The rocky road ahead: China, the US and the future of the dollar

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ABSTRACT
The future of the dollar depends partly on China and the US being able to effectively manage the tensions arising from the large bilateral trade imbalance and the build-up of foreign exchange reserves by China. We argue that these tensions are unlikely to change over the medium term. While tensions can be managed, the possibilities for miscalculations and policy errors are significant given the complex, and sometimes inconsistent, interests of both countries’ policy-makers. In fact, China faces its own form of a ‘trilemma’ and the ability of the US to exercise its monetary power by shifting the burden of adjustment onto China is uncertain. Given this, and volatile international financial markets, miscalculations which might result in a collapse in the value of the dollar affecting its role as an international currency become a real possibility.

KEYWORDS
Exchange rates; dollar dominance; international currency; global imbalances; monetary power; renminbi.

INTRODUCTION
In discussions of the future of the dollar, China looms large. China’s re-emergence as a world economic power raises questions about whether its economic size will threaten the pre-eminent position of the US and the dollar. China’s aspirations to regional leadership together with increasing regional monetary cooperation since the Asian financial crisis raises the possibility of the emergence of an Asian regional currency which might challenge the dollar. And the current concerns over ‘global imbalances’ typically point to China as a potentially destabilizing player and has led to demands from the US and the EU for China to change its exchange rate policies.
In this paper, we argue that China’s re-emergence as an economic power is unlikely to point to the end of the dominance of the dollar. Nor do we see much possibility of any kind of Asian Currency Unit being a challenger. More problematic for the future of the dollar as the undisputed international currency, in our view, is that current tensions in the bilateral US–China economic relationship are likely to be enduring ones. Specifically, we argue that China’s foreign exchange regime is unlikely to change significantly over the medium term, defined as the next five to ten years, and that China’s bilateral trade surplus with the US is also a medium-term phenomenon. China’s foreign exchange reserves are likely to continue at high levels.

None of these factors, in themselves, necessarily point to a threatened future for the US dollar. As Dooley et al. (2003) have argued, the current imbalances may be sustainable. However, we argue while policy-makers in both the US and China have strong interests in preserving a stable international economic and monetary order, the role of the dollar in it depends on how well enduring bilateral imbalances and complex interests are managed. The main argument of this paper is that this management problem will extend well into the medium term and that it will be a challenging one. The roots of the management problem lie in a specific ‘trilemma’ faced by China’s policy-makers as they seek to cope with the stresses arising from China’s export-led growth model and from uncertainty over the extent to which the US will seek, and be able, to use its ‘monetary power’ when dealing with an emergent China. Given this, we argue that policy miscalculations and market reactions pose the greatest threat to the future value, and hence role, of the dollar.

We start by arguing that the threat to US dollar dominance does not come from China’s re-emergence or from a possible Asian Currency Unit but rather arises from the current imbalances and the policy history which lie behind them. We then discuss the possible future trends in the three key variables which will determine whether the current situation evolves into a more enduring problem, namely, China’s foreign exchange rate regime, trade surplus and official reserve holdings. We conclude by suggesting that the scope for mismanagement is considerable and that a rocky road lies ahead. The focus of the paper is primarily on China, not because we think that the main cause of problems or the main solutions are necessarily to be found in China but because analysis of the US is the focus of other papers in this volume.

WHERE DOES THE THREAT TO THE US DOLLAR COME FROM?

The re-emergence of China as an economic power does not, in itself, imply a reduced role in the medium to long term for the US dollar. As Helleiner
Table 1 Shares of world GDP, 1870–2001, selected countries

<table>
<thead>
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<th></th>
<th>1870</th>
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<td>4.5</td>
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</tr>
</tbody>
</table>


(this volume) has pointed out, many arguments in the economics literature point to the role of economy size, among other factors, as a determinant of the international currencies. Estimating the relative size of the Chinese economy is no easy matter; Maddison’s (2003) estimates are presented in Table 1.

