

The China Currency Problem:

A Reply to Albert Keidel

Abstract

In a recent policy brief Albert Keidel (2005) argues that China's exchange rate is not a problem, and that focusing on China's currency is a risky distraction for U.S. economic policy. This paper replies to Keidel, and diametrically disagrees with his analysis. The paper has four principal conclusions which are: 1) China's exchange rate is under-valued and is a significant problem; 2) The China exchange rate problem is part of a broader East Asian (and even global) exchange rate problem; 3) China needs to improve its performance regarding WTO compliance; and 4) Chinese manufacturing must shift from export-led growth to domestic demand-led growth. China's 2.1 percent currency revaluation in July 2005 has changed none of these conclusions.

Keywords: Undervalued exchange rate, export-led growth, domestic demand-led growth.

JEL ref.: F4

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June 2005

Comments given at a symposium titled "China's Currency: Not the Problem" held at the Carnegie Endowment for International Peace, 1779 Massachusetts Avenue NW, Washington DC 20036 on June 24, 2005.

Preface

This paper was presented as part of a symposium titled “China’s Currency: Not the Problem” held at the Carnegie Endowment for International Peace, Washington DC on June 24, 2005. On July 21, 2005, China revalued its currency by 2.1 percent. This small revaluation does not resolve the currency under-valuation problem, and China’s currency remains significantly under-valued. All of the conclusions of the paper remain intact.

Summary

In a recent policy brief Albert Keidel (2005) argues that China’s exchange rate is not a problem, and that focusing on China’s currency is a risky distraction for U.S. economic policy. Instead, Keidel argues that the real problem behind the U.S.-China trade deficit is inadequate productivity of American workers. This paper replies to Keidel, and diametrically disagrees with his analysis.

With regard to the U.S.-China trade deficit and exchange rate question, the paper has four principal conclusions:

- 1) China’s exchange rate is under-valued and is a significant problem for the United States.
- 2) China’s exchange rate problem is part of a broader East Asian (and even global) exchange rate problem.
- 3) China needs to improve its performance regarding WTO compliance.
- 4) Chinese manufacturing must shift from export-led to domestic demand-led growth.

Some facts about the U.S. trade deficit

The U.S. goods trade deficit was \$651.5 billion in 2004, and it is up 20.7 percent in the first four months of 2005. If the deficit continues growing at this rate for the rest of the year it will be \$786.4 billion in 2005, which is approximately 6.5 percent of gross domestic product (GDP). As shown in Table 1, the U.S. has large trade deficits with

every major region, and the deficit with China is the largest with any country or any other region. It is also the fastest growing among major country trading partners. Finally, as shown in Table 2, the China trade relationship is also the most unbalanced major manufacturing trading relationship as measured by the ratio of imports to exports. For every dollar of exports that the U.S. exported to China in 2004, it imported 5.67 dollars of imports from China.

The macroeconomics of reducing trade deficits

It is widely agreed that the magnitude of the overall U.S. trade deficit constitutes a significant macroeconomic problem. Consideration of the factors driving imports and exports suggests that there are only three ways to reduce a trade deficit. These are:

- (1) Domestic recession;
- (2) Increased growth in the rest of the world, and.
- (3) Exchange rate depreciation.

The first way to reduce the trade deficit is to have a domestic recession, perhaps induced by a surge in domestic national saving. This would lower national income and reduce imports. The second way is to increase world economic growth, which would raise foreign incomes and foreign demand for U.S. exports. The third way is to depreciate the exchange rate. This makes exports cheaper to foreigners, increasing demand for exports. It also makes imports more expensive to Americans, thereby reducing U.S. import demand.

Since recessions are clearly undesirable, this would suggest avoiding policy option one. Conversely, increased global growth is desirable. However, jump-starting global growth is a difficult task requiring globally based policy coordination. It will also

require the adoption of global Keynesian prescriptions, something that most policy makers are still unwilling to try. This points to the difficulty of this option, and the U.S. would be unwise to leave its national economic interest dependent on an acceleration of global growth. This leaves exchange rate depreciation as the only sure mechanism for reducing the U.S. trade deficit. As China now accounts for 25 percent of the U.S. goods trade deficit, the renminbi-dollar exchange rate will clearly need to be included in the adjustment process if it is to be globally balanced.

It is important to recognize that calling for Chinese exchange rate adjustment does not mean that only China needs to adjust. Other East Asian countries will also need to revalue their exchange rates for two reasons. First, as shown in table one, they too have large trade surpluses with the United States. Second, if they do not revalue this will undermine the impact of a Chinese revaluation since import production will likely just shift from China to other parts of East Asia, thereby lessening the improvement in the overall U.S. trade deficit.

