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The Political Economy of Asian Exchange Rates
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Thank you. It is a pleasure to be here at this very timely conference sponsored by CSIS and JEF. Economic developments in China are crucial to both of our countries, and to a resumption of global growth. Much of this conference is appropriately concerned with the issue of the exchange rate policy of the People's Republic of China. An assessment of that policy is the focus of my remarks.

Let me begin in a very American fashion -- with the bottom line. It is difficult for me to see how a sustained period of rapid and stable global economic growth, particularly in Japan and America, can occur under the current exchange rate regime in China. At the same time, the current Chinese exchange rate regime is deeply embedded, reflecting some fundamental weaknesses in the Chinese political and economic system. As a result, the much needed switch to a flexible exchange rate regime is unlikely to occur in the near future.

The current global cyclical rebound is driven primarily by a timely and appropriate fiscal and monetary policy in America. A similar recovery may be in its early stages in Japan, reflecting in part a change in monetary and foreign exchange policy that began in April. What is in question is whether that cyclical rebound will continue and be sufficient to generate sustained global growth.

Sustained economic growth requires a resumption of investment spending by corporations. Corporations in both Japan and America have suffered from a collapse in the asset values that underpinned their balance sheets. A premium is being placed on balance sheet repair. Free cash flow is being channeled into such balance sheet repair and not into business fixed investment.

Underpinning this focus on balance sheet repair is a perceived lack of pricing power and therefore of profitability for internationally traded goods. Economic science is not far enough advanced to know what the “tipping point” of perceived profitability is in corporate decision to cause a redirection of funds into fixed investment from balance sheet repair into new investment projects.

China affects this decision by offering itself as a low cost producer of many internationally marketed products. Its economy offers two attractive features: low labor costs and a large overhang of capital that was woefully mismanaged during that country’s totalitarian past. The addition of this labor and capital to the global marketplace naturally is putting downward pressure on the returns earned by those in the market before China entered.

Of course, the addition of China to the global economy is a development that both Japan and America welcome. In large part, our countries take this view in the belief that Chinese prosperity and participation in the world economy is the best path to preserving peace in East Asia and the Pacific generally. We also enjoy a material gain from Chinese participation. The real incomes of Japanese and American workers are enhanced by access to low cost Chinese made products.

More important to the future is the issue of productivity differentials. Due to its lower stage of development and the ability to “catch up”, productivity growth in China has outpaced productivity in both the U.S. and Japan. For example, Chinese annual productivity growth has exceeded America’s by 5 percent a year since 1994. Other things equal, Chinese produced products will enjoy an ever increasing advantage over those made in America or Japan.

This is where Chinese exchange rate policy, instituted in 1994, becomes critical. In market economies other things are not equal. Prices change. To maintain a stable competitive equilibrium, the Chinese currency, the Renminbi, would appreciate relative to the dollar and the Yen due to the difference in productivity growth rates. In a fixed exchange rate regime, this cannot happen. So, in effect, America finds itself locked into a currency zone -- and therefore a set of prices -- with a country that will be enjoying an ever widening cost advantage as time goes on.

The challenge for Japan is even more dramatic in an environment in which capital flows are causing the Yen to appreciate. Not only must Japan cope with the normal deflationary and competitive forces from China, its manufacturers and other exporters face the additional deflationary pressures of an appreciating currency. We all recognize that efforts to stabilize the dollar-Yen exchange rate were really efforts stabilize the Yen-Renminbi exchange rate and prevent the added deflationary pressure that results.

The challenge that fixed exchange rates pose in a world characterized by economic development and differential productivity growth has long been recognized by the economics profession. The Bretton Woods system of fixed exchange rates broke down,

in large part, because the naturally more rapid productivity growth in the rebuilding economies of Europe and Japan made a fixed exchange rate untenable with America and Britain with their largely undamaged infrastructures after World War II.

Immediately after the War, setting up a fixed exchange rate regime actually facilitated the key global economic strategy of rebuilding those economies. Capital and investment naturally flowed to those areas with the high returns offered by the need to rebuild. A highly competitive export sector was the natural way to obtain this needed capital in Japan and Europe, and a fixed exchange rate provided the tools.

But the needs for post-War rebuilding gave way to a peaceful and rapidly reindustrialized global trading system. The fixed exchange rate system was untenable in such a world. Bretton Woods coped by allowing periodic revaluations by countries like Germany and periodic devaluations by countries like Britain. But these bureaucratically sanctioned and internationally negotiated exchange rate changes were far from efficient and did not keep up with the realities of economics and markets.

Equally important, they created opportunities for highly profitable speculative gains. Markets could easily predict the intermediate term direction of currencies because they were driven by economic fundamentals. Over time, institutional and bureaucratic resistance to the inevitable exchange rate adjustments became untenable and large speculative flows took advantage of the situation. Periodic currency crises were the result.

Today we all recognize that any modern large economy that is truly part of the global trading system must have a flexible exchange rate policy. Yet, one of the fastest growing economies of the world does not, and it is wreaking havoc. By some estimates, China accounts for 10 percent of global economic growth and several times that in terms of growth of global trade, although its economy is only about 4 percent of the world's total in dollar terms. Moreover, its decision to maintain a fixed exchange rate is not governed by international agreement, like Bretton Woods, but by a unilateral judgment of its government.

