The Treasury Department's Currency Report, Dialogue with China and Related Topics

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Topic	Page

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The Treasury Department's Currency Report of December 12, 2006 (the Treasury Report) presented a number of valuable findings, but a few of its findings are questionable. In short, the Treasury Report significantly understates its legitimate criticism of Germany and Japan, while it characterizes China in ways not helpful for policy making that serves America's best interests—in particular the goal of improving American international competitiveness. In reviewing its findings, I am also able to answer the questions asked of me in the invitation to testify.

I want to emphasize at the outset how important the Treasury Department's new strategic high-level dialogue with China could be for American international competitiveness. But I also want to stress that for the dialogue with China to play this role, the U.S. government must use the dialogue wisely and not allow it to be distracted by issues which are not germane to and may even be harmful to attaining medium-term and long-term gains in U.S. competitiveness.

1. The Treasury Report's understated criticism of Germany and Japan

Looking at the correct statistical indicator, which is global trade in goods and services, and ignoring oil exporters in the Middle East, I want to emphasize that as a share of the U.S. trade deficit, running many years and even decades, global trade surpluses by Germany, Japan and the rest of non-China Asia have been very large and continue to be large. In contrast, until two years ago, China's trade surplus was very small. I'll come back to China in a minute. The main point is that if we review the overall medium-term situation, our search for causes of U.S.

lopsided imbalances needs to focus more on Germany and Japan—as the Treasury report does weakly—and less on China.

At this point I want to point out an important lesson in thinking about these issues. I want to give what is in effect a user "WARNING ALERT" on trade statistics. When the U.S. Commerce Department reports each month how big the U.S. trade deficit is and says which countries make up what share of that deficit, we should ignore that part of the announcement, because it is meaningless for assessing which countries are responsible for our deficit. A country could have a surplus with the U.S. and a deficit with the whole world. The bilateral–two-way–balance with the U.S. says nothing by itself about how much a country contributes to our deficit.

This is especially true of China, which processes and re-packages large volumes of goods from other countries for final shipment to America. Interestingly, this lesson also cuts the other way. The United States has bilateral trade surpluses with both the Netherlands and with Singapore, so we might be tempted to say these two countries do not contribute to America's trade deficit. Not so. Both countries have large global surpluses—Singapore especially so. It is not hard to imagine Singapore sending the bulk of its manufactured exports to China, for finishing and packaging there, before having them shipped to America from a Chinese harbor as last port of call. In this case, which country contributes more to the U.S. deficit? Clearly it is Singapore. But you cannot know this from the Commerce Department data.

In other words, America has a large deficit with the global supply chain, not with any particular country where goods happen to stop on their way. While America buys from the global supply chain, other countries sell to the global supply chain. If we look at which countries are running long-term big-time surpluses with the global supply chain, it is Germany, Japan and the rest of non-China Asia. This deserves much greater attention in the Treasury Report.

Let me point out what I think is a second important lesson in understanding these issues. I want to challenge our thinking about the U.S. trade deficit a bit. We may look on the U.S. deficit as a problem, but in fact, the U.S. trade deficit is essential for the global economy. Poor countries need markets. America wants to promote healthy growth and development in poor countries – not with foreign aid, not with subsidized loans – but through trade. Somebody has to buy poor-country products. America is playing that role in the world. Other major industrialized countries are not helping out – especially Germany and Japan. To put it a bit impolitely, Germany and Japan are slackers. Instead of running modest deficits and sharing the global development burden with America, Germany and Japan are themselves feeding off our deficit. They shouldn't need to do that. But that is what they are doing.

America needs to pressure Germany and Japan to join this essential program of development support—running global deficits to promote poor-country growth. To do this, Germany and Japan should spur their own domestic demand, especially consumption. This is in fact an important message stressed in the Treasury report. It is the first real country-specific conclusion in the Treasury report's bulleted summary, and for good reason. This is almost certainly the most important finding in the report – but the reader wouldn't really know it, because the report's treatment of this finding is muffled and understated. It is polite. I would recommend that it not be so polite. The health of the world economy is too important for us to go so easy on our friends.

