Alan Greenspan: China

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Finance, US Senate, Washington DC, 23 June 2005.

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Mr. Chairman and members of the Committee, I am pleased to be here today to offer my views on China's trade and exchange rate regime. I would emphasize that the views I will express are my own and do not necessarily represent those of the Federal Reserve Board.

Some observers mistakenly believe that a marked increase in the exchange value of the Chinese renminbi (RMB) relative to the U.S. dollar would significantly increase manufacturing activity and jobs in the United States. I am aware of no credible evidence that supports such a conclusion.

The enhanced integration of China into the world trading system is having a notable effect on Asia's trade with the rest of the world and on trade within Asia. After having risen rapidly through the 1990s, U.S. imports from Asia excluding China have flattened since 2000. This has occurred as production within Asia has evolved, with the final stages of assembly and exporting to the United States and elsewhere becoming increasingly concentrated in China. As a consequence, because exports by country are recorded on a gross basis rather than as value added, the widening of the United States' bilateral trade deficit with China, measured gross, has largely been in lieu of wider deficits with other Asian economies, including Japan. Measured by value added, our bilateral deficits with China would have been far less, and our bilateral deficits with other Asian exporters would have been far more.

Accordingly, an increase in the exchange rate of the RMB, relative to the dollar, would likely redirect trade within Asia, reversing to some extent the patterns that have emerged during the past half decade. However, a revaluation of the RMB would have limited consequences for overall U.S. imports as well as for U.S. exports that compete with Chinese products in third markets. Such a revaluation would affect Chinese value added but not the dollar cost of intermediate goods imported into China from the rest of Asia, which represents a significant share of the gross value of Chinese exports to the United States and elsewhere. (To the extent that exporters to China revalued as well, of course, the impact on overall Asian exports would be somewhat greater.)

The broad tariff on Chinese goods that has recently been proposed, should it be implemented, would significantly lower U.S. imports from China but would comparably raise U.S. imports from other low-cost sources of supply. At only slightly higher prices than prevail at present, U.S. imports of textiles, light manufactures, assembled computers, toys, and similar products would in part shift from China as the final assembler to other emerging-market economies in Asia and, perhaps, in Latin America as well. Few, if any, American jobs would be protected.

More generally, any significant elevation of tariffs that substantially reduces our overall imports, by keeping out competitively priced goods, would materially lower our standard of living. A return to protectionism would threaten the continuation of much of the extraordinary growth in living standards worldwide, but especially in the United States, that is due importantly to the post-World War II opening of global markets. Such an initiative would send the adverse message to our trading partners that the United States, while accepting the benefits of broadened world trade, is not willing to absorb the structural adjustments that are often necessary.

To maintain a rising standard of living, a dynamic economy such as ours requires a continual shifting of resources toward the most up-to-date technologies, financed not only by savings but also importantly by the depreciation of increasingly obsolescent facilities.

This highly dynamic process is mirrored in our labor markets, where jobs are constantly being created and destroyed at a rapid pace. New hires in the United States currently average more than a million per week, half resulting from voluntary job change. At the same time, during a typical recent week, about 150,000 workers are temporarily laid off and another 225,000 are subject to permanent job loss. Any effect of trade with China on U.S. employment is likely to be very small relative to the scale of job creation and job loss in our economy.

A policy to dismantle the global trading system in a misguided effort to protect jobs from competition would redound to the eventual detriment of all U.S. job seekers, as well as of millions of American consumers. Policy should aim to bolster the well-being of job losers through retraining and unemployment insurance, not to stave off job loss through counterproductive efforts to impede the process of income-enhancing international trade and globalization.

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While the presumption that a revaluation of the RMB will notably increase jobs in the United States by constraining imports or expanding exports is without statistical or analytical support, it is nonetheless the case that a more flexible RMB would be helpful to China's economic stability and, hence, to world and U.S. economic growth. Rapid accumulation of foreign, largely dollar, reserve holdings by the People's Bank of China, China's central bank, as a consequence of support for the RMB could boost the growth of the money stock, with the accompanying risk of triggering upward pressure on inflation and a general overheating of the Chinese economy.

The Chinese central bank's issuance of liquidity management bonds to lessen potential increases in the money supply created by foreign asset accumulation has accelerated since regular issuance began in April 2003. Nonetheless, only about one-half of the increase in reserves over the past two years has been offset, with the remainder showing through as money growth.

Because the Chinese financial system has considerable distance to go before achieving a satisfactory degree of soundness and flexibility, sterilization of continuing inflows of speculative funds will presumably become more difficult as the scale of these operations, already large, increases over time. In spite of its recent improvements, the financial system of China is still inordinately governed by administrative command and control. Market pricing of financial instruments is still accorded only a minor role.

Financial markets, if left free to continuously reprice interest rates and asset values, will identify and respond to imbalances far sooner than a system based on administrative edict. In market-based financial pricing systems, automatic adjustments are inherent. But in a highly administered system, supervisors can identify emerging imbalances only when these imbalances become visibly large and are already troublesome. Adjustment in a system requiring human intervention is accordingly far less flexible than in a system based on the automaticity of markets. Given this vulnerability to emerging imbalances, the buildup of ever-larger holdings of bonds resulting from sterilization of foreign exchange purchases poses threats to China's financial stability. Hence, the sooner the Chinese, in their own self-interest, move to a more flexible currency regime, perhaps leading other Asian currencies to become more flexible as well, the better for all participants in the global trading system.

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In the decades ahead, it is in our interest and that of the global economy that China continue to progress toward becoming a more market-based, productive, and dynamic economy in which individual initiative, not government decisionmaking, is the fundamental strength behind economic activity. For our part, it is essential that we not put that outcome, or our future, at risk with a step back into protectionism.