The data presented by Maddison point to a dramatic increase in China’s share of world GDP over the past three decades, an increase which outstripped that of post-war Japan in the period when the yen became an international currency. However, there are several reasons why the renminbi may not repeat this feat. First, economy size is only one factor determining international currency usage; other factors, such as confidence in the country’s stability, the deepness of its financial system and its level of economic development, all limit the possible emergence of the renminbi as a major international currency at least over the next decade or so. Certainly, using Kenen’s (1983) typology, the renminbi currently plays only a very limited role as a medium of exchange, store of value or unit of account for official uses. The renminbi also plays only a minor role in these functions in the private sphere. Second, if the historical experience is a reliable guide then, as both Kirshner and MacNamara (this volume) show, the pound sterling continued to play a significant role in the international monetary system long after Britain’s economic pre-eminence was lost. Indeed, the data presented by Maddison above show that the UK’s economic dominance had been eroded by 1870 and yet the pound sterling continued to be the dominant international currency until 1945 (see Chinn and Frankel, 2005: 9). Even if the extrapolation exercise undertaken by Goldman Sachs (2003) proved accurate, therefore, and China overtook the US as the world’s largest economy by mid-century, the dollar would likely continue for a significant time thereafter as the world’s leading currency.

If the renminbi is unlikely, on its own, to challenge the position of the dollar within the next 10–15 years, the same could be said of its use in an Asian currency basket or by any possible Asian Currency Unit. Liu (2002) has argued that the renminbi could become the core currency for an ‘Asian dollar’. But an Asian currency is a long run possibility at best. Chung and Eichengreen (2007) highlight the different agendas and arguments at
play in East Asia which make agreement on a move towards a regional currency problematic, the Asian Bond Fund and Chiang Mai Initiatives notwithstanding. Parallels with European monetary integration are commonplace but it should be remembered that the political commitment to, and bargaining between, leading European states which were necessary to realize the euro project are much more difficult to replicate in East Asia where historic rivalries between China and Japan are so evident. Given that the creation of the euro has to date only been a limited challenger to the dominance of the dollar, it is highly premature to expect that an Asian currency unit could be a greater challenge any time soon.

These two factors, the possibility of the renminbi replacing the dollar as China’s economic size increases and the possible emergence of an Asian currency unit, in our judgment pose little threat to role of the dollar as the dominant international currency over the next one to two decades. A greater challenge to the dollar comes, we argue, if current economic policy frictions and associated imbalances are not properly managed. To explain, the current situation is one marked by China having a large bilateral trade surplus with the US, a rapid build-up of official reserves expected now exceeding well over US$1 trillion and a managed but relatively slow appreciation of the renminbi against the US dollar.

The background to this situation is as follows. The renminbi had a de facto peg against the US dollar from 1996 until 2005. Following international pressure, especially from the US, to revalue the renminbi and to permit greater exchange rate flexibility, China’s central bank, the People’s Bank of China, announced on 21 July 2005 that (1) China would reform the exchange rate regime by moving to a ‘managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies’; (2) the Bank would announce the closing price of a foreign currency such as US dollar against the renminbi in the inter-bank foreign exchange market after the closing of the market on each working day, and would make it the central parity for trading against the renminbi on the following working day; (3) the US dollar/renminbi exchange rate would be adjusted to 8.11 yuan per US dollar effective immediately; and (4) the daily trading price of the US dollar against renminbi in the inter-bank foreign exchange market would continue to be allowed to float within a band of plus or minus 0.3% around the central parity published by the People’s Bank.

As a result of (3), the renminbi appreciated by 2.1% immediately against the US dollar. With respect to point (4), the band limits are the same as those which were used prior to the announcement. However, previously this band was set around a fixed rate against the US dollar. After the announcement, the band is set around a rate which itself may move on a day-to-day basis. Thus, the new exchange rate regime is best regarded as a tightly managed float. The band was increased to plus or minus 0.5% in
May 2007 following further pressure from the US administration. Since the July 2005 2.1% appreciation against the US dollar, the renminbi appreciated 5.4% between then and the May 2007 widening of the exchange rate band. Since the May 2007 band widening and the end of the year, the renminbi appreciated by a further 4.6% against the dollar. The increasing speed of the appreciation of the renminbi against the dollar in the second half of the year is a reflection of the relaxation of the tightness of China’s managed float rather than of any loss of control arising from the global fall of the dollar in the wake of the sub-prime financial crisis in the US.

