**China Versus the World?**

*Arvind Subramanian assesses the various strategies (along with their shortcomings) to persuade China to let its currency appreciate, concluding that multilateral pressure remains the best bet.*


Steve Weisman: Sometimes it seems that the whole world is ganging up on China over currency. Other times it seems like the whole world is siding with China on currency. As the United States tries to push China to let its currency appreciate, Arvind Subramanian, senior fellow here at the Peterson Institute, is here to talk about the latest developments after the IMF World Bank meetings and ahead of the Seoul Summit in November. Thanks, Arvind.

Arvind Subramanian: Thanks, Steve.

Steve Weisman: There are a lot of ideas floating about how to confront or persuade China to change its policies. Are there any promising ideas out there?

Arvind Subramanian: Yes. I think broadly there are two ways of going about it. One is to say, we will make China come around by imposing trade actions against them, which is what legislation passed a couple of weeks ago in the House does. It tries to restrict certain kinds of Chinese imports.

Steve Weisman: That is similar to other legislation that’s pending in the Senate.

Arvind Subramanian: Exactly. The alternative way is to go by the financial system, like capital. Here we’ve seen a spate of new ideas which have essentially consisted of saying, “China, we will not allow you to buy our assets anymore.”

Steve Weisman: We in the United States.

Arvind Subramanian: We in the United States.

Steve Weisman: Including Treasury—

Arvind Subramanian: Especially Treasury bonds. Or, “If you are able to buy ours, we should be able to buy your Treasury bonds.” So that if China buys dollars, the United States buys renminbi to fight fire with fire. That was [PIIE Director] Fred Bergsten’s proposal.

Steve Weisman: Those were provocative proposals. But they may be more theoretical than likely to happen.

Arvind Subramanian: Yes. They’re theoretical because there aren’t enough Chinese assets that can be bought, even if you wanted to do that. I think that’s the main problem with that proposal. However, there is a kind of third idea. A different way of fighting this currency war, which is what Martin Wolf wrote about in the Financial Times on Wednesday, which is what we’re now calling “QE2”—quantitative easing. That is, the [Federal Reserve] just prints a lot of dollars and floods the world market with dollars.
What that does is pump more dollars into, among other places, China. And so China has to keep buying more and more and more dollars to prevent its currency from appreciating. So that’s another way of fighting this currency war.

Steve Weisman: The Fed is already pondering quantitative easing for its own reasons which are probably as [PIIE Senior Fellow] Joseph Gagnon advocates, because this would reflate the US economy. Do you agree that that would be good?

Arvind Subramanian: I think it would be good for the Fed to do it, given current conditions. But as Joe and others have pointed out, the effects are going to be fairly weak. You need to do a lot of quantitative easing if you really want the economy to perk up. But remember that domestic politics in the US are now very conflicted on quantitative easing. Many conservatives feel already the Fed has expanded its balance sheet too much. I think any notion that the Fed’s balance sheet can be even more inflated in order to fight the currency war, let alone to reflate the economy, will not fly politically in the United States.

Steve Weisman: Our colleague Mike Mussa points out that if the Fed is going to embark on purchasing dollar assets, and that’s raised the hackles, imagine the idea of purchasing Chinese assets.

Arvind Subramanian: Exactly. Explaining that to the American people is going to take some sell. That’s not going to fly. That’s why I feel that the time has come to move from what the United States can do acting alone to what it can do acting in concert with a number of other countries to make China realize that this is really not a US issue alone, but a systemic issue.

Steve Weisman: But Treasury Secretary Geithner has waged a campaign to enlist India, Brazil, many other countries on this but they don’t seem to want to sign up.

Arvind Subramanian: Yes. I think there are two interesting new developments. One, you will see now that Japan and the European Union—but especially Japan—have become much more vocal about expressing anxieties about Chinese exchange rate policy. Today there’s a statement by a senior Japanese official saying, “This is getting difficult for us if China maintains its policy.” So that’s a new development. The second development is that many countries, such as Brazil, are starting to use capital controls to stem the tide of capital coming in.

Steve Weisman: Is India also heading down that road?

Arvind Subramanian: Yes, exactly. They’re going to face the same problem very soon. A lot of money is coming into India and the rupee has begun to appreciate once again, again posing a headache for the country. So I think the time is ripe for the three major countries—European Union, Japan, and the United States—along with Brazil, India, Korea, and South Africa to form what I would call a coalition of the willing and affected.

Steve Weisman: Why is a lot of this money flowing into Brazil and India and some of these other developing countries?

