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IN THE genteel world of international financial diplomacy characterized by staid summits and staged photo ops, martial metaphors are out of place. So in October, when Brazilian Finance Minister Guido Mantega warned of an impending “currency war,” he duly shocked the financial world. The United States, Britain, Switzerland and Japan, Mantega complained, were all simultaneously attempting to push down their currencies in an effort to export their way out of their economic doldrums. Their policies were in obvious conflict, since not every country can weaken its exchange rate against the others. This was a zero-sum game that could only come to grief.

Moreover, these policies came at the expense of emerging markets, which would see their exchange rates rise and thus the price of their exports increase to uncompetitive levels as a result of the tsunami of capital now flooding into their markets as investors tried to find better returns than those offered by the West. Developing nations would be forced to meet fire with fire. Their governments would be compelled to slap on controls to prevent financial capital from flowing in. They would impose taxes on foreigners seeking to buy their stocks, bonds and other securities. Their central banks would have no choice but to intervene in the foreign-exchange market to prevent their currencies from rising.

Then in November, when the U.S. Federal Reserve decided to launch a second round of quantitative easing, purchasing Treasury bonds with the goal of supporting employment growth and stamping out deflation, this drumbeat of criticism came to focus almost entirely on the United States. The Fed purchasing $600 billion of U.S. Treasury securities, investors concluded, would mean still lower Treasury yields and a weaker dollar. There would be even-larger financial flows to emerging markets, and it would be harder for a struggling Europe and Japan to increase their exports.

Officials in Europe and Asia joined Mantega, criticizing Washington for attempting to solve its problems at the expense of other countries. German Minister of Finance Wolfgang Schauble, in the sort of pointed language one rarely hears among allies, characterized U.S. policy as “clueless.” When President Barack Obama arrived in South Korea in mid-November for the G-20 summit hoping to triumphantly conclude a yearlong negotiation over currencies and trade, he found himself isolated not only from emerging markets but also from his supposed European friends.

U.S. policy makers, for their part, maintained that the Fed was simply pursuing its dual mandate of stable inflation and full employment. If that pursuit implied a weaker dollar, then so be it, but manipulating the currency, they assured everyone within earshot, was not their intent. They saw the responses of emerging markets, led by China, as only frustrating a necessary currency adjustment. Responding to accusations that the United States had engaged in competitive devaluation of the dollar, Treasury Secretary Timothy Geithner in turn accused emerging markets of “competitive nonappreciation”—of refusing to increase the value of their currencies in order to keep their goods cheap in foreign markets.

At this point, what had started as a war of words showed signs of escalating. That Congress will retaliate with “exchange dumping” tariffs on Chinese exports (increasing duties on the low-priced products “dumped” on the American market) is a real possibility—in which case China will respond in kind. The result would be an economic and financial war of attrition that no one can win. Among the likely casualties: free trade and investment. It is not too much to say that globalization hangs in the balance.

HOW HAVE we gotten into this fine mess, one might ask. Just as the origins of the Second World War cannot be understood in isolation from the First World War and the Treaty of Versailles signed at its conclusion, the current international currency war cannot be understood in isolation from the monetary conflicts and agreements that preceded it. Our story begins not in the seat of royal power outside Paris, however, but in the leafy resort town of Bretton Woods, New Hampshire. There in 1944, while World War II still raged, forty-four nations met to shape the postwar monetary world. They saw the uncoordinated currency devaluations that started with Great Britain’s abandonment of the gold standard in 1931 and economic nationalism (proliferation of tariffs, quotas and exchange controls) more generally as having fanned the tensions that exploded into World War II. In the future, they agreed, similar problems had to be avoided at all costs.

To this end, they decided to create a system of pegged exchange rates in which every country declared a par value for its currency against the dollar or gold. They created the International

Monetary Fund to monitor the compliance of countries with their currency commitments. While private purchases and sales of currencies for trade-related purposes were to be freely permitted, financial transactions would be controlled to prevent financial instability like that which had brought down the global monetary and financial system in the 1930s.

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The Bretton Woods agreement did, however, have one significant weakness. It included no way of compelling a country running chronic export surpluses to revalue its currency. The British

delegation, led by the renowned economist John Maynard Keynes, had advocated the adoption of such a mechanism. Specifically, Keynes suggested that the IMF should be empowered to tax the international reserves of a chronic surplus country that failed to adjust its policies.

But the United States, emerging from the war in a position of economic strength, understood that its balance of payments would be strong for some time, making it the likely target of such measures. American officials therefore vetoed Keynes’s proposal. The irony, of course, is that this decision came back to haunt America six decades later, once China assumed the role of chronic surplus country and there was no legitimate international sanction to compel it to adjust its currency.

