U.S.-China Relations: The Case for Economic Liberalism

James A. Dorn

In its *2005 Report to Congress*, the U.S.-China Economic and Security Review Commission—also known as the U.S.-China Commission (USCC)—recommended that China appreciate its currency, the renminbi (RMB), "by at least 25 percent against the U.S. dollar" or face "an immediate, across-the-board tariff on Chinese imports." The commission argued that such an action could be justified under Article XXI of the World Trade Organization (WTO), "which allows members to take necessary actions to protect their national security." The key idea behind the commission's protectionist policy stance is that "China's undervalued currency has contributed to a loss of U.S. manufacturing, which is a national security concern" (USCC 2005: 14).

There is no doubt that financial repression in China has led to an undervalued currency, but that in itself does not pose a national security risk to the United States. Workers in U.S. manufacturing lose their jobs for many reasons. Blaming China for displacing American textile workers, for example, and thereby jeopardizing our national security is rather farfetched, to say the least. Moreover, U.S. manufacturing output has been increasing as American workers become more productive (Griswold 2006: 12).

When China hawks and protectionists on Capitol Hill join forces, as they did to defeat CNOOC's acquisition of Unocal in the summer of 2005, a dangerous precedent is established that threatens the future of a liberal global economic order and undermines a constructive U.S.-China policy of engagement (Dorn 2005). Although it is proper to criticize China for its human rights violations and its lack of a

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transparent legal system, we should not ignore the substantial progress China has made since it embarked on economic liberalization in 1978. U.S. economic security, as well as China's, will depend on promoting economic liberalism, rather than fostering protectionism.

In this article, I first address four major questions posed by the USCC at its August 22, 2006, hearing on "China's Financial System and Monetary Policies," and then elaborate on those questions by considering China's repressed financial system, the case for economic liberalism, and the politics of China's economic reform movement.

Major Questions

In my testimony before the USCC (Dorn 2006b), I briefly addressed the following questions as presented to participants on Panel IV, "The Macroeconomic Impact of Chinese Financial Policies on the United States."

1. *Is the present equilibrium sustainable? That is, are we in a New Bretton Woods Era? Or, do we need a new Plaza-Louvre Agreement to manage adjustment?*

The "present equilibrium" is an equilibrium only in the sense of a status quo. In an economic sense, it is a disequilibrium due to financial repression in China and government profligacy in the United States. The status quo is sustainable only to the extent that China and the rest of the world are willing to accumulate dollar assets to finance our twin deficits.

We may be in a "New Bretton Woods Era" in the sense that China and other Asian countries peg their currencies to the dollar as a key reserve currency, but the analogy to the original Bretton Woods system is misplaced. There is no golden anchor in the present system of fiat monies, and private capital flows and floating exchange rates have fundamentally changed the nature of the global financial architecture.[1] The International Monetary Fund (IMF) has been searching for a new identity since the collapse of the Bretton Woods system of "fixed but adjustable" exchange rates in the fall of 1971 when the United States closed the gold window and suspended convertibility. The Mexican peso crisis in 1994–95 and the Asian currency crisis in 1997–98 resulted in large part because of excessive domestic monetary growth and pegged exchange rate systems in the crisis

[1]For a discussion of the new Bretton Woods system, see Dooley, Folkerts-Landau, and Garber (2003).

countries.[2] Since that time many emerging market countries have adopted inflation targeting and floating exchange rates. Trying to form a new IMF-led system of managed exchange rates with central bank intervention would be a step backward rather than forward (see Schwartz 2000).

We do not need a new Plaza-Louvre Agreement to manage global imbalances. Just as the negotiations approach to trade liberalization gets bogged down in the global bureaucracy, government-led coordination of exchange rates is apt to fare no better. There are many more players today than in the 1980s, when China was still in the minor league. A surer route to successful adjustment is for each country to focus on monetary stability, reduce the size and scope of government, and expand markets. International agreements are difficult to enforce, and no one really knows what the correct array of exchange rates should be. Millions of decentralized traders in the foreign exchange markets are much better at discovering relative prices than government officials who are prone to protect special interest groups. The United States, for example, wants the renminbi (also known as the yuan) to float—but only in one direction.

