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China currency under pressure

By Howard Schneider, Monday, May , 11:33 AM

BEIJING — For years, the chief source of tension between the world's two biggest economies has been Washington's concern that China undervalues its currency to bolster trade.

Suddenly, it's become Beijing's concern, too.

Inflation is bubbling and consumer unhappiness is rising, as the price of imports chugs higher as measured in China's currency, the yuan. At the same time, international investors are wary of the yuan because of the government's close management of the currency.

The result: a shift in the discussion inside the Chinese government, where advocates of export-led development have typically held sway. The change could make it tougher for those advocates to fend off U.S. pressure.

Leading members of Congress have charged that China's currency policy directly siphons away American jobs, and last fall the House approved legislation that would tax Chinese imports to offset any edge provided by the low value of the currency.

President Obama has cited China's exchange rate as an obstacle to a healthier world economy, and critics of globalization say the policy lets the world's second-largest economy in effect undermine potential competitors in countries such as India and Brazil. The International Monetary Fund has chimed in, reporting that the yuan is significantly below its true value.

All that political pressure, however, has yielded only modest change in a country where tens of millions of workers depend on an industrial complex built around churning out cost-competitive goods, be they blue jeans, bicycles or iPods.

What is changing now is the growing recognition in China that its cut-rate currency has another side: rising local costs and other effects that could take a toll on the social order prized by the country's political leadership.

By setting a low exchange rate, rather than letting market forces set the yuan's value like that of other major currencies, China is inviting higher inflation because imported fuel and food are artificially expensive. Government-set fuel prices have increased twice this year, prompting a truckers strike in Shanghai last month. Food prices are also rising — particularly sensitive in a country where per capita income is just $3,000 a year and tens of millions remain in poverty. Overall inflation, at 5.4 percent, is well beyond the government target.

The managed exchange rate is also limiting the international use of the renminbi, also known as the yuan, frustrating Beijing's commercial and political aspirations. Moreover, the currency policy is resulting in a surplus of foreign exchange holdings, much of which is locked away in low-yield — and some Chinese argue risky — U.S. Treasury securities instead of helping develop the country.

There has been no announced change in China's currency policy, but the People's Bank of China allowed the currency to rise more quickly in April than previous months, and on Friday set its target level for the yuan at 6.49 — the lowest since the early 1990s.

"Beijing seems to be close to officially admitting that yuan appreciation has more pros than cons. This contrasts to their previous reluctance to publicly justify any appreciation," Wei Yao, an economist with Societe Generale China in Hong Kong, wrote in a new report.

Yu Yongding, an economist at the Chinese Academy of Social Sciences and former adviser to China's central bank, acknowledged that letting the yuan rise and fall freely on world markets, like the dollar or the euro, "will cause a lot of pain," with millions of Chinese possibly losing their jobs as China's exporters lose the advantage of a low exchange rate.

But he said this toll would be offset by growth and other benefits elsewhere in the economy. Such a dramatic shift, he said, "will be economically necessary. … The exchange rate has become a sort of burden on China. We are creating a lot of distortions [in the economy] to maintain it."

The debate over currency policy is part of a larger struggle in China over how the benefits of economic growth are distributed across society. The outcome of that discussion is critical for U.S. hopes that China will evolve from being the world's factory floor to an open lucrative market for American goods and services.

For that to happen, China will have to revamp a financial system that in many ways remains a tool of government control — favoring large exporters, state-owned companies and the government itself at the expense of families, small businesses and other firms that rely on the domestic market.

China keeps a rein on capital moving into and out of the country. The government sets the maximum rate banks can pay to depositors and the minimum they can charge for loans — a boon to the large state-owned banks because the rules give them a cheap source of savings and limit competition from private financial firms. With interest rates on savings deposits even lower than the rate of inflation, the result is a transfer of tens of billions of dollars of wealth each year from Chinese families to the state-dominated banking sector, according to Eswar Prasad, a Brookings Institution analyst and China expert.

Chinese officials have been acknowledging for years the need to foster local consumption and moderate the country's large trade and investment surpluses with the rest of the world.

But in recent months, the pace of change has by some accounts quickened. The minimum wage is increasing, and the government recently announced plans to eliminate income taxes for an additional 48 million people. These steps increase the amount of money Chinese consumers have to spend. Meanwhile, restrictions on property sales in major cities are expected to curb rapidly escalating home prices. China's bank regulator said it plans a gradual move to liberalize interest rates.

There are also steps toward promoting the use of the renminbi in world trade. Analysts see those measures as eventually leading to an exchange rate that better reflects market forces and looser controls on the movement of capital. China has agreed to let more of its currency trade in Hong Kong, where the renminbi can be used to issue corporate bonds and other financial instruments to fund projects in mainland China.

Meanwhile, officials from the People's Bank of China have begun speaking in public about using the exchange rate as a way to control inflation — an approach that top Chinese officials have in the past tried to minimize.

The government has announced broader ambitions for the renminbi to partly supplant the dollar as the dominant currency in world trade, but this would require much freer use of China's money than is currently allowed.

Chinese exporters say they see change coming.

At the Canton Fair, a mammoth trade show in Guangzhou, thousands of companies filled 11 million square feet of space with the output of China Inc., from plastic trinkets to advanced industrial machinery and high-tech consumer products. Zhang Xiaofen, a salesman for the Sun-flex line of industrial grinding and abrasive materials, said the company is planning for a rise in the value of the renminbi.

"We have to control for it. An enterprise like ours — we don't have a say. We know the renminbi will rise, but everybody will have to manage the change," she said.

Researcher Liu Liu contributed to this report.