

## How to Level the Capital Playing Field

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China's decision to invest heavily in Japanese government bonds has set in motion a process of action, reaction and blame. Faced with a strengthening yen, Japanese authorities intervened in the market to buy US dollars. Japan took the blame for its allegedly unilateral move, but the end result would have been the same if the Chinese had themselves bought US assets. The Japanese were just unwitting intermediaries who, on top of the blame, now have to take on even more exchange-rate risk.

Little can be done to stop the People's Bank of China from accumulating foreign exchange reserves and thus steering the yuan exchange rate. And China's capital controls prevent the US, Japan and the European Central Bank from retaliating; there are simply no significant yuan assets that foreigners are allowed to invest in.

The US government has become so frustrated by this situation that Congress is now seriously considering designating China a currency manipulator. Trade sanctions currently under consideration would be illegal under World Trade Organization rules and could throw global trade into turmoil.

There is, however, one solution that does not involve breaking any international commitments. The US and Japan could declare that they will henceforth only allow sales of their public debt to countries whose public debt US and Japanese residents are also allowed to buy and hold. Instead of the 'moral suasion' that they have tried in vain, the two governments could simply tell their Chinese counterparts that they can buy more Japanese or US assets only if they in turn allow foreigners to buy Chinese assets.

Imposing such a reciprocity requirement on capital flows would be perfectly legal, because there are no legal obligations in this area. Japan and the US have notified the IMF (as also has Korea) that they have liberalised capital movements under Article VIII of the IMF rules. But, this was a voluntary choice, not an obligation (indeed China, although a member of the IMF, has not opened its capital account under Article VIII).

Capital controls are always somewhat leaky. But given their scale, China's investments would be difficult to hide in the West. No reputable Western financial institution would dare act as an illicit intermediary for the Chinese, especially if it were required to certify that its assets came from a country in which foreigners can buy and hold public debt.

As a practical matter, the reciprocity requirement would have to include a provision to grandfather in the existing stock of official Chinese assets abroad, which is already valued at over \$2.5 trillion. But China would in effect be unable to continue its intervention policy, and that is what would matter for foreign exchange markets.

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Such a plan would not be without risks. Might the Chinese react emotionally and dump their holdings of Treasuries and US agency debt? It's not impossible, but this dumping would not be as simple as it sounds. What would the Chinese Central Bank do with the proceeds from selling its Treasury holdings? There aren't too many things it could do with trillions of dollars: Either it could hold cash in the form of bank deposits, which would mean a massive refinancing of the US banking system, or it could buy other US assets, which would mean a refinancing of the US private sector. And even if the Chinese did sell Treasuries, this is a large and liquid market, meaning that other buyers would come forward and the interest rate paid on the US debt might not increase by much.

The reciprocity requirement could be extended to private debt instruments as well, although that would probably be unnecessary given the People's Bank of China's past reluctance to invest so heavily in private assets. Buying euro assets would constitute another alternative, but it is an unattractive one at present and would be blocked off if Europe adopted the same reciprocity requirement.

So now the burden of action falls on the US. Washington might waver because it relies heavily upon foreign investment to finance its fiscal deficit. But that is why a reciprocity requirement would be the ultimate test of America's commitment to its stated economic ends. Would the US rather have a freer yuan or continued access to Chinese funding for its government deficit? It cannot have both.

For Tokyo (and Seoul) the choice is much easier: there is no reason why this reciprocity requirement should not be imposed immediately.