subsidies off-budget, as by imposing affordable housing regulatory mandates on banks and by providing implicit taxpayer guarantees on Fannie Mae and Freddie Mac bonds, does not give us more housing at nobody's expense.

Lawrence H. White is the F. A. Hayek Professor of Economic History at the University of Missouri St. Louis and an adjunct scholar at the Cato Institute. He is the author of Competition and Currency, Free Banking in Britain, *and* The Theory of Monetary Institutions.

ENDNOTES

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CHAPTER 11 CHINA MUST REVALUE TO CORRECT GLOBAL IMBALANCES *v.* CHINESE REVALUATION WILL NOT CORRECT GLOBAL IMBALANCES

China Must Revalue to Correct Global Imbalances

Advocate: C. Fred Bergsten

Source: "The Dollar and the Renminbi," Statement at the Hearing on U.S. Economic Relations with China: Strategies and Options on Exchange Rates and Market Access, Subcommittee on Security and International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC, May 23, 2007

Chinese Revaluation Will Not Correct Global Imbalances

Advocate: David D. Hale and Lyric Hughes Hale

Source: "Reconsidering Revaluation: The Wrong Approach to the U.S.–Chinese Trade Imbalance," *Foreign Affairs* 87 (January/February 2008): 57–66

Should China revalue its currency, the renminbi (whose principal unit is the yuan), against the dollar? Officially, the Chinese government pegs the renminbi to a basket of currencies in a crawling peg regime. Unofficially, China continues to maintain the renminbi at a fairly stable exchange rate against the dollar. Many economists have argued that the renminbi is undervalued against the dollar and that China's exchange-rate policy intentionally maintains this undervaluation to promote exports. Such concerns prompted Congress to pressure first the Bush administration and now the Obama administration to urge the Chinese government to revalue the renminbi and to threaten to impose tariffs on imports from China if it doesn't.

Efforts to pressure China to revalue its currency come in the broader context of global current account imbalances. The United States has run current account deficits of unprecedented magnitude since 2000; in 2007, this deficit reached $731 billion, about 5 percent of U.S. income. For its part, China has run very large current account surpluses—about $231 billion or 10 percent of its gross domestic product (GDP) in 2007. Moreover, the United States runs its largest bilateral deficit with China: $289 billion in 2007. Many observers conclude from these facts that the U.S. current account deficit is largely a consequence of the bilateral deficit with China and that the bilateral deficit in turn is a consequence of the exchange rate between the dollar and the renminbi.

CHINA MUST REVALUE TO CORRECT GLOBAL IMBALANCES

Advocates of renminbi revaluation assert that the imbalance in U.S.–China trade is a direct consequence of China's exchange-rate policy. Because China pegs its currency to the dollar at an undervalued rate, it reduces the price of Chinese-made products in the U.S. market and raises the price of American products in the Chinese market. Consequently, demand for Chinese goods rises, while demand for American goods falls. Renminbi revaluation would reverse these relative prices, leading to greater demand for American goods, falling demand for Chinese goods, and an adjustment of the trade imbalance.

C. Fred Bergsten develops this argument in detail here. Bergsten argues that the global current account imbalances that are the consequence of Chinese exchange-rate policies pose a serious threat to global economic stability. Adjustment of these imbalances requires exchange-rate realignments wherein the renminbi is revalued by as much as 40 percent against the dollar. And although Bergsten calls for other changes in Chinese practices, he claims that "China's currency policy . . . is thus by far the single most important issue in U.S.–China economic relations."

CHINESE REVALUATION WILL NOT CORRECT GLOBAL IMBALANCES

Others are more skeptical about the need for a change in China's exchange-rate policy and the impact that any such change would have on the U.S. current account deficit. These observers analyze contemporary global imbalances through an economic model that emphasizes cross-national differences in savings and investment rates rather than exchange rates. Within this framework, the U.S. current account deficit is a consequence of a very low national savings rate relative to investment. For the past few years, the U.S. savings rate has been close to zero. In contrast, China's current account surplus is a consequence of a very high national savings rate relative to its investment. Indeed, China saved almost 50 percent of its national income in 2008. Adjustment of the imbalance will thus require changes in these national savings rates. Americans must consume less and save more, and the Chinese must consume more and save less.

