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The Case for *Gradualism*

BY DIETER WERMUTH

Why a quick fix for China's currency would be a mistake.

In the early seventies, the fixed-rate Bretton Woods system broke down because stability-minded countries in Europe and Asia were no longer willing to import inflation from the United States. As long as the dollar was a scarce commodity, backed by gold, it was an advantage to use it as an anchor, but when the Vietnam War was increasingly financed via the printing press, when America's external deficits began to explode and inflation to rise and spill over into other countries, the consensus that had served the post-war economies so well finally broke down. The major currencies have been more or less freely floating ever since.

Bretton Woods has been making a comeback in Asia. The Chinese renminbi has been firmly pegged to the dollar at a rate of 8.28 for eleven years by now. Again, the world is being flooded with dollars, and without large-scale purchases by Asian monetary authorities the external value of the greenback would have declined substantially. A massive accumulation of international reserves has been the result of those interventions. This in turn has created vast amounts of domestic liquidity in Asian countries where printing presses must be running day and night. The difference between thirty-five years ago and now is that, so far at least, there is almost no indication that inflation is getting out of hand. So the countries which keep buying all those dollars do not complain, nor do they want to give up the peg as yet. In April, Chinese consumer prices were just 1.8 percent higher than

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one year ago, an inflation rate which the European Central Bank, for instance, would regard as price stability. As far as growth is concerned, the fixed exchange has had no visible disadvantages: the International Monetary Fund estimates the average annual real GDP growth rate for the twenty years through 2006 at 9.1 percent, with almost no evidence that the momentum is about to fade.

It is therefore not the Chinese who want to untie the dollar bond, it is rather the Americans who are pushing for a realignment—more precisely, for an appreciation of the renminbi. The Chinese would prefer to argue that something that ain't broke needs no fixing. They are dragging their feet and will only allow some upward adjustment of their exchange rate if the likely political repercussions of sitting tight outweigh the benefits. There is no theoretical limit to the amount of dollars they are able to buy. If the renminbi were weak, the situation would be quite different because China might run out of foreign exchange reserves at some point, but this is obviously not an issue today. The country will never run out of renminbi.

The main attraction of a fixed dollar exchange rate is international price competitiveness, as long as unit labor costs can be kept under control. This has been no problem at all: strong investment activity and the progressive introduction of market mechanisms have resulted in robust productivity gains while millions of underemployed workers, set free by technological advances in agriculture and state-owned companies, exert downward pressure on wages. China is repeating what Japan and Germany did after World War II: building a modern capital stock on the basis of a high domestic savings rate and stimulus from strong exports. An undervalued exchange rate, achieved through slower cost inflation than abroad, is part of the game plan, as is the exposure to world markets. Welcoming foreign direct investors and learning from them, if not ruthlessly copying their products, has also helped. One function of a stable and therefore predictable exchange rate is to reduce the required risk premia in new investment projects. This increases the number of viable projects.

China is not pursuing mercantilist policies, though, and in general does not try to be self-sufficient across the whole range. Imports have been increasing almost as rapidly as exports, in the order of 20 percent per year so far this decade, or almost twice as fast as nominal GDP. Sometime later this year, Japan will sell more of its goods and services to China than to the United States. So far, imports consist mostly of energy, raw materials, and capital goods, while the main exports are consumer electronics, other electronic goods, textiles, toys, and shoes but also chemicals. The degree of sophistication in foreign trade is rising rapidly and Chinese products are less and less synonymous with cheap stuff. Labor-intensive production will continue to play an important role for many years to come, though, because even with wages rising on the order of 10 percent annually, they are still extremely low. Nominal GDP per capita may be a poor proxy for wage differences, but it provides at least a rough idea: at $1,100 it is just 2.6 percent as high as that of the United States. China has a lot of catching up to do. It is in the interest of the world's exporters that this process is not derailed any time soon, for instance by a volatile exchange rate.

