There being no objection, the material was ordered to be printed in the Record, as follows:

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ECONOMICS FOCUS—PUTTING THINGS IN ORDER

CHINA OUGHT TO ALLOW MORE FLEXIBILITY IN ITS EXCHANGE RATE, SOONER RATHER THAN LATER

The Chinese government says that it intends, eventually, to make its exchange rate more flexible and to liberalise capital controls. In the past year or so, it has already eased some controls on capital outflows and officials have said recently that they will open the capital account further this year. On the exchange rate, much less has been done. The yuan has been pegged to the dollar for a decade; and the government is loath to change much until the country's banking system is in healthier shape: this week the prime minister, Wen Jiabao, said that a shift would be risky. But is China putting the cart before the horse? Other countries' experience suggests that it is, and that it is better to loosen the exchange rate before, not after, freeing capital flows.

Most commentary on the Chinese yuan tends to focus on the extent to which it is undervalued. It has been pegged to the dollar for a decade, and there is a widespread belief that it is unfairly cheap. In fact, this is not clear-cut. For instance, the increase in China's official reserves is often held up as evidence that the yuan is undervalued. Yet this largely reflects speculative capital inflows lured by the expectation of a currency revaluation. Such inflows could easily be reversed. Given the huge uncertainty about the yuan's correct level, it makes more sense for China to make its currency more flexible than to repeg it at a higher rate. Greater flexibility would be in China's interest: it would afford the country more independence in monetary policy and a buffer against external shocks. By fixing the yuan to the dollar, China has been forced to hold interest rates lower than is prudent, leading to inefficient investment and excessive bank lending.

The problem is that Chinese officials, along with many foreign commentators, tend to confuse exchange-rate flexibility and capital-account liberalisation. A commonly heard argument is that China cannot let its exchange rate move more freely before it has fixed its dodgy banking system, because that could encourage a large outflow of capital. A recent paper* by Eswar Prasad, Thomas Rumbaugh and Qing Wang, all of the International Monetary Fund, argues that, on the contrary, greater exchange-rate flexibility is a prerequisite for capital-account liberalisation.

Flexibility does not necessarily mean a free float. Initially, China could allow the yuan to move within a wider band, or peg it to a basket of currencies rather than the dollar alone. The authors first knock on the head the notion that the banking system must be cleaned up before allowing the exchange rate to move. Although financial reform is certainly essential before scrapping capital controls, the authors argue that with existing controls in place the banking system is unlikely to come under much pressure simply as a result of exchange-rate flexibility. Banks' exposure to currency risks is currently low and flexibility alone is unlikely to cause Chinese residents to withdraw their deposits or provide channels for them to send their money abroad.

The authors argue that it is also not necessary to open the capital account to create a proper foreign-exchange market. Because China exports and imports a lot, with few restrictions on currency convertibility for such transactions, it can still develop a deep, well-functioning market without a fully open capital account. A more flexible currency would itself assist the development of such a market. For example, firms would have more incentive to hedge foreign-exchange risks, encouraging the development of suitable instruments. The experience of greater exchange-rate flexibility would also help the economy to prepare for a full opening of the capital account. While capital controls shielded the economy from volatile flows, China would have time for reforms to strengthen the banking system.

China instead seems intent on relaxing capital controls before setting its exchange rate free. This ignores the history of the past decade or so: the combination of fixed exchange rates and open capital accounts has caused financial crises in many emerging economies, especially when financial systems are fragile. China would therefore be wise to move cautiously in liberalising its capital account, but should move more rapidly towards greater exchange-rate flexibility.

YUAN AT A TIME

The Chinese have tried to offset the recent upward pressure on the yuan by easing controls on capital outflows, for instance by allowing firms to invest abroad. While this is in line with the eventual objective of full capital-account liberalisation, it runs the risk of getting reforms in the wrong order. An easing of controls on outflows may even be counterproductive if it stimulates larger inflows. By making it easier to take money out of the country, investors may be enticed to bring more in.

Capital controls are not watertight. So although China will continue to be protected from international flows, its controls can be evaded through the under- or over-invoicing of trade. Multinationals can also use transfer prices (the prices at which internal transactions are accounted for) to dodge the rules. Despite extensive controls, a lot of capital left China during the Asian crisis in the late 1990s; recently, lots of short-term money has flowed in. Controls are likely to become even more porous as China becomes more integrated into the global economy. Thus, waiting for speculative and other inflows to ease before changing the exchange-rate regime might not be a fruitful strategy.

China ought to move to a flexible exchange rate soon, while its capital controls still work. Experience also suggests that it is best to loosen the reins on a currency when growth is strong and the external account is in surplus. China should take advantage of today's opportunity rather than being forced into change at a much less convenient time.

Mr. VOINOVICH. I also urge my colleagues to read a paper by the staff of the International Monetary Fund entitled ''Putting the Cart Before the Horse: Capital Account Liberalization and Exchange Rate Flexibility in China.'' That is a January publication by the IMF. I would have asked it be printed in the RECORD, but it is 30 pages long and I do not want to burden the CONGRESSIONAL RECORD with 30 pages. If my colleagues are interested in getting a copy of that article, I would be more than happy to supply it.

These papers show how exchange rate flexibility will facilitate economic development in China and why China does not have to wait until its banking system is more fully developed to move toward a flexible exchange rate.

Moreover, they note that China does not need to immediately float its currency to remedy the problems caused by an undervalued currency. All China needs to do is take steps in that direction, such as adopting a wider exchange rate ban or pegging the exchange rate to a basket of currencies instead of the dollar alone, for example, a basket of currencies in the ASEAN countries, including Japan. Either of these policies would likely cause an upward revaluation of the yuan. Unfortunately, the Bush administration has refused meaningful action to get China to move toward a flexible exchange rate.

Last year—I remember it well—on September 8—that happens to be my wedding anniversary—four of our leaders in this country summarily said there is no problem in terms of the exchange rate and they refused to go forward with something called a 301 investigation. The 301 investigation is allowable under the WTO. That is the way you bring into question whether somebody is following the rules. They said, no, we are not going to do it. Imagine what kind of a message that sent to the leaders of the Chinese Government, that we were not even willing to look at a 301 investigation. That was a mistake.

The United States-China Economic and Security Review Commission, a bipartisan commission established by Congress to examine China's trade policies, has concluded that China's exchange rate policy violates both its International Monetary Fund and World Trade obligations. That was a bipartisan commission that came together and issued this report. The commission said China is intentionally manipulating its currency for trade advantage in violation of its trading agreements. Yet the administration refuses to act. Unless the United States exerts direct pressure on China, however, it is unlikely that China will address the undervaluation of its currency. When I asked the question of Premier Wen, he said, We know there is a problem, but we are not sure when we will do it.

I can say they will not do it unless we continue to put pressure on them to do it and convince them that, again, it is not only in our best interest but their best interest if they want to be a player in the global marketplace.

That is why Wednesday's vote was important. It showed the Senate is willing to take matters into its own hands and take effective steps to address the serious problem if the administration continues to refuse to do so. No one wants to see tariffs imposed on Chinese exports, but the United States needs to take action to address China's unfair exchange rate policy. I hope Wednesday's vote will motivate the administration to do more to get China to address the serious market distortions caused by the undervaluation of China's currency.

I believe in fair trade and improving our trading relationship with China. I was one of the leaders in the Senate to