The Shanghai flu

by the St. Louis Post-Dispatch

A 9 percent drop in the Shanghai stock market triggered a 3.3 percent sell-off in the Dow Jones Industrial Average on Tuesday. It is a sign of how the rise of China as an economic powerhouse increasingly will send tremors through America's economy and politics in years to come.

The Chinese stock meltdown was the trigger for the sell-off on Wall Street, but not the cause. That's a key distinction for those trying to understand - and predict - market psychology. A month's worth of worrisome American economic news had the U.S. stock market poised for retreat anyway. American stocks react mainly to prospects for American corporate profits, and those prospects look less rosy now than they did a month ago.

After years of 10 percent annual economic growth, China now has the third-largest economy in the world. It is becoming increasingly integrated with the United States, which has both good and bad ramifications.

China provides Americans with cheap merchandise, everything from the electronics and socks that fill the shelves of big-box stores. But China sells much more to America than it buys. It accounts for $233 billion of America's monumental $763 billion annual trade deficit.

Basically, the Chinese send us goods and we send them cash. That cash is piling up in Beijing, which now has a massive $1 trillion in foreign reserves, mostly in dollars.

The Chinese invest those dollars largely in U.S. Treasury bonds and other American debt. Japan and other nations with whom we have a trade deficit are doing the same thing. That helps keep long-term interest rates low on American mortgages and car loans and keeps Americans buying things.

That also explains why Wall Street worries so much about China.

"People are worried that, if there is a significant downturn in the Chinese economy, that could influence their willingness to invest over here," says Gary Thayer, chief economist at A.G. Edwards.

The result is a sort of codependency. The Chinese, through their cheap labor and easy financing, enable Americans' addiction to buying stuff - so much stuff that we need to buy more stuff just to hold all our stuff. Our insatiable consumerism has helped enable the rapid industrialization of China.

This codependency can last for a long time, but probably not forever. At some point, China and other nations may tire of buying American bonds and stocks. They may spot better investments elsewhere. If that should happen, the value of the dollar would fall and American interest rates would rise.

Depending on how rapidly such a scenario played out, that could damage the American economy. We could be left both in recession and in hock. In fact, some analysts already say we have handed the Chinese an economic weapon they could turn on us. By deliberately dumping their dollars, the Chinese could create economic turmoil in the United States.

Of course, that would hurt China too, which is why it probably won't happen. A weakened America would import fewer Chinese products, putting Chinese people and factories out of work. Our codependency would be broken, with pain on both sides.

Still, countries are run by politicians, not business people, and politicians sometimes are irrational. "The dangers are really political, rather than economic," says James Little, Donald Danforth Jr. distinguished professor of business at Washington University.

Taiwan presents the biggest risk. China belligerently claims Taiwan as its own, while America pledges to defend its independence. America should aim at keeping that dispute firmly under control.

Meanwhile, the Bush administration should continue pressing the Chinese to raise the value of their currency, the yuan. Beijing sets the exchange rate low. That makes Chinese goods cheaper for Americans, while making American goods more expensive for the Chinese. But it also makes the trade imbalance worse.

Raising the yuan should be the first step toward easing America and China into a more balanced relationship. Over the long term, the Chinese must build domestic demand by raising the living standards of their people. They can't depend on profligate American spending forever.

One effect of the trade deficit is that there is lots of investment capital floating around in China, and much of it ends up in the stock market. Stocks on the Shanghai exchange rose 130 percent last year. That's a bubble that, despite Tuesday's plunge, hasn't burst yet.

When it does, it will send another wave of worry through Wall Street.

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