This latter consideration points to the need for a coordinated revaluation of East Asian exchange rates relative to the dollar via an “East Asian Plaza Accord” modeled after the Plaza exchange rate accord of 1985. Absent such coordination, individual East Asian countries are likely to resist revaluation out of fear that only they will revalue and other countries won't go along. Each fears that if it alone revalues, it will lose international competitiveness without providing meaningful benefit to the U.S. global account, which is the rationale for revaluation. Additionally, a coordinated East Asian Plaza Accord can provide an avenue for China to save political face over the exchange rate question and avoid looking as if it has capitulated to U.S. pressure. This is an

important consideration for Chinese policymakers. Lastly, just as East Asian currencies will need to revalue, so too the euro and Canadian dollar may also need further upward appreciation to correct the trade imbalance with these regions.

China's global trade surplus

A key element of Keidel's argument is that China's global trade surplus is modest and that a country's global surplus is the best indicator of whether a currency is over- or undervalued. However, there are two weaknesses with this argument. First, there are significant measurement problems regarding China's reported global trade surplus. Second, China's reported global surplus masks major regional imbalances that require exchange rate adjustment to correct them.

With regard to the measurement problem, China repeatedly appears to understate its trade surplus. In 2004 the U.S. reported a goods trade deficit with China of \$162 billion, yet the Chinese reported a surplus of just \$80.2 billion. Table 3 reports the results of an analysis done by the Fair Currency Alliance, which aggregated the bilateral trade deficits and surpluses of China's top forty-three trading partners and compared the outcome based on China's reported numbers with those reported by the forty-three trading partners. Based on this exercise, China's global surplus appears to be roughly four times larger than reported by the Chinese government.

When it comes to reconciling the official Chinese and U.S. trade numbers, one claim that is often made is that the difference is due to (i) the omission of trade with Hong Kong in the U.S. numbers, and (ii) failure to adjust the U.S. numbers for costs of freight & insurance.¹ However, this claim does not stand up to investigation. In 2004

¹ Imports are reported on a c.i.f. basis, that is inclusive of costs of freight and insurance. However, exports are reported on a f.o.b. basis, that is free on board.

China reported a trade surplus with the U.S. of \$80.2 billion. The U.S. reported a trade deficit with China of \$162.0 billion. If the reported U.S. trade surplus with Hong Kong is added to the China deficit, the trade deficit falls to \$155.5 billion. If the value of imports is then reduced by fifteen percent to take account of freight and insurance costs, the adjusted combined China – Hong Kong deficit falls to \$124.6 billion, which still far exceeds the reported Chinese number by 75 percent.

With regard to the question of whether global or bilateral surpluses are the appropriate indicator of an under-valued exchange rate, it should be recognized that global surplus numbers can mask serious regional problems that call for exchange rate adjustment. In the case of China, it reported a global surplus in 2004 of \$31.9 billion. This surplus consisted of an \$80.2 billion surplus with the U.S., and a \$48.3 billion deficit with the rest of the world (ROW). This in turn points to the need for China to revalue versus the U.S. dollar while, perhaps depreciating against other currencies (especially those of other East Asian economies).² A decomposition of China's global surplus therefore implicitly reconfirms the need for an East Asian Plaza Accord. The unambiguous conclusion is that China should revalue versus the dollar. This conclusion holds using both U.S. data and questionable Chinese data.

Other spurious arguments against a Chinese revaluation

In addition to the above arguments, several other spurious arguments are frequently invoked to dismiss the claim that China's undervalued exchange rate is a problem. One argument is that China's intellectual property rights violation and non-compliance with WTO rules is the real problem. While it is absolutely true that such

² Over the last three years China has enjoyed a considerable depreciation against the euro and other European countries. These currencies have risen against the dollar, to which the renminbi is pegged.

behavior is a problem, so too is the exchange rate. Rather than dismissing the exchange rate problem, the appropriate stance is to require that China do right with regard to both the WTO and the exchange rate.

A second argument is that American productivity failure is responsible for the China trade deficit. Higher productivity, achieved under decent work conditions, is always desirable. However, the notion that low American productivity is responsible for the U.S.-China trade deficit makes no sense. American productivity already ranks among the highest in the world, has been growing rapidly over the last several years, and far exceeds that of China. The real problem is that this productivity difference is swamped by a combination of Chinese wage suppression and an undervalued exchange rate. Focusing on the productivity of American workers is therefore a red herring. Even worse, it implicitly blames American workers for the trade deficit.

A third argument is that China's exchange rate is not undervalued because its real exchange rate has not depreciated significantly since 1998, at which time it was acceptable. This argument is wrong. Whereas it is true that the real exchange rate (i.e. adjusted for relative country rates of inflation) has not fallen much, it is not just relative inflation rates that matter for determining the appropriate exchange rate. It is also necessary to take account of the "size" and "productivity" of China's tradable goods sector, both of which have increased dramatically over the last seven years owing to massive inflows of foreign direct investment (FDI). This has increased China's export capacity, calling for a corresponding upward adjustment of the exchange rate.

