

## An RMB Revaluation: Could It Reduce Global Trade Imbalances?

On March 16, five U.S. senators re-introduced a new bill to crack down on unfair currency manipulation by countries such as China, which they say is having a negative effect on the U.S. economy. Even if the bill is not passed, President Obama will increasingly be expected to step up pressure on China to raise the value of the renminbi against the U.S. dollar. The proposed legislation has aroused a hot debate in both countries about the pros and cons of a renminbi revaluation.

China has pegged its currency to the U.S. dollar since 1994. After 2002, its trade surplus burgeoned, causing a huge global current account surplus. Meanwhile, as China's major trading partner, the United States suffered from a growing current account deficit. Many U.S. legislators attributed their nation's deficit to the Chinese government's currency manipulation to keep the renminbi artificially low. Ever since, a renminbi revaluation has been the center of the trade dispute between China and the United States.

Today, "legislators are trying to make constituents believe that the joblessness [in the U.S.] is caused by the trade deficit, and the trade deficit is the result of China manipulating its currency," says Charles Freeman of the Center for Strategic and International Studies, a Washington, D.C.-based public policy research institute, and a former assistant U.S. trade representative for China affairs. "However, I see no correlation between joblessness and the trade deficit, as well as the trade deficit and the undervalued renminbi."

He also says it is unlikely that increasing the value of the renminbi vis-à-vis the dollar will reduce the trade imbalance between the two countries. "If you look at the average cost of consumer goods in China and the equivalent wholesale costs of manufacturing goods here in the United States, you would see that the margin between the two is too high," he notes. "The labor costs are so high in the United States that it would be difficult for the U.S. to regain competitiveness solely through forcing the renminbi to appreciate by another 20%." In fact, he doubts whether any increase in the value of renminbi will move the production back to the U.S. If Chinese exports to the U.S. were to become more expensive, "the United States would shift its demand to other third party developing countries, such as Mexico," he says.

Echoing Freeman's view is a new article titled, "The RMB: Myths and Tougher-to-Deal-With Realities," by Pieter Bottelier, a senior adjunct professor of China studies at Johns Hopkins University's School of Advanced International Studies, and Uri Dadush, director of the international economics program at the Carnegie Endowment for International Peace, a Washington, D.C., think tank. According to Bottelier and Dadush, the immediate effect of a renminbi appreciation would be an increase in prices for U.S. consumers. "A 25% revaluation of the renminbi, which some economists have said is needed, would -- if not offset by a reduction in China's prices -- add \$75 billion to the U.S. import bill, since the United States imports three times as much from China as it exports there," they wrote. That rise in costs will most likely be passed on to the consumer. As they see it, a revaluation of the renminbi on its own would do little to redress global imbalances, and could initially lead to a wider U.S.-China trade deficit.

Zheng Hui, a finance professor at Fudan University in Shanghai, says, "Empirical analysis by Chinese scholars never finds a strong correlation between the appreciation of the renminbi and the reduction of China's current account surplus.... It is very difficult to [determine a] relationship because there is a time lag between the change of an asset price and the change of the prices of tradable commodities."

What's more, Zheng points out that "the trade structure of China and the United States is actually complementary.... China is specialized in producing low-cost manufacturing goods, while the United States has the comparative advantage in producing raw materials, intermediary goods and high-tech products." The way he sees it, most U.S. companies would not be negatively affected even if the renminbi depreciated and U.S. imports from China continued to grow. What's more, he says, "China runs a trade deficit with South Korea, Japan and Taiwan, because it imports large amounts of raw materials and intermediary goods from those countries to support goods being manufactured in China for export. So it is the East Asian region as a whole that is partly responsible for the U.S. trade deficit. Merely blaming China does not solve the problem," he says.

