Paulson's China opportunity

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With new diplomatic passport in hand, Treasury Secretary Henry Paulson soon will begin traveling the globe to further U.S. interests. A key stop this fall will be China, where there is an opportunity to expand the dialogue on the U.S.-China economic and commercial relationship.

The timing couldn't be better. Beijing is struggling with controlling an overheating economy, and Sens. Chuck Schumer, D-N.Y., and Lindsay Graham, R-S.C., have said they will push for a vote by the end of September on sanctions against China over the value of its currency.

These issues speak to Paulson's strengths. He understands that China's development of a market-driven financial system is the necessary centerpiece of a broader economic relationship between what will soon be the world's two largest economies. If he succeeds, he will demonstrate that expanding the type of engagement with China that has been followed in the U.S.-China economic and trade relationship for 25 years can also be a fruitful model for thorny diplomatic and security issues.

China's leaders realize it is in their country's interest to transform and open their financial system. They have crafted and adapted financial laws, regulations and institutions from scratch. Yet as the Dec. 11 deadline approaches for China to phase in its final World Trade Organization commitments in the banking sector, China still is far from full financial modernization. Engaging China to move more quickly on its financial reforms is the key to unlocking three very visible issues often raised by members of Congress and others concerned about the U.S.-China economic relationship.

The first is China's exchange rate. As Paulson noted in his confirmation hearing, only after China has developed a fully functioning, market-based financial system will the country be able to remove capital controls and move to a freely floating exchange rate. In the meantime, China's exchange rate should be allowed to reflect trade and capital flows at a faster pace.

Second is the U.S. trade deficit with China, which exists partly because U.S. consumers save too little while Chinese consumers save too much. Why? Because they must save for everything. China's social security and health insurance systems are practically nonexistent. Consumer credit systems are in their infancy. Once in place, a social safety net and consumer credit network should free up trapped savings, leading to higher consumption and more imports.

Raising domestic consumption also will ensure that China's economic growth is sustainable and not just reliant on exports. Another reliable engine of growth in the world would provide an additional major market for U.S. companies.

The third issue is competitiveness and a level playing field for U.S. companies operating in China and competing with Chinese exporters in other markets. This can't happen as long as the Chinese financial system allocates capital on nonmarket terms. Today the government sets interest rates too low, and banks with immature risk-management systems often don't lend on commercial terms. The result is that capital often flows to inefficient state-owned enterprises rather than to the most productive borrowers.

U.S. financial companies have considerable expertise in financial services and can assist China in developing financial systems and tools. Exposing China's financial markets and institutions to international best practices through true competition would help modernize the sector.

China's regulators say they are wary of destabilizing markets as they implement new laws and test their own relatively new powers to guide the financial system. Some also fear that granting more leeway to global financial service providers risks surrendering to foreign domination.

If history is any guide, these fears are misplaced. Sectors opened earliest to foreign investment tend to be the healthier and more competitive sectors of the Chinese economy today.

Adding Paulson's experience in dealing with China to continuing roles for Commerce Secretary Carlos Gutierrez and trade envoy Susan Schwab would signal to Beijing the importance the U.S. places on making progress on issues of concern. Paulson can bring a sharp focus on these key economic and financial issues at the highest levels in both governments. If he can advance this agenda, both economies will benefit.

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