China holds the key

Having stacked up dollars and artificially keeping the value of yuan low, China is able to sell its goods cheap in the global market.

By Alok Ray

The US dollar was becoming stronger against the Indian rupee throughout the worst period of the global financial crisis. During this time, the US economy's growth rate was negative while the Indian economy was still growing at around 6 per cent. But after the worst is over in US, the US greenback has started losing its value relative to the Indian rupee. In other words, the US dollar was strongest against the rupee when the US economy was at its weakest!

China continues to remain the fastest growing big economy in the world, despite the global recession. The Chinese currency, yuan, on the other hand, has now been depreciating against the Indian rupee.

Finally, the price of gold—contrary to all past trends and expert predictions—is going through the roof as the world economy is slowly recovering from the uncertainties of the worst economic crisis since the Great Depression of the 1930s.

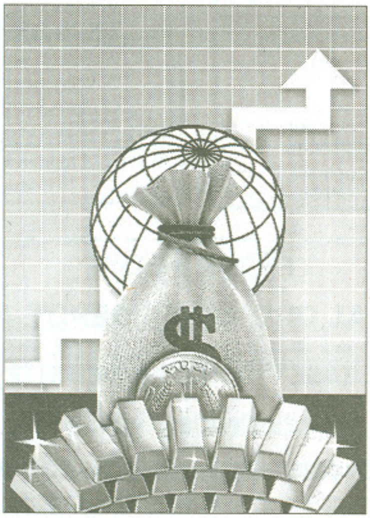
How to explain these apparently paradoxical developments?

Basically, during the worst phase of the recent world financial crisis, global investors were taking refuge in US government securities, the safest financial asset in times of global uncertainty. They knew that the US government would not default on its debt obligations simply because only it has the power to print dollars, the world's reserve currency. As a result, a massive switch to dollar from other currency assets was taking place, causing the dollar to appreciate against currencies like the rupee.

Now that the global economy is stabilising, investors are again looking for higher returns. What better places to invest than in the emerging economies in Asia which are returning to high growth at a much faster pace than the mature industrial economies of the West?

This process has been further helped by the Fed keeping the benchmark interest rate near zero in US. Anyone borrowing at 0.25 per cent interest in US and then investing in India at a much higher interest rate is making sure profits. Naturally, the rupee is going up against the dollar and the Sensex is booming.

China, the fastest growing economy in the world with a massive trade surplus against the US, has virtually kept the yuan pegged to the US dollar by purchasing the dollars flowing into China as a result of the trade surplus and private capital inflows. The objective is to give Chinese goods an artificial price advantage in global markets. As the dollar is now steadily falling against the rupee but the yuan-dollar exchange rate is being kept constant, the rupee is rising against the yuan.



The huge US trade deficit is basically caused by the US government and households spending much beyond their means. The overspending is financed by borrowing from the rest of the world (specially China, Japan and Gulf countries). American families have recently been forced to cut back their overspending habits to some extent due to the recession.

US may take time to recover

But the prospects of reining in the budget deficits by the federal and state governments are not bright for the near future, given the continuing war in Iraq and Afghanistan, the proposed extension of medical insurance to all Americans and the reluctance to raise taxes on the 'middle class' comprising nearly 95 per cent of tax payers.

So, the only other solution for the US is to make people switch towards American goods. A falling US dollar is required for that purpose. Since the Chinese are not allowing the dollar to fall relative to the yuan, the dollar has to fall even more against other non-Chinese currencies. China is, in effect, stealing jobs from others by its policy of currency manipulation.

Indian exporters are finding life doubly difficult. Indian goods are becoming increasingly expensive in US dollar and even more so when compared to Chinese goods selling in the same markets. On the other hand, imports are being cheaper in Indian rupees as the rupee appreciates. This benefits Indian firms using imported inputs (specially from USA and China) and generally helps to keep inflation in check.

For reasons already explained, the rest of the world is losing faith in the value of the US dollar. Though as yet there is no clear alternative to dollar, central banks of different countries are trying to diversify their international reserves towards non-dollar assets.

The euro is one option. But some of the euro-zone countries are in serious economic troubles. Many feel that the euro is currently overvalued and may fall in future. Therefore, a large movement towards the euro is not advisable. Despite the growing economic strength of China, the yuan cannot be an international reserve currency yet since it is not fully convertible. So, in the absence of any credible international paper money alternative to US dollar at this point, a shift towards gold makes sense.

The recent purchase by RBI of 200 tonnes of gold from IMF is a pointer. Speculators believe that a few other central banks may follow India which would further push up the price. Hence, speculators are buying gold right now in order to sell it later at a profit. Volatile stock markets and low interest rates are adding further to the attractiveness of gold as an investment option. So, all combined, it is not surprising that the price of gold is steadily heading north.

(The writer is a former professor of economics at IIM, Calcutta)