Is the Chinese currency, the renminbi, *dangerously undervalued* and a threat to the global economy?

Over thirty important experts offer their views.

Background:

Chinese companies themselves—with their virtually zero marginal labor cost work force—lack global reach. But are foreign companies now investing heavily in China as a manufacturing base setting the stage for ever-increasing global deflationary pressures? Areas such as the Pearl River delta are now attracting $1 billion per month in foreign investment. In theory, such a shock to the system should produce offsetting adjustments from the global central banking community. But have the central bankers responded adequately? How, if at all, should the G7 policy community address the Chinese currency issue? To what extent do escalating foreign investments in China set the stage eventually for a potential destabilizing of the entire world trading system? Or are all of these concerns essentially unwarranted?

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Yes, and the nightmare is coming.

BARTON M. BIGGS
Managing Director and Chief Global Strategist, Morgan Stanley

There is no doubt that the huge, mindless inflow of investment money into China is increasing global deflationary pressure on manufactured goods. This is causing dislocations in manufacturing industries and job markets not only in G7 countries but in developing economies as well. The consumers of the world are the beneficiaries through lower prices, but profits and jobs are being lost both in the West and the other developing economies. It is also questionable that the Western-owned manufacturing facilities in China have been or will be able to repatriate their profits. Plants in China may just be a great sinkhole for the West.

Furthermore, if geopolitical events and fear of terrorism cause the United States to close its borders and retreat to Fortress America, China with its massive exports will be the biggest loser from the inevitable contraction of world trade.

I am no international economist. Common sense suggests pressure should be put on China to allow its currency to find its own level which certainly would be higher against the dollar. As for the massive investment boom (or should I say "bubble") in China, a bust is bound to come. A country that does not have a free markets capital allocation mechanism is uniquely unqualified to mitigate the excesses of an investment boom. After all, if the West with its sophisticated public markets and information dissemination systems was totally incapable of coping with the technology bubble, what hope is there for China? The greater the bubble, the bigger the bust. In China's case, the resulting unemployment of perhaps even several hundred million young men and women could destabilize the world.

Of course the hope is that there is a central bank chairman hidden away in some musty office in Beijing who has the stature and knowledge of Greenspan and the guts that Greenspan lacked. I don't see that there is much the G7 central bankers can do. Economists have created the legend that China is the new engine of world growth. I fear it is a myth about to become a nightmare.

Yes, for both domestic and international reasons.

C. FRED BERGSTEN
Director, Institute for International Economics, and former Assistant Secretary of the Treasury for International Affairs

China should float the renminbi, and permit it to appreciate in the currency markets, for both internal and international reasons.

Domestically, China is wasting large amounts of resources by piling up excessive and low-yielding foreign exchange reserves. Its desire to continue insulating itself from Asian-type financial crises after it relaxes its exchange controls is understandable but its current hoard of more than $250 billion, second in the world only to Japan, is far beyond any conceivable need. Much of those reserves are placed in U.S. Treasury liquid assets, yielding less than 2 percent, while investments in China's booming economy typically yield at least five to ten times as much. A country that is still as poor as China (per capita income of about $1,000) can ill afford to use such an important share of its savings so unproductively.

Internationally, China is now the world's third or fourth largest economy and must increasingly think of itself as a key participant in the global adjustment process. Given both its low per capita income and its very large influx of foreign direct investment, it clearly should be running a sizeable current account deficit (compared with its present modest surplus). This swing would contribute importantly to the needed reduction in the U.S. current account deficit, and would require that the renminbi appreciate against the dollar along with the currencies of America's other major trading partners (notably Canada, Europe, Japan, Korea and Mexico). (The fact that those other currencies would also be rising against the dollar means that the appreciation of the renminbi in trade-weighted terms, which is what counts for its overall competitive position, would be much less than its rise against the dollar and would probably be rather modest.)

China's de facto dollar peg (and Hong Kong's explicit dollar peg) now produce perverse results in terms of the international adjustment process. When the dollar declines, as it has over the past year by a trade-weighted average of about 10 percent but by much more against the euro and yen, the renminbi falls along with it. China's international competitive position thus strengthens and its current account surplus rises further, placing additional pressure on America's other trading partners to accommodate the needed reduction in the U.S. deficit.