2. *What are the chances for an orderly vs. disorderly adjustment? What are the implications of each for U.S. capital markets?*

If China continues to open its capital markets and to make its exchange rate regime more flexible, it will eventually be able to use monetary policy to achieve long-run price stability (Taylor 2005). At present, the People's Bank of China (PBC) must buy up dollars (supply RMB) to peg the RMB to the dollar and then withdraw excess liquidity by selling securities primarily to state-owned banks. This "sterilization" process puts upward pressure on interest rates, which if allowed to increase would attract additional capital inflows. The PBC thus has an incentive under the current system to control interest rates and rely on administrative means to manage money and credit growth. But the longer this system persists, the larger the PBC's foreign exchange reserves become and the more pressure there is for an appreciation of the RMB/dollar rate.

The July 21, 2005, revaluation and a number of changes in the institutional setting to establish new mechanisms for market makers

[2] On Mexican monetary policy, see Sánchez (2005). On the Asian crisis, see Greenwood (2000: 146), who argues that "the cyclical elements of the crisis started with excess growth rates of money and credit from 1993 onwards."

and hedging operations are steps in the right direction. Financial liberalization will take time, and China will move at its own pace. The United States should be patient and realistic. Most of the costs of China's undervalued currency are borne by the Chinese people. Placing prohibitively high tariffs on Chinese goods until the RMB/dollar rate is allowed to appreciate substantially is *not* a realistic option. It would unjustly tax American consumers, not correct the overall U.S. current account deficit (or even our bilateral trade deficit with China), and slow liberalization.[3]

Adjustment requires that China not only allow greater flexibility in the exchange rate but also allow the Chinese people to freely convert the RMB into whatever currencies or assets they choose. Capital freedom is an important human right and would help undermine the Chinese Communist Party's monopoly on power by strengthening private property rights. A more liberal international economic order is a more flexible one based on market-determined prices, sound money, and the rule of law. We should help China move in that direction—not by threats, but by example. The U.S. government should begin by reducing its excessive spending, and removing onerous taxes on saving and investment.

An orderly adjustment based on market-liberal principles would help ease the costs to the global economy and to the United States in particular. Keeping our markets open sends an important signal to the rest of the world, and getting our fiscal house in order—by trimming the size of government and by real tax reform—would show that we mean business. Reverting to protectionism, on the other hand, would have a negative impact on the global financial system, and adjustment would be slower and more costly (Greenspan 2004).

3. What is the likelihood that China will seek to diversify its foreign currency holdings? How would they do so? What would be the consequences?

The composition of China's foreign exchange reserves is a state secret, but a reasonable estimate is that about 80 percent of China's $941 billion of reserves are held in dollar-denominated assets, especially U.S. government bonds. Any sizable one-off revaluation of the RMB/dollar rate would impose heavy losses on China. Other Asian central banks would also suffer losses on their dollar reserves as the

[3]According to a recent study by Daniel Ikenson, a trade policy analyst at the Cato Institute, "currency values have had little to do with changes in the trade balance in recent years" (Ikenson 2006: 1).

trade-weighted value of the dollar fell. No one wants to be the last to diversify out of dollars. If the euro becomes more desirable as a reserve currency, the PBC and other Asian central banks can be expected to hold more euros and fewer dollars in their portfolios.

The future of the dollar will be precarious if the United States continues to run large budget deficits and fails to address its huge unfunded liabilities. Foreign central banks would not wait for doomsday; they would begin to diversify now. Markets are ruled by expectations, so it is crucial for the United States to begin taking positive steps to get its own house in order—and to reaffirm its commitment to economic liberalism.

For its part, China can help restore global balances by moving toward a more flexible exchange rate regime and liberalizing capital outflows so that there will be less pressure by the PBC to accumulate foreign reserves. Delaying adjustment means faster accumulation of reserves, greater risk of capital losses by holding dollar assets, and a stronger incentive to diversify. Indeed, in a recent report, China's National Bureau of Statistics recommended that the PBC should increase the pace of diversification to reduce future capital loses from overexposure to the dollar (Zhou 2006).

If China does begin to increase the pace of diversification and the United States does not effectively resolve its long-term fiscal imbalance, the result would be higher U.S. interest rates, crowding out of private investment, and a decline in stock prices.

