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Investors look for a compromise between U.S. and China

By Alan Wheatley
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BEIJING: China has just ushered in the Year of the Ox, which is typically associated in the lunar calendar with calm, fortitude and success through toil.

That's just as well, for China and the United States will need great calm and fortitude if they are to repair, through hard work, the damage done by the accusation of the new U.S. Treasury secretary, Timothy Geithner, that Beijing manipulates its currency.

Now, it is true that the yuan's exchange rate is controlled by the People's Bank of China. How else did the central bank accumulate nearly $2 trillion in reserves? Was it by accident that the yuan rose 20 percent against the dollar over three years only to become rooted to the spot since last July?

Of course not. China, with extensive capital controls, actively manages its exchange rate.

But manipulation is a dirty word in currency diplomacy. If the Treasury were to determine in its next report to Congress in the spring that China manipulated the yuan, it would be obliged under U.S. law to begin negotiations with Beijing on the issue.

Given China's abhorrence of outsiders' poking their nose into its business, that would be sure to enrage Beijing.

By all accounts from Washington, the inclusion of the word manipulation in Geithner's written testimony to the Senate Finance Committee was due to sloppy staff work and poor interagency coordination within a young administration.

President Barack Obama acted quickly, first through his spokesman and later through a call to President Hu Jintao, to smooth ruffled feathers.

Still, the worry for a world in recession is that the United States and China are still talking past each other, rather than to each other, on how to reduce the imbalances at the root of the global economic crisis.

Speaking at the World Economic Forum in Davos, Prime Minister Wen Jiabao of China traced the crisis to "inappropriate macroeconomic policies in some economies and their unsustainable model of development, characterized by prolonged low savings and high consumption."

Wen had the United States in mind, and few would dispute that U.S. excesses were part of the problem.

But now that America is abruptly tightening its belt, many say it is incumbent on China, as the leading country with surplus savings in Asia, to take up the resulting slack in global demand by stoking domestic consumption.

Michael Pettis, an economics professor at Peking University, said he was worried that China was resisting a further rise in the yuan because it feared losing competitiveness to neighbors with depreciating currencies, like South Korea and Vietnam.

China must understand that as a major power, it does not have the luxury of acting like a small country, Pettis said on the economics Web site www.rgemonitor.com. "It must take the lead in the adjustment among Asian exporters, and that almost certainly means that its exports and trade surpluses should fall faster," he said.

Axel Merk, a manager of currency mutual funds in Palo Alto, California, said Geithner's comments were an insult to China. Moreover, Merk said, Washington was resorting to manipulation of its own to weaken the dollar without causing a disorderly rout.

But China cannot grow out of the global downturn with a cheap currency, Merk said. "China won't be bullied by the U.S.; however, a little more diplomacy and a little less populism may be beneficial to both China and the global economy," he said in a letter to investors.

So what is to be done?

Eswar Prasad, a professor of trade policy at Cornell University in New York, proposes a grand bargain.

First, both countries would pledge to do all they can to stimulate domestic demand. Second, China would agree to make the yuan more responsive to market forces, while the United States would set out a plan to cut its huge budget deficit once the economy began to recover.

Third, Washington would support a bigger role for Beijing in global financial institutions, giving China the clout its economic stature merits.

"The political leadership on both sides has to step up to get beyond nationalistic sentiments and convince their people that, in this interconnected world, China and the U.S. will sink or swim together," Prasad said. "There is a way. Is there the will?"

Correction:

Notes: