5. More about the Chinese Currency

IN THE DEBATE OVER China's exchange rate policy, overwhelming if not exclusive attention has been devoted to one argument that is erroneous, whereas a second argument that is valid has been virtually neglected.

The erroneous argument is that China's failure to revalue its undervalued currency, the yuan—also known as the renminbi (RMB), literally "the people's currency"—is responsible for substantial loss of U.S. jobs, especially in manufacturing.

The error of this argument lies in the fact that the loss of American jobs over the past few years—about 700,000 through the first three quarters of 2003—is directly attributable to something that is paradoxically part of the innovative character of the American economy and has hardly anything to do with China or any other of America's major trading partners. This "something" is the growth of U.S. labor productivity at an annual rate of about 4 percent. Productivity growth at this high rate means that, as a result of better equipment, training, and management, the level

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of employed labor that produced last year's gross domestic product could produce 4 percent more this year. In fact, the rate of growth of the U.S. economy in the past year has been about 3 to 3.5 percent, which means that employment has decreased by about 0.5 percent—namely, the 700,000 jobs referred to above.

So China's currency value really has nothing to do with the explanation of the so-called job-loss recovery of the U.S. economy.

The valid, but neglected, argument about China's currency is that China's failure to move from partial convertibility of the yuan (confined to conversion for current trade in goods and services) to full convertibility (including international capital transactions) is responsible for misallocation of China's own capital resources as well as the inability of China's policymakers, no less than of their critics, to estimate the yuan's "true" exchange value.

The yuan's "worth" in terms of the market basket of goods and services it can buy—what economists refer to as its "purchasing power parity"—is at least 40 percent greater than the 12 U.S. cents that is the nominal exchange value of one Chinese yuan (i.e., 8.3 yuan per U.S. dollar). Of course, the relevant market basket referred to here includes many categories of goods and services that are not internationally tradable—such as domestic personal services, real property, construction, and so on—and hence do not affect international transactions and payments or the nominal exchange value of the yuan.

However, capital transactions definitely do affect, often decisively, nominal exchange rates. For example, if holders of dollar or yen assets wish to invest in China, they can use those assets to buy yuan, thereby tending to prop up the exchange value of the yuan. On the other hand, if holders of yuan assets wish to acquire dollar or yen assets—for example, equities, bonds, property—they are unable to do so because the yuan is not convertible for such capital transactions. China allows, indeed encourages, foreign capital to flow in but prevents ordinary domestic Chinese capital from flowing out.

The principal exception to this impedance has been the use by China's Central Bank of the economy's surpluses on its current account transactions to purchase U.S. treasury bonds, thereby adding to China's official foreign exchange reserves. In the past four years China's reserves have grown from $168 billion in 2000 to $357 billion in 2003.

Thus if the individuals, households, and companies in China that hold trillions of yuan in bank deposits or other repositories wanted to diversify their holdings, hedge their risks of yuan holdings, or simply seek higher returns by acquiring dollars, euros, or yen assets, they are blocked from doing so because of the yuan's inconvertibility for normal capital transactions.

It is impossible to determine the extent to which holders of yuan would want to buy foreign assets that they are precluded from doing now. Some rough guesses, however, can be made. For example, China's aggregate savings rate of 30–35 percent annually—the highest of any of the major national economies in the world—means that its annual savings amount to about 3.5 trillion yuan, about $420 billion, an accumulation over the past four years of about 1.6 trillion yuan in bank deposits in China since 2000. If as little as, say, 2 percent of these holdings—a figure approximately equal to the percent of annual savings in Japan that is devoted to acquiring foreign equities, bonds, and other foreign assets—it would not be implausible to expect that purchases of foreign assets by Chinese holders of yuan deposits could be in the neighborhood of $32 billion, were the yuan to become convertible on capital account.

The outflow of capital from China that would be triggered by full convertibility of the yuan could thus exceed China's diminished current account surplus with the rest of the world. As a result, the yuan might not implausibly *depreciate*—that is, become less expensive relative to the dollar or euro—as it would be to appreciate. In any event, the real foreign exchange value of the yuan can only be determined *after* it becomes fully convertible, not just partially so as it is at the present time.

POSTAUDIT

With the passage of time, the numbers have changed (e.g., China's foreign exchange reserves and current account surpluses have grown enormously), but the core analysis and policy prescription remain essentially valid.