BRETTON WOODS was always doomed to fail eventually. For a quarter of a century after World War II, the system served the world well, but it had inherent flaws. The country at its center, the United States, starting from a position of strength, could afford to adopt a posture of benign neglect toward its exchange rate. It could leave to other countries the decision of how much their currencies would be worth in terms of dollars. Europe and Japan chose to peg at low levels that enhanced the competitiveness of their exports. Emerging from World War II with lower incomes and therefore lower labor costs than the United States, they pursued policies of export-led growth. And successful these policies were: competitive currencies translating into competitive manufacturing sectors enabled Europe and Japan to export their way to higher wages.

On this basis, the war-torn economies gradually closed the gap in incomes and manufacturing productivity vis-à-vis the United States. And as they did so, America moved from a position of external strength to one of weakness, financing its balance-of-payments deficits with dollars that foreign central banks and governments happily accepted, interested as they were in augmenting their buffer stocks of international reserves. With the European and Japanese economies expanding strongly and the United States comfortably living beyond its means, this was a happy situation all around.

By the late 1960s, however, the system constructed at Bretton Woods was coming under strain. With the Old World back on its feet, European critics of prevailing dollar-centric arrangements increasingly complained about the “exorbitant privilege” enjoyed by a United States permitted to maintain artificially high consumption standards at foreign expense. The flowery language was that of then–French President Charles de Gaulle and his finance minister, Valéry Giscard d’Estaing, but the sentiment was widely shared.

America's policies did nothing to reassure the country's foreign critics; instead, conditions in the United States grew increasingly inflationary as Washington pursued an ambitious social agenda and simultaneously got bogged down in a costly Vietnam War. The Nixon administration grew frustrated over the inability of the United States to adjust the value of the dollar so as to enhance the competitiveness of U.S. exports—something that was impossible so long as other countries unilaterally pegged to the greenback. Financial markets meanwhile found more ways around the measures taken by policy makers to limit capital flows. This in turn made it more difficult to stem the imbalances building up in the system.

PRESSURE ON the dollar-centric Bretton Woods structure grew increasingly intense. Following the failure of a series of half measures designed to combat U.S. inflation as well as stave off foreign investors' lack of confidence both in the dollar and in Washington's ability to pay back those dollars in gold, in early 1973 it all came crashing down. The dollar, the yen and the major European currencies have been floating ever since.

In contrast, developing countries from Latin America to East Asia continued to peg to the dollar or, less commonly, to other advanced-country currencies. To be sure, it took them a while to figure out how to adapt other policies so that their currency pegs would stick. Until they did, they stumbled from one financial crisis and forced devaluation to another. The overarching lesson these nations had to learn: making a currency peg hold requires subordinating monetary, fiscal and financial policies to that overarching goal.

By the end of the twentieth century the task had been mastered, and emerging markets settled into a position not unlike that of Europe and Japan in the 1950s and 1960s. They pegged their currencies to the dollar at low levels in order to enhance the competitiveness of their exports. They bought dollars as needed to prevent their currencies from rising. They limited domestic demand and ran external surpluses with the goal of fostering the growth of their manufacturing sectors. If this permitted the United States, the country on the other side of the transaction, to spend more than it could afford, well, then, this was just one of the costs of economic development. This system became known, for self-evident reasons, as Bretton Woods II.

By 2004, various Cassandras were warning that Bretton Woods II was riddled with inconsistencies not unlike those that brought down the original. Like its predecessor, Bretton Woods II provided the United States with cheap foreign finance. It thereby fed the inclination of American households to consume more than they produced and of the federal government to live beyond its means. Although the immediate consequences might be happy, over time financial imbalances would build up. As America became ever more indebted to the rest of the world, foreigners would grow increasingly reluctant to accumulate claims on the United States.

At some point those foreign investors would pull the plug, and the dollar exchange rate would come crashing down.

These dire warnings were both right and wrong. They were right that the continued accumulation of U.S. debt obligations by foreign governments and central banks—the phenomenon known as “global imbalances”—created dangerous vulnerabilities. But they were wrong in that they foresaw those vulnerabilities as leading foreign investors to flee the United States, causing a Treasury-bond-market and dollar crash. Instead, cheap foreign finance continued to flow into the U.S. Treasury market, depressing yields there and diverting resources into U.S. securitization markets where they fueled the subprime-mortgage boom that set the stage for the subsequent bust.

Then when the financial crisis went global, international investors desperate for safety moved into the most liquid market, namely, that for U.S. Treasury bonds. It was the ultimate irony that the dollar actually strengthened as a result of the economic downturn.

WHAT WE are seeing now, under the moniker of “international currency wars,” is the last gasp of Bretton Woods II. The United States can no longer afford to be the world’s “consumer of last resort,” vacuuming up the exports of manufacturers in emerging markets.

