



The Bottom Line

THE LATEST VIEW ON THE ECONOMY



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Let's Cut a Deal

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The falling U.S. dollar is grabbing enough attention these days that the Chinese authorities are signalling they will consider allowing their currency to edge upward once again. Since the March 9th resumption of the U.S. dollar's swoon (not coincidentally the bottom in the stock market), the Aussie dollar is up over 45%, the Canadian dollar has increased nearly 25% and the euro has risen over 15%. Over the same period, the renminbi/U.S. dollar exchange rate hasn't budged. With China now the number-one trading partner of the U.S., surpassing Canada early this year, the brunt of the burden of the 15% decline in the trade-weighted dollar has fallen on other countries.

China's foreign exchange policy is geared toward maximizing export-driven growth and it is surely working. China's share of U.S. imports has risen this year from 16% to about 20%, largely at the expense of Canada's share. With this week's APEC meetings and President Obama's trip to Asia, Treasury Secretary Tim Geithner hinted in a Wall Street Journal op-ed this week that China should allow its currency to float more freely—"hinted" is the operative word. What Geithner and the finance ministers of Indonesia and Singapore actually wrote was more general: *"Market-oriented exchange rates in line with economic fundamentals will be essential in assuring the resource and sectoral shifts to match and foster the new patterns of demand."*

The finance leaders then suggested that emerging economies must enhance their social safety nets (health care and retirement-benefit schemes) to drive down very *"high precautionary saving that contributes to global imbalances."* This is a very nice way of telling China that its currency manipulation has caused the growing imbalance between the U.S. current account deficit and its own current account surplus. The undervalued renminbi keeps Chinese exports overly competitive; and much of the Chinese surplus must be funneled back into the U.S. bond market to keep the renminbi undervalued, which holds U.S. interest rates inordinately low, which contributed sizably to the overleveraging in the first place. Many would argue, myself included, that this growing imbalance since the 1997/98 Asian crisis was the key source of the tech stock and housing bubbles in the U.S. and the resulting financial crisis in the world at large.

China is growing at the expense of the rest of the world. That was fine when global activity was strong and financial markets were booming. No one was complaining about cheap Chinese imports when unemployment was low. But now it prevents the full rebalancing in

global capital and trade flows that is necessary for long-term sustainable growth. China's economy is overheating and inflation is picking up.

The Bottom Line: President Obama will have a tough time presenting the case to China's leaders that renminbi revaluation is critical to strong and balanced global growth when his own government depends on the massive inflows of Chinese FX reserves to finance its widening budget deficit.

In the longer-run, rebalancing is a win-win proposition. In the short-run, however, China can do what it pleases and no country, especially not the U.S., will call them to task with the WTO.

Let's hope that behind-the-scenes negotiation will contribute to the orderly rise in the renminbi/U.S. dollar exchange rate, gradually reducing the U.S. current account deficit and the Chinese current account surplus. China runs the risk of increasing political unrest if employment growth slows too much, but the renminbi appreciation would help stabilize the U.S.-dollar-FX rates for Europe, Australia, New Zealand and Canada and provide the basis for stronger and less volatile long-term growth. After all, pressed too far, China's weak-currency policy would risk bankrupting its most important customer and damaging the growth prospects of the rest of the region.

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