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China thinks the Washington Consensus is dead! – Responses to Laurence Brahm

In PacNet *65, Laurence Brahm argued that the international economic and financial architecture was undergoing renovation. His claim that China was both promoting this transformation and will benefit greatly from it triggered considerable commentary. We reprint some of the comments below, along with his response.*

TED TRUMAN: I am afraid that Laurence Brahm does not know what he is talking about. There is no long-term significance in the fact that China and other countries are buying SDR-denominated "bonds" from the IMF.

All lending to the IMF is denominated in SDR, including lending under IMF quotas, bilateral lending, and lending under the New Arrangements to Borrow (NAB). The fact that some of the instruments of that lending are called bonds, which are at best exchangeable to a limited degree among governments, is not relevant.

What the IMF will sell to China are short-term instruments that are intended to finance IMF lending operations. Once those loans are repaid, China will be repaid. China will in effect lend dollars to the IMF and shortly thereafter receive dollars back.

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ROBERT MADSEN: I agree that the global crisis has discredited a number of U.S. policies and attitudes and sent people scurrying about looking for ways to improve the system, but in several places the Brahm analysis strikes me as internally inconsistent. Among the points that I question are:

1) Brahm's claim that the "post-colonial order created at Bretton Woods" has been destroyed. The collapse of the Bretton Woods system actually occurred in the 1970s, when all the major countries abandoned their pegs and floated their currencies. That left the IMF without its job of managing a fixed-rate regime, so it sought new work organizing ad hoc bailouts for countries in crisis. Many believe that it made a mess of this, too, exacerbating the problems in East Asia, for example, in 1997 and 1998.

2) If anything, the recent global crisis has increased the importance and influence of the IMF. When Brahm says that China and the rest of the BRICs want to use SDRs – which are, after all, the IMF currency – as a future reserve, he implies that the world is actually moving back toward the original Bretton Woods vision. We can argue about whether that is possible, but not about the new interest in the IMF.

   Brahm asserts that China and the rest of the world have concluded that "there are no models" for economic development. The truth is that for the last decade most of the big economies – Japan, China, the rest of East Asia, the oil exporters, Germany, and others – have all employed a single economic model: that of export-led growth. These countries were perfectly happy to run large current account surpluses, amassing ever larger stocks of foreign reserves in order to insure themselves against further financial crises. In other words, they expected the United States to provide in the form of current account deficits the demand necessary to keep the world economy growing.

   Has the world rejected that model? Absolutely not. China has increased its domestic spending dramatically, but it fought tooth and nail to prevent the G20 from putting exchange rates and current-account surpluses on the international agenda. Andrea Merkel, meanwhile, has reaffirmed the uniquely German belief that while American deficits are bad the United States has a moral obligation to continue running them. As for the developing world, can Brahm name one country that has declared that it now wants to run current account deficits in order to reduce the global need for American profligacy? Of course not. The bulk of the international community remains wedded to the export-led model of economic growth.

3) Brahm contends that China is committed to finding a new reserve currency. This statement is either obvious – everyone, including many American economists, believes that the world should move toward a more balanced system – or else it is incorrect. China's senior economists realize that it will take at least a couple of decades to transition from the dollar to a different reserve system. Before Beijing can even aspire to that role for the RMB, for instance, it must get its hands off the banking system, develop deep and transparent stock and bond markets, remove the country's capital controls, and build a body of securities law in which international traders had real confidence. The SDR, meanwhile, suffers from the enormous disadvantage of having no economy behind it. That China would buy a paltry $150 billion in SDR-denominated bonds and adopt a few other new policies cannot change these fundamental realities. Beijing realizes that, for better or worse, the world is stuck with the dollar for a long time to come.

   I wish Brahm were right. I wish that China and the developing world were willing to jettison the export-led development model and the necessity for American deficits that it entails. It would also be nice if the major economies could replace the current floating-rate system with something (if such a thing exists) that provides more stability for small countries rather than leaving them to be devastated by the contagion effect. And ideally Beijing would have reacted to the crisis by accelerating the liberalization of its financial sector rather than by increasing the extent of state intervention in the banking and mortgage markets. The real danger, in short, is that the global crisis has not brought enough progress in these areas of desirable reform and that many countries are settling back into their old habits.

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Laurence Brahm

The technical comments in the responses are interesting, but they miss the whole point. There is a Chinese saying about picking up seeds and losing the watermelon. To avoid confusion from the comments that spin my essay out of context, some clarification follows.

Our global financial architecture has and continues to change. So will the role and influence of the U.S. dollar vis-à-vis the yuan. This is a function of China's bulging foreign exchange reserves, our debt, and the inter-linkage between the two. The global recession that began in September 2008 has only accelerated this process. We should not live in denial of this, but understand it, and think of creative ways to respond.

As for clarification of some of the comments from Ted and Robert:

I specifically refer to China as a creditor. From this, it is obvious that the loans will be repaid.

Of course China is still buying our treasuries and supporting the dollar. It has no choice because more than half its foreign exchange reserves are already locked in with us. But the Chinese are also not stupid. They are looking for diversification. If no better option is out there, then they will find a way to create one, as they have with other situations. That is what this is all about.

Yes, another international settlement currency will not happen overnight. However, moves in finding one are underway by China and its other BRIC partners. As we all know, China does things in steps and piecemeal, eventually bringing the pieces together. Then surprise, something happens. Actually, most of the time it is not a surprise, just nobody was observing. This time let us observe because China told the world in its 2009 financial report issued in June that it will seek to de-couple from the U.S. dollar. Today the yuan is informally freely convertible in almost all countries bordering China. So it is logical to have swap and settlement agreements with these same countries and expand yuan convertibility circle in the fashion of "walking across the river one rock at a time."

The obvious first steps are well underway. The number of Chinese companies in coastal manufacturing cities that can settle foreign trade transactions in yuan to ASEAN countries (under a pilot program) increased to 365 recently. It will increase to 600 by year end, expanding the regional footprint to include Tianjin and Beijing (slated as financial cities after Shanghai). Previous players were based in southern manufacturing cities. China is pushing OPEC to price oil in a basket of currencies (that would include a heavy yuan weighting) instead of dollars. China is preparing to move the yuan toward convertibility and the circumstances today make that closer to reality than even a year ago.

China would like a greater voice in the IMF and current rules will force a wait of four years before restructuring allows China to have the influence it wants, so it is chipping away at it, playing creditor for influence. Beijing is particularly irate over recent IMF criticisms to revalue the yuan. So they want some say from the inside. Can you blame them?

As for the yuan playing an influential role in a future alternate global settlement currency, from China's perspective – game's on!