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**WHY CHINA SHOULD NOT CAVE IN TO U.S. PRESSURE: SOME
COMMON SENSE THINKING**

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ABSTRACT

WHY CHINA SHOULD NOT CAVE IN TO U.S. PRESSURE: SOME COMMON SENSE THINKING

Drawing from Japan's experience, this paper argues that a cave-in to bashing can lead to a destructive dynamic whereby bashing causes cave-in (appreciation), unresolved trade surplus, which sets up expectations of further bashing and more cave-ins—as long the surplus remains unresolved. Bashing is a political weapon that changes the economic environment and a problem in itself. Thus China must not cave in to U.S. bashing. The paper argues that China's exports reflect productivity increases and the financial stability delivered by its fixed exchange rate system; that buying/selling foreign exchange to maintain fixed rates is not currency manipulation—otherwise almost all countries would be currency manipulators because most have managed floats; that a free float would not be right for China; and that appreciation alone will not solve the surplus “problem” but China would likely deflate. The paper argues that the trade frictions likely reflect U.S. special interests in the export and import-competing sectors, which have lost out to Chinese competition; by agitating for appreciation, the special interests will increase costs/lower living standards for millions of U.S. consumers and throw millions of poor Chinese laborers out of work. The paper recommends that China assesses its exchange regime based solely on its economy's own needs; that it must ensure that any policy revision is not viewed as a cave-in to bashing, which would be interpreted as a loss of control of its economic destiny. The U.S. must rein in the special interests; and reform its broken Social Security/Medicare and tax system to encourage rather than discourage saving.

KEYWORDS: Yuan, Exchange Rates, Bashing, China

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WHY CHINA SHOULD NOT CAVE IN TO U.S. PRESSURE: SOME COMMON SENSE THINKING

Recently, the U.S. postponed its expected condemnation of China as a currency manipulator—for selling cheap stuff to U.S. consumers at fixed exchange rates. The U.S. promises trade sanctions—possibly setting off a trade war—if it finds China “guilty.”

JAPAN BASHING

This is not the first time the U.S. has raised hell about “unfair” exchange rates. Remember “Japan Bashing” from the 1970’s on? Then Japan was out-competing the U.S. in steel, autos, and high tech stuff like televisions, and had the biggest bilateral trade surplus. The U.S. alleged unfair trade; that the surplus meant an undervalued yen. To unwind the surplus, the yen must rise! Trade tensions escalated; Japan occasionally acquiesced; and the yen appreciated. But the pressure never quite stopped! The yen appreciated and appreciated; by 23 percent in 1971-73 and 37 percent in 1977-78. But the “problem” remained. Then the dollar began appreciating in the early 1980s! The yen rose 49 percent in 1985-87 to offset that and more. The “problem” remained. It rose 36 percent in 1993-95 to a low of 80. The “problem” remained. Japan still had the largest bilateral surplus—but the bashing stopped. By 1995, the Japanese economy was on its knees, trapped in its lost decade.

Did the ever appreciating yen contribute to the collapse of the Japanese economy? There is yet no consensus, but Stanford economist Ronald McKinnon ties what he calls the “syndrome of the ever rising yen” to Japan’s deflation trap of the 1990s. Whatever the final consensus, common sense dictates a critical eye must be cast upon a solution that *never solves the original problem!* That is because an intractable surplus can create a destructive dynamic. Think of it as follows: Suppose appreciation resolves the surplus. We get an equilibrium chain of events—bashing, appreciation, surplus resolved, end of story. Now, suppose the surplus never gets resolved. Then an unstable dynamic is unleashed, whereby bashing leads to a cave-in (appreciation), unresolved surplus, which then sets up expectations of further bashing and more cave-ins (appreciations)—as long as the “problem” never gets solved! Then the pressure on the targeted currency never quite stops. *And bashing becomes a political weapon that changes the economic environment and is a problem in itself.* Let’s examine the case of China.

SOME HISTORY—THE WHEN, HOW, AND WHY OF CHINA-BASHING

In 1994, China fixed its yuan at 8.68 per dollar to stabilize its inflation rate; before, its inflation was high, volatile, and had spiked to 20 percent annually. The policy worked. By 1996, inflation had fallen to track U.S. inflation. During the 1997-98 Asian crisis, China famously held firm to the policy despite great pressure to devalue. The move gave China policy credibility and financial stability after the crisis. The yuan’s value was certain and

producers could focus on what were important—improving productivity, quality, and cutting costs. The country exploited its advantage in abundant, industrious labor, and become competitive in light, consumer, manufactures. All was well, transparent—the yuan’s value, labor intensive manufactures, while the advanced economies specialize in capital intensive production--standard economic theory.

