China responds to US pressure on the yuan

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Amid mounting US pressure, the Chinese government announced a “reform” to its exchange rate regime last weekend. The shift allows greater market flexibility and ends the yuan’s de facto peg against the dollar, which has been in place since July 2008.

The move was aimed at heading off criticism of China prior to this weekend’s G20 summit in Canada, after US President Obama sent a letter to leaders last week that specifically targetted countries with large trade surpluses—such as China and Germany.

China ended the yuan’s 14-year peg against the dollar in 2005 after threats from the US, allowing it to gradually rise against the dollar by 21 percent. In mid-2008, however, as the global financial system plunged into turmoil, the Chinese central bank effectively re-pegged the yuan at around 6.82 to the dollar to maintain the competitiveness of Chinese exports. Since then Beijing has been under fire as “mercantilist” and “protectionist” from Washington, which is desperately seeking to increase exports in order to reduce the huge US trade deficit.

Tensions between the US and China escalated earlier this year after the Obama administration imposed a series of tough trade penalties on imports of Chinese steel pipes and other goods. Washington also provocatively approved a large arms sale to Taiwan, which China regards as part of its sovereign territory. Obama ignored Beijing’s protests and met with the exiled Tibetan Dalai Lama. The US not only regards China as an economic rival, but is seeking to contain its growing global strategic influence.

The Obama administration had threatened to formally name China as a “currency manipulator” in a report to Congress due in April, but pulled back at the last minute. It appears that an understanding was reached—Washington postponed the report in exchange for Beijing’s support for new sanctions against Iran in the UN Security Council. After the resolution passed earlier this month, the heat returned to the Chinese currency issue.

Former International Monetary Fund China economist Eswar Prasad told the *Financial Times* this week that Beijing’s decision to end the yuan peg was a tactic designed to steal Washington’s “thunder” at the G20 summit. “They have taken the issue right off the table for the G20 and can refocus attention on what they see as the real problem for global financial stability—rising government debt in the advanced economies, especially the US,” he said.

International reactions only underscore the sharpening tensions between the major powers amid the worsening global economic crisis. Obama described China’s currency decision as “a constructive step” but US Treasury Secretary Tim Geithner warned that “the test will be how far and how fast they let the currency appreciate”.

The European Central Bank and the European finance ministers welcomed the announcement, but a German finance ministry spokesman warned: “We want to wait and see to what extent and in what time span the currency valuation will be adjusted.” In recent months, the yuan has fallen as much as 15 percent against the euro, compounding the problems facing European exports. In a small concession to the European powers, China will from now on link the yuan to a basket of currencies—including the euro—not just the US dollar.

Japan’s Finance Minister Yoshihiko Noda hailed the currency decision as “a plus for the Chinese and Asian economies as well as the world economy”. Tokyo has been under pressure from Washington to take a stance against China on the currency issue, which Japan has been reluctant to do. China is now Japan’s largest market for capital goods and components, which are largely used for products that are then exported, particularly to the US and Europe.

As major governments were cautiously welcoming Beijing’s decision, the Chinese central bank issued a follow-up statement on Sunday stressing that a drastic appreciation of yuan was “not in China’s interests” and that the exchange rate would remain “basically stable”.

The statement immediately drew criticism from a group of Republicans and Democrats in the US Congress, headed by Senator Charles Schumer, who are campaigning for legislation to restrict Chinese imports. “Just a day after there was much

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hoopla about the Chinese finally changing their policy, they are already backing off," Schumer declared. "It vindicates our initial skepticism. We intend to move forward as quickly as possible with legislation."

To ward off US criticism, Beijing allowed the yuan to appreciate against the US dollar by 0.4 percent on Monday—the largest shift in five years. Global share markets reacted positively, with the Euro Stoxx 50 index up 1.1 percent, the Dow Jones industrial average rising 0.6 percent and Japan's Nikkei 225 up 2.4 percent. The share market reaction was not just to the yuan's appreciation, but to the prospect of an easing in US-China tensions, in the short term at least.

However, the underlying economic problems in China and internationally remain. To maintain a stable exchange rate, the Chinese central bank had been intervening daily into foreign exchange markets to buy foreign currencies, especially the dollar. China has accumulated huge foreign currency reserves of $2.4 trillion, which, in turn, it has invested primarily in US government bonds. Earlier this year, the *Wall Street Journal* expressed concerns that an appreciation of yuan would reduce China's purchase of US assets and lead to the drying up of cheap credit for the US government.

Despite pressure from Washington for China to reduce its dependence on exports and capital investment, Beijing has been unable to significantly boost domestic consumption, other than through its huge stimulus package. The stimulus spending has compounded Beijing's economic problems, by creating a massive speculative property bubble and potentially huge levels of bad debt for the government and state banks.

The *Washington Post* last week drew attention to the anarchic infrastructure and real estate developments being carried out by China's local governments and their investment companies, which are now sitting on a potential "debt bomb" of 7-11 trillion yuan ($US1-1.6 trillion). The newspaper quoted economist Xu Xiaonian, who compared the speculative property bubbles in Chinese cities to the one that burst in the Gulf emirate Dubai last year. "There's tens, or hundreds, of Dubais waiting in the pipeline," he declared.

The Chinese government is facing two interconnected problems over exchange rates. The first is that the anticipation of the yuan's appreciation against the dollar will lead a greater inflow of speculative capital, which will go mainly into the already inflated real estate market. In announcing its decision last weekend, the Chinese central bank carefully used the word "flexibility," thus allowing for a possible depreciation against the dollar to dampen the expectations of speculators.

The second and more fundamental problem is that a rapid appreciation of the yuan will compound the crisis of China's export industries, which are already operating on small profit margins. This takes places amid growing demands and strikes by Chinese workers for higher wages.

In "pressure tests" conducted earlier this year, the Chinese government estimated that a revaluation of 3 percent would result in a fall of 30-50 percent in profits for home appliances, auto and mobile phone manufacturers. Light industries are even more vulnerable, with a 1 percent yuan appreciation having the same impact on textile industry profits. The chinaware industry would be unviable if the yuan rose by even 1 percent. It is estimated that 25 million textile jobs could be threatened by a small yuan appreciation.

Given the potentially explosive social consequences of falling exports, sections of the Chinese ruling elite are pushing for a hard-line stance against US demands. An editorial in the *Global Times* on June 12 called to stop persuading US politicians to abandon their protectionism, arguing that China must instead identify possible retaliatory measures and discuss them publicly. "Such discussion is not just a show for the Americans, but to make the Chinese public aware that an actual trade war with the US can break out. We will perhaps suffer some losses, but must inflict greater damage on the US, and teach a real lesson to the American protectionists and their supporters," the article declared.

The rise of belligerent protectionism in both China and the US underscores the depth of the global economic crisis and the real dangers of trade war as each power seeks to offload its own economic woes onto its rivals. While the frictions between the major powers might not erupt into the open at this weekend's G20 summit, they will certainly produce some tense exchanges behind closed doors.

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