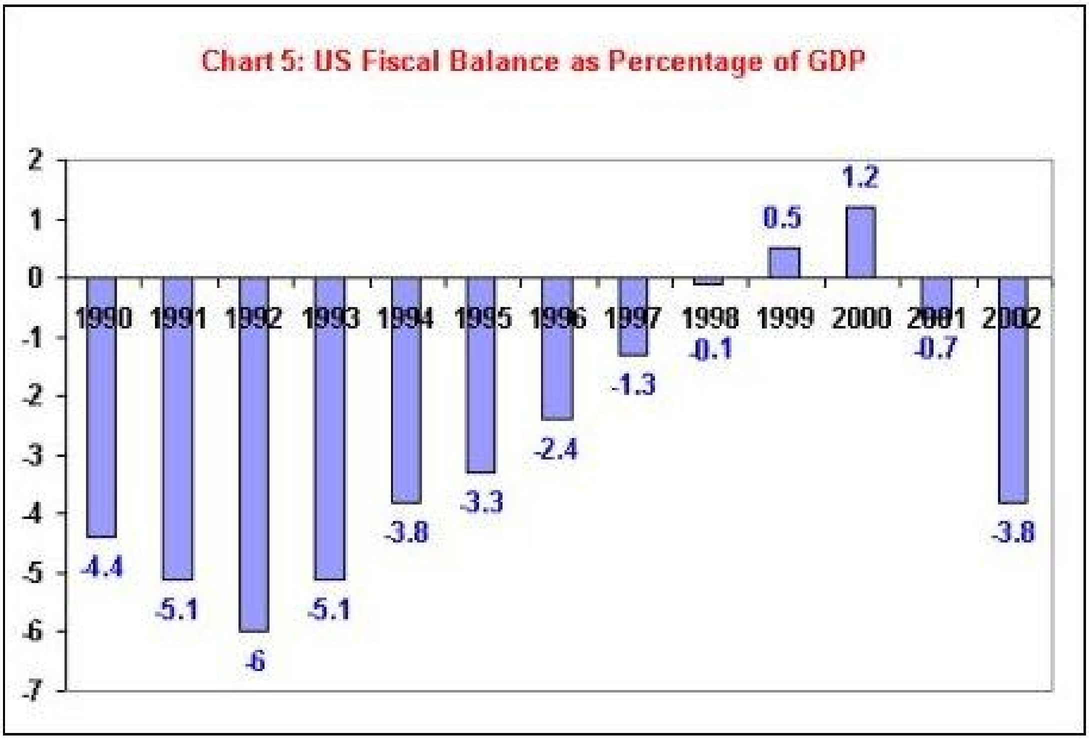
For long, this episode of rising reserves in till-recently poor countries appeared almost conspiratorial, because these reserves were being invested in dollar denominated assets including government securities in the US and played an important role in financing the burgeoning current account deficit in the US (Chart 3). The choice of US assets was, of course, determined by the facts that the dollar still is the world’s reserve currency and the US the world’s sole superpower, both of which engender confidence in American, dollar-denominated assets. The direct benefit for the US was obvious. With America experiencing growth without the needed competitiveness, that growth was accompanied by a widening of the trade and current account deficits on its balance of payments. Capital inflows into the US helped finance those deficits, without much difficulty. For example, UBS estimates that in the second quarter of 2003, the central banks in Japan and China bought $39 billion and $27 billion of dollars respectively. If these are invested in American assets they would finance close to 45 per cent of the estimated $147 billion US current account deficit in that quarter. They indeed were. Central banks, mostly from Asia, are estimated to have financed more than half of the US current account deficit in the second quarter.