Over the past twelve months, the trade surplus has been $57 billion or 4 percent of nominal GDP which is somewhat less than the surpluses of Japan or Germany these days, and much smaller than the Swiss, Swedish or Singaporian ones. Yet China is a major net exporter of capital, something that, *prima facie,* does not make sense for such a poor country with so much market potential. From a Chinese point of view, it is a sustainable situation, even though it can not be optimal in terms of resource allocation. There are several explanations. First, while the investment ratio is somewhere around 40 percent (!), the national savings rate exceeds it by four percentage points. Because of a lack of profitable investment opportunities at home, surplus savings have no place to go but foreign countries. Second, imports are either not yet fully liberalized, or are held back by sub-standard trade finance or by bottle

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necks in transportation. Third, private capital imports must overcome considerable hurdles in the form of limitations on foreign ownership, political meddling, corruption, and obscure legal processes. China is already an important player in world trade but it could participate even more in the international division of labor if these obstacles were removed, to the benefit of all. As long as China's capital stock, on a per capita basis, is so small compared to its potential, or compared to that of the G7 countries, the goal should be to turn the country into a net capital importer. This must have precedence over a currency realignment.

Perhaps the insistence that China must do something about its exchange rate mostly reflects the fear that real GDP growth is too fast for the rest of the world, and the United States in particular. Structural change must accelerate in the rest of the world as China sets the pace. Everybody is in favor of structural change, as long as only others are affected. If China would slow down in the wake of a less competitive exchange rate, adjustment processes in the other countries could be less demanding and painful.

China's economy is probably already much larger than comparisons of nominal GDP numbers suggest. This is why the exchange rate issue is causing so much excitement. At U.S. $1,410 billion, its size is only 11.6 percent as large as that of the United States, but in purchasing power terms (PPP), as used by the IMF in its last *World Economic Outlook,* it has already arrived at 63.2 percent, an increase by a factor of almost 5.5. In these terms, China's GDP exceeds Japan's by 91 percent. If China maintains an annual growth rate of 9 percent for another nine years, while the United States expands by 3.5 percent annually, its PPP-GDP will be the world's largest. Even then, its GDP per capita would only be a quarter that of the United States, and would thus not necessarily mark the end of its catching-up process. These are scary numbers from a geo-political point of view. Consider energy consumption: if China's growth continues at its blistering pace until per capita energy consumption reaches present U.S. levels, world energy consumption would be twice as high as it is today. Note that China's economic expansion is focused more on goods than on services

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and therefore more energy-intensive than growth in the United States, Japan, or Europe. An oil price of $100 per barrel would then be considered low. The recent explosion of oil and other commodity prices, as well as those of intermediate goods such as steel or chemicals, has given the world a foretaste of things to come.

If the PPP calculations are worth anything—and my gut feeling suggests that they are—a revaluation of the renminbi by 5 percent or even 10 percent will not make a big difference. After further prodding and arm-twisting, the Chinese may agree to such a step, well aware that the little improvement in their terms of trade is nice to have while international competitiveness is not seriously damaged. If the renminbi would be valued according to PPP terms, it would take 1.52 of them to buy one dollar, rather than 8.28 today. Think of the upheavals this would cause for the world economy.

What if the Chinese decided to leave the exchange rate unilaterally pegged to the dollar? In that case it can be expected that, under the assumption of continued political stability, China's real growth would remain high, in particular that of the capital stock—but also that of household consumption. The modernization and expansion of the capital stock leads to further rapid gains in productivity and real wages. Inflation will also accelerate as capital-intensive manufacturing industries attract workers from the services sectors—the Balassa-Samuelson effect—and thus drive up wages for the remaining ones. On average, wage growth therefore exceeds productivity growth. The undervaluation of China's real exchange rate will gradually disappear. Imports will then rise which in turn tends to reduce the trade surplus. Even under fixed exchange rates it is therefore likely that trade imbalances will disappear over time.

For politicians who look for quick fixes, such gradual processes do not look like a genuine option, and they will therefore keep up the pressure on China. Economists though should appreciate that standards of living are improving at a rapid pace in such a poor and at the same time vast country, not least because of a stable exchange rate regime. Rich countries are always the best trading partners—and neighbors. ◆