We must all be clear both with ourselves, and in our nations' dealings with China, that this unilateral judgment to maintain a fixed exchange rate carries the implication that China does not view itself as a full member of the global economic community. It is not yet willing to take on the rights and responsibilities of a great nation, as we understand them at the dawn of the 21st century, although it aspires to be one.

A fixed exchange rate means that, as capital controls grow ineffective, a country cannot maintain an independent monetary policy. Instead, its monetary policy must react to the monetary policy of the country to which it is pegged. In effect, the monetary policy of the world's most populous nation -- one that actually invented paper money -- is made several blocks from where we are now assembled, at the corner of Constitution Avenue and 20th St. Surely a truly great nation would not assign responsibility for such an important aspect of its sovereignty to another country.

Indeed, China's self-imposed decision to maintain a fixed exchange rate regime says much about its self image. It is saying that it is more like the war ravaged nations of the

world in 1946 -- dependent upon others for economic survival -- than it is like the rapidly modernizing and peaceful image of a nation that it tries to project to the world and to the Chinese people.

There are, I believe, three fundamental reasons why China is refusing, and probably will continue to refuse, to adopt a flexible exchange rate. Each is a sign of economic and political immaturity. Those of us in nations that participate on a normal basis in the global trading community should take heed of these signs. It is not we who are pointing out these weaknesses and lack of maturity, but the government of China itself by maintaining a fixed exchange rate. We should govern our business, economic, and international relations with China accordingly.

First, China's fixed exchange rate is dependant on strict capital controls. One of the hallmarks of a modern economy is the ability of capital to move freely both within a country and outside the country. When this exists, a fixed exchange rate ultimately becomes untenable since markets, not bureaucracies, determine the supply and demand for a currency. It is of course the sovereign right of China to maintain its very tight regime of capital controls. But it does say that the Chinese government itself does not believe that it is capable of allowing market participants -- including those who do business in China -- to freely move their capital about the world.

This, in turn, says a great deal about the true nature of property rights in China. If one cannot move one's capital about without bureaucratic approval, then the ownership of that capital is attenuated, at best. Global businesses should be cognizant of that fact. China claims to be desirous of global capital, yet this is not a desire based on a wish to

establish a long term business relationship of mutual benefit. Rather, it is a desire to bring capital into its territory where that capital becomes subject to its bureaucratic control. Repatriation of that capital is not at the discretion of the provider and nominal owner of that capital, nor is repatriation of the profits earned.

Indeed, this attitude is reflective of China's view of the rule of law and contracts generally. As many businessmen will tell you, contracts are frequently renegotiated on a unilateral basis and the intellectual property protections we take for granted under the rule of law do not exist. Again, it is China's sovereign right to set the rules of the game within its own territory. But, we should be cognizant of the signal that sends regarding China's true interests in establishing business relationships. They are short term and subject to change by the unilateral determination of the Chinese government. Our businesses should invest accordingly.

The second weakness revealed by the maintenance of a fixed exchange rate is the inability to actually conduct an independent discretionary macroeconomic policy. As I mentioned, a fixed exchange rate ultimately means that Chinese monetary policy will be determined by the Fed. Now, as a former Fed governor I should state quite clearly that I believe the Chinese couldn't have picked a better institution to run monetary policy. The Fed does an outstanding job.

But, of necessity, the Federal Reserve must make monetary policy based on the perceived economic needs of the United States and the 12 Federal Reserve Districts within the United States. China does not have a seat at the table. The Fed cannot and should not make its decisions based on the perceived economic needs of China. So, a

decision by the Chinese government to let the Fed run its long term monetary policy necessarily means that it does not think itself capable of performing that task.

Underpinning this is the problem of data. Economic information is always imperfect. Here in America we make revisions to our National Income Accounts that at times completely change our view of the economy. So, perfection in data is not the standard by which a nation's statistical infrastructure should be judged. Indeed, the problem with China's statistics is that they are too perfect -- and therefore likely to be wrong. Consider, for example, the recent growth estimates published by the Chinese government for the nation's Gross Domestic Product. In 2000, the economy grew 8.0 percent. In 2001, it grew 7.5 percent. In 2002, it grew 8.0 percent. In the first half of 2003 it grew by an odd 8.2 percent, but it still may come in at a nice round number for the entire year.

This is a genuinely remarkable set of statistics which suggest one of two possibilities. The first possibility is that the statistics are accurate. If this is true, then the Federal Reserve is, inadvertently, doing a fabulous job managing the Chinese economy. The second, and more likely, possibility is that these data are statistically worthless as they give no indication of what is actually happening in the Chinese economy.

The lack of good statistical infrastructure is a major weakness for the Chinese economy. It is a legacy of China's recent past as a command and control economy. The incentive structure in such economies is to report data that adheres to plan, whether such data is accurate or not. In short, the statistical base is not based on *information*, but on *misinformation*. Basing policies on such data is not just worthless, it is actually

counterproductive -- like chasing a mirage in a desert. Chasing the mirage involves an expenditure of time and energy that could be better devoted to other efforts and objectives.

