A fair exchange?

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China has helped to finance America's vast current-account deficit

UNTIL last year nobody seemed to care that the Chinese yuan was pegged to the dollar. But now China's exchange-rate regime has become one of the hottest topics in international finance—yet more evidence of China's growing influence on the world economy.

Many economists argue that China's fixed exchange rate distorts trade and investment flows. By refusing to allow its exchange rate to rise against the dollar, China, they say, is hindering the adjustment in global exchange rates needed to reduce America's current-account deficit, which now stands at more than 5% of GDP. As a result of its pegged exchange rate and large capital inflows, China's foreign-exchange reserves have more than doubled since early 2002 to over $480 billion, most of it in American government securities. China is not alone: other Asian economies have also intervened heavily to prevent their currencies appreciating. But sooner or later, those economists say, China will lose its appetite for dollars, causing the greenback to tumble.

However, Michael Dooley, David Folkerts-Landau and Peter Garber at Deutsche Bank reject this view. In a series of papers, they argue that America's current-account deficit will be happily financed by China and other Asian countries for at least another decade. The present arrangements, they say, look rather like a revived Bretton Woods, the system of fixed exchange rates that prevailed for a quarter of a century after the second world war. Once again, America is at the centre of the system. The old periphery consisted of Europe and Japan, which used undervalued currencies, supported by capital controls and the purchase of dollar reserves, to rebuild their economies after the war. But the new periphery is made up of China and other Asian economies which, it is argued, also peg their currencies to the dollar at artificially low rates. These countries want to keep their exports competitive in order to create jobs for their vast pool of underemployed workers.

But will America accept the political costs of rising imports and job losses in manufacturing? The three Deutsche Bank economists argue that China compensates America in two ways. First, it allows foreign firms to invest in Chinese factories, using cheap labour to earn fat profits (which turns those firms into an effective American lobby to counter resistance to Chinese imports). Second, the Chinese government invests a large chunk of its export earnings in Treasury bonds, helping to finance America's current-account deficit. This keeps American interest rates low and so supports consumer spending. In essence, China is buying dollar assets to ensure that Americans can afford to keep buying its exports. The return on Treasury bonds is lower than the returns at home in China, but, according to Messrs Dooley, Folkerts-Landau and Garber, the Chinese government is prepared to pay that price to ensure export-led growth.

America and Europe used to enjoy a similar relationship. The main question mark was, and still is, over the willingness of the periphery to accumulate claims on America. As Jacques Rueff, a French economist, put it in 1965 : “If I had an agreement with my tailor that whatever money I pay him returns to me the very same day as a loan, I would have no objection at all to ordering more suits from him."

A marriage of convenience

This view of Asia's relationship with America helps to explain why in recent years it has proved possible to finance America's large current-account deficit without a bigger rise in American bond yields or a bigger fall in the dollar. However, the authors' claim that this arrangement is in the mutual interest of both America and Asia is questionable, as is their conclusion that America can therefore continue to run a large current-account deficit for another decade.

For a start, it seems doubtful that a cheap yuan is part of China's long-term development strategy. Until a couple of years ago, China's trade-weighted exchange rate was being dragged up by the strong dollar. China even passed up an opportunity to devalue the yuan during the Asian crisis. A second problem with the theory is the assumption that China can control both its exchange rate and its inflation rate. If a country holds down its nominal exchange rate, its real exchange rate tends to rise through the effect of higher inflation, which blunts its international competitiveness in just the same way. Indeed, large capital inflows into China are currently creating excess liquidity and pushing up its inflation rate.

A third flaw is that in the original Bretton Woods system there was no real alternative to the dollar as a reserve currency. Today there is the euro, into which the Asians could diversify instead of holding dollars. And lastly, if China continues to run a large trade surplus with America and Europe while holding down its exchange rate, exporters may face mounting protectionism. The "revived Bretton Woods" may be a brief marriage of convenience, but there is a high risk of a messy divorce.

The marriage could prove particularly costly for America. In 2003 China and the rest of Asia financed over half of America's budget- and current-account deficits. This benefits America in the short term, but at the cost of allowing bigger imbalances to build up in the long term. The Asian central banks are masking market signals; America's current-account deficit reflects insufficient saving by households and an excessive budget deficit. Normally, investors would demand higher bond yields to compensate them for the increased risk, thereby giving the government a warning as well as an incentive to borrow less. But Asia's buying of Treasury bonds, with little regard for risk and return, is keeping yields artificially low, which makes pruning the budget seem less urgent. At the same time low interest rates prolong America's unhealthy consumer spending and borrowing binge.