WHAT’S NOT TO LIKE?

A curious observer might ask: So, what’s not to like? Hordes of rural Chinese labor flooding into world markets to rise out of unrelenting poverty. Hordes of U.S. working families flooding discount stores to gobble up cheap consumer goods that raise living standards. What’s not to like? Enter U.S. special interests! U.S. mercantilists and their political, academic, and media allies point angrily to China’s surpluses and turn to an old playbook—undervalued yuan! Currency manipulation! The yuan must rise! *China-Bashing* had begun and like its cousin, *Japan Bashing*, morphed into increasing threats. By March 2005, Congress had threatened a 27.5 percent tariff on all imports from China, unless the yuan was substantially appreciated. China acquiesced, the yuan appreciated 22 percent over 3 years, *but the trade surplus widened!* Another 20-40 percent needed, came the experts! Sounds familiar? So, how does another Asian economy deal with the thuggish return of the 800-pound economic gorilla? First, *DO NOT CAVE!*

REASONS WHY CHINA SHOULD NOT CAVE

(1) CAVE-INS SET UP A DESTRUCTIVE DYNAMIC:

As explained, a cave-in to bashing can create expectations of more bashing and more cave-ins, if the surplus remains stubborn. This leads to unending, upward pressure on the currency and economic problems.

(2) ARGUMENT HAS NO MERIT:

Why is the yuan undervalued now, but not in 1994? Or 1997-98? Or anytime before the large surpluses? And why did the U.S. not protest when the policy was first implemented? Because the policy was standard fare--until China became too competitive for U.S. special interests. Let’s simplify matters. Apple and Google now compete at a fixed exchange rate of one both using dollars. Apple has a successful iPhone. Suppose Google creates its own phone. Business is slow but through innovation and cost cutting, Google eventually makes a better product at lower price. Apple lobbies its politicians who threaten legislation unless Google appreciates (raises) its price until it becomes uncompetitive or less competitive. Such an argument is thuggish, without merit.

(3) FIXED EXCHANGE RATES ARE NOT CURRENCY MANIPULATION:

Another baseless argument is the demonization of fixed rates as currency manipulation. Fixed exchange rates were prevalent in history--witness the 19th century gold standard, the post-war fixed rates, which facilitated world recovery, and the 1980s European Monetary System, where Europe implicitly fixed to the deutschemark to import Germany's monetary policy. A priori, there is absolutely nothing manipulative about fixed exchange rates. In addition, the special interests have used the basic operations of fixed exchange rate systems to prove that China currency manipulates. Under fixed rates, central banks must buy excess foreign exchange or sell foreign exchange to meet excess demand. The special interests claim that China is preventing the yuan from reaching its market equilibrium, and thus currency manipulating, Q.E.D. By that definition, most countries in the world currency manipulate because they either fix or have managed floats. This feckless criticism asserts its conclusion rather than argue the merits of fixed/managed systems versus free floats for developing economies. We will tackle that problem head-on.

(4) FREELY FLOATING EXCHANGE RATES IS NOT THE ANSWER FOR CHINA:

With liberalized open capital accounts, exchange rates today are asset prices, like stock prices, forward-looking entities driven by current conditions and by expectations of future fundamentals, like news, market sentiments, and in perverted cases, bubbles. Thus exchange rate will not deliver the "equilibrium" rate that gives a zero trade balance (or some norm)--which China is being bashed to achieve. In other words, if foreign exchange demand were primarily demand to finance imports, the trade balance would drive the foreign exchange market and produce the equilibrium rate that broadly resolves a surplus/deficit. But import demand is only a very small fraction of the demand for foreign exchange, which are mostly asset-related, hedging, investment, and speculation-related. Thus, a fully flexible yuan would not eliminate the trade surplus but instead only introduce volatility complications for China, particularly given its thin, underdeveloped financial markets. As an aside, even free floats are not fully free--as the *Wall Street Journal* has correctly pointed out, free markets for currencies do not exist because currency supply is controlled by a monopolist, the central bank.

In addition, the special challenges that volatile exchange rates pose for developing or emerging economies with relatively thin financial markets may explain part of the so-called "fear of floating" phenomena first documented by Calvo and Reinhart in a seminal paper. That's why most developing/emerging markets choose fixed or managed exchange regimes vis-à-vis the dollar, the dominant international currency. So, why the fuss by the special interests about a floating yuan? They are reduced to insinuating that surpluses require appreciation.

