



Revaluing the Yuan: Where Politics and Economics Collide

Published : July 25, 2005 in [Knowledge@Wharton](#)

When powerful forces collide head-on at the intersection of politics and economics, the crash is bound to be loud and unsettling.

Consider the current rift between the United States and China over China's currency, the yuan. The Bush administration is publicly pressuring China to allow the yuan to rise against the dollar to stave off protectionist legislation in the U.S. Senate. Some lawmakers, responding to concerns on the part of manufacturers and labor unions, assert that cheap Chinese exports -- made even cheaper by a yuan whose exchange rate, they say, is too low in relation to the dollar -- give Chinese firms unfair advantage over American companies and is a major contributor to the U.S. trade deficit and current-account deficit. In response, Chinese officials, who have kept the yuan fixed at 8.28 to the dollar since 1994, have said firmly that they will not be coerced into taking action by a foreign government seeking to meddle in a matter of national sovereignty.



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Faculty members at Wharton and other China-watchers predict that China will eventually revalue the yuan, probably this year, because it is in China's own long-term interest to do so. But the United States, by trying to force the issue in such a vociferous, public manner, is unnecessarily antagonizing the Chinese and possibly delaying the revaluation, according to these experts. They say that the application of pressure by the United States is a political move designed to assuage interests adversely affected by competition from China. They add that revaluing the yuan will not revitalize industries that have been battered by a longstanding and irreversible trend of certain jobs moving to China, where labor and production costs are cheap.

"The Chinese are very proud and they are most likely to revalue when we don't expect it," says finance professor [Richard Marston](#), director of the Weiss Center for International Financial Research at Wharton. "I think they will do something this year, and it will be modest. The more pressure we put on them, the more they are going to balk."

Wharton finance professor [Jeremy Siegel](#) says the U.S. pressure on China simply is "not right," adding that countries should be left alone to decide what exchange rates they want to set.

Steve H. Hanke, a professor of applied economics at Johns Hopkins University and a longtime foreign exchange and commodities trader, calls the U.S. move "completely politically driven" and "economic nonsense." He adds: "I think [U.S. officials] are playing to the special-interest crowd. There's no question about that."

Richard Moody, vice president and senior economist at PNC Financial Services Group, in Pittsburgh echoes these views, calling "extraordinary" the amount of pressure the United States is applying to China. "It really is a sovereign decision of the Chinese government as to where they set their currency," he says. "And the pressure they're coming under is complicating the process. It's helping to drive a lot of speculative money into China, with people hoping to make a quick gain on any revaluation of the currency. It's potentially very destabilizing for the Chinese economy."

China has kept the yuan pegged to the dollar in order to encourage exports, which have contributed so much to its stunning economic growth in recent years, and to keep a damper on inflation. Determining how much the yuan should be allowed to appreciate against the greenback is tricky business for Beijing: A rising yuan would make China's goods more expensive overseas, curtailing sales and reducing economic growth.

Marston says China essentially has two options: Allow the yuan to appreciate against the dollar or peg the yuan's value against a basket of currencies -- the dollar, the euro and the Japanese yen. But whatever action they decide to take, Chinese officials should make a bold enough move to avert calls for another revaluation. They are, however, unlikely to be sufficiently bold. "Once they take any action, it will be seen as not enough and it will encourage further speculation," Marston notes. "I'd tell them to choose an exchange rate high enough so as to reduce the pressure for further changes. Piecemeal attempts would require additional changes in the future and increase pressure. They should repeg the yuan against the dollar or, preferably, against a market basket.

"What we need to ask is, 'What can the Chinese do to respond to the pressure without making major changes?' Marston continues. "They could just announce a modest appreciation and then repeg the yuan at 5% more or less than that. That clearly will relieve some of the pressure but could lead to further calls for additional moves."

A Basket of Currencies

Marston says the components of a currency basket, and the weight accorded each currency, would reflect the relative importance of the countries that are major trading partners with China. The advantage of a basket is that if there were a movement by the euro against the dollar, for example, China could adjust to that movement. If the euro were to rise against the dollar, it would force an appreciation of the yuan against the dollar and a depreciation of the yuan against the euro.