James Carville, Bill Clinton's campaign manager, once said: "I used to think if there was reincarnation I wanted to come back as the president or the pope...but now I want to come back as the bond market. You can intimidate everybody." Thanks to the behaviour of Asian central banks, the bond market has lost its bark. It is subsidising rather than punishing American profligacy, allowing deficits to grow for longer. When the inevitable correction comes, it will be all the more painful.

True value

China's purchases of American bonds are clearly distorting financial markets, but how undervalued is the yuan? It is tricky to estimate the equilibrium exchange rate for a country that is undergoing massive structural change. The yuan was grossly overvalued in the 1980s and was then devalued several times. But between 1994 and 2001 its real trade-weighted index rose by 30% (see chart 9). Since the dollar started its decline, it has fallen by 11%.

According to some observers, the rapid growth in China's exports proves that China's exchange rate is too low. In fact it proves no such thing: China's imports are growing equally fast. And although China has a big trade surplus with America, its overall trade surplus has virtually disappeared so far this year.

On the other hand, China's large surplus on its “basic balance” (the current-account surplus plus net inflows of foreign direct investment) and its rising foreign-exchange reserves suggest that in a free market the yuan would rise. But in the longer term, if China scrapped its capital controls, the yuan would probably fall as households diversified into foreign assets. Overall, therefore, the case for a big yuan revaluation is weaker than is commonly claimed.

American politicians shout the loudest for a yuan revaluation, but if it happened it would probably do little to reduce America's trade deficit. Few firms in America still make goods that compete directly with China. China's exports also have a high import content, so a rise in the yuan makes imported components cheaper, limiting the rise in export prices. According to a study by Lawrence Lau at Stanford University, only 20 cents in every dollar of Chinese exports to America reflect value added by domestic Chinese production, so even a 20% rise in the yuan against the dollar would increase the price of Chinese exports to America by only 4%.

Nevertheless, many economists think that the dollar does need to come down to help reduce America's current-account deficit, and China must play its part in that. Morris Goldstein, an economist at the Institute for International Economics in Washington, DC, reckons that the yuan is at least 15% undervalued. He feels that an appreciation on this scale would ensure both that China achieved an overall balance on its external payments (ie, it would run a current-account deficit sufficiently large to offset its underlying net inflow of capital) and that China bore its fair share of the adjustment in the dollar.

By itself a stronger yuan might make little difference, but it would encourage other Asian countries to revalue their currencies too. Asian currencies together account for 40% of the dollar's broad trade-weighted index. Unless they revalue, the euro will continue to bear the brunt of the adjustment in global current-account imbalances. Since mid-2001 the euro has risen by almost 50% against the greenback.

By far the strongest argument for a revaluation of the yuan is that it is in China's own economic interest. The dollar peg has, in effect, forced it to adopt America's super-lax monetary policy. Large capital inflows and rising foreign-exchange reserves have caused rapid growth in the money supply and bank lending as well as rising inflation. Excessive credit has fuelled over-investment and a property bubble, increasing the risk of yet more bad loans. The central bank cannot easily raise interest rates to cool down its economy, because that would attract more foreign money.

Moreover, an undervalued exchange rate, by subsidising exports, discourages investment in the non-tradable sector and cramps domestic consumption. A revaluation of the yuan would help to reduce China's reliance on exports as well as stemming the inflows of foreign money and allowing China to regain control of its monetary policy.

Easy does it

Until its shaky banking system has been stabilised, it would be foolish for China to open its capital account and let its currency float. That could risk massive capital flight and a banking crisis. Mr Goldstein instead suggests a two-stage currency reform. First, China would switch from pegging the yuan to the dollar to pegging it to a basket of several currencies, including the yen and the euro; its exchange rate would also be increased by 15% and its permitted trading band widened modestly to allow more flexibility. At a later stage, China could move on to liberalise capital flows and adopt a floating exchange rate.

Eswar Prasad, head of the IMF's Asia and Pacific department, disagrees. In a recent speech he argued that given the huge uncertainty about the correct level of the yuan, it made more sense to introduce greater exchange-rate flexibility for China as soon as possible rather than trying to settle on a particular exchange rate. A flexible exchange rate would help to buffer the economy against shocks. But greater flexibility should not be confused with fully opening up the capital account, which cannot safely be done yet. Indeed, says Mr Prasad, during the period of transition to a more flexible exchange rate, some capital controls might even need to be tightened to protect the banking system.

Whatever happens to China's exchange rate, it is clear that China is carrying increasing weight in international finance. Not only does America's monetary policy affect China, but increasingly China is affecting interest rates in America.