

Economic Interaction

At a hearing before the U.S.-China Economic and Security Review Commission on August 22, 2006, James A. Dorn, Vice President for Academic Affairs, Cato Institute, offers his ideas on the impact of China's financial system and monetary policies on U.S. exchange rates, capital markets and interest rates. Excerpts follow.

Macroeconomic impact

If China continues to open its capital markets and to make its exchange rate regime more flexible, it will eventually be able to use monetary policy to achieve long-run price stability. At present, the People's Bank of China (PBC) must buy up dollars (supply RMB) to peg the RMB to the dollar and then withdraw excess liquidity by selling securities primarily to state-owned banks. This "sterilization" process puts upward pressure on interest rates, which, if allowed to increase, would attract additional capital inflows. The PBC thus has an incentive under the current system to control interest rates and to rely on administrative means to control money and credit growth. But the longer this system persists, the larger the PBC's foreign exchange reserves become and the more pressure there is for an appreciation of the RMB/dollar rate. Those pressures have led to reform, with the July 21, 2005 revaluation and with a number of changes in the institutional setting to establish new mechanisms for market makers and hedging operations as the currency becomes more flexible.

China will move at her own pace. What matters most is that she moves in the right direction—toward liberalization, not centralization. We must be patient and realistic. Most of the costs of China's undervalued currency are borne by the Chinese people. Placing prohibitively high tariffs on Chinese goods until the RMB/dollar rate is allowed to appreciate substantially is not a realistic option. It would unjustly tax American consumers, not balance our overall current account deficit or even our bilateral trade deficit with China, and slow liberalization.

Adjustment requires that China not only allow greater flexibility in the exchange rate but also allow the Chinese people to freely convert the RMB into whatever currencies or assets they choose. A more liberal international economic order is a more flexible one based on market-determined prices, sound money and the rule of law. We should help China move in that

direction—not by threats, but by example. The U.S. Government should begin by reducing its excessive spending and removing onerous taxes on savings and investment.

While it is useful to consider the macroeconomic impact of Chinese financial policies on the United States, it is well to remember that China is still a relatively small economy. What matters most for the U.S. economy is to pursue sound monetary and fiscal policies at home. If we follow such policies and maintain an open trading system, U.S. prosperity will continue.

The case for economic liberalism

Engagement does not mean dictating what the RMB/dollar exchange rate should be or calling for a new Plaza-Louvre type agreement to correct global imbalances. When the Group of Five industrialized nations (United States, United Kingdom, Japan, Germany and France) met in 1985 to agree on collective action to lower the foreign exchange value of the dollar, China was not a factor. The PBC's foreign exchange reserves were only \$12.7 billion, and China's overall current account was roughly in balance. Intervention in the foreign exchange markets and various changes in fiscal policies in the G-5 did help to bring the dollar's value down, but the U.S. current account deficit still reached a peak of 3.4 percent of GDP in 1987, at which time the G-6 met in Paris to reverse course and intervene to stem the dollar's slide.

Today, the U.S. current account deficit has risen to more than 6 percent of GDP, China is the world's third largest trading nation, and Asian central banks play an important role in financing the U.S. budget deficit. A new Plaza Accord would require a much larger group to negotiate—the Group of 20—without any credible enforcement mechanism. William Cline of the Institute for International Economics has argued that emerging market economies in Asia can overcome the “prisoner's dilemma” by jointly agreeing to allow their currencies to appreciate against the dollar. The extent of overall appreciation would then be much smaller than if each country acted alone. He would also have the Federal Reserve, European Central Bank and Bank of Japan intervene in the foreign exchange market to push the dollar lower.

The argument that intervention is necessary to get all parties to agree to let their currencies appreciate against the dollar in East Asia is questionable. Stephen Green, senior economist at Standard Chartered Bank in Hong Kong, notes that it is unlikely that Asian currencies would stand still while China let the RMB/dollar rate appreciate. If a country did not follow suit, it might have a temporary advantage. But as its trade surplus grew, there would be pressure to revalue or suffer inflation as a means to revalue the real exchange rate. Changing one price—the exchange rate—

is far less costly than changing the relative price level.