Such logic underpins the analysis of David Hale and Lyric Hughes Hale. They suggest that Congress has placed far too much emphasis on the bilateral relationship with China; What matters is the multilateral position. Moreover, focusing on the exchange rate is unwise because a revaluation will not only do little to correct the imbalance but also create a backlash in China. Instead, they advocate a broader range of reforms designed to integrate China more firmly into the global economy. In addition, China must reform its tax system, restructure its corporate and banking sectors, and encourage consumption.

POINTS TO PONDER

1. What industries in China have an interest in an undervalued exchange rate? Does this valuation hurt any group in China?
2. What are the arguments for and against Bergsten's proposition that a revaluation of the renminbi will correct the bilateral trade imbalance?
3. What, if anything, could the U.S. Congress do to reduce the U.S. multilateral current account deficit?
4. How should the burden of adjustment be distributed between surplus and deficit countries?

C. Fred Bergsten

The Dollar and the Renminbi

The Central Role of China in the Global Imbalances

The U.S. global merchandise trade and current account deficits rose to $857 billion in 2006. This amounted to about 6.5 percent of our GDP [gross domestic product], twice the previous record of the middle 1980s and by far the largest deficit ever recorded by a single country.[1] 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, more than 9 percent of its GDP. Its trade surplus has doubled again in the first quarter of 2007, suggesting that its current account deficit will exceed $300 billion in 2007—the largest ever recorded by any country. 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 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 [renminbi] by intervening massively in the foreign exchange markets. It has been buying $15–$20 billion per month for several years to hold its currency down, and its level of intervention jumped to a monthly average of $45 billion in the first quarter of this year.

By keeping its own currency undervalued, China has also deterred a number of other Asian countries from letting their currencies rise very much (if at all) 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 U.S. 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 percent of the dollar's trade-weighted index. The most obvious Asian candidates for sizable currency appreciation in addition to China are Japan, whose currency is also substantially undervalued despite the absence of intervention for over three years, Taiwan, Hong Kong, Singapore, and Malaysia.

China has recently let the RMB rise marginally against the dollar. Since China continues to link its exchange rate to the dollar and the dollar has fallen against virtually all other currencies, however, 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.

The Risks for the U.S. and World Economies

These global imbalances are unsustainable for both international financial and U.S. 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 sell-off 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 U.S. inflation and interest rates, severely affecting the equity and housing markets and potentially triggering a recession. The global imbalances represent the single largest threat to the continued growth and stability of the U.S. and world economies.

The domestic political unsustainability derives from the historical reality that sizable 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 U.S. 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 U.S. 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 U.S. 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, continued failure to correct the currency misalignments could have a devastating impact on the global trading system.

The Policy Implications

It is thus essential to reduce the U.S. and China imbalances by substantial amounts in as orderly a manner as possible. The goal of the global adjustment should be to cut the U.S. global current account deficit to 3–3½ percent of GDP, about half its present level, at which point the ratio of U.S. 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 follow-up, 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 have two crucial payoffs vis-à-vis our external economic position. It would reduce the excess of our domestic spending relative to domestic output, which can only be met by additional net imports, and it would reduce the shortfall of our domestic savings relative to domestic investment, thereby cutting our reliance on the foreign capital inflows that drive up the value of the dollar and undermine our trade competitiveness. 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.[2]

China needs to adopt policies to promote an opposite adjustment, reducing its uniquely high national saving rate by increasing domestic consumption. China can increase domestic spending directly through higher government expenditures on health care, pensions, and education. Such new government programs are needed for purely internal reasons 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 also reduce the precautionary motive for household saving in China; this would boost private as well as government demand, contributing importantly to the needed international adjustment.[3] A number of important Chinese policy goals, such as increasing employment and curbing energy consumption, would also be served by such shifts in the composition of China's growth strategy.[4]

Large changes in exchange rates will also have to be a major component of the adjustment process. The dollar will need to fall, hopefully in a gradual and orderly manner over the next several years, by a trade-weighted average of about 20 percent. A change in China's currency policy, in both the short and longer runs, is thus by far the single most important issue in U.S.–China economic relations.[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 U.S. global current account deficit by about $150 billion per year, more than one third of the total adjustment that is required.

