

# Wrong on the Yuan

By Calla Wiemer

China has taken a certain amount of heat from outgoing Treasury Secretary Henry Paulson for helping bring on the global financial crisis. But his newly sworn-in successor has just raised the temperature a notch. In written testimony to the Senate last week, Timothy Geithner invoked the dreaded “currency manipulator” label intimating that China is deliberately undervaluing the yuan. This is a heavily loaded term that the Bush administration for some years managed to dance around. Currency manipulation is prohibited under the International Monetary Fund Charter and can be taken as grounds for retaliatory trade sanctions.

The attention to the exchange rate is misplaced. A coherent story of global payments imbalances and the financial crisis can be told without recourse to charges of an undervalued yuan. Likewise, an agenda for getting out of the crisis and setting the global economy on a more balanced path does not depend on the yuan. The policy focus should be on stimulating consumption in China. The need for that predated the crisis but is now magnified by it.

Both China and the U.S. pursued macroeconomic policies from 2001 to 2007 that were successful in achieving high growth with low inflation. Just how successful in China’s case is only revealed when real growth figures are derived, following standard international practice, by subtracting the inflation rate from the nominal growth rate. This approach shows that from a slowdown that bottomed out in 2000 with growth at just 2.3%, the pace soared to robust double digits and stayed there for seven years. The year 2001 was pivotal due to China’s World Trade Organization entry, although the foundation for sustained growth had been laid in the late 1990s with state sector downsizing, housing privatization and liberalization of labor migration.

In a pattern typical of developing countries in their take-off phases, China’s surging growth brought a rise in the national saving rate. What makes China’s case stand

out is that the saving rate started from an already high 38% in 2000. An inexorable climb from then onward elevated the rate to 51% in 2007. A litany of factors is routinely cited for why China’s saving rate is high: the need to provide for one’s own retirement; the need to self-insure against risks of illness, injury, or job loss; the need to meet children’s education expenses; and the need to accumulate funds to support lumpy expenditures on consumer durables or business start-ups in the absence of credit markets that function to do so. But although these factors explain a high level of saving, they do not offer insight as to why the saving rate rose so dramatically during a time when, if anything, life became less precarious and the financial system became more functional.

A standard economic theory of saving—Franco Modigliani’s life cycle hypothesis—explains the rise in saving. The hypothesis holds that current income is apportioned to consumption over a lifetime. This means, first, that any income growth above the norm will be disproportionately saved in the current period to be meted out for consumption purposes in future years. Since only those in their working years benefit from faster income growth, only this segment increases its consumption while those in retirement consume based on the lower income of an earlier time. The hypothesis implies, second, that a rising share of population in the workforce will also result in an increase in the saving rate. On both counts—unusually rapid income growth and a demographic bulge moving into working ages—China’s rising saving rate is as the theory predicts. In other words, it has nothing to do with the exchange rate.

A rising saving rate has implications for China’s external accounts. National saving that isn’t used for domestic investment is invested abroad. To fund that capital outflow, exports must exceed imports. In China’s case, a rise in saving was paralleled by a rise in domestic investment from 2000 to 2004, leaving the saving surplus and hence the trade surplus constant as a share of GDP at a modest 2.0-2.5%. In

2004, fearing the economy was overheating, the Chinese government clamped down on investment spending and the saving-investment gap began to widen. With investment held in check over the next few years against a continued increase in saving, the trade surplus boomed.

On the U.S. side, the capital inflow—not just from China but from the developing world as a whole plus the oil exporting countries—had an incipient deflationary impact. Upward pressure on the dollar from the demand for U.S. assets made U.S. goods less competitive, and without countervailing action this would have caused the economy to falter. Expansionary monetary policy kept that from happening, however, as the Greenspan Federal Reserve kept interest rates very low for a very long time.

The liquidity boost from a credit expansion triggered by innovative new financial instruments also contributed. This combination fueled wealth gains that stimulated U.S. consumer demand and kept the economy going.

Both the U.S. and China thus enjoyed strong growth with low inflation for a nice, long stretch. The U.S. propagated this trend with low interest rates and financial innovation, while China propagated it with a stable exchange rate and ongoing reform of its economic system.

China is no different from most emerging market economies in adopting policies of foreign exchange market intervention, capital controls and interest rate regulation. It takes very sophisticated economic institutions to pull off liberalized foreign exchange and financial markets, and even then there are no guarantees of immunity against crisis. In the emerging market context, the exchange rate is an important macroeconomic policy lever. Currency appreciation reins in an economy that is

overheating; depreciation stimulates an economy that is flagging. China’s course of gradual yuan appreciation since 2005 proved effective in allowing the economy to grow at high speed while still keeping inflation in check.

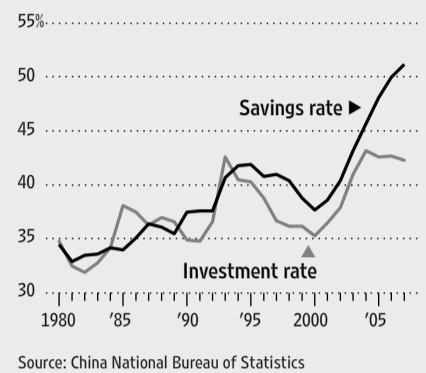
China’s growth, however, has relied too much on exports and not enough on domestic consumption—a problem for long term, sustainable economic growth. The remedy is to direct fiscal spending toward consumption, in particular for health care and education where China is notably lacking. Given the sagging state of external demand, strong domestic stimulus can be exercised without danger of the overheating that might call for currency appreciation as an offset. The exchange rate, then, can stay where it is. A fiscal stimulus that succeeded in restoring consumption to the share of GDP witnessed as recently as 2003, given a maintained investment share at the 2004-07 level, would cause China’s trade surplus to disappear.