People say, "But Germany and Japan have freely floating foreign exchange markets. Their currencies must be at the right levels." This misses the point. Exchange rates won't fix this problem. I have taught graduate courses on the Japanese economy and lived in Europe and researched Europe's economy, so I am familiar with their situation. Germany and Japan run

Table 1
Global Surplus in Goods and Service as Share of U.S. Trade Deficit (%)

	U.S.	Japan	Germany	China	Euro Area	Netherlands
1990	-100	33	65	14		16
1991	-100	192	-6	41		40
1992	-100	226	-7	14		35
1993	-100	140	12	-17		26
1994	-100	99	12	8		21
1995	-100	77	21	12		25
1996	-100	20	26	17		23
1997	-100	45	29	40		23
1998	-100	44	22	27	85	14
1999	-100	26	4	12	23	7
2000	-100	18	0	8	3	4
2001	-100	7	9	8	17	5
2002	-100	12	20	9	32	4
2003	-100	15	19	7	29	7
2004	-100	15	22	8	27	8
2005	-100	10	20	17	15	7
2006*	-100	7	19	20	7	8

* First half of 2006
Source: IMF, International Financial Statistics, 1990-2006 and Janurary 2007.

surpluses because they have structured their economies, and their financial systems, to save rather than consume. This is especially true with regard to the high levels of corporate savings in both economies – something the Treasury report points out very clearly. Exchange rates won't fix this. Germany and Japan need to change those structures. And America needs to strongly encourage them to do so.

It is true, Germany and Japan host our troops and military bases on their soil—but that should not be a Treasury report concern. This is what I consider the most valuable finding in Treasury's report, put in my own blunt language: From the perspective of global economic leadership and the need to correct for lopsided imbalances – Germany and Japan, as fully industrialized countries with per-capita GDP levels more than twenty times China's, are slackers and have been for a long time. This needs to change. The Treasury Report needs to say so clearly.

2. The Treasury Report's mixed and at times problematic treatment of China

The report spends considerable effort evaluating China's economy, its foreign trade, its foreign exchange reserves, and its exchange rate. The report's chronicle of China's recent reforms is useful, and the statistical presentation is accurate. However a number of unsubstantiated assertions mischaracterize China's current situation in ways that distort our understanding of the competitive challenge China presents to America.

As background, let us review China's trade surplus. And please remember, this is China's global surplus, not the Commerce Department's bilateral surplus with America—which tells us nothing. Two years ago, in 2004, China's global trade surplus was 8 percent of America's trade deficit. Only 8 percent! The Netherlands that year had the same size global surplus as China! The Netherlands' surplus was 8 percent, too. The whole European Currency Area's surplus was 27 percent of the U.S. deficit that year, and the combined global surplus of Japan and the rest of non-China Asia was an even larger share America's deficit. In contrast, China's surplus was only 8 percent. Even so, complaints at that time about China—because of the large *bilateral* surplus reported monthly by the Commerce Department—bordered on the vitriolic.

3. Misplaced emphasis: China's currency as a "core issue" in the U.S.-China relationship

If China's trade surplus was only 8 percent of the U.S. deficit just two years ago, why is China's currency a "core issue," as the Treasury Report declares it to be? The truth is, China's currency was a core issue even back when its global surplus was so small. But while the controversy surrounding China's currency has remained at a high level, for whatever reasons, trade statistics now make the controversy appear to be more justified. China's global surplus is now quite large. What has happened since 2004? For Europe and Japan, the extraordinary surge in petroleum prices temporarily made their global surpluses seem more moderate. Please see Table 1. This shift, of course, had nothing to do with their exchange rates.

For China, the critical development over the past 5 years is that China has joined the WTO – a wrenching change to its trade relations with the world and a change that has nothing to do with China's exchange rate.

As one might expect, even before China's formal accession to the WTO, foreign and domestic investors in China geared up their export production platforms to be ready to take advantage of China's pending membership. This gave exports a head start in expressing the impact of WTO accession. And then the multi-fiber agreement ended. China's exports received another boost – again in ways that had nothing to do with the exchange rate.

At the same time, China's imports responded more slowly to WTO accession. Tariffs came down dramatically, but reductions in non-tariff barriers and fluctuations in domestic demand—especially after an anti-inflation credit tightening in late 2004—have not supported import growth fast enough to keep up with exports, although imports too are growing very fast. What is more, some import-related WTO accession components came into play with a lag—for example the provision allowing foreign firms to open up to 40 independent retail branches in China only really came into play in 2005. Implementation of these provisions is further slowed by the sometimes glacial pace of China's domestic licensing process.