China's legitimate desire for a stable exchange rate would be enhanced by a managed float of the renminbi. The rate is now kept virtually constant against the dollar but, in light of the dollar's sharp rise against virtually every other currency from 1995 until a year ago and its substantial fall since, the "real effective" (inflation-adjusted, trade-weighted) exchange rate of the renminbi has been quite unstable. China would promote many of its own purposes, as well as international prosperity, by floating the renminbi.

No, China's role is a blessing to the world economy.

GENE H. CHANG
***Director, Institute for Asian Studies, University of Toledo, Ohio, and co-editor of* China Economic Review**

Is the RMB undervalued? The purchasing power of the RMB is higher than its official exchange rate, a 4.75:1 ratio, but this is common for all developing countries. The same ratios for India and Russia are 5.33 and 4.18 respectively, and average ratios for low-income and lower-middle–income countries are 4.85 and 4.05 respectively. The RMB is not abnormal. The official exchange rate of the RMB has experienced a de facto devaluation of about 5 percent since 1999, due to domestic deflation and a rise in productivity. Yet this did not make the RMB substantially undervalued, as the black market exchange rate for the RMB in 2002 was the same of the official rate.

The U.S. and Japanese concerns about an undervalued RMB come from the flood of cheap products from China. The Chinese labor cost is low, as is its productivity. The low Chinese labor cost was due to an unlimited supply (120 million-plus) of rural surplus labor, who are willing to work at the subsistence level. It is a market outcome and little can be done to alter it at this stage.

Although China has substantial trade surpluses with the United States, it runs huge trade deficits with its other Asian neighbors. China's overall current account surplus is $30 billion, which is only one quarter of Japan's. Foreign capital flooded to China in recent years because of the recessions in the United States and Japan and unstable situations in Indonesia, Philippines, and other countries, not because of an undervalued RMB.

Revaluation of the RMB is not a solution for the domestic economic problems of the United States and Japan. First, the trade deficits with China account for less than 1 percent of U.S. GDP; thus the effect is very limited. Second, a revaluation of the RMB may cause the trade deficits to widen rather than shrink, because China's products are often necessities with inelastic demands. In this case, a J-curve could prevail. Finally, revaluation of the RMB must result in a loss in consumer's surplus in importing countries.

Rapid growth of the Chinese economy, rather than a revaluation of RMB, is the most effective solution for the concerned problems. As its economy grows, China will increase imports from the United States, Japan, and the rest of world. China (including Hong Kong) already imports more from the rest of Asia than Japan. China's demand turned the otherwise-soft world steel market to buoyant in 2002. This momentum continues as U.S. and Japanese auto parts and assembled autos flood into China this year. In fact, China's overall trade balance already turned to a deficit in January, 2003. It is therefore evident that the concern about the undervalued RMB is unwarranted, and that the growth of China's economy is a blessing rather than a threat of the world trading system.

China's effect on the world is fundamentally healthy.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

It is true that China runs a current account surplus ($17 billion in 2001, smaller however than the surpluses of Taiwan, Belgium, Switzerland, and several larger countries), and has built up its foreign exchange reserves to $270 billion, an increase of $58 billion over the past year. These are signs, in a poor country, that the currency is undervalued. The yuan (rmb) has been fixed to the U.S. dollar at 8.28 since 1994; the extensive buildup of China's reserves suggests the currency would have appreciated in an unconstrained market.

However, China has not sterilized its buildup of reserves; money supply has increased rapidly, and has been accompanied since 1998 by a stimulative budget, both associated with annual growth in excess of 7 percent on official figures. Moreover, China's accession to the World Trade Organization requires very much greater trade liberalization by China than by its trading partners, suggesting that by the end of the transition period in 2007 China may require some currency depreciation. The indicated policy, in my view, is to allow some flexibility in the exchange rate, recognizing that it will lead to modest currency appreciation in the near term, but creating an environment in which some depreciation can take place smoothly and non-traumatically in the coming years.

