

Confronting China's bureaucracy on its own terms

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The Chinese government's recent decision to change its currency regime left markets and government officials scratching their heads. It combined a token revaluation of 2 per cent with a band mechanism for further currency movement and the establishment of a basket of currencies as a benchmark. Transparent it was not, leaving key questions unanswered.

In hindsight, two conclusions emerge about decision-making processes in China that the west would be wise to incorporate into its thinking. First, the solution had all the hallmarks of a classic bureaucratic compromise. In Washington, the standard "decision memo" written by the bureaucracy has three options. The first is a version of "do too much", the last is the equivalent of "do too little". The decision-maker is naturally driven to pick the middle option.

Within the Chinese bureaucracy there were certainly elements advocating a significant revaluation of the renminbi – mainly those responsible for financial and monetary issues, and the ones most likely to have regular conversations with western counterparts. This was one reason US officials with these responsibilities were confident that the Chinese would move.

There were also elements of China's bureaucracy that opposed any move. These groups had primary responsibility for agriculture and for managing the consequences of urban-rural disparities. The biggest potential effect on bilateral trade of a significant revaluation was not in manufactured exports but in agriculture, in which China is hugely inefficient and is rapidly shedding workers. This movement of workers to the cities from the countryside would be exacerbated by a sharp drop in the relative price of imported food.

The result was the middle option – a move so small as to be unlikely to change much of anything in the short run. For the bureaucracy, though, this new regime provides a growing number of levers with which to manage their currency's value. In our efforts to negotiate with the Chinese, we should recognise the nature of our adversary. It is a bureaucratic state with multiple objectives, but one that will reach a unified stand designed to enhance its own interests.

The second fact is that the Chinese do not seem to care much about the highly public efforts in the US to change their behaviour. There is little doubt they benefited from behind-the-scenes technical assistance provided by the US Treasury and Federal Reserve. But the token nature of the actual revaluation can be viewed as antithetical to all the related political posturing in Washington. It is important to understand why this is the case.

Consider for example the bill by Charles Schumer, which gained a two-thirds majority in the US Senate on a procedural vote. The senator's bill proposes dramatic action – a 27.5 per cent tariff on all Chinese imports – but gives the US president two chances to postpone the tariffs a total of two years. The president would almost certainly opt for a delay, which of course gives his critics two opportunities to attack him for inaction. Worse, it creates the appearance to the Chinese of the president having publicly to back down before them at the negotiating table.

From China's perspective, the apparent seriousness of America's intent has also been undermined by delays in key US appointments. In particular, the office with primary responsibility on the currency issue, the under-secretary of Treasury for international finance, was left vacant for months. Until very recently, Timothy Adams, the nominee for the post, was, like all Treasury nominees, blocked in the Senate over concerns with the timing of Cuban payments for agriculture imports from America. This naturally signals to the Chinese that US concern over its \$190bn (€154bn) trade deficit with China is secondary to its concern over \$380m of agriculture exports to Cuba.

Even the congressional vote to stop CNOOC's bid for Unocal seemed unconnected to the broader set of US economic disputes with China. There was no effort to link them rhetorically. Moreover, the Chinese might rightly wonder how the US can push for freer markets and less political control of trade on one hand, while actively intervening politically on another matter.

In the end, it is impossible for the US system to negotiate on Chinese terms. But we should be mindful of how Beijing is likely to interpret US domestic politics. One approach with tactical negotiating merit recently passed the US House of Representatives. The bill would allow US companies harmed by Chinese behaviour more scope to sue for damages in the courts. This has the clear advantage of fighting on their terms; using individual and specialised rules and procedures to enhance the negotiating power of our side. On the other hand, it does not offer a comprehensive solution to the Chinese currency challenge or to the bigger challenge of US competitiveness. A better solution would be to set duties on Chinese imports equal to the expected appreciation of the renminbi in the non-deliverable forward market. This would let global financial markets pull the currency to its appropriate value and force China to convince the world when its currency was properly valued.

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