The renminbi is also allowed to float against other major currencies in the currency basket but the bands for these currencies have not been announced. As Stetser (2006) argues, the much smaller movement of the renminbi against the US dollar indicates that the dollar continues to be by far the most important currency in China’s currency basket.

Between 1985 and 1996, when the renminbi was depreciating albeit under a multiple exchange rate system, China’s balance of trade was in a relatively small annual surplus or deficit as shown below in Figure 1. The surplus increased after the de facto peg was established in 1996 but fell again in 1999 and 2000. Since 2002 the annual trade surplus has, however, grown rapidly.

China’s trade pattern is best understood in triangular terms; basically China runs large trade deficits with Japan from which it imports capital goods and runs large trade surpluses with the United States to which it exports consumer goods. Until the late 1990s, this triangle kept the balance of trade in rough balance as shown in Figure 1. However, there has been a large and growing bilateral trade surplus with the US for well over a decade as shown in Figure 2.

It is this bilateral surplus, and China’s official reserves build-up, shown below in Figure 3, that has attracted considerable attention from US
policy-makers and, more recently, from the European Union and G-8 leaders concerned about the size of ‘global imbalances’. China’s exchange rate regime, and its implicit peg to the US dollar from 1996, has been the source of much discussion amid accusations that China is an ‘exchange rate manipulator’ (For extended discussion see Bowles and Wang, 2006.)

Not surprisingly, the present situation has caused considerable tensions between the US and China, with the US pressuring China into letting the renminbi appreciate in an effort to reduce the bilateral trade deficit. The Schumer–Graham proposal for a 27.5% tariff on Chinese imports to offset the extent of China’s alleged ‘currency manipulation’ remains an option.
before the US Senate ready to be reactivated should US Treasury Secretary Henry Paulson Jr. fail to persuade the Chinese leadership to take corrective measures. Approximately 50 China-related trade bills were introduced in the US Congress in 2007.

For their part, China’s policy-makers have continued with their public declarations that they are moving to a more flexible exchange rate system but have provided no details of when or to what degree. As noted above, China did suddenly announce in July 2005 a change in its exchange rate policy. In September 2006, coinciding with Paulson’s visit to Beijing, the renminbi appreciated at a faster rate against the US dollar than in the previous year as a prelude to a loosening of the exchange rate band in May 2007.

The implications for the future of the US dollar depend in part whether the current tensions are a temporary episode or whether they are part of a longer-term problem. If the former, then the current renminbi–dollar exchange rate dispute may lead to a change in the relative values of the two currencies but will not affect the role of the dollar as the key international currency just as it did not after other ‘realignment’ episodes. If the underlying economic forces are more permanent and if China does not readily accept the need for ‘realignment’ then the implications for the US dollar will be more profound. It increases the need for, and stakes in, the bilateral management of existing tensions; should this not prove possible then a sudden collapse in the value in the dollar and a consequent undermining of its role as an international currency become possibilities. Which scenario is most likely to occur requires a medium-term analysis of what is likely to happen with respect to China’s exchange rate policy, the trade surplus and the level of official reserves. We discuss each of these in turn below.

**MEDIUM-TERM ISSUES**

**Will the exchange rate regime change?**

China has already relaxed its de facto dollar peg and moved to a slightly more flexible exchange rate system. Over the medium term greater flexibility might be expected (see Bowles and Wang, 2006 for discussion). Furthermore, there has been widespread discussion among Chinese economists about the long run future of exchange rate policy. A review of leading academic articles on the subject suggests that the majority of economists believe that a flexible rate regime is preferable. China will gradually open its banking, insurance and securities markets under the terms of its WTO accession and the separate bilateral US–China agreement. The key question for Chinese economists is the relationship between these financial liberalization measures, other possible future capital market openings and the reform of the exchange rate system. The issues which have attracted
attention are how fast each of these reforms should take place and what should be their sequencing. Many economists have argued against any rapid changes and believe that the reform of the exchange rate system and the opening up of capital markets should proceed simultaneously – but gradually.

