



## Facing Up to China's Currency

*Nicholas R. Lardy suggests the Obama administration may avoid labeling China a currency “manipulator” to keep cooperation going on other issues.*

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Steve Weisman: It's the beginning of April and a new chapter with US-China relations. This is Steve Weisman at the Peterson Institute for International Economics with Nicholas Lardy, senior fellow at the Institute, to talk about the events of the next couple weeks and the weather surrounding US-China relations. Thanks Nick.

Nicholas Lardy: Thank you, Steve.

Steve Weisman: April fifteenth is the supposed deadline by which time the Treasury Department and the Obama administration must decide on whether to label China a manipulator of its currency. What do you think will happen?

Nicholas Lardy: I think it's extremely unlikely that they will label China a manipulator this time around. There are just too many issues in play, too many risks and outcomes in other domains that would be adversely affected.

Steve Weisman: What other domains?

Nicholas Lardy: Three come immediately to mind. One is the Chinese efforts to bring North Korea back to the six-party talks, the talks that have been suspended now for several months. Second is the willingness of China to support tougher sanctions on Iran. They have supported sanctions in the past; it's fairly clear they have not been very effective. The administration would like to get tougher UN sanctions and they need Chinese support to do that, and there's some indication the Chinese are willing to move on that front. Thirdly is the participation of the Chinese president in the nuclear talks, which begin in Washington just a few days before April fifteenth. Up until today, the Chinese were being very coy, saying they had not yet made a decision about whether or not their president would actually participate or whether they would send some lower level diplomat to represent them.

Steve Weisman: Members of Congress are pressuring the administration to take this step on the manipulator issue. Many of our colleagues—including Fred Bergsten here—think that the administration should do this. How much pressure do you think there is on the Obama team?

Nicholas Lardy: I think the pressure is very modest. This is a movie we've seen before. Congress thinks it can be helpful by being the bad cop in the relationship. Some would even argue this seemed to work four or five years ago when the Chinese did change policy a little bit in mid 2005, in part because the administration was pointing to congressional bills saying if you don't move you're likely to get a less favorable outcome as a result of congressional actions. So, certainly that's the game that Senator [Charles] Schumer [of New York] has

played repeatedly, and I think that's the game he's playing now. A hundred and thirty people in the house signing a letter—it's a freebie—and the key point here is that the chairman of the Ways and Means Committee, whose committee has jurisdiction over this issue in the House, did not sign the letter.

Steve Weisman: That's the new chairman.

Nicholas Lardy: Yes, the new chairman. And he has been very equivocal about whether or not he thought any of these currency bills would be effective. That's also a problem for the Treasury Department even if you believe, as I do, that the currency is significantly undervalued. You also, to recommend this course of action, have to be prepared to believe that it increases the chance that the Chinese will actually take appropriate action, and I think that's a very hard case to make in the current situation.

Steve Weisman: In other words, labeling them might backfire.

Nicholas Lardy: It could easily backfire. It's fairly clear there's an intense debate underway within Beijing on this issue, and those that want to move forward and allow the currency to appreciate again certainly don't want to be vulnerable to the criticism domestically that they have caved into foreign pressure. This is the kiss of death for Chinese policymakers. So, if we play the name-and-shame game I think it's likely to work against us.

Steve Weisman: If the Chinese currency is undervalued, and it's undervalued because China has taken certain steps to keep it undervalued, does it necessarily follow that the word "manipulation" should be applied anyway?

Nicholas Lardy: You can get into a theological argument about this. Some people go back and look at the original legislation and what the original legislative intent was. I think on any common sense definition they are manipulating. They've been buying up about \$40 billion worth of foreign exchange per month over the last year or so to keep the currency from appreciating. So, they're definitely massively participating in the market. Now whether you want to call that a managed float or manipulation—it doesn't really matter. But it's clear, in the absence of this action by the Chinese central bank, that the RMB [renminbi] would have strengthened substantially over the last few years.

Steve Weisman: Treasury Secretary Geithner has said that eventually China will let its currency appreciate. What do you think he means by that?

Nicholas Lardy: Well, I think he believes, as I do, that appreciation is in China's own self-interest, and that there is a contention of forces underway, and that eventually the good argument will win out in China and they'll allow their currency to appreciate. I think that's basically his perspective. I would guess, also, that he is of the view that there's a risk if you name them that you'll slow down the process.

Steve Weisman: Now, just shifting focus slightly to the economic picture in China, which has been recovering nicely and has led some to wonder whether China's economy is overheated. You don't necessarily take that view, but how does the Chinese exit strategy from its [stimulus] fit into this currency issue?

Nicholas Lardy: We have to begin by recognizing that their stimulus program was huge relative to the size of their economy. It was much bigger than that of the United States. It was also better designed so they got a quicker recovery than we did. But it primarily took the form of an increase in credit from the banking system, so the exit strategy will be to slow down the rate of growth of credit creation, and that's a trajectory that they have embarked on. The exact details will become clear over the coming months. Now, in theory, you could argue that a currency appreciation would help this process of rebalancing their economy and slowing it down a little bit.

Steve Weisman: How does that theory work?

Nicholas Lardy: The theory is, of course, if you appreciate a little bit, your exports will become more expensive in the rest of the world, so your export growth will slow down a little bit so the demand for the goods that are being produced for the foreign market will moderate slightly so there will be less demand in total. The problem with this for China is really twofold. First of all, the effect of currency has a substantial lag. It's at least six months before currency changes have much effect on any real economic variables, and the Chinese have much better direct instruments to control the pace of credit creation. They have reintroduced credit quotas in which they administratively set how much each bank can lend over the course of the year and how much they can lend in each quarter. So, they don't have to just raise interest rates and hope that this all filters through via market mechanism. They have very specific administrative methods that, at least in the past, have worked. So their first inclination is not to rely on a policy instrument like the exchange rate, which might contribute with a lag of three or four quarters, but go directly to the source and instruct the banks about how much to lend.

Steve Weisman: Nick, as recently as a few months ago in one of these conversations, you agreed that US-China relations were going through a rough patch. Do you think things have improved a little bit?

Nicholas Lardy: I think they have improved. I think some of the press articles have overestimated the roughness of the patch, but there certainly was some increased concern about a range of issues, and several of these issues have not been really significantly ameliorated. But I do think things are improving. I think the visit a few weeks ago of [James] Steinberg, the deputy secretary of state, tried to put a floor on the relationship. The Chinese have reciprocated with being more willing to cooperate with us on Iran sanctions, for example. I think both sides have recognized that without these positive actions there was a risk that things could get much worse.

Steve Weisman: When is the Chinese president's visit?

Nicholas Lardy: I believe the nuclear meeting in Washington is on the twelfth and thirteenth of April.

Steve Weisman: Okay. Nick Lardy, thank you very much.

Nicholas Lardy: Thank you, Steve.