Consequently, China's global surplus suddenly jumped beginning in late 2004, as exports continued to expand while credit tightening caused imports to grow less quickly. In 2005, China's surplus, instead of 8 percent of the U.S. deficit, was at 17 percent, only slightly less than Germany's 20 percent. In the first half of last year, 2006, China's surplus was slightly more than Germany's level, 20 percent for China versus 19 percent for Germany.

In the short-to-medium term, this high degree of trade-flow instability, brought about by such huge adjustments to China's trade regime, is virtually unavoidable. And it is important to point out that these dramatic changes over two short years did not reflect a sudden shift in China's exchange rate. It barely changed at all. Indeed, at this preliminary stage in China's WTO adjustments, so many parameters are changing so fast that it would be foolish to insist that trade flow adjustments have been caused by exchange rates. Let me repeat that point. China's global trade surplus has grown suddenly larger – putting it on a par with Germany's – but not because its exchange rate shifted.

How can we know whether China's trade will achieve a rough balance once WTO accession forces work themselves out? We can't know now. We will just have to wait and see. Anything could happen. China's trade balance might even eventually swing into a long-term modest deficit as the Renminbi gains hard-currency status in much of Asia. What we can know is that it would be a mistake to try to correct short-term imbalances now by forcing exchange rate adjustments. The non-exchange-rate forces are too powerful and moving too fast for such a strategy to make sense.

In sum, the Treasury Report's highlighting of China's currency as a "core issue" is an unfortunate emphasis. Stressing this issue is a kind of shortcoming in the report. In its headline summary bullets, the Treasury Report asserts that the "cautious pace" of exchange rate reform in China "impedes adjustment of international balances." Analysis supporting this assertion is lacking. The report doesn't say by how much China's behavior impedes such adjustment, but it cannot be very much. We have already seen how global imbalances have many explanations—more reliably, the global balances of Germany and Japan are good explanations. And we have also noticed that some degree of global trade imbalance – in the form of an industrialized-country deficit – is desirable. We have also seen that exchange rates are not likely to be effective in countering the short-term swings in China's trade—or longer-term swings for Germany and Japan, for that matter. So for the Treasury Report to finger China's exchange rate as a significant factor in causing undesirable global imbalances is not warranted by analysis and unnecessarily supports popular jingoist thinking on the subject.

4. Domestic demand is too strong for China's growth to be export-led

In another of its headline summary bullets, the Treasury Report states that China has "a growing dependency on exports to drive its economic growth." This kind of statement fuels the misleading thought that China's growth is export-led and that alleged instruments of its export success, like its exchange rate, must be crucial to its whole growth record. China's GDP data and the Treasury Report's own appendix indicate this is not true.

To begin with, parsing the Treasury Report's clever wording, it is useful to point out that just because something is "growing" doesn't mean that it is large or significant. It is true that in 2005, when you look at expenditure accounts for China's GDP, the contribution of net exports to GDP growth increased. But so did the contribution to growth of domestic demand—indeed, domestic demand accounted for much more of China's growth than the increase in net exports.

This point is acknowledged in the Treasury Report's own appendix—far from the summary headline bullets. In reviewing indicators for ranking countries by the impact of their exchange rate regimes, the Annex concludes that "although the contribution of China's external sector to growth is positive, growth in domestic demand is so strong that contribution of the external sector to growth appears to be modest." This is a good statement. But it is buried in an appendix. The report's headline bullet gives the wrong impression.

Indeed, the notion that China's remarkable GDP growth record depends on exports – and on exports to the United States at that – is widespread. But a quick look at recent history dispels this notion. In the latter 1990s, when the U.S. economy was booming because of hi-tech expansion, China's economy was in a growth slump caused by domestic policy developments. Conversely, as the United States went into recession in 2002—causing serious trouble for many Asian economies—China's economy had already come out of its growth slump and had accelerated GDP growth past 9 percent, on its way to 10-percent growth. Unlike other Asian economies, China didn't follow the ups and downs of U.S. demand – quite the reverse. China's growth is not export-led. The Treasury Report should make this point more forcefully.