This is the key point; while some change in the direction of greater exchange rate flexibility is likely, it is also highly likely that it will only be a gradual change and will fall far short of the sort of immediate 20–40% appreciation that US legislators are seeking. This is not simply in deference to the views of academic economists on reform sequencing as indicated above. It also stems from the imperative of providing jobs in the export sector. Kaplan (2006), for example, argues that the politically important export-oriented manufacturing sector has been key to reducing the flexibility of China’s exchange rate system.5

Equally important, many Chinese academics and policy-makers view the 1985 appreciation of the yen as part of the Plaza Accord as being directly responsible for the emergence of the bubble economy which burst in 1989 and ushered in a recession from which Japan has yet to recover (see Anon, 2003). While the US entered its longest post-war growth period in the 1990s, Japan had by far its worst post-war growth decade. Chinese analysts point to the rapid appreciation of the yen/depreciation in the dollar in 1985 as a powerful explanatory variable in explaining these outcomes. Chen (2003), for example, argues that by forcing an appreciation on Japan as a result of its ‘financial hegemonism’, the US was able to obtain ten years of economic prosperity. Now, he argues, China is being faced with pressures to revalue as a result of the new financial hegemonism of the US and Japan.

The ‘exchange rate realignments’ of the past, such as those with Japan in 1985 and South Korea in 1989, have been seen as an attempt by the US to force other countries to adjust their policies in the name of ‘burden sharing’ but where the US does not accept its share of the burden. While China may be willing to go some way down this road, top leaders do not see it as being in China’s economic interests to move more than gradually on this issue.

The case for a gradualist approach has been made by People’s Bank Governor Zhou Xiaochuan. In ‘Remarks on China’s Trade Balance and Exchange Rate’, Zhou (2006) argued that:

Due to the accelerating development of globalization … it is likely that it will take several years before global trade could reach a new equilibrium. China as a large developing economy with heavy employment pressures and a still fragile financial system, could only adopt a gradualist approach to adjust its economy in a controllable manner.

The IMF has recently held a conference to discuss the global imbalances, and most of the participants believed it was appropriate
to pursue a gradual adjustment, and radical measures could result in unanticipated consequences. Besides, some participants suggested that the US has been too slow in making internal adjustment.

Some advisors have prescribed ‘shock therapy’ to Russia and Eastern European countries, but later on this was described as ‘shock with no therapy’. We should be cautious to offer the same prescriptions again, so as not to have credibility jeopardized. China will only consider to take the gradualist reform approach that wins the trust of the masses of the Chinese people, rather than a ‘shock’, not to mention that the US has not taken the lead to use ‘shock’ to adjust its imbalances.

The gradualist approach to economic reform, a hallmark of the near 30 year Chinese reform process, will not be abandoned in order to find a quick exchange rate fix. Zhou did state that market forces ‘could be allowed gradually to play a greater role in the floating exchange rate’. However, it is unlikely that anything like the Plaza Accord, which in essence is behind much of the US position, will be acceptable to China. The effects of the Plaza Accord on Japan, the effects of ‘shocks’ more generally, and the unwillingness of the US to take measures to solve its own internal structural economic problems (such as its low savings rate), all point to a slower rather than faster pace of exchange rate adjustment. The implications of this for the exercise of US monetary power are discussed in the fourth section.

Will the trade balance continue to be in large surplus?

The answer to this question is partly dependent on the answer given above concerning the likely path of the exchange rate. But this is not the only factor that needs to be taken into consideration for a number of reasons. An exchange rate change may not lead a large reduction in the trade balance anyway, especially with the US given the nature of China’s trade. Of importance here is the high percentage of processing trade in exports (over 55%). This stems from China’s role as a supplier of low cost labor to the global economy with firms importing the raw materials which are then manufactured in China before being re-exported. A second point is the high percentage of China’s exports (over 57%) which are accounted for by foreign-funded enterprises. This, too, is the result of China becoming viewed by international capital as a location of choice as an export platform.

