FROM THE FOUNDER

A World Of Exporters

But who'll buy the world's stuff?

THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY

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Global policymakers are wondering why their two economic tools—fiscal and monetary policy—aren't working. Or at least, not very well. The most compelling theory is that global asset prices, specifically the real estate and sovereign debt instruments on bank balance sheets, still remain overvalued. The economy can't gain traction until these prices have cleared.

Indeed, a primary reason for today's worldwide middle-class angst is the perception that powerful banking and other elites have used bailouts, guarantees, subsidies, central bank bond purchases, and other measures to prop up asset prices that are unsustainable. It has been like trying to keep the tide from dropping.

As a result of this predicament, the industrialized world has seen a collapse in domestic demand, which has made the world a dangerous place. Brazil's finance minister said the world is flirting with "an international currency war." A trade war may be just around the corner. Here's why the situation is so dangerous.

The industrialized world's central banks now have only one bullet left in their revolver—quantitative easing, which means central bankers directly buy debt to keep bond yields from rising. Recently, with the U.S. economy showing signs of sluggishness, particularly in employment, the Federal Reserve announced that the gates potentially will open wide for more so-called quantitative easing. This is also another way of saying that America is about to let the dollar seriously weaken.

Today, the entire industrialized world is engaged in one form or another of quantitative easing. (In Japan, the process is called non-sterilized intervention.) The unintended consequence is that the world faces the potential for a subtle though nasty round of competitive currency devaluations. Is a trade war just around the corner?

This situation leaves the Chinese in a precarious position. Premier Wen Jiabao has already complained that the significant renminbi appreciation demanded by Washington, and now eurozone officials, would wreak havoc in China. Not long ago, Chinese officials argued that their currency's relationship with the dollar is irrelevant—that the current account imbalance was the result of America's lack of saving. Now they claim that an upward adjustment in the Chinese currency's value will somehow produce revolution.

Beijing officials nevertheless may have a point. China's exports represent from 25 percent to 35 percent of its GDP. Conventional wisdom holds that China is the world's great surplus economy. But that's only partly true. While China runs a massive surplus with the United States, it runs a trade deficit with the rest of the world. Therefore, the U.S. import market remains vital for China until Beijing officials can see if their five-year plan to stimulate consumption has any chance of success.

With the dollar likely to seriously weaken, it is fascinating to see the clever Chinese maneuvering to keep the euro and yen from weakening as well. Beginning last year, Beijing engaged in a number of shrewd maneuvers, first using bonds and capital goods purchases to help send the yen soaring. Lately, the Chinese have developed an infatuation with all things German. Beijing has increased its purchases of German sophisticated high-tech capital goods. They have bought the troubled European sovereign debt to help a destabilized European banking sector. Most recently, the Chinese announced they were in love with all things Greek. They promised massive investments and purchases of more Greek government bonds.

Despite these efforts, Beijing's game may be quickly coming to an end. Like their American counterparts, eurozone policy officials are demanding that the Chinese dramatically appreciate their currency anyway. By the middle of 2011, China is in danger of becoming the meat in an industrialized world sandwich.

For good or bad, there is a sea change underway in global policy thinking. Unable or unwilling to stimulate adequate domestic demand at a time of global overcapacity, the entire world is intent on becoming a net seller, not buyer, of tradable goods and services. Even Barack Obama is calling for a doubling of U.S. exports.

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The emerging global view is that, in a deflationary environment, nothing could be better than a devaluing currency, despite their protests to the contrary. For those economies not devaluing, export incentives and government-to-government backroom deals for sales of capital goods are the new norm. Could there be a more conducive environment for a global trade war?

There would be no winners in such a confrontation. The United States cannot decouple from China and vice versa. A trade war would leave China bleeding, greatly increasing the chances for a bursting of its financial bubble. That would be bad news for the world. The huge global deflationary pressures that would likely result would render the already-embattled world central bankers powerless. Translation: The gun now would have no bullets.

Yet there are also no easy answers here. A recent International Monetary Fund study concludes that for China to maintain 8 percent growth over the next decade, the minimum necessary for social stability, its share of world trade would need to double. Good luck with that.

If ever there were a need for a Bretton Woods-style international agreement on currencies, macroeconomic policy coordination, bank regulation, and trade, it is now. The world cannot be comprised exclusively of net exporters. Someone needs to buy the world's stuff. Is anyone in the global policy community listening?

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