A fourth spurious argument is that a floating exchange rate would depreciate China's currency relative to the dollar owing to currency flight out of China. Like the

productivity argument, this argument is a red herring. It is true that were China to float its currency and abolish capital controls there would likely be massive capital flight out of China by Chinese residents owing to a desire to diversify wealth holdings and to escape the risks associated with China's banking and political systems. However, such an argument is a diversion since no one is calling for China to float its currency now. Instead, the call is for China to revalue its currency peg now, and perhaps also switch from an exclusive dollar peg to a broader currency basket peg. Floating of the Chinese currency should be a long-term policy goal that may take years to achieve, and is contingent upon the development of a sound Chinese financial system with secure property rights.

A fifth and final spurious argument against Chinese currency revaluation is that China's foreign reserve accumulation says nothing about the need for an exchange rate revaluation. The accumulation of reserves by China's central bank is the result of China being forced to defend its currency against market-driven appreciation. Financial markets are therefore putting upward pressure on the renminbi. There are multiple causes of this upward pressure, including the trade surplus, FDI inflows, and speculative "hot money" inflows driven by the prospect of a possible revaluation. The fact that some of this reserve accumulation is driven by speculation does not mean that revaluation is unwarranted. Instead, there are good reasons based on "economic fundamentals" for a revaluation, and financial speculators are rationally acting upon this.

Time to change China's development model

China's exchange rate is a significant problem that needs to be addressed. In addition there is a serious problem regarding China's current model for developing its

manufacturing sector, which contributes to international trading imbalances. Chinese manufacturing relies on export-led growth --- which is a collection of policies including an under-valued exchange rate, wage suppression, industrial subsidies, closed distribution systems, government procurement restrictions, FDI performance requirements, and strategic restriction of imports to raw materials, inputs and capital goods. China has now become a manufacturing global powerhouse, and its continued reliance on export-led manufacturing growth has become incompatible with an open and balanced international trading system. Such a policy generates massive trade surpluses, creates deflationary conditions in the rest of the world, and generates artificial deindustrialization in other industrialized countries that play by the rules. It also undermines industrial development in other developing countries. Given China's emergence as a global manufacturing power, Chinese manufacturing must shift to domestic demand-led growth if the current international trading system is to be sustainable.³

Epilogue: U.S. Policy Failure

The bottom line is that China's economy has now reached such size that its undervalued exchange rate and export-led manufacturing development policy are serious problems for the current open, multilateral, international trading system. However, China has benefited from these policies and may even still benefit, albeit now in a zero-or even negative sum global context. Consequently, Chinese policymakers are resistant to change, and international pressure will need to be brought to bear if China is to change.

The world consists of nation states, and China is pursuing its national interest. On the U.S. side there has been a major failure of U.S. international economic policy with

³ I have examined the issue of export-led growth and contrasted it with a domestic demand-led growth paradigm in a number of papers. See Palley (2006, 2003, 2002).

the U.S. trading short-term consumption gains at the expense of its manufacturing base and the accumulation of large international debts.

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Table 1. Regional composition of the goods trade deficit:

	2004 Goods Trade Balance (\$ billions)	Jan.-Apr. 2004 Goods Trade Balance (\$ billions)	Percent share	Jan.-Apr. 2005 Goods Trade Balance (\$ billions)	Percent share	Percent Change Jan.-Apr. 2004 v. 2005
Total (census basis – not seasonally adjusted)	- \$651.5	- \$186.7	100.0%	- \$225.3	100.0%	20.7%
North America	- 110.8	- 35.2	18.9	- 37.7	16.7	7.1
Canada	- 65.8	- 21.3	11.4	- 22.5	10.0	5.6
Mexico	- 45.1	- 13.9	7.4	- 15.2	6.7	9.3
Western Europe	-114.1	- 38.2	20.5	- 42.3	18.8	7.3
Euro area	- 82.9	- 24.9	13.3	- 26.5	11.8	6.4
Pacific Rim	-282.5	- 78.1	41.8	- 97.1	43.1	24.3
Japan	- 75.2	- 24.4	13.1	- 28.1	12.5	15.2
China	-162.0	- 42.2	22.6	- 56.7	25.2	34.4
OPEC	- 71.9	- 20.4	10.9	- 26.0	11.5	27.5
Rest of the World	- 72.2	- 14.8	7.9	- 22.2	9.9	50.0

Source: United States Department of Commerce and author's calculations.

Table 2. U.S. Import/Export ratios

Country	2001	2002	2003	2004
China	5.32	5.66	5.36	5.67
Canada	1.33	1.30	1.32	1.35
Mexico	1.29	1.38	1.42	1.41
EU-15	1.38	1.57	1.63	1.62
Japan	2.20	2.20	2.27	2.38

Source: Commerce Department and author's calculations.

Table 3. Alternative measures of China's Trade Surplus.

	1999	2000	2001	2002	2003
<u>China's trade surplus with the U.S.:</u>					
- Chinese data (\$ billions)	23.5	30.9	29.4	44.1	60.3
- U.S. data (\$ billions)	68.9	84.2	84.1	104.2	124.9
<u>China's global trade surplus:</u>					
- Chinese data (\$ billions)	37.7	35.4	35.3	45.1	
- 43 partner data (\$ billions)	140.4	171.6	170.3	189.9	

Source: Fair Currency Alliance.