What is important is that intra-firm may be insensitive to exchange rate changes and the large processing trade will mean that a renminbi appreciation will cheapen imports thereby offsetting some of the effects of an appreciation on export prices. For this reason, US multinational capital is generally less concerned by US administration pressure for renminbi
appreciation than by possible trade restrictions. It also explains why the trade balance depends on more than simply the exchange rate.\(^6\)

Also of relevance is the role that trade has played in China’s development strategy. The leadership’s development goals are summarized by the UNDP (2005: 91) as follows:

In the 1980s, China formulated the ‘three-step’ strategy of modernization. Step one was to double 1980 GDP and solve the basic food and clothing problem; step two was to double GDP again by the end of the twentieth century; and step three was to proceed in realizing modernization by the middle of the twenty-first century. In 2002, the Chinese government proclaimed that ‘victory has been achieved in reaching the second step in the three-step modernization strategy’.

China’s leaders now see the immediate goal as reaching a GDP per capita of approximately US$3000 by 2020 followed by the attainment of an ‘affluent life’ for its citizens by mid-century. The spectacular growth of the past 25 years, therefore, is not seen as having completed an economic transformation but as merely completing the initial stages of a much longer process. In this process, trade has played a crucial role.

The question is whether China’s trade will continue to expand at the high rate that it has in the past two decades. Flassbeck et al. (2005: 4–5) conclude that ‘the speed with which China penetrated world markets is not unprecedented … During the first years of China’s reform period initiated by Deng Xiaoping, export growth in China was significantly slower than in other Asian countries during their catch-up periods’ (emphasis in original). By the mid-1990s export growth accelerated and looked more typical of the Asian catch-up economies. However, according to Flassbeck et al. (2005) ‘since 2000, Chinese exports have, by far, outpaced the performance of other countries in comparable periods. China almost doubled its exports in three years from 2000 to 2003’.

The picture that emerges from this is that China’s export growth, apart from the past few years, has not been exceptional by East Asian standards. If we look at comparative historical experiences, therefore, then China’s export growth might be expected to slow down somewhat from the exceptionally rapid pace of the early 2000s but to continue to increase substantially nonetheless.

For the trade balance, of course, what also matters is the growth of imports. Here, Flassbeck et al. (2005: 5) argue that ‘despite recent rapidly growing imports to China, large external surpluses seem to be a rather common feature of Asia’s growth experiences’. Indeed, one of the features of East Asian economic growth has been precisely its ability to avoid the trade deficits (and associated balance of payments constraints) which have plagued development efforts in other regions, most notably, Latin America.
There is no historical comfort here for those looking for a quick solution to current ‘global imbalances’.

There are two factors which, we think, might have some moderating effect on the growth of exports. First, it should be noted that China already has a relatively high trade/GDP ratio for a large country. China’s trade/GDP ratio at over 60% is a comparatively high figure compared with a figure of approximately 25% for Japan and 30% for the United States. As such, it might be expected that there are limits to how much further it can increase suggesting that trade growth may move closer to the more modest (although still significant) GDP growth rate. If this were to happen it would, in fact, reduce China’s export growth rate of approximately 30% p.a. to a third of that.

Second, the rapid rise in the trade/GDP ratio reflects the fact that China has followed an export-led industrialization strategy and ever greater interaction with the global market. There is some evidence to suggest that this may be modified over the medium term.

Large regional inequalities and the underlying social tensions which they have caused have become key concerns for China’s top leadership. As a result the 11th Five Year development plan, announced in March 2006, explicitly addressed the need to reduce these inequalities, suggesting that increased attention to rural areas and a greater reliance on domestic demand would be features of future economic policy. Over the medium term, therefore, this could produce at least a moderation in the extent to which the export-led development strategy, with its emphasis on the coastal areas, is pursued.

This review suggests that China’s export growth, and trade surplus, can be expected to continue over the medium term. The comparable historical experience of other East Asian countries points to this as does the fact that China has been able to rapidly move up the technological ladder with regard to export composition (see Edmonds et al., 2005). We have identified two factors which might mitigate this growth over the medium term, the most important of which is the change in orientation of government policy itself away from an export-led strategy to one which places a greater emphasis on domestic demand in response to widening regional and urban–rural inequalities.

A – certainly overly optimistic – prediction is made by People’s Bank Governor Zhou (2006) when he states that ‘the PBC anticipates that it needs a time span of two to three years to achieve an approximate trade balance’. Even under this optimistic scenario, however, he points out that ‘what is worrisome is that, according to the analysis by Chinese economists, even China basically realized a global trade balance, the United States might still incur large trade deficits and it would still be very difficult to achieve a bilateral trade balance between China and the US’.