4. What are the likely consequences of a failure to address global current account imbalances?

The most serious consequences of not addressing the global current account imbalances would be the persistence of market socialism in China and creeping socialism in the United States. The failure to address global imbalances means the failure to accept economic liberalism. China needs to move toward a market-liberal order, which means it needs a rule of law that protects persons and property; and the United States needs to resist protectionism and reduce the size and scope of government.

While it is useful to consider the macroeconomic impact of Chinese financial policies on the United States, it is well to remember that what matters most for the U.S. economy is to pursue sound monetary and fiscal policies at home. If we follow such policies and maintain an open trading system, U.S. prosperity will continue.

China's Repressed Financial System

There is no doubt that China's financial system is repressed: capital controls limit freedom of choice, the exchange rate is undervalued and distorted by massive government intervention, interest rates are heavily regulated, the private sector is discriminated against in favor of state-owned enterprises (SOEs), banks and security firms are mostly government owned and controlled, and corruption is rampant.[4]

China has the most restricted capital markets in Asia. Portfolio investments are heavily controlled, as are most other capital account transactions. Changes are occurring, such as more lenient treatment of qualified foreign and domestic institutional investors, but much remains to be done.[5] A ranking of Asian countries based on the UBS capital restrictiveness index indicates that China has a long way to go before it reaches the degree of capital freedom enjoyed by top-rated Hong Kong (see Figure 1).[6]

By suppressing two key macroeconomic prices—the interest rate and the exchange rate—and by failing to privatize financial markets and allow capital freedom, China's leaders have given up flexibility and efficiency to ensure that the Chinese Communist Party (CCP) retains its grip on power. The goal is to build a "socialist market economy," not a genuine free market based on private property rights and the rule of law. Restricting economic freedom, including the free flow of information essential to efficient capital markets, inevitably retards both personal and political freedom.

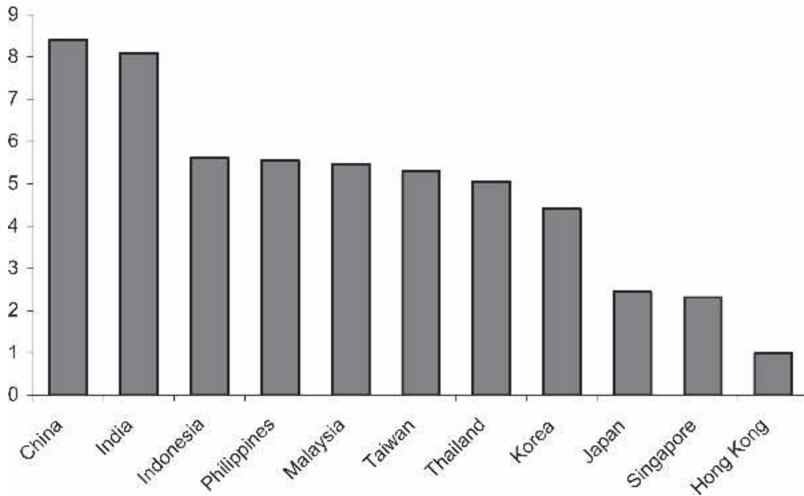
China's financial repression means the PBC cannot have an independent monetary policy aimed at achieving long-run price stability. Rather, the PBC has a schizophrenic policy aimed at managing both the exchange rate and the price level. Such a policy is untenable in the long run if China wants to become a world-class financial center with capital freedom. Moreover, as the trade account grows, it becomes more difficult to control capital inflows and to "sterilize" them by selling central bank bills to prevent new base money (created when

[4]This section draws on Dorn (2006a).

[5]On recent reforms, see Fred Hu (2005) and Stephen Green (2006a). Green calls the April 13, 2006, liberalization of controls on capital outflows for qualified banks, mutual funds, and insurance companies "revolutionary." The change is an important signal for reform, but the measures still need to be implemented and the sums involved will be small.

[6]The UBS capital restrictiveness index is based on a score of 10 (closed capital account) to 1 (open capital account). In calculating this index, UBS takes account of "the number of legal impediments to capital account transactions" and "the size and variability of actual ex post capital flows." See Anderson (2005: 23, n. 3).

