Beijing's uneasy embrace of the greenback

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When top US and Chinese officials meet today for the first high-level talks of the Obama administration, the American complaints about China's currency that long bedevilled relations will barely be on the table.

For years, Washington alleged that Beijing unfairly manipulated its currency, the renminbi, to support exports and demanded China allow it to appreciate to force structural changes in its economy.

Humbled by the financial crisis and heavily reliant on Beijing to climb out of it, Washington has shifted gear, relegating the currency to a subset of its push for broader economic reforms in China.

"The US has for now given up on pushing China on currency issues, partly because Washington has less leverage over Beijing than at any other point in recent history," says Eswar Prasad of the Brookings Institution in Washington.

"The US now has enormous financing needs for its budget deficit and current account deficit, making it more dependent on China than ever before."

Other issues have naturally forced themselves higher on the bilateral agenda for this week's meeting in Washington, notably climate change and efforts to extend cooperation on green energy initiatives.

Inter-agency rivalry in Washington over management of the China relationship between the Treasury and the state department has also given the so-called strategic economic dialogue a broader remit.

When the top-level dialogue was founded in 2006 on the initiative of Hank Paulson, the then Treasury secretary ensured that its sessions were focused primarily on economic exchanges.

The irony of the US retreat on the renminbi, though, is that China has been powerless to wean itself off its addiction to buying US debt, the other side of the bilateral financial ledger.

The global crisis does not appear to have lifted the confidence of Beijing in its own currency. Instead, Chinese leaders have repegged the renminbi to the US dollar in the past 12 months in the search for a stable environment to ride out the turmoil.

Beijing broke the decade-old US dollar peg in mid-2005, allowing the renminbi gradually to appreciate against the greenback during the following three years. Alarmed by the emerging financial panic and an abrupt collapse in exports, Beijing called a halt to the appreciation last July. The renminbi has been stable against the greenback ever since.

Chinese analysts insist the repegging is a temporary measure, a safe port in the global storm before it is calm enough for the ship of currency reform to head out into international waters again.

"Right now, we need stability above all. If we get through this crisis, the currency will be back on a more flexible track," says Peng Xingyun of the Chinese Academy of Social Sciences.

In the meantime, the same problems that forced Beijing's hand in 2005 have returned to haunt Chinese policymakers a second time.

China's foreign exchange reserves burst through the $2,000bn (€1,400bn, £1,217bn) mark in the second quarter, fuelled by speculative inflows of cash trying to take advantage of the rapid recovery in the Chinese economy.

China's commitment to a pegged currency means it must swap the dollars flowing into the country for renminbi. The extra funds injected into the system are adding to the already loose monetary policy introduced late last year to counter the global slowdown.

"Strong pressures on, and market expectations for, the renminbi to appreciate will likely re-emerge as early as the end of this year," says Wang Qing, Morgan Stanley's China economist.

Beijing's struggle to manage the renminbi underlines the difficulties with its other significant recent announcement - a call for an alternative to the US dollar as a reserve currency.

Within China, support for an alternative to the greenback is seen more as a political signal than a concrete proposal. "It is our way of expressing our unhappiness with the US," says a senior Chinese economist, adding that Beijing knew there was no alternative in the short term to the dollar.

Beijing is trying to push money offshore, investing in commodities and overseas companies, and gradually trying to internationalise the renminbi by allowing it to be used for some regional trade transactions.

But the size of China's reserves means these initiatives have little measurable impact on the pile of foreign cash the People's Bank of China has under management. In the foreseeable future, the central bank has little choice but to invest its foreign currency holdings in US dollars, because there is no other asset class that can handle such large sums of money.

"The Chinese leadership understands very well that their economy is locked into a difficult and unhealthy embrace with the US and would like to tear themselves away from it," says Mr Prasad.

"Much as they may detest it, the embrace is only going to get tighter in the short run."

Issues on the agenda

Climate As the world's two top carbon emitters, the US and China acknowledge they will be at the heart of any deal at this year's Copenhagen conference. But the US dismisses any idea of the two countries forming a "G2" group to thrash out deals other countries would sign up to subsequently. China has resisted calls for a specific cap on emissions and for the scrapping of tariffs on clean energy technology.

Rebalancing The US wants China to shift away from its reliance on investment and exports and move towards more domestic consumption - a strategy that can be achieved only if Beijing makes substantial changes to its economy. Such reforms would require China to liberalise its financial sector and promote service industries. Over time, this would reduce the bilateral trade imbalance. China says such reforms are under way, but cannot be rushed because of the challenges of managing the transition of millions of poor rural residents into a more modern economy.

North Korea The US is worried about North Korean nuclear proliferation. China is concerned about the risk of instability in a transition of power from Kim Jong-il, the North Korean leader. While the two countries helped push through UN sanctions after Pyongyang's nuclear and missile tests, Beijing expresses fears that some of the tough measures Washington favours could make North Korea more unstable and disrupt trade.

Trade Washington and Beijing have clashed this year over "Buy American" and "Buy China" provisions attached to their respective stimulus packages that excluded foreign businesses from publicly funded projects. US officials say this spat has highlighted the need for China to sign up to the World Trade Organisation's "government procurement agreement" in the autumn. "Buy American" was watered down in Congress so that it did not affect GPA signatories.

Investment US companies have invested heavily in China for years, but recently Chinese companies have started doing the same in the US. Both countries have concerns: Beijing that the US government is hampering access on the basis of national security and Washington that there is a "hardening of attitudes towards foreign investment" in some sectors in China.

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