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 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) through whatever technique is most feasible for the Chinese authorities.[9]

A U.S. Strategy for the Renminbi

It is obvious that China is extremely reluctant to make the needed changes in its currency policy. It is equally obvious that U.S. efforts on the issue over the past three years, whether the "quiet diplomacy" of the Administration or the threats of Congressional action, have borne little fruit to date. A new U.S. policy is clearly needed.

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.

I would therefore suggest a new five-part strategy for U.S. 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 alteration" in those practices, but inexplicably failed to draw the obvious conclusion of its own analysis.[11] The latest report, submitted last December, 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 that, if China fails to make a significant "down payment" appreciation of at least 10 percent prior to the release of Treasury's next semiannual report, it will be labeled a "manipulator." This would trigger an explicit U.S. negotiation with China on the currency issue.

Second, the Administration should notify its G-7 [Group of Seven] partners and the IMF [International Monetary Fund] that it plans to make such a designation in the absence of major preventive action by China. These other countries would prefer to avoid a U.S.–China confrontation on the issue and could be brought into a multilateral effort on the issue, reducing its confrontational bilateral character, if they were convinced that the United States was serious about pursuing it. The objective of that international effort, hopefully spearheaded by the IMF,[12] should be a "Plaza II" or "Asian Plaza" agreement that would work out the needed appreciation of all 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.[13] 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 [World Trade Organization] case against China's currency intervention as an export subsidy and/or as a violation of the provision in Article XV (4) that member countries "shall not, by exchange action, frustrate the intent of the provisions of the Agreement." As Chairman Ben Bernanke indicated in his highly publicized speech in Beijing in December 2006, 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.[14]

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 inconvertibility on capital account, so Treasury would have to select the best available proxies in the financial markets. The message of U.S. policy intent would be crystal clear, however, and at a minimum there would be a further sharp increase in 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. (All other undervalued Asian currencies, including the Japanese yen, could be purchased directly, with immediate impact on their exchange rates against the dollar.)[15]

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, about the same level in real terms as its current rate of about 120:1). 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 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 oppose 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 and as long as they are compatible with the rules of the WTO, could hardly be labeled "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 U.S. 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 [U.S. Senate Subcommittee on Security and International Trade and Finance, Committee on Banking, Housing and Urban Affairs] almost two decades ago.

ENDNOTES

1. 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 the full Committee on May 1, 2002.
2. 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.
3. 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.
4. See Daniel H. Rosen and Trevor Houser, "What Drives China's Demand for Energy (and What It Means for the Rest of Us)," in C. Fred Bergsten, Nicholas Lardy, Bates Gill and Derek Mitchell, eds. *The China Balance Sheet in 2007 and Beyond*, Washington: Peter G. Peterson Institute for International Economics and Center for Strategic and International Studies, April 2007.
5. The short-term success of the new Strategic Economic Dialogue [SED] will be judged largely by whether it achieves effective resolution of this problem. The SED 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.

9. This two-step approach was initially proposed by my colleagues Morris Goldstein and Nicholas Lardy, "Two-Stage Currency Reform for China," *Financial Times*, September 12, 2003.
10. See Morris Goldstein, "Paulson's First Challenge," *The International Economy*, Summer 2006.
11. Treasury (and the IMF) has 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. It might be desirable to amend U.S. law, however, by replacing the controversial (and pejorative) term "manipulation" with the unambiguous (and emotionally neutral) term "intervention."
12. Congress could direct Treasury to use the "voice and vote" of the United States to seek effective implementation by the IMF of its existing rules against competitive currency undervaluation.
13. See William R. Cline's "The Case for a New Plaza Agreement," Washington: Institute for International Economics, December 2005.
14. These ideas are 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. 16–24. Congress could require the Administration to bring such a case or cases, once a country was found to be violating its currency obligations, in any legislation that it passed on these issues.
15. Congress could write a requirement for such action, once a country was found to be violating its currency obligations, into legislation on these issues.