Noting that the European Union also has begun to put pressure on the Chinese regarding the yuan -- in a dispute centered on Chinese textile exports to Europe -- Marston says America should ease up on China. "With the Europeans joining us now, we ought to sit back and wait for the Chinese to respond. We ought to use a little less rhetoric and a little less action in the Senate and try to use backdoor diplomacy."

Finance professor [Richard J. Herring](#), director of Wharton's Joseph H. Lauder Institute of Management and International Studies, believes that China will ultimately move to a currency-basket peg, probably without explicitly identifying the weights attached to each currency and probably with a modest appreciation relative to the dollar. "They will probably also adopt a band around that peg within which the exchange rate will be allowed to fluctuate," Herring notes. "That will put China's exchange rate policy in line with most of the other countries in Asia. Currently only three, including China, peg to the dollar. The timing, of course, is anyone's guess, but U.S. policy seems decidedly counterproductive in this regard."

When China makes the shift, "it will be, quite properly, to meet China's own best interests, not to satisfy either the Americans or the Europeans," adds Herring. "The problem for China is that its capacity to 'sterilize', or offset, the impact of purchases of dollars with yuan is constrained by the underdevelopment of Chinese capital markets and the implicit limits on placements of bonds with Chinese banks. This is, indeed, the reason that most countries that have undervalued exchange rates ultimately adjust."

Wharton's Siegel says China will "eventually" revalue the yuan but is uncertain when that might be. "I don't think they want to revalue but I think they will for political reasons. Something like 10% is a possibility."

Moody of PNC expects that China will allow the yuan to float within a band of plus or minus 10% against either the dollar or a basket. He says such a modest move will probably leave the United States

unsatisfied, but that it will be sufficient for the Chinese for the time being. "There are reasons to suggest why it would be in China's interest to have a more flexible currency," he explains. "It would give them more control over monetary policy. By pegging the yuan to the dollar, they are implicitly following the monetary policy of the [U.S.] Federal Reserve. If China's economy continues to grow and inflation becomes a concern, it's in their interest to be in control of their own currency. Today, inflation is relatively tame, but over time it could become a concern."

The Wharton faculty members and Moody all say that China will not, and should not, allow the yuan to float freely against the dollar at this time. "It's not realistic for China at this point to go to a freely floating currency," Moody argues. "The dynamics of their economy are not consistent with that." In a report titled "China Outlook," Moody writes that China lacks "the types of efficient and transparent capital markets and financial institutions that are a necessary ingredient of a system with free flows of capital - into and out of a country - and a market-determined exchange rate."

"I tend to think they are not going to go to a float," says Siegel. "Years into the future that might work. But right now they will just do a revaluation to get the Americans off their backs." Adds Marston: "There's no possibility at all that China will go to a floating exchange rate. The notion they are suddenly going to adopt a free-market philosophy for their currency is crazy."

An Old Story

Complaints that China has been "manipulating" its currency to the disadvantage of the United States have risen periodically in recent years. The lower the yuan against the dollar, the cheaper Chinese products are for Americans to purchase and the more expensive U.S. goods are for people in China to buy. Many in the United States point to China's large trade surplus with the United States as evidence that the yuan is unfairly undervalued. The U.S. trade deficit with China stood at \$162 billion in 2004. The total U.S. current-account deficit -- the combined balances on trade, income and other transfers with all countries -- was \$665.9 billion in 2004, up \$135.3 billion from 2003, according to preliminary figures compiled by the U.S. Bureau of Economic Analysis

But Herring says American officials are mistaken to think that revaluing the yuan is the answer to the huge U.S. current-account deficit. "Although hectoring China about the exchange value of the yuan seems to be the centerpiece of U.S. policy for dealing with the current-account deficit, it should be remembered that even a very large appreciation of the yuan would have only a modest impact on the trade-weighted exchange value of the dollar. China's share of U.S. imports is about 10%, so even a 20% appreciation of the yuan -- which is much larger than most experts anticipate -- would have at best a 2% impact on the trade-weighted exchange value of the dollar. The answer to our current-account deficit lies not in Beijing, but in Washington, D.C."

