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The Great China Currency Debate: For workers or speculators?

Everyone is talking about China's currency, it seems. Amidst months of building tension, there is an apparent consensus among most economists, the financial press, and leading economic policy makers in the West that the renminbi is hugely undervalued, making China's exports unfairly competitive. The global imbalances created by such 'mercantilist' and 'protectionist' exchange rate strategies, it is argued, have been a central cause of global financial instability. China must therefore revalue, for the good of both itself and the world.[1]

In particular, this position has been spearheaded by leading economic commentators such as Paul Krugman, Fred Bergsten or Martin Wolf, who have called for aggressive action against China on this issue. More diplomatically, it has also been advanced by what might be called a 'G20 consensus' of leading central bankers and finance ministers.[2] It is with this logic that 130 members of the US Congress called on the Obama administration in March 2010 to label China a 'currency manipulator', which would then allow for other punitive measures to be taken against China.

Yet, despite the consensus, in early April the US government postponed its report on international exchange rates due for 15 April and took a more conciliatory approach. Tim Geithner, US Treasury secretary, acknowledged two days before the US-China summit on 24 May that China has made progress in rebalancing its economy towards domestic consumption and away from exports even though its currency remains pegged to the dollar.[3] Given expectations that China's currency will be an important election issue in the US, why did this apparent capitulation occur so easily?

Despite the sense of absolute certainty emanating from revaluation advocates, reality is far more complex than they suggest. Indeed, China's trade surplus reflects the strength of corporate America (and Europe and Japan) as that of China. Moreover, revaluation advocates argue that currency appreciation should happen through nominal revaluation, rather than only through real appreciation. This logic is best understood as reflective of speculative interests and detrimental to the developmental interests of China given that it would forfeit China's ability to appreciate through gradually rising wages, contrary to the claims of those leading the debate in the West.

Is the renminbi undervalued?

Similar to the previous crescendo in this debate in 2005, there is actually no agreement as to whether the renminbi is undervalued or by how much. Revaluation advocates generally maintain that the answer to this question is self-evident by virtue of China's very large trade surpluses. In March 2010, economists at the Peterson Institute of International Economics in Washington claimed that the renminbi is undervalued by about 25 per cent on a trade-weighted average basis, and by about 40 per cent against the US dollar, based on assumptions of how much revaluation would be required to reduce China's current account surplus to 3-4 per cent of GDP. They also suggest that China's currency policy is half as market-oriented as in 2005 given that its foreign exchange interventions are about twice as great today (about $30-40 billion per month) as then ($15-20 billion per month).[4]

However, the issue is much more complex. Invariably, wide ranges of estimates can be obtained, depending on definitions and assumptions. Hence, prominent economists or institutions such as the IMF estimate that the renminbi is much less undervalued, if at all, or instead, that the US dollar is overvalued.

Notably, China's trade surplus in goods exploded from around 3 per cent of its GDP in 2004 to a peak of over 9 per cent in 2007. At the same time, the government allowed the renminbi to appreciate against the US dollar by over 20 per cent from July 2005 to July 2008, which should have reduced China's surplus with the US, not increased it. This suggests that the surpluses have borne little relation to the valuation of the Chinese currency.

Revaluation advocates have retorted that the renminbi was so undervalued that much more revaluation is needed. More sophisticated versions of this argument contend that other intervening factors, such as interest rate differentials, have prevented renminbi revaluation from inducing the necessary adjustments.[5]

In the midst of the squabble, Prime Minister of China Wen Jiabao asserted in March 2010 that the renminbi is not undervalued, a claim ridiculed by many in the Western media. However, as if to prove Wen correct, the trade balance of China registered a deficit in March 2010 for the first time since April 2004, due to a sharp rise in imports and fewer exports of labour-intensive goods. While probably temporary, this dip nonetheless underlines that China's trade position is more tenuous than usually appreciated.[6]

Alternative interpretations

The revaluation advocates generally ignore the nature of China's integration into networks controlled by transnational corporations (TNCs). Foreign funded enterprises accounted for 58 per cent of China's exports and imports in 2005, or even more if their subcontracting arrangements with locally-owned firms are included within a wider understanding of these networks dominated by transnational corporations (TNCs). Hence, revaluation is unlikely to have much effect on the competitiveness of Chinese exports because so much of the inputs for these exports are imported (and priced as intra-firm transfers), cancelling out the potential effect of any currency movement.[7]

Another important dimension is the financial account given that capital flows have a huge bearing on currency valuations. For instance, the *Financial Times* admitted in a recent editorial that estimates of undervaluation vary massively in part because of movements on the capital account. If freed, these could lead to a flood of capital outflows that might temporarily push the renminbi down instead of up.[8] These concerns are particularly pertinent given the huge resurgence of carry trading in East Asia since autumn 2009, which dwarfs China's surpluses and reserves many times over.

However, the TNC dimensions of such financial dynamics are rarely explored. For example, TNC transfer pricing practices, which are used for intra-firm transfers within the TNC networks that dominate China's trade, are also often used for avoiding taxes or capital controls.[9] Hence, much of the trade account might actually represent capital movements. More generally, Chinese surpluses (and US deficits) could, in fact, represent the increased profitability of US companies operating in the global market.[10] As a result, the real significance of the trade data must be examined with much caution. False evaluations on the basis of such trade data can ironically serve to justify attempts to further subordinate China within these TNC networks. Indeed, Tim Geithner suggested that recent US conciliation towards China is related to Beijing's relaxation of some of the restrictions facing TNCs, such as 'indigenous innovation' rules introduced in 2009, which US corporations claimed would exclude them from public procurement contracts.[11] In other words, the currency confrontation might well be a bargaining chip for other strategic issues.

