China's Currency Crunch

Why Beijing should adopt a more flexible exchange rate.

By Marvin Goodfriend and Eswar Prasad

As the U.S. trade deficit continues to balloon, American politicians are back on the warpath against their favorite target: China. The rising bilateral trade deficit with Beijing, which could top $300 billion this year, provides ammunition for those in Washington who argue that Chinese currency policies are at the root of the U.S. trade imbalance. China's surging foreign exchange reserves (now more than $1 trillion) and massive current account surplus (nearly 10 percent of its gross domestic product) fuel American accusations of Chinese currency manipulation: By maintaining a fixed exchange rate against the dollar, China keeps its currency cheap and therefore gains an unfair advantage selling its products overseas. Until Beijing lets the value of its currency appreciate, critics contend, there is no hope of a more level playing field.

Chinese leaders, of course, see it differently. They accept that their exchange rate will someday need to be determined by market forces. But, faced with the pressures of running the world's hottest economy, they view currency reform as a distraction. These days, they are more preoccupied with completing their country's dramatic transformation from an agricultural backwater to industrial powerhouse. For Beijing's bureaucrats, there is little reason to let their currency appreciate, even modestly; doing so could dampen exports, which might cool their ability to create jobs for the millions of migrants pouring into their cities each year. And then there is the matter of pride: Who wants to do anything a bunch of American politicians tell you to do?

But never mind what the Americans think. China has a better reason to adopt a more flexible exchange rate: It would be good for China. For all its economic success, Beijing is juggling a number of dangerous imbalances. For example, China's astonishing growth—now more than 11 percent a year—has been largely fueled by domestic investment and exports, while domestic consumption remains relatively stagnant. Most countries would envy the surge of money flowing into China from overseas. But so much, so fast has made capital very cheap. Tremendous sums are flowing into real estate and equity markets, raising the risk of asset price bubbles that could easily burst.

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To avoid those dangers, Beijing should aim for an independent interest rate policy whose main objective is to keep inflation low and stable, rather than being preoccupied with tightly managing the level of the exchange rate. Trying to keep the yuan from rising against the U.S. dollar means that China's central bank must print more money to keep interest rates low and the currency cheap. There's then a chance that too much money will end up chasing too few goods. Low inflation creates a healthier environment where people, companies, and governments are able to make sounder savings and investment decisions based on more certainty about prices. That doesn't mean that monetary policy should ignore other economic goals such as high and stable growth. But by focusing on low inflation, the economy is less likely to lurch forward recklessly, stumble, and fall.


Currency reform can help keep inflation low and stable.

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Exchange rate flexibility, however, is hardly an end in itself. But it would make some of the other reforms that Beijing seeks easier to push forward. Take, for example, controlling bank-financed investment. Right now, China's central bankers target a particular exchange rate because they have no choice. That means there's little wiggle room to raise interest rates sufficiently to help deter reckless investment in overheated industries, such as China's auto industry, where manufacturing plants continue to pop up even as car prices fall. If China's central bankers had the ability to raise interest rates within a system of flexible exchange rates, it would reduce the risk of boom-bust cycles. But if they were to try and sharply raise domestic interest rates while the country is still maintaining its fixed exchange rate, more money could flow in to take advantage of these higher rates. That money would remain too cheap, fueling even more investment, eventually causing the economy to overheat. With a flexible exchange rate, China's central bankers could solve the problem before it begins.

Chinese officials often argue that their outdated and stodgy banking system must be fixed before they can even begin to think about currency reform. But they have it backward. As China has opened its markets during the past decade, the central bank has been trying to get banks to function like modern financial institutions that respond to interest rates, rather than just getting their marching orders from Beijing. But since the central bank has little control over interest rates, it has essentially reverted to its old practice of telling banks how much to lend and to whom. That doesn't encourage those banks to behave like normal, independent commercial entities carefully assessing and pricing risk. With a flexible exchange rate and the freedom to change interest rates, central bankers would be better able to encourage state-owned banks to become robust and efficient financial intermediaries that could in turn aid in the transformation of the economy by financing the more dynamic private sector.

Allowing the exchange rate to appreciate would also boost domestic consumption. China is a country of diligent savers, with about one quarter of after-tax personal income tucked away for a rainy day. But if Chinese households could get more dollars for their yuan, their purchasing power would go up and they would spend more, not only on items made at home but on global goods as well. And isn't that what economic welfare is all about—the ability to spend more?

After all, that is the ultimate goal of Chinese leaders: for its citizens to eventually enjoy the same kind of spending power that people in richer countries like the United States enjoy today. Beijing shouldn't dismiss currency reform simply because American politicians are using it as a rhetorical weapon back home. Chinese leaders should view a flexible exchange rate as a healthy step in their society's transition to a market economy. And doing so will have one other benefit: American politicians will have to find something else to complain about. FP