David D. Hale and Lyric Hughes Hale

Reconsidering Revaluation: The Wrong Approach to the U.S.–Chinese Trade Imbalance

China's economy has grown dramatically in the last decade: it is more than twice as large as it was ten years ago. This spectacular rise means that Beijing can influence the global economy today in ways that would have been unimaginable in the 1990s—a development that has led to widespread concerns in the United States. Many officials in Washington and small U.S. manufacturing companies allege that Beijing has deliberately undervalued its currency and manipulated markets in order to promote the growth of its exports.

Consequently, many U.S. politicians are clamoring for action to redress China's growing annual trade surplus with the United States, which currently stands at $250 billion. They assume that increasing the value of the yuan against the dollar will simultaneously decrease Chinese exports to the United States by making them more expensive and boost U.S. imports to China by making them cheaper. As the 2008 presidential election [approached], the U.S. Congress [was] actively discussing protectionist legislation and new tariffs that would punish China if its currency does not appreciate faster than the current rate of five percent.

But revaluation—no matter how vehemently it is advocated—is unlikely to achieve the desired result of reducing the U.S. trade imbalance with China. Taxation reform, the restructuring of the corporate and banking sectors, the gradual opening of capital accounts, and the encouragement of domestic consumer spending would each have a more measurable and lasting effect on China's current account surplus. There is also scant reason to believe that Beijing will accept the large-scale revaluation of 20 percent or more sought by certain members of the U.S. Congress. Such a policy could result in fewer exports, lost jobs, and capital flight to other emerging markets with cheaper labor costs, not to mention increased currency speculation and exchange-rate losses on hundreds of billions of dollars worth of U.S. Treasury debt now held by the Chinese government.

In addition, the trade imbalance that a revaluation of the yuan is supposed to fix is not the dire threat that many in Congress have made it out to be. The growing Chinese trade surplus has actually produced numerous benefits for the world economy and for U.S. corporations and consumers. It has handsomely rewarded U.S. companies, such as

Wal-Mart, which have enjoyed record profitability as a result of low labor and production costs in China. Critics forget that China's central bank, the People's Bank of China, uses the surplus to buy U.S. debt, which benefits the U.S. economy, Furthermore, some 27 percent of China's exports are actually generated by U.S.-owned corporations, which pass on their savings to consumers back home.

Simply strengthening the yuan will not correct the U.S.–Chinese trade imbalance, much less bring China's dynamic economy into lasting equilibrium; at best, it is a flawed solution to an ancillary problem. The greater and far more critical challenge is to properly complete China's integration into the global economy. China is but one cog, and revaluation just one lever, in the complex machinery of international trade. Unfortunately, many U.S. politicians with little knowledge of economic theory, trade flows, or investment patterns have not grasped the intricacies of the Chinese economy and its place in the global marketplace. And so they seek a jingoistic, politically popular solution to a complex and multifaceted problem.

The Perils of Revaluation

This is not the first time Washington has sought to intervene in Beijing's monetary affairs. In the early 1930s, President Franklin Roosevelt's administration supported legislation to raise the price of silver in order to both garner support for the New Deal from western senators in silver-producing states and increase U.S. exports to China. But this proved to be a disaster for China, which was then on the silver standard rather than the gold standard. Unlike the rest of the world, China had experienced economic growth during the early years of the Great Depression due to low silver prices and rapid industrialization. The Silver Purchase Act of 1934 compelled China to revalue its currency, decreased its exports by almost 60 percent, and plunged the Chinese economy into chaos—while failing to increase U.S. exports to China. In the twenty-first-century world of highly mobile capital, information, talent, and technology, similar policies of economic containment, such as those currently circulating in Congress, are even more likely to fail.

Nevertheless, Washington remains obsessed with China's exchange-rate policy. Labor unions and second-tier U.S. manufacturing firms insist that China has kept its currency artificially undervalued in order to boost its international competitive position. They point out that China has a trade surplus with the United States equal to nearly two percent of its GDP [gross domestic product], compared with a peak of 1.2 percent for Japan in the 1980s, when the U.S. government last panicked about trade imbalances with Asia.

