A currency move could boost household consumption, making the Chinese economy more balanced and less dependent on exports.

China is expected to announce that it will allow the renminbi or yuan, to appreciate against the dollar in the coming days. The currency’s value would fluctuate day to day and any increase in value could be gradual and limited. Even so, the move would be good news for the Obama administration, because an undervalued renminbi keeps China’s exports cheap and makes American exports more costly by comparison.

Will a somewhat more flexible exchange rate benefit the American economy significantly? What kind of effect will it have on the changing Chinese economy and other Asian economies?

Eswar Prasad, economist, Cornell University
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What’s Good for China

Eswar Prasad is a professor at Cornell University and a senior fellow at the Brookings Institution. He is a former head of the International Monetary Fund’s China Division.

A shift in China’s currency policy is not a panacea for imbalances in either the Chinese or U.S. economies, but it puts in place an important piece to a complex jigsaw puzzle.

The immediate benefit of a modest currency adjustment is that it will cool off some of the overheated rhetoric in China and the U.S., allowing the nations to focus on important economic and strategic issues rather than getting into petty trade disputes.

A modest appreciation of the renminbi will not by itself wipe out America’s trade deficit or China’s trade surplus. But if this move generates momentum towards a more flexible exchange rate, it could help achieve some important objectives. Chinese officials speak of banking reforms as a key priority and consider their huge trade surplus a structural problem having nothing to do with currency policy. There is, in fact, a deep connection between these issues.
A Slow Motion Train Wreck

Desmond Lachman, a resident fellow at the American Enterprise Institute, is a former managing director of Salomon Smith Barney and a former International Monetary Fund economist.

One cannot but help get a feeling of déjà vu following Timothy Geithner's current visit to Beijing to extract from the Chinese the minimal amount of exchange rate flexibility that will allow him to resist strong Congressional pressure to deem China a currency manipulator.

Is this not what happened in July 2005 when China misled then-Treasury Secretary John Snow into believing that an initial move toward a more flexible Chinese exchange rate would be the start of better policy coordination between the two countries to address China’s very large bilateral payment surplus with the United States?

China’s modest currency appreciation between July 2005 and September 2008, which was unaccompanied by measures to promote Chinese domestic consumption, did nothing to slow China’s rapid export growth or to halt its ballooning trade surplus with the United States.

Complicated Risks

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Many of the criticisms of the Chinese exchange rate policy are quite sensible, especially those that identify other developing countries as bearing some of the burdens of the Chinese policy (mostly in the form of forgone export opportunities).

But I think advocates for a stronger renminbi have exaggerated the benefits of such a move for other developing countries and may have under-estimated some of the risks for China.

The benefits of a revaluation on other developing countries will not be instantaneous. It took China 10 to 15 years to build its powerful export clusters in the coastal regions and that was already considered as a supersonic speed. Adjusting China’s exchange rate, while moving things in the right direction, is not going to solve the immediate challenge of jump-starting growth during this round of global recession.

Beijing Will Do What Benefits China

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China will soon adjust the exchange rate target it intervenes in markets to achieve. Based on my analysis, I would anticipate a 3 percent to 5 percent initial appreciation of the yuan to the U.S. dollar followed by a wider range for daily adjustment going forward.

If that daily adjustment resembles China’s 2005 to 2008 appreciation then over the course of 2010 Beijing will have made a reasonable effort to satisfy its critics. Some of those critics in Congress and elsewhere believe a 40 percent move is necessary; the best analysis suggests that 15 percent strengthening is enough to move China toward a smaller trade surplus. With 5 percent up-front and regular movement to reflect market forces thereafter, China can get more than half-way to that goal this year.

After cheering China’s move, we must turn to the reality that it will not solve our problems. The United States must move beyond a singular focus on currency to talk about many other factors shaping our trade with China. Two cost distortions on the Chinese side stand out: underpriced borrowing costs for state-related firms; and subsidized research and development costs due to lax intellectual property rights enforcement. That said, the currency move will help, not hurt, and if other emerging markets in Asia follow China’s move — as is expected — our export opportunities will be bolstered notably.

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A Rising Trade Surplus

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The renminbi is only one of many variables that affect U.S. and global trade. even within China. China’s huge trade surplus is a consequence of a number of policies that shifts income from consumers to producers, and in so doing cause Chinese production to rise much faster than China’s ability to consume what it produces.

If the renminbi appreciates while real interest rates decline, as currently seems to be happening, the positive impact of a rising renminbi can be more than easily offset by the lower cost of capital for manufacturers. In this case we could easily see a rising renminbi coincide with a rising trade surplus, much as we saw from July 2005 onwards, when a rising renminbi and declining real interest rates, along with a vibrant U.S. consumer financing market, saw a surge in China’s trade surplus.

The recent thaw in trade tensions is likely to be very temporary. Ultimately what drives trade conflict is when the trade surplus country cannot adjust quickly, while high unemployment in the trade deficit country creates impatience for rapid change. China needs several years to make what will be a difficult adjustment toward a more balanced economy, but with high
unemployment in the U.S. likely to persist for several more years, it is not clear that the U.S. will be willing to wait.