

Off-kilter

The euro zone crisis hints at the unsustainable nature of China's trade policy

The takeover of France's parliament in June by President Francois Holland's Socialist Party marked a shift in thinking about the euro zone crisis. Europeans are increasingly turning against the austerity measures championed by Germany in favor of initiatives to bolster public finances, boost growth and lower unemployment.

No one knows yet what the lessons of this ongoing crisis will be; whether austerity, stimulus or some other measures will help to resolve the crisis. Yet one of the early takeaways appears to be a new understanding of the danger of trade imbalances. As the crisis unfolds, it has become clear that it is not just Europe's largest debtors that are in jeopardy, but also its largest creditor.

China should be watching the effects of the euro crisis on the German economy carefully. China's current account surplus shrunk from its height of 10.1% of GDP in 2007 to 2.9% in 2011, yet the country still maintains one of the world's largest surpluses. The lessons of the euro zone suggest that the long-term health of the Chinese economy may depend on alleviating this imbalance.

False parables

It's clear that trade imbalances are at the root of the euro crisis. In the past, however, many observers pictured these imbalances as a product of the lazy, indulgent culture of the "Club Med" countries, which took advantage of the hard-working and high-saving Germans to support their extravagant lifestyles. Greeks, Spaniards and other Mediterraneans have retired early and vacationed often, all while enjoying generous government benefits.

That may be true, but the euro zone's current troubles have less to do with a pension for *sies-*



STRENGTHENING TIES: A Frenchman carries his son past a polling station in the French embassy in Beijing

tas than variations in economic competitiveness that were exacerbated by the single-currency zone. Between 2003 and 2005, Germany carried out a series of reforms to reduce taxes, unemployment benefits and pensions, boosting the manufacturing sector and increasing exports as a result. But because it shared a currency with countries with smaller trade surpluses and even deficits, Germany continued on with a euro that was far too cheap relative to its economy.

The euro artificially boosted German exports, and therefore its trade surplus. Meanwhile, peripheral countries in which the euro was "too strong" saw their economies weaken, unemployment rise and deficits balloon.

More Europeans are beginning to understand that their predicament is the result of these economic imbalances within a single currency, and not moral weakness on the part of the debtor countries. Trade surpluses are simply a function of the differences in the cost of production (wages,

▶ Taking out the trash: Alarm over China's campaign against illegal residents is vastly overblown

Hostility to foreigners living in China is on the rise, according to some pundits. On May 15, officials announced a 100-day campaign to "sweep out" foreigners illegally living in Beijing, a crackdown which has been informally adopted by a handful of other Chinese cities. Just a few days later, Yang Rui, host of an English-language program on CCTV, launched an online tirade against "foreign trash" who "come to China to earn money, traffic in people and deceive the public."

Several news organizations linked the

events with mounting tension in the run-up to China's leadership transition this fall, as well as insecurity borne of a slowdown in the economy.

"Before China's Transition, a Wave of Nationalism," crowed one *New York Times* headline; "Chinese Lash Out at Foreigners Amid Turmoil" claimed an article from *Bloomberg Businessweek*.

China has definitely had its share of anti-foreigner sentiment in the past, and the new campaign is a step in the wrong direction. But there's little evidence to

support alarmist claims that the campaign constitutes broad-based xenophobia. While no official reason has been given for the campaign, the timing suggests it may be an ad hoc fix to an online outcry over a video posted on the internet in early May, which showed a British man apparently sexually assaulting a Chinese woman on the streets of Beijing.

As far as xenophobic campaigns go, China's current efforts are mild. The crackdown is temporary, expiring in just over three months. Enforcement has so



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raw materials, etc), currency and other factors. For international trade to occur, some countries must be creditors and others must be debtors, and the global total of trade surpluses must equal the total deficits.