FIGURE 1
UBS Capital Restrictiveness Index



Source: Anderson (2005: 23), based on CEIC, IMF, and UBS estimates.

the PBC buys dollars and other foreign currencies) from creating excessive money and credit growth.[7]

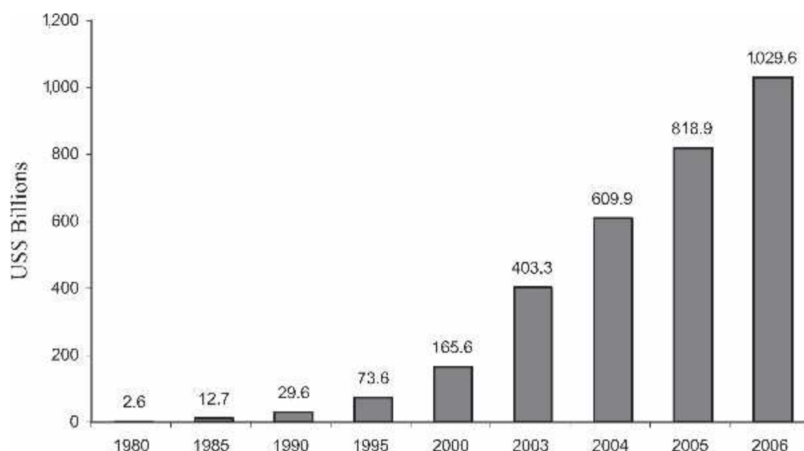
The CCP faces a dilemma: it can either maintain the status quo by suppressing capital freedom to retain its grip on power or it can gradually normalize China's capital markets and risk losing power. The best way to help China move toward market liberalism, and away from the status quo, is to stick to a policy of engagement rather than succumb to destructive protectionism.

The Case for Economic Liberalism

Engagement does not mean dictating what the RMB/dollar exchange rate should be or calling for a new Plaza-Louvre type agreement to correct global imbalances. When the Group of Five Industrialized Nations, the G-5 (United States, United Kingdom, Japan, Germany, and France) met in 1985 to agree on collective action to lower the foreign exchange value of the dollar, China was not a factor. The PBC's foreign exchange reserves were only $12.7 billion (see Figure 2), and China's overall current account was roughly in balance.

[7]On the difficulty of preventing "hot capital" from entering China, see Green (2006c).

FIGURE 2
China's Foreign Exchange Reserves, 1980–2006E



Source: *UBS Asian Economic Monitor,* "China by the Numbers (July 2006)," p. 24.

Intervention in the foreign exchange markets and various changes in fiscal policies in the G-5 did help to bring the dollar's value down, but the U.S. current account deficit still reached a peak of 3.4 percent of GDP in 1987, at which time the G-6 met in Paris to reverse course and intervene to stem the dollar's slide (see Cline 2005).

Currency intervention is often sterilized and has no permanent effect on the real exchange rate. The dollar had already begun to fall against the major currencies *before* the Plaza Accord. The 1985 agreement accelerated that process. The Bank of Japan (BOJ), however, engaged in sterilization to offset the dollar sales (yen withdrawals), limiting the impact on the yen/dollar rate. After the 1987 accord, the BOJ bought dollars and allowed the monetary base to grow rapidly, creating the bubble economy. The bubble burst in 1990 after the BOJ sharply cut money growth in mid-1989. The lesson is that exchange rate intervention can wreak monetary havoc. The countries that suffered the most from the Asian financial crisis were those that had mistaken monetary policy.[8] As John Greenwood, chief economist for Invesco Asia, Ltd., observed, "The general lesson is that to control money and credit growth within reasonable ranges that are

[8]For a fuller treatment of the Plaza and Louvre agreements, and the mistakes in Japanese monetary policy, see David F. DeRosa (2001: 8, 36–54, 199).

compatible with low inflation in the longer run, the external value of the currency must be free to adjust—especially upwards" (Greenwood 2000: 146).

Today, the U.S. current account deficit has risen to more than 6 percent of GDP, China is the world's third largest trading nation, and Asian central banks play an important role in financing the U.S. budget deficit. A new Plaza accord would require a much larger group to negotiate—the Group of 20—without any credible enforcement mechanism. William Cline of the Institute for International Economics has argued that emerging market economies in Asia can overcome the "prisoner's dilemma" by jointly agreeing to allow their currencies to appreciate against the dollar. The extent of overall appreciation would then be much smaller than if each country acted alone. He would also have the Federal Reserve, European Central Bank, and Bank of Japan intervene in the foreign exchange market to push the dollar lower (Cline 2005: 9).

