Inscrutable China
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The announcement a few days ago that China was changing its exchange rate was not surprising. The small size of the revaluation, 2 per cent, was in line with expectations. It was just another instance of Chinese policy makers' long-standing preference for proceeding with economic and financial reform in small steps. Only the timing took the markets off guard: most observers had expected China to wait until the U.S. Congress took its August recess so that it would not look like the country was bowing to foreign pressure.

But do these modest changes help to solve either China's problems or those of the world? To echo Chairman Mao's famous quip about the effects of the French revolution, it is too early to tell. The key will be not the one-time change in the level of the currency, which is too small to matter, but whether this shift bodes a new era of greater flexibility.

Greater currency flexibility is needed if the Chinese government and the People's Bank are to more effectively steer their economy. In the last year, the Chinese authorities have continued to relax restrictions on capital inflows and outflows. As a result, interest rates and financial conditions in China are increasingly tied to interest rates and financial conditions in the United States.

Unfortunately, the low level of interest rates prevailing in the United States is not appropriate for China. This is evident in China's unsustainable rate of investment – at last report, investment is running at a staggering 45 per cent of GDP. This boom is being fueled by cheap credit. Much of the resulting investment is poorly allocated and unlikely to yield positive returns. This investment bubble will only culminate in a crash down the road if it is not smoothly deflated now.

Hence, China needs tighter financial conditions than the United States. In the past, the authorities could tighten financial conditions simply by instructing banks not to lend. Now, however, China's banks are being commercialized. The decision to sell 9 per cent of China Construction Bank to Bank of America is a signal that in the future lending decisions will be guided by commercial motives. In addition, new channels are developing through which credit can flow into the property market without first going through the banks. Thus, the only effective way of tightening credit is by raising interest rates. And this requires cutting the link between the yuan and the dollar – that is, letting the exchange rate float.

Whether or not the Chinese authorities will let this happen is unclear. When revaluing the yuan on July 21st, they also retained the fluctuation band limiting daily movements in the exchange rate to 0.3 per cent (although they sensibly redefined that band in terms of a basket of currencies instead of just the dollar). In principle, this band provides considerable scope for flexibility. The exchange rate can move by 1 ½ per cent a week, or more than 6 per cent a month. But the same band has been in place for years, and the Chinese have never permitted the yuan such flexibility. The statement by the People's Bank that movements in the exchange rate would henceforth "depend more heavily on market conditions" has been interpreted to imply a commitment to greater flexibility, but actions speak louder than words. We will have to wait and see.

Acceptance of greater exchange rate flexibility on China's part is also needed to address the problem of global imbalances – to narrow the U.S. current account deficit without precipitating a global recession. At 7 per cent of GDP, the U.S. deficit is clearly unsustainable. So far, foreign investors have financed it, but they will not increase the share of their wealth devoted to claims on the United States forever, without limit. Stabilizing the share of foreign wealth held in the form of claims on the United States will require reducing the U.S. deficit to 3 per cent of GDP. In turn, that will require the dollar to fall against foreign currencies, including the yuan, by at least 20 per cent.

Ideally, this adjustment will be spread over two years. If the entire 20 per cent fall in the dollar were to occur immediately, it would raise inflation and interest rates in the United States and severely damage Europe's export competitiveness, threatening a global recession. But waiting years to commence this adjustment would be worse. By then, the deficit will be even larger, U.S. indebtedness will be higher, and the exchange rate change will have to be larger, which will be more painful for everyone concerned. Better would be a gradual adjustment of the dollar against Asian and European currencies starting now. This is the only way of restoring the U.S. deficit to sustainable levels without precipitating a recession.

The euro cannot be expected to take the brunt of this adjustment, given the weakness of the European economy. Better would be a 15 per cent rise in the yuan and a 5 per cent rise in the euro over the next year, which together would yield the 10 per cent fall in the dollar needed to begin rebalancing the world economy. The same combination of adjustments could then be repeated the following year.

Clearly, then, global rebalancing will require continued currency flexibility on China's part. But there is also a danger: hot money flows into China may accelerate in anticipation of the yuan's further strengthening. This makes it all the more essential that the Chinese authorities allow the currency to exhibit greater volatility. Only the presence of a two-way bet – only the possibility that the yuan can fall as well as rise from day to day – will prevent currency traders from all lining up on one side of the market and limit speculative inflows.

But China will allow its currency to move more freely only if there is a constructive reaction from the United States. In particular, protectionist posturing by the U.S. Congress must end, since the Chinese authorities react negatively to threats.

Even better would be if the U.S. responded with constructive policy adjustments of its own, and specifically if it addressed the budget deficit that is at the root of the country's external imbalance. Less exchange rate adjustment would then be required. The strain on the global financial system would be less. And this constructive response by the United States would show the Chinese authorities that positive action on their part begets positive action abroad.

So far, neither the Congress nor the Bush Administration have shown the necessary resolve. In their absence, we will have to rely the intelligence and selflessness of the Chinese authorities to stabilize the world economy. It is a strange world indeed in which the prospects of the rich depend on the charity of the poor.

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