(5) SUSTAINED SURPLUSES DO NOT IMPLY CURRENCY MANIPULATION EITHER:

The insinuation of trade surpluses/appreciation also has little merit. Nothing in economic theory suggests a rigid connection. In daily lives, people run sustained life-long deficits with their grocers, covered with paper money, which can continue for as long as the grocer is willing to accept the paper. In the 19th century, Britain ran years of large surpluses with an emerging United States economy, which ran concurrent large deficits, without any hysteria about the imperative for pound appreciation or ELSE! In the modern era--for years now--Australia has run consecutive trade deficits without similar cries for Australian depreciation! Why?

Both examples demonstrate the macroeconomic nature of trade balances, whereby the latter offers a country a means of shifting its consumption/investment profile over time through borrowing from or lending to the world—given expectations about its future incomes and investment prospects. For instance, in the 19th century, the U.S. needed lots of capital to grow and to finance its railways and other infrastructure, and Britain had the savings to accommodate it. In recent years, Australia has been investing and consuming the world boom in commodity prices. The macroeconomic aspect of trade balances is not controversial but the usual fare taught in U.S. universities. *The trade balance simply has a wider macroeconomic significance than whether some special interests in export or import-competing markets have grown unhappy with the exchange rates that they face.*

(6) IT IS DIFFICULT TO KNOW WHAT THE TRUE EQUILIBRIUM EXCHANGE RATE IS:

If the yuan is supposed to be undervalued, what then is the true equilibrium yuan-dollar rate? We have already argued that the free float is not the way to go. The short answer is that it is very difficult to know for sure. Oh there is no shortage of economic approaches to determining the true equilibrium exchange rate of an economy, including the relative and absolute purchasing power parities approach, the behavioral equilibrium exchange rate approach, the macroeconomic balance approach, and the newer equilibrium view, a promising approach which brings more theory to bear on the topic.¹ Needless to say, the vivid number of approaches cautions one that monk-like humility is probably required when attempting estimates of exchange rate misalignment. Uncertainties in data and model specifications and subjective judgments on what constitutes equilibrium (or norms) color all findings, which as expected tended to run the gamut.

For instance, on the yuan, a 2005 IMF Working Paper reviewed several estimates of yuan undervaluation.² Using the macroeconomic balance approach, two estimates found a 15-30 percent undervaluation, one estimate found a small undervaluation, while another found a small *overvaluation*. Not to belabor the point, another study on the yuan, also vintage 2005, found some approaches showing significant undervaluation, some showing little or none,

¹ See Charles Engel (2009), "Exchange Rate Policies" Federal Reserve Bank of Dallas.

² Steven Dunaway and Xiangmin Li (2005), "Estimating China's Equilibrium Real exchange Rate" IMF Working Paper WP/05/202.

and some indicating slight overvaluation.³ Undaunted, these same authors returned to work in 2008 using an updated data set and found a 10 undervaluation, but warned researchers about “pitfalls in measuring exchange rate misalignment.”⁴

(7) *CAVING WOULD NOT SOLVE THE SURPLUS BUT COULD CAUSE DEFLATION:*

Since trade balances are fundamentally macroeconomic in nature, appreciations alone will not necessarily shrink the surplus. In other words—viewed in isolation—exports may fall and imports rise with an appreciation, but it is what also happens in the rest of the economy that will determine where the trade balance finally ends up.

Let’s do some analytics. From a macroeconomic standpoint, we know by definition that the appreciation must shrink the current excess of Chinese savings over investments to get a fall in the Chinese surplus ($S - I$); or equivalently shrink the current excess of Chinese income over domestic expenditure. The problem is, a priori, nothing suggests that an appreciation alone could achieve that macroeconomic outcome. Falling exports from appreciation may cause Chinese incomes and savings to fall, but investments (and imports) would also likely fall under the deflationary conditions—particularly if the caving in to bashing also sets up the unstable, dynamic of more and more expected appreciations. Then, investments could easily shift operations abroad where things would be cheaper. In fact, if the fall in investments should be greater than the fall in savings, one could even see a rise in the Chinese surplus!

In a severe scenario, the upshot is a bad recession and deflationary conditions—unless the Chinese fiscal pump is primed aggressively to offset the recession and reduce national savings (beyond the fall in investment). Whether aggressively increasing public debt and decreasing national savings (see section below) so as to reduce the trade surplus would be wise policy is an issue the Chinese will decide for themselves. For the U.S, the same macroeconomic constraints apply—unless the U.S. tightens its domestic expenditures relative to income (i.e., investments relative to its savings), its deficit situation would likely not change. A decrease in Chinese exports to the U.S. would simply be replaced by increased exports from another country (say Vietnam).