What got the latest controversy started was legislation introduced by U.S. Sen. Charles Schumer, a New York Democrat, to impose a 27.5% tariff on imports from China as a response to the so-called currency "manipulation." The Senate is expected to vote on the bill this summer.

According to *The Wall Street Journal*, U.S. Treasury Secretary John Snow told reporters on May 17 that "in the absence of reforms, I'm very concerned there will be mounting protectionist pressure in the United States. That's something we need to avoid." Those comments came the same day that the Treasury Department issued a report to Congress on international and exchange-rate policies. The report stopped short of officially calling China a country that "manipulates" its currency to get a leg up on international competitors, but it nonetheless strongly urged China to allow the yuan to appreciate.

In a formal statement accompanying the report, Snow said China's current rigid currency regime has become highly distortionary. Among other things, he said, the current yuan-dollar exchange rate "poses risks to the health of the Chinese economy, such as sowing the seeds for excess liquidity creation, asset price inflation, large speculative capital flows, and over-investment. It also poses risks to its neighbors,

since their ability to follow more independent and anti-inflationary monetary policies is constrained by competitiveness considerations relative to China. A more flexible system will also support economic stability, which we understand is of paramount importance to the Chinese leadership."

Snow stressed that the United States is not calling for "an immediate free float with fully liberalized capital markets," explaining that China is not prepared for such a major shift. What the United States wants, according to Snow, is "an intermediate step that reflects underlying market conditions and allows for a smooth transition -- when appropriate -- to a full float."

The Threat to China's Economy

Hanke of Johns Hopkins finds Snow's comments unconvincing. "Snow has contradicted himself several times. He says '[China] is ready to have a flexible system, but we don't want them to have a free float.' He doesn't know what he's talking about."

Hanke, who was an adviser to the Indonesian government during the 1998 Asian currency crisis, says a major revaluation of the yuan would devastate China's economy. He says a 25% revaluation, for instance, would bring on "a complete economic slump. The negative ripple effects would be unbelievable and quite destabilizing in China. ... You already have such a mountain of non-performing loans in China, and that would become catastrophic. Also, the real-estate boom or bubble along the coast would completely collapse and the banking system would implode."

In addition, says Wharton management professor [Marshall Meyer](#), "Chinese agriculture is very inefficient, and farmers are heavily subsidized. Revaluation will lower the prices of imported foodstuffs, with grievous consequences for farmers' income and possibly political stability. The numbers are striking: 62% of China's population is rural. That means that farmers' cash income comes from the 40% of food sold on the market. About 10% of this 40% is already imported. If the 10% goes to 20%, farmers lose a third of their cash income."

Meanwhile, in testimony before the Senate Banking Committee in Washington on May 26, Snow predicted that China would revalue the yuan, also known as the renminbi, by mid-October, when the Treasury Department is scheduled to release its next report on currency manipulation, according to news reports. A day later, Chinese officials reiterated their position that they would take a cautious approach to economic reforms, Reuters reported. Zhang Yansheng of China's National Development and Reform Commission said much work was still needed in such areas as currency, taxation and foreign-trade policy to minimize the impact of yuan reform on China's economy, according to Reuters. "It will be better to keep the renminbi's exchange rate stable for another two years," Zhang told the *International Business Daily*, a newspaper published by the Chinese Ministry of Commerce, Reuters reported.

U.S. officials may complain about China's foreign-exchange policy but Marston says it should also be kept in mind that China is a major purchaser of U.S. Treasury securities, which helps to keep the U.S. current account deficit from being worse than it is. And having the Chinese revalue the yuan will not make a major dent in reducing that deficit.

Says Marston: "The current-account deficit is at records levels. It's a very serious problem. The deficit, which stems from low savings rates in the U.S., has to be financed by capital inflows from abroad. To make inroads on lowering that deficit, you can change the exchange rate between the dollar and other currencies. But I think the deficit is far too large for currency changes have a major effect. The U.S. savings rate is only 1% of GDP [gross domestic product], an all-time low. Unless we do something about savings in this country, we're not going to have a major change in the current-account deficit. Some say, 'If we could only get China to revalue its currency, our deficit would disappear.' No economist believes that."

