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

[From the Economist, Mar. 19, 2005]

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 liberalize capital controls. In the past year or so, it has already eased financial 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 under-valued. A rise in purchasing power implied by this is often held as evidence that the yuan is undervalued. Yet this largely reflects speculative capital inflows, which is not necessarily evidence that it is unfairly cheap. In fact, this is not cut and dry. For instance, the increase in China's official reserves is often held as evidence that the yuan is undervalued. Yet this largely reflects speculative capital inflows, evaded through the under- or over-invoicing of trade. Multinationals can also use transfer pricing (the prices at which internal transactions are accounted for) to dodge the rules. Despite extensive controls, a lot of capital evades them. By making it easier to take money out of the country, investors may be enticed to bring more in.

Capital controls are not watertight. Although China will continue to be protected from international flows, its controls can be compromised. For instance, the 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 evades them. By making it easier to take money out of the country, investors may be enticed to bring more in.

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 Chinese residents to take money out of the country. A more flexible exchange rate might also help ease the fiscal tension caused by the rising cost of financing the current-account deficit. But there is little evidence that these changes are having much effect. Most of the increase in Chinese 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 insurance against exchange risks, encouraging the development of suitable instruments. The experience of greater exchange-rate flexibility would also help the economy cope with 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 two decades. As soon as China liberalized its exchange rates and open capital accounts has caused financial crises in many emerging economies, especially when financial systems were fragile. China has been forced to hold interest and capital-account controls. In the past year or so, it has already moved to make the capital account 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 shield the economy from speculative inflows. As best as they can, the Chinese authorities have been trying 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 relatively low inflation and make the 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 the China Economy.” 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 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 band or pegging the exchange rate to a basket of currencies instead of the dollar alone, for example, to 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 summarized 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. I asked them, 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 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 the 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 shows the United States 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 its currency.

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