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China Recalculates: Slow Down And Be Happy

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During the Cold War, one learned not to put too much stock in the five-year plans of the Soviet Union. For one thing, it was hard for them to meet their agricultural goals because they had a drought every year. China's planning record has been better and it's newly minted five-year plan, recently presented to the National People's Congress, is historic, or will be if its goals are met.

Gone, or at least modified, are the mercantilist policies of producing and growing to the max, financing high domestic investment with super-high domestic savings, exporting as much as possible, importing as little as necessary, and accumulating the difference in a big pile of foreign money. Gone, or at least reduced, is the subsidy China gives to foreign consumers at the expense of Chinese consumers through a low-wage, low-cost policy.

In other words, China is planning deliberately to allow its ten percent growth rate to slow a bit in order to give the Chinese people more of the fruits of their own labor. Hence, slow down and be happy.

Not gone yet is China's reluctance to promote all these new goals with yuan appreciation. That simple deed would go far toward reducing China's external imbalance in trade as well as its internal imbalance in consumption and saving.

Reducing China's accelerating inflation rate is also a high priority in the new plan. The year-over-year consumer inflation rate has been 4.9 percent for the past two months and is expected to rise. The central bank, the People's Bank of China, has tightened monetary policy through jawboning and through a series of increases in bank reserve requirements, a rather blunt tool of monetary policy. Yuan appreciation would help reduce inflation directly by lowering import prices.

Floating the yuan would also relieve the monetary authorities of self-defeating exchange rate intervention. Instead of allowing yuan appreciation to reduce imbalances and inflation directly, the PBOC is forced into exchange pegging purchases of dollars to hold down the yuan. This intervention results in a massive increase in the Chinese money supply that feeds the inflation it hopes to tame.

In other words, they tighten with reserve requirements and ease with open market operations in the foreign exchange market. Floating the yuan would end this dilemma as well as reduce the imbalances described earlier.

We Have a Dog in This Fight

Allowing the yuan to float would help tame inflation by directly reducing import prices and costs; it would also remove the need to engage in self-defeating, money–creating exchange-market intervention. The first part of that has long been an argument for yuan appreciation; the second part—eliminating the rapid growth of money by ending exchange pegging operations—is relatively new. It simply strengthens the case for floating.

So far I've been talking only about benefits to the Chinese people. However, by reducing Chinese imbalances, it will help reduce U.S. imbalances as well.

The Chinese and U.S. economies fit together like adjacent pieces of a jigsaw puzzle. The Chinese have been living well under their means and saving as a nation. We have been living beyond our means and going into debt. They accumulate foreign reserves; we accumulate foreign debt. They save a lot and export their saving through their current account surplus; we save next to nothing and supplement our saving through our current deficits. Their foreign surpluses have built up a net creditor position internationally; our foreign deficits have added to our net debtor position since the mid-1980s. Chinese citizens have not enjoyed all the fruits of their labor; ours have enjoyed more than the fruits of their labor.

We need a new five-year plan. It would be easy to write—just use the mirror image of China's. We need to produce more, consume less, export more, import less, and increase our national saving by reducing the budget deficit and our current account deficit. We need to speed up and be not less happy, but less indulgent. Since our economies do fit together like the yin and yang symbol, China's success will help us and our success will help them. Let's recalculate together.