

**CHINA AND THE INTERNATIONAL FINANCIAL
INSTITUTIONS – A CRS AND BRETTON WOODS
COMMITTEE WORKSHOP**

**OCTOBER 3, 2005
SUMMARY**

PANEL I: CHINA AND THE IMF

***MR. ALBERT KEIDEL, SENIOR ASSOCIATE CARNEGIE ENDOWMENT FOR
INTERNATIONAL PEACE***

Keidel argues that American politicians use China as the scapegoat for all of America's own problems, arguing that a forced, significant revaluation of the RMB will solve most of this country's economic woes. The General Accounting Office (GAO), however, has scrutinized China's methodology employed to determine the RMB's value and have found it accurate.

Several "false signals" are being used to support arguments for action against China. One often cited is the trade imbalance. However, although China has a trade surplus with the United States, it has a trade deficit with the rest of the world. A second false signal is China's accumulation of dollar reserves. Keidel claims this is not the result of trade surpluses, but of large investment inflows caused in part by speculators' betting that China will yield to U.S. pressure and revalue the RMB.

Rather than pointing the finger at China, Keidel says, Washington must work to restructure the U.S. economy in a way that will redress the global imbalances. A lack of political will makes these policy positions extremely difficult and politically unattractive.

The political aspects of economic and foreign policy are also an important aspect in the China debate. The nature of the American 2-party system leads to an exaggeration of issues, and parties often coalesce around a position and sound bites that may or may not be based on informed policy and fact.

It is in the United States' long-term national security interest to continue to build its relationship with China and to engage China as a partner in a rules-based international system.

MR. CHARLES BLUM, PRESIDENT, INTERNATIONAL ADVISORY SERVICES GROUP

Reputable experts, Blum said, do believe the RMB is overvalued. Estimates range from 15 – 40%. China's huge level of official reserves, recently valued at \$740 billion, roughly half its GDP, is evidence of overvaluation, Blum says.

According to Blum, substantial revaluation of the RMB is important for four reasons:

- The low value of the RMB serves as a subsidy on all exports from China, depressing prices levels to the point that even the most efficient U.S. producer will have trouble matching them;

- The RMB rate also serves as a hidden tax on *all* goods and services offered to China from abroad, hindering access to that growing market;
- RMB undervaluation is a direct contributor to the U.S. trade deficit and helps explain why China now accounts for nearly one quarter of American's global deficit;
- Revaluation of the RMB is the linchpin to the appreciation of the Japanese yen, the Korean won, and a number of other undervalued currencies that affect U.S. exports and imports.

China's July 21 move from its long-time peg to a "basket of currencies" resulted in minimal change and was done chiefly to appease critics. The value has barely changed over the past nine weeks – a rise of only two one-hundredths of one RMB.

Continued undervaluation of the RMB is also a problem for China – China attracts too much investment into its export sector and too little for production aimed at the domestic market. The result of excess capacity is price deflation, a squeeze on profits, and hence difficulty in making debt repayments. China's banking problems are partly the result of its currency policy.

What is the IMF's relationship with China? Blum posed 4 questions for reflection on the IMF's role:

- Since the breakdown of the Bretton Woods system 30 years ago, what is the Fund's mandate to avoid imbalances in trade flows and balance of payments? What leverage does the Fund use to assure compliance?
- Second, it seems that today's global monetary system is effectively a U.S. current account deficit system. What happens when the system collapses?
- Will the excess credit around the world in the countries that are "successful" in international trade and finance generate bubble economies that must burst?
- How can emerging countries expect to develop and enjoy social and political peace if they fall into this trap of overdeveloped export sectors and all of the accompanying symptoms?

STEVE DUNAWAY, DEPUTY DIRECTOR, ASIA AND PACIFIC DEPARTMENT, THE INTERNATIONAL MONETARY FUND

Critics of the Chinese currency policy are calling for a properly valued currency, however because a significant portion of the dollars in China are speculative, it is very difficult to ascertain an equilibrium exchange rate for the RMB. As China continues to open, myriad assumptions and unpredictable external factors will come into play, making it impossible to project where the rate will be in immediate future much less the long term.

The Chinese currency question is a manifestation of the whole issue of global imbalances. While global imbalances "should" be addressed, the political will necessary for governments to make changes doesn't usually surface until crisis is at hand and drastic changes must be made.

The U.S. Treasury has indicated that the Fund has been asleep behind the wheel with regards to China, however consultations have taken place between China and the Fund since 1999. The IMF continues to make recommendations on China's monetary policy and structural reform based on surveillance at two levels: the country level and the regional/international level.

