THE CHINESE EXCHANGE RATE AND THE U.S. ECONOMY

Statement by
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THE TREASURY DEPARTMENT'S REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY AND THE STRATEGIC ECONOMIC DIALOGUE

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The Central Role of China in the Global Imbalances

The US global merchandise trade and current account deficits rose to $850-875 billion in 2006. This amounted to about 7 per cent of our GDP, twice the previous record of the middle 1980s[2]. The deficits have risen by an annual average of $100 billion over the past four years.

China's global current account surplus soared to about $250 billion in 2006, about 9 per cent of its GDP. China has become by far the largest surplus country in the world, recently passing Japan and far ahead of all others. Its foreign exchange reserves have also passed Japan's to become the largest in the world and now exceed $1 trillion, an

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[2] I note with pride that, based on the work of my colleague Catherine L. Mann, I predicted precisely such an outcome for 2006 in the third paragraph of my testimony before this Committee on May 1, 2002.

enormous waste of resources for a country where most of the huge population remains very poor.

China's role in the global imbalances is even greater than these numbers might suggest. A substantial increase in the value of the Chinese currency is an essential component of reducing the imbalances but China has blocked any significant rise in the RMB by intervening massively in the foreign exchange markets, buying $15-20 billion per month for several years to hold its currency down. China has recently let the RMB rise marginally against the dollar but, since it continues to link its exchange rate to the dollar and the dollar has fallen against virtually all other currencies, the average exchange rate of the RMB is weaker now than in 2001 when China's current account surplus accounted for a modest 1 percent of its GDP. The world's most competitive economy has become even more competitive through a deliberate policy of currency undervaluation.

About one quarter of all of China's economic growth in the past two years has stemmed from the continued sharp rise in its trade surplus. China is thus overtly exporting unemployment to other countries and apparently sees its currency undervaluation as an off-budget export and job subsidy that, at least to date, has avoided effective international sanction.

By keeping its own currency undervalued, China has also deterred a number of other Asian countries from letting their currencies rise very much against the dollar for fear of losing competitive position against China. Hence China's currency policy has taken much of Asia out of the international adjustment process. This is critical because

Asia accounts for about half the global surpluses that are the counterparts of the US current account deficit, has accumulated the great bulk of the increase in global reserves in recent years and is essential to the needed correction of the exchange rate of the dollar because it makes up about 40 per cent of the dollar's trade-weighted index. The most obvious Asian candidates for sizable currency appreciation in addition to China are Japan, Taiwan, Singapore and Malaysia.

The Risks for the US and World Economies

These global imbalances are unsustainable for both international financial and US domestic political reasons. On the international side, the United States must now attract about $8 billion of capital from the rest of the world every working day to finance our current account deficit and our own foreign investment outflows. Even a modest reduction of this inflow, let alone its cessation or a selloff from the $14 trillion of dollar claims on the United States now held around the world, could initiate a precipitous decline in the dollar. Especially under the present circumstances of nearly full employment and full capacity utilization in the United States, this could in turn sharply increase US inflation and interest rates, severely affecting the equity and housing markets and potentially triggering a recession. The global imbalances probably represent the single largest current threat to the continued growth and stability of the US and world economies.

The domestic political unsustainability derives from the historical reality that dollar overvaluation, and the huge and rising trade deficits that it produces, are the most accurate leading indicators of resistance to open trade policies in the United States. Such overvaluation and deficits alter the domestic politics of US trade policy, adding to the number of industries seeking relief from imports and dampening the ability of exporters to mount effective countervailing pressures. Acute trade policy pressures of this type, threatening the basic thrust of US trade policy and thus the openness of the global trading system, prompted drastic policy reversals by the Reagan Administration, to drive the dollar down by more than 30 percent via the Plaza Agreement in the middle 1980s, and by the Nixon Administration, to impose an import surcharge and take the dollar off gold to achieve a cumulative devaluation of more than 20 percent in the early 1970s.

The escalation of trade pressures against China at present, despite the strength of the US economy and the low level of unemployment, is the latest evidence of this relationship between currency values and trade policies. With deep-seated anxieties over globalization already prevalent in our body politic, and the failure of the Doha Round to maintain the momentum of trade liberalization around the world, <u>continued failure to correct the currency misalignments could have a devastating impact on the global trading system.</u>

<u>The Policy Implications</u>

It is thus essential to reduce the US and China imbalances by substantial amounts in as orderly a manner as possible. The goal of US adjustment should be to cut our global current account deficit to 3-3 ½ percent of GDP, about half its present level, at which point the ratio of US foreign debt to GDP would eventually stabilize and should be sustainable. China's goal, already accepted in principle by its political leadership but without any significant policy followup, should be to totally eliminate its global current account surplus and stop the buildup of foreign exchange reserves.

