

# China's yuan revaluation a response to increased US pressure

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Last week's decision by the Chinese central bank to revalue the yuan by 2 percent against the US dollar reflected two sets of pressures operating on the Chinese government.

On the one hand it was aimed at deflecting US demands, especially from the Congress, that China revalue its currency or face retaliatory tariffs. On the other, the small size of the revaluation reflected concerns within Chinese financial circles that too rapid a movement could have adverse consequences for the banking system.

With the small increase having virtually no effect on the US trade deficit with China, the governor of the People's Bank of China, Zhu Xiaochuan, held out the prospect that the increase was an "initial adjustment".

The Chinese currency has been pegged to the greenback at 8.28 yuan for a dollar for more than a decade. Now it is set at a rate of 8.11 and will fluctuate against a basket of currencies, including the euro, rather than be set against the dollar alone. The new system is similar to Singapore's managed "basket, band and crawl" model in which currency floats within a set policy band.

The US and the European powers have been calling for a revaluation on the grounds that the low value of China's currency, on top of low-cost labour, gives it an unfair advantage in international trade. For their part, China and the other Asian exporters have sought to keep the value of their currencies low by buying up dollar-based assets, thereby financing the US balance of payments deficit now running at close to \$700 billion. China's foreign currency reserves reached \$711 billion in June, an increase of 51 percent on the year before.

The revaluation is expected to put on hold moves in the US Congress for the imposition of retaliatory tariffs. Last April, 67 senators passed a resolution, sponsored by Charles Schumer and Lindsey Graham, declaring that if China failed to revalue its currency within six months a 27.5 percent tariff would be imposed on all Chinese imports.

The resolution led to increased pressure on Chinese authorities from US Treasury Secretary John Snow who has been pressing for a revaluation for the past two years. At the G-7 finance ministers meeting in Washington last April Snow warned the Chinese that US patience was running out. In May,

Snow persuaded Congress not to brand China "a currency manipulator" but again warned Beijing to expect serious political consequences.

To placate the Congress, Snow organised a meeting between Schumer and Graham with Federal Reserve Board chairman Alan Greenspan. Greenspan has opposed protectionist measures on the grounds that this could upset global financial mechanisms and jeopardise the funding of US deficits. Schumer, however, accused the Bush administration's position on the yuan as having the "strength of a wet noodle".

According to reports in both the *Financial Times* and *Wall Street Journal*, Snow, who had indicated that a revaluation would come before Chinese President Hu Jintao's visit to the US in September, was told a week in advance of the new exchange rate regime. The *Financial Times* reported that he had assured Beijing that the US would warmly welcome the move and that there would be broad international support.

But whether the currency regime change is enough to placate protectionist moves in the Congress remains to be seen. So far the revaluation is well short of the currency shift of up to 40 percent being demanded by some of Beijing's critics and the 10 percent increase that former secretary of state Henry Kissinger has told Chinese authorities will be needed to stave off protectionist legislation.

Schumer said the Chinese action was a positive first step but he hoped for more. "We are going to watch and see what happens over the next few months," he said. The president of the National Association of Manufacturers, John Engler, who has headed the push for revaluation, said he hoped by October "to see that China's currency has moved significantly enough to begin correcting long-standing trade distortions."

Jia Qinggao, a US specialist in Peking University, told the *New York Times* that the revaluation of the yuan was part of Beijing's efforts for a calmer relationship with Washington. "My feeling is that the leadership would really like to take the politics out of the relations and return to a more pragmatic atmosphere. I don't expect that this one step will resolve the tension completely. But I think once the first step is taken, it will be easier to make currency adjustments later on," Jia said.

But even if such measures are taken, they will make little difference to the trade problems of the US. As the *Financial*

*Times* commented on July 25: “China mainly assembles imported parts and components manufactured elsewhere. The local value-added in its exports is as low as 15 percent. Any loss of competitiveness from a stronger exchange rate would be largely offset by cheaper imports. Even a 25 percent revaluation would raise prices of many Chinese exports by only about 4 percent.”

