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ECONOMIC VIEWPOINT

How China Is Threatening a Global Recovery

When you filter out the daily noise of international economic activity -- stock market fluctuation, merger deals, trade disputes -- today's most important trend is the decline of the dollar. Not long ago, the depreciating greenback would have been measured almost entirely against such currencies as the euro and the yen. But there is an important new guy on the block: the Chinese yuan. Beijing's failure to revalue it against the dollar is fast becoming an explosive global problem.

Since the mid-1990s, the U.S. has imported far more than it has exported. Recently, more capital has been flowing out than is coming in. This is producing a rapidly growing deficit in our international accounts. The upshot is that Uncle Sam is now relying on inflows of almost \$4 billion of foreign capital each working day. The resulting debt not only is expensive but also puts the U.S. at the mercy of fickle overseas investors. If money from abroad started to dry up, the Fed would have to jack up interest rates to make investing in the U.S. more attractive, or the U.S. would have to slash consumption. These measures would hurt not only Americans but also other economies that are dependent on U.S. growth.

A gradual decline of the dollar is the least disruptive way for America to put its balance of payments on a more sustainable footing, but the dollar's descent still has a long way to go. C. Fred Bergsten, director of the Institute for International Economics, told Congress in late June that although the dollar has dropped against other currencies by 10% to 20% since early 2002, it's only halfway to where it should be. Yet for the decline to continue in an orderly way, other nations must allow market forces to work and let their currencies rise.

That's what is happening to the euro. Its value has increased some 20% to 30% vis-à-vis the dollar in the past year or so. But the same cannot be said of Japan, South Korea, or Taiwan, where there is ample evidence that central banks, in an effort to promote exports, have been suppressing the rise of their currencies by selling them for dollars.

An even bigger problem is China, where large trade surpluses and growing reserves should dictate a revaluation of the yuan. Nevertheless, the currency remains fixed to the dollar at a rate of 8.2 to 1. Every time the dollar notches down, the Chinese currency automatically follows suit, making that country's exports even more competitive. As long as the tight dollar-yuan linkage exists, other Asian nations won't allow their currencies to float upward. They refuse to put themselves at a competitive disadvantage.

Nearly all the burden of upward adjustment of other currencies against the dollar has thus fallen on the euro. European exports are being hit just as the Continent tries to expand economic growth. As John-Paul Betbeze, chief economist of Crédit Lyonnais in Paris,

told me, the soaring euro could throw the Continent into serious recession and cripple recent critical financial and social reforms. A weakened Europe is a huge drag on global growth.

The obvious solution is for China to revalue its yuan. But China doesn't see it that way. According to Nicholas R. Lardy, author of *Integrating China into the World Economy*, Beijing is worried that its trade surplus won't last. It feels its currency reserves contain speculative funds that could quickly reverse course. Beijing also fears social upheaval that could come with higher unemployment stemming from a decline in exports.

Nevertheless, Lardy believes that it would behoove China to loosen the link between its currency and the dollar, however slightly. So does Fred Hu, managing director of Goldman, Sachs & Co. in Hong Kong. Both told me that China's competitiveness ought to be able to withstand a more flexible currency policy. I agree, because I think China's commercial prowess goes well beyond low prices. China has enormous industriousness, a huge reservoir of talent, and a deep domestic market attractive to foreign investors.

Goldman's Hu, a deft observer of Chinese politics, predicts that Beijing won't change course for at least several months. The reason: The issue is too contentious within the government. But waiting would be a colossal mistake. In an increasingly networked global economy, there should be no big free riders. That includes the PRC -- now the fifth-largest trading nation, the biggest destination for foreign investment, and the world's fastest-growing manufacturing hub.

China should make a preemptive move toward a more flexible currency. Otherwise, Washington and Europe could put excruciating pressure on the Middle Kingdom, creating serious tension in global markets and precipitating a political crisis between China and its major trading partners. With an outcome like that, everyone would lose.

By Jeffrey E. Garten