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**HEADLINE:** America has little to teach China about a steady economy JOSEPH STIGLITZ

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As excitement over China's revaluation has died down - including jubilation by some of the speculators, who have at last earned an (albeit modest) return - it is time for a calmer assessment about what it does and does not mean for China, for the US and for the global economy.

There remains considerable uncertainty. Though China has demonstrated a willingness to adjust its exchange rate, we do not know what will follow; will the total adjustment over the next couple of years be 10 per cent or 40 per cent? The speculators, surely, will be betting on more. And as China wisely sterilises these inflows, we can expect a continuing build-up of reserves, with this being used by speculators and their allies as an argument for further revaluation. But China will, hopefully, see through this.

The key question is how the appreciation will affect global imbalances, China's trade surplus and the US trade deficit and what, if any, will be the knock-on effects. America's trade deficit of Dollars 700bn is nine times China's trade surplus. China's economy has been going gangbusters; rapid growth with little inflationary pressure. The revaluation will hardly make a dent. Even larger revaluations are not likely to do much to the global imbalances.

First, we do not know accurately the size of China's surplus because, in an attempt to circumvent exchange controls, there is over-invoicing of exports and under-invoicing of imports - part of speculative flows. The large import content of China's exports, particularly to America, mean that China's competitiveness will be little affected. Economists disagree about whether the import content for exports to America is 70 per cent or 80 per cent but, whatever the number, it means that the effective appreciation was almost certainly under 1 per cent. In the case of a larger revaluation, Chinese companies would probably respond to the loss of competitiveness by cutting margins, reducing further the effect of the revaluation. This revaluation - even if followed by further moderate ones - is likely only to slow the rising tide of China's exports slightly.

But whether this, or a succession of revaluations, eliminates China's trade surplus will have little effect on the more important problem of global trade imbalances, and particularly on the US trade deficit. Much of China's recent gains in textile sales, for

instance, after the end of quotas last December, came at the expense of other developing countries. America will once again be buying from them, and so total imports will be little changed.

More fundamentally, the trade deficit equals capital inflows, and capital inflows equal the difference between domestic investment and domestic savings. That is why, normally, when the fiscal deficit goes up (so domestic savings goes down), the trade deficit goes up. Neither President George W. Bush nor John Snow, the US Treasury secretary, has explained how China's revaluation will change these basic equations. Unless domestic investment goes down or domestic savings go up, the trade deficit will persist, unabated. The trade deficit could diminish but if it does, it will not be a pretty picture. Domestic investment, for instance, could go down if we succeed in getting our wish and China's trade surplus disappears; with China no longer using the money from its trade surplus to fund our huge fiscal deficit, medium- and long-term interest rates would rise. The economic downturn, and the decrease in investment, would be compounded if the increase in interest rates pricked the housing bubble.

There is a myth of mutual dependence: China needs to export goods to the US, which needs China's money to finance its deficit. But China could easily make up for the loss of exports to America - and the wellbeing of its citizens could even be improved - if some of the money it lends to the US was diverted to its own development. China has huge investment needs. If its government is going to lend money, why not finance its own development? Why not fund increased consumption at home, rather than that of the richest country in the world, to pay for a tax cut for the richest people in the richest country, or to fight a war which most view as anathema? But the US could not so easily make up for the gap in funding without large increases in interest rates, and these could play havoc with the economy.

There is a second myth: that China would benefit from letting its exchange rate float freely, letting market forces set the price. No market economy has foresworn intervening in the exchange rate. More to the point, no market economy has foresworn macroeconomic interventions. Governments intervene regularly in financial markets, for instance, setting interest rates. Some market fundamentalists claim that governments should do none of this. But today, no country and few respectable economists subscribe to these views. The question, then, is what is the best set of interventions in the market? There is a high cost to exchange rate volatility, and countries where governments have intervened judiciously to stabilise their exchange rate have, by and large, done better than those that have not.

Exchange rate risks impose huge costs on companies; it is costly and often impossible to divest themselves of this risk, especially in developing countries. The question of exchange rate management brings up a broader issue: the role of the state in managing the economy. Today, almost everyone recognises that countries can suffer from too little government intervention just as they can suffer from too much. China has been rebalancing and, over the past two decades, markets have become more important, the government less so. But the government still plays a critical role. China's particular blend

has served the Chinese well. It is not just that incomes have been rising at an amazing 9 per cent annually,

and that high rates have been sustained for more than two decades, but the fruits of that growth have been widely shared. From 1981 to 2001, 422m Chinese have moved out of (absolute) poverty.

The US economy is growing at a third the pace of China's. Poverty is rising and median household incomes are, in real terms, declining. America's total net savings are much less than China's. China produces far more of the engineers and scientists that are necessary to compete in the global economy than the US, while America is cutting its expenditures on basic research as it increases military spending. Meanwhile, as America's debt continues to balloon, its president wants to make tax cuts for the richest people permanent. With all this in mind, China's leaders may not feel they need to seek advice from the US on how to manage either the exchange rate or the economy.

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