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Pressure on China to stop currency war

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U.S., IMF threaten nations that don't let money appreciate

The United States and other members of the global economic establishment are taking a harder line on China's practice of tightly managing its exchange rate, saying the country's policies risk fomenting a currency war that would destabilize the global economy.

U.S. Treasury Secretary Timothy Geithner and the International Monetary Fund said separately Wednesday that many emerging-market countries are under pressure to weaken their currencies to keep their economies competitive. Neither Mr. Geithner nor the IMF explicitly mentioned China, but the chief culprit was clear.

China maintains strict controls on international capital, which help it keep the yuan from rising. Investors then divert the money they would have invested in China to other fast-growing nations, putting upward pressure on the foreign-exchange rates of those countries. That forces them to similarly manage their exchange rates or risk making their exports too expensive. It also makes it more difficult for slow-growing developed countries such as the United States and Japan to stimulate their own economies through exports.

The risk, Mr. Geithner said, is that the race to drive down currencies will unleash a "damaging dynamic" that stokes inflation in developing economies such as Brazil and causes the price of housing, consumer goods and other assets there to jump at an unsustainable rate. A higher exchange rate in those countries would relieve some of that pressure; it would cool the factory economy while making imports cheaper.

The United States has been pressing China to relax its exchange rate policies for years. But in a shift toward hardball diplomacy, the Treasury Secretary said the desire of China and other emerging markets to play a greater role at the IMF could be tied to a commitment to allow their currencies to appreciate - "policies that will reduce [their] reliance on exports and strengthen domestic demand," he said.

Finance Minister Jim Flaherty expressed support for driving a harder bargain with China, telling reporters in Ottawa that he and Mr. Geithner had already discussed the issue. "I think Mr. Geithner has a point," Mr. Flaherty said. "We don't want these kinds of distortions in currency values or distortions in trading relationships, so it's a very important topic."

It's a high-stakes diplomatic gambit, given China's well-known aversion to the appearance of being bullied into action by its trading partners.

In Brussels Wednesday, Chinese Premier Wen Jiabao told a business conference that "Europe shouldn't join the choir" of nations demanding a higher yuan, warning of social instability in the world's second largest economy because a rapid increase of the currency would lead to mass factory closures. "If the yuan isn't stable, it will bring disaster to China and the world," Mr. Wen said.

Mr. Geithner's remarks represent a new approach by the established economic powers in the Group of Seven to get China to buy into their view that exchange rates should be allowed to float freely. By emphasizing that China is putting at risk its fellow emerging market countries, Mr. Geithner is making a bilateral spat between the world's largest economies a collective problem. The threat of blocking China's ascent at the IMF is meant to bring China to the table, something the country has little reason to do as long as its economy powers ahead.

"It's a very savvy approach," said Eswar Prasad, a former head of the IMF's China division. "China is spinning this narrative that the U.S. is acting in its own interest, Japan is acting in its own interest, so why shouldn't we act in our interest?"

The shift in negotiating tactics comes as economic officials converge on Washington over the next few days for a series of meetings that will be dominated by rising tensions over what Brazilian Finance Minister Guido Mantega last week called a "currency war."

IMF Managing Director Dominique Strauss-Kahn acknowledged in the Financial Times Wednesday that "there is clearly the idea beginning to circulate that currencies can be used as policy weapons," an approach that "would represent a very serious risk to the global recovery."

The yuan has risen about 2 per cent against the U.S. dollar since the People's Bank of China in June pledged greater flexibility. Mr. Geithner last month called that pace "too slow," and the U.S. House of Representatives passed legislation that would allow the U.S. Trade Representative to enact import tariffs to retaliate for exchange rates deemed to be artificially low.

Japan intervened in foreign-exchange markets for the first time in six years in September to weaken the yen. The Federal Reserve appears set to create dollars to buy Treasuries, a prospect that is putting downward pressure on the dollar. South Korea, the Philippines, Thailand, Malaysia and India have either intervened in currency markets or have indicated they are prepared to do so.

All the chaos in currency markets is being driven by the imbalanced nature of the global economic recovery.

The IMF said Wednesday that advanced economies will grow 2.2 per cent in 2011, while the gross domestic product of emerging market and developing nations will increase 6.4 per cent. Investors are chasing the growth, plowing massive amounts of money into countries such as Brazil and India, forcing the currencies of these nations higher. Governments and central banks are reacting to try to stem the rise, worried that stronger currencies will undermine their export-dependent economies.

Marc Chandler, global head of currency strategy at Brown Brothers Harriman in New York, said he thinks countries at this time are mostly trying to slow the ascent of their exchange rates, rather than actively undermine their neighbours. Still, there's a risk the rhetoric could become a self-fulfilling prophecy, he said. "If you think it's a currency war, you'll act like it's a currency war - it leads to a downward spiral," Mr. Chandler said.

Mr. Prasad, who is now professor of trade policy at Cornell University in Ithaca, N.Y., and a scholar at the Brookings Institution, called a true currency war a "fairly serious risk."

With reports from Bill Curry in Ottawa, Joanna Slater in New York and Bloomberg News