Beijing's Global Forum

The views of the Wharton faculty on the yuan were echoed by economists and others who attended the Fortune Global Forum in Beijing on May 17. During an afternoon session on the global impact of dollar depreciation, Stephen Roach, chief global economist of Morgan Stanley, called "pure politics" the criticism from U.S. lobbying groups that the fixed yuan exchange rate has caused the country's huge trade deficit. "What worries me most is that the value of the yuan becomes too correlated to the value of the dollar. The U.S. is China's biggest export market. Any adjustment the U.S. makes to its current account will affect China's exports, sending ripple effects" throughout the country, Roach said, adding that the Schumer bill introduced into the U.S. Senate in April is "an upsetting measure."

Stuart Gulliver, chief executive, corporate, investment banking and markets, HSBC, said China's trade surplus is largely due to its cheap labor. Trade with China accounted for only 10% of total U.S. trade, he noted, adding that in order for the U.S. to solve its deficit problem, it should control excessive consumption in addition to pushing for dollar depreciation." As for when China should move to reform its fixed rate currency system, the country should do so when it "feels that the time is right." In terms of which direction the reform should go, he said, "obviously that falls within China's sovereignty." If the yuan were to appreciate too early, he added, that would only introduce more speculative capital to the market.

Li Jiange, vice director of the development research center of the State Council, noted that senior Chinese government officials have said repeatedly that China's currency reform should be carried out according to the country's needs, taking into account the potential impact on China's financial systems, trade and manufacturing. Kevin Watts, chairman of Merrill Lynch International, suggested that the yuan exchange rate is not the top economic challenge facing the world, and its importance is being exaggerated.

As many experts attending the discussion pointed out, political pressure -- not economic factors -- is pushing the U.S. to demand yuan appreciation. Most agreed that any drastic yuan appreciation would not only be disastrous to China but also bad news to American consumers who have grown used to cheap made-in-China goods and products.

During a session at the Forum on "Understanding China's Capital Markets," Zhou Xiaochuan, governor of the People's Bank of China, noted that "If we reform the exchange-rate system in a way that will improve foreign and domestic investors' confidence, such reform benefits the capital markets." Zhou also said that Prime Minister Wen Jiabao's speech earlier made it clear that the government will not carry out currency reform in a hurry. No timetable was offered.

China's State Administration of Foreign Exchange on May 10 issued rules capping short-term borrowing offshore at \$34.8 billion for foreign banks and \$24.5 billion for Chinese banks. The move was aimed at releasing pressure on the yuan caused by growing capital inflows. On May 18, China expanded its foreign exchange trading system in an effort to help develop China's interbank foreign exchange market and release speculative pressure on the yuan.

On May 20, China said it is raising duties on 74 textile products starting June 1. The new tariffs will curb China's textile exports to the U.S. and Europe. China's garment exports have surged since a global quota system was scrapped at the end of 2004. Among the 74 items are seven kinds of clothing imports that the U.S. targeted for new trade quotas.

Then on May 30, China announced that it was rescinding its planned tariff increases on Chinese-made textiles exported to the U.S. and Europe.

The View from Chinese Economists

Peng Xinyun, a currency expert at the Institute of Bank and Finance, Chinese Academy of Social Sciences, told reporters that it's not the best time for yuan appreciation. To recapitalize state-owned banks, China recently injected a total of \$60 billion of its foreign exchange reserves into the Bank of China, the China Construction Bank and the Industrial and Commercial Bank of China. If the yuan were to appreciate, the capital level at those banks would come down, dealing a blow to the government's efforts to recapitalize them. "China won't allow yuan appreciation until the commercial banks have adequate access to capital," he said.

