Reflections on the Euro

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

TO THE EDITOR:

The Winter 2014 *TIE* offered a bundle of quite interesting commentaries from top policymakers, academics, and market operators. What I found characteristic was that it was left to a representative of a European non-euro country, Miroslav Singer of the Czech National Bank, to ask the unwelcome but most relevant question about whether the promises made by the creators of the euro to the European public in terms of increased welfare and harmony in Europe have been fulfilled. Obviously, they haven't.

Nonetheless, the contributions from many eurozone commentators in "Improving the Euro" create the impression that if only EMU had been constructed in a way that would have prevented the present crisis, then everything would be fine. It wouldn't, however. The euro may constitute a "landmark in European integration" according to former European Central Bank board member Jörg Asmussen, but progress toward integration shouldn't be considered as an end in itself. Soon after its inception in 1999 and prior to the present crisis, the eurozone became the slowest growing economic area in the world, as its benefits—no exchange rate risks, lower transaction costs, increased price transparency, and so on—were overestimated and overstated, while its drawbacks—different national political, social, and cultural priorities which can't be removed by "better rules"—were underestimated and understated. Besides, other economic areas in the world are proving that you can thrive without a common currency.

The euro's history up to now confirms what we know about other monetary unions of the past: They didn't work without a proper political union. But a political union in Europe is not in sight, as the forthcoming European elections on May 25 are set to confirm. Therefore, even when the euro crisis is eventually overcome and the best possible rules have been introduced, the drawbacks of a common currency used among widely differing economies will continue to show its effects: permanent political wrangling, suboptimal use of scarce resources going into transfers, and less welfare than could be obtained otherwise.

Every confederation of states must deal with the question of which policy areas to put under central authority, and which areas are better left in national custody. What answer to that question could be expected, however, if for major European countries the issue was not whether a common currency would make sense at the stage of integration reached in 1999, but rather the question were, "How do we get rid of the then-dominant European currency exposing our own underperformance?"

—STEFAN SCHÖNBERG
Former Deputy Director of International Relations, Deutsche Bundesbank

"It was left to a representative of a non-euro country, Miroslav Singer of the Czech National Bank, to ask the unwelcome but most relevant question about whether the promises made by the creators of the euro have been fulfilled. Obviously, they haven't."

TO THE EDITOR:

I always enjoy reading *TIE*. But Stephen Cecchetti's short piece on "Why the Euro Remains a Relatively Strong Currency" put his finger on the difference between Fed and ECB monetary policies that was new and convincing to me. The U.S. Federal Reserve has been more expansionary by buying government bonds and leaving them on its balance sheet, whereas the European Central Bank injects base money through repo agreements that continually expire. Thanks for the revelation!

—RONALD MCKINNON
Professor Emeritus of International Economics, Stanford University

The Battle Rages

AEI Resident Scholar Derek Scissors takes issue with Greg Mastel's views on currency and trade and Chi Lo's outlook on the prospects for Chinese economic reform in TIE*'s last issue. Mastel and Lo respond.*

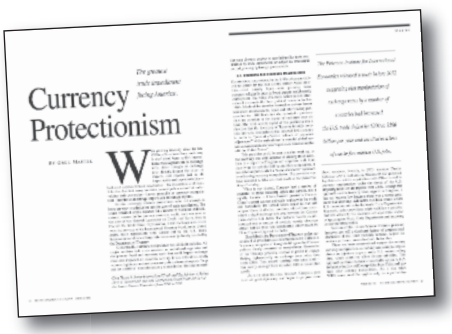
BOTH ARE WRONG

Trade analyst Greg Mastel characterizes "currency manipulation" as the largest trade impediment facing the United States and offers a new policy option. The policy option is thoughtfully crafted but his view that currency manipulation is America's biggest trade impediment is very hard to support.

Most protectionist arguments cite a trade deficit as intrinsically harmful, which is itself an error. It is particularly odd when currency critics—Mastel is part of a large group—focus on trade deficits, since the exchange rate is tenuously linked to merchandise trade balances in the high-profile cases of Japan and China.

The main reason to emphasize currency in Trans-Pacific Partnership talks is to bind Japan. But Japan is now running arguably its largest merchandise trade deficits in the post-war era. The bilateral U.S.-Japan deficit, which is less informative than the aggregate balance, also shrank in 2013. These deficits developed almost immediately after the yen's decline against the dollar in late 2012.

