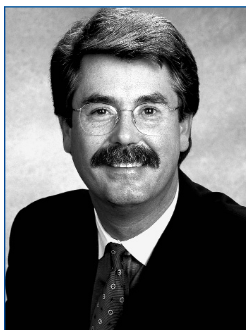
June 2007

Global Central Bank Focus

by PIMCO's Paul McCulley

What Can Go Wrong: China*


Paul McCulley

If it is not too much of an intellectual stretch to say that China is part of the monetary union that is called the United States—the 51st state, if you will—then it is not too much of a stretch to say that what can go wrong is that China decides—or is forced—to secede.

First, the 51st state. As noted earlier, China has kept its currency, the yuan, tied as closely as possible to the value of the U.S. dollar because that makes China's exports more competitive. But in doing this, China has essentially ceded the control of its monetary policy to the Federal Reserve, in the same way that all the 50 states in the United States have.

Here's why.

Both the United States and China have fiat currencies, which are not backed by anything but each sovereign's declaration that they are legal tender for all debts, public and private.

In such fiat currency regimes, the sovereign has the ability to choose one of two goals for its central bank: stabilizing either the domestic purchasing power of the currency or the foreign exchange value of the currency. The sovereign can stabilize the domestic purchasing power of the currency by having its central bank target a domestic price for the currency, which is done by raising or lowering interest rates, or by having the central bank target the quantity of its currency, which is done by having the central bank set a growth rate for the domestic money stock or money supply.

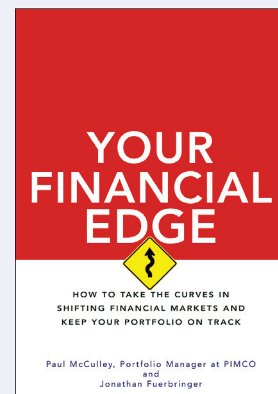
*This month's column is an excerpt from my just-released book, *Your Financial Edge*, co-authored with Jonathan Fuerbringer. It's from Chapter 3, "What Can Go Wrong?," pages 89–95, and details the nature, and risks, of the *de facto* monetary union between the United States and China.

Unfortunately in the case of books, there is a long lead time between the writing and the publishing; Jonathan and I actually wrote this passage some nine months ago.

But the essential message remains the same, and echoes the conclusion of PIMCO's annual **Secular Forum**, completed last month: Evolution of the Bretton Woods II paradigm, involving faster appreciation of the Yuan, along with China's enduring bid for commodities and diversification of its reserves, imply a secular upward bias to both inflation and long term real interest rates in the United States.

Your Financial Edge is available on Amazon.com and at your local bookstores. As noted last month, all my royalties will go to the **Morgan Le Fay Dreams Foundation**.

The July issue of *Global Central Bank Focus* will be a review of Fed Chairman Bernanke's semi-annual testimony to Congress on monetary policy.



Excerpted from Your Financial Edge: How to Take the Curves in Shifting Financial Markets and Keep Your Portfolion on Track. *Copyright (c) 2007 by Paul McCulley and Jonathan Furerbringer. Used with permission of the publisher, John Wiley & Sons.*

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The sovereign can stabilize the foreign exchange value of the currency by having its central bank target the price of the currency in the foreign exchange market, letting currency reserves rise and fall as necessary as a consequence of foreign exchange intervention activities.

What a fiat currency country cannot do is instruct its central bank to use all three possible monetary policy levers: a domestic interest rate, the size of the domestic money stock, and the currency's foreign exchange value.

By the laws of central bank plumbing, a fiat currency country's central bank can peg only one of these three policy targets; once one of the variables is pegged, the other two become market-determined, unless constrained by regulatory structures.

In the United States, the Federal Reserve pegs the domestic price of money—the overnight interest rate between banks that is called the federal funds rate. In turn, growth in the domestic money stock and the foreign exchange value of the dollar all adjust, via market forces, to be consistent with the Fed's chosen peg for the fed funds rate. Accordingly, the United States does not have a currency policy per se, either strong or weak. It has a fed funds policy.

In contrast, China has chosen to give its central bank a target for the foreign exchange value of its currency, pegged to the dollar. This in theory means that China cannot have a target for its domestic short-term interest rate or growth in its domestic money stock. This is not precisely correct, though, because China does not have an unregulated capital market or a fully private domestic banking system. So China, unlike the United States, does retain some degree of control over variables besides the yuan's pegged exchange rate versus the dollar.

