The dollar yuan exchange rate

China's current account surplus is once again on the increase as the global economy revives. As unemployment in the West remains stubbornly high, however, there has been persistent pressure from both the U.S. and Europe on China to appreciate its currency. It may be recalled that, China appreciated its currency by more than 20% against the dollar between mid-2005 and mid-2008 before suspending the appreciation. Since 2005, the yuan has appreciated about 15% in trade weighted terms, and is back to where it was in 2000.

The exchange rate issue may be heading for a confrontation during the next couple of weeks. On April 15, the U.S. Treasury is due to publish its semi-annual report on the exchange rate policies of its trading partners. There is considerable political pressure, particularly from the U.S. Congress, to brand China as a currency manipulator. Such a declaration would facilitate the imposition of import duties and/or filing a complaint of unfair trading practices against China before the World Trade Organisation (WTO). WTO rules generally prohibit subsidies to exports. (While charging China with subsidization of exports through its exchange rate policy, the U.S. and Europe conveniently overlook their own direct subsidies to agriculture, which are affecting African exports as also are the major block in the way of a successful outcome of the Doha Round.) The treaty also has a clause barring members from frustrating the objectives of the treaty "by exchange action". The question whether Chinese policy contravenes the provision has no clear answer. For one thing, this particular provision goes back to the era of fixed exchange rates: to what extent is it valid in the current environment? Again, if China maintains parity with the dollar – i.e. an unchanged exchange rate – how could at least the U.S. charge it with subsidization?

In the United States, economists like Nobel Laureate Paul Krugman have argued that, global economic growth would be about 1.5 percentage points higher, if China stopped restraining the yuan and running trade surpluses (The Economic Times, March 20th), and advocate pressuring China on the issue through trade sanctions. Others like Stephen Roach, Chairman of Morgan Stanley Asia, stoutly oppose such pressures, arguing that the best way of reducing the U.S.'s deficit is by raising the savings rate. They see the issue of global imbalances as arising more from the differing savings investment equations in various countries, not exchange rate alone; the U.S. has deficits with other countries as well: China accounts for only a third of the total.

Overall, it is debatable whether an appreciation of the Chinese currency would do much to reduce the U.S. trade imbalance. On reason is that U.S. manufacturing has hollowed out over the last few decades, with many industries closing down, unable to face the competition from imports. Therefore, unless there is a basic change in the consumption habits of Americans, a yuan appreciation may only lead to substitution of imports from China to imports from other countries – or, even, continued imports from China, but at higher prices.

As a global economic power (the world's largest exporter and the second largest economy) China would be extremely reluctant to be seen to bow before western pressures on the issue of the exchange rate, whatever the economic logic. China's exchange rate policies are also hurting many Asian countries whose currencies have appreciated against the yuan. Perhaps a more multilateral approach towards China's exchange rate policy may stand a better chance of success than bilateral pressure. (India itself had a bilateral trade deficit in excess of $ 20 bn in fiscal 2008-09, and it is growing rapidly.) A co-operative solution, rather than confrontation, is obviously in the interests of not only the individual countries but the global economy itself, at a time when it is just coming out of recession. After all, it should not be forgotten that Chinese exports keep global inflation lower than what it otherwise would have been, and the U.S. needs Chinese surpluses to finance its fiscal deficit without a sharp rise in interest rates.

There is also a broader issue involved. Are surplus countries to be blamed for the woes of the deficit countries? (On an even broader plane, are the poor poor, because the rich are rich?) One recent article by Martin Wolf (Financial Times, March 17th) suggesting this was headlined 'China and Germany unite to weaken the world economy': China is expected to have a current account surplus of $ 300 bn in the current year, and Germany $ 200 bn. In a way, this argument is on par with the way some western economists blamed Asian savings habits for the financial crisis of 2007-08. The pseudo logic was that Asian surpluses kept dollar interest rates low, thereby tempting U.S. home owners to borrow more, and U.S. investors to invest in more risky assets, to increase yields: this, they claim, was the real cause of the crisis. The ‘logic’ is on par with that of a bank management blaming depositors for its bad debts: after all, had the depositors not placed money with the bank, how could it have created those bad debts?

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