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If China sharply revalued the yuan, as American politicians are demanding, it could actually hurt the United States and help China

CHINA is being cast as the villain once again. By holding its exchange rate artificially low, it is stealing jobs and causing the United States to run a huge trade deficit. Beijing must therefore be forced to revalue the yuan. These are the arguments behind an increasingly protectionist mood in Washington. Yet they are largely flawed. A stronger Chinese currency would not much reduce America's trade deficit. Indeed, the irony is that China, not America, has more to gain from setting the yuan free. Without a more flexible exchange rate, there is a growing risk that China's sizzling economy will boil over.

America's anger at China is clearly growing. In February it filed a complaint to the World Trade Organisation (WTO) against Chinese export subsidies. In late March the Department of Commerce announced tariffs of 10-20% on glossy paper imported from China, to offset the impact of alleged government subsidies. This reversed a 23-year-old policy of not imposing countervailing duties on a non-market economy. Then in early April the Bush administration filed two more complaints: one on Chinese pirating of DVDs and CDs, and the other over restrictions on the sale of foreign films and music in China.

Although by themselves these actions are trivial, together they point to an increasing appetite for tougher action against China. The Bush administration is under increasing pressure, particularly from Congress.

Congressmen complain that the so-called China-US Strategic Economic Dialogue (a series of high-level talks between the two countries launched last year by Hank Paulson, the treasury secretary) has so far failed to produce results. The recent deterioration in trade relations does not bode well for the next meeting, which begins on May 22nd. Many commentators now reckon that Congress will inevitably pass some kind of China-bashing legislation later this year. A sharp economic slowdown in America as a result of the collapsing housing market would make this even more likely.

The biggest risk comes from measures linked to China's supposed exchange-rate misalignment. The infamous Schumer-Graham bill, which proposed a 27.5% tariff on all Chinese goods to offset the yuan's alleged undervaluation, was withdrawn last year. But the two senators behind it are working with others on a new WTO-compatible version that could soon appear. Although the new bill is unlikely to include across-the-board tariffs, it could have sharp teeth.

Meanwhile, the target of all this hostility looms ever larger: China's trade surplus with America increased to $233 billion last year, accounting for almost 30% of America's total deficit. China's total current-account surplus reached an estimated $250 billion, or 9% of GDP, up from only 1% in 2001. Worse still, in the first four months of 2007, its trade surplus jumped by 88% compared with the same period in 2006.

The making of myths

China officially abandoned its decade-long policy of pegging the yuan to the dollar in July 2005. Since then it has risen by only 8% against the greenback. Because the dollar itself has weakened, the yuan's trade-weighted exchange rate has barely budged. In real trade-weighted terms it is about 10% cheaper than at the dollar's peak in 2002. As a result, it is not just the usual protectionist suspects that demand action, but many mainstream American economists are now calling on China to revalue by 20% or more. Yet the standard arguments for a revaluation are based partly on a series of myths.

The first myth is that there is overwhelming evidence that the yuan is grossly undervalued. China's large bilateral trade surplus with America proves nothing. It largely reflects Asia's changing supply chain. Much of what America buys from China today once came from Japan, South Korea and Taiwan. China now imports components from these countries, assembles them and exports the finished goods to America. Knock out these and America's bilateral deficit with China shrinks by more than half. Even so, China's overall current-account surplus is also huge. The surge in its foreign-exchange reserves, to over $1.2 trillion, also suggests that the yuan is undervalued: without those massive purchases of dollars, the currency would have risen.

However, not all economists agree that the yuan needs to be sharply revalued. At one extreme is Morris Goldstein, of the Peterson Institute for International Economics, who argues that the yuan is undervalued by 40% or more against the dollar and should immediately be revalued by 10-15%. In the other corner many highly respected economists, including Robert Mundell, an economics Nobel prize-winner, and Ronald McKinnon, of Stanford University, strongly argue against a big appreciation of the yuan.

The devil to measure

Economists find it devilishly hard to define the “correct value” for a currency. On purchasing-power parity (PPP), the yuan is clearly undervalued against the dollar. Perhaps by as much as 50%. But PPP is not useful for determining the optimal exchange rate between two countries of such different levels of income. It is natural for average prices to be lower in poorer countries because wages are lower. As countries get richer and their productivity rises, their real exchange rates appreciate. And although the depreciation in the yuan's real trade-weighted value since 2002 looks perverse, this follows a real appreciation of 50% between 1994 and 2001 (see chart 1).

