Global Financial Crisis II: Is Protection Next?

Invoking the 'scarce currency' clause would allow the US to legitimately discriminate against Chinese imports, says DEEPAK LAL

In my column a year ago (December 2007) I concluded that the credit crunch was unlikely to lead to another Great Depression. Since then, with the series of policy mistakes outlined in my last column, and the continuing freeze in global credit markets leading to the beginning of a downward spiral in global output, such an outcome is no longer improbable.

The parallels with the 1920s continue to grow. The most recent being the exposure of Bernard Madoff, who made off with billions from the purportedly most sophisticated investors, in a scam that would make his 1920s' predecessor Charles Ponzi look like a rank amateur. Whilst the emerging threat of deflation, and the movement of the Fed to 'quantitative easing' (a polite word for printing money) — possibly on a scale that would make even Robert Mugabe blush — points to the possibility of the Great Moderation followed by the Great Crash being followed by another Great Inflation, the Great Crash could still lead to another Great Depression if the world slips into protectionism.

The auguries are not good: The continuing failure to complete the Doha Round despite the recent assurances from the G20; the at best equivocal supposition of the Fed to 'quantitative easing', and the move- ment of the economy. To continue with 'business as usual' in a quasi fixed exchange rate system will only accelerate a 'beggar thy neighbour' down- ward spiral in the global economy.

Both Germany and China have used their explicit or implicit fixed exchange rate regimes to follow export-led growth, with their surpluses being recycled to fuel consumption and housing booms in the 'deficit' countries of the Club Med and the US. With the slowing down of the world economy, and the credit crunch leading to global deleveraging, this 'model' is no longer sustainable. China has signalled its desire to boost domestic demand through an infrastructure-led fiscal stimulus. Germany is still demurring.

China is the likely target of the US protectionist impulse. The invocation of the 'scarce currency' clause would allow the US to discriminate against Chinese imports, without breaking any international agreements. Moreover, if this led to a 'carbon tariff', with the Green Turn being promised by Obama, protection could also be cloaked in virtue: Helping to save the planet!

How could China (and possibly India which could also suffer in this scenario) preempt this threat? The most obvious step is to open up the capital account and float the currency. A fully convertible floating currency (like the Japanese yen) cannot be declared 'scarce'. Also, instead of Chinese manufacturers making centralized bets on foreign investments. The authors would also be forced to create an efficient private domestic banking system and end the financial repression which continues to distort the economy. To continue with 'business as usual' in a quasi fixed exchange rate system will only accelerate a 'beggar thy neighbour' downward spiral in the global economy.