### **Stay the Course or End the Peg?**

Among the scholars from both countries offering suggestions about how China should respond to the U.S.'s pressure, Hua Min, director of the Institute of World Economy at Fudan University, asserts that China should "stay the course" and continue pegging the renminbi to the dollar. "It is very risky for China to appreciate the renminbi, especially at this juncture of the financial crisis," he notes. "China is relying on its labor-intensive manufacturing industries to bolster its economic growth. An appreciation of the renminbi would reduce demand for Chinese goods from the U.S. If China's exports were to plummet, the country's exporters would go bankrupt or lower wages to maintain profit margins. Many workers would lose their jobs and it would destabilize society."

Zheng of Fudan has a different view. According to him, the renminbi is undervalued to allow China's exporters to gain competitiveness. "If the Chinese government continues to peg the [renminbi] to the dollar, there will be a price distortion between tradable commodities and non-tradable commodities ... in China," he notes. "The excessive investment in China's manufacturing industries and underinvestment in service sectors would continue. China's exporting sector would keep growing while other sectors, such as the services producing non-tradable commodities, would never develop, and the economy would continue to grow unhealthily, with a negative impact on China's long-term economic development." Zheng concludes that China should allow a modest renminbi appreciation, especially after the global economy recovers from the downturn.

William Helkie, adjunct professor at University of Maryland in College Park in the U.S. and a former senior adviser at the U.S. Federal Reserve, cites another negative impact of the renminbi remaining pegged to the dollar. "With China's rapid productivity growth, the rate of capital return in China becomes higher than the rate of capital return in the United States. A large amount of capital denominated in U.S. dollars flows into China seeking investment opportunities. In order to maintain the peg between the renminbi and the U.S. dollar under the fixed exchange rate regime, China's central bank has to buy all the extra U.S. dollars at the fixed rate and place them on its balance sheet. So the high-powered money on the central bank's balance sheet would go up, resulting in an increase in the money supply in China," notes Helkie.

That growth in money supply, he adds, "would either result in the increase of the price in the goods market, or the increase of the price in the asset market. The latter is exactly what China experienced in the past two years – the asset bubble, that is, a periodic real estate

and stock market booms that heighten the financial risk.”

## Off Balance

In a book titled, *The Future of China's Exchange Rate Policy*, published in July last year by Washington, D.C.-based Peterson Institute of International Economics, Morris Goldstein and Nicholas R. Lardy, two of its senior fellows, stated that the “stay-the-course” strategy is not feasible, particularly because its external imbalance is much bigger than it was “five or six years ago.” Rather, they wrote, “A currency appreciation could reduce the growth of exports and increase the growth of imports, thus reducing China’s external surplus so that China could reach an internal balance.”

Under the peg, they added, “the Chinese authorities frequently have been slow to raise general interest rates for fear of attracting higher levels of capital inflow. In contrast, a more flexible exchange rate policy in the short run would allow the central bank greater flexibility in setting domestic interest rates and pave the way for the introduction of more market-determined interest rates.” Finally, they noted that allowing China’s export sector to gain unfair competitiveness through an undervalued renminbi undermines “the Chinese government’s policy of fostering innovation, improving and upgrading China’s industrial structure, and accelerating the development of service industries.”

Goldstein and Lardy highlighted the fact that that by 2007, China’s global current account surplus was 11% of GDP and the undervaluation of the renminbi was much larger, at 30% to 40%. “No longer could the exchange rate disequilibrium be eliminated in one step without a large contradictory impact on the domestic economy,” they wrote.

Their book offers a “three-stage” approach to assisting China gradual move to a floating exchange rate regime. “In stage one, China should continue to appreciate the real value of its currency vis-à-vis its trading partner at a pace of 4% to 5%. Difficulties in labor-intensive export industries as a result of the continued appreciation of the renminbi should be addressed through trade adjustment assistance to redundant workers,” noted the authors, adding that the assistance would help the labor-intensive manufacturers that are no longer viable and “could propel the needed structural adjustment of China's economy.”

In stage two, as the financial crisis reaches an end and global growth recovers, the government should allow the renminbi to appreciate more rapidly so that much of China’s current account surplus would be eliminated over three to four years. In stage three, when China’s current account surplus has been dramatically reduced, “intervention in the exchange market should be curtailed still further so that the renminbi would essentially be floating.”

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