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Abstract:

As experts have long recognized, debates about exchange rates are largely political. Even existing exchange rates are results of both market forces and manipulations by the big players including the central banks. The slogan of central bank independence is largely a smokescreen to hide the roles of specific factions of big capital in each nation state. According to economic theory, the exchange rates are indeed a general equilibrium solution under stringent assumptions of a model economy without frictions. Therefore, there should be an FEER for any pair of currencies. In the real world, the frictions matter. Most importantly, these include but are not limited to political interventions. The reality is complex. Just to mention one set of contradictory forces, a revaluation of RMB upwards will ease inflationary pressures on China but will not be welcome to the powerful exporting interests particularly in Southeast China. The practical political question from the Chinese side is how far to revalue and how fast. The American jawboning as well as the frictions of the complex economies of the world have led to considerable fluctuations in the RMB-dollar rate. The overall tendency is towards revaluation of RMB. However, imbalances will not disappear soon enough. Underlying all these imbalances are both political factors and global financial instability together with the economic weakness of the US . The long- term growth rate will not and perhaps can not equal that of the golden age of capitalism during the 1950s and 60s. The policy- induced weaknesses from the Bush-Greenspan era are still with us and will not disappear soon.The problems of heavy financialization and indebtedness including the lack of fundamental institutional reform in the US will not go away any time soon. Thus the medium term outlook for the US and the World Economy is crisis- ridden and uncertain. This will most likely result in more political frictions internationally. China will loom large in this conflictual scenario but so will many others including the EU. Khan(2002, 2004) had proposed a Hybrid GFA(HGFA) which would crucially make room for effective regional financial architecture. A reformed IMF and the RFAs together, liberated from the straitjackets of monetarism and a simplistic long run equilibrium view where money is neutral can form an HGFA that can work--- not without inevitable frictions--- reasonably well. More recently, I have elaborated on these ideas in a report to the UNDP in Khan(2012). The main point is to take seriously the unevenness of the global economy and address the emerging problems strategically through an enhanced, more democratic global economic governance system. From this perspective, making G-20 an effective economic forum is a step in the right direction. But more needs to happen. In particular, the voices of the poorer nations need to be heard. The US-China economic issues, including the exchange rate issues, need to be viewed within this broader perspective. The policy makers of the powerful economies in the world then would be able to perform globally the kind of necessary public service that the New Deal was intended to perform domestically in the US during the 1930s.

Keywords: Hybrid Global Financial Architecture, Unevenness, U.S.-China Frictions

The debate on US-China exchange rate has been an almost constant feature during the 21st century. The New York Times reported in late 2010 that the critics of Chinese policy

> "...[s]ay there was a way to create a half-million American jobs over the next two years without adding a dime to the debt or deficit. And say it would also revive moribund Rust Belt factories, reduce the country's gaping trade deficit and help stabilize the international economic system. (NYT Sep.18, 2010)

If only fixing the problems of the largest economy in our world were that simple!

As experts have long recognized, debates about exchange rates are largely political. Even existing exchange rates are results of both market forces and manipulations by the big players including the central banks. The slogan of central bank independence is largely a smokescreen to hide the roles of specific factions of big capital in each nation state. Does this mean that there is no fundamental equilibrium exchange rate(FEER)?

According to economic theory, the exchange rates are indeed a general equilibrium solution under stringent assumptions of a model economy without frictions. Therefore, there should be an FEER for any pair of currencies. In the real world, the frictions matter. Most importantly, these include but are not limited to political interventions. This is quite clear on the Chinese side and one might say that there is a certain charm in the non-hypocritical manner in which the Chinese acknowledge the primacy of their internal---far from transparent---politics in setting their policy targets. On the American side, however, there is a camouflage of technocratic, supposedly politics- free jargon-ridden economic rhetoric. Even progressive critics in the US such as Robert Scott of the Economic Policy Institute seem to be seduced by the rhetoric and accept uncritically the results from models when they confirm the conventional wisdom regarding U.S.-China problems.

Economic modeling is worthwhile and much can be learned from both sectoral econometric models and economy wide models. Notwithstanding such attempts to model our complex economy for which I, too, plead guilty, the recognition of the imperfections of global markets and global politics will be vital for solving the problems of exchange rate issues between China and the US. More broadly, the issue of global exchange rate mechanism must be seen as part of building a new global financial architecture of which exchange rate mechanisms are a transparent part. But first let us take a close look at the actual situation of the yuan(more generally, RMB)-dollar exchange rates.