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Will reserves continue to build-up?

Given the answers to the above two questions – that we expect the exchange rate regime to change only slowly and the trade balance to continue in surplus – it might seem obvious that China’s massive foreign exchange reserves will also continue to climb. This conclusion, however, is not so straightforward for two reasons. First, the increases in foreign exchange reserves – of which it is estimated that approximately 80% are held in US dollar denominated assets – is not only due to the trade surplus. Second, if outward capital controls are relaxed there will be a demand for foreign currency which the People’s Bank might meet through selling off its reserves.

With respect to the first point, China’s official reserves have been increasing as a result of (i) the People’s Bank sterilizing the trade surplus (i.e. by buying up the surplus foreign exchange); (ii) foreign direct investment inflows; and (iii) speculative inflows driven by the expectation of an appreciation in the renminbi.

As a way of getting a handle on the relative size of the first component compared to the latter two, we disaggregate China’s monthly foreign reserve increases since the move to the ‘managed float’ in July 2005 in Table 2 below.

This shows that of the approximately US$723 billion increase in reserves over this period, around 60% was the result of the trade surplus and 40% was the result of FDI and/or ‘hot money’ inflows. Expectations of further appreciation of the renminbi during 2007 resulted in significant speculative inflows China’s capital controls notwithstanding.

The trade surplus, therefore, is a significant source of the rising official reserves and FDI inflows are expected to continue to be positive and significant. What is not so clear is whether speculative money inflows will continue; not so long ago China was worried about the extent of capital flight, much of which was illegal. Which brings us to the second point, namely, whether capital controls on the outflow of capital from China will be further relaxed. If they are, then the demand for foreign currency may increase which the central bank may meet from official reserves if they wish to maintain exchange rate stability. Barring a major political upheaval and a rapid relaxation of outward capital flows, however, we might expect the current level of official reserves – the world’s largest – to continue.

The question is, what does China need these reserves for? And is it willing to indefinitely exchange real goods for US dollar denominated assets?

There are several studies by Chinese researchers analyzing the optimal level of reserves, a figure which is determined by, inter alia, four months’ import coverage, debt levels, foreign interest rates and the degree of trade openness. According to most of these studies, China’s reserves are currently well above the optimal level.7
The main arguments why the current level of reserves is harmful include the observations that a build-up of reserves is associated with the loss of real output, higher risks as a result of a potential US dollar depreciation, higher political risks associated with more conflict with the US, increased difficulty of domestic monetary management as a result of the need to sterilize the inflows, and a reduced ability to borrow from the World Bank.

In the light of this, it is not surprising to find Chinese leaders indicating that they do not wish to see a further build-up of reserves. Vice President Zeng Qinghong is quoted as saying that China ‘would take comprehensive measures to avoid further significant growth’ in reserves (see McGregor, 2006). Such measures, as yet unspecified, could include increasing imports

### Table 2

Components of China’s foreign exchange reserves increases, US$ billions (July 2005–September 2007)

<table>
<thead>
<tr>
<th></th>
<th>FER (1)</th>
<th>Change in FER (2)</th>
<th>Total exports (3)</th>
<th>Total imports (4)</th>
<th>Trade surplus (5) (2)–(5)</th>
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<tr>
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Source: FER from the People’s Bank of China; total exports and imports from China customs.

Note: FER = total foreign exchange reserves.
MANAGING COMPLEXITY: CHINA’S TRILEMMA AND THE UNCERTAINTY OF US MONETARY POWER

The discussion above has been an exercise in ‘informed futurology’. Our guess as to the most likely path of events over the medium term is that, first, we will not see a dramatic change in the China’s exchange rate regime or a rapid change in the value of the renminbi relative to the US dollar. Certainly, some appreciation can be expected and perhaps a further gradual widening of the currency trading band. But the key word here is gradual; China’s reforms have been premised on gradualism and this is not about to change with respect to the exchange rate especially when the interests of the export sector are added to this.

