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COMMENTARY

Yuan Compromise?

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President Bush and Chinese President Hu Jintao will have a lot to talk about at their meeting in Washington later this month. China has quietly joined the U.S. as a superpower whose efforts are essential to maintain global peace and security -- a fact evident in the efforts to meet the challenges posed by the nuclear ambitions of rogue states like North Korea and Iran. Contentious as they are, however, these issues are easier ones on which to find common ground than the central economic question of the proper value of China's currency. This seems odd at first blush, since the exchange rate is simply a number, and numbers are usually easy to compromise on -- by splitting the difference, for example. Not this time. Behind the currency issue, each nation has a strongly felt principle, and compromise on it will not be easy to achieve.

In China's case the matter of principle is continued control of the process of economic development by the government and the Communist Party. In America's case it is whether markets or government policies will be the fundamental drivers of global trade. This is quite different from the traditional debate over whether America gains economically from trade; it clearly does. But under an exchange rate fixed by Chinese authorities and not the market, it is the Chinese government that implicitly decides who in America benefits from our trade relationship: consumers or producers, borrowers or lenders. American sensibilities hold that this is a matter best left to the market.

The Wall Street Journal has argued the case for fixed exchange rates for countries like China as an important check on monetary policy. Under this line of reasoning, internal market forces can efficiently set relative prices. For example, labor and product markets determine that it takes 1,000 hours of paid labor to buy a car. But if there is no external anchor, a central bank could run monetary policy to have a worker make $20 an hour and buy a $20,000 car, or earn $2,000 an hour and buy a $2 million car, with very different implications for efficient functioning of markets. Since good data are hard to come by in a developing country, even a well-intentioned central bank could easily make a mistake and produce an inflationary spiral. And of course, central banks might not always have the best of intentions. Under this analysis, the efficiency and economic freedom of having the market set relative prices is protected from central bank mischief by forcing the central bank to run a monetary policy that is anchored globally by a fixed exchange rate.

The problem with this reasoning in China's case is that the market does not set relative prices domestically. As the largest employer, the state plays a key role in determining wages. It controls (or attempts to) the movement of people from the low-paying countryside to the high-paying cities, thereby blocking the market mechanism from working. It determines how many engineers, doctors and factory workers will be educated, who those engineers will be, and where they will be assigned, at least initially. It directly administers prices for a wide array of products and subsidizes those companies that cannot economically produce and sell their output at those given prices using the administered prices of inputs that the state makes available.

In this environment, a fixed exchange rate doesn't protect market-determined prices from state mischief perpetrated by the central bank. Instead, it protects state mischief in setting administered prices from the rigors of the price mechanism set in international markets. The Chinese authorities are intent on maintaining a fixed exchange rate not to provide discipline to the People's Bank of China, but to maintain state control of the economy. This is a matter of principle that China finds it difficult to compromise on under its current political system.

America, however, benefits from this arrangement. The Chinese clearly undervalue their exchange rate. This means American consumers are able to buy goods at an artificially low price, making them winners. In order to maintain this arrangement, the People's Bank of China must buy excess dollars, and has accumulated nearly $1 trillion of reserves. Since it has no domestic use for them, it turns around and lends them back to America in our Treasury, corporate and housing loan markets. This means that both Treasury borrowing costs and mortgage interest rates are lower than they otherwise would be. American homeowners and taxpayers are winners as a result.

There are losers, of course, most notably American producers of goods that are now made in China. Yet the losses to these producers are outweighed by the benefits from Chinese subsidies of our imports of consumer goods and the reductions in our borrowing costs from generous Chinese lending. Though correct, in politics these gains are now beside the point.

The matter of principle on which the American political process is now becoming focused is that it is the Chinese government, not our political process or the independent determination of markets, that is determining the result. We are buying more tee shirts, shoes and appliances and living in larger homes than we otherwise would because of a Chinese government decision. We are producing fewer appliances and less agricultural output than the market would have us make as well, thanks to a decision by the Chinese government. It does no good to tell American politicians that if the Chinese want to subsidize us we should let them, because the very fact of their subsidy changes our behavior in a way determined by them, not by us.

When Mr. Hu visits America, he will do his best to diffuse tensions about the U.S. current account deficit, which he sees as the basis of our concern about his currency policies. He will argue that our current account deficit is largely determined by the fact that we consume too much and save too little. Many American economists will echo this sentiment. But it is disingenuous for Mr. Hu to make this argument since it is his policies that subsidize both our consumption and our borrowing by lowering the prices of these activities. And, in America, unlike in China, it is market-determined relative prices that drive economic decision-making.

If history is any guide, Mr. Hu will also attempt to mollify the political process -- and reduce the current account deficit -- by announcing a Chinese government shopping spree. He may buy more Boeing jets and maybe even GM cars in a high-profile attempt to curry favor with key constituents. That is nice, but it does nothing about the fundamental matter of principle that it is the Chinese government, not markets, and not Americans, who are shaping how much is bought and from whom. This puts Mr. Bush in a box. He confronts a need to work with Mr. Hu on making the world a safer and more secure place, but also a domestic political process that is willing to risk our trading relationship with China on a deeply felt matter of principle. Mr. Bush is a man who likes to act on deeply held matters of principle, and to the maximum extent it is prudent, he should do so in this case.

Later this year as the election approaches, the political pressure on the China trade issue is only going to become more difficult. As long as this remains a matter of conflicting principles between China and the U.S., legislation seems likely to pass the Congress before November. The final bill would doubtless be designed to inflict maximum damage on China at minimum cost to the U.S. The best thing Mr. Bush can do in his talks with Mr. Hu is to make clear that it is a matter of principle with us, a fact the Chinese do not seem to understand. By resisting revaluation, Mr. Hu is making China poorer in order to maintain the principle of communist control of the economy and so understands that leaders often must act on principle.

The only way out of this dilemma is to convert these divergent principles into something quantifiable and then compromise on numbers. Only the two presidents can do this. To date, each nation has been conducting its own internal political debate on the topic, between the Congress and the administration in America, and between reform-oriented institutions like the Peoples' Bank of China and harder-line elements of the Chinese bureaucracy. The result has been mounting tension.

As a matter of principle, Mr. Bush should seek to leave office with an exchange rate consistent with one that would be market-determined, a goal requiring an appreciation of the yuan of roughly 1% per month. In the last year, the Chinese position has been "as little as possible," a pace that to date has amounted to less than 1% per quarter. Splitting the difference between these two rates would produce a compromise pace of adjustment that would be challenging but manageable for the Chinese economy. It should also be one that would answer America's justifiable concerns about currency manipulation. Mr. Hu may still feel that his principle of not risking party control prevents him from such a compromise. But then his choice would be clear: an economically damaging fight on principle in which China would be the bigger loser, or splitting the difference on numbers.

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