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INDICES	COMMODITIES	CURRENCIES
FTSE 100	5,730 +0.47%	5,800
S&P 500	1,178 +0.19%	5,750
Eurofirst 300	1,087 +0.16%	5,700
Nikkei 225	9,498 -0.02%	5,650
Shanghai Comp	2,955 -0.54%	

Markets data delayed at least 15 minutes Portfolio Markets data

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From WORLD 10:24am

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Seeks to diversify reserves away from weak dollar

• Price of gold continues to rise and shine
• Commodities rally while equities struggle

Both China and US are at fault in currency war

By Felipe Larraín

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China's exchange rate policy is currently the predominant issue in global economics and was the big talking point at the recent annual meetings of the International Monetary Fund. On the outside this often looks like an argument just between China and the US. But its implications go well beyond these two countries. Many emerging markets, especially those in Asia and Latin America, have much to lose if the crisis over currencies is not solved quickly. To do so, both China and America must act.

At present the gap between economic growth and interest rates in the US and in emerging markets is growing. Thus the US dollar needs to depreciate against emerging market currencies. That is where the catch lies. Against which should it fall? Clearly, it can only depreciate against those that move according to market forces.

This means that if the exchange rate between the Chinese and American currencies moves very little, then other emerging markets bear the brunt as the dollar adjusts elsewhere. Countries like Brazil, Chile, Colombia and Peru – as well as developed but fast-growing economies such as Australia and South Korea – face unpleasantly large appreciation

pressures. These are placing a heavy burden on their export and import-competing sectors, principally agriculture and manufacturing.

Some countries find this problem is made worse by a loss of market share to China in third-country markets. China and Mexico, for example, compete as exporters to the US. But since 2009 the Mexican peso has appreciated 9 per cent against the dollar while the renminbi has appreciated 3 per cent. This puts extra pressure on Mexican producers, which will get worse if this trend continues.

Faced with this unpleasant situation it should not be surprising that emerging markets have begun to take action, including a combination of appreciation, reserve accumulation and capital controls. Chile, for example, has not intervened in the foreign exchange market so far, but has announced a significant deceleration of government spending coupled with greater diversification of its public finances.

Elsewhere in Latin America, Peru and Colombia have both accumulated reserves and let their currencies appreciate. Other countries, like Brazil, have stepped up controls on capital inflows, with others likely to follow suit if the situation does not improve.

Of course, Latin America is not a homogenous region. Countries in South America are more dependent on natural resources and less reliant on the US than Mexico, for instance, which is highly reliant on the US. Mexico also has a more diversified export base that includes a robust manufacturing sector. Central America is somewhere in the middle. Yet all these countries are experiencing strong currency pressures, while the pain is especially acute among those who are reliant on commodities, such as copper and iron ore, that are in strong demand from China.

If the world economy is to avoid slipping further into a destructive cycle of currency intervention and capital controls, both China and America must act wisely. Emerging market nations are deeply worried about the consequences of a new round of quantitative easing in the US and other industrial markets, especially given the effectiveness of this policy as a way to boost growth is very much in doubt.

The Bank of Japan recently led the way on this front, while the latest economic figures in the US reveal significant weakness in job creation. This makes the prospect of QE more likely, as Ben Bernanke, chairman of the Federal Reserve, hinted strongly on Friday. The first round of QE, following the 2008 crisis, was necessary, even though it doubled the US monetary base. However, a new round would add even more excess liquidity to the US economy and many of those extra dollars will end up chasing assets abroad, adding to appreciation pressures in emerging markets.

On the Chinese side greater flexibility in exchange rate is needed. Indeed, such a policy should be in the interests of both China and America. By letting market forces have a little more influence, the Chinese would reduce the need for QE in the US, and in turn offset protectionist pressures there. This would allow China to share with its emerging market trading partners a more proportional part of the burden of the global currency adjustment that is now under way.

Both countries must, in other words, contribute to eliminating global imbalances and undue exchange rate pressures on fast-growing developing nations. If they don't they will place an even heavier burden on those emerging economies whose potential for growth can help push the world into a new era of sustained prosperity. That would be in the interests of all nations – China and the US included.

The writer is finance minister of Chile

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