Our analysis suggests that China’s export growth is likely to continue over the medium term although at a reduced rate. The comparative historical experience of other East Asian countries suggests that, in general, China’s experience has not been not exceptional and there is no reason to therefore expect a sudden slow down or reversal. While this is true in general, the export growth of the past four or five years has been exceptional and is likely to either slow down or be reigned in. From a policy perspective, the export-led industrialization strategy is seen within China as being responsible to a considerable degree for the widening regional income inequalities, inequalities which the new leadership view as threatening social stability. Over the medium term a greater reliance on the domestic economy can be expected, a shift – again gradual – which may lower the trade surplus.

We have also suggested that the level of China’s foreign reserves is recognized as being excessive and as one that is causing policy-makers problems both domestically and internationally. While the scale of reserves, and the switch to a foreign exchange basket float, mean that diversification out of the US dollar is likely, again this is most likely to occur gradually. In April 2007, China decreased its holdings of US dollar denominated bonds but only by a relatively small amount. It is not in the interests of the Chinese leadership to spark a fall in the value of the dollar.

However, managing the interests of both China and US over the medium term, in the face of the enduring economic tensions which we have identified, will be no easy matter. On the Chinese side, policy-makers wish to maintain the current exchange rate regime, gradually bring down the trade surplus although recognizing that this will not necessarily happen with the US bilateral surplus, and prevent foreign exchange reserves from increasing much further. But this is a difficult task with potentially inconsistent objectives (such as maintaining the exchange rate regime but avoiding a
further reserve build-up). Indeed, China faces its own ‘trilemma’ being unable to simultaneously meet all three objectives. Underlying the trilemma is the export-led growth model which mitigates against a rapid move towards a more flexible exchange rate regime. The export-led model does have its critics within China (from the so-called ‘new left’) and the inequalities that it has spawned has led to some shift of emphasis by the current Party leadership; however, it is unlikely that this will lead to sufficient change to ease the trilemma in the medium term.8

The most likely path to try to escape from this trilemma is a continued gradual opening of the capital account in China. Trade liberalization, especially on the goods side, has already been pushed quite rapidly under the terms of WTO membership and is partly why imports have grown rapidly since 2001; this has been overshadowed, however, by an even faster growth of exports. Capital account liberalization may provide a partial release from the pressures of the trilemma. In mid-2007, the Chinese leadership announced its intention to set a state-owned investment company which would be provided with an initial capital of US$200 billion, the sum being taken from official reserves. The investment company would seek investment opportunities overseas with these funds. The move signals a desire by the leadership to increase capital outflows and to earn a greater return on at least a portion of the reserves. Such a move may be problematic in that other countries may seek to protect key industries from Chinese investment. The Committee on Foreign Investment in the US already screens investment and proposals are underway for some type of arrangement in Europe; the concern over foreign investment by state-owned or controlled companies is a particular concern and China can expect to find itself under scrutiny in this regard.9

How successful, therefore, China will be in solving its trilemma by capital outflows remains an open question.

On the US side, policy-makers have expressed the desire to see the renminbi appreciate substantially against the US dollar and for the bilateral trade deficit with China to shrink significantly so that more painful domestic structural changes can be avoided. The problem for the US policymakers is that, even if they were successful in achieving a significant renminbi appreciation, this may do little to solve either the bilateral or overall trade deficit. But more fundamentally than that, US pressures on China to allow the renminbi to appreciate form part of the exercise of US monetary power. Indeed, Cohen (2006: 31) has argued that ‘the macro-level dimension of monetary power consists, first and foremost, of a capacity to avoid payments adjustment costs, either by delaying adjustment or by deflecting the burden of adjustment on to others’. The US trade deficit, occurring in the context of a foreign war and domestic tax cuts, would require major policy changes and adjustments to address, including tax increases on the high income earners who have benefited so much from the tax cuts of recent years.
(see Leiserson and Rohaly, 2006). The unwillingness of Washington elites to countenance this has led to the attempt, backed by some sectors including organized labor, to pressure China into a rapid appreciation of the renminbi in order to slow its export growth. Such pressures have worked in the past, most notably, on Japan in 1985 and on South Korea in 1989 but China’s leadership has shown itself much less willing to accommodate US pressure in this respect. While Japan and South Korea may have had limited ability to resist such pressures due to their security dependence on the US, China is in no such position. As indicated in the discussion above on the exchange rate regime, one of the reasons that China’s leadership is unwilling to change its gradualist approach is precisely because it argues that the US has failed to make sufficient internal adjustments of its own. How far the US is able to exercise its macro-level monetary power over China, therefore, is subject to uncertainty.