Washington has already taken punitive action. The U.S. Commerce Department shocked the financial markets on March 30, 2006, by

announcing new trade measures against China's paper industry, potentially opening the door to many more attempts by U.S. companies to block Chinese imports. It introduced duties on Chinese paper imports because of allegations that the paper industry in China benefits from unfair subsidies, such as low tax rates and low-cost loans. This announcement broke with the 23-year-old U.S. policy of treating China as a nonmarket economy not subject to countervailing duties. Before this change, U.S. companies could only file antidumping cases against Chinese firms. The Bush administration's decision to pursue these sanctions reflects the new political mood inside the Beltway.

Washington may have forgotten how its silver policy affected China in the 1930s, but Chinese policymakers remember, and they do not want to undertake another massive revaluation that could produce domestic deflation and cripple exports, leading to massive job losses. Such caution is especially understandable given the experience of other Asian countries that heeded international advice. When China's neighbors followed the International Monetary Fund's prescription to liberalize their financial systems during the 1990s, they experienced a major crisis because of their large current account deficits and huge dollar debts. China was actually on the road to a freely floating exchange rate and full convertibility just prior to the East Asian financial crisis of 1998. But after the meltdown throughout the region, Beijing was convinced that in a world of hedge funds and rampant speculation, it was safer to protect one's currency.

In the aftermath of the Asian crash, there was a risk that China would devalue the yuan, leading to a cascade of other devaluations throughout Asia, which would have deepened the crisis. Instead, China took a long-term view. It exhibited regional leadership and left the yuan alone. After all, it did not really need to take the risk. In fact, due to forced devaluations elsewhere in the region, China's real exchange rate actually appreciated by 30 percent during the crisis. Nevertheless, its exports remained resilient due to high productivity growth. As late as 2002, Beijing continued to resist the temptation to devalue, even though doing so would have been to the country's immediate export advantage. China was unafraid to stand alone; its steadfastness proved to be its first act of global citizenship in the postwar period.

Traditionally, it has been China's banks that have opposed currency revaluation, out of fear that it might damage the financial sector. But today, resistance to a more flexible exchange rate is also coming from interest groups in China, such as industrialists and farmers, who fear losing their competitive edge in the export market. China depends on manufacturing employment for 109 million jobs—compared with the United States' 14 million manufacturing jobs—and the government is naturally concerned that a significant exchange-rate appreciation could reduce manufacturing employment in China: export prices would rise, and markets for cheap

Chinese products abroad could dry up. Some textile companies in the manufacturing hub of Guangdong Province are moving factories to Cambodia and Vietnam because of rapidly rising wages and uncertainty over Beijing's exchange-rate policy. Chinese farmers are also worried in the longer term about international competition now that World Trade Organization agreements have made the Chinese market more porous to imports. These farmers are a potentially powerful constituency given that two thirds of China's population resides in the countryside and increased imports would have a major impact on the developing rural economy.

China's Global Trade Deficit

Unlike many of their counterparts in Washington, officials in Beijing understand that U.S.–Chinese trade imbalances are a function of something much greater than exchange rates or even bilateral trade. Production has become so globally integrated today that very few manufactured goods are actually made in a single country from start to finish. Unlike Japan, for example, China does not have a vertically integrated domestic economy that can produce an entire product line from raw materials to finished goods. Instead, China is the last stop on the global assembly line. It imports components from other Asian countries, completes the manufacturing process, and then exports finished products to the United States. In 2003, intermediate goods produced by companies in Japan, Singapore, South Korea, and Taiwan accounted for 34 percent of all Chinese imports, compared with 18 percent in 1992—and the percentage is probably several points higher today. Also, because China serves essentially as a finishing shop, barely 20 percent of the value of the products it exports is actually captured by the Chinese economy. As a result, although China has a trade surplus with the United States, it has a trade deficit with the rest of Asia. In fact, China's trade deficit with East Asia grew more than threefold, from $39 billion to $130 billion, between 2000 and 2007, just as China's trade surplus with the United States increased nearly threefold, from $90 billion to over $250 billion, during the same period.

