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The Yuan Thing That Matters

- By IRWIN STELZER



Pity the world's leaders as they converge on Toronto later this month, and equally pity the Canadian city, which will spend millions to cope with the violence that demonstrators might rain upon it, as they have on past such gatherings.

The leaders, or at least the conscientious among them, are starting to meet with their diplomatic sherpas for briefings on the world's economic situation. Good luck to them if they can peer through the fog of conflicting reports.



Reuters

A vendor counts yuan banknotes in Shanghai. If only they were worth more.

There is general agreement that the Greek financial fiasco cannot be confined to that too-small-to-fail country. The seizing up of bank credit, as bankers still in shock from the aftermath of the collapse of Lehman Brothers once again refuse to lend to each other, is proof enough that the ripple effects of Greece's problems can capsizes even

the larger vessels of its euroland partners, not to mention other countries. That's about the extent of agreement.

Some advisers are telling their masters that the situation is now under control. Greece has an austerity program in place, it is being monitored, and the eurozone countries will make cash available until the deficit is under control. As proof, they will argue that recent bond sales by Portugal, Spain, Italy and Ireland went rather well.

Others will be telling a different story. Greece, they say, might squeeze through this year and next with a little help from its friends, but by the end of 2011 it will surely have to restructure its debt, which will be well above 100% of its GDP. The European and U.S. banks that hold Greek paper will take a haircut on the order of 30%, their balance sheets will shrivel, reducing their ability to lend, and Europe will return to recession—the dreaded double dip. As for those "successful" bond sales: Portugal had to pay 5.2% in order to borrow, 0.7 percentage points above the rate investors previously charged, while Spain's new three-year bond yields 3.32%, a full 2.5 percentage points more than similar, less risky German bunds pay.

These interest-rate premia are no small matter, especially if they spread to other nations' bonds. The World Bank estimates that a one-percentage-point increase in bond yields would slow world growth from the 3.3% forecast for this year and 3.3% again the next, to an anemic 2% and 0.7% in 2010 and 2011, respectively, with high-income, developed countries clocking in at the trivial rates of 0.9% and 0.6%.

Sherpas will also be telling the leaders different stories about the policies needed to keep the worldwide recovery on track. German Chancellor Angela Merkel will hear that she must stick to her plans to reduce Germany's deficit, running at about 5% of GDP, lest the sort of inflation that destroyed German democracy in the 1930s be unleashed. She is listening.

Fortunately for the prospects of avoiding another recession, the €80 billion of cuts will be spread over four years, with most of the savings scheduled for 2013 and 2014. Still, austerity it is most likely to be,

partly to show other countries it can be done. History trumps economics.

That policy might suit Germany, which is growing rapidly on the back of an export boom fueled by a devalued euro, but it certainly doesn't suit French President Nicolas Sarkozy, whose budget deficit is 8% of GDP. He told the press, "If we add austerity to austerity, we are going into recession." With heavily debt-ridden Club Med countries taking large chunks out of their spending, Germany should be acting as consumer of last resort, stimulating domestic spending to avoid the predicted anemic growth rate from turning negative. But the tax increases Ms. Merkel has scheduled—economists agree most such increases are the least efficient way to tackle a deficit—will reduce businesses' incentives to take up some of the demand slack created by government cutbacks. So, again, austerity it is to be and history trumps economics.

The G-20 is also split on the question of what measures are necessary to reform the financial sector. Germany and France want to regulate short selling; Britain and America are unenthusiastic. America wants German and Spanish banks to publish the results of U.S.-style stress tests. They refuse.

On one thing all save one of the leaders will agree: China's insistence on pegging its currency to the dollar is causing serious imbalances in world trade. Like President Barack Obama, European leaders are looking to exports to lead a job-creating recovery. The undervalued yuan makes that unlikely. The Chinese regime is keeping its export machine in high gear: exports in May were 48.5% above year-earlier levels. The displeasure of trading partners unwilling to retaliate is of no consequence to these Chinese über-realists. A very nervous election-year American congress might just move from threats to action, changing the cold war over trade into a hot one.

So don't bother reading the G-20 communiqué. It will tout agreements reached even though the really important issues will remain unresolved.

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