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Leave the yuan alone

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In July 1927, the governor of the Bank of England, Norman Montagu, visited the governor of the New York Federal Reserve Bank, Benjamin Strong. He had a mission.

In 1925 Britain had gone back to the gold standard, but at a rate overvalued by about 10 percent. Gold was flowing out of London, threatening the British gold reserves and consequently the international monetary system.

To prevent a run on the pound sterling, Montagu had to raise interest rates, but that would have killed the fragile British economic recovery, with potentially unenviable political and economic repercussions.

Montagu found a way out of his predicament. If he could persuade the Federal Reserve Bank of New York to lower its interest rate and adopt an easy money policy, the drain on the British gold reserves would stop.

He succeeded in talking Strong into such a policy. The effect proved to be disastrous, to say the least. The lax monetary policy in New York fuelled a stock market boom that crashed in 1929, taking the world into the Great Depression of the 1930s.

In December this year, a high-powered U.S. delegation chaired by the secretary of the Treasury, Henry Paulson, will go to Beijing. The chairman of the Federal Reserve, Ben Bernanke, will be among the members of the delegation.

The U.S. Treasury has already stated officially that one of the purposes is to exercise pressure on China to allow the yuan to fluctuate more freely.

The economic situation in the mid-1920s and the middle of the first decade of the 21st century are not comparable, but the scenario of one major economic power pushing another one into inappropriate policies later to be judged wrong looks disturbingly similar.

The American delegation will try to persuade China to solve a predominantly American domestic economic problem - to redress the imbalances of public finances and the balance of payments that has run out of control because of the lack of saving by American households, stimulated by the Fed's cheap money policy a couple of years ago.

This problem has very little to do with U.S. competitiveness and even less with the rate of the yuan.

A revaluation of the Chinese currency will not help much. When the United States in the mid-1980s forced Japan to make a dramatic revaluation of the yen (the Plaza agreement), the effect on the U.S. balance of payments proved to be negligible.

But the negative effects on the Japanese economy were significant, as this policy contributed to slow growth in Japan from 1990 onwards. It is still holding Japan in its grip.

The world needs strong and sustainable growth. With a U.S. growth rate definitely lower in 2006 than in 2005, and expected to be even lower next year, high growth is not coming from the United States.

Europe is showing growth of around 2 percent - insufficient to pull the rest of the world along. Japan is likewise operating at a growth rate of about 2 percent, and recent figures indicate it is slowing down.

So where is global growth to come from in the next couple of years? From China, India and Southeast Asia, all seemingly steady on growth patterns of between 5 and 10 percent.

The last thing the world needs at this time is lower growth in China, forced on it by the United States, with the inevitable result that global growth will head downwards in 2007. This is precisely what a forced revaluation of the yuan will lead to.

Companies operating in China will probably react in the same way Japanese companies did in the 1980s after the Plaza agreement - that is, they will maintain prices in yuan by cutting profit margins and/or squeezing labor costs.

Many of the companies operating in China and exporting to the United States are not Chinese, but American, European and Japanese.

A profit squeeze will affect their investment plans in a negative way. A downward pressure on wages for the Chinese labor force will tend to reduce private consumption in China at a time when rising domestic demand in Asia is crucial for maintaining a persistent pattern of high global growth.

So history may repeat itself in the way that a major economic power, facing difficulties of its own making, forces another one to adopt a policy that is eventually harmful not only to that country, but also to the global economy.