The United States should take the lead in addressing the imbalances by developing a credible program to convert its present, and especially foreseeable, budget deficits into modest surpluses like those that were achieved in 1998-2001. Such a shift, of perhaps 3-4 percent of our GDP, would reduce the excess of our domestic spending relative to domestic output and the shortfall of our domestic savings relative to domestic investment. Fiscal tightening is the only available policy instrument that will produce such adjustments. Hence I strongly recommend that the new Congress take effective and immediate steps in that direction.[3]

China needs to adopt policies to promote an opposite adjustment, reducing its uniquely high national saving rate by increasing domestic consumption. China can do so most easily through higher government spending on health care, pensions and education. Such new government programs are needed for purely internal reasons anyway because of the unrest in China that has resulted from the demise of state-owned enterprises that provided these benefits in previous times. They would reduce the precautionary motive for household saving in China and boost private as well as government demand, contributing importantly to the needed international adjustment.[4]

Large changes in exchange rates will also have to be a major component of the adjustment process. <u>A change in China's currency policy, in both the short and longer</u>

[3] See my testimonies on that topic to the House Budget Committee on January 23 and the Senate Budget Committee on February 1. I suggest there that the external imbalances are in fact the most likely source of a crisis that could force the United States into precipitous and thus unpalatable budget adjustments if preemptive action is not taken.
[4] See Chapter 2 of *China: The Balance Sheet* and Nicholas Lardy, "China: Toward a Consumption-Driven Growth Path," Washington: Institute for International Economics, October 2006.

runs, is in fact by far the single most important issue in US-China economic relations. The short-term success of the new Strategic Economic Dialogue will be judged largely by whether it achieves effective resolution of this problem.[5]

An increase of at least 20 percent in the average value of the RMB against all other currencies, which would imply an appreciation of about 40 percent against the dollar[6], and sizable appreciations against the dollar of other key Asian currencies, will be required to achieve an orderly correction of the global imbalances.[7] Such a change could be phased in over several years to ease the transitional impact on China.[8] It could be accomplished either by a series of step-level revaluations, like the 2.1 percent change of July 2005 against the dollar but of much larger magnitudes and with a substantial initial "down payment" of at least 10-15 percent, or by a much more rapid upward managed float of the RMB than is underway at present. An increase of 40 percent in the RMB and other Asian currencies against the dollar would reduce the US global current account deficit by about $150 billion per year.

Over the longer run, China should adopt a more flexible exchange rate that will respond primarily to market forces. These forces would clearly have pushed the RMB to much higher levels by now in the absence of China's official intervention. There is some

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[5] The Strategic Economic Dialogue also has the long-term potential to foster a more constructive relationship between the two countries that will inevitably lead the world economy over the coming years and perhaps decades. It thus begins to implement the "G-2" concept proposed in my "A New Foreign Economic Policy for the United States" in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade,* Washington: Institute for International Economics, 2005, pp. 53-4.

[6] See William R. Cline, *The United States as a Debtor Nation,* Washington: Institute for International Economics, 2005, especially Table 6.2 on page 242.

[7] I have studiously refrained from mentioning the very large Chinese bilateral trade surplus with the United States, which should not be a primary focus of policy because of the multilateral nature of international trade and payments. At present, however, the bilateral imbalance is a fairly accurate reflection of the global imbalances and is thus more relevant than usual.

[8] See Morris Goldstein and Nicholas Lardy, *A New Way to Deal with the Renminbi,* Financial Times, January 20, 2006.

justification, however, for China's fears that an abrupt move to a freely floating exchange rate now, particularly if accompanied by abolition of its controls on financial outflows, could trigger capital flight and jeopardize its economy in view of the fragility of its banking system. Full-scale reform of China's exchange rate system will have to await completion of the reform of its banking system, which will take at least several more years. Hence the adoption of a flexible exchange rate regime in China, which is essential to avoid re-creation of the present imbalances in the future, can be only a second stage in the resolution of the currency problem and the immediate need is for a substantial increase in the price of the RMB (especially against the dollar).[9]

<u>A US Strategy for China's Currency</u>

It is obvious that China is extremely reluctant to make the needed changes in its currency policy. It is equally obvious that US efforts on the issue over the past three years, whether the earlier (and recently resumed?) "quiet diplomacy" of the Administration or the threats of Congressional action or the new Strategic Economic Dialogue, have borne little fruit to date. <u>A new US policy is clearly needed.</u>

One cardinal requirement is for the Administration and Congress to adopt a unified, or at least consistent, position. To date, there has been something of "good cop (Administration) – "bad cop" (Congress, e.g., the threat of the Schumer-Graham legislation) bifurcation between the two branches. China has exploited these differences, essentially counting on the Administration to protect it from the Congress – a bet that, to date, has paid off.

[9] This two-step approach was initially proposed by my colleagues Morris Goldstein and Nicholas Lardy, *Two-Stage Currency Reform for China,* <u>Financial Times,</u> September 12, 2003.

I would therefore suggest a new five-part strategy for US policy on the currency issue.

