There may be trouble brewing in the global financial system. With US external debt now over US$2.5 trillion, foreign creditors may soon demand higher interest rates in order to keep money flowing into America. In turn, this might lead to a US recession that will eventually spread globally. However, such a disaster could be averted if other countries were to allow their currencies to move upward, writes Jeffrey E. Garten, dean of the Yale School of Management, in the first installment of a two part series. Europe is already doing its part by tolerating a strong euro; Asian governments, for the most part, are not as cooperative. According to Garten, China’s delinking the yuan from the dollar would be an important first step. While there are understandable arguments against revaluation, in reality, China has no other choice: As a major global economy, it has to play its part in managing a system where the adjustment burdens are better shared. – YaleGlobal

Dealing with a Declining Dollar – Part I
To avert a currency crisis, China must take on greater responsibility in managing the global financial system

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NEW HAVEN: The Chinese inaction on revaluation of the yuan at the conclusion of the Group of Seven (G-7) meeting in London this past weekend was not surprising. But it was unfortunate. True, Beijing said that it would eventually move towards flexible exchange rates, but it has been saying that for a long time. Without a cooperative arrangement with China to better align the G-7 currencies in the near future, the world economy will be at risk.

The overall global financial problem has by now been well-diagnosed. And it has not disappeared even with the recent – and probably temporary – strengthening of the greenback. Outsized US current account deficits and the equally egregious lack of savings are causing Uncle Sam to borrow over a billion dollars each day from foreign creditors.

Time to stop leaning: Weakening dollar helps Chinese yuan, pegged to the greenback, rake in sales but threatens world financial stability. (Image by Debbie Campoli, (C) 2005, YaleGlobal)
The US external debt now exceeds US$2.5 trillion, and overseas creditors may soon demand ever-higher interest rates to keep their money flowing into America. The risk of such actions is a US recession that will eventually spread globally.

Most economists prescribe a large devaluation of the dollar to stimulate exports and restrain imports, thereby reducing the current account deficit. The greenback has already depreciated about 15 percent against its trading partners since 2002. Some experts say it will require another 10 to 15 percent to reduce deficits by about half, leading to capital inflows that markets can comfortably sustain.

A dollar devaluation of that magnitude would make the United States economically poorer and politically weaker at a time when the need for US leadership on the world stage – from fighting terrorism to championing free trade – has never been greater. Indeed, a global superpower with a weakening currency is an oxymoron.

How, then, should the world adjust to today’s imbalances? The dollar’s descent need not be so pronounced if other countries were to allow their currencies to move upward, and therefore, more evenly spread the burden of adjustment. Europe is doing its part by tolerating a super-strong euro and not intervening in markets to hold it down. Asian governments, for the most part, are playing a more mercantilist game by selling their currencies for dollars to artificially suppress their exchange rates. Some governments – Beijing being the most important – have merely linked their currencies to the dollar, bearing no adjustment burden at all.

If the dollar continues to sink, and if Asian currencies stay artificially depressed, all upward pressure would shift to the euro. In this case, Europe would become even more uncompetitive, fanning serious protectionist pressures in the EU, which generates one-third of global GDP.

China’s delinking the yuan from the dollar – the rate is now a fixed 8.25 yuan to US$1 – will not be the sole answer to all global imbalances. China’s exports will still be highly competitive, and it will still need massive imports to fuel its large and rapidly growing economy. But because of its growing regional clout, Beijing would most likely lead the way for others in Asia to show more currency flexibility. If China and the rest of Asia shared the financial burden, the shift would be highly significant.

To be sure, China has some understandable arguments against revaluation. For example, the government does not want to upset an already fragile banking system. Further, Beijing worries that revaluation could interfere with a growth strategy that must produce some 25 million jobs a year to insure social stability. But there are stronger counter-arguments. First, China should address its domestic economic problems more directly, by restructuring banks’
balance sheets, strengthening domestic capital markets, creating foreign-exchange hedging instruments, improving corporate governance, and so on – processes which have begun, but could certainly accelerate.

Second, China has dealt with its overheated economy almost entirely with non-market administrative dictates, such as ordering banks to curb lending, rather than allowing market forces to influence interest rates and currency levels. But these ad hoc measures are unlikely to work well enough; indeed, China's goal of slowing GDP growth has been realized only modestly thus far. A stronger yuan could help, while also damping inflation.

Third, foreign investment is pouring into China, partly in anticipation of upward movement of the yuan. As a result, China's foreign-exchange reserves exceed US$600 billion, second only to Japan. In fact, China's trade surplus has been growing, and its reserves have increased by over 50 percent in the last year alone. The longer a revaluation is postponed, the larger and more disruptive it will be. Awash in money, moreover, China is too susceptible to reckless extensions of credit – already an issue that threatens to even worse.

Beijing has acquired an enormous stake in the smooth expansion of global commerce. China, and other nations aspiring to increase trade and investment, would do better in a world where major currencies are relatively stable against one another – not tightly fixed, as during the gold-standard days, but moving within predetermined ranges. Right now, the system is seriously out of kilter. The key countries, China among them, need to devise a system where the adjustment burdens are better shared. It is time for a formal accord on global currencies.

The explicit goal of a new arrangement would be a one-time move to new parities among key currencies, parities that can fluctuate within specified ranges. China would inject some flexibility into the yuan by, say, pegging it to a basket of currencies and allowing a 5 percent fluctuation range. The agreement would cap the rise of the euro, again around a range, and Japan would agree not to artificially constrain the rise of the yen. With the burdens more equitably distributed, the United States could avoid a huge devaluation.

The agreement would have to be based on an overriding consensus that currencies cannot and should not bear the bulk of global economic adjustment. Domestic fiscal, monetary, labor, and regulatory policies should play at least as important a role. That means Washington must get cracking on its spending and taxing policies, Europe on its stifling regulations, and China on its overextended banks.

Chinese officials often think of their country as a poor developing nation that needs a huge amount of time to integrate itself into the global financial system. The Middle Kingdom's per-capita income may be tiny, but by virtue of size, indigenous entrepreneurship, and smart policymaking, the country has forced a massive change in the global industrial structure in less than a decade. Much more is yet to come, as China dominates global manufacturing, moves quickly into several high-tech sectors, and sees tens of millions of its new workers enter the global
economy. The world doesn't have the luxury of allowing a long, slow pattern of Beijing's acceptance of more responsibility for managing the global economy. Ultimately, neither does China.

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