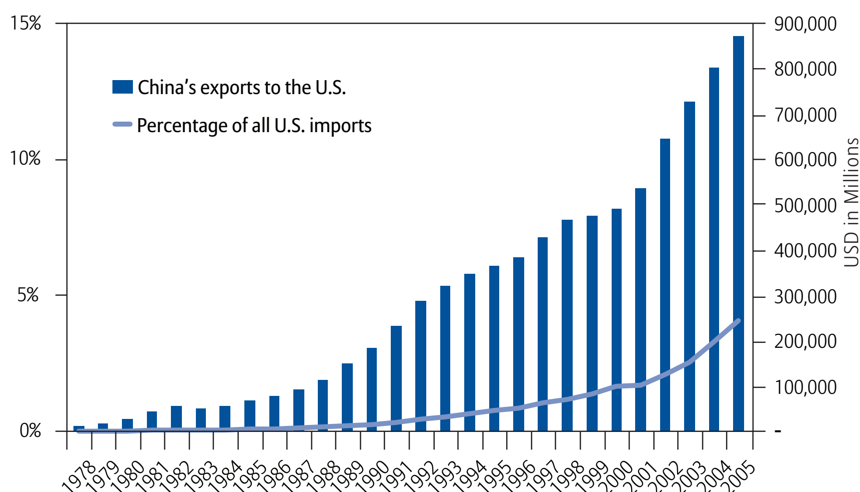
But these are technical matters, which should not obscure reality: China does not have an independently determined domestic monetary policy, because China has chosen to peg its currency to the dollar, thereby importing U.S. monetary policy.

This exchange rate tie is part of the mercantilist model China chose to move it along the path from a centrally planned to a market-centered economy.

If a country wants to shift from a centralized economy to a capitalist system, it has to expose what its people can manufacture to a market test. But the country cannot do that at home because it does not have a free market. So it has to see if what its people make will sell in the rest of the world's markets. The country's economy becomes mercantile, focusing its development efforts on exporting abroad, as can be seen in China's case in the chart below.

First the government, through a central bank, fixes the value of its currency at a low exchange rate so that its exports will compete well abroad. Then manufacturers grab market share in the developed world, which has the markets that will test the value of the country's resources—in China's case, labor

Export Mania: The Route to a Market Economy



Source: PIMCO Data from Bureau of Economic Analysis
This chart is not indicative of the past or future performance of any Allianz Global Investors product.

and savings. As products are sold abroad, the central bank builds up huge reserves of foreign currency, and they are funneled back to the countries where the products are being sold—in this case, mostly to the United States. So it ends up as a grand vendor financing scheme to finance the goods that are sold abroad.

The fact that the currency is undervalued and the central bank has large dollar reserves gives foreign investors confidence to invest in China. The undervalued currency means foreigners can invest cheaply and hope for big gains when the currency does rise in value. The large reserves mean that China has the wherewithal to keep control over the mercantilist process, if there is no protectionist threat.

So the foreign exchange reserves are effectively acting as collateral for the direct foreign investment, which brings technology and capitalist knowledge. The technology and foreign investment help the country move up the production ladder, making higher valued-added goods at each step up.

Mercantilism reigns in much of Asia, where high domestic savings rates mean a relatively low level of consumer buying at home, huge foreign exchange reserves, undervalued currencies, and large current account surpluses.

This is not the American model. Americans operate on the theory that consumption comes first; hearses don't come with Uhaul trailers, and, therefore, Americans spend accordingly. In Asia, consumption is an afterthought in the pursuit of ever-greater stores of international wealth.

Neither the Asian model nor the Anglo-Saxon model is inherently right or wrong. People's utility functions are not homogeneous: different strokes for different folks. And because people's utility functions are different, there is scope for win-win international trade: We can help each other out, whether willingly or unwillingly, as China has helped us on our current account deficit and we have helped China on its economic development.