Consumer confidence and household balance sheets in America having been damaged by the crisis, spending remains subdued and the U.S. economy’s recovery from the recession continues to disappoint. Households, having seen the value of their single most important asset, their homes, dissolve in a puff of smoke, are saving more in order to rebuild their retirement nest eggs. Firms conscious of the weakness of retail sales hesitate to invest in capacity expansion and equipment.

For the economy to start growing again and to begin bringing unemployment back down to tolerable levels, the United States will have to export more. This adjustment was postponed by the 2009 fiscal stimulus. The intention of this intervention was to prevent domestic demand from contracting too quickly while stretching out the change from a consumption-based economy back to an (at least partly) manufacturing-led system over a tolerable time period. But with the stimulus now having peaked and there being no room—or political appetite—for more, the inevitable adjustment is under way.

This means that the prices of U.S. goods will have to fall in order to encourage other countries to purchase more American products. The Fed, not without reason, has concluded that the worst way of lowering the relative price of U.S. exports is by allowing the domestic price level to fall. Deflation would further damage corporate and bank balance sheets. It would further demoralize American consumers, who would postpone spending in anticipation of ever-lower future prices. Once this process started, it would be very hard to stop. If there is one lesson of Japan's recent history, it is: avoid this deflationary trap at all costs. With this in mind, in late 2010 Mr. Bernanke and Company opted to further ease domestic credit to prevent deflation from setting in.

And the lower the Fed pushed yields on U.S. Treasuries, the more it motivated investors to search for higher yields abroad. In practice, those investors didn't have to look far. Stronger growth in emerging markets meant that interest rates there were higher. Investors therefore borrowed at rock-bottom rates in the United States in order to buy higher-yielding securities in emerging markets.

But here was where the strategy came into conflict with Bretton Woods II and raised the specter of a currency war. As international investors pulled their money out of dollars in order to invest in stocks and bonds denominated in Brazilian reals, Thai baht and Indonesian rupiah, there was a tendency for the dollar to fall and these other currencies to rise. Exporting is the bread and butter of manufacturing enterprises in developing countries—necessarily so, given the limited size of their domestic markets. Stronger currencies threatened the profitability and, indeed, the very survival of those export industries.

In China—and in emerging markets generally—export-oriented manufacturing is integral to the government's development strategy. Labor productivity is higher in manufacturing than in agriculture. The most straightforward way of boosting incomes is therefore by shifting workers from the farm, where their productivity is low, to the factory, where it is higher. Learning by doing and productivity spillovers are also more prevalent in manufacturing than in agriculture and services. In developing countries, workers and managers in export-oriented industries acquire technological know-how and skills on the job that they are then able to apply elsewhere in the economy. Where assemblers rely initially on imported parts and components, for example, over time local suppliers, who learn how to produce parts and components to international standards, spring up to meet their needs.

This is the model of export-led, manufacturing-based economic growth that has served China and other East Asian countries well. And the operation of that model in turn requires keeping the local currency at competitive levels against the dollar, the currency of the main market in

which their exports are sold.

AT THIS point the irresistible force meets the immovable object. Rock-bottom yields in the United States mean that emerging markets find themselves on the receiving end of a flood tide of capital flows. Their currencies strengthen against the dollar, which in turn threatens their manufacturing base and puts economic growth and development at risk.

Desperate measures are then deployed to repel the influx of capital, or at least to slow it down. China intervenes in the foreign-exchange market to mop up the additional dollars. It instructs its banks to limit their lending in order to prevent the influx of capital from fueling inflation and eroding export competitiveness. Brazil triples an existing 2 percent tax on money entering the country meant for investments in fixed-income instruments like bonds. Taiwan bars foreigners from investing in interest-bearing, set-term savings accounts. Indonesia imposes a one-month holding period for foreign investments in its debt market. Thailand introduces a 15 percent withholding tax on interest and capital gains on bonds held by foreign investors.

Those foreign investors, for their part, are more than a bit perturbed by these new financial measures. But receptive as ever to the siren song of high interest rates in emerging markets, they devise ways around the authorities' locks and levies. The new measures therefore work imperfectly. While the flood of capital into bubbly emerging markets abates, it does not subside entirely.

U.S. policy makers, for their part, are equally displeased. Quantitative easing does less to boost U.S. economic growth insofar as it does not also produce a weaker dollar that encourages the demand overseas for U.S. exports. And this is how we come to find ourselves in the world of tariff threats. American politicians, fearing anti-incumbent sentiment as a result of continued high unemployment, look for someone to blame other than themselves. The obvious targets are China and other emerging markets that have shown themselves reluctant to let their currencies strengthen against the dollar. Congress therefore reacts by threatening to slap a punitive tariff on Chinese exports.

Whether this would do much to improve the U.S. employment situation is of course dubious. All that the imposition of such a tariff would mean is that what we now import from China we would just import from other East Asian countries. But whatever the argument for slapping a tariff on Chinese exports may lack in economic logic, its political rationale, in the eyes of your typical congressman, is impeccable.