A negotiated approach to resolving trade imbalances presumes that "experts" know the relevant market-clearing exchange rates and that governments can agree to enforce them—neither of which has proved to be true. Financial markets are much more complex now than in the 1980s, and private capital flows swamp official flows. Any exchange rate that is fundamentally misaligned will eventually be attacked, and governments will be ill-equipped to prevent it. Moreover, the longer adjustment is delayed, the higher the cost in terms of resource misallocation. China is piling up billions of dollars in foreign exchange reserves to defend its undervalued currency, and wasting valuable capital that could earn a much higher return in the booming private sector or be used to help privatize SOEs or finance the transition to a fully funded pension system.[9]

The argument that intervention is necessary to get all parties to agree to let their currencies appreciate against the dollar in East Asia is questionable. Stephen Green, senior economist at Standard Chartered Bank in Hong Kong, notes that it is unlikely that Asian currencies would stand still while China let the RMB/dollar rate appreciate (Green 2006b: 2). Letting all Asian currencies increase at the same rate against the dollar would not put anyone at a competitive disadvantage for interregional trade. If a country did not follow suit, it may have a temporary advantage. But as its trade surplus grew, there would be pressure to revalue or suffer inflation as a means to revalue

[9]On how reserves could be used to help China make the transition to economic liberalism, see Deepak Lal (2006a).

the real exchange rate. Changing one price—the exchange rate—is far less costly than changing the relative price level.

Rather than a new Plaza-Louvre type agreement, an alternative approach to correcting global imbalances is to have monetary authorities agree on common principles and objectives. In a world of pure fiat monies, the principle should be to establish credibility by having central banks constrain themselves to long-run price stability. Many central banks already have adopted inflation targeting and have substantially reduced inflation.

Hans Genberg, executive director for research at the Hong Kong Monetary Authority, has suggested creating a "zone of monetary stability" in East Asia. The key step would be to agree on a credible inflation target regime. To be consistent with capital freedom, central banks would not intervene to peg exchange rates. The information contained in flexible rates would be useful in the conduct of monetary policy, and some monetary authorities may choose to follow the Singaporean model by using the exchange rate as an operating target. (Hong Kong would maintain its currency board and have a hard peg to the dollar.) With regional price stability and financial integration, interest rates would converge and exchange rates would be less volatile. Although a common currency may evolve—either for the region or more likely for a smaller bloc of countries—it is not necessary to realize these benefits (Genberg 2006: 17).[10]

China needs an independent central bank to stabilize the growth of nominal income and prevent inflation. Relaxing capital controls would take pressure off the RMB/dollar exchange rate while interest rate liberalization would allow a more efficient allocation of capital. A more flexible exchange rate regime would allow the RMB to find its true value in the marketplace. The problem is to get China to adopt liberal economic principles when its political regime is illiberal. For the United States to threaten China with protectionist measures for not adopting liberal principles is counterproductive. Carrying out the threat would make both China and the United States less liberal.

A better tactic is for the United States to follow its own liberal principles and put its house in order before telling others what to do. After all, government profligacy is behind the U.S. fiscal deficits and low saving rate that mirror our persistent current account deficits. We are fortunate America is still a haven for foreign investors, but at some point accumulating further dollar-denominated assets may not be

[10]Adopting a single currency for Asia is neither economically nor politically feasible at this time or in the foreseeable future. Economic conditions and political environments are too diverse to warrant a currency union (see Anderson 2006).

prudent for foreign central banks and private investors. Indeed, the growth of entitlement programs could double the size of the federal government as a percent of GDP—from 20 percent to 40 percent—by 2075 (CBO 2002). The resulting deficits would be enormous and put significant upward pressure on interest rates, especially if foreigners failed to hold our debt. We do not need an international agreement to limit the size of our government; we can do it ourselves by sticking to the principles of economic liberalism.

China has expressed its long-run desire to make the RMB fully convertible, allow market forces to guide the exchange rate, and to liberalize interest rates. It is in China's self-interest to do so. Creating an international market-liberal order is a slow process, in which the United States must take a leadership role—not by dictating policy, but by example and persuasion. Sound domestic monetary policy, unilateral free trade, and limiting the size and scope of government are essential in that endeavor.

