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News Analysis

China and the U.S. Embark on a Perilous Trip

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By LOUIS UCHITELLE
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The dollar may be on a healthier course for now, but that does not silence the prophets of doom who fear a collapse of the currency or some other economic crisis as Americans continue to buy far more abroad than they sell.

The question is, Are those who see catastrophe ahead Cassandras accurately foretelling the future or Chicken Littles, wrong yet again about the dangers of a falling dollar?

The announcement from China on Thursday that it would, at long last, raise the value of the yuan against the dollar and continue to do so gradually quiets the alarmists for the moment. Thanks to the revaluation, no one can claim that the sky is falling - at least this weekend. "The Chicken Littles are really wrong," said James Glassman, chief domestic economist at J. P. Morgan Chase.

But such criticism hasn't stopped the Cassandras from pressing their case.

Even gradually reducing the value of the dollar by an amount large enough - say 30 percent to 40 percent - so that Americans are finally discouraged from buying increasingly expensive Asian goods, may have unpleasant consequences. Among other dangers there is the risk that China will cut back on its purchases of American government securities, contributing to a sharp rise in long-term interest rates.

The Cassandras who hold this view are a distinct minority, like their original in ancient Greece. Still, the most prominent, like Paul A. Volcker, the former Federal Reserve Board chairman, are hard to ignore.

"The circumstances seem to be as dangerous and intractable as any I can remember," Mr. Volcker said Thursday, repeating an earlier warning in a February speech. "If people lose confidence in the dollar as a store of value, or lose confidence in the political strength of the United States relative to other countries, there is going to be trouble. I'm not saying a crisis is inevitable or that an orderly adjustment is impossible, but at some point big adjustments will have to be made."

The problem stems from America's persistent buying of much more from other countries, particularly China and Japan, than those countries purchase from the United States. The payment for the imports is in dollars, and because the foreigners do not use all of the dollars to make offsetting purchases here, they lend the excess back to Americans, who then use the loans to purchase more from abroad.

That satisfies this country's desire to consume and Asia's desire to step up production and employment for its vast population. But America's indebtedness to the rest of the world is rising at an annual rate approaching $700 billion. Everyone agrees that this indebtedness cannot continue to go up indefinitely. But while the pessimists see a sharp painful correction in the not-so-distant future, the optimists, a camp that includes the Bush administration and much of Wall Street, argue that the present arrangement is quite sustainable.

"The Asians have no choice but to hold onto our dollars," Mr. Glassman said. "If they dumped them, they would be jeopardizing their own development."

To which Stephen S. Roach, chief economist at Morgan Stanley - whom many on Wall Street view as too pessimistic - replies: "Because nothing bad has happened yet, there is a growing conviction that nothing bad will happen."

The revaluation that the Chinese initiated Thursday, even if it is the first step in what turns out to be an orderly devaluation of the dollar against the yuan and other Asian currencies, is not by itself enough to resolve the imbalance in America's international accounts.

The challenge will come once the price of imports begins to rise. At that point, Americans will have to produce for themselves much more of what they consume - or pay a lot more for the privilege of importing. Ideally, the process would involve America's becoming a much bigger producing nation, even stepping up its exports to Asia, while Asia - and especially China - takes on more of the role of consumer.

That is essentially the view of the Bush administration as outlined by Ben S. Bernanke, the newly appointed chairman of President Bush's Council of Economic Advisers. "We probably have little choice except to be patient as we work to create" the necessary conditions for a reversal of roles, he said in a recent speech.

That is not an easy transformation. Americans now produce only about 75 percent of the merchandise they purchase, importing the rest. That is down from 90 percent or so a decade ago, according to various studies. The percentage was even higher in the late 1980's, the last time the dollar went through a long, similarly managed decline - in those pre-euro days - against the German, French and Japanese currencies.

As the dollar fell, manufacturing did revive in the United States. Exports jumped and the trade deficit shrank, but the interest rate manipulation involved in managing the currency helped to produce the stock market crash in October 1987, or so some economists argue.

This time the housing bubble could burst if the flow of dollars lent from Asia were to slow too abruptly. The result would be a shortage of money to lend and a rise in mortgage interest rates, which are tied to the yields on the Treasuries that the Japanese and Chinese often buy in the lending process.

That would not be a happy ending, but Henry Kaufman, the economist and money manager - reflecting the optimism on Wall Street that revaluation and gradual adjustment will work - argues that China and Japan benefit in other lucrative ways from lending to the United States.

For the Chinese, acquiring Treasuries strengthens the capital base of their shaky banking system.

The Japanese government, for its part, turns a profit. "It has a budget deficit of, say, $300 billion, which it funds by borrowing from the Japanese people at 1 percent," Mr. Kaufman said. "That money is reinvested in Treasuries at 3 percent or so, giving the Japanese two percentage points' profit. If the dollar were to weaken they would lose money. Why would they want to lose money?"

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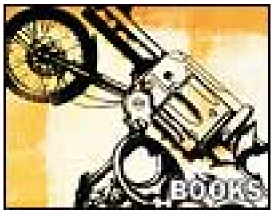

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