Is Chinese policy dangerously deflationary for the rest of the world? China's official prices were essentially stable during the past year (-0.4 percent)—just the kind of performance inflation hawks should strongly approve—but also reminding us of an ancient Chinese curse: May your wishes be granted! With its large (but largely unskilled) agricultural labor force, China has the potential to continue to grow production of labor-intensive products, no doubt putting competitive pressure on these sectors worldwide, and increasingly also on other sectors, as skills increase. Is this dangerous? It is certainly discomfiting to those in direct competition with Chinese-made products, and requires adjustment. But for the world economy it is fundamentally healthy—both providing invigorating competition and permitting higher living standards everywhere.

Yes, and if there's no change the big losers will be developing countries.

TATSUYA TERAZAWA
Director, Japan External Trade Organization, New York

The Chinese RMB in my view is clearly undervalued. China runs the highest trade surplus with the United States and continues to record a high level of current account surplus. China's foreign reserve is piling up at an astonishing speed. Since 1994, its foreign reserve has increased by more than five times. The current dollar peg was introduced in January 1994. In spite of the dramatic enhancement of the competitiveness of the Chinese economy and industry during the period since then, the currency level has been remained basically unchanged for nine years. The change in the currency regime or the level is long overdue.

The arbitrarily low level of the RMB is a serious problem for the global economy. In addition to being the cause of exporting deflation to the world and a drag on the dollar, it can well wipe out or seriously affect the hope for economic development of many developing countries. Already new foreign direct investment (FDI) to Southeast Asia, which has been the engine for growth of the region, is dropping substantially. Although currency level is only one of the causes, the arbitrarily low RMB is certainly accelerating the shift of FDI from Southeast Asia to China.

The damage can be more devastating for less developed economies. In January 2005, import quotas on textile trade will be abolished. With quotas gone, Chinese textile exports are expected to dominate the global textile market. The losers will be the developing countries depending upon textile exports for their growth. Pakistan depends upon textiles for 73 percent of their total exports. For India, Indonesia, and the Philippines, the figure are 23 percent, 15 percent, and 8 percent respectively. For these countries, competition with Chinese textile exports coupled with an arbitrarily low RMB will most likely lead to the devastation of their textile industries which is so important for them. From the development policy perspective, such an outcome should definitely be avoided. The most market-consistent way to deal with this problem is to appreciate the RMB or to shift the RMB to a float system before the damage is done. Otherwise, a huge amount of economic aid may be necessary to offset the negative impact. We also need to be fully reminded that the most vulnerable countries are the countries with much more importance after September 11 for security and anti-terrorism reasons.

Yes, dangerously undervalued.

CHRISTOPHER W. HUGHES
Senior Research Fellow & Deputy Director, Centre for the Study of Globalisation and Regionalisation, University of Warwick

The renminbi is undoubtedly dangerously undervalued with potentially destabilizing consequences for the regional economy in East Asia. The risk is of China again triggering a series of competitive devaluations that could lead to a repeat of the Asian financial crisis of 1997. Japan is often blamed for initiating the crisis in the ASEAN states due to the close to 60 percent depreciation of the yen against the dollar in 1995–1996, thus squeezing out their exports at the higher value end of the production chain. However, it is often forgotten that China in 1994 deliberately devalued the renminbi by 33 percent, thus squeezing ASEAN exports also at the lower end of the production chain. China's growing image as an economic competitor at all stages of the production chain, resulting from a range of comparative advantages including the undervaluation of the renminbi, could force Japan into the devaluation of its own currency to maintain competitive advantage. Japan is once again considering trying to export its way out of recession and to facilitate this by forcing down the yen. At the same time, the United States also appears content to see the value of the dollar fall. If these three major economic players in East Asia engage in competitive devaluations, the consequences for the ASEAN states could be dire. They are already suffering from heavy competition from China in many of their traditional exports, and China's dollar peg means that it is sucking up investment from Japan and outside the region that might otherwise have gone to Southeast Asia. Devaluations by Japan and China as their competitors at the top and bottom ends of the production ladder will once again choke off their export-led growth and precipitate financial instability. Greater currency coordination is still necessary in East Asia, and Japan should make further moves to internationalize the yen in order to prevent damaging exchange rate fluctuations.

Yes, but state controls prevent this adjustment.

EDWARD N. LUTTWAK
Senior Fellow, Center for Strategic and International Studies

In spite of all evidence to the contrary, including the most dramatic case of Argentina, dominant opinion holds that only market forces matter, not the institutions and policies that constrain and deform market forces.

