# Tensions rise in currency wars



By Alan Beattie in Washington

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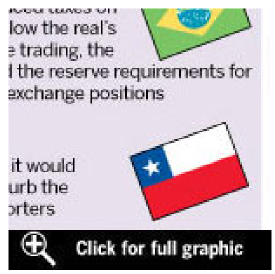
If the world's shell-shocked investors thought that 2011 might see an outbreak of peace in the currency wars, they were sadly mistaken. Not only did Brazil last week take more action to stem the rise in the real but Chile, one of the most free-market of emerging economies, has also unveiled a campaign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

The International Monetary Fund last week revealed an attempt 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 doubt that 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 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 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 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 said at the time that Malaysia was shutting the stable door just as the horse was trying to get back in. But a 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 Kenneth 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," Professor 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.

"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.