Rather than a new Plaza-Louvre type agreement, an alternative approach to correcting global imbalances is to have monetary authorities agree on common principles and objectives. In a world of pure fiat monies, the principle should be to establish credibility by having central banks constrain themselves to long-run price stability. Many central banks already have adopted inflation targeting and have substantially reduced inflation.

China has expressed its long-run desire to make the RMB fully convertible, allow market forces to guide the exchange rate, and to liberalize interest rates. It is in China's self-interest to do so. Creating an international market-liberal order is a slow process, in which the United States must take a leadership role—not by dictating policy, but by example and persuasion. Sound domestic monetary policy, unilateral free trade and limiting the size and scope of government are essential in that endeavor.

The politics of China's economic reform

Since the start of the reform movement in late 1978, China's leaders have declared that the country's top priority should be to achieve robust economic growth and improve the standard of living. The failure of central planning and the Soviet development model led to institutional innovation and economic restructuring. China's accession to the World Trade Organization (WTO) in December 2001 was further evidence of the commitment to liberalize trade and the financial sector.

Progress has been made since 2001, but much remains to be done. There has been considerable discussion of how China should sequence its economic reforms and make the transition from financial repression to capital freedom. It is clear that opening capital markets without reforming state-owned banks and without maintaining monetary stability could lead to substantial capital flight and exacerbate the problem of non-performing loans. Moreover, there must be an effective legal system to protect newly acquired private property rights.

In a recent interview, Zhou Xiaochuan, head of the PBC, emphasized that China is committed to creating an institutional framework for a more flexible exchange rate regime "based on market demand and supply," and "gradually realize RMB convertibility...by lifting the restrictions on cross-border capital movements in a selective and step-by-step manner." In sequencing the financial sector reforms, the first priority is to put the banking system on a sound footing by recapitalizing

large state-owned banks and turning them into joint-stock companies with the participation of foreign strategic investors. Further progress must also be achieved in widening the scope of foreign exchange transactions, including liberalizing the capital account. Zhou recognizes that institutional change cannot occur overnight because “people need some time to learn and adapt to change.” A new “mindset” must be developed. Moreover, he understands that China “cannot wait to start reforming the exchange rate regime until all banking reform measures have been completed.” Reform must move along a broad front.

Policy recommendations

The United States and China need to continue the policy of engagement and recognize that it is more important to focus on the issue of capital freedom than on the narrow question of the proper exchange rate. China should continue to liberalize its exchange rate regime, open its capital markets, allow full convertibility of the RMB, liberalize interest rates and use domestic monetary policy to achieve long-run price stability. Most importantly, China needs to privatize its stock markets, its banks and its firms.

The PBC’s Monetary Policy Committee has been concerned with the lack of flexibility in the current financial system and made the following recommendations at its third quarterly meeting in 2005:

- “The market itself should be allowed to play its role in economic restructuring.”
- “Market-based interest rate reform policies should be continuously carried out.”
- “Measures should be taken to further improve the managed floating exchange rate regime and maintain the exchange rate...at an adaptive and equilibrium level.”
- “Efforts should be made to advance financial reform” and “to enhance the effectiveness of monetary policy transmission.”

Those pro-market policy recommendations are a positive sign and a clear signal that China’s top policymakers are aware of what needs to be done to improve the financial architecture.

China has promised to allow full participation by foreigners in its banking sector by 2007 and to further open to foreign portfolio investment. However, China is intent on moving at its own pace, especially regarding the transition to a floating exchange rate regime. According to Zhou, the “noises” being made on Capitol Hill (e.g., by Democratic Senator Charles Schumer and

Republican Senator Lindsey Graham) for protectionist measures—if China does not significantly revalue the RMB/dollar exchange rate—“will not change the basic conditions and sequence of China’s exchange rate reform.”

Congress can best foster sound U.S.-China relations by not treating China as an inevitable enemy and by taking the opportunity to capitalize on China’s emergence as a market economy, albeit a “socialist market economy.” In particular, U.S. policymakers should treat China as a normal rising power, not as a probable adversary, continue to liberalize U.S.-China relations and hold China to its WTO commitments; and recognize that advancing economic freedom in China has had positive effects on civil society and personal freedom for the Chinese people.

Protectionist measures to force China to revalue would place a large tax on U.S. consumers and not advance capital freedom. Adherence to the principles of a liberal international order—as opposed to protectionist measures designed to force international agreements—should be the primary object of U.S. policy.