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Political Economy of Renminbi Revaluation

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A. Economic Pressure for the Renminbi's Revaluation

Since August 1994, China has maintained a steady nominal peg of its renminbi (RMB) currency against the U.S. dollar, although it claims officially that its currency exchange rate is a managed and floating one on the supply and demand of currency market. The de facto fixed exchange rate of the RMB have given a great boost to the stunningly rapid growth of the Chinese economy and Chinese trade with the U.S.A. and other developed countries.

The coercion over the RMB's revaluation comes from inside and outside China.

The dramatic growth of Chinese exports has created a great trade surplus with the U.S.A. and some other developed countries. Its trade surplus in the balance of payments is translated into the increase of China's foreign currency reserves, which as a result surge quickly. In 2001, the reserve was $212.2 billion. At the end of 2003, it had reached $403.3 billion. "China's has the world's second-largest foreign currency reserves after Japan, with the equivalent of nearly US$610 billion (euro 470 billion) at the end of 2004. That rose by US$209.9 billion (euro 161.5 billion) last year, driven in part by a surging trade surplus."[1]

We should notice that, in the year 2004, the Chinese trade surplus only touched US$20 billion, and the net capital inflow reached US$112 billion, but foreign currency reserves increased US$209 billion. It is an important showcase that the majority of foreign currency reserves come from capital inflow. Some part of the capital inflow is the so-called "hot money," which was kept in extremely close watch by China, and complicated the issue of RMB revaluation for the decision of Chinese government.

Under the de facto pegged exchange rate, the huge foreign currency reserves increase the base money supply, and therefore may create an inflationary tendency in the long run, and overheated bank lending in the short run. As a result, in some degree, now the Chinese government has to stand up to the macroeconomic distortion caused in large part by the excessive money and bank loan growth.

China insists that its trade surplus is not the main cause of its dramatic foreign currency reserve, and makes efforts to keep its trade surplus shrinking or at a balanced level. So it looks likely that there is no excuse of trade surplus to appreciate the RMB. But some Western opinions think otherwise. That is the tit-for-tat controversy between China and some Western countries on whether RMB revaluation could be helpful to relax the trade strains between each other.

But what is the equilibrium value of the RMB exchange rate? Most scholars in the Western countries and even China itself had a tacit consensus that it is undervalued, although to varying degrees. That is why the Chinese government makes a commitment publicly that the decision mechanism of RMB exchange rate is on the track of reform.

The economic pressure for RMB revaluation also stems from the outside.

In economic growth, China is much quicker than the U.S.A., Japan, and some other developed countries. More importantly, in productivity growth, China has also outpaced them. Last year, Mckinsey & Company concluded from its research report, that China's manufacture productivity was one-fifth higher than that of some major countries in Europe, and only 8% lower than that of the U.S.A.[2] That is largely why China has been nicknamed "The World's Factory." The ratio of economic development between China and some Western counties has changed a lot, definitely requiring an adjustment in the ratio of their currencies. The breakdown of the fixed exchange rate of Bretton Woods system, was partly due to the catch-up of economic development in West Germany and Japan relative to the U.S.A. and Britain. In short, the aforementioned is the pressure stemming from the structural imbalance of world economic development.

Some U.S. critics complain that it is China's "manipulation of its currency" which has given Chinese firms a huge competitive advantage against American companies, and correspondingly cost thousands of American jobs. Some commentators in Japan and some other developed countries have joined the orchestra to press for RMB revaluation. The content will be explored in the following parts of this article.

B. The U.S.A.'s Politics of Pressure for Renminbi Revaluation

The RMB revaluation is now posed as a fundamental obstacle for the relationship between China and the U.S.A. Most recently in late May, senators of both parties on Capitol Hill condemned the Bush Administration's failure to ratchet up the pressure on China to revaluate the RMB, and threatened to raise tariffs against Chinese imports within a certain time, unless the RMB gets appreciated. The protectionist anger in the U.S.A. has lasted two years. The reason is simple: Many American workers were out of jobs on the backdrop of in-

1. "China's Foreign Reserves Fall," *Forbes,* March, 11, 2005.