These factors point to a much more potentially unstable situation than that described as the revived ‘Bretton Woods II’ system. It is the case that both the US and China have an overarching common interest in the preservation of a stable international economic and monetary order. However, they have different interests within it and the main threat to the dollar arises from the scope for mismanagement and the length of time during which cooperation will be needed. US unilateralism, hectoring and demands coupled with Chinese nationalism and exclusion from a major role from the international financial institutions leave plenty of room for overreactions, political miscalculations and policy errors. The only credible alternative to the dollar is the euro and although China’s central bank, along with others in Asia, would undoubtedly like to diversify their reserve holdings to a greater extent and shift into euros, it is not in the interests of China to do so in a way which sparks a panic in the markets. But while malevolence is unlikely, the scope for policy miscalculations and misunderstandings between China and the US is large.

It is not difficult to imagine a scenario in which China, not wishing to rapidly alter its exchange rate regime or relent on its export-led growth strategy but frustrated in its attempts to invest overseas through its state-owned foreign exchange investment company, decides to sell off dollars in sufficient quantity that the markets overreact. Or that the US, frustrated by the failure of its monetary power to bring the Chinese policy-makers to heel, imposes trade sanctions sparking a reaction from Beijing to buy fewer US Treasury Bonds. With two countries whose interests may not be reconcilable separately or jointly, and in a world of volatile international financial markets, miscalculations are far from unlikely. The future of the dollar rests in no small measure on the ability of the two powers to successfully navigate the rocky road ahead.
BOWLES AND WANG: THE ROCKY ROAD AHEAD

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NOTES

1 In July 2005, when China revalued against the US dollar by 2.1%, Malaysia immediately followed suit. There is some evidence, therefore, of an informal ‘renminbi peg’ but it is still very limited.

2 The renminbi does play some role as a medium of exchange in other countries in the region especially for tourists and small businesses.

3 As an example of the political bargains which contributed to the creation of the euro, consider that the fall of the Berlin wall, and the consequent prospect of German reunification, led some member states to regard reinforcement of EC institutions as the best way to avoid an institutionally weak EC being dominated by a bigger Germany. The solution of a currency union was particularly appealing since Germany (or, more precisely, the Bundesbank) was already perceived as playing a leading role in the EMS. Germany, for its part, traded its initial reluctance to adhere to EMU, and thus relinquished the mark, in exchange for unqualified support of reunification on the part of its EC partners. It is conceivable that regional structures in East Asia may be viewed as necessary to constrain a strong China in future but the mechanism for achieving this is a long way off.


5 See, however, Bowles and Wang (2006) where we are more cautious about this since this constituency lost out in 1998 when China chose not to devalue the renminbi in the wake of the Asian financial crisis.

6 As a result, as we point out elsewhere, even some of the harshest critics of China’s policies do not anticipate that revaluation of the renminbi alone would eliminate the US balance of trade deficit. See Bowles and Wang (2006) for more details.

7 See, for example, the studies by Liu and Ren (2004) and Tang (2006).


9 See Bounds and Wiesmann (2007) for discussion of the possible use by European governments of ‘golden shares’ to prevent the takeover of European firms by foreign state-owned entities. In 2005 the Chinese state-owned oil company CNOOC withdrew its bid for California-based energy firm Unocal after opposition from US politicians. Since then there has been a general increase in wariness about ‘sovereign wealth funds’ culminating in the G7 expressing concerns in October 2007. Wei Benhua, Vice Head of China’s State Administration of Foreign Exchange, has responded that ‘the newly established China Investment Corporation (CIC) has been grabbing global attention, and some certain countries are intentionally spreading ideas of a China threat’. See ‘China Asks for Fair Treatment of Wealth Funds’ (2008).
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