Tensions rise in currency wars

News analysis

Investors might be fighting the tide for some time as countries grapple with capital flows, writes **Alan Beattie**

If the world's shell-shocked investors thought that 2011 might see an outbreak of peace in the currency wars, they were sadly mistaken. Not only did Brazil last week take more action to stem the rise in the real but Chile, one of the most free-market of emerging economies, has also unveiled a campaign of intervention against its currency.

With a sense that the battles against destabilising capital inflows are here to stay has come a determination to set new rules of engagement on controlling them. But given the uncertainty and political explosiveness around the issue, any such venture faces a tough future.

Last week the International Monetary Fund revealed a bid to put itself at the centre of the debate, releasing a study arguing for global rules to constrain governments' use of capital controls. But observers are doubtful it will broker a deal soon. "The IMF has made a pre-emptive grab for power without a clear idea of what it is asking for," says Eswar Prasad, a former senior IMF official now at Cornell University.

The case for global rules is that one country's actions can spill over to others. Last year's rash of direct currency market intervention to slow speculative capital inflows, for example, proved self-perpetuating as country after country rushed to stop its own exchange rate being the only one to rise.

But as the IMF itself admits, the issue is highly complex. Aside from direct currency intervention, measures range from inflow controls, such as a requirement that Chile once had for investors to post interest-free deposits at the central bank, to banking regulations such as Brazil's decision last week to raise reserve requirements on foreign exchange positions, to emergency blocks on investors taking money out of the country in a crisis.

And while many economists have coalesced around the view that short-term inflow controls are a legitimate tool to prevent destabilising capital movements, views on their efficacy are varied – and have shifted considerably over the past decade.

During the 1990s, enthusiasm for free markets led the US Treasury and the IMF's management to try to amend the fund's mandate, proposing changes to its articles of association to promote capital account liberalisation. The effort foundered on opposition from emerging market countries, and the currency collapses of the 1997-1998 Asian financial crisis convinced many of the dangers of a sudden reversal of speculative capital flows.

A pivotal moment came in 1998 when Mahathir Mohamad, then Malaysia's prime minister, imposed controls on capital outflows to spare the ringgit the fate of other south-east Asian currencies. The action's effectiveness has been disputed, since it came as the regional crisis was abating.

Some at the time said Malaysia had been shutting the stable door just as the horse was trying to get back in. But the lack of apparent ill effects from Mr Mahathir's action caused a rethink about controls, and particularly about measures such as Chile's, designed to encourage longer-term flows such as foreign direct investment and discourage short-term "hot money".

Subsequent research led by Ken Rogoff, a Harvard University academic who did a stint as the IMF's chief economist, showed the benefits of capital account liberalisation to emerging market economies were, at best, unproven. "These are very tough intellectual questions to which there are no crisp answers, but there is a good case for emerging markets to limit inflows now to prevent a crisis in four or five years' time," Prof Rogoff says.

Yet while the academic centre of gravity has shifted, sometimes policy has been slower to move. The US for example, targeted even Chile's light-touch controls in negotiations over a bilateral trade deal and continues to try to write strict limits on capital controls into such pacts.

> 'The IMF has made a pre-emptive grab for power without a clear idea of what it is asking for'

"This is the legacy of a quasi-ideological position which wrongly equates free trade with liberalisation of the capital account," says Jagdish Bhagwati, a leading trade economist from Columbia University, who has consistently criticised US policy in this area.

The IMF and many economists urge governments to try other means first, such as tighter fiscal policy and allowing the exchange rate to rise, before resorting to direct action. Even then, Prof Rogoff says, countries should choose more subtle interventions such as banking regulation rather than quantitative controls on outflows. "Clearly capital flows can be used as an excuse, as they are in China and India, for financial repression – to protect domestic financial services sectors from competition and retard their development," he says.

While the IMF may have brought the capital controls debate out into the open, it is unlikely to come to a neat and rapid conclusion.