2. *Financial Times,* June 16, 2004.

creasing Chinese imports, which is regarded as obtaining its advantage by the valuation of the RMB. According to American statistics, the U.S.A.'s trade owed China US$160 billion in 2004, reaching as high as 25% of the overall U.S. trade deficit of $668.1 billion last year. China was the No. 1 source of the U.S.A.'s trade deficit. In addition, as many as 1.5 million jobs in American manufacturing industry have been replaced by Chinese imports.

There are congressional and electoral incentives in the U.S.A. to press hard for RMB revaluation. U.S. domestic manufacturers and many workers had an urge to restrain Chinese imports by on-off RMB revaluation. Some of U.S. lawmakers, who need the supporting votes of the labor unions and Chinese-imports-competitive manufacturers, would like to act with the requirement of the vested interests. The hot money, which has flowed into the Chinese capital market to bet on the fortune of RMB revaluation, also demands that U.S. politicians push for revaluing the RMB. Otherwise, their currency speculation would be defeated. When the election comes, the voice for RMB revaluation would be louder than before, because the politicians want to please their constituency. For example, in the run-up to the American presidential election last year, either Mr. George Bush or his counterpart Mr. Kerry would turn up the heat on this topic, to strive for votes. In contrast, after Mr. Bush took office once again this year, his administration eased its previous hard-line stance, and became the persuasive check on revaluing the RMB.

However, American businessmen or companies importing the cheaper Chinese goods would lose benefits from RMB revaluation. A large number of American direct investments in China have gone to the processed or assembled trade, exporting the goods processed in China to the American market. In fact, a substantial ownership of the American trade deficit to China is American itself, rather than Chinese. If the RMB appreciates, this interest group would be unhappy. Although we do not know from the media their lobbying efforts at slowing down the RMB revaluation pressure, we could not deny that they are doing something sensitive in a low-profile way.

Although American Chinese-imports-competitive firms lost benefits from the artificially lower RMB, American consumers at home were able to enjoy the benefit of cheaper imports from China. However, consumer pressure is weak and sporadic, having far fewer lobbying voices in Washington than do large Chinese-imports-competitive industries. Regardless of that, American policymakers should think twice seriously about the interests or welfare of American consumers, before they really make a substantial policy.

C. Interdependence in the Renminbi's Revaluation

On April 7, in testimony before the Capitol Hill, Treasury Secretary Snow urged the senators to let "financial diplomacy" work its course, and called the proposed amendment bill seeking to penalize China "a bad mistake"[3]

EIRNS/Wolfgang Lillge

Moderator Dr. Jonathan Tennenbaum and Dr. Ding Dou at the Berlin seminar on June 28. Dr. Ding underlined that China will never accede to outside pressure to revalue its currency, but will take into account its national interests.

I think that Mr. Snow's rhetoric is right and reasonable. The issue of RMB revaluation is too complicated, involving the ramifications of interests both in China and the U.S.A.

Is the U.S.A. the real loser in U.S.A.-China trade or the trade deficit against China? On the side of China, more than $200 billion, equivalent to about one-third of the foreign currency reserves in China, have been used to purchase U.S. treasury paper as its own official reserve currency. China ranks as the second-largest holder of U.S. debt in the world.

Now the U.S.A.'s overloaded debt burden gives its economy the nature of important reliance upon the great amount of debt purchased by foreign countries. If the RMB is forced to revalue, Chinese dollar-denominated assets would shrink greatly, causing a net benefits loss to China. However, with a stronger RMB versus the dollar, China would decrease its buying interests on U.S. bonds, and other Asian central banks would maybe follow suit. If so, the dollar would lose confidence. Less bond purchases by foreigners could cause interest rates in the U.S.A. to go higher, ultimately damaging the U.S. economy. The low interest rates and low inflation, which have supported economic prosperity in the U.S.A. for some years, would no longer exist. This issue links China and the U.S.A. tightly together, putting both countries in the position of "mutually assured destruction."

China now depends greatly upon the American market, while its exports to the U.S.A. reaches as astonishingly high as above one-tenth of the value of its GDP. In 2004, the export tax refund in China was about RMB 420 billion, constituting

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3. News from International Information Programs, usinfo.state.gov/eap/archive/2005/apr/07-353487.html.

3% of its GDP, with some part of it going to subsidize the welfare of American consumers. It looks likely that the American good life also depends upon the Chinese contribution, although China is now a developing country and the life of its ordinary people lags behind the U.S.A. very much.

