The Australian

Death throes of a monster

- **Niall Ferguson and Moritz Schularick**
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A FEW years ago we came up with the term "Chimerica" to describe the combination of the Chinese and American economies, which together had become the key driver of the global economy.

With a combined 13 per cent of the world's land surface and about a quarter of its population, Chimerica nevertheless accounted for a third of global economic output and two-fifths of worldwide growth between 1998 and 2007.

But we called it Chimerica for a reason: We believed this relationship was a chimera - a monstrous hybrid like the part-lion, part-goat, part-snake of legend.

Now we may be witnessing the death throes of the monster. The question US President Barack Obama should have been considering during his visit to Asia this week was whether to slay it or to try to keep it alive.

In its heyday, Chimerica consisted largely of the combination of Chinese development, led by exports, and US overconsumption. Thanks to the Chimerican symbiosis, China quadrupled its gross domestic product between 2000 and last year, raised exports by a factor of five, imported Western technology and created tens of millions of manufacturing jobs for the rural poor.

For the US, Chimerica meant being able to consume more, save less and still maintain low interest rates and a stable rate of investment. Overconsumption meant that between 2000 and last year, the US outspent its national income by a cumulative 45 per cent. Goods imported from China accounted for about a third of that.

For a time, Chimerica seemed not a monster but a marriage made in heaven. Global trade boomed and nearly all asset prices surged. Yet, like many another marriage between a saver and a spender, Chimerica was not destined to last.

The financial crisis has put the marriage on the rocks. Correcting the economic imbalance between the US and China - the dissolution of Chimerica - is now indispensable if equilibrium is to be restored to the world economy.

China's economic ascent was a result of a strategy of export-led growth, following the earlier examples of West Germany and Japan after World War II. But there was a key difference: China made a huge sustained effort to control the value of its currency, the renminbi, resulting in a huge accumulation of reserve dollars.

As Chinese exports soared, the authorities in Beijing consistently bought dollars to avoid appreciation of their currency, pegging it at about 8.28 renminbi to the dollar from the mid-1980s to the mid-90s, then allowing a modest 17 per cent appreciation in the three years after July 2005, only to restore the dollar peg at 6.83 when the global financial crisis intensified last year.

Intervening in the currency market served two goals for China. By keeping the renminbi from rising against the dollar, it promoted export competitiveness. Secondly, it allowed China to build up foreign currency reserves (primarily in dollars) as a cushion against the risks associated with growing financial integration, painfully illustrated by the experience of other countries in the Asian crisis of the late 1990s.

As a result, by 2000 China had currency reserves of $US165 billion. They now stand at $US2.3 trillion ($2.5 trillion), of which at least 70 per cent are dollar-denominated.

This intervention caused a growing distortion in the global cost of capital, significantly reducing long-term interest rates and helping to inflate the real estate bubble in the US, with ultimately disastrous consequences. In essence, Chimerica constituted a credit line from the People's Republic to the US that allowed Americans to save nothing and bet the house on,

well, the house.

Nothing like this happened in the 1950s and 60s. At the height of post-war growth in the 60s, West Germany and Japan increased their dollar reserves roughly in line with US gross domestic product, keeping the ratio stable at about 1 per cent before letting it move slightly higher in the early 70s. By contrast, China's reserves soared from the equivalent of 1 per cent of America's gross domestic product in 2000 to 5 per cent in 2005 and 10 per cent last year. By the end of this year, that figure is expected to rise to 12 per cent.

The Chimerican era is drawing to a close. Given the bursting of the debt and housing bubbles, US household savings will have to rise, and Americans will have to kick their addiction to cheap money and easy credit.

The Chinese authorities understand heavily indebted US consumers cannot be relied on to return as buyers of Chinese goods on the scale of the period up to 2007. And they dislike their exposure to US currency via close to two trillions of dollar-denominated reserve assets. The Chinese authorities are "long" the dollar like no foreign power in history, and it makes them very nervous.

Yet there is a strong temptation for both halves of Chimerica to keep this lopsided partnership going. Despite much talk of the need to reduce global imbalances, the biggest imbalance of all persists. This year, America's trade deficit with China will be about $US200bn, the same as last year. And China has again intervened in the currency markets, buying $US300bn to keep its currency and hence its exports cheap.