Yet for at least forty years, economic theory (notably the general theory of the second best) has explained why partially free markets need not achieve a like part of free-market optimality, and may to the contrary be worse than markets that are even less free.

There are no homogeneous ordinal levels below perfection, but rather complex interactions—and that indeed is why we need complex economic policies. Or more simply: a 90 percent solution may be worse than a 70 percent solution.

China today is a case in point, and by far the most important. There is a large scope for market forces in the Chinese economy, but there are also powerful state controls. As a result, the renminbi is greatly undervalued. That of course results in huge trade surpluses which should generate a corresponding demand for the renminbi, increasing its relative value, making Chinese exports more expensive. But state controls prevent this adjustment, hence China is experiencing "high speed" growth by selling deliberately undervalued exports.

Of course China is only copying the Japanese model of the 1960s, the Taiwanese model of the 1970s, the Korean model of the 1980s.

But China is not Taiwan, Korea, or even Japan. Its labor market is many times larger than Japan's in the 1960s and of an altogether different dimension as compared to Taiwan or Korea. Having started with the most manpower-intensive , lowest added value products—textiles and such—China is now ascending steadily through the categories, but without the limitations of scale of its predecessors. So long as there is no counter-intervention to correct the imbalance caused by the deliberate undervaluation of the renminbi, Chinese exports will continue to have a a deflationary impact world-wide. Chinese high-speed growth and a global economic slowdown are not only compatible but congruent phenomena. It is high time to cast aside dogma to take action.

Revaluation without reform of the financial system would cause confusion.

TAKESHI OHTA
Chairman, Daiwa Research Institute, Inc.

No doubt the Chinese currency (the RMB) is undervalued judging from various data, e.g., its purchasing power parity set by the International Monetary Fund and the International Bank for Reconstruction and Development (2 yuan/$), the Big Mac Index (3.7 yuan/$), the daily official intervention in the market to manipulate stability of its de facto fixed exchange rate (8.3 yuan/$), and the resultant accumulation of the official reserves ($270 billion).

China's continued fixed investments have resulted in high productivity and enormous production capacities. Thus Chinese consumer goods, becoming cheap and good in quality, have driven competitors out of the export market. A risk to upset a global demand-supply balance, putting a downward pressure on the prices of tradable goods, is looming large. But on the other hand, China is now a most important recipient of neighboring countries' exports as Japan used to be in the 1980s. At the same time, it has become a global factory for the world major manufacturing companies. From Japan, many large- and mid-cap companies are rushing into China. Examining these developments, I would conclude that the RMB should not be considered as a threat to a global economy, although it poses problems to some consumer goods manufacturers in the world markets and may exert a deflationary impact in the future.

In Japan, some politicians and bureaucrats are calling for the yuan to be revalued, but the revaluation of the RMB without reform of the financial system would simply cause confusion and disturbance. The Chinese government now appears to seriously consider some reform programs as a member of the WTO. Since the government hitherto used to act in an incremental way, the pace of progress would be slow and clumsy. At the moment there may be no other alternative, but there is a risk that such incremental approach ends up with "too late, too little." It will be of some help for the Chinese officials to reexamine Japan's experience since the early 1960s.

China should boost domestic demand rather than revalue.

XIN XIE
Asia Economist, Bank of America, Singapore

There is no clear indication that the currency is undervalued. First, the REER (real effective exchange rate) of the RMB has appreciated by about 50 percent since 1990. It has stayed roughly at the same level as it was at the beginning of 1998. Second, the currency account surplus is just about 1.5 percent of GDP if transfer payments are excluded. Third, the recent foreign direct investment inflows are likely to be more oriented toward the domestic market than the earlier foreign direct investment inflows from Hong Kong and Taiwan, reducing their impact on exports. Additionally, those inflows will likely have to import materials in their production for the domestic market, leading to a smaller current account surplus. Finally, deflation in China means that the current account surplus is partly due to weak demand in China, not due to the weakness in the currency. The right policy for China is to boost domestic demand, rather than revalue its currency.

The concerns over the impact of the rising competitiveness of Chinese exporters are justified. Their impact will be big and far-reaching. But the impact is a positive shock rather than a negative shock in the sense that once the necessary adjustment is made by the rest of the world according to the comparative advantage of each economy, the world will benefit in the net from the emergence of China. The concern should be over how to find the best way to adjust and take advantage of China's emergence rather than how to stop it, or to slow it.

