Op-ed page piece

Basket Case

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Misguided efforts to encourage China to abandon its peg to the dollar may well earn the Bush administration and politicians such as Sen. Charles Schumer low grades in both economic and foreign policy. East Asian dollarization was underway as a result of China's peg to the dollar, building a long-term mutual interdependence among the U.S. and East Asia. Now, the yuan is linked also to the euro, the yen and the South Korean won. Dollarization is gone.

China moved to this basket when it broke that dollar peg at the urging of the Bush administration and members of Congress. That it was a very small revaluation misses the point that the dollar is now one of several currencies. People's Bank of China Governor Zhou Xiaochuan said any country that had at least $10 billion in annual trade with China would have its currency in the basket. No doubt by the time China's banking system can accommodate its country being the second largest economy after the U.S. in GDP purchasing power parity terms, China will have completely abandoned the dollar.

The potential second-round effect of breaking the yuan-dollar peg is that it sends a signal to OPEC that it, too, may want to move toward pricing oil in a basket. China could already have an implicit agreement among one or two OPEC members to push such a move. From a U.S. perspective, the global dollar dependency was ideal, as a large portion of the global economy -- the U.S., the Far East countries and OPEC -- was tied together by the dollar. The U.S. was constructing more stable economic and security ties to regions around the globe through the dollar.

Japan, China, Taiwan, Korea, Hong Kong, Singapore and Thailand have stockpiled nearly a combined total of $1.2 trillion or approximately 25% of outstanding U.S. Treasurys. At the same time, U.S. consumers have been the beneficiaries of low bond yields and value-priced consumer products -- a win-win situation. The U.S. and Far East countries had a major incentive to continue building a working economic and security relationship due to their interdependence.

But the U.S. hounded China to revalue, which says in effect to East Asia, Don't hold as many U.S. Treasurys. Cnooc also dropped its bid for Unocal after objections by members of Congress: The message is that the U.S. is selective about its economic friends and allies and prefers countries in the West. It is a small step for China to factor this round of economic experiences with the U.S. into its future security plans.

Bernard K. Gordon recently outlined on this page the message that Cafta sends to East Asia countries on building their own trading blocs -- a message driven home by the U.S. resolve to have China revalue. And the Chinese signaled back that they got the message by moving to a basket of currencies. Some OPEC members, already viscerally hostile to the U.S., probably didn't need to see the Chinese move to a basket to rethink their own position on the dollar.

The rationale for the U.S. to pressure the Chinese into the yuan revaluation was built on a very weak economic rationale. Ronald I. McKinnon pointed out on this page that revaluations of the yen didn't work with Japan and listed the many adverse economic implications for China of breaking the dollar peg. But the major adverse implications are clearly for the U.S. China and East Asian countries will likely move over time toward a yuan wall -- that the U.S. helped construct by pushing China off the dollar peg.

Should OPEC move to price oil in a basket, you could see U.S. bond yields go up by a percentage point. Other credit markets around the globe probably don't have the necessary liquidity, so you won't see massive liquidation of the nearly $10 trillion dollars of foreign holdings of U.S.-denominated assets. But a slowdown or halt to incremental foreign purchases of dollar assets may be enough to generate sizeable adverse impacts on bond yields and the U.S. economy.

In fairness to the Bush team, China almost certainly prefers to have the yuan eventually become the currency of choice in East Asia, in order to enhance China's hold. So it eventually would have weaned itself from the dollar anyway. But U.S. wrongheadedness has hastened that process by perhaps many years.

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