

Currency Concerns Are Misplaced

An RMB appreciation may not have its intended effect

By *Patrick Chovanec*

There is no question that China needs to move towards a more market-based exchange rate for the RMB. For starters, it benefits China's trading partners by removing one factor that aggravates their competitive disadvantage. More importantly, it would benefit China allowing the country's citizens to finally realize the buying power and quality of life they've rightfully earned over the past 30 years. Additionally, it eases the economic burden imposed by the ceaseless accumulation of foreign exchange reserves—far beyond what China needs or can invest profitably.

The real question is whether the US should make twisting China's arm on currency its sole policy objective, to the exclusion and detriment of all other concerns—or how much an appreciation will help the US at all. While a more flexible exchange rate—and the stronger RMB that would likely result—would be a step in the right direction, it's not a silver bullet. Also, it would have little effect in the absence of more substantive economic reforms. The narrow focus on currency is a huge distraction from far more pressing issues.

For some time now, China has sold more than it buys from the US, and brings in more capital than it invests abroad. That means unused dollars are piling up in China, and normally when the supply of something outstrips demand, its price should drop. These fundamentals dictate that the dollar should depreciate (making US goods more attractive to Chinese consumers) while the RMB strengthens (making Chinese goods more expensive in America), eventually closing the gap in trade.

Instead, the Chinese government steps in and buys dollars at the current exchange rate and stockpiles them as official reserves. If only the Chinese would stop



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interfering, critics argue, and allow both currencies to find their true level. Doing so would allow American products to become more competitive and the trade imbalance to correct itself.

Sounds good, but the problem is we've been here before. In the early 1980s, Japan was running a chronic trade surplus with the US and accumulating dollar reserves on a massive scale. Economists argued an undervalued Japanese yen was to blame. So in September 1985, the central banks

of the US, Japan, Britain, France and West Germany agreed on what became known as the Plaza Accord. Over the course of the next two years, they intervened heavily in global currency markets to bring the value of the dollar down by over 50 percent against the yen, moving from 250 to 125 yen to the dollar.

The outcome baffled and frustrated economists. While the cheaper dollar had a significant effect in reducing America's trade deficit with Europe, Japan's trade

surplus with the US hardly budged. In fact, it grew. How could this be? Why didn't the new exchange rate make US goods more competitive and erase the trade imbalance with Japan?

The reason was structural. The post-war Japanese economy had been based on export-led growth. Its financial system, supply chains and distribution channels were all geared to push exports. The cheap yen was one pillar supporting this structure, but when that changed, other factors swung into effect to maintain the status quo.

Following the Plaza Accord, the Japanese banking system flooded the economy with cheap credit to fuel continued expansion and brushed bad debts under the rug. On the equity side, Japan's incestuous system of corporate crossholdings within industry groups created an environment where managers cared more about preserving market share and output than maximizing profits. The country's domestic distribution system, virtually impenetrable to outsiders, created a formidable barrier to imports, regardless of price.

Exchange rates are prices, but they

only matter so long as prices matter. We normally assume that prices do matter, but soft budget constraints and subsidies embedded in the structure of an economy can blunt or entirely negate the impact prices should have. That's what happened in Japan.

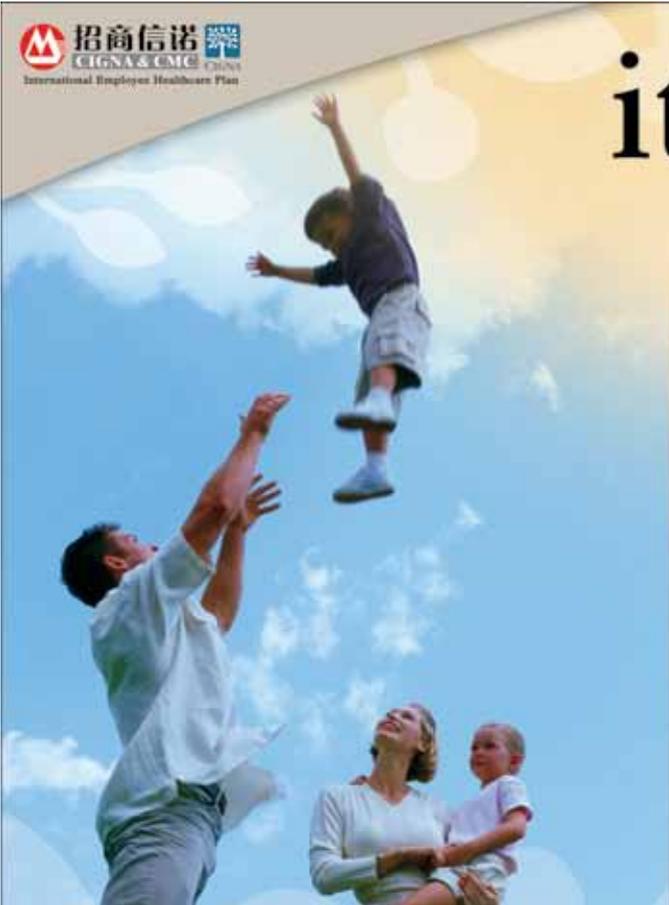
China, too, has relied on an export-led model to fuel its stupendous growth in the past 30 years. With the collapse in overseas demand caused by the global financial crisis, much talk has been devoted to the need to foster domestic consumption as an engine of growth. But China's actual response to the crisis has been to rely on an explosion of cheap lending and state subsidies to freeze the existing economic structure in place, in the interests of social stability. Foreign companies are increasingly worried they will be locked out of China's most promising markets, in favor of state-owned firms that often put other goals ahead of profits.

If the US were to successfully strong-arm China into strengthening the RMB against its will, the result could be a replay of the Plaza Accords. Like Japan, China would find other ways—cheap credit, soft budgets, subsidized inputs—to insulate its

export sector from market forces, in reaction to what it would see as a hostile assault. The result would be lose-lose. The US would not get the trade correction it was looking for, and China would adopt policies that end up harming its own economy.

America's interests, and the world's, would be much better served by encouraging China to open its markets to greater competition, foster capital markets that allocate resources more efficiently and develop a social safety net that makes labor markets more flexible and unlocks the savings of China's vast population. America can also send a clear signal that it welcomes Chinese investment, offering China a more productive way to use the dollars it does earn. If progress is made on these fronts, it will help create an environment in which prices do matter, and a more market-based currency can make a difference in producing lasting outcomes. 

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