According to Yi Xianrong, a researcher at the Institute of Bank and Finance, Chinese Academy of Social Sciences, the benefits to the U.S. from the yuan's peg to the dollar actually outweigh the negatives. Furthermore, now is not the right time for yuan appreciation. Agricultural exports are not a big concern, he said, noting that China's agricultural products can compete in the global markets and will become even more competitive once further technological progress is made.

Lin Yifu, director of the China Center for Economic Research at Peking University, expressed the following views while talking to Sino.com visitors about economic issues: "The large fiscal deficit and low savings rate are the main causes for the huge U.S. trade deficit. Appreciation of the yuan won't help the U.S. with its trade deficit at all, because most of China's exports to the U.S. are labor-intensive products that are not produced in the U.S. If the yuan were to appreciate, the U.S. would have two choices: It could continue to buy those products from China, but it would have to pay more, further enlarging the deficit; or it could buy those products from other countries that also have cheap labor. The reason that the U.S. hasn't bought those products from other countries is because they are relatively more expensive than China's. That's why yuan appreciation won't help the U.S." He also noted that the Chinese government still has a number of fiscal responsibilities, such as recapitalizing state-owned banks burdened by bad loans and supporting the social security system.

Ba Shusong, vice director of the Finance Research Center at the State Council's Development Research center, suggested that "American politicians seem to believe that yuan appreciation could narrow the country's current-account deficit." Instead, he said, the U.S. government "should choose the following measures: tightening its economic policies, including narrowing its fiscal deficit, and raising interest rates to curb consumption while encouraging saving. It is a process full of economic and political adjustments, and there could be substantial political obstacles. That's why American politicians prefer pushing for dollar depreciation over making internal economic adjustments."

The U.S. "also hopes that other currencies' appreciation could release pressure on the dollar," he added. "It's the fundamental reason that the U.S. is actively pushing for yuan appreciation ... But even a substantial yuan appreciation would have only a very limited role in helping the U.S. improve its trade situation.... In fact, given the economic interdependence between China and the U.S., any substantial import tariff measures adopted by the U.S. unilaterally wouldn't be efficient and would harm the U.S. economy in the longer term."

Huang Zemin, an expert on exchange rates and dean of the business school at East China Normal University, told Chinese reporters that "at present, China should focus its exchange-rate reform on the foreign-currency administration system. Due to China's economic reliance on trade, balance of payments should be the main factor for judging whether the yuan exchange rate is reasonable. Our exchange rate has been balanced in the past three years.... The trade imbalance between China and the U.S. is not because of the yuan exchange rate, but because of the two countries' different trade structures."

U.S., European Protectionism

Salvador Rojí, professor of multinational financial management at the Complutense University of Madrid, predicts that China will "ultimately wind up revaluing its currency because of pressure from other countries, especially the United States." The revaluation process will be gradual, he says, to avoid any breakdown in economic stability.

As for the politically sensitive area of textile exports, China is already restricting its exports through increases in its export taxes -- an action that is "something quite different from placing direct limits on the volume of exports," adds Rojí. "Whether they do that will depend on regional trade agreements between China and Europe, which include other products and services traded bilaterally."

Asked if it is hypocritical of the U.S. and the EU to place limits on free trade now that it is causing

problems for U.S. and European textile manufacturers, he notes that "historically, there have been many occasions when the U.S. and Europe have not hidden their protectionist feelings about third parties. In the West, the halo of liberalism doesn't cover everyone, and very few countries fully embrace free trade. Generally, it is only small countries that do, like Singapore and Holland, which have minimal domestic markets and need to open themselves to the outside. Given the semi-protectionist history of both the U.S. and EU, we cannot talk about 'hypocrisy.' It's simply that they are defending their social and political interests. And they do not hide that fact."

In looking at whether each country should have the right to control its own currency, Rojí suggests that sovereign states can utilize their exchange rate as a tool to compensate for any increase in their inflation rate that cuts their [global] competitiveness, as well as for providing benefits to specific economic groups, such as exporters. However, when governments give up that power, as in the case of the euro zone members, governments can only carry out fiscal policies, improve efficiency and productivity, and set wage limits. They cannot make use of the devaluation safety valve.

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