The Misdirection of “Currency Wars”

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A standard ploy of both magicians and politicians is called misdirection, where the audience is distracted from the real movement by a feint. The so-called “currency war,” which has become the title of books, articles and conferences, is such a misdirection.

Some officials, notably Brazilian Finance Minister Guido Mantega, have been leading the charge, arguing that developed countries such as the U.S., by pursuing unorthodox monetary policy, have sparked powerful forces that destabilize emerging market economies through capital flows, driving their currencies sharply higher.

Emerging Markets

It is indisputable that international capital movement is volatile and that the accommodative monetary policy in the U.S. and other developed economies has shifted interest rate differentials more in favor of emerging markets. This shift has likely spurred private capital flows. That is both a common ground and a point of departure.

Capital inflows into the emerging markets are driven by a number of considerations, not just interest rate differentials. Consider, for example, that growth differentials and higher returns on investment have also been attracting investment flows, especially in recent years.

The general investment climate is shaped in part by the risk appetite of investors. The “risk-on” and “risk-off” matrix has shifted in recent years, not as much by the pursuit of U.S. monetary policy as by the shifting response to the European debt crisis.

In a recent speech, Federal Reserve Chairman Bernanke cited research by the International Monetary Fund and others that concluded that monetary policies of the advanced economies were not the dominant drivers of private savings into emerging markets. He went further and noted that capital flows into emerging markets have slowed considerably over the past couple of years, and even the U.S., Europe and Japan continued to ease monetary policy.

If the cry of “currency war” is misdirection, what exactly is it trying to distract our attention from? Many emerging market countries want to have currencies that, some economists argue, are below fair value. They do so to promote exports and bypass domestic structural obstacles to growth.

Under-valued currencies in and of themselves may attract capital flows from foreign investors anticipating
currency appreciation. Moreover, purposefully weak currency strategies often leave developing countries more vulnerable to inflation and more sensitive to the monetary policies of other countries.

Currency Flexibility

The U.S., through numerous administrations, and in various declarations of the Group of Seven industrial nations, has consistently advocated greater currency flexibility. Such flexibility would allow greater independence in the conduct of monetary policy and offer greater insulation from external developments.

This, of course, applies not only to Brazil, but also to China, the world’s second-largest economy. A more flexible currency regime would help officials refocus their economy from one driven by external demand to one led by domestic consumption. It would allow the Chinese people to enjoy a greater share of their country’s economic success and prowess.

Brazil’s finance minister claimed that the U.S. was being selfish in pursuing monetary policy without taking into account the impact of such a policy on other countries.

Yet, the real selfishness and beggar-thy-neighbor policies are not from the monetary easing of the U.S. and other advanced economies, but the reluctance of many emerging countries to allow their currencies to appreciate in the face of stronger growth, capital inflows and larger reserve positions.

Monetary Policy

Even if there are costs for developing countries from the easy monetary policy of the advanced economies, there are also benefits. Part of the reason why the economies of many developing countries have slowed is that their exports to the U.S. and Europe have decreased as those economies decelerated.

Easier monetary policy, which has taken on an unorthodox characteristic given that benchmark rates are near zero, is meant to help fuel a recovery in aggregate demand. Stronger U.S. and European growth would stimulate trade as well as underpin growth in emerging markets.

Aggressive monetary policy in the face of a weak domestic economy is not the equivalent of a currency war. To the contrary, the fact that some developing economies insist on having under-valued currencies is more directly recognizable as “shots” in a currency war.

Such policies can be associated with costs, such as greater sensitivity to inflation and limits on the independence of their own monetary policies. There are various drivers of capital flows to emerging markets, and those capital flows do not appear to be correlated with U.S. or European monetary policies.

It is interesting to note that, for the better part of the past four months, as the Fed signaled then pursued QE3, the European Central Bank announced its Outright Market Transactions and the Bank of Japan expanded its asset purchase program, the Brazilian real has been largely flat. The U.S. dollar has largely been confined to a BRL2.00-BRL2.05 trading range, though has strengthened recently.

Investors recognize that there are a number of emerging market countries, such as Mexico, Poland,
Turkey and South Africa that have embraced currency flexibility to a greater extent. They have increased the capacity of their own capital markets to absorb inflows as well as absorbing a greater part of their own domestic savings.

**U.S. Dollar and Chinese Renminbi**

There is another dimension to debate about currency wars. Many observers argue that the U.S. dollar is in an inexorable decline and that it will be increasingly supplanted by the Chinese renminbi. On the other hand, China itself is not above deflecting criticism of its rigid currency regime by criticizing the international monetary regime and the role of the dollar.

**The internationalization of the renminbi has been more bluster than substance. The role of the renminbi in the world economy remains minor.**

The numerous swap lines that China arranged with many developing countries, which captured the imagination of many critics of the U.S., have not been used. Few countries have chosen to add the renminbi to their reserves.

The Dim Sum market, the offshore renminbi market in Hong Kong, a special administrative region of China, is dominated by Chinese state-owned companies, banks and property firms. Renminbi in Hong Kong is not fungible with renminbi onshore. The currency requires special authority to be used within China itself. Outside of Chinese trade with Hong Kong, most of Chinese trade continues to be conducted in U.S. dollars.

There has been some diversification of reserves away from the dollar and euro in recent years. However, it has not gone to the Chinese renminbi, but to the Australian and Canadian dollars. The kind of transparency and flexibility that an international currency requires still seems beyond the ken of Chinese officials.

**More Rhetoric than Politics**

Currency wars then, in either expression, seem to be more in the realm of rhetoric than politics.

There has been a long and sustained push from the developed countries to get emerging markets to embrace more flexible currency regimes. The adoption of unorthodox monetary policy by the U.S., Europe and Japan may, on the margins, increase such pressure but few have capitulated.

Instead, they have developed a host of other tools, such as macro-prudential policies, to blunt the impact. China may one day provide the world’s key currency, but that day is not in sight, and the role of the dollar as the numéraire continues.