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# China Plays Backseat Driver on Dollar Policy: Caroline Baum

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Commentary by Caroline Baum

Nov. 30 (Bloomberg) -- President **Barack Obama** got an earful from China's leaders on his inaugural trip to Asia earlier this month.

They wanted to know about the weak U.S. **dollar**, rock-bottom **interest rates**, big budget **deficit**, trade protectionism in the form of tire tariffs and "massive speculation" inflating asset bubbles around the world. China's top banking regulator, **Liu Mingkang**, said U.S. policies were creating "new, real and insurmountable risks" to the global recovery, especially in emerging economies.

Obama took it all in. Too bad his ubiquitous teleprompter didn't provide him with an appropriate response: The dollar is our currency, but your problem.

That's what President **Richard M. Nixon's** Treasury Secretary, **John Connally**, told a delegation of Europeans worried about exchange rate fluctuations in 1971. The comment is equally relevant today.

In hitching its currency, the yuan, to the dollar, China cedes sovereignty over its monetary policy. That's China's choice.

Once made, if China is unhappy about the dollar/yuan exchange rate, "tough luck," said **Bill Poole**, former president of the Federal Reserve Bank of St. Louis, in a paper prepared for the Cato Institute's Annual Monetary **Conference** on Nov. 19.

Of, By, For U.S.

Poole made several other points, albeit in a more diplomatic manner:

-- It is not the responsibility of the U.S. to conduct its policies for the benefit of other countries;

-- Neither the Fed nor any part of the U.S. government has an obligation to maintain the purchasing power of dollar- denominated assets in a currency other than the dollar;

-- The U.S. is obligated to maintain price stability at home, which is good for the world economy.

U.S. interest rates may be too low, the dollar may be too weak and speculation may be rampant in emerging markets. But these are considerations for U.S. policy makers as they relate to U.S. price stability and economic growth. It is not the Fed's mandate, nor its business, to deliver price stability to China, Taiwan and Singapore.

That's not the way everyone sees it. Curiously, the same folks who regularly insist that the Treasury, not the Fed, runs "**dollar policy**" claim the onus for the weak dollar and yuan rests with the Fed.

Whose Policy?

For the record, the Treasury can instruct the Fed to intervene in the foreign exchange market to buy or sell dollars. It cannot prevent the Fed from offsetting those purchases or sales via open market operations. Which means that the Fed has de facto control over the dollars in circulation, and any suggestion the Treasury has a "dollar policy," -- strong, weak or otherwise -- is hogwash.

U.S. monetary policy may not be the right fit for China's booming economy. However, allowing the yuan to float, and most likely appreciate, would reduce China's competitiveness.

Last year U.S. **imports from China** totaled a record $337.8 billion, almost five times the value of exports to China, according to the U.S. Census Bureau.

Does China want to reduce its exports and create mass **unemployment** as it seeks to absorb agricultural workers from the countryside into its urban factories? The unwillingness to let the yuan appreciate suggests it does not.

Hooking Up

When a country decides to maintain a fixed-exchange rate, it has to buy or sell its own currency to maintain the peg. China is an extreme example, accumulating $2.3 trillion of **foreign exchange reserves**, most of it in U.S. dollars, from its **trade surplus**.

China's exporters get paid in dollars and convert those dollars to yuan, courtesy of the People's Bank of China. Where does the PBOC get the constant stream of yuan it needs to buy dollars? It creates them, which has the effect of increasing bank reserves. The banks, in turn, lend those yuan out, which increases the money supply.

China's **M2 money supply** is growing at a 29 percent year- over-year rate, which, in economist parlance, is "unsustainable." The U.S. has a potential inflation problem, with banks hoarding more than $1 trillion of **excess reserves** rather than making new loans. Its M2 money supply has shown no growth since June, and **bank credit** has been falling almost consistently for the last 13 months.

Bubble Trouble

While the lag between money growth and inflation can be long and variable, China's inflation problem is more immediate, its asset bubbles more threatening. The Chinese government enacted a $586 billion stimulus package last year and reduced interest rates five times, producing a $1.3 trillion expansion in credit this year. China's **benchmark stock index** was up more than 80 percent before last week's slide, and property prices are booming.

If China's authoritarian leaders think the dollar is too weak, interest rates are too low or speculation too destabilizing, they can do something about it. Telling the U.S. how to run policy isn't the solution. Letting the yuan float would be a start.

Or, as that ancient Chinese proverb says (OK, I made that part up), lie down with dogs, you get up with fleas.

(**Caroline Baum**, author of "Just What I Said," is a Bloomberg News columnist. The opinions expressed are her own.)

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