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On the Issues

Market Comrades

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While China recently announced that it will adopt a more flexible currency valuation, its long-term economic growth depends largely upon promoting more efficient saving and investment.

Ceremonial gift-giving is an integral part of doing business in China. The value lies not so much in the gift (whose packaging is often more elaborate), but in the possibility of cementing a mutually beneficial relationship.

And so it was a few weeks ago with the headline-grabbing announcement that China would revalue the yuan against the U.S. dollar. The modest gesture may make more possible a comprehensive economic dialogue between China and the United States in the interest of both nations.

The announcement on July 21 by the People's Bank of China that it would revalue the yuan, abandoning the eleven-year-old peg of 8.28 yuan per U.S. dollar, caught financial markets by surprise. The jolt led market participants to gauge effects of current (and perhaps future) revaluations on currency values and interest rates. And, some U.S. political leaders claimed a victory in the campaign to blame Chinese "market manipulation" for external imbalances facing the United States.

But there is a bigger story here. The July 21 announcement opens with this statement of purposes: "With a view to establish and improve the *socialist market economic system* in China, enable the market to fully play its role in resource allocation as well as put in place and further strengthen the managed floating exchange rate regime *based on market supply and demand. . . .*" (emphasis added). The inherent conflicts in the phrases—"socialist market economic system," and "market supply and demand" with capital controls and a managed float—highlight both the central economic challenges facing China and the need for a comprehensive U.S. economic policy toward China.

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China's Economic Challenges

On the one hand, China's hesitancy to give up its currency stability is understandable. Currency stability contributed to confidence by foreign investors to build capacity in China and stimulated an export-led surge in growth that has established China's place in the world economic firmament. Now the world's seventh-largest economy (using market exchange rates), China's GDP has more than quintupled in the past twenty-five years. And the per-capita income of China—less than that of Ghana or Nigeria twenty-five years ago—is now comparable to that of the Philippines. Chinese poverty has declined significantly, and life expectancy and literacy have improved with the fast pace of economic growth.

On the other hand, the currency peg likely has led to some capacity growth that may be uneconomic in the longer run (to the extent that the yuan was or is undervalued), and the peg limits the ability of Chinese monetary policy to cool an overheating economy except through blunt administrative controls. For an economy whose

second-quarter GDP growth (announced the day before the revaluation) topped 9.5 percent, this question is a live one.

The revaluation of the yuan will restrain Chinese exports a bit. But this shift will have only a negligible effect on the current account deficit of the United States, so long as U.S. national saving and investment are not much affected. In that sense, the strident emphasis on the yuan's foreign-exchange value by mercantilists in the U.S. Congress is a red herring.

The bigger danger of focusing on currency valuation is that it will distract attention from the real question for China: how to promote efficient saving and investment. Improving this efficiency will make China better off—the reason it should be on the minds of Chinese economic officials.

Sustained economic growth requires a financial system that promotes efficiency in the allocation of capital, rewarding savers and allowing the most promising entrepreneurs to achieve success. Centrally directed credit allocation can promote high rates of saving, investment, and growth for a period of time, but directed credit is no substitute for the market. Japan's stumble in the 1990s as U.S. growth rose tells a cautionary tale of the advantages of a flexible economy with strong financial markets in advancing productivity growth and living standards.

China's national saving rate is extraordinary; estimated at more than 40 percent of GDP, it exceeds the high saving rate of Japan in its period of postwar development. This high saving rate is driven in part by demographic considerations, with rising life expectancy and an aging society with fewer workers per older individual in the future. But the Chinese financial system also contributes to high rates of saving, with poorly developed markets for consumer finance, home mortgages, and insurance. And "precautionary saving" is high in China, as the public safety net for retirement, illness and disability, and unemployment insurance is weak.

Estimated at about 50 percent of GDP, the Chinese fixed-investment rate is also extraordinary. This high rate of investment bespeaks industrial development and infrastructure in highways, telecommunications, and transport facilities, as any frequent visitor to China knows.

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Here is where Chinese officials increasingly confront the conflicts of the "socialist market economy" phrase. *If sustained*, China's rapid economic growth will continue to enhance its role on the world stage, rivaling Japan by mid-century and eventually the United States and the European Union in the second half of the century. But that "if" should not be taken lightly.

In spite of China's accomplishments in raising living standards, its government-dominated banking system allocates credit poorly, and bank dominance combined with gaps in investor protection have impeded the growth of domestic capital markets. Indeed, many Western economists believe that the Chinese banking system as a whole is insolvent, with nonperforming loans possibly as large as 40 percent of GDP. Correcting this problem will be more difficult than banking cleanups in the United States and Japan both because of the scale of Chinese nonperforming loans and because of the greater cost in a poorer economy of diverting resources toward financial restructuring.

By favoring administrative fiat over well-functioning financial markets, China is sowing the seeds of lower productivity growth and economic growth in the future. At about 50 percent of GDP, China's fixed investment is almost certainly well above its efficient level, nearly three times that of the United States and twice that of India or the average ratio for lower-middle-income countries collectively.

Now one might observe that Chinese officials should focus only on the short run, given the need to grow sufficiently rapidly to absorb tens of millions of underemployed rural workers in more bustling cities. But the accumulation of large amounts of unproductive and poorly allocated capital only sets up a day of reckoning, with potentially devastating consequences for investment, output, and employment. To ignore this political reckoning would be a significant blunder.

How the United States Should Respond

China has much to gain from improving the efficiency of its economic growth. The United States has a strong interest, too—one which should promote an exhaustive dialogue with China on economic policy. Absent reforms, surplus saving from China and other emerging

Asian economies will exacerbate U.S. external imbalances and distort allocation of capital in the United States. And the possibility of a significant correction in China in the medium run should focus American policymakers more than the protectionist rumblings in some congressional quarters.

The U.S.-Japan economic dialogue suggests constructive avenues of engagement—encouraging market liberalization, capital-market reform, cleanup of the banking system, and improved corporate governance—as well as discussions of exchange-rate policy. Particularly in recent years, such discussions between the United States and Japan have led to structural transformations benefiting Japan and the world economy. These shifts have occurred not because of American pressure, but because of the Japanese government's belief that such changes will advance Japanese growth and living standards.

The Bush administration has constructively engaged China in matters of economic reform. But the public focus on the exchange rate muddies the waters. Policies to strengthen capital markets will lead to greater domestic demand by Chinese households and an improvement in the quality of investment by Chinese firms. And U.S. assistance in designing social insurance programs can help China manage its transition to a market economy.

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China's announcement is the modest ceremonial gift that can deepen our economic ties. We should respond with a policy dialogue that is good for China and for us.

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