Parallel with the small current account surplus is the fact that growth in exports is matched by growth in imports of goods and services. Thus, China puts downward pressure on prices in the industries of its exports, but puts upward pressure of similar magnitude on the prices of the industries of its imports. The difference is that the impact on exports prices is more concentrated than the impact on the world price of imported products, making the latter less noticeable.

In aggregate, China's emergence does not reduce demand for the rest of the world. In fact, it adds to the global demand as the fastest growing economy, if one does not take a simplistic accounting view of the world. Thus, the emergence of China does not require a monetary response. It requires structural changes to facilitate the realignment of industries given the challenge and opportunities.

Yes. A quick 30–50 percent revaluation is needed.

EAMONN FINGLETON
***Tokyo-based writer and author of* In Praise of Hard Industries: Why Manufacturing, Not the Information Economy, Is the Key to Future Prosperity**

China passed an important milestone last year when it displaced the United States as Japan's largest source of imports. The United States had held that position since 1945. For me, as a Tokyo-based observer, there could hardly have been a more telling indication of how big China had become.

Although in the past economists have been wise to counsel a sense of proportion about a nation whose citizens are in the main still quite poor, China must now unquestionably be considered a major league economy not only in total output but increasingly in the sophistication of its manufacturing industries. As it takes its place in the big league, there is inevitably going to be a painful adjustment problem for other nations. By keeping the renminbi artificially low dollar, China is not doing even the bare minimum to limit unnecessary trauma for other economies.

The basic point is that China's fast-rising exports clearly signal that it has made enormous strides in productivity in recent years. Rising productivity should, of course, be reflected in a stronger renminbi. For the West, the immediate effect of a higher renminbi would to be curb the pressure of Chinese competition on Western jobs. For China, the effect would be to allow it to import more and thus to boost the living standards of China's still generally very poor workers. A revaluation of 30 to 50 percent is called for—and quickly.

Given the large gaps between the G7 and China, the G7 enjoys comparative advantages in very different industries than China. The emergence of China thus will be a bigger plus for the G7 than for most other countries. In fact, as the process of adjustment takes its course, this point will increasingly be clear to all people concerned. Recent press reports in Japan have changed from focusing on the competitive threat posed by China to Japan's industries to focusing on the market provided by China for Japan's industries. Thus in the short run, I do not see any urgency for a G7 policy addressing the RMB issue.

In the long term, a flexible exchange rate for China will be more desirable for the world and Chinese economies. Additionally, if the U.S. dollar depreciates sharply, the RMB should be revalued to maintain its relative value against other currencies. The U.S. dollar is overvalued, but not the RMB.

The undervaluation causes a structural imbalance in trade.

YOSHIO SUZUKI
Member of the House of Representatives, Japan

For the past two decades, the exchange rate of the renminbi against the U.S. dollar has declined in real as well as nominal terms. This implies that the low valuation of the Chinese currency today results from two factors: manipulation by the Chinese authorities with regard to nominal value, and the deterioration of China's terms of trade as far as real value is concerned. Manipulated undervaluation of the currency is disruptive for the global economy, but the deterioration of the terms of trade is no threat to the global economy.

The renminbi is de facto pegged to the U.S. dollar through the U.S. dollar buying operations of the Chinese authorities, with the result that China's foreign currency reserves had increased to $74.2 billion, or 6 percent of GDP, by the end of 2002.

The undervaluation of the renminbi causes a structural imbalance in world trade. Moreover, the pegging of the currency to the U.S. dollar has a destabilizing effect in relation to other currencies, particularly the yen and the euro. For China, large holdings of foreign currencies involve high opportunity costs and are inefficient and destabilizing in terms of monetary control.

The deterioration of China's terms of trade is the result of a price decline in labor-intensive goods manufactured in China, including the production base in China of foreign companies, relative to capital- and technology-intensive goods manufactured in the rest of the world, particularly in industrialized countries. This is favorable for us.

The value of the renminbi should be allowed to decline in real terms. The further decline in nominal terms should be corrected toward revaluation, relative not only to the U.S. dollar but also to the yen and the euro. The renminbi should be floated in the future, when China has developed a money market and established a forward currency market.

