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What Happened to Paulson's China Talks? This Year, Pay Attention

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This is the year to pay attention to the annual gathering of America's and China's top diplomatic and economic officials.

An unusual confluence of circumstances means the seventh annual U.S.-China Strategic and Economic Dialogue, taking place Tuesday and Wednesday in Washington, has the potential to give crucial momentum to China's opening of its financial system and loosening of currency controls.

With China gunning this year for the prize of the International Monetary Fund's recognition of the yuan as a reserve currency, the U.S. is trying to use that as leverage to get China to speed up efforts to liberalize its economy. Add Chinese President Xi Jinping's state visit to the U.S. in September, the nascent U.S. presidential election campaign and China's hosting of next year's Group of 20 meetings, and you have the ingredients for action.

"This is a good year to make progress on opening up China's markets," said David Dollar, who served as U.S. Treasury attaché in China and is now a senior fellow at the Brookings Institution in Washington.

Tim Adams, a former Treasury undersecretary for international affairs, said it's especially important for the U.S. and China to work on these policies now. "It's the end of this administration and next year is the presidential election," said Adams, president of the Institute of International Finance in Washington.

Bush Meetings

The annual dialogue has alternated between Beijing and Washington since the Obama administration started it in 2009 as a broader version of meetings begun by Henry Paulson, Treasury secretary under President George W. Bush.

The gathering this year is led by Treasury Secretary Jacob J. Lew, Secretary of State John F. Kerry, Chinese Vice Premier Wang Yang and State Councilor Yang Jiechi. Past meetings have also included

Chinese central bank Governor Zhou Xiaochuan, Federal Reserve Chair Janet Yellen and dozens of other senior government representatives, such as financial regulators and officials for trade and agriculture.

The meetings occur against a backdrop of rising U.S. concern over Chinese intentions sparked by disputes over the South China Sea and rampant computer hacking just three months before Xi's visit to the White House.

Security Issues

Defense Secretary Ashton Carter last month called on China to halt its land reclamation efforts in the disputed waters of the South China Sea and vowed that U.S. warships and military aircraft would ignore Chinese objections to their operations in the area.

A Chinese military buildup, including a planned 10 percent increase this year, also is raising alarms over Xi's desire to project power far from the mainland.

Meanwhile, the Obama administration is considering possible retaliation for a computer hack of government files at the Office of Personnel Management. Data on as many as 14 million individuals may have been stolen, according to a lawmaker who asked not to be identified while discussing ongoing investigations. U.S. officials privately blame the attack on the Chinese government, allegations that the Chinese Embassy in Washington denies.

The IMF this year is conducting a twice-a-decade review of its Special Drawing Rights basket, a group of currencies that includes the dollar, euro, yen and pound. China's request to join hinges on whether the yuan is deemed "freely usable" -- meaning it's sufficiently present in official reserve holdings, with a deep and broad foreign-exchange market. Inclusion would be an endorsement of China's progress toward economic openness.

The issue has placed Zhou and Lew on the same side, in a way. For Zhou, acceptance in the SDR club would be a reward for getting the Communist Party to open up the nation's financial system and loosen controls on the yuan. For Lew the review is doubling as an incentive to get China to do more, faster.

Common Interests

"There is a commonality of interests between the U.S. administration and economic reformers in China" on the issue, said Eswar Prasad, a former IMF official who teaches at Cornell University in Ithaca, New York. Getting those financial and market-oriented reforms is "essential to improve the functioning of

China's economy and to make its growth more balanced and sustainable.”

Group of Seven finance ministers and central bank governors agreed on the desire to include the yuan in the SDR basket, as long as the IMF's criteria are met, German Finance Minister Wolfgang Schaeuble said last month after a meeting that included Lew.

China's leadership, prodded by Zhou, 67, head of the People's Bank of China since 2002, has taken dozens of steps to win at the IMF this time.

Deposit Rates

They include raising a ceiling on deposit rates, widening the yuan's daily trading band and setting up yuan-trading hubs in financial centers such as London and Singapore. That's not enough for the U.S. and Lew, who has called for further steps to make the yuan's exchange rate more market-determined, allow freer capital flows and strengthen financial regulation.

“They've still got some work to do moving on that path, but they've made a lot of progress,” Lew, 59, told an audience in London on May 27. He said in March that reforms geared toward internationalizing the yuan would make China's economy “more balanced internally and externally,” an outcome that benefits the world as a whole.

Another Review

In theory, the IMF could conclude its review this year by saying that China is not ready yet and offer another review at the end of 2016, according to Prasad. That outcome would be negative for China, which wants to be in the SDR before it assumes leadership of the G-20 major developed and developing economies for 2016.

“I suspect that the U.S. would be truly on board with that position,” he said.

Winning the IMF's blessing, following a rejection in the last review in 2010, would give the yuan prestige as a reserve currency that makes it more attractive for central banks to hold and potentially reduces the dollar's dominance worldwide. From a technical standpoint, owning SDRs counts toward a country's official reserves; the U.S. holds \$50 billion worth, out of about \$280 billion worldwide.

IMF Managing Director Christine Lagarde has said it's a question of when, not if, the yuan will join the SDR. Given that the rest of the world is embracing the yuan as a global currency, it wouldn't be smart for the U.S. to oppose it, or even ask China to do too much, Dollar said.

“If the U.S. side supports including the yuan in the SDR, it’s just a recognition of the fact that China’s economic and financial clout is rising,” said Shi Yinhong, professor of international relations at Renmin University in Beijing and an adviser to China’s State Council.