Japan is an older society, producing less for export. It is likely to run goods trade deficits, or small surpluses, for years to come. If such balances matter, no restriction on Japan is required. On a charitable view, calls for a TPP currency chapter are a means to coerce Japan into eliminating non-tariff barriers, which is the true problem the United States faces in bilateral trade.



The currency saga now focuses on China. However, the link between the yuan and China's still-large trade surplus is unclear.

From 1998 to 2004, the yuan was fixed and China's goods trade surplus declined. The jump in the surplus—more than tripling—occurred in 2005, the same year Beijing set the yuan on a very slow climb. The surplus rises sharply through 2008, while the yuan edges higher. With regard to the bilateral deficit in goods, it rises by more than half from 2005 to 2013, even as the yuan rises by over 30 percent against the dollar. The exchange rate again does not drive the trade balance.

The huge range involved suggests weak data analysis.

One response is to claim currency manipulation costs American jobs. Mastel cites a Peterson Institute study arguing currency policies cost between one and five million U.S. jobs. First, the huge range involved suggests weak data analysis.

Second, the huge jobs range is generated by tying higher imports to job loss. But a growing economy creates jobs and consumes more imports. In 2006, goods imports rose more than $180 billion over 2005 and labor force participation rose 0.6 percentage points over that period. A weak economy cuts imports and jobs. In 2009, imports fell $540 billion from 2008 while labor force participation fell 1.6 points.

As with Japan and its non-tariff barriers, the United States suffers far more from Chinese policies having little to do with currency. American exports are blocked primarily by the regulatory and financial protection of state-owned enterprises. This protection seals off large portions of the Chinese economy from American goods and services no matter how competitively they are priced. In the longer term, Chinese IPR theft has undermined American comparative advantage, reducing the value of the trade relationship for the United States.

Derek Scissors is a Resident Scholar at the American Enterprise Institute.

These problems are difficult to understand, much less address, making currency manipulation a convenient symbol of what we don't like about U.S.-PRC trade and trade in general. But it is just a symbol.

China expert Chi Lo warns that those expecting quick and fundamental economic reform in China are likely to be disappointed. He is probably right in this, but his reasoning raises a number of pointed questions.

Lo claims fundamental economic reform cannot begin until political reform breaks down existing interests, lest it "destroy the system that has made China successful." But China has not fallen victim to its own economic success, it has fallen victim to a decade of anti-competitive, dis-equalizing, environmentally destructive, and financially unsustainable statism, which merely appeared successful for a relatively short time.

Lo's reasoning raises a number of pointed questions.

These harmful policies followed twenty-five years of genuine, gradual, market-oriented reform that was supremely successful. The switch from a market model to the statist reversion occurred under the Hu Jintao government and has greatly weakened the economy. It is why market reform must restart now or China faces a very high risk of stagnation.

This is a book-length topic but Lo's own examples are suggestive. It is true that opening the capital account will remove much of Beijing's ability to use the financial system as a policy tool. But that use has become disastrous. Outstanding bank loans stood at 13.1 trillion yuan in 2002. Lending accelerated immediately after Hu became General Secretary in autumn that year. By the end of 2013, outstanding loans stood at 71.9 trillion yuan, 5.5 times higher (urban incomes increased 3.5 times in this period—all official figures.) And this does not include the explosion in non-bank, "shadow" finance in the past five years.


China's Reform Agenda

The result is that corporate debt is the highest among large economies. As a percentage of GDP it exceeds 120 percent, where the Bank for International Settlements puts the danger line at 90 percent. Local government debt is far smaller but piles onto that. Rapid capital account opening needs to occur precisely because it would curb the government's ability to manipulate the financial system.

Outside finance, ecological depletion is erasing the contribution of physical resources to growth, while an aging society reduces the contribution of labor. This is happening right now. Integrated land and labor markets would go a long way in addressing these problems but the dates for such reforms are floated as 2018 or 2020.

Lo notes that net exports have not contributed to GDP growth in recent years, calling it a sign of healthy rebalancing. This is due to weakness in external demand, not any action by China. What needs to move inland is not state-directed investment but the kind of reform that made the coast wealthy and attractive to multinationals and domestic migrant workers alike.

What is glaringly absent from Chinese decision-making is a sense of urgency. Lo is right that implementation of fundamental change will be a long struggle, all the more reason it must begin immediately. After the next Party Congress in late 2017, China will be three years more indebted and three years older, a situation all too reminiscent of Japan's unwillingness to act in the 1990s. China does not need to depart from thirty-five years of success, but from a full decade of missteps. It does not have the leeway to wait years more just to start to rectify matters.