With stronger private property rights and long-run price stability, China would attract and retain capital—including human capital. People would be free to choose in international capital markets and free to trade. A fully convertible RMB, a flexible exchange rate, and a stable domestic price level would enhance both economic and personal freedom.

It makes no sense for a capital-poor country like China to suppress market forces and to accumulate massive foreign exchange reserves, now approaching $1 trillion. According to Greenwood (2001: 93), "If China's capital markets and its industries were normalized (through deregulation, proper implementation of the rule of law, the encouragement of private markets, and extensive private ownership), then China's balance of payments would no doubt undergo a major transformation."

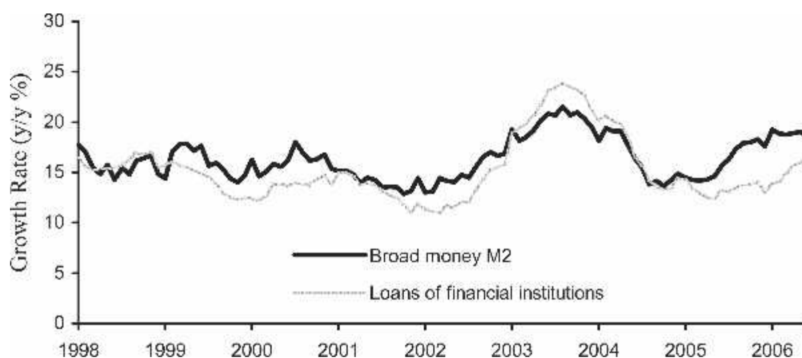
The transition to capital freedom will be smoother, says Greenwood, if the PBC pursues a policy of monetary stability—that is, provides a framework for long-run price stability. To do so, however, the PBC must let market demand and supply determine the equilibrium value of the exchange rate and focus primarily on controlling domestic money and credit growth, which means interest rates must also be liberalized. Meanwhile, "under a fixed nominal rate framework, external capital controls are much more likely to be maintained and the adjustments to the trade and current account are therefore much less likely to occur" (Greenwood 2001: 93–94).

If Beijing chooses to keep the RMB/dollar rate undervalued and maintains capital controls, China will continue to experience stop-go

monetary policy (see Figure 3) as the domestic money supply responds to the balance of payments and the PBC attempts to sterilize capital inflows.

FIGURE 3

Growth of Money and Credit, China, 1998–2006.H1



Source: *UBS Asian Economic Monitor,* "China by the Numbers (July 2006)," p. 6.

Beijing needs to be more forthright in describing its financial and monetary system. The State Council announced earlier this year that it wants to achieve an external balance in 2006, but China's overall trade surplus will match or exceed last year's historical high of $102 billion. Likewise, the PBC constantly says its goal is to pursue a "sound monetary policy" and "keep the RMB exchange rate basically stable at an adaptive and equilibrium level." Yet, money and credit continue to grow at rates inconsistent with long-run price stability, and the exchange rate is still pegged at a disequilibrium level.

The PBC (2006) recommends "better coordination among the various macro policies, transformation of government functions, and institutional innovation." It also promises that the "foreign exchange system reform will be deepened," including "facilitating trade and investment, promoting capital account convertibility, expanding channels for capital outflow, fostering the growth of [the] foreign exchange market, [and] further improving the RMB exchange rate regime." Finally, the PBC has committed to "preserve the continuity and stability of monetary policy, and promote appropriate growth of money and credit, in order to provide a stable monetary and financial environment for economic restructuring."

Those objectives are laudable, but thus far the rhetoric has failed to

match the reality. For example, in its "Monetary Policy Report" for 2003, the PBC stated that it "continued to carry out sound monetary policy," even though broad money growth (M2) had grown on average by 20 percent that year. The report also said that the PBC would maintain the RMB exchange rate "at an adaptive and equilibrium level" (PBC 2003). Yet, the RMB/dollar rate remained fixed at 8.28 from 1994 until July 21, 2005, when it was revalued by 2.1 percent, and has only appreciated slightly since then to about 7.98 RMB/dollar. As a result, China's foreign exchange reserves have more than doubled since 2003 (see Figure 2). Clearly, financial repression is the hallmark of China's state-directed financial regime. The pace of reform will depend largely on how much power the CCP is willing to give up in favor of the flexibility and liberalization needed for maintaining robust economic growth and stability.

