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Op-Ed Contributors

The Great Wallop

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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 percent of the world’s land surface and around a quarter of its population, Chimerica nevertheless accounted for a third of global economic output and two-fifths of worldwide growth from 1998 to 2007.

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 President Obama must consider as he flies to Asia this week is 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 American overconsumption. Thanks to the Chimerican symbiosis, China was able to quadruple its gross domestic product from 2000 to 2008, raise exports by a factor of five, import Western technology and create tens of millions of manufacturing jobs for the rural poor.

For America, Chimerica meant being able to consume more and save less even while maintaining low interest rates and a stable rate of investment. Overconsumption meant that from 2000 to 2008 the United States consistently outspent its national income. Goods imported from China accounted for about a third of that overconsumption.

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 since 2007 has put the marriage on the rocks. Correcting the economic imbalance between the United States 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 that followed the examples of West Germany and Japan after World War II. However, there was a key difference: China made a sustained effort to control the value of its currency, the renminbi, which resulted 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 around 8.28 renminbi to the dollar from the mid-1980s to the mid-’90s. They then allowed a modest 17 percent 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 the competitiveness of Chinese exports; second, 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. The result was that by 2000 China had currency reserves of $165 billion; they now stand at $2.3 trillion, of which at least 70 percent 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 United States, with ultimately disastrous consequences. In essence, Chimerica constituted a credit line from the People’s Republic to the United States that allowed Americans to save nothing and bet the house on ... well, the house.

Nothing like this happened in the 1950s and 1960s. At the height of postwar growth in the 1960s, West Germany and Japan increased their dollar reserves roughly in line with the American gross domestic product, keeping the ratio stable at about 1 percent before letting it move slightly higher in the early 1970s. By contrast, China’s reserves soared from the equivalent of 1 percent of America’s gross domestic product in 2000 to 5 percent in 2005 and 10 percent in 2008. By the end of this year, that figure is expected to rise to 12 percent.

The Chimerican era is drawing to a close. Given the bursting of the debt and housing bubbles, Americans will have to kick their addiction to cheap money and easy credit. The Chinese authorities understand that heavily indebted American 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 the American currency in the form of dollar-denominated reserve assets of close to $2 trillion. The Chinese authorities are “long” the dollar like no foreign power in history, and that 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 around $200 billion, the same as last year. And China has again intervened in the currency markets, buying $300 billion to keep its currency and hence its exports cheap.

United States policy makers, 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 favor a “strong dollar,” it’s 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 American 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 American economic policy on measures to stimulate domestic purchasing. American fiscal policy is clearly on an unsustainable path, and the Federal Reserve's negligible interest rates and the 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 falls disproportionately outside Chimerica. Unless China's currency is revalued, we can expect an uncoordinated 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 "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 last week intervened 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. From 1960 to 1978, for example, the deutsche mark appreciated cumulatively by almost 60 percent against the dollar, while the Japanese yen appreciated by almost 50 percent. 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.

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 his visit to China this week, President Obama must 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 percent growth; America gets 10 percent unemployment. The deal is even worse for the rest of the world — and that includes some of America's biggest export markets and most loyal allies. The question is: What can the United States 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 they 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 President Obama can offer in return for a substantial currency revaluation of, say, 20 percent to 30 percent over the next 12 months: a clear commitment to globalization and free trade, and an end to the nascent Chinese-American tariff war.

For as long as the People's Republic has existed, the United States 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.