³ Cheung, Chinn, Fujii (2005), “Why the Renminbi Might be Overvalued (But Probably Isn’t)” University of Wisconsin.

⁴ Cheung, Chinn, Fujii (2009), “Pitfalls in Measuring Exchange Rate Misalignment: The Yuan and Other Currencies” University of Wisconsin.

GIVEN THE MANY ISSUES, WHY DO THE BASHERS FOCUS ONLY ON EXCHANGE RATES?

Two reasons--first, the refrain works politically. The surplus is visible and the currency-trade balance nexus is widely covered in the media. Casual observers are not as familiar with the more abstract analytics on the macroeconomic nature of trade balances. Second, exchange rates are what the special interests really care about since appreciations allow them to regain market share and competitiveness.

IS CHINA'S SAVING RATE TOO HIGH?

The special interests and their allies sometimes resort to blaming the surplus on China's "excess" saving—the so-called savings glut—which they then blame on China's supposedly out-of-date social welfare system. In this telling, China's safety net for welfare, health, retirement is sparse and lags those in modern Western industrial societies. That creates insecurity and uncertainty among the Chinese resulting in way too much precautionary saving and way too little consumption. Thus, a good dose of yuan appreciation would increase Chinese purchasing power and correct their under-consumption.

Amazingly, this idea has been generalized such that some are arguing that the world has been amiss in focusing too much on *deficit-riddled* countries--always pushing them to adjust, while the miserly surplus countries go scot-free. Now, the new wisdom goes: those surplus misers must be called to account for causing those deficit-riddled countries to lose their discipline on spending. How can the deficit-spenders help themselves if the savers save so much? Some of the adults can be forgiven for thinking that something important has been turned upside down. The special interest and their academic/media allies have succeeded in making profligacy cool!

As regards China, who can assess whether it's saving too much but the people who are doing the saving, given their own personal circumstance? They will probably stop when they think it is too much. But two issues stand out clearly. One, one can think of good reasons for China to save a lot; and incidentally, good reasons also for Western industrial societies to save more, given their demographics. China's one child policy has meant that the present aging generation has far fewer descendents to depend upon in old age than has been the cultural and historical tradition. It is no wonder the economy would adjust and save a lot and more.

Second, the Western state's welfare and retirement is clearly not the solution. The last thing China wants to do is to import that system, particularly that of the United States. Presently, unfortunately, the U.S. is broke, with regard to its *unfunded* Social Security (retirement) and Medicare/Medicaid (the elderly/the poor) liabilities (\$50 trillion up the unfunded creek by some estimates, more than 3 times its current GDP). And, going by the experience of Medicare/Medicaid, the recent passage of a massive new entitlement called National Health care is the government's way of doubling down on "broke." Nobody, except Congressional

Democrats and the mainstream U.S. media (and it is doubtful even they really do), it seems believe that the new health entitlement will reduce the budget deficit! The accounting trick seems to be: Let's push the day of reckoning into the future. And the belief that somehow future generations can foot the bill and solve the problems probably accounts for why the country does not save--including its government, which has further ramped up spending and debt to unprecedented levels.

In addition, the incentives to save are simply not there. The U.S. tax system seems determined to discourage savings by taxing capital and saving (capital gains taxes, taxes on interest income, double taxation of dividends) and subsidizing borrowing (home mortgage interest deductions). Anybody living in the U.S. knows that recent surveys after survey show that too many baby boomers in their fifties and sixties have very meager savings for retirement, which together with government profligacy explains the miniscule overall U.S. national savings. Low U.S. national savings is the major underlying reason for their intractable external deficits--the elephant in the room which the special interests and their academic/media allies shrug off, preferring to wail instead (oh, if only the yuan were higher!)

The point is that while China's safety net may not be optimal, the safety net of the West, and of the United States, is not the shining example to follow either. If China wishes to improve, perhaps Singapore could be the better model (But doesn't Singapore save too much too?? One could hear the special interests wailing!). If structural blame for the bilateral surplus/deficit has to be assigned, the structural problems are as much with the modern U.S. economy as with the emerging Chinese economy. The structural reform scapegoat does not reside only in China.

WHAT SHOULD CHINA DO?