In other words revaluation, even by a significant amount will do little to shift the imbalances in the global economy, and remove the threat of a rapid loss of confidence in the US dollar. Significantly, the former chairman of the Federal Reserve Board, Paul Volcker, has repeated his warning of last February that “the circumstances seem to be as dangerous and intractable as any I can remember.”

“If people lose confidence in the dollar as a store of value, or lose confidence in the political strength of the US relative to other countries, there is going to be trouble. I’m not saying a crisis is inevitable or that orderly adjustment is impossible, but at some point big adjustments will have to be made,” he told the *New York Times*.

In a comment published in the *Financial Times* last Wednesday Nobel laureate economist Joseph Stiglitz pointed out that America’s trade deficit of \$700 billion is nine times China’s trade surplus and that “even larger revaluations are not likely to do much to the global imbalances.”

The major problem for US exporters is not the value of the Chinese currency but the lack of significant economic growth in major markets such as the EU and Japan. In Asia, the pervasive poverty has prevented any significant expansion of internal consumption. China, in particular, has very high savings rates of 40 percent of gross domestic product or 25 percent of household income.

Moreover, the competition from Asia comes from US and European firms, which have sought to counter falling profit rates by moving their operations to cheap-labour regions. In other words, the rise of China, and Asia as a whole, as a cheap labour platform, is not the cause, but rather the result, of deepening contradictions within the world capitalist economy.

Beijing has been walking on a fine line in dealing with US and European pressure on the yuan. The integration of China into the world capitalist market in the 1990s has produced huge unemployment, poverty and increased social tension.

Although China’s energy industries such as oil and electricity, which are increasingly depend on import or foreign loans, will benefit from a higher value of yuan, the engine of the economy—the export sector—could suffer.

The Shanghai-based *International Finance News* warned that large corporations may be able to absorb the 2 percent appreciation but small businesses, dependent on tiny profit margins, could face serious troubles. It is estimated that for each 1 percent rise in the yuan, each sub-sector of the textile industry will see its profits from exports reduced, including a drop of 12 percent in cotton sector, 8 percent in wool, and 13

percent in garments. Smaller segments of the garment industry that depend more highly on exports will face even higher losses.

“Uncompetitive small-and-medium-sized companies would then likely face bankruptcy, causing possible job losses for several hundred thousands workers. Since most of the employees in the textile industry come from low or medium income families, the loss of jobs could possibly trigger even greater social problems,” the Chinese paper noted.

Chinese analysts and economists have also warned that the pressure of foreign and domestic speculators could trigger a collapse of China’s real estate bubble. Since the US and other powers openly began advocating a yuan revaluation in 2003, tens of billions of dollars of “hot money” have flooded into China to buy yuan-based property.

In Shanghai, half of the property market is estimated to be inflated by speculative funds and in total, over 60 percent of capital in purchasing homes or new construction is lent from China’s debt-stricken banking system. More speculators are expected to move in to bet on a further appreciation of yuan.

Despite the so-called “cool-down” policy introduced last year, newly released official data shows that the investment bubble, especially in real estate, continues. China’s fixed asset investment rose 25.4 percent on a year-on-year basis to \$US353.7 billion during the first half of the year.

Financial authorities in China are now engaged in a delicate balancing act. While they want to give the impression that there is greater flexibility in the Chinese currency in order to fend off demands from the US for a rapid revaluation, they also want to maintain capital and currency controls in order to prevent violent shifts of investment funds and speculative capital. If there is an expectation that the value of the yuan will rise further, then “hot money” will continue to move in. However, Chinese authorities, having witnessed the consequences of the Asian financial crisis of 1997-98, are also fearful of the consequences of an outflow.

It is a measure of the fragility of the global financial system, in which no national government has control over vast market forces, that economic management has become a kind of guessing game.



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