The disjuncture between currency appreciation and rising trade surpluses is also partly explained by rising productivity, which compensates for currency appreciation by lowering unit-labour costs. While China's success in this respect has caused it to be blamed for its overenthusiastic interventionist industrial policies, it is also important to ask; how was the consumption of its surpluses guaranteed?

Evaluation of international balance of payments data actually suggests the opposite of what the revaluation advocates claim. Arguably, financialization in the US drove consumption and deficits in the US. In turn, these drove China's high levels of investment, thereby buttressing its industrial policies and surpluses. This alternative explanation is supported by the fact that China's trade surplus only really took off in the mid-2000s, several years after the US current account deficit started to massively increase following the East Asian crisis in 1997-98 and several years after a huge surge in net foreign direct and other investment into China from about 2001 to 2005. China's entry into the WTO in 2001 obviously had some influence on these dynamics, although merely as an institutional facilitator of the more systemic rerouting of TNC-dominated production networks through China that followed the East Asian crisis.[12]

Nominal or real revaluation?

Many argue that China must nonetheless adjust to its de facto surplus and that this is better planned rather than brought about through instability or crises. However, adjustment can take many forms.

Revaluation advocates generally argue that adjustment needs to happen through nominal revaluation. This, it is argued, is essential to rebalance the economy towards more domestic demand and consumption by making imports

cheaper, thereby raising real incomes, and by penalising exporters against those producing for the domestic market. This should again dampen inflation in China by lowering the cost of imports in domestic consumption. Some also add that revaluation would reduce the inflationary tendencies generated by large surpluses.

However, if the argument for revaluation holds any water, it would apply to real exchange rates, not necessarily nominal exchange rates (unless these follow the former, which is not always the case).[13] Let us assume that China's trade account would rebalance if its real exchange rate appreciates. This could take place directly through nominal revaluation, although the effects might be offset by a variety of speculative movements on the income and financial accounts. Alternatively, real appreciation can take place through higher prices or wage/cost inflation relative to trade partners or competitors. Indeed, this is happening now; price inflation in China is currently higher than in the US and upward wage pressures in China contrast with stagnant, if not falling wages in the US. Hence, real appreciation is already taking place, a point which Beijing sometimes makes.

This helps to clarify the developmental predicament of revaluation. Gradual real appreciation through rising wages would offer an ideal way of increasing domestic consumption and rebalancing the economy. Moreover, as a relatively poor developing country, rising real wages in China would contribute to the goals of economic development. China can do this now since its surplus position can serve as a substantial buffer against possible adverse balance of payments consequences due to rising real wages.

In contrast, nominal revaluation would effectively forfeit China's ability to adjust in this way, by abdicating the role of wages to the role of international prices. In other words, the option of using its surpluses and reserves in a developmental manner would be abandoned in deference to rewarding speculators and market arbitrage.

Moreover, nominal revaluation would probably exacerbate the squeeze on wages as export-oriented and import-competing enterprises would respond by attempting to lower unit-wage costs. Indeed, this tendency has been observed since 2005 and would have exacerbated the low share of consumption to GDP, opposite to what the revaluation advocates argue. Nominal revaluation would also place downward pressure on agricultural incomes by depressing farm gate prices. This developmental dimension is lacking in most of the current mainstream Western debates on China's currency, even though many Chinese economists argue precisely along these lines. Their logic is imminently sensible.

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[1] For further discussion, see Andrew M. Fischer, 'The Perils of Paradigm Maintenance in the Face of Crisis.' Paper presented at UNRISD conference on 12–13 November 2009, Geneva.
[2] Leading revaluation advocates include economists at the Peterson Institute for International Economics in Washington (e.g. Fred Bergsten, Nicolas Lardy, Morris Goldstein, and Arvind Subramanian), commentators such as Martin Wolf and Paul Krugman, central bankers such as Ben Bernanke and Mervyn King, and economists working for Goldman Sachs and other large private financial institutions. For instance, see Mervyn King, 'Speech at the University of Exeter, 19 January 2010'. Bank of England, London, and Paul Krugman, 'Taking On China'. *New York Times*, 14 March 2010. I am indebted to Geoff Tily for suggesting the term 'G20 consensus'.
[3] See Geoff Dyer, 'Geithner softens his stance on China', *Financial Times*, 23 May 2009.
[4] C. Fred Bergsten, 'Correcting the Chinese Exchange Rate: An Action Plan'. Testimony before the Committee on Ways and Means, US House of Representatives, 24 March 2010.
[5] For instance, see Michael Pettis, 'How Will an RMB Revaluation Affect China, the US, and the World?' *Roubini Global Economics EconoMonitor*, 17 March 2010.
[6] See Fischer, 'Perils,' and Andrew M. Fischer, 'Is China Turning Latin? China's balancing act between power and dependence on the wave of global imbalances'. ISS Working Paper No. 496, February 2010.
[7] This point was made in 2005 by Lawrence Lau and Joseph Stiglitz, 'China's alternative to revaluation.' *Financial Times* 24 April 2005.
[8] *Financial Times*, 'China's currency is not worth a battle,' editorial, 5 April 2010.
[9] See Huizhong Li, Ping Huang, and Jialun Li (2007). 'China's FDI Net Inflow and Deterioration of Terms of Trade: Paradox and Explanation'. *China and World Economy* 15(1): 87-95.
[10] See Jan Kregel, 'Financial Flows and International Imbalances – The Role of Catching-up by Late Industrializing Developing Countries.' Working Paper No. 528, Levy Economics Institute, February 2008.
[11] See Dyer, 'Geithner.'
[12] See Fischer, 'Perils' and 'Is China Turning Latin?' for elaboration and data.
[13] For an excellent discussion, see pp. 14-22 in UNCTAD, *Trade and Development Report 2007*.