
Triangular Trouble: The Euro, the Dollar and the Renminbi

Thomas I. Palley



Dr. Thomas Palley has been Chief Economist with the US – China Economic and Security Review Commission. He has also been Director of the Open Society Institute's Globalization Reform Project. Before that he was Assistant Director of Public Policy at the AFL-CIO. An economist, Dr. Palley, holds a B.A. degree from Oxford University, and a M.A. degree in International Relations and Ph.D. in Economics, both from Yale University. He has published in numerous academic journals, and written for The Atlantic Monthly, American Prospect and Nation magazines. He is also author of two books: Plenty of Nothing: The Downsizing of the American Dream and the Case for Structural Keynesianism, Princeton University Press, 1998, and Post Keynesian Economics: Debt, Distribution, and the Macro Economy, Macmillan Press, 1996.

For the last several years the euro has been appreciating steadily against the US dollar. Given the Chinese renminbi and other East Asian currencies are pegged to the dollar that means the euro has been appreciating steadily against all. This spells trouble for Euroland, and it suggests European policymakers should join with the US to address the global problem of under-valued currencies.

The euro has now appreciated approximately seventy percent relative to its historic low against the dollar, set on October 26, 2000. This appreciation has been economically justified given Europe's large trade surplus with the United States. That surplus peaked in 2005 and is now gradually coming down as the Euro appreciates, which is exactly how a market based global economy is supposed to correct international financial imbalances.

Some in Europe are beginning to raise red flags regarding this appreciation, but the reality is it is still within the bounds of reasonableness. Though the

euro has appreciated seventy percent against its historic low, it has only appreciated twenty percent relative to its January 1999 introductory parity.

That said, European concerns about exchange rates are justified, but the focus should be East Asia's currencies, not the dollar. The key player is China, which has the largest surplus. Additionally, other East Asian countries are rationally reluctant to adjust their currencies absent a Chinese revaluation, as they fear losing competitiveness. This means China's refusal to significantly revalue its currency against the dollar is forcing a lop-sided adjustment process that places the burden of rebalancing the US trade

deficit exclusively on Europe. That is imposing a deflationary burden on Europe that could easily undermine the European economy.

Europe is now experiencing double trouble as its surplus with the US begins to fall while its deficit

Europe and the US are in competition for sales to China and each may fear antagonizing the Chinese government. This has triangulated Europe and the US to their disadvantage and to the benefit of China.

with China is large and growing. Between 2002 and 2006 the European Union's deficit with China rose from 54 billion euros to 128 billion euros. At current exchange rates the 2006 deficit was 179 billion dollars, and the EU Chamber of Commerce expects that deficit to hit 260 billion dollars in 2007.

In a sense, Europe now finds itself involuntarily on the same path that the US voluntarily locked itself into in the late 1990s. That path is characterized by rising trade deficits, weakened manufacturing investment spending, and loss of manufacturing jobs.

The renminbi's under-valuation stands to lower European exports and increase imports from China as spending is redirected from European produced goods to cheaper Chinese goods. The resulting increased trade deficit will directly cost jobs, and reduced demand and profitability of European manufacturing companies will reduce investment spending. Furthermore, European manufacturers will have an incentive to close plants and shift production and new investment to China, just as happened in the US.

These effects are likely to be especially disruptive from a regional perspective. Whereas Germany's high value-added capital goods exporters may still be able to prosper, the economies of Italy, Spain, and other Mediterranean countries stand to be badly impacted. Additionally, manufacturing in Central Europe's new member states stands to be severely affected, making their integration into the European economy more difficult.

The bottom line is that by all reasonable standards China's currency is under-valued against both the dollar and the euro. China is running huge and growing trade surpluses with both Europe and the US; it has a growing global trade surplus; and on top of that it has an even larger current account surplus since its trade surplus is supplemented by massive foreign direct investment in-

flows.

These conditions suggest Europe and the US have a common interest in closely cooperating to pressure China to adjust its currency. Yet, so far, that

has not happened. One reason is that until recently the euro was under-valued so that Europe had no grounds for or interest in pressuring China to re-value. A second reason

is that Europe and the US are in competition for sales to China and each may fear antagonizing the Chinese government. This has triangulated Europe and the US to their disadvantage and to the benefit of China. The implication is that fixing the structural problem of triangulation and remedying the failure to cooperate on the China currency question should be urgent policy priorities for both sides of the North Atlantic partnership.

Finally, in addition to greater coordinated economic diplomacy regarding China, Europe and the US should work together to establish a new system for managing key currency exchange rates. Such a system would help avoid economically and politically costly exchange rate misalignments to which current arrangements are prone. □



Value of the Euro in Dollars