The indirect benefits of this arrangement are even greater. For more than a decade now, the US has benefited from a long period of buoyancy, so much so that it has accounted for 60 per cent of cumulative world GDP growth since 1995. That buoyancy came not because the US was the world's most competitive nation in economic terms. Rather, till the turn of the last decade growth was accounted for by a private consumption and investment spending boom, spurred by the bubble in US stock and bond markets (Chart 4) that substantially increased the value of the savings accumulated by US households. The money market boom was encouraged by the flight of capital from across the world to the safe haven that dollar denominated assets were seen as providing. Investment of reserves accumulated by the Asian countries was one important component of that capital inflow. With the value of their savings invested in stocks and securities inflated by the boom, consumers found confidence to spend.



To be sure, when the speculative boom came to end in 2000, triggered in part by revelations of corporate fraud, accounting scandals and conflicts of interest, this spur to growth was substantially moderated. But the low interest rate regime adopted by the Fed still encouraged debt-financed consumer spending. Together with the return to deficit-financed spending by the American state (Chart 5), justified by its nebulously defined war on terror, America is once again witnessing buoyant output growth even if this has not improved the employment situation significantly. In fact, 2.6 million manufacturing jobs have been lost in the US since Bush assumed office in 2001.



The only threat to US buoyancy throughout this period was the possible unsustainability of the widening current account deficit in its balance of payments. But the boom was not aborted, because the rest of the world appeared only too willing to finance those deficits, even if at falling interest rates in some periods.

Unfortunately, few other countries benefited directly from this chain of events. They did not because they did not have the military power to create the required confidence in their currencies, even if sheer competitiveness warranted a decline in the dollar. Some countries benefited indirectly: China, for example, because of the export boom to the US; the UK because, among other things, of a boom in services, including financial services. But overall, to use a phrase popularized by former US Treasury secretary Lawrence Summers, the world economy was flying on one engine.

Within the imperial order always fearful of a "hard landing", this has created two imperatives. First, in the medium term, the world needs other supportive engines, which must be from within the developed economies. Second, till that time, and even thereafter, US growth must be sustained. The new discovery that Asian currencies, particularly the Chinese renminbi, is under- and not overvalued, stems from the second of these two concerns. With the US current account deficit expected to exceed 5 per cent this year, there are few who are convinced that it would find investors who would be confident enough to continue financing that deficit. This is becoming clear from the fact that the share of the deficit financed by central bank investments is rising, as private investors grow more cautious. Thus, if the dollar is not to collapse, the US current account deficit must be curtailed and reversed.

However, this cannot be ensured by curtailing US growth and therefore the growth of US imports. It is necessary to boost exports, so that growth can coexist with a reducing trade and current account surplus. This is where China and the fact that it notched up a record $103 billion trade surplus with the US last year comes in. Ignoring the fact that simultaneously China had recorded a trade deficit of $75 billion with the rest of the world, the surplus with the US is seen as a direct consequence of China's undervalued exchange rate, which has been pegged to the dollar since 1995 despite rising capital flows and reserves. Thus, the story goes, if China revalues its currency vis-à-vis the dollar by anywhere between 15 and 40 per cent, depending on the advocate, China would absorb more imports from and be able to export less to the US, correcting the trade imbalance between the two countries.

But that is not all. If China revalues its currency, it is argued, Europe would improve its competitiveness lost as a result of the appreciation of the euro vis-à-vis the dollar and therefore the renminbi, allowing it to register higher export growth. Further, China's revaluation would reduce the need to pressurize Japan to revalue the yen, despite its own surpluses with the US and the high level of its reserves. This deals with the danger that yen revaluation might abort the feeble recovery that Japan is experiencing after a decade of stagnation. These benefits could possibly yield the supportive engines needed to keep the world economy in flight.

In this assault on the less-developed nations, involving a complete reversal of the argument regarding the currency regime in developing countries, the US and its allies are finding strange supporters. Trade unions and manufacturing companies located in the US who have experienced job and market losses have joined the chorus through organizations such as "The Coalition for a Sound Dollar". They are even threatening to take the Chinese to the dispute settlement body of the WTO on the grounds that it is manipulating the exchange rate to win unfair gains from trade. There effort is ostensibly aimed at invoking a provision in the World Trade Organisation that bars countries from influencing exchange rates to "frustrate the intent" of WTO trade agreements. In practice, the clamour is all intended to get the US government, in a pre-election year, to increasing pressure on China to float its currency.

