RANKED AMONG THE WORLD'S TOP 10 THINK TANKS
CEPS Commentary
Thinking ahead for Europe
CENTRE FOR EUROPEAN POLICY STUDIES

How to Level the Capital Playing Field in the Game with China

Daniel Gros

23 September 2010 (revised 8 October 2010)

With the US threatening to label China a 'currency manipulator', this commentary presents a plan to address global imbalances without risking a trade war. It proposes a 'reciprocity' requirement – if the US can't buy Chinese government bonds, then China can't buy US bonds either. But then the US would have to bite the bullet and rely on domestic savings to finance its own fiscal deficits.

The endless discussions about global imbalances, and China's supposedly self-serving exchange-rate policy, have for a long time resembled discussions about the weather: everybody talked about it, but nobody did anything. This is now changing.

The recent move by China to invest heavily in Japanese government bonds has set in motion a chain reaction. The Japanese authorities had little choice but to react to the Chinese move by intervening themselves in the only really liquid market, namely the market for dollars. Japan got the blame for its 'unilateral' move, but the end result was the same as if the Chinese had bought US assets themselves. The Japanese are only unwitting intermediaries, who, on top of the blame, have to take on even more exchange rate risk.

Overall it seems that the rest of the world with free capital markets can do little to stop the Central Bank of the People's Republic of China from continuing to 'steer' its exchange rate[1] by accumulating more and more international reserves – it does not matter whether these are US or Japanese. Neither the US, Japan nor the European Central Bank can do the same (as proposed in Bergsten, 2010)[2] because China has capital controls in place and there are simply no significant renminbi assets that foreigners, especially foreign central banks, are allowed to invest in.

[1] This contribution takes as a given that the exchange rate matters for the current account, and hence potentially it has implications for employment in the US and other slowly growing advanced economies. This is of course disputed by the Chinese authorities. For a recent empirical assessment of the impact of the renminbi exchange rate on trade (im?)balances, see Thorbecke (2010).

[2] Bergsten (2010) apparently assumes that Chinese capital controls are not effective – it is unclear on what he bases this assumption. His proposal seems to be aimed also at Japan, treating any foreign exchange intervention in the dollar market as an action warranting a US response. However, as argued here, the recent Japanese interventions were simply a reaction to increased buying of Japanese bonds by China.

Daniel Gros is Director of the Centre for European Policy Studies (CEPS) in Brussels. This column appeared in a slightly abridged version in the *Wall Street Journal*, Asia edition, 21 September 2010.

CEPS Commentaries offer concise, policy-oriented insights into topical issues in European affairs. The views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

Available for free downloading from the CEPS website (http://www.ceps.eu) • © CEPS 2010

The US political system has become so frustrated by this situation that the Congress is now seriously considering whether to label the country a 'currency manipulator'[3] and impose trade sanctions, an act that would be illegal under WTO rules and would threaten to throw the global trading system into turmoil.

But there is another way. The US (and Japan) could easily prevent the Chinese Central Bank from continuing its intervention policy without breaking any international commitment. The US and Japan (and the euro area countries) only need to invoke the principle of reciprocity and declare that they will restrict sales of their public debt henceforth to only official institutions from countries in which they themselves are allowed to buy and hold public debt. Instead of the 'moral suasion', tried in vain by the Japanese, the Chinese authorities would just be told that they can buy more US T-bills and Japanese bonds only if they allow foreigners to buy domestic Chinese debt.

Making capital (in)flows conditional on 'reciprocity' would be perfectly legal under the IMF statutes which require only convertibility for current account transactions.[4] Several emerging economies have used special taxes to discourage capital inflows without encountering any objections from the IMF or any other international financial institution.

This 'reciprocity' measure would of course be equivalent to a very specific form of controls on capital inflows. Capital controls are always somewhat leaky, but not in this case because the Chinese Central Bank would find it difficult to hide the transfer of its huge investments through western financial institutions. No reputable financial institution would dare to become a hidden intermediary for the Chinese given that no institution bidding for hundreds of billions of T-bills would take the risk of secretly fronting the Chinese government or central bank as it would have to certify to the US authorities that the beneficial owner is not from a country in which foreigners cannot buy and hold public debt instruments.

As a practical matter, the introduction of the reciprocity requirement should provide a grandfathering of the existing stocks of Chinese official assets abroad (already above $2,500 billion). However, the Central Bank of China would not be able to continue its interventionist policy – and that is what counts for foreign exchange markets. It would still have to invest the proceeds of the continuing current account deficit (running at about a $1 billion a day), and it would face the problem of re-investing the flow of T-bills coming due.