5. The Treasury Report continues the word games involving currency "flexibility"

As in earlier similar Treasury Reports, the word "flexibility" plays a central role. There is a reason for this. Very few good economists are comfortable in declaring that a currency like China's is undervalued or overvalued. It is difficult to make a reliable calculation on this point—as one of the methodological appendixes to this Treasury Report makes clear. This is especially so in a case like China's, where so-called "market forces" don't give an accurate indication of which way the currency's "equilibrium" value should be. The glaring non-market characteristic of China's exchange rate is that it operates in an environment where short-term capital flows are heavily regulated. There is no real way to tell which way China's currency would go if capital account restrictions were lifted at the same time that the currency was allowed to float freely. There is a good possibility that the currency would depreciate rather than go up in value.

While good economists are hesitant to declare where an equilibrium currency value might be with regard to trade, when it comes to capital controls and domestic money supply, economists pretty much all agree that you need exchange-rate flexibility if you want to have both an open short-term capital account and domestic independence in setting monetary policy. So, while responsible economists shy from the word “revalue” for China, they are happy to call for “flexibility.” Economists know that this only refers to arcane capital-account and monetary policy issues, but most of the world thinks it means appreciation. It doesn’t.

But even the capital-account validity of the “flexibility” mantra falls apart in China’s case. Take for example the Treasury Report’s headline bullet asserting that “China’s economy … needs a flexible exchange rate regime.” The report develops this theme again in another summary headline bullet when it says “China’s cautious approach to exchange rate reform continues to exacerbate distortions in the domestic economy.” What this is getting at is the notion that if a country tries to keep its exchange rate fixed—or nearly fixed—then capital inflows could threaten to increase the money supply to dangerously inflationary levels, requiring extraordinary and increasingly expensive efforts by the central bank to moderate the size of the domestic money supply. But in China’s case, there is a hitch. China has fairly effective regulation of capital flows. Theory and practice both indicate that if a country can control short-term capital flows adequately, then it can keep its fixed exchange rate and still manage domestic monetary policy independently. China doesn’t really need currency flexibility unless it opens up to freely flowing short-term capital, something nobody—not the IMF, not the World Bank, not the U.S. Treasury—is recommending that China do.

China agrees that—at some point in the future—it will need currency flexibility, which means the ability to shift up and down. But this will only be necessary once China has succeeded in developing its financial sector well enough to open short-term capital flows. But since it knows it cannot open its capital account now without risking a crisis like the 1997 Asian financial crisis, it knows it doesn’t need to have a truly flexible exchange rate yet. It is true that

China’s regulation of short-term capital flows isn’t perfect. There is “leakage” of capital in or out. But China regulates its capital flows well enough so that exchange-rate flexibility is still a requirement only for the distant future.

The Treasury Department is well aware of all these relationships, and yet it continues to slip in this slippery word “flexibility” in ways that leave it caked in ambiguity. This greatly reduces the Treasury Report’s transparency and usefulness.

6. China’s foreign exchange build-up should not be a concern

It is worth mentioning that the Treasury Report thankfully does not point to China’s seemingly large stock of foreign reserves as a problem. This is an important lesson – China’s mounting foreign exchange reserves are not evidence of exchange-rate manipulation. Just in a factual sense, an appendix to the Treasury Report points out that one useful indicator of necessary reserve size is in relation to domestic money supply, especially if a country is considering opening its short-term capital account at some point. By this measure, a Treasury Report appendix table shows that China’s ratio of reserves to money supply is quite reasonable and much lower than the ratio listed for many other economies in the table.

But it is also important to point out that there is a speculation game going on here—and the U.S. Congress may be an unwitting participant. When foreign, including American, speculators hear U.S. government criticism of China’s reserve levels, they are encouraged to think America will force China to revalue—so they speculate more. And China’s reserves go up as a result. And then there is more criticism, and then more speculative flows, and then higher reserves, and so on. This all could have a bad ending for the speculators, but it is not a sign of exchange-rate misalignment.

7. The Treasury Report finds that no country deserves designation as a currency manipulator

This is the last of the report's headline bullets, and while I don't have the knowledge to verify that this is true for other countries, I can say that I am satisfied that this is the correct conclusion to draw with respect to China.

8. The U.S. exchange rate policy is good for the U.S. economy

Interestingly, repetition of the maxim that a strong dollar is good for the United States, by always saying the same thing, ends up not saying very much at all and, importantly, ends up minimizing instability in currency markets. In this sense, a "strong dollar" policy is no policy at all. The United States has not intervened in currency markets in a long time. This is a good policy for the U.S. economy, because major currency adjustments around the world are rendered as smooth as possible. Needed adjustments occur, and some of them are large, but accompanying speculative instability is minimized.

