The Washington Post

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China's currency of opportunity

By Robert J. Samuelson, Published: June 22

The United States and China have a wonderful opportunity to do a deal over the ever-contentious issue of China's undervalued currency — but will probably blow it. For years, American presidents and congressional leaders have urged a major revaluation of the renminbi (RMB), which contributes to massive Chinese trade surpluses with the United States and the world. Now, China has an independent reason to revalue the RMB: combating inflation.

In the past year, China's inflation has surged. Consumer prices rose 5.5 percent for the year ending in May, and many economists expect further increases. Chinese leaders fear that higher inflation threatens their power. Indeed, higher inflation helped trigger the 1989 Tiananmen Square protests.

"Inflation keeps Chinese policymakers up at night," writes Cornell University economist Eswar Prasad in the Asian Wall Street Journal. It feeds "social instability, especially in urban areas where there are already rumblings of discontent at dismal employment prospects and the growing gap between rich and poor."

Here are the makings of a deal, because a higher RMB would both dampen China's inflation and reduce large U.S. trade deficits. China's exports would become more expensive, its imports cheaper. American exports would become more competitive globally.

Start with the effect on U.S. trade.

In a new study, economist Robert Scott of the Economic Policy Institute, a liberal think tank, estimates that a 28.5 percent RMB revaluation would reduce the U.S. current account deficit (the broadest measure of trade) by $190 billion after 18 to 24 months. The shift, Scott says, would add as many as 2.25 million jobs. In 2010, the U.S. current account deficit with all countries totaled $470 billion. His estimates assume that an RMB revaluation would also prompt other Asian countries (Taiwan, Singapore, Malaysia) to revalue their currencies for the same reason: to contain inflation.

Higher currencies would help China and its neighbors with inflation in two ways. First, imports, especially food and oil, would become cheaper. Second, weaker demand for labor in export industries would relax wage pressures. This would help preempt a devastating wage-price spiral — higher wages fueling higher prices, which fuel yet higher wages.

It seems like a win-win situation. What stops it?

Politics, mostly. “The currency issue has become so politicized” in China, says Prasad, that economic arguments “make little headway.” Also, it’s a bad time politically to negotiate. In 2012-13, both countries face changes: a presidential election in the United States; a scripted transfer of power to a new president in China. Finally, the United States would achieve a long-standing goal (a big RMB revaluation) and in return would give ... what? President Obama might pledge to oppose anti-Chinese protectionist legislation, but he could not bind Congress or another president.

The resulting impasse with China poses yet another threat to the fragile global economy. China’s impressive economic growth rests on increasingly wobbly pillars. The most obvious danger is political: that huge U.S. trade deficits and stubborn unemployment lead to protectionism. In 2010, the American trade deficit with China was $273 billion. If the United States went protectionist, other countries — fearing a flood of Chinese exports diverted from the United States — might follow suit.

The second wobbly pillar is a housing boom that derives from a cheap credit policy fostered, in turn, by the undervalued RMB. “There’s a risk that you could have a big decline in housing investment,” says economist Nicholas Lardy of the Peterson Institute for International Economics. Spurred by low interest rates, housing construction zoomed from 3.4 percent of gross domestic product (GDP) in the 1997-2003 period to 9 percent in 2010.

The trouble is that many housing units were bought on speculation. One survey found that 18 percent of families in Beijing owned two or more properties, Lardy says. If prices stopped going up, speculators would suffer losses and construction would probably fall. The effects would ripple throughout the economy, because housing absorbs 25 percent of steel production and large shares of cement, copper, aluminum and other industrial commodities, he says.

Here’s the connection between cheap credit and the undervalued RMB. As money earned from trade surpluses poured into China, the central bank — the People’s Bank of China — kept interest rates down to avoid attracting more money from abroad. Rates were also kept low to minimize the government’s own borrowing costs. But the low rates on bank deposits (less than inflation) punished savers, who looked for higher returns by investing in housing.

In one way or another, the biggest threats to China’s economy — inflation, its reliance on exports and the suspect housing boom — are bound up in the undervalued RMB. The Chinese hope to muddle through by letting the RMB rise at a snail’s pace. This has worked before. If it doesn’t now, the global recovery would suffer another body blow.