

Three Wise Men in the East

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A European troika embarked this week on a trip to Beijing to press for a revaluation of the Chinese currency. U.S. Treasury Secretary Henry Paulson and his predecessors have already made this journey several times without much success. Now Jean-Claude Juncker, the president of euro zone's finance ministers, Jean-Claude Trichet, the president of the European Central Bank, and Joaquin Almunia, European commissioner for monetary and economic affairs, will try to persuade their interlocutors that action on this front is long overdue.

This visit is a watershed. Until recently, it seemed that the renminbi's exchange rate was a major issue for the U.S. but only a second-order one for Europe. At a time when no fewer than three bills envisaging potential trade retaliation against China were under discussion in the U.S. Congress, Europe was surprisingly silent. It displayed no strong views on the exchange-rate regime or on the valuation of the Chinese currency. When asked, EU officials routinely referred to the latest G-7 communique. For all practical purposes, Europe was relying on U.S. activism.

This benign neglect makes little economic sense. Contrary to appearances, China is just as important for Europe as it is for the U.S. In 2006, EU exports to China exceeded those of the U.S. and its imports from China were only marginally lower. Its trade deficit is certainly smaller, but it is rising fast. Furthermore, the lack of Chinese exchange-rate flexibility combined with structural weakness in the Japanese yen has contributed to a sharp appreciation of the euro vis-a-vis the dollar, the yen and the renminbi. Since the dollar started to weaken in spring 2002, the euro (with other European currencies) has de facto played the role of the main adjustment variable in the currency game and this trend has accelerated in recent weeks.

The Europeans' prolonged patience probably has more to do with their internal arrangements than with their economic interests. Exchange-rate policy has always been a delicate issue for the euro area, because France and Germany (among others) have had different views on who should have responsibility for it. Historically, France regarded it as a matter for government while Germany left it up to the central bank. Consequently, the exchange-rate policy of the euro is governed by complex and ambiguous arrangements that contribute to inertia. What's more, this policy only applies to the 13-member euro area, not to the 27-strong EU, among whom countries like Britain and Poland have their own currencies. That makes it harder to develop a single attitude toward the renminbi for the entire EU.

The fact that it takes three people to speak with one voice is an indication that Europe's "who does what" dilemma is still complex. But the fact that they are making the trip to Beijing jointly is a signal that this is not an insurmountable impediment to expressing views anymore and that, now that the chips are down, the Europeans are starting to get their act together.

This does not make their task easy. As the U.S. knows from experience, the Chinese leadership does not readily yield to the pressures of financial diplomacy. Moreover, the Europeans are torn

between two opposite goals. From a long-term perspective, upward flexibility of the dollar exchange rate of the renminbi would contribute to reducing the U.S. deficit and would therefore lighten the burden on the euro. But any hint that China might sever its monetary link to the dollar would be interpreted by markets as an indication that the Peoples' Bank of China would stop stockpiling dollars in whatever quantities are needed to keep the exchange rate fixed. In other words, the world economy would be losing a player with an insatiable appetite for dollar assets -- which is likely in the short run to push the euro up rather than down. To speak about the renminbi is therefore a delicate balancing act.

Even if the Europeans ultimately succeed in convincing the Beijing leadership that China has to take its part in the global monetary rebalancing, there will be a price to pay for it. China is being asked to behave like the great economic and monetary power it has become and to rise to the responsibilities that come with that power. But it has not yet been granted the seat at the table - be it at the G-7 or in international financial institutions -- which is commensurate with that new responsibility. The Europeans know that, at the end of the day, they will have to forgo the vast overrepresentation they enjoy in key international institutions in order to make room for China and other emerging powers, for example through reducing their weight in IMF votes. This is hardly an incentive for Europe to move decisively.

So it would be premature to assume that Europe has abandoned procrastination, said goodbye to its internal disputes and embraced external financial activism. Nevertheless, this week's trip is an indication that it intends to be part of the global monetary conversation.

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