—Derek Scissors

Greg Mastel Responds:

Derek Scissors raised several objections to my article on currency manipulation as a trade barrier (Winter 2014, "Currency Protectionism"). For the sake of simplicity, I have grouped his arguments into four key points:

■ *Currency manipulation does not cause trade deficits*. I would certainly not suggest that currency manipulation is the only factor impacting trade imbalances. I would, however, say that there is overwhelming evidence that a number of countries employ currency manipulation to create larger trade surpluses and smaller trade deficits

Greg Mastel is Senior International Trade and Tax Adviser at Kelley Drye & Warren LLP.

Mastel, *continued*

than would be the case if market forces were allowed to operate. By interfering with the normal adjustment of currency values through intervention, these countries are effectively preventing market forces from forcing adjustment of trade imbalances, gaining trade advantages and transferring unemployment to their trading partners.

■ *Economic estimates of the job impact of currency manipulation have such a broad range of outcomes that they are unreliable*. Though I have considerable personal regard for Fred Bergsten and his colleagues at the Peterson Institute for International Economics, I did not participate in the model they built so I would leave it to them to defend it. I do note though that having a large possible range of outcomes is really just a recognition that many factors can impact trade imbalances and employment. It is difficult, however, to credibly argue that an artificially low value for a country's currency, which acts both as an import tariff and an export subsidy, does not serve to advantage a country's trade position with attendant impacts on employment in that country's trading partners. The degree of effect may be argued, but the direction really cannot.

■ *China and Japan are not manipulating the value of their currency*. Unfortunately, currency manipulation is not a problem confined to China and Japan. There is strong evidence cited by Mr. Bergsten's study that at least a dozen countries manipulate the value of their currency for trade gains and cases can be made for others. As far as Japan and China go, it is really only necessary to listen to their leaders to discern policy. Japan's Prime Minister Abe proclaimed it "vital" that Japan maintain a weak yen. Chinese officials routinely reject calls to allow the yuan to substantially appreciate against the dollar in the interest of preserving "stability." In 2014, China has strengthened efforts to keep its currency weak with the yuan hitting eighteen-month lows versus the dollar in April and drawing an expression of "particularly serious concerns" from the U.S. Department of the Treasury.

There is overwhelming evidence that a number of countries employ currency manipulation.

■ *Currency manipulation is not the largest trade barrier*. Unquestionably, there are other serious trade impediments, including violation of intellectual property rights, facing U.S. exporters. These deserve the attention of U.S. policymakers. But currency manipulation affects literally every import and every export in international commerce from a currency manipulator. Even if the estimates from the Peterson Institute for International Economics and others were off by an order of magnitude, currency manipulation would still likely be the largest trade impediment facing the United States.

U.S. trade policy has slowly evolved from focus on tariffs to non-tariff barriers to newer issues like investment and intellectual property. The "new" issues must take their place alongside old issues for trade agreements to remain relevant to modern commerce. Currency manipulation is today's "new" issue. The scripts for trade negotiations, such as the Trans Pacific Partnership, must either reflect that new reality or they will become largely irrelevant exercises with little political support.

—Greg Mastel

Chi Lo Responds:

We generally agree that China needs to revive structural reforms urgently. What is debatable, and often not sufficiently appreciated, is the constraint on Beijing's ability to deliver deep reforms and whether a "shock therapy" would do the trick to speed up the changes.

The focus of China's reform challenge is that its economic success in the past thirty-five years has also created huge distortions in the system, and resistance to change is strong, as I discussed in my last article in the Winter issue. Even the Chinese leadership admitted openly that it would need stronger political support to push through deep and significant changes, hence the need for political reforms which China has been avoiding. In the short term, we can expect easy economic reforms that should help keep hopes up for more drastic changes later.

The former Hu-Wen administration indeed did not add to the reform momentum that was generated by the impressive changes that China made in the twenty years before it. The current Xi-Li government knows the urgency to revive structural reforms, but they are constrained by the resistance from the vested interests and reactionary forces.

Just look at the anti-corruption campaign, which addresses the root of the distortions of the system, which Xi waged since he took power just a year ago. Several "tigers," or high-profile officials who are very close to the old forces,

Chi Lo is Senior Economist at BNPP IP (Asia) Ltd.

including Bo Xi-lai, Zhou Yong-kang, and most recently Song Lin, have been caught and removed. This reflects the leaders' determination to address the root problems by standing up to old powers.