Indeed, the use of the dollar peg to guide monetary policy is a tacit indication that the Chinese leadership recognizes the weakness of its data system. It provides some realistic fact on which to run policy. If the Chinese are tacitly recognizing this, so should we. Our businesses and government agencies should not base their policies on reported Chinese data. Inward investment and plans for profiting from the so-called "China market" is occurring in a statistical fog. Businesses should substantially raise the risk premia they associate with such business plans.

The final weakness revealed by the fixed exchange rate is a political one. It goes without saying that the current Chinese exchange rate policy is mercantilist in nature. What is less understood is that mercantilism has an underlying political imperative that goes back to the original mercantilist policy practitioners like Colbert, who was Louis XIV's economic adviser.

The objective of Colbert, and Louis XIV, was not to enhance the well being of the people of France, but of the French state. And, as Louis famously stated, *l'état c'est moi*. Mercantilism works to that end by accumulating wealth and purchasing power in the hands of the government. Then, as now, wealth in the hands of the state was viewed as increasing the state's ability to wage war by purchasing the armies and armaments.

Adam Smith reacted to this perception in The Wealth of Nations by stating that it was the productive power of the country as a whole, not the finances of the state, that determined true economic well being. It is natural for a government to adopt a mercantilist perception of national well being. After all, here in Washington we often confuse the well being of the country with the size of the government's surplus or deficit. But as Adam Smith, John Maynard Keynes, and Milton Friedman would all argue, that perception may be natural, but is wrong.

The objective of mercantilism is fundamentally not economic in nature as we understand that term. It is political. It is designed to enhance the power of the state. Under Chinese mercantilist policies, the state accumulates wealth in the form of highly liquid assets including U.S. Treasury and agency debt. The losers are the peasants and workers who are paid wages in a currency that has a purchasing power value that is deliberately kept low.

In democratic countries with floating exchange rates there is also a political dimension to foreign exchange policy. Producers, particularly exporters and those who compete with imports, tend to favor lower exchange rates. Although less politically organized, consumers tend to benefit from a higher exchange rate. So, in a democratic country, political debates about foreign exchange policies are between different elements in the population, they are not between the state and the population.

In China, political decisions are made by the bureaucratic and military elite that controls the state without any accountability to the people. The Chinese state not only has the same vested interest in mercantilism as Louis XIV, it also has the same interest as

exporters generally as elements of the state, particularly the army, own some of the leading exporting firms. So, the maintenance of a fixed exchange rate also symbolizes an inherent political fact about China: economic policies are made in the interests of the state and the elements that make it up, not in the interests of the economy or the population more generally. We should view this as a fundamental weakness -- or immaturity -- in Chinese political and economic development, but of course it is the sovereign right of the Chinese state to have a different view.

In sum, I would like to emphasize a need for a realistic assessment of the foreign exchange situation in Asia. There is no question that global economic development and growth would be greatly enhanced by a floating Chinese exchange rate. The status quo is unsustainable. But it is equally true that the Chinese themselves do not view themselves, their economy, and their political structure, as sufficiently mature to handle the rigors of a market determined exchange rate.

They lack the confidence to allow the free mobility of capital and the ownership and property rights this entails. They lack the statistical base and the fact based reporting system to intelligently manage an independent macroeconomic policy. Moreover, they lack the political accountability that we take for granted that would incline decision makers to look out for the wealth of the nation, and not the power of the state.

We should therefore not expect a change in Chinese exchange rate policy to occur without further development and sophistication in these other aspects of Chinese political and economic life. Sadly, there is little we can do about this. But we can

recognize what the Chinese themselves are admitting about their political and economic system.

Our decision makers should take this lack of political and economic maturity into account and be as realistic as the Chinese government. This does not mean we should punish America's middle and working class with tariffs, as some are now proposing. It does mean that those with long term fiduciary responsibility to corporate shareholders should carefully consider whether or not they have fully accounted for all the risks in doing business with China. I suspect many have not.

There are a natural set of questions any firm should ask about any business partner. Can that partner be trusted to stick to a contract? Are the economic and business facts presented by that partner in negotiations ones that can be trusted? Is that partner interested in a long term business relationship or just grabbing as much benefit it can in the short run? If the answers to these questions are unsatisfactory, then one should use great caution before committing capital to any venture or making ones own business dependent upon the prospective partner.

Much of our modern global economy is based on a set of operating assumptions about how one acts and how we expect our partners to act. We should be clear about these expectations. One of these expectations is that China rapidly act to overcome the weaknesses that prevent it from allowing its currency to float. A floating exchange rate is not the sine qua non of the modern economy, but it is reflective of certain other conditions that are: capital mobility, informative data, and policy that focuses on the well being of the people of a nation, and not on the well being of the state.

If we adopt this attitude, then the government of China will come to recognize that becoming a part of the modern global economy entails responsibilities as well as rights, and will be able to make a more informed and realistic decision about their exchange rate, and about other aspects of their economy and national life.