Ultimately, though, China will graduate from the American University for the Study of Capitalism. It will switch from a mass production economy to a mass production and mass consumption economy and have the courage and ability to free its exchange rate and shift away from its mercantilist model. So China will secede at some point. In fact, China took a first step in that direction in the summer of 2005 when it revalued the yuan by 2 percent, making it stronger against the dollar, and let it float marginally upward thereafter. That process was accelerated a little in the fall of 2006. These moves came under pressure from the United States, but China has only moved a little, so its special monetary union is still effectively a going concern.

Even if secession is a slow process, interest rates and inflation will be higher than they would be otherwise. As the Chinese currency is allowed to appreciate against the dollar, their goods will become more expensive for Americans, and it is not clear how much competition from other emerging market countries will offset that upward price pressure. And as the yuan appreciates, China's central bank will be selling fewer yuan for dollars, reducing the dollar reserves that are recycled into the U.S. Treasury market. That means interest rates could be higher than otherwise. That is going to be unpleasant for American investors—but it should not be worse than that.

If this is an abrupt process, which could happen under threats of protectionism from the United States, all the above should happen but at a pace that could be quite disruptive to the economy, sending interest rates higher quickly, the dollar down quickly, and inflation higher, and—if the dominos all fall the wrong way—causing a recession. And because China's tie to the dollar is so entwined with helping finance the U.S. current account deficit, the threat of a big disruption from an accelerated secession is greater.

Either way, therefore, it is not much of a stretch to say that China could have a big say over interest rates, inflation, monetary policy, and even the pace of economic growth in the years ahead.

Our belief that this secession can be deliberate and orderly is based on the fact that China cannot leave its mercantilist path or opt out of its currency tie too early because that would destroy its developmental model. China still needs to move slowly toward the free trading of its currency to get all the benefits it wants from its transition to capitalism.

There is the threat that protectionism could force China to untie from its dollar anchor a lot faster. While Americans have not been ardently protectionist for some time, the idea of retaliation against China has been gaining ground. One big threat, a trade bill sponsored by Senator Charles E. Schumer, a New York Democrat, and Senator Lindsey Graham, a South Carolina Republican, was pulled back in the fall of 2006 after China indicated that it was slightly speeding up its divorce from the dollar. But the threat will remain because the Schumer-Graham trade bill had gotten China's attention, and it is not yet clear if the secession process is moving fast enough for politicians like Schumer and Graham.

Protectionism also remains a threat because it is an attractive strategy for a politician from a vote-getting point of view. The cost of protectionism can often be spread very lightly among millions of American consumers. For example, consumers pay more for sugar because of protectionism, but that is not making them single-issue voters against the politicians who support the quotas. Only the sugar worker is going to be a single-issue voter for that politician. In the case of China, we think the cost of a sudden policy swerve will be much more severe for millions of American consumers, but it is still not likely to turn these consumers against a few politicians.

Assuming we do not get an escalation of protectionism, China will do the unwinding of the yuan in its own time frame, on the installment plan. And that will be to the benefit of the United States because it should help bring the current account deficit down to a manageable, not just a sustainable, level, without a big economic disruption.

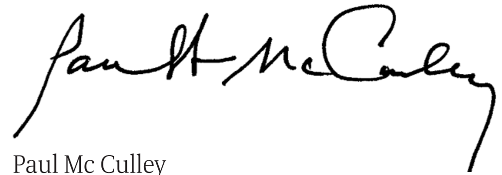
There are, of course, other things that can go wrong with China. One of them is happening right now. It is the price of oil and it is sapping growth potential in the United States.

The path of economic development for China and other emerging market countries means that demand for energy is growing faster than supply, which naturally leads to an increase in the real price. In addition, that higher price transfers more wealth to oil producers, many of whom do not like the United States. The situation could end up in fisticuffs.

In the long run, the world needs the real price of energy to go up enough to encourage conservation efforts and the development of alternative forms of energy. That way, everything works out—eventually.

The flip side is a roller-coaster ride on which you get nasty spikes in oil prices that are destabilizing to the economy and to the geopolitical stability of the world. Spikes do not help create conservation and energy alternatives. You need a steady higher price to encourage conservation. Investors cannot deal with the price of oil whizzing about by $15 a barrel all the time.

The flip side is with us right now. It is the consequence of China's development plan, and so far it is not working out the way that it should. It is not making us—the United States—conserve and create energy alternatives.



Paul Mc Culley

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