As these figures make clear, far too much emphasis has been placed on bilateral issues between the United States and China—rather than on trade imbalances as a global issue. For one thing, they suggest that being on the short end of a trade imbalance is not necessarily an economic liability. China supporters in the United States, including the Club for Growth and a number of academic and Wall Street economists, have warned against anti-China protectionism precisely on the grounds that the Chinese trade surplus is not necessarily such a bad thing for the United States. Ballooning corporate profits have given China a savings surplus, which it recycles into U.S. Treasury securities as part of its foreign exchange reserves. U.S. firms have

also shared in this boom: their profits from business in China rose to over $4 billion this year—50 percent more than a year ago.

Furthermore, as a recent study by the Hong Kong Institute for Monetary Research ([HKIMR,] the think tank of Hong Kong's de facto central bank, the Hong Kong Monetary Authority) shows, the yuan's value is a function of China's overall trade balance, not simply of its surplus vis-à-vis the United States. In fact, the HKIMR researchers argue, currency appreciation would not have the expected effect of decreasing China's exports. It could actually have the opposite effect by decreasing the cost of the imports China needs in order to create finished goods for export to the United States and Europe.

Beyond Revaluation

The real challenge, as Beijing well understands, is helping China integrate its booming economy into the international system. As China's growth rate continues to rise, many in China, including Zhou Xiaochuan, the head of the People's Bank of China, have begun to worry about inflation, which is now at its highest level in 11 years. China's foreign exchange reserves now exceed $1.4 trillion—equal to approximately 50 percent of GDP. During the past two years, the Shanghai stock-market index has risen from 1,000 to 6,000. Last May, the trading volume on the stock markets in Shanghai and Shenzhen exceeded that on all the stock markets of the rest of Asia and Australia combined. Today, China accounts for five percent of all global stock-market activity.

So far, China's monetary policy alone has failed to curtail its very high growth rate, now over 11 percent. The People's Bank of China cannot use one common tool to restrain the stock market, regulating margin debt, which allows investors to use borrowed funds in order to buy stocks: such debt does not exist in China. It has instead responded by steadily increasing bank reserve requirements and nudging up interest rates. But if it raises interest rates sharply, it could attract capital inflows from foreign investors, which would bolster the currency. Higher interest rates could also keep even more Chinese money at home. Neither outcome would slow down the economy. Chinese policymakers will therefore need to look beyond monetary policy and focus instead on reforming tax laws, increasing consumer spending, encouraging capital outflows, and changing the regulations governing Chinese corporations.

China traditionally refunded to producers the 17 percent value-added tax (VAT) on production inputs that was paid on exports. But last June, it announced that it would phase out the VAT rebates on 25 percent of the products it exports. It has eliminated rebates on energy-intensive goods such as coal, refined copper, primary aluminum, crude steel, and activated carbon, all of which are produced in industries suffering from overinvestment. China will maintain the VAT rebates on higher-value-added products, such as machinery, because it regards them as the locomotive for growth in the future.

Due to its growing domestic market and the sheer scale of its manufacturing activities, China has managed to accrue corporate and government savings at an unprecedented rate. But the transition to capitalism has been rocky and imperfect. China's failure to pay corporate dividends has swollen corporate treasuries, leading to a cycle of overinvestment in capital equipment and to a form of corporate speculation on the stock market that is similar to the Japanese practice of using surplus capital for short-term, high-risk investing, known as Zaitekku. A change in the regulations governing Chinese corporations that would force them to pay dividends to all shareholders would cure a major distortion.

Ultimately, China will also have to shift to a new policy that boosts domestic consumption and reduces the country's dependence on exports. Consumer spending has not kept pace with overall GDP growth: its share of GDP has slumped from 50 percent in the 1980s to 36 percent today. Consumption has been eclipsed by huge gains in capital spending and exports. The government has made some moves to increase consumer spending, such as introducing measures abolishing the taxation of farmers and increasing government spending on health care and education. Nevertheless, Chinese households still have the world's highest savings rate—between 23 and 25 percent. This is because the country's social safety net remains so inadequate that many people save more in order to pay for education, health care, and retirement. Ironically, to decrease the household savings rate and boost consumer spending, the government will have to reinstate some socialist policies that disappeared in the 1990s.

