A Learning Resource Report

Reading Materials for Participants of The International Forum

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Revaluing the Renminbi – What Choices for China?

"While China is running a large ($100bn in 2002) bilateral trade surplus with the US, its trade balance with the rest of the world is in deficit, at $75bn… Bilateral trade balances are especially misleading in this case because China processes goods previously exported to industrial countries by other emerging Asian economies."

About 50% of China's exports are generated by foreign corporations producing in China at lower costs to compete on world markets. Consumers in America, Japan and Europe are the beneficiaries of this.

- What happens when the RMB is revalued by 20%-30%? How will it affect China? What could it mean for the companies and economies of Europe, America and East Asia?

"China's exchange rate cannot be analyzed in isolation from the pattern of global payment imbalances. At 5 per cent to 6 per cent of GDP, the US current account deficit is not sustainable and its correction would be aided by a further depreciation of the dollar."

Central banks of China and Japan together purchase dollars that fund almost 45% of the US current account deficit..

- Does this represent a lifeline for the US dollar? What happens to the dollar if this stops?
- Would a revaluation of China's currency set off a precipitous fall in the US dollar – and what might this do to the US economy?

China's exchange rate has helped its economic growth, creating the estimated 20 million jobs a year that are needed to employ people moving to the cities.

- Would a revaluation of the RMB significantly reduce growth? If so what might be the implications for social instability and the capacity for the government to control the outcome?

The Following three articles summarize some of the issues surrounding China's balance of trade and the implications for the revaluation of the Renminbi. This material is provided for the participants of The International Forum and is to be used for learning purposes only.

Part I: A Modest Proposal for China's Renminbi

By Morris Goldstein and Nicholas Lardy

The current debate on the renminbi exchange rate is appropriate given China's role as a leading economic and trading power. But the debate has become so politicised that crucial facts are being ignored and dubious arguments are replacing sound analysis. A medium-size revaluation of the currency may not be as "sexy" as a large revaluation or no revaluation but it rests on a firmer foundation and is more consistent with China's long-term interest.

Those arguing for a large revaluation of the renminbi—35 per cent or more—sometimes confuse bilateral trade balances with overall current account balances. While China is running a large (Dollars 100bn in 2002) bilateral trade surplus with the US, its trade balance with the rest of the world is in deficit, at Dollars 75bn (Pounds 47bn). Bilateral trade balances are especially misleading in this case because China processes goods previously exported to industrial countries by other emerging Asian economies.

During the first half of this year, China's current account surplus declined to about 1 per cent of gross domestic product. Adjusting for the recent overheating of its economy and other factors, China's underlying current account surplus is probably no greater than 2 or 3 per cent of GDP.

China's capital account surplus is often overestimated by focusing too much on foreign direct investment. The overall capital account surplus during the 1999-2002 period averaged a modest 1 per cent of GDP—far below the 4 per cent surplus for FDI.

When China does liberalise capital account outflows, there will be downward pressure on the renminbi. With a stock of household savings equal to about 100 per cent of GDP, it would not take much international diversification to turn net capital flows from surplus to deficit.

China's build-up of Dollars 135bn in international reserves over the past 18 months does not imply that it is passing up profitable investment opportunities. The investment share of GDP and the rate of expansion of bank lending are both too high. The real risk of an undervalued exchange rate is that it will handicap China's efforts to achieve long-term financial stability.

Those who maintain that a revaluation of the renminbi is unnecessary have done no better in their analysis. As long as China maintains controls on capital outflows, runs surpluses on both the underlying current account and capital account and accumulates reserves, there is a compelling argument that the renminbi is undervalued. Export processing means that it takes a larger revaluation to change China's trade balance.

China's average import tariff rate has fallen following entry to the World Trade Organisation and future trade reform is likely to expand imports further. But clothing, one of China's main exports, is likely to receive a big boost from the scheduled expiry of the multi-fibre agreement at the end of 2004, potentially doubling China's share of the market. Thus, China will not necessarily switch to running current account deficits in the future.

China's exchange rate cannot be analysed in isolation from the pattern of global payment imbalances. At 5 per cent to 6 per cent of GDP, the US current account deficit is not sustainable and its correction would be aided by a further depreciation of the dollar.

But an appropriate dollar depreciation will be frustrated if the Asian economies do not do their part on currency appreciation. China has a weight of nearly 10 per cent in the dollar's trade-weighted index and an appreciation of the renminbi is a sine qua non for Asian currencies to appreciate more generally.

Consumer prices have risen over the past two quarters and, with monetary growth expanding and good prospects for economic growth, exports and FDI, renminbi appreciation need not drive China into Japan-style deflation, as some have argued.