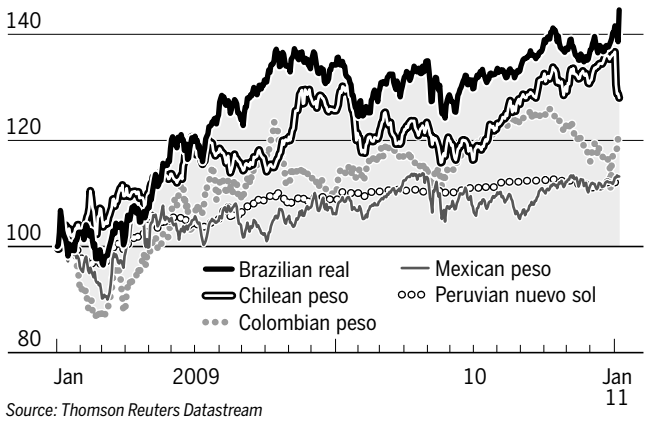
Video: Barney Jopson on Brazil's currency move at www.ft.com/brazilreal

The strength of Brazil's currency, the real, is a long-term problem for the country's businesses Alamy

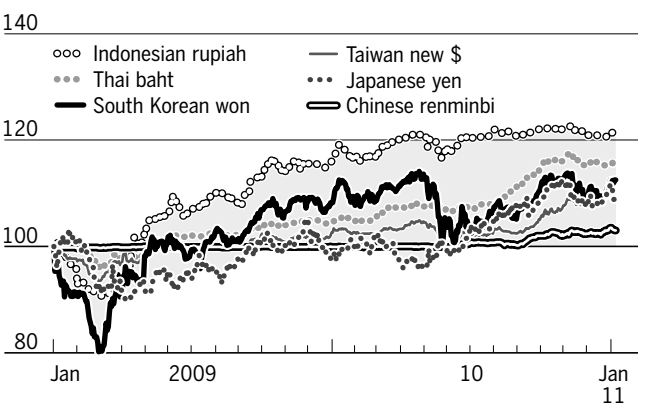
Tracking global capital flows

The rising tide of emerging market currencies

Latin American currencies against the $ ($ per currencies, rebased)



Asian currencies against the $ ($ per currency, rebased)



Source: Thomson Reuters Datastream

Latin America

Brazil
In October 2009 Brazil reintroduced taxes on money entering the country to slow the real's appreciation. To curb speculative trading, the central bank last week increased the reserve requirements for domestic banks against foreign exchange positions

Chile
In January the central bank said it would spend up to $12bn this year to curb the peso's strength and help its exporters

Colombia
The central bank is buying $20m daily until at least mid-March. Tax exemptions on foreign loan interest were recently eliminated

Peru
In 2010 the central bank bought $9bn on the spot market – equivalent to about 6% of GDP – and the Treasury bought $500m. The bank also raised deposit requirements on bank accounts

Mexico
The central bank is buying $600m every month to build up its reserves

US

In 2009 the US Federal Reserve started buying longer-term government bonds to 'improve conditions in private credit markets' In a move dubbed QE2, the Fed initiated a $600bn bond-buying programme in November 2010. Tim Geithner, treasury secretary, defended the move, saying: 'We will never seek to weaken our currency as a tool to gain competitive advantage or to grow the economy.'

Asia

China
In June last year it began allowing the yuan to gradually appreciate (the first time since 2008). The central bank recently increased the amount of money Chinese banks must have on deposit with it

Japan
In September 2010 the central bank initiated its first currency intervention in more than six years, sending the yen down against the dollar, in a move it said was to stabilise the market. Ahead of the G20 meeting in Seoul, Naoto Kan, prime minister, called on South Korea and China to 'act responsibly' on exchange rates

South Korea
In June last year it set a limit on foreign exchange derivatives that banks can hold

Thailand
In October 2010 it imposed a 15% withholding tax on interest payments and capital gains for government and state-owned company bonds to stem inflows. It also removed limits on overseas investment and loosened restrictions on lending to foreign borrowers

Taiwan
From late 2009 the central bank reminded the 6,000 registered foreign institutional investors (FINI) that they should adhere to the rules they agreed to. This was seen as a warning to the 20 FINIs who account for two-fifths of all FINI trading

Indonesia
The government is considering restrictions on the movement of short-term money; a month holding period was introduced and bonds with one and three-month maturities were halted. Those measures may be expanded

Fonte: Financial Times, London, January 10 2011, Primeiro Caderno, p. 4.