Beijing is also trying to slow the growth of its foreign exchange reserves by encouraging more capital outflows. Last May, Beijing changed the rules in this area, permitting Chinese special investment funds to invest in foreign equities and foreign firms to invest in Chinese equities. The change produced an immediate rally on the Hong Kong exchange, where Chinese institutions routinely buy "H" shares, shares of Chinese companies approved for listing in Hong Kong. (These sell at a significant discount compared with similar shares on the Shanghai exchange due to lower retail demand and a smaller market.) The Chinese government magnified the rally by announcing that it would give Chinese citizens more freedom to purchase Hong Kong equities and allow mutual funds to invest in a wider range of foreign markets. China hopes that this strategy of encouraging capital outflows will succeed in the same way that it did in Japan a few years ago—by reducing bloated foreign exchange reserves and bringing the economy into lasting equilibrium.

A Global Player

Despite Beijing's understandable reluctance to cave in to U.S. demands, the odds are good that China will eventually change tack and allow its exchange rate to appreciate more rapidly due to political pressure from Washington. But exchange-rate appreciation will have a far less significant impact on China's trade surplus than the economic policy changes China is already pursuing. For the past 30 years, China has been engaged in a complex process of integration into the world economy. No matter how many sensible economic reforms are implemented in Beijing, much of the burden for integrating China into the global economy will fall on the international community. And this process will require more than unilateral efforts by the United States to protect its own interests; it should instead be approached as a multilateral issue that will affect almost every nation on earth.

The time has come for a broad international effort to integrate China into the global economy. The United States should reform the traditional G-8 [Group of Eight] summits to include China as its ninth member. The G-7 ([Group of Seven,] the group of highly industrialized states) admitted Russia during the late 1990s, and China is a far more important economic player now than Russia was then. Indeed, there cannot be a serious discussion of global economic issues without the active participation of Beijing. The admission of China to the G-8 process would create a major global forum in which the leading industrialized countries could discuss the impact of China's export boom on other nations' economies and address the environmental impact of Beijing's growing demand for commodity imports and energy resources. In the end, only a skillful combination of structural reforms in China and coordinated multilateral efforts will create a more balanced economic relationship between Washington and Beijing.

PART V
DEVELOPMENT IN THE GLOBAL ECONOMY

Do developing societies benefit from participating in the global economy? Do they experience more rapid growth if they actively manage their participation in the global economy or if they simply open their borders and allow the global market to work? This basic question—Is development best promoted by markets or by the state?—has been at the center of the debate over development since at least 1950. The last twenty-five years have brought a dramatic shift in government orientations. The state played the central role and international markets a much smaller role in development strategies until the early 1980s. Today, the state's role is greatly reduced, and the role of markets is greatly enhanced. Has this change in the relative importance of the state and the markets been good for development, or would developing societies realize more rapid progress with a more active state role? Each chapter in this part looks at this question in a different context.

Chapter 12 takes a close look at the relationship between participation in the international trade system and participation in the economic growth. Since the mid-1980s, governments in developing societies have opted to integrate their economies into the global trade system. This strategy is quite distinct from the policy of the post–World War II period, when governments sought to develop by insulating themselves from the global trade system. The shift toward development strategies based on trade openness has generated a debate about the relationship among trade, economic development, and poverty reduction. David Dollar and Aart Kraay argue that trade boosts development and provides income gains that are distributed widely across society. In short, trade reduces poverty. Dani Rodrik argues that trade is not a "magic bullet" for development. There is little evidence, he argues, to support the claim that trade openness, by itself, is a recipe for sustained growth.

Chapter 13 considers the debate over the impact of foreign aid on the least developed societies. Policy makers have long believed that development requires investment and that developing economies lack the savings required to finance the needed investment. Governments