US policymakers, meanwhile, seem equally willing to prolong America's addiction to cheap money as long as economic recovery seems so fragile, regardless of the effect on the dollar's exchange rate with other currencies. (When American officials insist that they favour a "strong dollar", it is usually a sure sign that they want the opposite.)

And why would Americans want to discourage the Chinese from buying yet more dollar-denominated securities? With trillion-dollar deficits as far as the eye can see, the Treasury needs all the foreign buyers it can get.

The reality, however, is that an end to Chimerica is in the American interest for at least three reasons. First, adjusting the exchange rates between the currencies would help reorient the US economy - primarily by making American exports more competitive in China, the world's fastest-growing economy.

Second, an end to Chimerica would lessen the potentially dangerous reliance of US economic policy on measures to stimulate domestic purchasing. US fiscal policy is clearly on an unsustainable path, and the Federal Reserve's near-zero interest rates and printing of dollars are artificially inflating equity prices.

Finally, renminbi revaluation would reduce the risk of potentially serious international friction over trade. The problem is that as the dollar weakens against other world currencies - notably the euro and the Japanese yen - so does the renminbi, magnifying China's already large advantage in global export markets. The burden of post-crisis adjustment thus falls disproportionately outside Chimerica.

Unless China's currency is revalued, we can expect an unco-ordinated wave of defensive moves by countries on the wrong side of Chimerica's double depreciation.

Already we are seeing the danger signs. Last month, Brazil imposed a tax on inflows of "hot money" - large, volatile flows of foreign investment that may exit an economy as quickly as they appeared - to try to slow the appreciation of its currency, the real. A number of Asian economies intervened last week to weaken their own currencies relative to the dollar. Similar currency games were a feature of the worst economic decade of the 20th century, the 1930s. Historically, as production costs and income levels in countries have risen, their currencies have adjusted against the dollar accordingly. Between 1960 and 1978, for example, the deutschmark appreciated cumulatively by almost 60 per cent against the dollar, while the Japanese yen appreciated by almost 50 per cent. The lesson is that exporters can live with substantial exchange rate revaluations so long as they are achieving major gains in productivity, as China still is.

This week, to be sure, China's central bank has suggested that it might be willing to switch from the dollar peg to some form of exchange-rate management, taking account of "international capital flows and movements in major currencies". But, like the recent Chinese comments about replacing the dollar as the premier international reserve currency, this may be no more than rhetoric.

During this week's visit in China, Mr Obama had to resist the temptation to respond to these overtures with rhetoric of his own. This is not the time for big speeches, but for subtle diplomacy. Right now, Chimerica clearly serves China better than America. Call it the 10:10 deal: the Chinese get 10 per cent growth; Americans gets 10 per cent unemployment. The deal is even worse for the rest of the world - and that includes some of the US's biggest export markets and most loyal allies. The question is: what can the US offer to make the Chinese abandon the dollar peg that has served them so well?

The authorities in Beijing must be made to see that any book losses on its reserve assets resulting from changes in the exchange rate will be a modest price to pay for the advantages it reaped from the Chimerica model: the transformation from third-world poverty to superpower status in less than 15 years. In any case, these losses would be more than compensated for by the increase in the dollar value of China's huge stock of renminbi assets.

It is also in China's interest to kick its currency-intervention habit. A heavily undervalued renminbi is the key financial distortion in the world economy today. If it persists for much longer, China risks losing the very foundation of its economic success: an open global trading regime.

And this is exactly what the US President can offer in return for a substantial currency revaluation of, say, 20 per cent to 30 per cent over the next 12 months: a clear commitment to globalisation and free trade, and an end to the nascent Chinese-American tariff war.

For as long as the People's Republic has existed, the US has been the principal upholder of a world economic order based on the free movement of goods and, more recently, capital. It has also picked up the tab for policing the oil-rich but unstable Middle East. No country has benefited more from these arrangements than China, and it should now pay for them through a stronger Chinese currency. Chimerica was always a chimera - an economic monster. Revaluing the renminbi will give this monster the peaceful death it deserves.

Niall Ferguson, a history professor at Harvard, is the author of The Ascent of Money. Moritz Schularick is a professor of economic history at the Free University in Berlin.

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