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The role of the Chinese economy in the world economy: A U.S. perspective

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ABSTRACT

In this paper I first review the amazing progress that free market economic reforms have brought to the Chinese people after years of central control and suppression of markets. Thanks to greater economic freedom, economic growth increased sharply and hundreds of millions of people have been removed from poverty. By all accounts, however, economic freedom in China has a long way to go. The U.S. perspective should be that these market reforms continue. These further reforms toward economic freedom and economic growth in China will be beneficial to the United States. Such reforms would include a greater transparency about the monetary policy strategies, more openness of the capital accounts and less exchange rate and stock market intervention. Such economic reforms should be welcomed and encouraged by the United States and other countries.

1. Introduction

There is a wide range of perspectives in the United States on the role of Chinese economy in the world economy. Americans—both inside and outside of the U.S. government—express their opinions about China often, and these perspectives change over time. Here I give the perspective of an American economist who has served several times in the U.S. government and who has had the opportunity to engage directly with the Chinese people from students to business leaders and government leaders on economic issues over the years.[2]

2. An economic miracle, but not an economic mystery

No credible perspective on the Chinese economy can ignore the amazing economic gains over the past 35 years during which the growth of the economy increased sharply creating hundreds of millions of jobs and rising incomes throughout the country. According to the World Bank, 700 million people were removed from poverty during this period. What a contrast to the decades of stagnation in China in the decades before this miracle. China represented only 1.8% of world GDP in 1979 and it's over 10% today. In 1996 per capita income in the United States was 15 times greater than in China; now it is 4 times greater, and the gap is getting smaller every year.

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[2] For example, thirty years ago on my first visit to China, I taught an economics course at the People's University of China where students from around China attended, including David Daokui Li who is now a professor of economics at Tsinghua University. Much later as Under Secretary of Treasury in the United States I interacted with Chinese officials in the Chinese Finance Ministry and the People's Bank of China including Governor Zhou Xiaochuan regarding exchange rates and other financial issues.

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Some say that this amazing "Economic Miracle" is an "Economic Mystery." But it is not a mystery to an economist. It is the predictable effect of introducing greater economic freedom in China beginning in earnest in 1979. More attention began to be was paid to incentives, to the use of markets, to limiting the role of government, to more predictable policy, and to a greater emphasis on the rule of law. On the international side China began to open up to foreign trade and eventually unified its currency. And as China made these changes, three long decades of economic boom of 10% annual growth came. It was a demonstration of how basic economics works.

There are, of course, many other such demonstrations in history. Earlier economic reforms brought amazing benefits to other parts of emerging Asia, including Hong Kong and South Korea, and more recently to countries—such as Brazil, Poland, South Africa—on other continents. The same principles of economic freedom benefitted the United States over its history and remain essential to U.S. economic prosperity today. In fact, the United States had a revival of reforms in the 1980s which benefited the economy. It is no coincidence that while Deng Xiaoping was bringing economic reform to China and Margaret Thatcher was bringing economic reform to the United Kingdom, Ronald Reagan was bringing reform to the United States.

Some say that the approach to economic reform in China is different than in the United States, and they stress that difference when discussing the growth miracle. They use the term "Beijing Consensus" to describe the Chinese reforms, and they contrast the reforms with the standard economic freedom reforms which they label the "Washington Consensus." But the direction of movement toward economic freedom is much the same in China as in other success stories; if anything the three-decade long introduction of markets in China has been faster than during the 240-year history of economic freedom in the United States.

Clearly these economic successes in many parts of the world—including the United States—encouraged China and its leaders to move toward economic reforms. Indeed, the first considerations of reform likely trace back to the 1970s when the U.S. administration "went to China" and brought attention to the advantages of a market economy. These connections are often downplayed or even denied by those who are uncomfortable with the simple and straightforward concept of basic economic freedom.

3. The need for continuing the reforms

In my view, China still has the potential to remove millions more from poverty by growing very rapidly, even if somewhat below the thirty-year 10% annual pace. But to move the miracle forward, the reforms must move forward. The Chinese economy and its growing middle class need to integrate more into the world economy. Economic reform must continue if these benefits are to be fulfilled. On the domestic side, there needs to be an improvement on such reform indicators as the World Bank's "doing business" indicator. China needs to achieve its stated goals of reducing corruption and creating greater adherence to the rule of law.

