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Over the last several weeks, the US dollar's depreciation against the euro and yen has grabbed global attention. In a normal world, the dollar's weakening would be welcome, as it would help the US come to grips with its unsustainable trade deficit. But in a world where China links its currency to the dollar at an undervalued parity, the dollar's depreciation risks major global economic damage that will further complicate recovery from the worldwide recession.

A realignment of the dollar is long overdue. Its overvaluation began with the Mexican peso crisis of 1994, and was officially enshrined by the "strong dollar" policy adopted after the East Asian financial crisis of 1997. That policy produced short-term consumption gains for the US, which explains why it was popular with US politicians, but it has inflicted major long-term damage on the US economy and contributed to the current crisis.

The overvalued dollar caused the US economy to hemorrhage spending on imports, jobs via off-shoring, and investment to countries with undervalued currencies. In today's era of globalization, marked by flexible and mobile production networks, exchange rates affect more than exports and imports. They also affect the location of production and investment.

China has been a major beneficiary of the US' strong-dollar policy, to which it wedded its own "weak renminbi" policy. As a result, China's trade surplus with the US rose from US$83 billion in 2001 to US$258 billion in 2007, just before the recession. So far this year, China's surplus has accounted for 75 percent of the total US non-oil-goods trade deficit. The undervalued yuan has also made China a major recipient of foreign direct investment, even leading the world in 2002 — a staggering achievement for a developing country.

The scale of recent US trade deficits was always unsustainable, and the dollar has therefore fallen against the yen, the euro, the Brazilian real and the Australian and Canadian dollars. But China retains its undervalued exchange rate policy, so that the yuan has appreciated relatively less against the dollar. When combined with China's rapid growth in manufacturing capacity, this pattern promises to create a new round of global imbalances.

China's policy creates adversarial currency competition with the rest of the world. By maintaining an undervalued currency, China is preventing the US from reducing its bilateral trade deficit. Furthermore, the problem is not limited to the US. China's currency policy gives it a competitive advantage relative to other countries, allowing it to displace their exports to the US.

Worse still, other countries whose currencies have appreciated against the yuan can look forward to a Chinese import invasion. China's currency policy means that dollar depreciation, rather than improving the US trade balance and stanching its leakage of jobs and investment, may inadvertently spread these problems to the rest of the world. In effect, China is fostering new imbalances at a time when countries are struggling with the demand shortfall caused by the financial crisis.

The dollar is part of an exchange-rate Rubik's cube. With China retaining its undervalued currency policy, dollar depreciation can aggravate global deflationary forces. Yet a mix of political factors has led to a stunning refusal by policymakers to confront China.

On the US side, a lingering Cold War mentality, combined with the presumption of US economic superiority, has meant that economic issues are still deemed subservient to geopolitical concerns. That explains the neglect of US-China economic relations, a neglect that is now dangerous to the US, given its weakened economic condition.

With regard to the rest of the world, many find it easy to blame the US, often owing to resentment at its perceived arrogance. Moreover, there is an old mentality among Southern countries that they can do no wrong in their relationships with the North, and that they should exhibit solidarity with each other regarding those relationships.

Finally, all countries have likely been shortsighted, imagining that silence will gain them commercial favors from China. But that silence merely allows China to exploit the community of nations.

The world economy has paid dearly for complicity with and silence about the economic policies of the last 15 years, which have culminated in the deepest and most dangerous recession since the 1930s. It will pay still more if policymakers remain passive about China’s destructive currency policy.

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