Yet the euro zone crisis shows the danger in allowing these imbalances to get out of hand. As the cost of servicing its debt rises, the deficit country's economy may crumble, leaving the surplus country with unpaid debts and lower trade. Many analysts now say that Germany must undergo the pain of higher inflation to claw back the unfair gains it reaped from an undervalued currency.

Lessons for China

As for Germany, China's trade surplus is not evidence of moral superiority or even a particular thriftiness on the part of its

leaders, but rather the logical outcome of its trade policy and capital controls.

China's central bank has set tight capital controls, both to prevent destabilizing capital inflows and outflows and support export manufacturers by keeping the renminbi at a constant and relatively low value. To do this, the People's Bank of China prints money and buys all of the foreign currency that its exporters bring back into the country. It then recycles this foreign currency back out through its massive foreign exchange reserves.

Since the beginning of the financial crisis, many in the US have been anxious about being beholden to China, which as of April held US\$1.15 trillion of US debt. But China could not discontinue its purchases of US dollars and euros without changing either its capital controls or the size of its export industry.

In reality, China's massive purchases of US dollar reserves should be more of a concern for China than the US. As the euro zone crisis shows, the surplus country's economy is often at the mercy of its debtors. If a surplus country produces too much and consumes too little, eventually debtors lose the ability to buy its imports, service their debts and expand their economies to repay what they owe.

Many of China's economic regulators, including PBoC governor Zhou Xiaochuan, understand what is at stake and are pushing to narrow trade imbalances by adjusting the country's growth model away from exports and investment and towards consumption. "One important goal of reforming Chinese exchange rates is to promote the balance of interna-

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tional payments. When we set the RMB exchange rate at a reasonable and balanced level, then capital will flow not just in one direction, but flow in and out [of China]," Zhou said during an interview in January.

But Zhou and other proponents face opposition from those who fear that such a shift would cause unemployment and social unrest to spike. With China's economy showing signs of slowing, the central bank allowed the Chinese currency to gradually weaken in May, reversing the decline of the trade surplus in previous months. It remains to be seen which faction will win out in coming months.

The euro zone crisis suggests that many of the world's trade imbalances may not be sustainable, and that rebalancing must happen in some form. Germany's example demonstrates that it would be far better for China to increase consumption on its own terms than adjust its trade imbalance while looking down the barrel of a gun. ♦

far amounted to checking passports at bars frequented by foreigners on weekends and offering a hotline for citizens to report illegal residents.

A more serious crackdown might have included dramatically tougher visa restrictions, such as those implemented in the US in 2001 or the ongoing visa quota reductions in the UK. The government could charge police officers to inspect the documentation of all foreigners with a "reasonable suspicion" of being illegal residents, as required by a 2010 Arizona law currently under review by the US Supreme Court. It could spur civilian anti-immigrant vigilante groups into action (such as the so-called "Minutemen" in the US), or introduce large-scale deportations (like France's expulsion

of Roma immigrants in 2010).

China's system of enforcement and regulation for foreigners illegally entering, residing and working in the country is nowhere near as developed as in the US and Europe. Visa rules are inconsistent from city to city, and officials frequently ignore past applicant rejections and overstays. Chinese companies regularly employ foreign residents on tourist visas, who renew them with perpetual "runs" to Hong Kong.

Such measures pale in comparison with the ironclad thicket of rules found in Western countries. These can include face-to-face interviews for visa applicants, heavy fines for employers of illegal migrants, and arrest, deportation and forbidden re-entry for even minor visa overstays or illegal

employment.

Chinese jingoists avow that the "Western media" holds double standards for China. The argument is mostly nonsense, but in this case they may have a point.

Yang's comments are no worse than the angry anti-immigrant diatribes regularly heard from conservative pundits in the US, and enforcement against illegal foreign residents in China is laughable compared to anti-immigrant backlashes in the West.

Those who sloppily claim that visa checks outside Beijing bars are tantamount to a xenophobic backlash would do well to reflect on how their own country treats foreigners. ♦