In international policy, China needs to transition from a "wall" country, as it's restrictions on capital markets have been classified, to an "open" country as United States international policies have been classified. It should set up rules for eventually removing these capital controls. Currently, 36 countries now have open capital accounts, but 48 are classified as "gate" countries, and 16 countries—including China—are classified as "wall" countries with varying degrees of capital controls (see Fernández, Klein, Rebucci, Schindler, and Uribe (2015)). Such a reform could occur with a transition period and should be accompanied by adequate enforcement of safety and soundness regulations on financial institutions.

Though controversial, the reform would be conceptually similar to the agreement in the late 1990s to begin removing such controls by the International Monetary Fund (see International Monetary Fund (1997)). In this regard important progress has been made with the incorporation of the RMB into the Special Drawing Right by the International Monetary Fund. Continued economic reforms along these lines will also benefit the world economy and alleviate concerns expressed in the United States and elsewhere about a lack of transparency and unfairness. Such reforms should be welcomed by the United States.

Indeed, some key international reforms could be approached jointly by China and the United States, perhaps with China and US leading other countries in a global reform. Volcker (2014) has recently called for global reforms noting that "the absence of an official, rules-based, cooperatively managed monetary system has not been a great success." Let me now consider, by way of example, how such a reform might take place and the important role that China could play.

4. International reform jointly led by China and the United States

I start by summarizing the challenges now facing financial and currency markets in the international economy. Following the 2008–2009 global financial crisis and the start of the recovery, the Japanese yen significantly appreciated against the dollar. The appreciation of the yen and the corresponding depreciation of the dollar was likely due to the Fed's repeatedly extending its large scale asset purchases—quantitative easing—along with its zero interest rate policy, while there was little or no change in policy at the Bank of Japan. This large appreciation of the Japanese yen is shown in the first part of Fig. 1.

However, the adverse economic effects of this sharp currency appreciation on exports from Japan became a key issue in the 2012 election in Japan, and when the Abe government won and came into power it urged the Bank of Japan to implement its own massive quantitative easing. With a new governor, Harihiko Kuroda, appointed at the Bank of Japan, this is exactly what happened. As a result of this change in policy the yen fully reversed its course and depreciated to levels before the financial crisis of 2008 as shown in the second part of Fig. 1. In this way the monetary policy of one central bank—the Fed—appeared to affect monetary policy at another central bank—the BOJ—in currency-war like fashion.

The moves of the ECB toward quantitative easing in the past two years seem to have similar motivations, and were likely influenced by the impacts on the exchange rate of quantitative easing in Japan. An appreciating euro was, in the view of the ECB, a

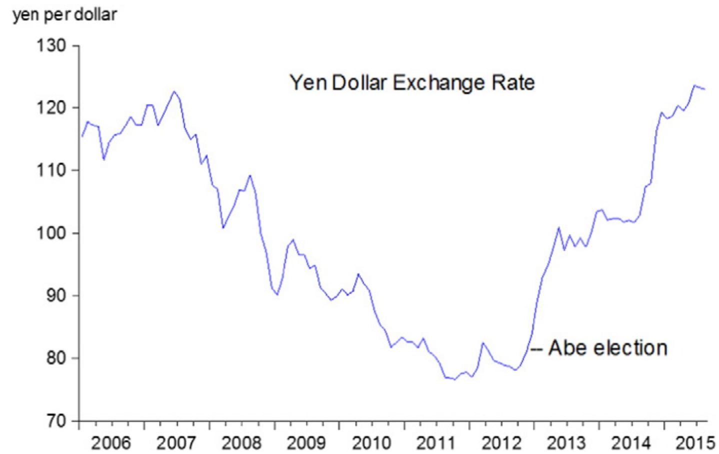

Fig. 1. The yen-dollar exchange rate, 2006–2015.
Source: Board of Governors of the Federal Reserve System, H.10 Foreign Exchange Rates, downloaded from FRED data base maintained by the Federal Reserve Bank of St. Louis.

cause of the weak European economy, and the ECB response was to initiate another large round of quantitative easing. At the Jackson Hole conference in August 2014, Mario Draghi spoke about his concerns about the strong Euro and hinted at quantitative easing, which then came. This shift in policy was followed by a weaker euro and a stronger dollar as shown clearly in Fig. 2.

These actions were accompanied—with remarkably close timing—by widespread depreciations of currencies in emerging market countries as capital flows reversed. This is shown in Fig. 3, which plots the dollar index against a large group of countries: Mexico, China, Taiwan, Korea, Singapore, Hong Kong, Malaysia, Brazil, Thailand, Philippines, Indonesia, India, Israel, Saudi Arabia, Russia, Argentina, Venezuela, Chile and Colombia. August 2014 was a big turning point for currency markets.

