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On the Issues

Yuan Answers?

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If China decides to adopt a flexible exchange rate, as many U.S. policymakers have urged, gains in U.S. exports and national savings in the long term will be offset by higher prices on Chinese goods and higher interest rates in the short term.

From op-ed pages to the chambers of Congress, the United States has turned up the volume on its efforts to get China to stop fixing the exchange rate of the yuan against the dollar. But many think that China will not want to be seen as buckling under U.S. pressure: public demands, under this view, will only make the Chinese take longer to move to a flexible exchange rate. Presumably U.S. officials know this. So why are they pushing? To be sure, part of it is politics—cheap words and a touch of economic isolationism applied to Chinese clothing exports might let off enough congressional steam to avoid self-inflicted wounds like a stiff tariff on everything we buy from China. But could there be more to the voluble U.S. diplomacy than just political posturing?

Results of a Stronger Yuan

Exchange-rate flexibility is certainly in China's own best interest. The continued need for China to buy dollars to maintain the peg suggests that the yuan would appreciate without Chinese intervention in currency markets. The end of the exchange-rate peg will reduce Chinese money growth and rein in inflationary pressures. It will also help slow the excessive credit growth and mounting bad loans that threaten to undermine China's banking system. This will in turn put the brakes on an investment binge that makes the country vulnerable to a hard landing if exports falter. China should still see solid growth with a stronger yuan, but increasingly this will be fed by rising household consumption. Having long followed Mao's exhortation for diligence and frugality, Chinese workers will finally get to consume the results of their labor rather than see it put on container ships.

So if it is good for China to revalue, why don't its leaders just go ahead? Even without U.S. pressure, there are entrenched interests to overcome in China. Exchange-rate changes have far-reaching effects, so some people inevitably will be hurt. A stronger yuan will make life harder for Chinese exporters. Some may well have grown lazy from living with a built-in cost advantage and easy access to credit, and might not be productive enough to compete on a level global playing field. Banks that have provided credit to inefficient enterprises will likewise be hit as poorly made loans turn sour. In turn, the government will face pressures for costly bailouts. And policymakers might worry about the tricky timing, including the possibility that events in the rest of the world could cut demand for Chinese exports before home-grown demand picks up. The underlying fear is of a threat to civil stability should growth not remain strong enough to absorb the ongoing migration of rural workers to coastal provinces. And yet, the Chinese hoard of $650 billion in

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reserves provides plenty of balm to apply against slipping demand or banking sector difficulties, while rising U.S. incomes and steady job creation suggest undimmed demand for Chinese products.

Effects on U.S. Markets

Over time, the move to a flexible yuan will be good for the United States. Stronger Chinese domestic demand will boost U.S. exports and allow for higher U.S. national saving without slower GDP growth. Indeed, the larger international economic problem is not strong growth in China, but instead the lack of it in Europe and Japan.

At first, however, the United States will feel a sting from a stronger yuan. If China's currency is undervalued by 27 percent, as some have claimed, U.S. consumers have been getting a 27 percent discount on everything made in China, while the Chinese have been paying 27 percent too much for Treasury bonds. One might wonder why the United States is complaining in the first place. Revaluation would end the Chinese fire sale. Americans will pay more for everything from shoes to electronics. Other global investors will buy up U.S. bonds the Chinese no longer want—and Americans might even save a bit more—but the Treasury and the public will have to pay higher interest rates. A stronger yuan will mean not just a steeper cost of financing government debt, but also higher payments for U.S. homeowners on those frothy interest-only mortgages. And do not expect U.S. job gains from revaluation. China's undervalued currency has cost jobs, but they were lost in Malaysia, Honduras, and the other low-cost countries from which U.S. clothing and toys will be sourced as Chinese exports slow.

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So if there is short-term pain in this for the United States, why pressure China to revalue? U.S. policymakers surely understand the downsides of a yuan revaluation for the U.S. economy. And they certainly must realize that their very public campaign only makes it more difficult for the Chinese to take action. Could it be that this is the point? A cynic might hope that the push for a Chinese exchange-rate change is not a response to misguided political pressures, but is instead a devious attempt to prolong the enormous benefits the United States derives at China's expense from the fixed dollar-yuan exchange rate. Or perhaps this is accident, not design. Either way, the administration has come up with a brilliant strategy to keep the good times rolling.