4. China's Currency Dilemma and How to Resolve It

CHINA'S CURRENCY VALUATION elicits growing criticism and resentment among some policymakers in the United States and also generates controversy and confusion among policymakers in China. But there is a way of resolving the dilemma—standing pat versus revaluing—that would be sensible and beneficial all around.

That the partly convertible Chinese yuan (equivalently know as the renminbi—literally "people's currency") is now and has been tightly pegged to a fully convertible U.S. dollar is itself an anomalous situation. "Partial convertibility" means that, whereas holders of liquid yuan assets can use them to purchase current imports of goods and services from abroad, they cannot normally use yuan to purchase foreign stocks, bonds or for direct investment abroad.

From the point of view of American critics of China's currency peg, the fact that the U.S. bilateral trade deficit with China in 2004 was $160 billion, whereas two-way trade between China and the United States was nearly $220 billion (China's imports

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from the United States were less than $30 billion) suggests that the yuan is *under*valued, that the tight peg of 8.28 per yuan per U.S. dollar indicates that Chinese policymakers are manipulating the yuan's value to the detriment of U.S. exports, and that the yuan should be revalued or the dollar peg removed.

China's trading partners in Asia and Europe are no less critical of the yuan's dollar peg, although they are less vociferous than the U.S. critics, preferring to let the United States do the heavy lifting on this matter. Because the dollar's value has declined relative to the euro and the yen in global exchange markets, other countries whose currencies' values float criticize China's dollar peg because it effectively *depreciates* the yuan relative to nondollar currencies. As a consequence, the exports of those countries are less competitive with China's exports than they otherwise would be, whereas China's exports to those countries are boosted.

On the other hand, from China's point of view, criticism by other countries of the yuan's dollar peg doesn't allay worries among Chinese policymakers about altering the yuan's value. Their fear is that any appreciable change in the dollar peg might lead to still greater difficulties and more heated criticism than does the present policy. For example, if the peg were lowered by, say, 15 percent, to 7 yuan per dollar, China's bilateral trade surpluses with the United States would probably not change much nor would its global trade surpluses be much affected. Underutilized production capacity in China's booming export sector is so large that production would continue even if profit margins were narrowed. Moreover, a lowered peg would likely increase China's imports of oil and metal ores, adding further demand pressures to those already-inflated markets and generating additional criticism of China by other consumers. Chinese policymakers also fear that, were the peg to be changed, the effect would be to attract "hot" money into China in anticipation of further adjustments in the future, thereby contributing to inflation and overheating of the Chinese economy.

Finally, and probably most significant, if China were to allow the yuan's exchange value to float while maintaining its blocked capital account, pressure to make the yuan fully convertible could grow. In each of the past two years China has allowed about \$4–5 billion of capital export transactions, for the purpose of acquiring particular foreign assets favored by China's policymakers—such as oil refineries and high-tech industry (for example, the Lenovo acquisition of IBM's PC business). These transactions, however, are only a drop in the bucket. Behind them loom liquid deposits in the major Chinese banks of more than 21 trillion yuan, or more than 180 percent of China's GDP. The holders of these huge yuan assets include business enterprises, urban and rural households, agricultural deposit holders, and other entities. If as much as 10 percent of these holders of yuan assets were to seek to diversify their portfolios by acquiring foreign assets, the yuan might as likely depreciate as appreciate relative to the U.S. dollar!

Resolution of China's currency dilemma lies in synchronizing two policy changes: (1) a further unblocking of China's capital account and (2) a broader float of the yuan on foreign exchange markets. China's current account surpluses would continue to generate a large supply of foreign currencies; substantially unblocking the capital account and allowing convertibility of between 5 and 10 percent of liquid bank deposits would generate additional demand for them. China's huge foreign exchange reserves (\$660 billion) would provide an adequate cushion for any short-term volatility that might ensue.

By allowing a partial and gradually rising proportion of liquid yuan assets to be freely convertible into dollar, euro, and yen assets, China's policymakers would contribute measurably to improved efficiency in the allocation of the Chinese economy's large capital resources and at the same time contributing to more effective functioning of the global economy and neutralizing the foreign critics of China's currency policies.

POSTAUDIT

The analysis and policy perspective remain valid, notwithstanding that China has devalued the yuan by a cumulative 5 percent, with its peg to the dollar allowed to fluctuate around a narrow 1–2 percent band.