International clamour for revaluation of the Chinese yuan

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In recent months, China has been the target of a growing international campaign calling for the revaluation of its currency—the yuan. The yuan has been fixed or "pegged" in a narrow range against the US dollar since 1994. Over the last year as the US dollar has weakened against the euro and other currencies, the yuan has followed suit, making Chinese exports even more competitive, particularly in European and Japanese markets.

The result is a chorus of calls in Europe, Japan and from sections of the US manufacturing industry for a revaluation of the yuan by as much as 30 to 40 percent. China's "undervalued currency" and cheap goods have become convenient scapegoats for a host of economic ills—from the prolonged recession in Japan to the problems of manufacturers in Europe and the US.

In May, the vice-president of America's National Associations of Manufacturers, Franklin J. Vargo, complained in a congressional hearing: "We must press China to end the manipulation of its currency and allow the yuan-dollar exchange rate to be determined by the market." Just last week, a gathering of executives from US textile companies called for greater protection against Chinese goods. "If this acceleration [of imports] continues, China will have 70 percent of the entire market in a very short period of time. This could mean the additional loss of 630,000 jobs," one chief executive said.

US politicians have been quick to jump on the bandwagon. Senator Joseph Lieberman, a contender for the Democratic Party presidential nomination, criticised the policies of the Bush administration, declaring: "Bush's laissez-faire means I don't care." On July 31, 16 congressmen wrote to Bush, stating that the yuan was "unfairly" undervalued by 15 to 40 percent and hurt jobs in the US. Republican Congressman Don Manzullo warned Bush of an electoral backlash, saying "voters next year are going to take their anger out at the polls" unless jobs were protected.

The calls in Japan have been even more insistent. Japanese Finance Minister Masajuro Shiokawa, who has repeatedly accused China of "exporting deflation" to Japan, reiterated his hard-line view on August 7 at a meeting of financial ministers in Manila. "It doesn't serve Japan's interest to have what we perceive as an artificially high yuan," he said. Tokyo has spent a massive 2.39 trillion yen to buy US dollars in order to keep the value of the currency low but finds its efforts undercut by the position of the yuan.

In Europe, there have been similar demands. EU Commissioner Romano Prodi told the *South China Morning Post* last month that he was "afraid of a possible protectionist wave in Europe" unless the Chinese government considers the euro as an alternative reserve of foreign exchange to the dollar. As the dollar has fallen in value, Beijing has had to take steps to prevent the value of the yuan from rising outside its pegged range, resulting in huge purchases of dollar-denominated securities and in dollar reserves.

The discussion about the yuan has highlighted the degree to which the world's major economies have become heavily dependent on China as a source of cheap labour, and in the case of the US, as a source of finance to assist in managing its massive trade and budget deficits. Far from resolving the current economic problems in the US, Japan and Europe, a revaluation of the yuan has the potential to trigger instability, particularly in the US.

During a tour of China last month, Morgan Stanley's chief economist Stephen Roach pointed out that commentators and politicians were engaged in the wrong "blame game." He went on to explain that the vast bulk of cheap "Chinese" exports were in fact produced by foreign-owned subsidiaries based in China.

"The world has formed an erroneous perception that newly emerging Chinese companies are capturing global market share with reckless abandon. In fact, China's increasingly powerful export machine has the stamp of America, Europe and Japan written all over it. That has been true over most of the past decade," Roach commented.

"From 1994 to the middle of this year, China's exports tripled from $US121.0 billion to $US365.4 billion. It turns out that 'foreign-invested enterprises'—Chinese subsidiaries of global multinationals and joint ventures with industrial-world partners—accounted for fully 65 percent of the cumulative increase in total Chinese exports over that period."

Roach explained that efforts to revalue the yuan could rebound. "[By] putting pressure on China to change its currency regime, the industrial world is working at crossed-purposes—in effect, squandering the fruits of its own efforts.