First, China should ignore the bashers. Second, it should look inwards. What does the economy need? Exchange rate policy cannot be decided independently of other macroeconomic policies and concerns like asset/goods inflation and over-exposure to one external borrower. Besides the protectionist threats from the U.S., the latter two issues constitute the two major potential risks from continuing the current exchange rate stance. The inflation issue stems from continuing to import a zero-interest monetary policy from the dominant economy in the current Chinese environment, where Chinese property prices have reportedly been accelerating rapidly. The over-exposure stems from the continuing accumulation of reserves in the form of U.S. government and agency debt.

Normally, the biggest reserves risk for a country is a depleting reserve position. But China's problem has been exactly the opposite--rising reserves accumulation. With its surpluses and foreign direct investment inflows, China has had to accumulate significant reserves to maintain its fixed exchange rates. Presently, its reserves are about \$2.4 trillion, about 50 percent of its GDP--about the same proportion as Malaysia's reserves, not out of line with that of other high reserves countries. Of the total, however, the common conjecture in the

media is that perhaps about 70 percent or about \$1.7 trillion consists of U.S. government or agency paper. The risk of over-exposure to one single borrower is thus similar to the risks associated with a commercial bank's over-exposure to one borrower. Thus, China's exchange rate assessment must hinge on the balance of these risks for its economy if it maintains the current course.

Third, China must hire a top U.S. media/public relations firm to argue its case. Presently, the U.S. media is the dominant presence worldwide and China is an economic piñata, with old-line Keynesians having a field day swinging at it. Fourth, it must stipulate an end to political bashing as a pre-requisite to any negotiated solution. Fifth, it must ensure that any revision in its exchange policy is firm and clearly viewed as one in China's own economic interest. Above all, it cannot be viewed as having caved in to bashing and losing control of its own economic destiny.

WHO ARE THE REAL MERCANTILISTS?

Let's recap: China's cheap manufactured exports raise the living standards of millions in the working and middle classes of the U.S. Meanwhile, millions of rural Chinese are lifted from sheer unrelenting poverty. But special interests in U.S. manufacturing in its exports and import-competing markets lose business and market share, and together with their allies in politics, academia, and media complain vehemently about too much cheap imports from China (China's surpluses), unfair trade, and unfair currencies; they demand that long-established terms of trade be changed in their favor or they threaten trade sanctions, possibly even start a trade war. Ultimately, they want less imported into the U.S. so that they greater market share. China, on the other hand, fears losing export markets and trade. So, who are the real mercantilists here? Those who will restrict trade or those who want to trade?

There is a well-known theory within the field of "Public Choice" originated by the late University of Maryland economist, Mancur Olson. Mr. Olson considered why within democratic societies, special interest groups, which are normally a minority of the population, are so adept at protecting their own interests often at the expense of consumers, which are the majority of the population. Mr. Olson's insight was to balance the gains from winning a policy battle. Since the gains/stakes per agent are much greater for special interest groups because of their small, these groups are much more motivated to commit significant resources to protect their interests. On the other hand, the individual stakes are much smaller for the more numerous and dispersed consumers.

Take a simple example. Suppose a special interest group, one million in size, spends \$1 million to get a policy passed, which provides them benefits of \$10 million at the expense of consumers. If successful, their gains are \$9 per person. However, the losses for the 330 million consumers (using the U.S.) would only be about 3 cents per person. Comparing the

stakes, the special interest group would be about 300 times more motivated than consumers to commit resources to get the policy passed in their favor. Therefore, motivated special interests often lobby politicians, academia, and media successfully to trample on the interests of the majority, the consumers. The true mercantilists are arguably these special interests determined to maintain its market share at the expense of trade, or possibly even starting a trade war, which would damage trade and world welfare.

WHAT SHOULD THE U.S. DO?

The impending fiscal train wreck, notwithstanding, the U.S. economy to date is the greatest juggernaut of production and innovation in the history of mankind, flexible and dynamic, which has contributed significantly to world welfare. Its latest contribution is the internet, computer and mobile technology, which will revolutionize human communications for years to come. It is a pity that every time this economic juggernaut encounters successful international competition in manufacturing, it resorts to bullying behavior on behalf of narrow special interests against its own consumer's welfare and that of the working poor worldwide. Therefore, the U.S. also needs to look inwards. It has to rein in those special interests; it has to reform its tax system to encourage instead discourage savings; it has to rationalize its Social Security and Medicare systems, which also discourage personal savings. Finally, it has to stop bashing and bullying successful international competitors. The world is catching on. After Japan, China, who will be next? India? Stop the bashing!