Mr. Geithner, to his credit, emphasized in his written testimony the importance of consumption stimulus in China. He would do well to stick to that argument going forward and exclude further pronouncements on the exchange rate. Meanwhile, rising health care and education spending in China presents the prospect of greater demand for medical equipment and educational aids. This suggests the U.S. might do well to pursue a negotiating strategy focused on intellectual property rights and a freer market for ideas the better to exploit its comparative advantage—instead of a trade war rooted in a wrong-headed assessment of the yuan.

Ms. Wiemer is a visiting scholar at the University of California, Los Angeles, Center for Chinese Studies.

## Saving for the Future

China’s investment and saving rates as a percentage of GDP, 1980-2007



Source: China National Bureau of Statistics

# Islamist Contortions

By Sadanand Dhume

For those who wonder what problems corruption-ridden and disaster-plagued Indonesia must tackle most urgently, the Indonesian Council of Ulama has the answer: yoga.

On Monday, the Council, a quasi-official grouping of 700 Islamic clerics, decreed that Muslims should shun the ancient Indian practice. The clerics worry that Hindu-influenced chants and invocations might weaken Muslim believers’ faith. The decree, though not legally binding, carries the force of moral authority, and, as is not uncommon in the Muslim world, the unspoken threat of enforcement by vigilantes.

The Council’s decision was not entirely unprecedented. Malaysia’s National Fatwa Council issued a similar ban last November. Nonetheless, it comes as a reminder of the challenges the world’s most populous Muslim-majority country faces as it struggles to nurture a fledgling democracy in the face of the increasingly undemocratic demands of fundamentalist Islam.

To be sure, Indonesia is no Saudi Arabia. The majority of the country’s Muslims—88% of its 235 million people—practice a gentle folk Islam infused with elements of the archipelago’s long Animist-Hindu-Buddhist past. The country’s constitution is nonsectarian. Overt legal discrimination against non-Muslims, the cornerstone of government policy in neighboring Malaysia, is rare. Most people live in harmony.

But in recent years, Indonesian funda-

mentalists—including hardline clerics, politicians from the Prosperous Justice Party and vigilante groups such as the Islamic Defenders Front—have grown increasingly assertive. These groups don’t always agree with each other on tactics, but have broadly similar worldviews. They have spearheaded the persecution of the minority Ahmadiyya Muslim community, the passage of a so-called antipornography bill that encourages vigilantism and discriminates against non-Muslim cultures, and a regulation that forces Christian schools to offer religious instruction on Islam.

Put bluntly, Islamic fundamentalism puts a crimp on Indonesia’s otherwise impressive democratic flowering. It’s at odds with individual rights, freedom of conscience and freedom of expression. In a mature democracy, you wouldn’t find a government body called the Coordinating Board for Monitoring Mystical Beliefs in Society outside the pages of a novel. In Indonesia, it helps the government determine which groups are labeled “heretical” or “deviant.”

After two successful national elections since the end of Suharto’s 32-year-reign in 1998—and with another due this year—Indonesians are justifiably proud of having mastered the processes of democracy. But the gains may be chimerical unless they can defend their ability to publicly scruti-

nize, criticize—and, if necessary, mock—bad ideas that come from Islam as readily as those drawn from a political manifesto.

Since the 1970s, Indonesian Islam has been stripped of its legendary tolerance toward other faiths by a combination of rapid urbanization, compulsory religious education in government schools, and the efforts of Middle Eastern and homegrown purifiers of the faith. In recent years, this Arabization of Indonesian Islam has gathered pace as globalization has brought the religious and political discourse (often indistinguishable from each other) of Riyadh

and Tehran to Jakarta. Reminded daily that they are recipients of God’s final revelation, a large minority of Muslims—perhaps between 10% and 15%—embrace the fundamentalist notion that the cause of their backwardness lies not in a failure to embrace modernity but in a failure to fully embrace their faith. Many more, while not full-blown fundamentalists themselves, are broadly sympathetic to these ideas.

Indonesia’s fundamentalists have shown themselves to be better motivated and better organized than their opponents. Weak or sympathetic politicians (including President Susilo Bambang Yudhoyono), courts and police allow them to use violence or the threat of violence to control the public square—by driving Playboy magazine out

of Jakarta, or by attacking secular nationalists at a high-profile rally for religious freedom. Meanwhile cultural norms put any public criticism of Islam out of bounds. Hardliners can be chided for distorting the faith, but an unspoken code of self-censorship ensures that no one ever questions the faith itself. The kind of robust debate between believers and unbelievers that marks most democracies is notable for its absence in Indonesia.

To put this in perspective, consider that Indians are free to debate the caste-centered and sexist aspects of Hindu scripture. The Spaniard who believes in contraception and gay rights can flatly declare that he doesn’t care what the Bible says or what the Pope thinks. But an Indonesian who publicly expresses similar sentiments about the Quran or the prophet Muhammad immediately invites threats of violence.

This constrained national discourse cedes fundamentalists the moral high ground, a crucial advantage in this battle of ideas. Unless Indonesians can find a way to broaden the debate, to allow purely secular and even antireligious arguments to set up stall in the public square, they should not be surprised to find themselves in a land where clerics set the agenda, both in yoga class and outside it.

Mr. Dhume is a Washington-based writer and the author of “My Friend the Fanatic: Travels With a Radical Islamist” (Skyhorse Publishing, May 2009).

## Why are Indonesian clerics bent out of shape over yoga?