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China's current account and personal freedom

In the decade before the Asian crisis, the countries of East Asia were harangued by the right-wing ideologues of the US to open up their capital accounts, adopt freely floating currencies, and deregulate domestic interest rates.

The meltdown of 1997-8 brought a general re-assessment. Former cheerleaders of deregulation (including the International Monetary Fund) now put great emphasis on strengthening financial sectors (especially prudential supervision), and accept that this will take significant time.

In the meantime, rules and restrictions are justified, even necessary. The volatility of foreign capital flows is acknowledged. Careful sequencing of reform is now seen as essential. This fundamental revisionism seems to have escaped James Dorn ("China's choice: capital freedom or punishment", *Weekend AFR* February 11-12).

We can agree readily about China's economic deficiencies and vulnerabilities: "a sea of non-performing loans; misallocation of capital, with overinvestment in the state sector and under-investment in the private sector": the list goes on.

But what is the right strategy for addressing these problems?

For Dorn, the answer is simple: the old remedy of freeing capital flows, floating the exchange rate, and market-determined domestic interest rates.

Economic freedom drives political liberalisation. These economic restrictions are in place to "ensure that the Chinese Communist Party retains its grip on power". These controls "violate private property rights and attenuate both economic and personal freedom." "Capital freedom …would ... help bring about political reform."

Let's leave aside the question of why the Chinese Communist Party would want to implement policies which would end its "grip on power" (for the residents of the Zhongnanhai, this may not seem a compelling argument), and focus on the narrow economic issue: is it technically a good idea?

Dorn blames the Asian crisis on the failure to float exchange rates. How does this fit with his own example of a well-performing economy – Hong Kong – which maintained a fixed rate through the crisis, and still does? His authority for the panacea of a floating rate is John Greenwood, a principal architect of Hong Kong's extreme version of a *fixed* rate – a currency board. Further support for the freeing of the currency comes from Ludwig Erhard, but the convertibility Erhard lauds is the 1958 *current account* convertibility, which China already has.

On interest rates, Dorn just seems ill-informed – the key short-term interest rates are set in the US (as in all OECD countries) by the central bank – what does he think the Fed is doing when it announces a change in the rate?

If the issue is the long-term bond rate, that requires exactly the policies that are being implemented – the development of a deep and liquid financial market, which takes years (even decades) of careful institutional development, not a policy edict.

Without diminishing the case for reform, the painful experience with de-regulation might be acknowledged by Dorn. Even where there are deep and mature financial markets, capital flows can be volatile, and exchange rates reflect this volatility – the yen moved between 80/$ and 147/$ over a two- year period in the mid-1990s.

And, in passing, would it be too much to expect consistency in the prescription – if he favours capital movement, shouldn't Dorn also criticise the US refusal to allow the Chinese firm CNOOC to buy the US oil company Unocal?

Galbraith once said "no good idea is ever improved by exaggeration". More flexibility in the exchange rate will help resource allocation and make macro-management more effective. There are huge efficiency gains to be had from privatising many of the Chinese state-owned enterprises, and unleashing the dynamic of the private sector.

Working towards an open external capital market is a desirable medium-term objective. But one of the primary lessons of the Asian Crisis is the importance of institutions. Wing Thye Woo of the University of California puts it this way: 'The main issue of the Washington Consensus was how to get the prices right, while after the Asian crisis it is how to get the institutions right'.

Institution-building takes time. This is what is currently under way in China. No doubt a case can be made that the pace is too slow, some priorities are faulty, or that some policy elements are simply wrong. But this debate has to take the form of a serious analysis of the process of institution-building with nuanced policy prescriptions, not a doctrinally-driven polemic.

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