International

China's Currency Problems

Brian Wingfield, 05.03.07, 6:00 AM ET

WASHINGTON, D.C. -The pesky problem of China's undervalued currency just won't seem to go away.

Even after Beijing agreed to a gradual appreciation of the yuan in 2005, China's current account surplus has surged to record levels, fueling speculation that the currency needs to appreciate even further.

But when Chinese officials visit Washington later this month in the second meeting of the "Strategic Economic Dialogue" between the two countries, the Bush administration is not expected to push for a major revaluation of the yuan. Instead, the talks will focus primarily on longer-term issues, such as tourism, energy and the environment, intellectual property rights and reducing the U.S.' trade deficit with China.

"China needs to do more on the currency [issue] for a lot of reasons," Treasury Secretary Henry Paulson said in a speech at the Peterson Institute for International Economics. "But I think to get to the trade balance, we're going to have to get to some other things and it's those kinds of things we're focused on--though we're always focused on the currency--to a large extent in the SED."

Specifically, Paulson wants to see stronger and more efficient capital markets in China, increased domestic consumption and more exports from the U.S. to China.

"I don't believe that there's much China could do with the currency that would make a difference in the trade balance," he adds. According to Paulson, if Beijing works to establish competitive and efficient capital markets, this will then lay the groundwork for a currency that is in fact market determined.

It probably is a good idea to let the spat over the exchange rate cool for a while. For at least the past five years, the dispute over China's exchange rate has been a sore subject for many U.S. policymakers who have argued that the cheap yuan has caused a flood of imports into the U.S. and E.U., and displaced millions of jobs, particularly in the manufacturing sector.

But China has let the yuan appreciate against the dollar by 6.6% in less than two years and is not likely to let it rise by much more anytime soon, at least without intense international pressure.

According to Morris Goldstein, a senior fellow at the Peterson Institute, the administration should abandon its "quiet diplomacy" approach and put a "down payment" of 10% to 15% appreciation against the dollar right away.

"The Treasury should press for putting the exchange rate issue at the top of the agenda for the May 2007 meeting of the Strategic Economic Dialogue and for keeping it there until greater progress is made," Goldstein says in a new study on the issue, adding that the administration should report this month to Congress that Beijing has engaged in "currency manipulation."

He makes a compelling argument. According to Goldstein, China's total current account surplus has ballooned from 1% of its gross domestic product in 2001 to 9% in 2006. And if one looks at the real exchange rate--essentially taking into account price differences between the U.S. and China--the yuan has actually depreciated against the dollar. In addition, he says, Beijing has not really allowed market forces to determine the yuan's value, and it continues to flout the International Monetary

Fund's guidelines, which prohibit currency manipulation.

On Capitol Hill, Sens. Charles Schumer, D-N.Y., and Lindsey Graham, R-S.C., have echoed these sentiments, arguing that China has continued to manipulate its currency and engage in illegal trade practices in the past two years, and that stronger action on the part of the administration to bring China into line in order to protect U.S. workers.

"Simply put, the current options are not yielding results," Schumer said in recent testimony to the Senate Finance Committee.

But one problem for critics of U.S. policies and protectionists is that the current approach to the currency issue doesn't seem to have had much of an effect on jobs in the economy at large here. According to Goldstein, "The U.S. economy is operating at full employment, and China's exchange rate policies are clearly not a key driver of aggregate employment in the U.S., although they may impact particular groups."

Eswar Prasad, a professor of trade policy at Cornell University, agrees with Paulson that the U.S. should work to help China establish a sound financial system instead of narrowly focusing on the exchange rate between the yuan and the dollar.

"What is really important is for China to have balanced economic growth," he says. Allowing the yuan to float freely could have bad implications if the country's financial system is not in good shape. If people quickly pulled their money out of China, it could send foreign exchange markets haywire. Prasad says the best approach for China is to have a flexible exchange rate while managing its growth.

One of the first rules in diplomacy--economic or otherwise--is to do no harm. At the moment, it doesn't appear that the dollar-yuan exchange rate is having an enormously harmful effect on the broad U.S. economy. The administration has recently levied several complaints against China at the World Trade Organization for its trade policies, and it has slapped anti-subsidy tariffs on some Chinese goods. For now, this seems to be the best approach to dealing with, rather than meddling with, its currency.