A study by two IMF economists, Steven Dunaway and Xiangming Li, found that estimates for the undervaluation of the yuan ranged from zero to nearly 50%, depending on which method was used. Another recent study, by Yin-Wong Cheung, Menzie Chinn and Eiji Fujii, concluded that using conventional statistical methods it is hard to prove that the yuan is much undervalued. Such uncertainty may partly explain why America's Treasury Department has so far ducked labelling China as a currency manipulator in its twice-yearly report to Congress. Another reason is that it is loth to give ammunition to the protectionist lobby.

Myth number two is that the sharp increase in China's trade surplus is due to an explosion in cheap exports. Until 2004 China's surplus was relatively modest, but it soared over the next two years (see chart 2). Jonathan Anderson, chief Asia economist at UBS, points out that export growth actually slowed between 2004 and 2006 (see chart 3). The main reason for the bigger trade surplus was a sharp slowdown in the annual real growth rate in imports, from more than 30% in early 2004 to less than 15% last year.

The entire increase in China's trade surplus since 2004 has come from trade in heavy industrial materials and equipment. China used to import increasing amounts of steel, aluminium, chemicals and machinery, but import growth collapsed after 2004 when the government started to tighten policy, causing a sharp slowdown in construction, one of the biggest importers of machinery and materials. At the same time China continued to invest heavily in metals and equipment, creating substantial excess capacity, so import growth remained relatively weak last year. Mr Anderson argues that imports should recover as overcapacity is used up.

The third fallacy is that imports from China destroy jobs and harm the American economy. It is hard to see how China can be blamed for job losses when America's unemployment rate (4.5%) is close to its lowest for decades. Trade with China may affect the composition of jobs in America, but it has little impact on total employment. It is true that some workers are harmed by trade with China, just as there are some losers from all international trade. But the American economy overall is better off, so in theory there is ample room to compensate any losers.

Trade with China helps, not harms the average American. Thanks to imports from China, prices are lower and real incomes higher. Commentators often refer to the “cheap” yuan as being an unfair subsidy for Chinese exporters. But it is a moot question who exactly is subsidising whom. Not only do cheap imports subsidise American consumers, but China's large purchases of Treasury bonds also hold down American interest rates, thereby subsidising home buyers. Suppose that overnight the yuan rose by 30%, what would happen? American interest rates would rise as China needed to buy fewer Treasury securities and prices at Wal-Mart would increase. If consumer spending and imports then collapsed, this would certainly reduce America's trade deficit, but in a much more painful way than most Americans have in mind.

Wishful thinking

The biggest myth of all is that a revaluation of the yuan would greatly reduce America's trade deficit. The real cause of the deficit is that Americans spend too much and save too little. This means that the country has to import surplus savings from abroad by running a current-account deficit. If a stronger yuan did not cause Americans to save more, it would do little by itself to reduce the trade deficit.

Another reason why even a big rise in the yuan would do little to reduce America's deficit is that there is little overlap between American and Chinese production, so American goods cannot replace Chinese imports. Instead, other countries, such as Indonesia and Vietnam, would probably replace the Chinese. Shifting purchases to higher-cost producers amounts to imposing a tax on American consumers, says Stephen

Roach, chief economist of Morgan Stanley.

Even where America and China do compete, as in electronics, the high import content of China's exports blunts the impact of exchange-rate movements on export prices, because a rise in the yuan reduces input costs. About half of China's exports consist of goods that have been assembled from imported components. And domestic wages and materials account for about 30% of the cost of those re-exports. Mr Anderson estimates that a 10% rise in the yuan would increase average export prices by only 3-5%.

If a yuan revaluation encouraged other Asian economies to follow suit, the impact on America's trade deficit would be larger, but still modest. If a 10% revaluation of the yuan were matched by all other Asian currencies, the dollar's trade-weighted index would fall by 4%. Yet, the 19% decline in the dollar's trade-weighted index since early 2002 has failed to trim the deficit.

None of this means that a yuan revaluation leaves America's trade deficit unchanged, simply that any change would probably be small. Nouriel Roubini, of Roubini Global Economics, finds evidence that China's trade balance is affected by movements in its exchange rate: the yuan has fallen sharply against the euro since 2002 as a result of the dollar's decline, and China's exports to Europe have consequently grown at a faster rate than its exports to America. A stronger yuan might therefore curb China's exports to America, but America's deficit would continue to loom large if imports from China were simply replaced by those from elsewhere.