First, it is clear that China has aggressively blocked appreciation of the RMB through its massive intervention in the currency markets and that the Treasury Department has severely jeopardized its credibility on the issue by failing to carry out the requirements of current law to label China a "currency manipulator."[10] The Treasury report of May 2005 indicated that "…if current trends continue *without substantial alteration* (italics added), China's policies will likely meet the statute's technical requirements for designation." The report of May 2006 sharply criticized China for its currency policies, clearly suggesting that there has been no "substantial alternation" in those practices, but inexplicably failed to draw the obvious conclusion of its own analysis.[11] The latest report, submitted last month, was much milder. Treasury has thus been reducing its criticism of China's currency practices even as the RMB has become increasingly undervalued and China's external surpluses have soared.

The Treasury policy needs to be changed sharply and quickly. The Administration should notify the Chinese immediately that, if China fails to make a significant "down payment" appreciation of at least 10 percent by the time of the next meeting of the Strategic Economic Dialogue in May and prior to the release of Treasury's next semi-annual report, it will be labeled a "manipulator." This would trigger an explicit US negotiation with China on the currency issue.

[10] See Morris Goldstein, "Paulson's First Challenge," *The International Economy*, Summer 2006.
[11] Treasury and the IMF have justified their inaction on the grounds that there is insufficient evidence that China is manipulating its exchange rate with the "intent" of frustrating effective current account adjustment. This is of course ludicrous because it is highly unlikely that China (or any country) would admit such a motive and it is impossible to discern any other purpose for the policy.

Second, the Administration should notify its G-7 partners and the IMF that it plans to make such a designation, in the absence of major preventive action by China, with the goal of galvanizing a multilateral effort on the issue and reducing its confrontational bilateral character. The objective of that international effort, hopefully spearheaded by the IMF through its new "multilateral surveillance" initiative, should be a "Plaza II" or "Asian Plaza" agreement that would work out the needed appreciation of the major Asian currencies through which the impact on the individual countries involved (including China) would be tempered because they would not be moving very much vis-à-vis each other.[12] The Europeans have an especially large incentive to join the United States in such an initiative because their own currencies will rise much more sharply when the dollar experiences its next large decline if China and the other Asians continue to block their own adjustment (and perhaps to head off the incipient United States-China "G-2" implied by the Strategic Economic Dialogue).

Third, the Administration (with as many other countries as it can mobilize) should also take a new multilateral initiative on the trade side by filing a WTO case against China's currency intervention as an export subsidy. As Chairman Ben Bernanke indicated in his highly publicized speech in Beijing last month, in connection with the first Strategic Economic Dialogue, China's exchange rate intervention clearly represents an effective subsidy (to exports, as well as an import barrier) in economic terms. It should be addressed as such.[13]

[12] See William R. Cline's "The Case for a New Plaza Agreement," Washington: Institute for International Economics, December 2005.
[13] This idea is analyzed in Gary Clyde Hufbauer, Yee Wong and Ketki Sheth, *US-China Trade Disputes: Rising Tide, Rising Stakes,* Washington: Institute for International Economics, August 2006, pp. 16-26.

Fourth, if the multilateral efforts fail, the United States will have to address the China currency issue unilaterally. Treasury can pursue the most effective unilateral approach by entering the currency markets itself. It is impossible to buy RMB directly, because of its continued inconvertibility, so Treasury would have to select the best available proxies in the financial markets. The message of US policy intent would be crystal clear, however, and at a minimum there would be a further sharp increase in speculative inflows into the RMB that would make it even more difficult for the Chinese authorities to resist their inflationary consequences and thus the resultant pressures to let the exchange rate appreciate. (Other undervalued Asian currencies, notably the Japanese yen, could be purchased directly with immediate impact on their exchange rates against the dollar.)

The United States has of course conducted such currency intervention on many occasions in the past, most dramatically via the Plaza Agreement in 1985 and most recently when it bought yen to counter the excessive weakness of that currency in 1998 (when it approached 150:1). All those actions have been taken with the agreement of the counterpart currency country, however, and usually in cooperation with that country. This would be the essence of the proposed “Plaza II” or “Asian Plaza” agreement, as suggested above, and the multilateral approach would be preferable now as always and should be pursued vigorously by the Administration. Failing such agreement, however, the unilateral option is available and might have to be adopted.

Fifth, the Administration should quietly notify the Chinese that it will be unable to continue opposing responsible Congressional initiatives to address the issue. Congress should then proceed, hopefully in cooperation with the Administration, to craft legislation that would effectively sanction the Chinese (and perhaps some other Asians) for their failure to observe their international currency obligations.

Such unilateral steps by the United States, although decidedly inferior to the multilateral alternatives proposed above, could hardly be labeled as “protectionist” since they are designed to counter a massive distortion in the market (China’s intervention) and indeed promote a market-oriented outcome. Nor could they be viewed as excessively intrusive in China’s internal affairs, since they would be no more aggressive than current US efforts on intellectual property rights and other trade policy issues (including the filing of subsidy and other cases on such issues with the WTO). Such steps should therefore be considered seriously if China continues to refuse to contribute constructively to the needed global adjustments and if the Treasury Department continues to whitewash the Chinese policies by failing to carry out the clear intent of the law fashioned by this Committee almost two decades ago.