Forex Focus: Give Peace A Chance

By Katie Martin

A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--Two plus two always makes five in the rumor-filled currency markets, and this week is no exception.

While the dollar was falling heavily, the hottest talk in town was that China was engineering this decline, selling bucks fast to shove their value down and keep the trade-weighted yuan nice and weak.

Now that the dollar is perking up, or at least stabilizing, there's a growing suspicion that secret forces are once again at play.

Like the "China intervening to weaken the dollar" rumor, this is pretty much impossible to prove or disprove at this point, but it still makes enough sense that it would be daft to rule it out. So here goes.

Maybe the U.S. and Asia are coming to some sort of deal on currencies. Maybe the global political heavyweights are going to wrench success from the jaws of defeat and come to a deal on foreign exchange when they hold the Group of 20 leaders' meeting in November. After all, the G20 finance ministers are all set to hold a meeting at the end of this week in advance of the leaders' summit.

It's clear that something has to be done.

In recent months, the dollar has come under enormous pressure as investors have placed chunky bets that the Federal Reserve will pump squillions of dollars into the U.S. bond market to prop up the wobbly economy and avert a fresh bout of recession.

As the dollar has fallen, authorities around the world have felt compelled to take action to weaken their own currencies to protect exporters and safeguard their own recoveries, in what has been dubbed, rightly or wrongly, a currency war.

Asia is the main hotbed for this, but Latin America is in the frame too. Official accounts have been feasting on dollars as they try and push their currencies down, but puking them up again, diversifying into things like euros for the same reason as everyone else has been selling bucks: the Fed is set for further easing.

So the dollar has ended up weaker, and the threat of more and more intervention has grown stronger.

This has looked unsustainable to any sensible observer for weeks, but the recent International Monetary Fund meeting in Washington failed to produce a solution. Perhaps next month's G20 meeting will have more luck.

Note that the Fed has been taming investors' expectations for QE2, as it's known. Further bond buying will be relatively small, steady and measured, we are now told, not a fresh shock-and-awe maneuver. That has given the dollar at least a little stability.

Also note that Asia has started to look somewhat more favorably on currency strength. Singapore tightened monetary policy last week, and China has been doing its bit to let the yuan climb, slowly but surely, too.

Meanwhile, the U.S. Treasury calmed the situation with China over the yuan last Friday by delaying a report that looked set to label China a currency manipulator. Dodging that key step towards tough trade restrictions looks like an olive branch.

Maybe the deal is that the U.S. tones down its QE and in effect stabilizes the dollar. It also stops trying to bully through Asian currency strength on its terms. In return, Asia starts letting its currencies climb. It's global rebalancing at work.

This is something of a long shot. After all, the IMF meeting failed to sort out the mess that is the currency markets for a reason: the various different vested interests simply could not agree on the best way forward.

What's more, Brazil is keeping the currency war (as its own finance minister called it) alive and well by refusing to attend the G20 finance ministers' meeting this week. Instead, Brazil continues to ramp up efforts to hold down the its currency, the real.

Still, it's in no one's interests to let the currencies spat turn into a hideous trade war that could upend the fragile global economic recovery. It's not inconceivable that the powers-that-be could be working behind the scenes to sort this out. Indeed, one would hope that they are.

In early European trading hours Tuesday, the euro was at $1.3920 against the dollar, below the $1.3990 level it held late in New York Monday, according to trading system EBS. The dollar was higher against the yen, at Y81.40, from around Y81.20.

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