If the RMB is forced to appreciate and Chinese imports into the U.S.A. decline, the U.S. trade deficit would not decline correspondingly, because it is far more likely that the U.S.A. would import from other low-wage countries to replace the Chinese goods. American economic obsession comes from its structural imbalance, with 70% of its GDP deriving from the intangible service industry. So it is destined that the U.S.A. must import tangible manufactured goods from other countries. To cut off its trade deficit is naturally impossible, at least in the short term. So the mutual benefits of U.S.A.-China trade also connect the two sides together, to the degree that one cannot live well without the other.

The aforementioned interdependence between China and the U.S.A. has progressed crucially to such a sensitive and fragile level, that both sides look cautiously at RMB revaluation, because they both are afraid of the too high costs of non-cooperation or even sanctions. Financial diplomacy, mentioned by Mr. Snow, other than governmental interference in the marketplace, might be the optimal option to create a peace lobby. Gradual and peaceful negotiations could adjust and compromise the interests of both sides to the accepted level.

D. The Chinese Politics of Safeguarding the Renminbi

In the simple economic sense, by China itself, the RMB had the pressure or even requirement of revaluation. But in the broader sense of political economy or simple politics in China, RMB's peg versus the U.S. dollar should be maintained.

The political incentives in China to safeguard the de facto fixed exchange rate of the RMB, consist of social confidence, social stability, the Communist Party's sovereign image, and some others. These political elements are vital interests to the rule of the Chinese Communist Party, or even to the nation of China itself. It has been in large part impossible to separate the interests of Chinese Communist Party and those of China as a nation, although many Western analysts like to do so.

The RMB's peg against the dollar since 1994, has laid a fundamental anchor for prices and all kinds of transactions, and furthermore has stimulated rapid economic growth and prosperity. Therefore, a highly stable exchange rate of the RMB has created the accustomed environment of ordinary people's confidence in their government and Communist Party. Confidence produces clear prediction, and clear prediction produces clear signals of macro-economic and micro-economic adjustment in China. Some economists even argue that the RMB's peg makes it look like a simulation of the Bretton Woods system for China's foreign currency operations. Robert Mundell, the Nobel Laureate in Economics in 1999, clarified that "there was no reason for China to change its much-criticized currency peg to the U.S.D. China has had an anchor for over 10 years, and it is a winning strategy."[4]

Social confidence or stable predication is fundamental for the economy in transition, whose society and economic structure is on the fast track of change, causing many complaints and even social unrest. Although China has obtained admired economic growth, it is now full of many headaches, such as the enlarging gaps between the haves and have-nots, the coastal region and the hinterland, the urban city and the remote countryside. Indeed, discontents among many social groups are simmering. The economic reflection of the discontent, is the large existence of the lion's share of an underground economy in China, especially in the hinterland and the countryside.

The social psychology in China looks fragile and sensitive, lacking trust and faith among the people. The 56-year-long authority of the Communist Party is the most important element to decrease the crisis of a lack of faith, even though it sometimes is the target of social discontent. Stable prices, such as the stable foreign price of the RMB against U.S. dollar, are no doubt helpful to the stabilization of predication in China. If the RMB became volatile in a relatively large band, the predication of all kinds of transactions would be damaged. For example, the underground bank system would become highly prosperous.

The Chinese Communist Party knows the great importance of social confidence very well. During the Asian financial crisis in 1997, while speculation about the RMB's depreciation was fashionable around the world, Chinese Premier Zhu Rongji made a public commitment on the scene, of turning up his thumb to show that the Chinese RMB absolutely would not depreciate. In the objective sense, it was helpful to contain the contagion of Asian crisis, highlighting China's contribution to the world. But primarily, it serves Chinese national interests first.

Social stability is another political incentive to the insistence over the RMB peg. For the time being in China, the destructive elements for social stability are the high unemployment rate and high non-performing loans.

If the RMB appreciates now, Chinese exports would be in a catastrophe. Like some other Asian countries, the Chinese economy is export-led, and the stable exchange rate is part and parcel of this development model. The index of Chinese foreign trade dependence reached astonishingly as high as 60% versus its GDP. The RMB could go to revaluation in one night, but the long-lasting export structure could definitely not be adjusted overnight. In addition, Chinese import-competitive industry would be damaged heavily. The RMB's revaluation would stimulate greatly the imports of foreign goods, causing the decline of domestic industry which com-

4. Interview with Robert Mundell "China Should Keep Currency Peg," *China Daily,* March 6, 2005.

petes with foreign counterparts.