The nature of Fund governance makes any sudden or sweeping action unlikely and probably impossible. As a cooperative body, the Fund is unable to impose drastic, sudden policy changes on member countries. Offered policy recommendations are only as successful as member countries wish them to be. Members of the Fund's board hold varying views on the

best course in China, which further slows action – some advocate rapid change and others prefer a slow, steady revaluation.

PANEL II: SHOULD THE WORLD BANK CONTINUE LENDING TO CHINA?

MR. ALBERT KEIDEL, SENIOR ASSOCIATE CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

The World Bank should continue its involvement in China for several reasons. China remains a very low-income country on a per capita basis, specifically in the Central and the Western regions where per capita income is approximately \$1300. There exists no system of cross subsidies, which would help address regional poverty. Much is made about the China's vast reserves, however these are largely speculative funds and ready to move out at a moment's notice.

Borrowing from the World Bank ensures that China receives both loans and important policy advice, expertise and discipline that are as important as the resources. It is in the U.S. national security interest that China mature and become a sustainable economy with a strong middle class. The World Bank and the Asian Development Bank are the best way to leverage U.S. resources in China. American development assistance is joined by that of other countries and is delivered with technical expertise, policy advice, and knowledge that will eventually render China self-sufficient.

For the U.S. to block continued World Bank lending in China would return us to a Cold War mentality and would ultimately jeopardize U.S. national security.

ADAM LERRICK, FRIENDS OF ALLAN MELTZER PROFESSOR OF ECONOMICS; DIRECTOR OF THE GAILLIOT CENTER FOR PUBLIC POLICY, CARNEGIE MELLON UNIVERSITY; VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Lerrick conceded that the World Bank plays an important role in emerging markets, however asserted that the Bank's function is veiled in several myths. Lerrick proceeded to detail what he views as the fictions surrounding Bank lending.

It is a fiction that the World Bank lends only to countries that cannot borrow on capital markets. The Bank lends less than 1% of what the private sector does. With \$700 billion in foreign exchange reserves, China can easily borrow in world capital markets.

Another fiction is that the World Bank lends for projects unattractive to private sector lenders. The private sector doesn't care what the project is, if they will be repaid, they will lend.

Bank supporters point to the knowledge and expertise embedded in Bank lending as its biggest value. However, a wealth of capable consultants worldwide offer the same services. From this perspective, Lerrick said, the Bank could be viewed as the only consultant that actually pays clients to take its advice.

It is a myth that there is a qualitative difference between World Bank loans and those from the private sector. Money is money and if a head of state or minister of finance can get it for a cheap rate by sitting through a lecture from the World Bank on how to run his economy, then he'll sit through it. That does not translate to implementation.

Another myth, Lerrick continued, is that the World Bank wants countries to graduate – no bank aspires to lose its clients. The best Bank clients, in fact, are countries like India, China, and Mexico

because they will almost certainly repay their loans. When lending decreases, Lerrick said, the Bank lures former clients by lowering the conditionality of the loans in order to sweeten the deal for borrowers.

As the Bank's largest borrower, China has considerable influence over the Bank. As Keynes said, "If you owe the bank £10, you have a problem – if you owe the bank £10 million, the Bank has a problem." Being a large borrower from the Bank is tantamount to being a large shareholder.

Lerrick concluded by saying that the World Bank needs to stop thinking of itself as a bank and realize that it is a development agency.

JOHANNES ZUTT, COUNTRY PROGRAM COORDINATOR FOR CHINA AND MONGOLIA, THE WORLD BANK

Zutt countered Lerrick's point about revenue from loans to middle income countries. Some income is indeed generated, which is then put into the IDA program. While the discussion has centered on why the Bank continues lending to China, Zutt said that it is also worth examining why China continues to want to borrow from the Bank. They want access to the transfer of knowledge and expertise that come along with the loans. China also enjoys a comfort level working with a neutral, disinterested party that provides policy advice motivated only by what is best for China's economic performance.

Why is it not feasible for China to contract its projects out to consultants – a contracting issue? The Bank offers one-stop shopping – the lending and technical expertise offered while viewing the big picture and prescribing remedies that are purely in the interest of China's attainment of sustainable development. China continues to borrow from the Bank for this reason – the MDBs are meeting a need and adding value to China's borrowing.

JAMES E. ROCKETT, RESIDENT DIRECTOR, THE ASIAN DEVELOPMENT BANK'S NORTH AMERICAN OFFICE

Rockett agreed with much of what Keidel said, and stated that continued MBD involvement in China is essential from the vantage point of capacity building. The ADB's engagement in China is divided 12% to agriculture and rural development; 61% transportation sector – highways, roads, etc; 27% environmental projects.

The ADB remains engaged in China because, among other reasons, regional cooperation pays off. With epidemics such as the avian flu and SARS, China's cooperation has been very valuable. The ADB is also contributing to monetary and financial integration as well as trade and investment integration.