One might immediately object to this proposal by asking: What if the Chinese react emotionally and dump their holdings of T-Bills and US agency debt on the market, severely disrupting the US government debt market? This 'dumping', however, would not be as simple as it sounds. What assets would the Chinese Central Bank buy when it sells T-Bills? There are not many choices if the Chinese Central Bank wants to dispose of thousands of billions of dollars. Either it holds cash in the form of bank deposits, which would mean a massive refinancing of the US banking system, or it buys other private US assets, which would mean a welcome refinancing of the US private sector. Brender & Pisani (2009) and Gros (2009) argued that the huge acquisitions of US government debt by Asian central banks during the boom years (2003-07) were a key factor in the financial crisis because they created an excess demand for safe and liquid assets. This situation induced the US financial system to use securitization to create new forms of supposedly safe and liquid assets out of US mortgage debt. The collapse of the housing bubble then showed that these assets were neither safe nor liquid. Thus, even if the imposition of a reciprocity requirement were to be limited to government debt and if it had only a limited impact on the ability of China to intervene in the renmimbi dollar market, it could already make a significant contribution to the stability of the US financial system if it forced the Chinese central bank to buy hundreds of billions of USD in private US assets.

Moreover, the reciprocity requirement could be extended to private debt instruments as well. Since foreigners, especially foreign official institutions, are not allowed to freely hold renmimbi bank accounts in

---

[3] Technically Congress is 'only' considering the authorization of a new criterion for the imposition of countervailing duties and has refrained from formally making any such provocative accusation.

[4] Section 3 of Article VII of the Articles of Agreement of the IMF (on Controls of capital transfers) specifies that "members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b) and in Article XIV, Section 2". (http://www.imf.org/external/pubs/ft/aa/aa06.htm#2).

China, the US authorities could introduce a similar rule, or just levy a special tax[5] on bank accounts held by foreign official institutions from countries with capital controls. At the very least, the US could eliminate the existing exemption of foreign official holdings of US assets from withholding taxes on interest payments.

But extending the controls on capital inflows from China to more and more instruments is probably not necessary as the Chinese Central Bank is unlikely to invest hundreds of billions of dollars (or euro) in private assets. Buying euro assets would of course constitute an alternative, but this does not appear too attractive at present, and would be prevented by the Europeans adopting the same reciprocity requirement.

The US might hesitate to impose a reciprocity requirement for sales of its public debt because (in contrast to Japan) it needs foreign financing for its public sector deficit. But this also constitutes the litmus test for the sincerity of the US authorities, who cannot have it both ways, i.e. China's financing of its external deficit *and* an end to currency intervention. The choice is now up to the US, it can easily stop Chinese interventions without violating any international commitment if it is willing to rely on domestic savings to finance its own fiscal deficits.

Japan should have no problem with the approach proposed here since it can easily finance its budget deficit with domestic savings. The same should hold true of the eurozone, which has a current account in rough balance, indicating that domestic savings are sufficient to finance all domestic investment and budget deficits.

References

Bergsten, C. Fred, (2010), "We Can Fight Fire with Fire on the Renminbi", *Financial Times*, 4 October (http://www.iie.com/publications/opeds/oped.cfm?ResearchID=1669).

Brender, Anton and Florence Pisani (2010), *Global Imbalances and the Collapse of Globalised Finance*, CEPS Paperback, Brussels (http://www.ceps.eu/book/global-imbalances-and-collapse-globalised-finance).

Goodhart, Charles and Dimitrios Tsomocos (2010), "How to restore current account imbalances in a symmetric way", syndicated column (available on http://www.eurointelligence.com/index.php?id=581&tx_ttnews[tt_news]=2903&tx_ttnews[backPid]=901&cHash=1e554e1611).

Gros, Daniel (2009), "Global imbalances and the accumulation of risk", VoxEU (http://www.voxeu.org/index.php?q=node/3655).

Mundell, Robert A. (1960), "The Monetary Dynamics of International Adjustment under Fixed and Flexible Exchange Rates", *Quarterly Journal of Economics*, Vol. 84, No. 2, pp. 227–257.

Thorbecke, Willem (2010), "The effect of a renminbi appreciation on US-China trade imbalances", VoxEU.org (http://www.voxeu.org/index.php?q=node/5623).

[5] The spirit here is different from that of Goodhart &Tsomocos (2010), who propose taxing capital exports on the grounds that private capital markets are inefficient. By contrast, the key consideration underlying the present proposal is the desire to 'level the playing field' in terms of capital controls and hence the potential for foreign exchange intervention.