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For the Must-Do List: Retire the Dysfunctional Key Currency System

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The most recent development in the blame-game over international payments imbalances is what the Brazilian finance minister has termed “currency wars”. The US shares his concern about competitive devaluations in the sense that it blames trade balances on currency manipulation by surplus countries, pointing to China’s refusal to allow market forces to influence the value of the yuan. As Secretary Timothy Geithner argued before the October meeting of G-20 finance ministers and central bankers in South Korea, this gives China a “huge” short-term advantage that is unfair to all its trading partners. Meanwhile, other countries see the 10 percent decline in the dollar against major currencies from June to October as the primary cause of currency tensions and Brazil’s central bank governor views the Federal Reserve’s prospective quantitative easing as a form of intervention that will create “serious distortions”.

Given the US view that the critical measure of global imbalances is reflected in countries’ current account positions, Secretary Geithner proposed that the G-20 agree to limit trade imbalances to 4 percent of GDP for both surplus and deficit countries. The majority of members rejected the numerical limit and called on the IMF to examine the causes of “persistently large” imbalances. Nevertheless, the agreement reflected the US goal of reducing excessive trade imbalances by moving “toward more market-determined exchange rate systems that reflect underlying economic fundamentals”.

This emphasis on allowing the market to determine exchange rates perpetuates an ongoing ideological bias that ignores the role of private capital flows – recorded in the capital (not current) account – as a major determinant of exchange rates that, in the absence of capital controls, drives changes in trade balances. For more than two decades, cross-border private financial flows have dwarfed the volume of international trade. Most of these flows originate in the $30 trillion unregulated off-shore banking market where the exchange rate for any given currency (including the dollar) is determined without regard to “fundamentals” based on real economic activity, including trade.

The global economy is, in fact, held at the mercy of this market where more than 80 percent of transactions represent borrowing and lending among the largest financial institutions for purposes of taking positions on interest and exchange rates. Engaged in what is known as the “carry trade”, they borrow in a low interest rate currency to invest in assets denominated in a currency with a higher interest rate. Profits are
earned not only on the interest spread but gains from the depreciation of the funding currency they sell and the appreciation of the investment currency they buy.

Beginning in the 1980s, a strategy of keeping US interest rates higher than those of other major currencies was critical for ensuring private flows into dollars to maintain its strength. While Secretary Geithner says the US will “preserve confidence in a strong dollar”, this interest rate strategy cannot be repeated now without inflicting serious harm on a fragile US recovery. And it would mean – as it has meant for three decades – that a strong dollar would price many US products and services out of both foreign and domestic markets. But the key currency system has harmed others as well. Most countries – those that do not issue the major currencies – must promote exports to earn the strong currencies needed to buy what they cannot produce at home, and must suppress wages and domestic demand to remain competitive.

Such a system results in growing investments in credit-generating assets of any country that issues a key currency, increases the availability of credit and lessens the demand for savings in that country, and drives up debt in its domestic economy to mirror rising external debt. A new system is urgently needed – a clearing-house framework, for example, that would allow all countries to pay for international transactions in their own currencies, would use international reserves held by the clearing house to settle net balances between countries, and make changes in reserves the measure for determining changes in exchange rates.

In short, proposals for creating a new international monetary system must top the agenda for leaders of the G-20 when they meet in November. Less fundamental solutions will not only fail to prevent excessive imbalances and currency wars, but will perpetuate a system that can continue to block US and global economic recovery.