

CURRENCY WARS AND COLLATERAL DAMAGE: THE G-20 FACES ITS LITMUS TEST

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Framing the Issue

Long gone are the days when the G-20 proved an essential forum to facilitate a pragmatic and consensual approach to dealing with the global economic crisis. International coordination, which was remarkable when almost everyone was in the downdraft, now seems distant and elusive. Reconciling divergent recovery paths and national interests appears formidably difficult. Make no mistake, the Seoul meeting will be as critical a test for the G-20 as the Washington and London meetings were.

The occasion could not be more taxing, as the antagonistic views in the U.S. and China about each other's responsibilities in global rebalancing are leading to a standstill with harmful consequences for others. As with many wars between powers, it is often the small nations in the middle that suffer the most. In this case, it is the emerging economies and Latin American countries in particular that are caught in the crossfire of the U.S.-China currency war.

Policy Considerations

The problem is well known. The U.S. economy does not look good; double-dip recession, deflation and liquidity traps are keywords of the day. With interest rates already near zero, the Federal Reserve is now aggressively trying to avoid a relapse by reflatting the economy with a new dose of quantitative easing (QE2). But with U.S. households swamped with debt and less-than-bright business prospects at home, the liquidity boost moves largely overseas where expected returns are higher. This U.S. dollar tsunami is far too large for emerging economies to swallow.

Despite the free-market rhetoric, QE2 is ultimately a euphemism for the weak dollar. With virtually no fiscal room to stimulate the economy, exports are the only hope. Narrowing the U.S. current account and reducing global imbalances are other prized outcomes. This Fed-engineered dollar depreciation seems an appealing proposition from the American standpoint, except for the fact that the emerging world

and particularly Latin America cannot and should not bear the burden of the dollar realignment.

For starters, QE2 is a countercyclical policy that, by definition, is bound to be temporary. If QE2 is successful at all, U.S. inflation should ultimately pick up as a combination of excess liquidity and a surge in commodity prices, inducing the Fed to reverse gears and embark in monetary unwinding. In other words, QE2 is not a structural solution to America's woes. At best, it is a temporary patch that will make the patient feel better for some time. But the strategy has negative side effects, especially on the smaller economies that, unlike China, cannot prevent the appreciation of their currencies.

Latin America is one case in point. The region is at a critical crossroad in its development strategy. During the last two decades, it has lost a significant share in global manufacturing exports and has become even more specialized in primary products. This has not been a problem so far, but it will become a major one once China's appetite for commodities stabilizes, which many predict will happen during this decade. Strong currencies today only deepen a pattern of specialization that is not going to pay off forever.

In this context, it is no wonder that, to varying degrees, the Latin American and other emerging countries' defensive response to the currency wars is increasingly consensual. However, their tactics are severely limited. Foreign reserve accumulation is being actively pursued in countries such as Argentina, Brazil, Colombia and Peru, while capital controls have been implemented in Brazil and Argentina, and are being

debated elsewhere in the region. True, the benefits of these interventions tend to be limited given the size of the problem, but the counterfactual is certainly worse. Where would the Brazilian real be today had the government explicitly chosen full exchange rate flexibility?

More fiscally responsible countries can relieve their central banks from part of the burden of intervention by winding down stimulus packages to generate a primary surplus. The surplus could be applied to mop up the flood of dollars by reducing dollar debt or purchasing foreign assets. But with a gloomy outlook for the global economy, significant public savings in emerging countries may be too much to ask.

Action Items for the G-20

Individual responses aside, this currency war poses a clear demand for the G-20 to stop the U.S. and China from pursuing the beggar-thy-neighbor policies that ultimately represent a major threat to global economic stability. The U.S. is exporting its problems to the smaller emerging economies, while China's reluctance to appreciate its currency ultimately means a loss of competitiveness not for the U.S. but for those countries that produce similar goods.

Seoul was planned to deliver some modest progress on the two main agendas opened at the London Summit: financial reform (now limited to the new Basel III recommendations), and financial safety nets (where we expect the G-20 to salute recent IMF proposals and declare victory).

But the currency issue should dwarf all of this to become the actual real test for the G-20's ability to coordinate global economic policies. Will the group be able to broker a workable truce in the currency wars, or will it emulate similar flops in the Copenhagen meeting on climate change, or at the never ending Doha rounds?

Emerging countries should actively support the first option. Otherwise, their role will no longer be that of the innocent bystander, but a casualty in other people's wars.