INVESTORS.com
POWERED BY INVESTOR'S BUSINESS DAILY

IBD EDITORIALS

For Global Health, China Must Liberalize

By JAMES A. DORN
Posted 08/19/2011 01:34 PM ET

Chinese officials have been highly critical of the U.S. debt buildup and the political wrangling in Washington that ha
crisis.

But China could well turn that leery eye inward to find policies that are preventing financial markets from functioning
and which may yet spread the next serious malady to global financial markets.

One problem is that China is the largest holder of U.S. Treasury securities, with more than $1 trillion invested. With
for U.S. debt, Congress would have been more constrained in its deficit spending, and U.S. growth would have bee

China now holds more than $3 trillion in official foreign exchange reserves, the result of large trade surpluses and i
However, China is a net exporter of capital via the purchase of Treasuries and other government securities. The lar
is the result of an exchange-rate policy designed to undervalue the yuan.

Which brings us to the second major problem: if the Chinese currency were allowed to freely float, there would be n
official reserves. Traders, not communist party members, would determine the exchange rate. Adjustment would oc
voluntary decisions, not via central plans.

A more flexible exchange rate and a fully convertible yuan would increase the range of choices open to people, exp
and increase popular pressure for political reform.

The legacy of central planning still haunts the banking sector. Lending, interest rates, and the major banks themsel
the state. Even more ominous is that most of the lending is to state-owned enterprises. Investment decisions are th
and corruption is rampant.

Stimulus spending allowed China to escape the 2008—09 global financial crisis, but the rapid expansion of bank cr
sheet lending, has led to excess money growth and an inflation rate of more than 6 percent. UBS data show that C
including off-balance sheet loans, now stands at about 180 percent of GDP, up sharply from 2008.

If the economy slows, nonperforming loans could swell. The excess credit could turn into a debt crisis. That crisis c
bursting of the Treasury bond bubble, once the Federal Reserve begins to increase interest rates, or once markets
and reduce the real debt burden.

China needs to tame domestic inflation and further liberalize its economy. Yet, there is strong political pressure to c an artificially low rate and "sterilize" the newly minted yuan — that is, drain off excess yuan by selling central bank b requirements, and setting tighter lending quotas.

Price controls and capital controls are also being used to suppress inflation and to limit private choices. But as long export-led development model, with financial repression, the hoard of foreign exchange reserves will grow and mos lent to the U.S government, not to private enterprise.

The reality is that both China and the U.S. are growing the state sector at the expense of the private sector. Crony c liberalism, is now the norm.

For China to become a global financial center and achieve financial harmony, there must be privatization of the ban freedom, flexible exchange rates, market-based interest rates, and a rule of law that assigns responsibility to private

The mispricing of credit/risk and monetary manipulation plague both China and the U.S. Beijing is right to criticize U creating fiscal and monetary uncertainty. But what Beijing wants is more, not less government control, while the sol creating economic and social harmony is less government.

With a rule of law and limited government, voluntary exchanges in private free markets would increase individual sc while promoting the general welfare. That concept of spontaneous order is now foreign to most politicians. Politics a trumped what the great French liberal Frederic Bastiat called the "law of liberty."

The challenge for both China and the U.S. is to restore the balance between the state and the market — to maximiz coercion. Rebalancing can then be market-directed, economic relations normalized, and politics put in its proper pla

— Dorn is vice president for academic affairs and a China analyst at the Cato Institute in Washington, D.C.