If China does not adjust its exchange rate, it risks further over-expansion in its financial sector, a reversal of the progress made against its bad loan problem, an upsurge of protectionism in the US and Europe against China's exports and increased regional tensions within Asia. A medium-size revaluation of the renminbi—between 15 and 25 per cent—would be the best response to the current disequilibria. It would be an investment in China's financial stability and could set the stage for a wider international agreement on a more sustainable pattern of exchange rates and payments positions. By acting soon, China can lead the way.

The Financial Times, August 26, 2003

Part II: Snowed in Beijing

Opinion Editorial: The Wall Street Journal, September 3, 2003

Treasury Secretary John Snow is in Beijing this week urging China to revalue its currency -- counsel that we're happy to say the Chinese seem more than prepared to ignore. It's a shame Mr. Snow didn't focus on China's bigger economic challenge: liberalizing the flow of capital.

We sympathize with Mr. Snow in the sense that it's hard for any political actor to resist the flavor of the month, and China's strong yuan is now it. Everyone from the Democratic Presidential candidates to the usual suspects at the National Association of Manufacturers insist that China's swelling foreign exchange reserves are proof that the country is holding down the value of its currency to boost exports and steal American jobs. They say the market should set the value of the yuan. Allowing market forces to work sounds good to us, but first let's look at how China is failing to do so before jumping for the quick and dirty fix of currency manipulation.

It's true that the People's Bank of China is holding the value of the yuan stable against the U.S. dollar. But take the glib pronouncements that the yuan is 40% undervalued with a grain, or rather a block, of salt. The yuan might be under pressure to appreciate now, but that's only because capital is largely free to enter China but not free to leave. If the market were truly allowed to determine the yuan's value, it would quickly come under *selling* pressure.

That's because if capital controls were lifted, some of the trillions of yuan in Chinese household savings would migrate abroad in search of higher returns. China so far has been unable to channel this domestic capital into efficient enterprises because its state-run banks are mismanaged and its stock and bond markets are dysfunctional. Much of the country's own savings have been wasted on loss-making state-owned enterprises. That leaves China overly dependent on foreign investment, which has created its most efficient companies and accounts for more than half of its exports.

That's the real story behind China's rising forex reserves. Trade flows aren't the problem; China's trade surplus has actually been falling of late. Rather there is a surge of foreign investment into the country, partly due to its entry into the World Trade Organization. But this has also been exacerbated by the international pressure on Beijing to revalue the yuan, which only encourages individuals and companies to buy and hold the currency in anticipation of windfall profits.

Some serious problems are emerging as a result. The capital inflow seems to be creating a curious form of overheating: Even though prices in the real economy remain stable, real estate prices in some areas are soaring. Bank loans in the first seven months of 2003 exceeded the total figure for all of 2002. In short, there's a lot of froth in China's economy at the moment, and some of the capital inflows look like "hot money" making exchange-range bets.

The central bank has prudently responded by lifting the reserve ratio for banks to 7% from 6%, effectively pulling $150 billion from the pool of money available for loans. The fact that this in turn caused a cash crunch that forced the People's Bank to put some emergency liquidity back into the system shows that many Chinese banks were indeed lending very aggressively.

Reforming the banks and creating efficient capital markets is not something China is going to do overnight. But neither would allowing the yuan to float freely be of much benefit to China or the U.S. Revaluing the yuan even by 20% won't eliminate the cost savings that are driving factories exporting to the U.S. to move to China from other countries, and would just complicate business decisions.

It would also create the expectation of even further revaluation, which could produce a deflation spiral in one of the few economies in the world that is actually growing. Japan shows that a steadily appreciating currency doesn't eliminate trade surpluses. It merely postpones the reforms needed to create a true market economy.

Beijing is now most likely to take a series of smaller measures, like the minor easing of capital controls announced yesterday, evidently as a gesture to Mr. Snow. Rebates on value-added tax for exporters will likely be reduced, and Chinese are being allowed to travel abroad more freely and take more foreign exchange when they do. Implementing WTO commitments to lower barriers to imports can also be hurried along. All of these will take some of the pressure off the yuan while the ground is prepared for more fundamental reforms.

If all else fails, it may be necessary to widen the trading band of the yuan to allow some appreciation. But Mr. Snow would have been better to focus whatever influence the U.S. has in Beijing on domestic market reforms that would help keep China's economy moving in the direction of greater freedom and prosperity.

Part III: Why China Is a Paper Tiger?

By Hugo Restall

Americans seem to be fixating these days on the idea of China stealing away American jobs. That's interesting because fear of China among its developing-country neighbors, who had much more plausible reasons to worry about the impact of this rising competitor in the same economic niches, has peaked and started to fade. Instead, Asians seem to have realized that not only is the China threat overrated, but the country is an engine of growth that benefits them.