Fear of the so-called China threat completely misses this critical point: the power of the Chinese export machine is more traceable to ‘us’ than it is to ‘them’,” he stated.

The huge profits being made by US corporations in China are undoubtedly one of the reasons for the relatively low-key approach of the Bush administration. US Treasury Secretary John Snow told a Senate Banking Committee as recently as July 31 that he had “no firm views” on whether the yuan was undervalued. He nevertheless indicated that Washington would use “quiet diplomacy” to encourage Beijing to allow the yuan to strengthen in value against the US dollar.

There is, however, a more fundamental reason for Washington’s quiet approach—any rapid change to the value of the yuan could affect the inflow of Chinese capital into the US, with potentially destabilising effects. As the London-based *Economist* noted on July 12: “Another reason for America to pull its punches is that China and other Asian countries hold their reserves largely in American government securities. If Asians lost their appetite for dollar assets, the greenback would fall even faster, and American bond yields would rise.”

In order to maintain the peg within the narrow band between 8.276 and 8.28 to the US dollar, China’s central People’s Bank has been compelled to engage in huge purchases of dollar-based assets over the last decade to offset China’s substantial trade surplus with the US. Over the last year, the process has accelerated markedly. As a result, China is second only to Japan in its holdings of US Treasury bonds, which have risen to $119 billion from $82 billion just a year ago.

In an article entitled “The Fed is in a dangerous game with China” on July 31, the British-based *Financial Times* commented that Beijing is now a major prop for the US Federal Reserve and its policies. “China is a silent but active partner in the Fed’s pump-priming. It would not be possible for US Treasury bond yields to be at current levels were China not a willing and able supplier of saving to the US,” it stated.

In other words, the world’s largest economy, the US, is heavily dependent on a continuing inflow of capital from China—a country confronting fundamental economic, social and political problems. US Fed chairman Alan Greenspan noted last month, in his own understated way, that the current level of the yuan required the Chinese government “to be very heavy purchasers of US dollar-dominated assets”. He warned that such a situation could not last indefinitely as it will inevitably create instability in the Chinese monetary system.

As Greenspan knows only too well, China’s financial system has a number of problems. Massive economic restructuring over the last decade, compounded by the necessity of maintaining the currency peg, has created $1.8 trillion in non-performing bank loans—equivalent to 140 percent of China’s gross domestic product (GDP). Most of the outstanding loans are held by the country’s four major state-owned banks which are considered to be insolvent.

Another problem is the high level of China’s foreign exchange reserves, which reached $340 billion in June, up from $286 billion last year. In part this is due to intense speculation on the yuan by international investors, who are buying up shares on the Chinese stock exchange to cash in on any yuan revaluation. The extra money available to Chinese investors has found its way into the property market in China’s major cities, creating a speculative bubble that has added to the danger of instability.

So far Chinese authorities have resisted pressure to revalue the yuan, concerned that a higher exchange rate would slow foreign investment and exports. Any economic slowdown is likely to rebound politically on the government as China’s high levels of unemployment lead to greater social unrest. At the same time, Beijing is doing its utmost to maintain a favourable investment climate and good relations with Washington.

An editorial in the *Asian Wall Street Journal* on July 31 commented on the relationship: “You might even say that China is an economic colony of the US, with its currency so tightly pegged to the dollar and American companies using it as a base for their low-cost manufacturing. That might seem like a strange idea given how nationalistic the Beijing regime is. But consider the government’s actual behavior, and it’s not hard to imagine that if Paul Bremer [US administrator in Baghdad] were running China instead of [President] Hu Jintao, he’d be accused of exploiting the country’s economy to benefit the US and other Western countries.”

The editorial went on warn of the dangers involved in pressuring Beijing to revalue its currency. “A sudden collapse [of the Chinese economy] would hurt the US because the market for US Treasury bonds might be disrupted, social unrest could damage American-owned factories and the market for US goods could dry up. In short, Americans should be somewhat concerned about China, but not for the reason they think.”

All of this augers further financial instability in China, the US and internationally.