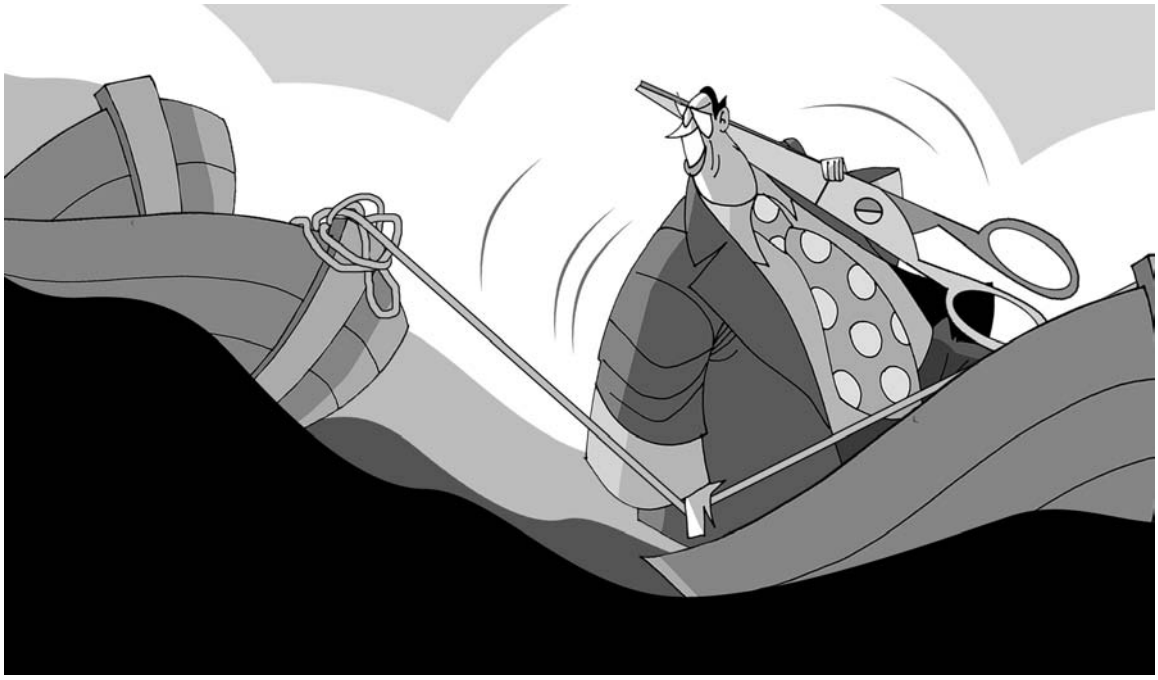

Illustration by BINAY SINHA

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 blanch — points to the possibility of the Great Moderation followed by the Great Crash being followed by another Great Inflation, the Great Crash could still turn into 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 support President-elect Obama has given to free trade; and his appointment of a Nobel prizewinning physicist who is a global warming fanatic as his energy secretary, are worrying trends. But, what should worry China (and possibly India) are Obama's statements about dealing with China's 'currency manipulation'. This could lead to a possible (and not unreasonable) route to protectionism by the incoming US administration.

As noted in my last column, the origins of the current global crisis, as that of the 1970s' Third World debt crisis, are the global imbalances caused by a surplus of savings in some countries being recycled through the international banking system. As in the 1970s, those of the oil producers are cyclical, and are already threatened by the fall in the oil price. Those in Japan are structural and '*sui generis*', given the high Japanese savings propensity which no one has convincingly explained. This leaves the large current account surpluses in China and Germany. China's trade surplus in the last year was $279 billion, Germany's $283 billion. More importantly, they are at the centre of two actual or quasi fixed exchange rate systems: Explicit in the case of EMU with Germany at its core, and implicit in the case of what has been dubbed the Bretton Woods II Asian system with China and the US at the centre.

A problem with any system of fixed exchange rates is that, if the surplus countries do not boost demand, the deficit countries have to deflate. In the 1930s the surplus countries — the US and France — refused to follow the implicit rules of the Gold Standard, leaving the burden of adjustment on the deficit countries, which had to deflate even harder, leading everyone into a Great Depression. That is why Keynes as an architect of the gold exchange system of quasi fixed exchange rates at Bretton Woods was adamant that, in the new exchange rate system, the burden of adjustment should be shared between surplus and deficit countries. The US in the guise of Harry White at first demurred but then agreed to accommodate the UK position by accepting the "Scarce Currency Clause" in the final Articles of Agreement of the IMF, as Article7. Under this clause debit countries are allowed to restrict imports from a country whose currency is declared 'scarce' by the Fund, whilst maintaining unrestricted trade with everyone else. (see Roy Harrod: *The Dollar*, Norton, p.109, and *Money*, Macmillan,1969).

The scarce country clause has not so far been invoked, as in the immediate post-war period of a dollar shortage it would have been curmudgeonly for the Europeans — the deficit countries — to have the dollar declared 'scarce' given the munificence of the US Marshall Plan in reviving their economies. In the 1960s, as the US became the debtor, it did not want to penalize these economies it had helped to build, and which were its allies in the Cold War. But may it now be resurrected, in particular against China, by the incoming Obama administration? In the eurozone, though there is no similar provision, and the recent German stance seems to rule out a massive fiscal stimulus, how long will the Club Med countries be willing to suffer the deflationary costs of adjustment without questioning the wisdom of their membership of the eurozone?

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 mandarins making centralized bets on placing the over $2 trillion of foreign exchange reserves, decentralized bets by the mass of Chinese savers would lead to better aggregate returns on these foreign investments. The authorities 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.