However, their hands are tied by strong resistance. The slow (and often lack of) progress in urbanization, land reform, implementing a property-holding tax, interest rate liberalization, capital account opening, and so on, is reflective of significant reactionary forces at work, despite the strong economic rationale for quick implementation.

A "shock therapy," such as opening up the capital account swiftly, might inflict costs outweighing the benefits. Financial volatility stemming from an open account when China's domestic interest rates, factor prices, capital markets, and so on are not reformed to allow for free capital flows is a risk too large for Beijing to take. Proper reform sequencing, not the lack of a sense of urgency, is the key problem.

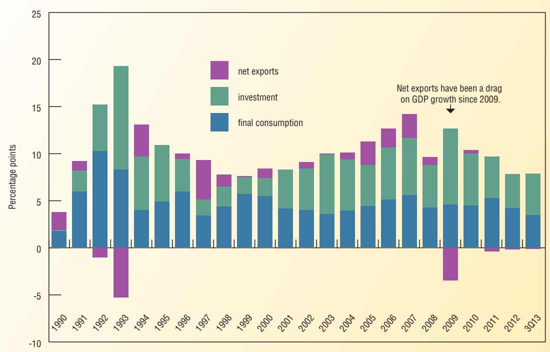
Finally, it is true that weakness in external demand has eroded net exports' contribution to GDP growth since 2009 (Figure 1). This has made the domestic sector the growth driver. The investment trends show that this is not all government-directed. "Smart money," as represented by foreign direct investment, has also been rebalancing towards China's inland provinces (Figure 2). The same trends are seen in income growth and industrialization (Figures 3 and 4).

Proper reform sequencing, not the lack of a sense of urgency, is the key problem.

Xi is not starting his structural reforms from scratch. His government has the resolve to make the changes and understands the urgency of the process, but it is constrained by the inherent resistance to reform. Xi's strategy is easy economic reforms first, then deep structural changes later as he needs the political apparatus to support him.

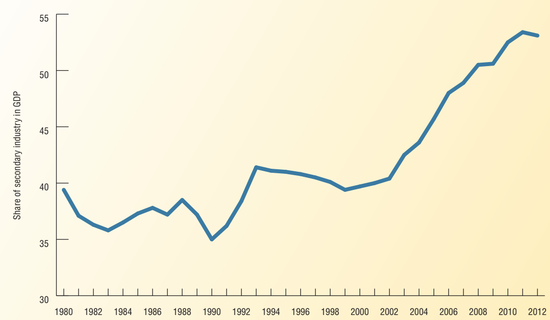
—Chi Lo

Figure 1: China: Contributions to real GDP growth



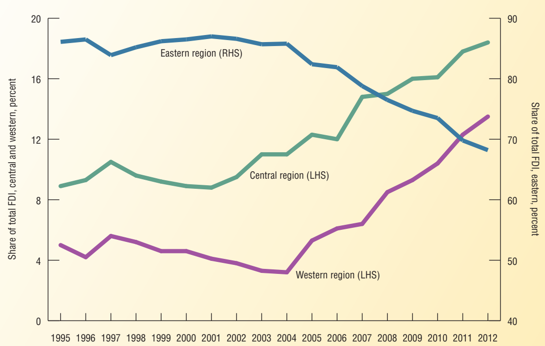
Sources: CEIC, BNPP IP Asia

Figure 3: Deepening industrialization in the inland provinces*



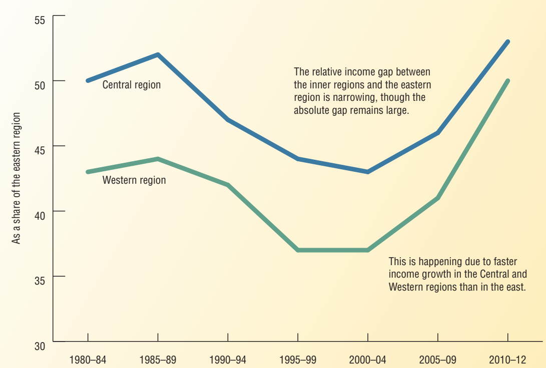
*Represented by Henan, Sichuan, Chongqing, Hunan, and Jiangxi.
Sources: CEIC, BNPP IP (Asia)

Figure 2: Foreign direct investment* moving inland



*Utilized FDI
Sources: CEIC, BNPP IP Asia

Figure 4: Per capita GDP rebalancing towards the inland



Sources: CEIC, BNPP IP Asia