With these global currency developments in the background, the actions of China to start to let the yuan move with other currencies and to explicitly depreciate the yuan relative to the dollar in August 2015 are quite understandable. This depreciation was exactly in reverse to the appreciation made ten years earlier as shown as shown in Fig. 4.

This change in Chinese monetary and exchange rate policy should not be viewed in isolation: It was a natural response to the series of exchange rate changes around the world that can be traced to unusual monetary actions in other large monetary areas: the United States, Japan, the Eurozone and many emerging markets as shown in Figs. 1 through 3. And, while seemingly small in Fig. 4, it was the beginning of more changes and larger changes starting in earnest in December 2015.

Nevertheless, the change was not understood well in many quarters of the world, and it created political criticism in the United States of so-called unfair trade practices in China.

That the real causes of this exchange rate volatility can be traced to unusual discretionary monetary policy around the world is consistent with the idea that a more rules-based international monetary system would reduce these fluctuations (Taylor (1985)). There is already an established body of research showing that the move toward rules-based monetary policy in the 1980s led to improved economic performance in the 1980s and 1990s in the developed economies (Clarida, Gali, and Gertler (2002)).

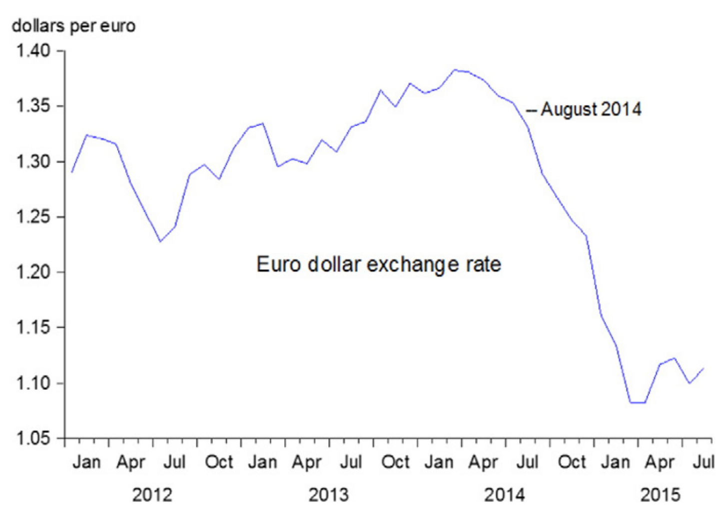

Fig. 2. The euro-dollar exchange rate, 2012–2015.
Source: Board of Governors of the Federal Reserve System, H.10 Foreign Exchange Rates, downloaded from FRED data base maintained by the Federal Reserve Bank of St. Louis.

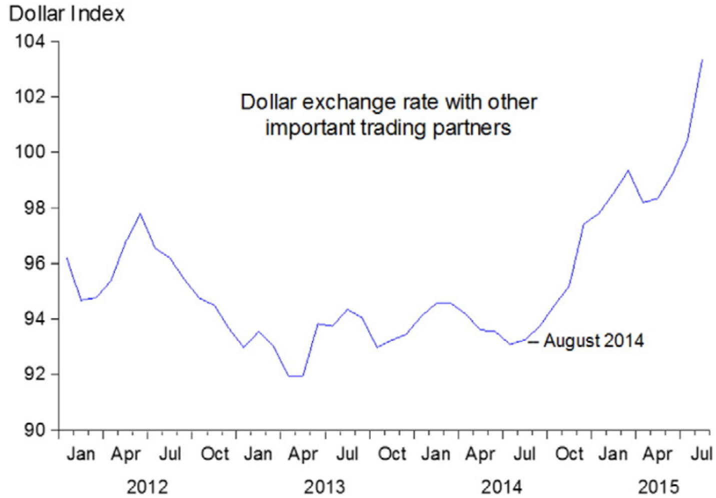

Fig. 3. Exchange rate of the dollar against a trade weighted average of Mexico, China, Taiwan, Korea, Singapore, Hong Kong, Malaysia, Brazil, Thailand, Philippines, Indonesia, India, Israel, Saudi Arabia, Russia, Argentina, Venezuela, Chile, and Colombia.
Source: Board of Governors of the Federal Reserve System, H.10 Foreign Exchange Rates, downloaded from FRED data base maintained by the Federal Reserve Bank of St. Louis.