Reading the popular press and accounts of Congressional debates, one could be forgiven for thinking that the evil character called China has forever fixed its exchange rate at a rate which is unfavorable to the US and favorable only to China. The reality is more complex. Just to mention one set of contradictory forces, a revaluation of RMB upwards will ease inflationary pressures on China but will not be welcome to the powerful exporting interests particularly in Southeast China. The practical political question from the Chinese side is how far to revalue and how fast. The American jawboning as well as the frictions of the complex economies of the world have led to considerable fluctuations in the RMB-dollar rate. The overall tendency is towards revaluation of RMB. Recently, a report from the reputable Peterson Institute pointed out:

> The latest semiannual estimates of fundamental equilibrium exchange rates (FEERs) by Peterson Institute researchers William R. Cline and John Williamson find that modest appreciation of the renminbi against the dollar, combined with higher inflation in China than in the United States, has narrowed the undervaluation of the Chinese currency from 16 percent in April to 11 percent in late October[2011]. However, the bilateral undervaluation of the renminbi against the dollar still amounts to 24 percent; this is the rise in the renminbi that would be required to achieve multilateral equilibrium if all currencies were to move to their FEERs.

Although my own estimates show an FEER that indicates a larger adjustment of RMB than does the Peterson Institute estimates, still the direction of the movement is the same in both exercises. The technical article by Cline and Williamson also reports real effective exchange rates where a further adjustment of only about 10.6 percent is needed(column 5 of their table 1).Furthermore, Cline and Williamson also observe correctly that US has bilateral exchange rate issues with other countries as well. Thus:

> The Mexican peso has become more undervalued than the renminbi. The safe-haven effect boosted the Japanese yen and the Swiss franc, and both countries intervened to resist appreciation. Because the yen had become overvalued but the franc remains undervalued, Japanese intervention was justifiable but Swiss intervention was not.

Underlying all these imbalances are both political factors and global financial instability together with the economic weakness of the US . The long- term growth rate will not and perhaps can not equal that of the golden age of capitalism during the 1950s and 60s. The policy- induced weaknesses from the Bush-Greenspan era are still with us and will not disappear soon.The problems of heavy financialization and indebtedness including the lack of fundamental institutional reform in the US will not go away any time soon. Thus the medium term outlook for the US and the World Economy is crisis- ridden and uncertain. This will most likely result in more political frictions internationally. China will loom large in this conflictual scenario but so will many others including the EU.

It is also proper to note here that the Chinese development strategy is flawed in its own terms. I have pointed out in an earlier essay written for the World Institute for Development Economics -United Nations University(WIDER-UNU) in Helsinki and in a chapter on China's Energy Security and Development Strategy(2010) that the current strategy is creating an unequal society within China and a serious ecological crisis. Internationally it will pit China against other powerful industrialized countries in a race for resources that will exacerbate global tensions and may even lead to war. This can be avoided by following a new egalitarian and eco-friendly development strategy on China's part. Khan and Gabriele(2010) have addressed the specific issue of creating an egalitarian innovation system.

Turning again to the exchange rate issues, let me conclude this short essay by observing that the global imbalances are largely a result of the demise of the Bretton Woods financial architecture and lack of a new Global financial architecture(GFA) to take its place. There have been many discussions since the Asian financial crisis in the late 1990s and-- needless to say-- since the great global recession more recently. As Barry Eichengreen correctly pointed out earlier, most proposals for ideal GFAs don't have "a snowball's chance in hell" to get implemented. Yet the discussions have been informative. The key asymmetries and imbalances have come to the fore. The neoliberal turn in general and of the IMF during late 1970s and 80s continuing almost upto now has been criticized to various degrees. Many alternatives have been suggested including some by the present author. Unfortunately, it must be admitted that until now not much has been done in terms of changing fundamental policy orientation of the international organizations and key national governments. But there is some possibility that as the debate opens up and dogmatism takes a backseat the chances of better policies and global and regional institution building will improve. My colleague Prof. Ilene Grabel has also recognized such possibilities in her recent work.Jose Antonio Ocampo and other progressive Latin American economists in particular, are also keen on exploring the possibilities for regional cooperation in financial matters.

In my working papers around 2001-2002 and my subsequent book, Global Markets and Financial Crises(Palgrave,2004), I proposed a Hybrid GFA(HGFA) which would crucially make room for effective regional financial architecture. A reformed IMF and the RFAs together, liberated from the straitjackets of monetarism and a simplistic long run equilibrium view where money is neutral can form an HGFA that can work--- not without inevitable frictions--- reasonably well. More recently, I have elaborated on these ideas in a report to the UNDP. The main point is to take seriously the unevenness of the global economy and address the emerging problems strategically through an enhanced, more democratic global economic governance system. From this perspective, making G-20 an effective economic forum is a step in the right direction. But more needs to happen. In particular, the voices of the poorer nations need to be heard. The US-China economic issues, including the exchange rate issues, need to be viewed within this broader perspective. The policy makers of the powerful economies in the world then would be able to perform globally the kind of necessary public service that the New Deal was intended to perform domestically in the US during the 1930s.

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