NBR BRIEFING

POLICY REPORT

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Renminbi Revaluation

As the U.S. trade deficit with China balloons, calls are being made in the United States for the Chinese government to revalue its currency, the renminbi (or yuan). The argument, in its briefest form, is that if the renminbi (which has thus far been pegged to the dollar at the approximate rate of 8.3 to 1) is allowed to grow in value relative to the dollar, then Chinese goods will become more expensive, and U.S. goods in China will become cheaper. Theoretically this means that the U.S. trade deficit with China should shrink, and that manufacturing jobs in the United States will be saved.

At issue: The swelling bilateral trade deficit with China (expected by some to reach $120 billion by the end of this year) and the loss of manufacturing jobs here in the United States (one in five people in the manufacturing sector of the economy have lost their jobs in the last three years).

- Will an increase in the value of the renminbi improve the bilateral trade balance and cease the hemorrhaging of jobs from the manufacturing sector?

  - **Glen Hubbard**, former economic advisor to George W. Bush, and now professor of economics at Columbia University argues that we should not put the blame on China for job losses in the United States. Hubbard states that the lower number of manufacturing jobs is due to large-scale systemic changes in the U.S. and global economy, much like the changes in agriculture at the end of the 19th century.

  - **Everett Ehrlich**, a former undersecretary of Commerce, argues that China's economic growth doesn't threaten U.S. workers; it threatens workers in places like Malaysia and Mexico. The real issue is productivity growth in the United States. Technology now permits the United States to produce more and better goods with fewer people. If the number of jobs does not grow in other areas, such as services, manufacturing workers lose out.

  - **Robert Kapp**, President, U.S.-China Business Council, writes, "No practically imaginable increase in the [renminbi]'s value would eliminate the very phenomena that have led to US demands for PRC action on the currency in the first place." What are at issue here are large-scale, global, systemic changes that are confronting the U.S. economy. China has been able to develop its economy thanks to technology-driven productivity gains, to the coordination of labor resources, and to modern managerial skills. Kapp adds, "Today's controversy will likely fade; the bigger questions implied by China's arrival as a… player in the global economy, with all the benefits and difficulties for China itself as well as for its global trade partners, will not."

- A little known fact is that China's trade balance with the rest of the world is at a deficit of approximately $75 billion, compared to a trade surplus of $120 billion with the United States.

- An editorial in the *Wall Street Journal* made the following observation: "Economists and journalists parse the data and reach a near-unanimous conclusion that China isn't using unfair tactics to steal American jobs, and revaluing the yuan [renminbi] wouldn't change much."

➢ Should the renminbi be revalued?

- **Morris Goldstein** and **Nicholas Lardy** of the Institute for International Economics argue that there should be a modest revaluation of the renminbi (to between 15-25 percent in the short term), but afterwards there should be an adoption of a managed float. In the longer term they advocate a three-currency basket peg (dollar, euro, yen) for the renminbi. This could allow the dollar to devalue versus the renminbi, without forcing the renminbi to revalue on world markets. They feel that an immediate unrestricted float of the renminbi would be dangerous – perhaps setting off a chain of events as bad as the Asian financial crisis of 1997.

- **Hubbard**, **Ehrlich**, **Kapp,** and **Mark Clifford**, Hong Kong Bureau Chief of *Business Week*, argue that a revaluation should not be forced. Instead the United States needs to focus on its own problems such as fixing its notoriously low savings rate and re-educating workers from sectors that have been hard hit by globalization.

➢ How fragile is the Chinese banking sector?

- Speculation that the renminbi will be revalued has led to a dramatic increase in speculative capital inflows into China (as investors rush in with dollars to buy assets before their value increases). The possibility of further inflation could severely damage the fragile banking sector.

- **Paul Coughlin**, the managing director for Asian government and corporate ratings at Standard & Poor's, cautioned that an increase in the currency's value in foreign exchange markets "would place additional strain on an already insolvent banking system."

- **Charles Wolf** of the RAND Corporation pointed out in a recent study the fragility of the financial system in China. According to Wolf, the balance sheets of China's four major state banks are riddled with non-performing loans. Estimates of their total value vary, but they may amount to more than 60% of China's GDP, or $1.6 trillion. Should China experience a run on its banks, large-scale capital flight, a significant reduction in savings, or a decline in capital formation, the ensuing financial crisis and credit squeeze could lower annual GDP growth by at least 0.5% to 1% and have an enormous impact on the region and the global economy.

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