INSIGHT
R. Seetharaman

Trade war versus currency war

We are witnessing significant action in currency market which impact global trade. In this regard, major central banks in 2011 have taken measures to protect their currencies. In October 2011, Japanese central bank action intervention in foreign exchange market.

The dollar surged more than 4 per cent to above 79 yen as Japanese authorities intervened to buy dollars. Being an export driven economy, the strengthening of yen can curtail its growth and hence this intervention. In recent times it had intervened in August and March of 2011 and also in September 2010.

In September 2011, the Swiss National Bank set a minimum exchange rate for the euro against the Swiss franc, in a bid to contain a rise in the franc that it says poses a threat to Switzerland's economy. The central bank said it will no longer tolerate an exchange rate below 1.20 francs per euro. The euro was trading at just above the 1.20 Swiss franc target after earlier being at around 1.10 francs. The euro also arose against the dollar. The SNB will enforce this minimum rate with the utmost determination and is prepared to buy foreign currency in unlimited quantities.

The franc's overvaluation was an acute threat to the Swiss economy and carries the risk of a deflationary development. The Swiss franc weakened sharply against the euro and dollar following the announcement. The move immediately knocked about 8 per cent off the value of the franc.

The downgrade of US from its top AAA rating in August 2011 had initially made the US dollar unattractive and hence global investors were shifting to various other currencies. Global players did not consider euro as a serious alternative due to the ongoing European crisis. However they considered Yen and Swiss franc as good bets.

The currency market is witnessing significant action. — *Bloomberg*

on the currency bill on China for passing as legislation. The proposed bill would allow the US government to impose additional duties on products from countries that subsidize exports by undervaluing their currencies.

However, there is a risk that if the legislation happens, it could trigger a trade war between the two major economies in the world — the US and China. The recent economic indicators of US economy would also be appropriately considered before passing such legislation. Yuan has gained 7 per cent against dollar since June 2010 after its removal from pegging.

The US and China are competing recently on the renewable energy segment. US weighs anti-dumping duties on a range of Chinese products. The US government will decide whether China-made solar cells, high-pressure steel cylinders, galvanised steel wires and steel wheels from China are dumped, or sold below cost, in the US.

If so, it could impose tariffs that impair Chinese companies' ability to sell those products in the US. In the past decade, trade between the US and China has nearly quadrupled, reaching $456.8 billion in 2010. The US is China's top exporting destination.

Japan and China will promote

However they considered Yen and Swiss franc as good bets and safe havens as well.

The central banks also realized the impact on their exports /economy due to these inflows and thereby took prompt action. Due to these actions Japanese yen and Swiss franc are no longer safe haven currencies. The action of both the banks had been intended to promote their exports and thereby promote economic growth. However, the inflows in currency market did not weaken the Japanese yen as expected.

We saw the euro remaining above 1.20 against franc after Swiss Central Bank's action and so were able to protect the Swiss economy. There could be further possibilities in 2012 for further weakening of currency as orders at Swiss industrial companies had fallen by about 5 per cent in December 2011. Swiss franc is weakening against dollar in 2012 due to euro crisis. However, we have seen Japanese yen once again rising by 4 per cent in 2011 against dollar despite the central bank action. Japanese yen could rise further in 2012.

The dollar had shown its resilience in 2011. Worries over borrowing in recent years have seen the dollar weakening, despite US Treasury highlighting that the country has a strong dollar policy.

However, a lack of safe-haven alternatives and a liquidation of risky assets unfolded, the US currency rallied sharply in the last few months of the year.

The dollar index, which tracks the greenback against a basket of currencies, jumped by about 9pc from its lows earlier in 2011.

The dollar reasserted itself as the global reserve currency of choice in 2011, despite concerns about US debt. Worries over eurozone sovereign debt prompted the dollar gains, as did the removal of the Swiss franc as an alternative safe-haven currency in September 2011.

The dollar index is now above between 80-81 and can even go up to 82.5 on account of improvement in recoveries in US economy.

We see that US is still holding exporting destination.

Japan and China will promote direct trading of yen and Yuan without using dollars and will encourage the development of a market for the exchange, to cut costs for companies. Japan will also apply to buy Chinese bonds in this year. The direct yen-yuan trades will aim to reduce currency risks and trading costs. 60 per cent of trade transactions between Japan and China are in dollars. China is Japan's biggest trading partner.

Investing in Chinese debt has become easier for central banks as issuance of Yuan-denominated bonds in Hong Kong more than tripled to 112 billion yuan ($18 billion) in 2011. Central banks from Thailand to Nigeria plan to start buying yuan assets as slowing global growth has capped interest rates in the US and euro.

The euro fell up to $1.2717 this week and then recovered after statements from German and French leaders to hold on Greece if private holders share burden of Greece. The euro has recovered now up to $1.276 from its 16th month low against the dollar. Weakness seen in euro until any solution comes to euro crisis however marginal recovery happens if any measures are indicated. The euro is still down by more than 1.3 per cent since year beginning.

The British pound marginally recovered to 1.54 against the dollar after talks in Berlin on Monday. The pound is continuing its steady decline against the US dollar, the sterling found itself down 0.43 per cent to start the year as pressures surrounding the eurozone linger. Early indicators suggest that 2012 may be a worse year than 2011 for the British pound.

The British visible trade balance is forecasted to have moved from a surplus to a deficit, which comes as little surprise considering how the British pound fared against the euro in November. On a year-over-year basis, production is forecast to have fallen by 2.2 per cent and 0.5 per cent, respectively, for the industrial and manufacturing productions sectors.

R. Seetharaman is the Group CEO of Doha Bank