SO THERE you have it: international disputes over exchange rates, the imposition of barriers to cross-border investment and serious disruptions to international trade, all putting globalization at risk. Leaving the question of what to do.

We can start with what not to do. From Brazil to China we hear officials arguing that the Fed's lax credit policies are the source of the problem. The United States should raise interest rates, they contend, to avoid destabilizing the international system.

But heeding those calls would be a mistake, given the danger of deflation and the weakness of the U.S. economy. The cure would be worse than the disease. Raising interest rates now and plunging the economy back into recession is the last thing America, and for that matter the world, needs.

What emerging markets are learning, and why they are experiencing such discomfort, is that there is no possibility of their decoupling economically from the United States. Like it or not, if U.S. growth is weak, they are going to feel the negative effects through less rapid export growth. By manipulating their exchange rates or tightening capital controls they can put off the day of reckoning, but they cannot avert the inevitable slowdown. Emerging markets need to realize that having the Fed raise interest rates in order to stem the flow of capital in their direction would only substitute an even more serious problem for the current one.

Pursuing a new global-exchange-rate pact—a new Bretton Woods agreement—would be equally misguided. Stabilizing exchange rates would require equalizing interest rates in the United States and abroad in order to remove the incentive for one-way capital flows. It would require bringing national monetary policies into line. But because economic conditions differ across countries—and will surely continue to do so—balancing out the level of interest rates would be a mistake economically. As soon as evidence of adverse consequences developed, political support for such an accord would dissolve. Any scheme to stabilize exchange rates, like in the good old days before the recovery of international capital flows, would quickly come to grief. This is a caution to those like French President Nicolas Sarkozy who have proposed a new Bretton Woods agreement as their contribution to the currency debate, and to those like World Bank President Robert Zoellick who have alluded, however obliquely, to the desirability of returning to the gold standard.

THE ONLY feasible solution is for emerging markets to accept the inevitable: the relative price of their exports rises and that of American exports falls. The question is whether these countries ultimately want to take this adjustment in the form of currency appreciation or inflation.

History shows that inflation is more socially disruptive. Not everyone's wages will rise at the same rate, and those who are left behind will feel aggrieved. China already experiences scores of protests and demonstrations each year by workers angry that their wages are not keeping up with the rising cost of living. The last thing the government needs is to provoke more such outbursts. The "daylight-savings time" approach of using the exchange rate to bring about this adjustment (appreciating the currency rather than relying on wages to rise piecemeal) will mean everyone's real incomes rise together because imports become cheaper as the exchange rate appreciates.

Emerging markets object that currency appreciation will hammer their exports and injure their manufacturing industries, eroding the benefits of learning by doing and productivity spillovers. But not all manufacturing industries are hotbeds of knowledge creation and technological dynamism. An undervalued exchange rate, the policy traditionally used to subsidize exports, is undiscriminating—it subsidizes exports across the board. If governments in China and elsewhere are worried about the consequences of abandoning that policy for productivity growth, then they should substitute targeted subsidies—investment tax credits, employment credits and the like—for that select subset of manufacturing industries where the positive productivity spillovers are concentrated. Some exporters would certainly be left out. It is those potentially disadvantaged exporters who are lobbying so intensely against the shift in currency policy. It is their pressure that is rendering their governments reluctant to move. But it is the only way for healthier growth to continue.

The United States needs to make it worth emerging markets' while to do the right thing. First, the World Trade Organization, partly with impetus from the United States, bars the selective subsidization of exports. But if the alternative is wholesale subsidization through the maintenance of an undervalued exchange rate—the status quo—then what does the United States have to lose? Under present circumstances, it would be prudent for the WTO to look the other way and for the United States to let it.

The other big worry of these countries is that America will not maintain the value of the U.S. debt securities that they have accumulated in the course of intervening to keep their currencies down. They fear that in response to a mounting debt burden, the Fed will turn to inflation, eroding the value of the U.S. government's debts. Or the United States could decide to repay principal and interest on Treasury bonds held by foreigners with low-interest securities rather

than cash. Either response would amount to debasement of America's external obligations.

Reassuring foreign central banks and governments with big investments in American Treasury securities would require Washington to put in place a credible plan for balancing the federal government budget. It would require putting the social security trust fund on a sustainable footing. It would require solving once and for all the problem of Medicare and Medicaid costs. Not only would emerging markets be reassured, but the United States itself would be better off.

Averting a currency war, then, is simple. Doing so doesn't require some grand bargain between the United States and China. It only requires each party to recognize what is in its self-interest. Restoring peace and harmony to the financial sphere doesn't require an outbreak of international cooperation. It only requires an outbreak of common sense.

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