Arvind Subramanian: This is happening for what you would call “push and pull” reasons. The push reason is that interest rate returns are very low [in the United States]. If you invest money in many assets in the United States, you’re going to get pretty much zero return. Whereas
in other countries like India and China, you get much more return. More important, I think, though, is the pull factor, which is the growth prospect. The real return to capital is very different between emerging market countries and industrial countries.

Steve Weisman: And the prospects even over the next 10, 20 years?

Arvind Subramanian: Exactly. Both these factors conspire to make capital want to move to emerging-market countries.

Steve Weisman: Is this what’s called “hot money”? I often hear that term, but I’m never sure what it means.

Arvind Subramanian: Yes, “hot money” is money that ordinary investors put in mutual funds. It’s money that goes into stock markets and other portfolio equity markets which can reverse itself quite easily. What is not “hot money” is if Wal-Mart or GE set up plants, set up a factory, set up a—

Steve Weisman: Long-term capital investment.

Arvind Subramanian: Long-term foreign direct investment. That’s not “hot money” because that usually goes to stay. With “hot money” the problem is that it can be fickle, right? For example, a lot of money going into India. But suddenly suppose India were to say, “We’re going to slap restrictions,” that money could go out very quickly. So it’s the volatility of flows that comes with “hot money” that emerging-market countries find hard to deal with.

Steve Weisman: Why is Japan part of this? Japan’s not a developing country anymore. What are they so worried about with China’s currency appreciating?

Arvind Subramanian: I think for one thing, what’s been happening is that there’s pressure on the Japanese currency to appreciate. And Japan can’t take this because its growth is slow and it’s still reeling from the aftermath of the crisis many years ago. But Japan is an anomaly, in the sense that it’s one country where the pressure on the currency to appreciate continues despite low interest rates and despite growth prospects being not very promising.

Steve Weisman: Isn’t that illogical?

Arvind Subramanian: Yes, exactly. I think nobody really understands, to be honest. But one of the explanations is that Japanese domestic investors don’t put their money abroad because Japan saves a lot domestically, and all that money is with the Postal Savings Bank or domestic guys who are very comfortable putting it in Japanese instruments.

Steve Weisman: Do the Japanese think that if China lets its currency appreciate, that’ll ease the pressure on the yen?

Arvind Subramanian: Yes, exactly, that’s it. That’s true for Japan. That’s true for Korea. That’s true for Singapore. That’s true for all these currencies. They’re under pressure, too, for their currencies to appreciate. But they don’t want to do that because if they let the currency appreciate and China doesn’t, it’s a double whammy for them in terms of how competitive they are vis-à-vis Chinese exports.
Steve Weisman: If it is increasingly clear that countries are pressuring China on this issue, why is it not working?

Arvind Subramanian: This is a classic collective action problem. Take any country. Take an emerging-market country like India, for example. India has a problem with the Chinese exchange rate. But, the China-India relationship is much more than the currency. So India has to consider the larger set of issues—whether it’s border issues, security issues, all those they weigh relative to the currency issue in that relationship. Similarly for the Asian countries; they’re involved in these complex and intertwined trading relationships. Are they going to jeopardize that?

Steve Weisman: And the same for the United States?

Arvind Subramanian: And the same for the United States.

Steve Weisman: The United States has to worry about North Korea and Iran—

Arvind Subramanian: Exactly, yes.

Steve Weisman: And the disputed waters around China.

Arvind Subramanian: Exactly, and Japan had to worry about getting rare earths because China imposed an export ban. That’s why my view is that it’s not just a multilateral issue, but it’s a multilateral issue that goes beyond economics. It’s really a bigger foreign policy issue, because for each country, it’s one amongst many other issues in their dealings with the United States, in their dealings with the system and in their dealings with China.

Steve Weisman: I’m no China expert, but Chinese politics seem more fragmented than ever. But China also seems more paranoid or I would say, resentful, than ever. I mean look at what happened with the Nobel Prize going to one of the dissidents. They immediately saw this as another attack on their integrity from the West.

Arvind Subramanian: Exactly so. I think the real reason why multilateralism can work is exactly the point that you raise. I think individually, countries don’t have a lot of sticks and carrots vis-à-vis China. Let’s face it, China’s very big. But, all countries acting together really isolates China. You know, China is seen to be acting against not one, not two, but the system as a whole. And that isolation, the opprobrium that comes with it, I think is ultimately the lever that the rest of the world has against China.

Steve Weisman: Thanks very much, Arvind.

Arvind Subramanian: Thanks, Steve.