The Politics of China's Economic Reform Movement

Since the start of the reform movement in late 1978, China's leaders have declared that the CCP's top priority should be to achieve robust economic growth and improve the standard of living. They chose this path of "peaceful development" to minimize the likelihood of civil and economic unrest that dominated the Mao regime. The failure of central planning and the Soviet development model led to institutional innovation and economic restructuring. China's accession to the World Trade Organization (WTO) in December 2001 was further evidence of the commitment to liberalize trade and the financial sector.

Progress has been made since 2001, but as the foregoing analysis implies much remains to be done.[11] There has been widespread discussion of how China should sequence its economic reforms and make the transition from financial repression to capital freedom. It is clear that opening capital markets without reforming state-owned banks and without maintaining monetary stability could lead to substantial capital flight and exacerbate the problem of nonperforming loans. Moreover, there must be an effective legal system to protect newly acquired private property rights.

In a recent interview, Zhou Xiaochuan, the head of the PBC, emphasized that China is committed to create an institutional framework

[11]For a summary of China's steps toward financial sector liberalization since December 2001, see Su Ning (2006), deputy governor of the PBC.

for a more flexible exchange rate regime "based on market demand and supply," and "gradually realize RMB convertibility . . . by lifting the restrictions on cross-border capital movements in a selective and step-by-step manner." In sequencing the financial sector reforms, the first priority is to put the banking system on a sound footing by recapitalizing the large state-owned banks and turning them into joint-stock companies with the participation of foreign strategic investors. Further progress must also be achieved in widening the scope of foreign exchange transactions, including liberalizing the capital account. Zhou recognizes that institutional change cannot occur overnight because "people need some time to learn and adapt to change." A new "mindset" must be developed. Moreover, he understands that China "cannot wait to start reforming the exchange rate regime until all banking reform measures have been completed" (PBC 2005a: 1–2, 13). Reform must move along a broad front.

Financial restructuring is occurring and the new exchange rate regime should allow for more flexibility, but one should not think that the CCP would easily give up its control over the financial sector or allow the exchange rate to be set by market forces. Political change must accompany economic reform if capital freedom is to be fully realized.

Policy Recommendations

The United States and China need to continue the policy of engagement and recognize that it is more important to focus on the issue of capital freedom than on the narrow question of the proper exchange rate. China should continue to liberalize its exchange rate regime, open its capital markets, allow full convertibility of the RMB, liberalize interest rates, and use domestic monetary policy to achieve long-run price stability. Most important, China needs to privatize its stock markets, its banks, and its firms.

The need for reform of China's financial sector is widely recognized by Chinese officials and leading economists. Wang Zili, vice director of the Guangzhou Branch of the PBC has emphasized the need for market-based interest rates that reflect supply and demand. He argues that without liberalization, the interest rate cannot effectively function as a tool of monetary policy: "A prerequisite for interest rates to take effect in macro-regulation is that capital demand and supply should be highly market-oriented." Thus, "the most important

thing for us to do is to form a reasonable interest rate structure."[12] Recently, banks have been given more discretion in setting loan rates, but the PBC still relies on administrative measures to curb excessive money and credit growth.

The PBC's Monetary Policy Committee has been concerned with the lack of flexibility in the current financial system and made the following recommendations at its third quarterly meeting in 2005:

- "The market itself should be allowed to play its role in economic restructuring."
- "Market-based interest rate reform policies should be continuously carried out."
- "Measures should be taken to further improve the managed floating exchange rate regime and maintain the exchange rate . . . at an adaptive and equilibrium level."
- "Efforts should be made to advance financial reform" and "to enhance the effectiveness of monetary policy transmission" (PBC 2005b).

Those pro-market policy recommendations are a positive sign and a clear signal that China's top policymakers are aware of what needs to be done to improve the financial architecture.

If China is to carry out its plans for financial liberalization and have a flexible exchange rate regime, the PBC must have greater independence. Indeed, He Fan and Zhang Bin (2004: 21), economists with the Chinese Academy of Social Sciences, have argued that Beijing "must make implementation of an independent monetary policy its top priority." With greater independence will come greater transparency and credibility. Until that time, the PBC will be heavily politicized and its statements will lack the credibility necessary to assure global investors that stop-go monetary policy has ended.

