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China's currency

Bending, not bowing

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The Chinese case for a stronger, more flexible currency

CHINA'S trade with America is notoriously skewed. But diplomatic exchanges between the two countries are more finely balanced. On April 3rd Tim Geithner, America's treasury secretary, tactfully postponed a report due this month that might have condemned China for manipulating its currency, keeping it weak to favour its exporters. Mr Geithner, who made an unscheduled trip to Beijing this week, said he would rather press America's case at its regular "Strategic and Economic Dialogue" with China in May and at the G20 summit in Canada in June. The delay puts America's diplomatic account with China briefly in surplus. What will China offer to clear the balance?

The immediate quid pro quo is the presence of China's president, Hu Jintao, at a summit on nuclear proliferation in Washington, DC on April 12th-13th. There is also talk of allowing the yuan to wobble a little more in daily trading with the dollar. In time it is expected to resume the slow crawl upwards that ended in July 2008.

America's Treasury is willing to bide its time. But its patience is not shared by members of Congress. Last month 130 of them wrote to Mr Geithner urging tougher action against China. After the currency report was postponed, Chuck Schumer, a New York senator, said he would push his bill to slap anti-dumping duties on some Chinese goods and countervailing tariffs on all of them if China did not allow its currency to strengthen.

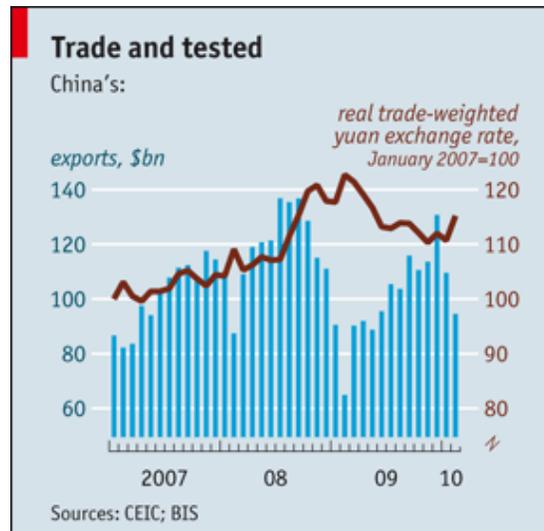
The tussle in America between a cautious Treasury and slap-happy senators is mirrored by subtle divisions in China. Its policymakers and economists are, of course, united in their distaste for America's tariff talk. Many can scarcely believe that a country so indebted to China would try to intimidate it. (Mr Schumer points out that the Chinese cannot dump their dollar holdings without undermining their own peg, thereby "cutting off their nose to spite their face".) But the noisy dispute between the two countries is drowning out an interesting debate within China on the virtues of its inflexible currency.

On one side of the discussion is the People's Bank of China (PBOC), the country's central bank. Its chairman, Zhou Xiaochuan, suggested last month that keeping the yuan stable against the dollar was a crisis measure which would be withdrawn "sooner or later". With China's recovery well advanced, the central bank is keen to get a grip on bank lending and keep a lid on inflationary pressures. A stronger yuan would cut import prices; a suppler one would give the central bank a freer hand to raise interest rates, without worrying about the capital inflows such rates might attract despite China's capital controls.

On the other side of the debate are China's commerce ministry and some members of its National Development and Reform Commission (NDRC), which formulates long-term economic strategy. Beyond the PBOC, Chinese policymakers do not see the yuan as a tool to manage inflation. They see it instead as a tool to "maximise export employment", says Stephen Green of Standard Chartered Bank, one that they are not yet ready to give up.

Although China's output grew by over 10% in the year to the fourth quarter, its policymakers believe they have done a better job of shoring up GDP than of shoring up employment, according to Eswar Prasad of the Brookings Institution, a think-tank. The World Bank says that rural wages (outside farms) fell by almost a fifth between 2007 and 2009 as migrant workers fled to their villages in search of jobs.

What accounts for this jobless recovery? Much of China's epic stimulus was channelled through its banks. But in doling out credit Chinese banks still follow a "political pecking order", as Yasheng Huang of the Massachusetts Institute of Technology has put it. They reserve the first and biggest bites for large state-owned enterprises. These firms in turn favour capital-intensive investment projects, which add more to the output figures than to the payrolls. As a result China's policymakers still count on the country's exporters to create jobs, Mr Prasad argues. They are reluctant to do anything to jeopardise their prospects.



How much damage might a stronger yuan inflict? Several studies suggest that China's exports fall by about 1.5% when its trade-weighted exchange rate, adjusted for inflation, strengthens by 1% (see chart). But if the yuan did move against the dollar, the currencies of China's neighbours and rivals might rise in sympathy, limiting the damage to its competitiveness. And China's coastal workshops have staged an impressive recovery from the worst days of the crisis, when factories closed and container ships idled in the ports. Exports in February were 8% higher than two years earlier. A few more months of robust figures may reassure policymakers that the country's exporters are back on their feet.

Some of China's rulers, it is true, see no benefit to China from a stronger yuan. But they are also the ones most determined to resist foreign pressure. They would, therefore, back down only if American tariffs inflicted real pain. There are not the only voices in the government. The PBOC recently appointed three scholars to advise it, two of whom, David Daokui Li and Xia Bin, have advocated currency reform. Whether they can overcome the commerce ministry and its allies remains to be seen. But their efforts to sell their ideas will come to naught if they are crowded out by imported arguments from America.