The downfall of both the export industry and import-competitive industry would cost numerous jobs in China. The majority of the export industry in China is labor-intensive manufacture, such the textile industry, absorbing a great number of laborers. And most of import-competitive industries in China are low-end service-oriented, offering many semi-skilled jobs.

Since the mid-1990s, the unemployment rate in China has been increasing. The registered unemployment rate in cities and towns in China is given as 3.5% or so by Chinese official bureaus. If the unemployment in the countryside is included, some economists estimate the jobless rate hits as high as 10% or so, and some of the jobless are long-term. It is not surprising that new graduates from universities cannot find work, but the scene would have been very hard to imagine only ten years ago.

Another explosive problem facing China is the high non-performing loans in banking and securities industries. Meanwhile, the savings rate in China has begun to have a tendency to decline. The Chief of the Chinese Central Bank, Dai Xianglong, confessed once that the non-performing-loan rate in Chinese state-run banks had reached 12%. Some economists estimate that it is indeed much higher. The weak banking system in China cannot afford the risk of opening up the capital accounts. If the RMB appreciates and floats in a relaxed band, the next problem immediately is the opening of the Chinese capital account, which the Chinese government is very much afraid of. The precedents of the Asian crisis, the Mexico crisis, etc., provide ammunition for keeping distance from the opening of the capital account.

The third political incentive to defend the RMB peg is the Communist Party's sovereign image among Chinese people. As long as the Chinese Communist Party maintains its sovereignty against foreign countries, it can keep its unchallenged authority among domestic people. Threatening China over its currency is nothing more than being counterproductive. Neither America's Capitol Hill nor Japanese government officials can coerce the Chinese government to do what they would like to see. Otherwise, the ordinary people in China could have the justification to sneer at their government.

On May 17 of this year, Chinese incumbent Premier Wen Jiabao told the delegation of the American Chamber of Commerce, that China will never succumb to foreign pressure on the RMB issue, and any kind of pressure or politicalization of economic problems would be ineffective in the settlement of problems.[5]

In a general sense, on any fundamental decision-making, government is inclined to risk-avoidance, rather than risk-loving or risk-neutrality. Of course, the Chinese government is no exception on this front. If the RMB maintains its peg versus the dollar, the risk for China is the potential inflation, due to increasing the base money supply. However, if the RMB appreciates, the risk for China is multifold and more plagued, from the erosion of social confidence, increased unemployment rate, higher non-performing loans, to the eclipse of the Communist Party's image.

Of course, the Chinese government may choose an appropriate timing to revalue the RMB. Nobody knows when and in what forms. After all, Chinese national interests have been integrated into the world, so the Chinese government has to weigh the affection and interests of other countries. How to balance them? It needs time, patience, and more importantly, concrete steps to prepare for that.

5. *China Daily,* May 17, 2005.

Maj. Gen. Afsir Karim (ret.)

An Indian Perspective On Central Asia

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The geopolitical importance of Central Asia needs no elaboration. The location of the region, forming a bridge between Europe and Southern Asia, is well known, but in various periods its importance has varied with the changing international security environments. Before oil became an important ingredient of strategic conflicts, Central Asia, as currently defined, remained by and large a peaceful region. The republics of Central Asia have yet to settle down politically and decide what their future course should be: Whether they will gravitate towards resurgent or moderate Islam, or follow the Western democratic pattern in the long run, is yet to be seen. The turmoil in Afghanistan had a major impact on this region, with ominous threats of Islamic fundamentalists still looming on the horizon.

The advent of U.S. forces in Afghanistan, withdrawal of the Soviet troops from this region, and the Chinese attempts to extend their influence in the region, started a new Great Game, in which several European and Asian powers, along with a new shadowy player, in the garb of resurgent Islam, have become actively involved. However, much depends on how we look at this game, and to which side of the geographic, political, ethno-religious divide we belong. The five countries that now constitute Central Asian Republics were, however, never given a chance to choose their future course or status