However, not all of American business supports this effort. Calman Cohen of the Emergency Committee for American Trade, which represents many large US companies doing business in China, is reported to have said that while the renminbi may well be undervalued, it was not the main cause of the industrial problems facing the US. His principal and well-founded fear is that action against China would adversely affect US companies that as part of their competitive strategy are sourcing their products from countries like China.

Not surprisingly, Rob Westerhof, chief executive of Philips Electronics North America and former chief executive of Philips Electronics East Asia, argues: “A free float or sudden revaluation would be bad for China and bad for business. Instead, Beijing should maintain the peg for now and aim for a gradual revaluation of about 15 per cent over the next five years. Free- floating the renminbi can be considered only when China has a well established financial system. That will take at least another 10 years.” He made it clear that “business prefers a stable renminbi-dollar exchange rate. A sudden revaluation of the renminbi would disrupt results for the many multinational companies (Philips included) that supply American and European retail chains with goods made in China. Currently, hedging against exchange rate fluctuations of a free-floating, unpredictable renminbi would be very costly for those companies.”

Unfortunately, some Asian countries, particularly those that have been experiencing an appreciation of their currencies from the lows they reached after the 1997 financial crisis are supporting the demand with the hope that they would benefit from the loss of Chinese export competitiveness that a revaluation of the renminbi would involve. Interestingly, Japan too is part of this group, even though it is itself intervening in currency markets to prevent the yen from appreciating too much against the dollar.

Thus at the end of September, the dollar recovered sharply against the yen as a result of Bank of Japan intervention, conducted through the New York Federal Reserve. This help reverse a prior downward lurch of the dollar vis-à-vis the yen. According to information released recently by the Japanese Finance Ministry, the government and central bank have spent a total of $ 40 billion between August 28 and September 26, taking the total amount spent on supporting the yen in the first nine months of 2003 to well above $100 billion. This willingness to intervene openly is partly explained by the fact that the G-7 has accepted that any excessive appreciation of the yen could abort a recovery which has come after a long while and which is seen as crucial for overall global growth. This support for action against yen appreciation goes against the G-7’s own recent statement that cam out in favour of exchange rate flexibility in the world, which it is now clear was aimed at developing Asia in general and China in particular.

Despite its own actions, the Japanese government has been willing to go along with the demand that the Chinese and other developing Asian countries should revalue their currency by opting for a float. Once again the fact that the developed countries believe that developing countries should do as the G-7 says and not as it does has been brought home.

The flaws in these arguments are obvious. A revaluation of the renminbi may reduce China’s trade surplus with the US, but it is unlikely to trigger either export or output growth in the US. Rather, the space vacated by the Chinese in US markets would be occupied by some other trading country such as Vietnam, Korea or the Philippines. Further, those Asian countries that expect to gain from the renminbi's revaluation would soon find that their current account surpluses and reserves are seen as grounds for identifying their currencies as undervalued and provide the basis for a revaluation demand. India, with less than $90 billion of foreign exchange reserves is already being targeted. Whatever gains would occur from China's revaluation would be shortlived.

Further, if China and other countries, like India, with rising reserves are deprived of those reserves on these grounds, the capital required to finance the current account and budget deficits accompanying US growth would soon dry up. This would drive up interest rates in the US, cut consumption and investment spending, make the current account deficit unsustainable, and ensure the collapse of US growth and the dollar that the revaluation is expected to stall.

In sum, the whole episode indicates that the desperation to protect the current imperial order is yielding a number of scatter-brained proposals. Economics has been reduced to deformed ideology, devoid of consistency and rationality. Fortunately, the Chinese have thus far stood their ground and refused to yield. Hopefully, other developing countries would also see where their best interests lie.