Economic evidence also indicates that the recent spread and amplification of deviations from rules-based monetary policy in the global economy are drivers of instabilities (Nikolsko-Rzhevskyy, Papell, and Prodan (2014)). Research also shows that each country following a rules-based monetary policy consistent with achieving national economic stability—and expecting other countries to do same—would take the world toward an international cooperative equilibrium (Taylor (1985)).

Therefore, these lessons indicate that a process of each country reporting on its monetary policy strategy and agreeing to commit to that strategy can be an important means of building an international monetary foundation. The lessons also indicate that it is essential that the process not impinge on other countries' domestically optimal monetary strategies. And, in keeping with the expansion of the global economy, emerging market countries should be part of the process. It's a topic for the all the IMF member countries not just the G7 or the G20. A clear commitment by the Federal Reserve and the Peoples Bank of China to move in this rules-based direction would help start the process. With the United States being the world's biggest developed economy, and China being the world's biggest developing economy, US and China could naturally lead. The IMF or BIS could help monitor and keep track of the strategies.

Such a process poses no threat to either the national or international independence of central banks. It would be the job of each central bank to formulate and describe its strategy. Participants in the process or parties to the agreement would not have a say in the strategies of central banks in other countries or currency unions other than that they be reported. And the strategies could be changed or deviated from if the world changed or if there was an emergency. A procedure for describing the change in strategy and the reasons for it would presumably be part of the agreement.

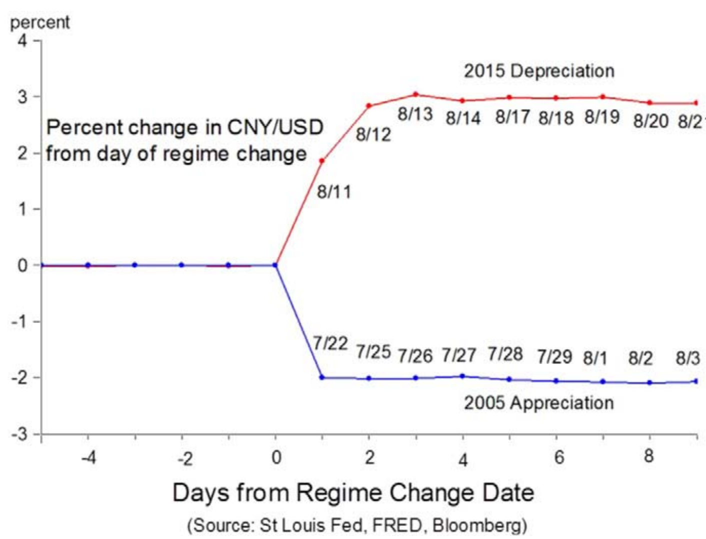

Fig. 4. Two changes in the Chinese exchange rate (CNY/USD): 2005 and 2015.

Many have called for reforms of the international monetary system. The Bank for International Settlements has been researching the issues and Caruana (2012), the General Manager of the Bank for International Settlements, has made the practical case. So the time may be ripe for such a reform. Major central banks have explicit inflation goals, and utilize policy rules. Again to quote Volcker (2014) who, harking back to "memories of a more orderly, rule-based world of financial stability, and close cooperation among nations," asked "What is the approach (or presumably combination of approaches) that can better reconcile reasonably free and open markets with independent national policies, maintaining in the process the stability in markets and economies that is in the common interest?"

The key advantage of this approach is that each country could choose its own independent strategy, avoid interfering with the principles of free and open markets, and contribute to the common good of global stability and growth.

5. Conclusion

In these remarks I first reviewed the amazing progress that free market economic reforms have brought to the Chinese people after years of central control and suppression of markets. These reforms included the freedom to sell surplus farm products, the freedom to set prices, the opening of stock markets, a unified currency, and an opening to foreign trade. Thanks to greater economic freedom, economic growth increased sharply and hundreds of millions of people were removed from poverty. These are the principles that also have led to prosperity in the United States.

By all accounts, however, economic freedom in China has a long way to go. The U.S. perspective should be that these market reforms continue. I believe that these further reforms toward economic freedom and economic growth in Chinese will be beneficial to the United States. Such reforms would include a greater transparency about the monetary policy strategies, more openness of the capital accounts and less exchange rate and stock market intervention. Drawing on my own experience as an international economic policy maker, I delved into a specific monetary reform that will help integrate China into the world economy. The United States and China could work jointly on this reform. In any case, such economic reforms should be welcomed and encouraged by the United States and other countries.

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