In addition to internal pressures for financial reform, China is facing external pressures from the U.S. Congress and the WTO for ending exchange and capital controls. China has promised to allow full participation by foreigners in its banking sector by 2007 and to be further open to foreign portfolio investment. However, China is intent on moving at its own pace, especially regarding the transition to a floating exchange rate regime. According to Zhou Xiaochuan, the "noises" being made on Capitol Hill (e.g., by Democratic Senator Charles Schumer and Republican Senator Lindsey Graham) for protectionist measures—if China does not significantly revalue the RMB/dollar exchange rate—"will not change the basic conditions and sequence of China's exchange rate reform" (PBC 2005a: 3).

[12]Quoted in "Reasonable Interest Rate Structure Urged" (2004).

Congress can best foster sound U.S.-China relations by not treating China as an inevitable enemy and by taking the opportunity to capitalize on China's emergence as a market economy, albeit a "socialist market economy." In particular, U.S. policymakers should

- treat China as a normal rising power, not as a probable adversary;
- continue to liberalize U.S.-China relations and hold China to its WTO commitments;
- recognize that advancing economic freedom in China has had positive effects on civil society and personal freedom for the Chinese people.[13]

Conclusion

President Hu Jintao's "big idea" is to create a "harmonious and prosperous society" via "peaceful development." To achieve that goal, however, requires institutional change—namely, a genuine rule of law that protects persons and property. As Wu Jinglian, one of China's leading reformers, recently stated: "If we don't establish [a] fair rule of law and don't have clear protection of property rights, then this market economy will become chaotic and corrupt and inefficient."[14] It also requires "new thinking," so that people come to understand and appreciate how nonintervention (*wu wei*), in the sense of limited government, is conducive to a spontaneous market order.

Long before Adam Smith, Lao Tzu argued that when the ruler takes "no action," "the people of themselves become prosperous" (see Dorn 1998: 104–6). China's leaders should turn to "Lao Tzu thought" if they want to realize a "harmonious and prosperous society." The success of the reform movement—and China's growing middle class—has come from increased economic freedom, not from top-down planning. Trade liberalization and the growth of the nonstate sector have been the keystones of China's new economy. It is now time to get rid of the last legacy of central planning—state-directed investment and capital/exchange controls—and end financial repression.

Congress would be wise to focus on capital freedom rather than bash China for its large trade surplus with the United States, and blame that imbalance on an undervalued RMB/dollar exchange rate.[15] Protectionist measures to force China to revalue would place

[13]For an expansion of these policy recommendations, see Carpenter and Dorn (2005).

[14]Quoted in "Official Urges Rule of Law in China" (2006).

[15]Stephen Green (2006b) argues that China's large processing trade means an appreciation

a large tax on U.S. consumers and not advance capital freedom (see Griswold 2006: 10–11). Adherence to the principles of a liberal international order—as opposed to muddling that policy conception by threatening to adopt protectionist measures intended to force international agreements—should be the primary objective of U.S. policy.[16]

For its part, China needs to follow the Tao of the market if it is to fulfill the promise of peaceful development. Ending financial repression by liberalization, privatization, and competition would increase the chances for political reform. The United States and other free countries can help China move in the right direction by adhering to a policy of engagement rather than reverting to destructive protectionism.

We must not repeat the mistakes of the 1930s, when the Smoot-Hawley tariff and monetary policy errors effectively ended the liberal international order.[17] Free trade and financial integration are essential for prosperity and peace. As Cordell Hull (1948: 81), U.S. secretary of state from 1933 to 1944, wrote, "Unhampered trade dovetailed with peace; high tariffs, trade barriers, and unfair economic competition with war."

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of the RMB/dollar rate could *increase* China's trade surplus, or at least not substantially decrease it.

[16]On the shortcomings of the negotiations approach to a liberal international order and the benefits of a principled approach, see Jan Tumlir (1989). Also see Roland Vaubel (1986) and Lal (2006b).

[17]On the Smoot-Hawley tariff and the end of the "liberal international economic order," see Lal (2006b: 39).

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