The Chances of a War with China are Rising

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The United States conducts monetary policy the same way it conducts foreign policy; unilaterally. When Fed chairman Ben Bernanke signaled last week that he was planning to restart his bond purchasing program (Quantitative Easing) he didn't consult with allies at the IMF, the G-20 or the WTO. He simply issued his edict, and that was that. The fact that the Fed's policy will flood emerging markets with cheap capital, pushing up the value of their currencies and igniting inflation, is of no concern to Bernanke. He operates on the same theory as former Treasury Secretary John Connally who breezily quipped to a group of euro finance ministers, "The dollar is our currency, but your problem."

Bernanke's 15 report could have been reduced to nine words: Inflation is too low and unemployment is too high. That said, Bernanke is not going to sit back hemming and hawing until congress figures out that the economy needs more support. He's going to put downward pressure on the dollar until inflation rises to the target 2%, increasing the prospects for lower unemployment, a narrowing of the current account deficit, and a faster rebound. Economist Edward Hugh sums it up like this:

"Unemployment in the United States (which is currently at 9.6%, and may reach 10% by the end of the year) is causing enormous problems for the Obama administration. The US labor market and welfare system are simply not designed to run with these levels of unemployment for any length of time. In Japan the unemployment rate is 5.1%, and in Germany it is under 8%. So people in Washington, not unreasonably ask themselves why the US should shoulder so much extra unemployment and run a current account deficit just to maintain the Bretton Woods system and the reserve currency status of the US Dollar.

My feeling is that the US administration has decided to reduce the unemployment rate, and close the current account deficit, and that the only way to achieve this is to force the value of the dollar down. That way it will be US factories rather than German or Japanese ones that are humming to the sound of the new orders which come in from all that flourishing emerging market demand."

Bernanke has drawn the same conclusions as Hugh, but that doesn't mean his strategy won't inflict considerable damage on US allies. It will. His beggar-thy-neighbor QE program will force trading partners to implement capital controls and other protectionist measures to maintain price stability. QE will also lead to more competitive devaluation as the world's largest economies fight for a bigger share of the export market. The impending clash could bring about the dissolution of the present trade regime and a sharp reversal of 30-years of globalization.

Bernanke's biggest problem is China. China was America's darling when it was loading up on Treasuries and fueling a historic consumption binge that filled Wall Street's coffers. But now that the purchase of US debt is preventing the Fed from implementing its monetary policy, Bernanke wants a change. Unfortunately, China is not cooperating. It's piling up foreign exchange reserves at record pace to maintain the dollar peg which is widening the current account deficit to precrisis levels. The yawning trade imbalance is pushing the world towards another crisis, which is why Bernanke and Co. are determined to persuade China to let its currency to appreciate to narrow the gap. (China's foreign exchange reserves surged to $2.65tr in the 3rd quarter)

Bottom line: The Fed cannot jump-start the domestic economy if the trade deficit continues to grow. It's impossible. The stimulus just gets flushed down the plughole. China is soaking up the lion's share of global demand by underbidding the US on everything under the sun. That's the real effect of the dollar peg, it gives China an unfair advantage over its competitors. A free-floating currency helps to level the playing field (even if US labor is competing with some of the world's worst paid workers) Bernanke's announcement last Friday, is just the first shot fired over Beijing's bow. There will be more to come. This weekend's meeting of the G-20 provides Treasury Secretary Timothy Geithner with the perfect opportunity to put the spotlight on China and to rail against currency manipulation. Many expect him to make a strong statement demanding changes to the policy.

An update by Reuters on Wednesday confirms the US position. Here's a blurp:

"The United States wants Group of 20 finance chiefs to commit to allowing market forces to set currency values and will discuss using targets for trade to measure progress, a senior U.S. Treasury Department official said on Wednesday.

Ahead of weekend G20 meetings in Gyeongju, South Korea, the U.S. official made clear Washington wants currency levels to be a focal point of the meetings and sees current account surpluses and deficits a vital part of the discussion….

From our perspective we believe these issues are fundamentally, inherently linked and that it is important for the G20 to be able to undertake cooperative action facilitating orderly adjustment of imbalances and also ensuring more effective adjustment of exchange rates in line with economic fundamentals," the official said." ("U.S. wants G20 commitment to allow currency rises", Reuters)

Neither the Obama administration nor the Fed want a full-blown trade war with China. They'd rather see China "assume its position in the global system". (as US diplomats aver) But that means that China will have to compromise on, what it considers to be, a matter of national sovereignty. And, there's the rub. China is a proud nation and doesn't want to be told what to do. But that's not how the system works. Behind the facade of free markets and international institutions, lies an imperial system ruled from Washington. That leaves Beijing with two options; they can either bow to US pressure and fall in line or shrug off Washington's demands and continue on the same path. If they choose to resist, relations with the US will grow more acrimonious and the probability of conflict will rise.

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