Chinese whispers

Many of the arguments heard in America in favour of a big revaluation of the yuan are flawed or at least exaggerated. However, many of the arguments used in Beijing for why a revaluation would endanger China's economy are equally suspect. For instance, the common claim that a big jump would seriously harm China's growth and employment contradicts the argument (also favoured by Beijing) that an appreciation would have little effect on China's trade surplus with America.

Or take another popular line of defence: it is often asserted that China cannot afford a more flexible exchange rate until its dodgy banking system is reformed and strengthened. **Eswar Prasad**, an economist at Cornell University, says this argument has it completely backwards. The distortions caused by today's rigid exchange-rate regime may themselves be the biggest threat to Chinese financial stability. A sound banking system requires an independent monetary policy, which uses interest rates rather than blunt directives, to guide credit. And a country cannot control its monetary policy unless it accepts a more flexible exchange rate.

By tying the yuan closely to the dollar, China has been forced to hold its interest rates lower than is prudent: higher rates would attract more “hot money” from abroad, putting upward pressure on the currency. The real rate of interest paid on bank deposits is negative and lending rates are far too low for such a fast-growing economy. Cheap money results in excessive bank lending and poor investment decisions, which could lead to an increase in non-performing loans. Excessively low interest rates are also fuelling stockmarket and property bubbles.

News that China's real GDP surged by a breathtaking 11.1% in the year to the first quarter and that consumer-price inflation had risen to 3.3% in March (it eased to 3% in April), stoked fears that the economy is out of control. But concerns about overheating in the usual sense of excess demand are exaggerated. China's widening current-account surplus and its strong investment imply excess supply. Excluding food, the inflation rate is only 0.9%. Instead, the real concern is that excess liquidity, as a result of the surge in foreign-exchange reserves and low interest rates, is flooding into shares (see page 84). Households are withdrawing money from low-yielding bank accounts to bet on the stockmarket. China needs much higher interest rates to cool its asset markets. To regain control over its monetary policy China needs to let the yuan rise.

A revaluation could also help the government succeed in shifting the balance of growth away from investment and net exports towards consumption. A stronger exchange rate would boost consumers' purchasing power, allowing them to buy more foreign goods. Excess saving in China is as much to blame for global imbalances as inadequate saving in America.

Most of the increase in saving has come from Chinese companies, which are earning record profits. But household saving is also kept high by the poor public provision of health, education and pensions. Partly as a result, consumption accounts for an unusually low share of GDP.

The good news is that the mix of growth is starting to become more balanced: over the past year, investment has slowed while retail sales have quickened, rising by 15.5% in the year to April. In other words, consumer spending is now growing faster than GDP. Dragonomics, a Beijing-based research firm, estimates that consumption rose from 37% to 40% of China's nominal GDP growth in 2006 and is set to rise again this year.

The stronger growth in Chinese consumer spending has got much less attention in America than the sharp increase in the country's trade surplus. The contribution of net exports to China's growth has increased so far this year. However, the near doubling of its trade surplus in the first four months of the year was probably a one-off, because firms brought forward their shipments so as to avoid an expected reduction in export-tax rebates. Exporters are also thought to be overstating their export revenues in order to dodge capital controls and bring in foreign money to invest in Chinese assets. If so, the trade surplus should stabilise in coming months.

In the long run, stronger domestic consumption could trim China's trade surplus. The government can encourage this by spending more. Its spending on health care and education rose by an average of 50% last year and it is budgeted to rise by more than 60% this year—but from such low levels that it could take years to increase social spending by enough to encourage households to save a lot less. Meanwhile, a stronger yuan would help to rebalance the mix of China's growth.

Mirror image

This turns the whole debate about China's exchange-rate policy on its head. It is China that has the most to gain from allowing the yuan to rise. If the spat between America and China were to ignite protectionism or financial instability, it could endanger the whole world economy. All the more foolish, therefore, that economic relations are based on misperceptions on both sides. America needs to stop making China a scapegoat for the failures of American policy. Only if it gets its own economic house in order, by boosting domestic saving, will its “advice” to Beijing seem credible. Likewise, China has no right to criticise American policy when its own economy remains unbalanced.

America is right that China needs to revalue, but for the wrong reasons. And arguing that a revaluation helps America's economy makes it less likely that Beijing will act. Moreover, if George Bush foolishly slapped harsh trade sanctions on China, America's economy would be the biggest loser. Likewise, China is foolish to resist a more flexible exchange rate partly because it does not want to be seen as caving in to America's demands, when it is in its own interest. If the world's two leading engines of growth remain at loggerheads, everyone will pay the price.

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