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Bad Signals

BY MAURO F. GUILLÉN (THE WHARTON SCHOOL) AND
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Never before has the global economy needed a stronger coordination and cooperation among its main actors with a view to supporting the incipient recovery in the high-income countries, which represent the largest markets in the world. The most important and urgent test has to do with the so-called currency war that has been going on for several years in latent form and has now broken out: the manipulation, more or less interested, of currency exchange rates with the goal of promoting one's exports and reducing the appeal of imports. The possible return of capital controls is not a welcomed development either.

This controversy is not new. China's policy of keeping the yuan's fluctuation within a very narrow band (effectively, a yuan-dollar peg) in an attempt to protect its export competitiveness has been hotly debated for years. Specifically, U.S. economic policymakers have maintained that China's currency policy is a central element of their trade policy, and is directly responsible for a large proportion of the U.S. current account deficit.

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Latin America is in Good Shape:
But Mexico to Face Hard Economic Decisions

BY SIDNEY WEINTRAUB
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I have been following Latin American developments for more decades than I care to remember. My sense of Latin America at the beginning was ambiguous—I found the region culturally fascinating, but economically and socially deficient. The main deficiencies were volatile economic growth, uncertain democracy, high inflation, and a tendency to blame others for the region's problems—such as the conviction that the terms of trade (the ratio between export and import prices) would inevitably remain unfavorable unless the region could replace its commodity exports with exports of manufactured goods. This was the central thesis of Raúl Prebisch, Latin America's best known and widely followed economic guru in the 1960s; for many years, Prebisch also directed the Economic Commission for Latin America (now ECLAC because of the addition of the Caribbean).

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The big change that has taken place over the last few weeks is that this Sino-American conflict is no longer a bilateral issue but a global one. The ballooning of the U.S. deficit after the respite caused by the crisis and the growth in Chinese international reserves (to $3.7 trillion), has added new aggravations and aggravated countries to the list. OECD governments are under pressure to reduce unemployment, and the temptation always is to look for quick fixes, such as a devaluation-induced export growth. This temptation is even more powerful when elections are near. The adverse effects of a round of competitive devaluations, however, would be felt not just in the labor market but beyond.

The big change that has taken place over the last few weeks is that this Sino-American currency conflict is no longer a bilateral issue but a global one.

Japan and the U.S. have taken the lead in terms of accusing China of currency manipulation. Meanwhile, China, Brazil and other emerging economies have charged the U.S. with implementing an excessively lax monetary policy, with two large rounds of quantitative easing. As a result, the U.S. dollar has lost ground, with the usual turmoil in global currency markets and the upswings in the prices of gold and a number of commodities. Cooperation is sorely needed at this point in order to avoid a generalization of the beggar-thy-neighbor policies that Joan Robinson so aptly described in the thirties. We don't know how many steps there are between a currency war and a trade war. What we know is that it starts with competitive devaluations and ends seriously compromising international trade relations and geopolitical stability.

It is not easy to quantify the magnitude of the appreciation of the yuan if it were to float freely in the market. It is not an exaggeration to think that it might increase in value by 10 or 15 percent. While substantial, this appreciation would not hurt Chinese export competitiveness. Let's bear in mind that since 2005 the gradual appreciation of the yuan relative to the dollar has coincided with a significant increase in the bilateral trade deficit. It is also germane to add that China's trade is becoming more specialized in product categories for which cost is not the only relevant factor. Thus, the price-elasticity of Chinese exports is on the decrease. This is a fact that U.S. multinationals know very well, given that they source from China a large proportion of their inputs, and in many cases they sell directly from China.

The second important fact to consider is that excessively accommodating monetary policies do contribute to the tension and the probability of an all-out currency war. Though the U.S. is not the only country that has engaged in monetary easing, it is by far the most aggressive. The flood of dollars after the second round of the Fed's purchases of U.S. bonds is putting downward pressure on the dollar relative to

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other currencies. The interventions by central banks in Japan, Switzerland, and a number of emerging economies (these in terms of capital controls) are worrisome. The renewed quantitative easing not only disturbs the implementation of monetary policies worldwide, but also makes it more difficult in some economies to absorb foreign capital flows, as a result of excessive appreciation of some currencies. That expectation of appreciation encourages capital outflows from economies with lower interest rates. The situation poses a trilemma for emerging economies: an inability to simultaneously adopt an autonomous monetary policy coupled with free movement of capital and exchange rate stability. We could be witnessing a spiral of protectionism starting with currency actions that could escalate into financial and even trade protectionism. The global trade and investment system needs stability, especially during these tough times of crisis and slow recovery.

These unresolved tensions will continue to monopolize the agenda for the G20 summit. We would like to point out, however, that the solution cannot be reduced to making the yuan exchange regime more flexible. It is also necessary to revisit essential aspects of the global financial architecture, including exchange rate regimes, which was the main task assigned to the IMF at the Bretton Woods conference in 1944. The IMF has recently taken decisive steps in this direction, not only changing the arithmetic of country representation and decision-making procedures but also acknowledging the various lessons about macroeconomic policy that have emerged from the crisis. It is healthy to engage in this "macroeconomic revisionism," especially if it comes together with consensus building and power sharing in the global economy.

Tim Geithner's proposal to place upper limits on deficits is worth considering. John Maynard Keynes made a similar proposal at Bretton Woods, and it was rejected by the U.S. While these type of proposals undermine national economic and trade sovereignty, global integration per se—well before placing limits on deficits have been under discussion—is the prime limitation on national policymaking. The persistence of large global imbalances continues to threaten financial stability. We must resist the temptation to protect and bet instead on cooperative solutions, unless we want to set the clock back to the 1930s. As Mark Twain famously argued, "history does not repeat itself, but it rhymes." ❏

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***Latin America Is In Good Shape*, from page 1**

After a decline of 1.9 percent in 2009, estimated GDP growth this year for Latin America is once again projected to be more than 5 percent. Brazil's GDP growth this year is estimated to be 7.6 percent, the highest in Latin America.

Last year (2009), the worst economic performer in Latin America was Mexico, which suffered a 6.5 percent fall in its gross domestic product (GDP). The reason for this decline was that more than 80 percent of Mexico's exports were manufactured goods sent mostly to the United States. Mexican exports are doing better this year because of the modest economic recovery in the United States. In 2009, when the economies of most Latin American countries declined, Argentina had positive GDP growth (0.9 percent) and Brazil had only a small GDP decline (0.2 percent) because China's strong demand for the soybeans of both countries compensated for weakness in their exports to other countries. The pattern of economic growth in China has contradicted what Prebisch fervently believed—that commodity prices would inevitably decline while prices for manufactured goods would increase over time. Prebisch did not live long enough to experience the emergence of China. Commodity prices have long been volatile, and at some point in the future, commodity prices will likely decline as China's economic needs change.

Latin America's average annual GDP growth was more than 5 percent a year from 2004 through 2008. After a decline of 1.9 percent in 2009, estimated GDP growth this year for Latin America is once again projected to be more than 5 percent. Brazil's GDP growth this year is estimated to be 7.6 percent, the highest in Latin America. Other than Haiti, which has suffered from natural disasters, Venezuela is the only country in Latin America in which GDP is expected to decline this year.

Foreign direct investment (FDI) into Latin America and the Caribbean grew in this century from an annual average of $66 billion a year from 2000 through 2005 to a high of $132 billion in 2008. FDI dropped sharply by $55 billion in 2009, but is expected to climb to more than $100 billion this year. According to ECLAC, most FDI in manufacturing is concentrated in low and medium-low technology intensive activities—a situation that does not augur well for the future of the region.