But what do sticky structural global trade surpluses in Europe, Japan and other parts of Asia mean for the American economy? They are not really caused by exchange rates. With some variations now and again, they reflect changes in global competitiveness and demands on America to improve its competitiveness. For example, American manufacturing, faced with competition from poorer, lower-wage, economies, has and is adjusting by increasing labor productivity. This generally means layoffs. It is my understanding that U.S. manufacturing output has not declined along with the decline in manufacturing employment, and, indeed, may not have declined at all. Foreign competition at prevailing and evolving exchange rates pushes American manufacturing to reform and raise productivity in ways that offer higher incomes to those who are still left as employees after the layoffs.

The same is true of America's industrial base. Should the United States manufacture domestically every major industrial product? Production of mature, well-known products using mature well-known methods may not be viable any more in the United States. If one or another sector in America's industrial base is considered vital to national security, the right way to support it is through special subsidies or tax benefits, not by trying to shift or control relevant exchange rates. Applying such a blunt policy instrument will do more harm than good.

All these changes imply a shifting labor force structure. The challenge is to use other non-exchange-rate and non-trade regime means to facilitate labor mobility and to ensure that all jobs receive a decent wage with adequate benefits. The notion that a higher minimum wage will cost the economy jobs does not, in my understanding, hold up to scrutiny. If a particular production process or service cannot survive if it is pushed to compensate adequately, then it probably shouldn't survive. America cannot sustain so-called competitive industries and products by keeping its labor force working for sub-standard pay and benefits. China's commercial emergence highlights this truth. Does America really want to keep workers in jobs where they have to suffer a standard of living kept low by wage levels in an international competitor's labor force? No.

9. China is a legitimate competitor, so we need to look to our own domestic competitiveness

My most important point for this committee is that China is a legitimate commercial competitor. Its success does not rely on currency manipulation. And China will continue to be a legitimate commercial competitor. America's strategy has to be to focus here at home and strengthen our own fundamental competitiveness – education, labor force mobility, pension mobility, health care, and safe cities as attractive places to work so we can compete in the global market for technical and managerial talent. Visa reform would help.

Instead, if we pretend that our problems are because of China's exchange rate, or China's banking system, or China's low wages, that is like sticking our heads in the sand. Let's not turn Treasury's new china dialogue into that kind of exercise.

10. The Treasury China dialogue is a good chance to enhance our competitiveness

Treasury's China dialogue is a chance to move away from entrenched misperceptions of our competitive challenge. Instead of blaming imaginary external causes for our competitive difficulties, we need to look to ourselves and the domestic roots of our competitiveness. Treasury's new China dialogue is a terrific opportunity that has taken many years to get started. Let's not waste it on dead-end feel-good distractions like exchange-rates.

I'll give three quick examples of alternative ways that Treasury's new China dialogue could contribute to longer-term competitiveness. There are many others.

First, America has a huge competitive advantage in selling healthcare services and technology, but China's healthcare system is seriously in need of reform if it is to become the really large market it can be. This Treasury-led dialogue can find ways to help China develop its healthcare system and that potential market for American goods and services. The Treasury Report already mentions that this kind of collaboration is on their agenda.

Second, China's rural economic difficulties and growing domestic inequality have a lot to do with China's resistance to importing staple foods – instead it pressures farmers to plant grain, which not only wastes precious water but also keeps farm incomes and consumption low. Higher rural consumption could be a large factor in helping China to shift its GDP growth intensity away from high investment rates to more balanced domestic demand patterns. We need to work to allay Chinese fears that the U.S. will use food supplies as a strategic weapon and encourage Chinese purchases not just of grain but of the whole food logistical system – storage and transport – they will need. America is extremely competitive in these technologies. This is an area where a slow build-up of trust and communication could make a difference.

Finally, on intellectual property rights – the wrong approach is to say China is just unwilling to protect American property rights and then to try to use sanctions to get what we want. The real situation is that China, like so many lower-income countries, has serious IPR problems of its own—including domestic rip-offs of food and baby products that kill people. This dialogue can help strengthen U.S.-China collaboration to find ways to improve China's whole domestic IPR protection system – possibly along the lines of U.S. Chamber of Commerce programs in a number of Chinese provinces.

China's challenge is an honest one – to meet it we need to look at needed change here at home at the same time that we capitalize on this new dialogue to strengthen opportunities in China.