It's perhaps understandable that Americans are very aware of their country's trade deficit at a time when the economy, while growing, isn't producing many new jobs. And China is the natural scapegoat, since bilateral trade was $103 billion out of kilter last year in favor of Chinese exporters, the biggest deficit America has with any single country.

In the world of public perception, it doesn't matter that the goods the U.S. is buying from China are largely low-tech commodities that it was already buying from other countries at higher prices. Or that the goods the U.S. is selling to China are on the whole more sophisticated products, and the American companies which make them need to capture a significant share of this new and growing market in order to maintain an edge over global competitors.

In fact, U.S. and Chinese economic interests are quite closely aligned, because the two economies are so complementary. You might even say that China is an economic colony of the U.S., with its currency so tightly pegged to the dollar and American companies using it as a base for their low-cost manufacturing.

That might seem like a strange idea given how nationalistic the Beijing regime is. But consider the government's actual behavior, and it's not hard to imagine that if Paul Bremer were running China instead of Hu Jintao, he'd be accused of exploiting the country's economy to benefit the U.S. and other Western countries.

First of all, the most productive sector of the economy is largely run by foreigners, for the benefit of foreigners. China may boast of being the largest recipient of foreign direct investment in the world, but it got that way in part by offering preferential tax treatment and other incentives to multinational companies. Those ventures in turn export not only their products, but also their profits, often hidden by manipulating the prices used for transactions within the companies.

The Chinese government, meanwhile, has been burning through its people's savings like an Internet company, to provide employment to hundreds of millions of workers. While a few state-owned companies are well run, they are the exception to the rule. Officially, the state sector is profitable, racking up $31.8 billion in net profits last year. But much, if not all of that is an illusion, the result of government investment and bank loans being booked as profit.

This happens because the true cost of capital to a state-owned company in China is effectively zero. Officially, the state-owned banks charge interest, but it's understood that they will continue to lend increasing amounts of money to the companies for the foreseeable future. Since Chinese continue to save at a high rate and put their money into savings accounts, this is sustainable for now, but not forever.

The financial open vein is particularly debilitating because private entrepreneurs have trouble staying in business. In almost every industry there is overcapacity because the state companies pile into product categories where there are profits to be made until there are no more profits. Then they continue producing, even at a loss. As a result, private companies which are concerned with making a return on their investment are driven out. Some are nimble enough to keep finding new niches, but by and large the only reliable way to recoup one's cost of capital is to be in an industry with high barriers to entry, natural or regulatory.

This is reminiscent of South Korea right before the Asian Crisis. The chaebols had the same "if we build it, the demand will come" mentality about continuously expanding capacity. By 1996, the top 50 business groups in South Korea, whose sales accounted for over 97% of GDP, were making a net loss. At least South Korea had already achieved developed country status, with companies that had proven records of entrepreneurial success and global brands, not to mention reserves of human capital to draw on. China has to face the challenge at a much earlier stage, albeit with one big advantage: Officially the government hasn't amassed much of a debt burden.

Here's one illustration of how poorly China's companies have performed: In 1993, nine of the country's best firms were allowed to list their stocks overseas, initially in Hong Kong. Five of them are today trading below their IPO price, with the average return for the last decade just 30%, or less than 3% per year. The companies listed on China's domestic stock markets are even more pathetic.

So China is using the hard-earned savings of its people, which could have been devoted to building globally competitive companies, and is instead throwing them down 100,000 state-owned ratholes so that Chinese workers can produce artificially cheap products for American consumers to enjoy. The government is even taking away the dollars earned by selling these products and loaning them back to the U.S. at low rates so that those American consumers can keep on buying.

There's still time for China to get wise. But the point here is that Americans should be sanguine about China's development model. Thanks to Beijing's own policies, China is giving them cheap capital, cheap manufactured goods sold below their true cost and a market for sophisticated, high value-added goods. At the end of the day, China will be left with uncompetitive companies, depleted savings and a balance-sheet recession. It will have to sell off the distressed assets of its failed banking system, at which point Western companies can buy up even more of the economy at fire-sale prices.

As a recent article by Yasheng Huang and Tarun Khanna in Foreign Policy suggested, the true competitive threat to Western multinationals comes from India. Entrepreneurial companies are growing up in truly competitive conditions and are starting to challenge on the world stage in sectors where the U.S. has enjoyed a very profitable edge, such as software.

One more thought about China: Since the two economies are complementary, it's ultimately not in the U.S. interest for Beijing to continue with its self-defeating policies. A sudden collapse would hurt the U.S. because the market for U.S. Treasuries might be disrupted, social unrest could damage American-owned factories and the market for U.S. goods could dry up. In short, Americans should be somewhat concerned about China, but not for the reason they think. The good deal they're getting now can't last forever.

The Wall Street Journal, August 1, 2003