Yes, but consider first China's two faces.

MAKOTO UTSUMI
President, Japan Center for International Finance

China has two faces, namely advanced industrial areas such as Shanghai (with a per capita annual GDP higher than Malaysia); and poor underdeveloped areas such as Guizhou Province (with a per capita GDP lower than Bangladesh).

Thus, China comprises two faces: one is advanced and industrialized, and the other poorest and underdeveloped.

In her advanced areas, China possesses a huge agglomeration of manufacturing industries, ranging from leading-edge technological types to very labor-intensive sectors such as textile, pushed along by investment from abroad. Moreover, these manufacturing operations are backed by limitless inflows of inexpensive labor from underdeveloped regions.

How can and must we deal with this huge country exhibiting these two disparate faces? This is an issue of great magnitude which we all face.

For a start, we must recognize that the part of China that is facing the industrialized world in areas of trade and investment is her advanced regions. Hence, we will have to ask the Chinese not only to strictly honor their obligations under the WTO scheme, but also to implement the common rules on capital account as being applied to a member of the industrialized world.

When and if capital transactions are liberalized in China as in other advanced countries, it would be virtually impossible for China to keep pegging the renminbi to the U.S. dollar. A more flexible exchange rate system will need to be introduced to mirror the market forces. In that case, it would be the natural consequence for renminbi exchange rates to appreciate.

From the Chinese perspective, the stronger renminbi which properly reflects China's economic capabilities would be in its own national interest. This includes China expanding its overseas investments and seeking a greater voice on the international stage such as, for example, with its increased quota share in the International Monetary Fund.

True, the RMB is undervalued, but the real challenge is financial market reform.

GINA DESPRES
Senior Vice President, Capital Research and Management Company

No. It's true that the RMB is undervalued and would appreciate if it were freely convertible. But the real danger China poses to the global economy is a future banking crisis that would undermine confidence in its currency and growth prospects. Averting this requires basic reforms of the China's financial system. The G-7 should focus its concern on China's continuing failures to let market forces govern the allocation of capital and credit, especially the vast bulk of public savings deposits controlled by state-owned banks.

Yes, but the answer is neither simple nor straightforward.

NORBERT WALTER
Managing Director, Deutsche Bank Research

As a matter of fact, the nominal U.S. dollar/Chinese yuan rate reflects an undervaluation of the CNY of some 20 percent, compared with its PPP-equivalent rate (i.e., nominal rate adjusted by CPI differentials). However, this is nothing new. Undervaluation has been around since 1993. So why is undervaluation an issue now?

The world has changed considerably since 1993. China is now a much more significant player in the global economy, while the traditional global engine of growth (the United States) is sputtering. For that reason, some may wish to see Chinese customers contribute more to global growth, and argue for a stronger CNY. So the question is whether a strong CNY would increase the volume of China's imports.

But the answer to this question may not be as simple and straightforward as some might argue. China's import growth has already been among the strongest in Asia (around 20 percent since 1999). Investment growth has been strong due to both WTO accession and pump-priming factors. Households, however, have increased savings due to growing job insecurity. Given the prospects of restructuring lying ahead, it is doubtful whether a stronger CNY will change the households behavior.

Furthermore, a stronger CNY may not necessarily reduce foreign direct investment inflows significantly, since China's attractiveness lies mostly within its vast potential market and resources, and hardly within its undervalued currency.

Considering these facts, little may be achieved for China and the global economy by a stronger CNY. Instead, a much bigger threat to the world economy would arise from instability in China if it were to float its currency and liberalize transactions on the capital account before its financial system is prepared to take the heat. This would be particularly dangerous if it led to a dramatic appreciation and growth would be impaired, followed by social unrest.

No. There's virtually no link to global deflation.

CHRIS LEUNG SHIU KAY
Principal China Economist and Vice President, DBS Bank

The answer is no. The renminbi has little to do with global disinflation/deflation. In fact, based on our DBS Real Effective Exchange Rate model, the Chinese currency is only marginally undervalued at the moment. Revaluing the renminbi would not alter the fact that the wage growth going forward is likely to lag significantly behind the 4 percent annual increase in labor productivity. Surplus labor, totaling more than 200 million people, is keeping a lid on wage growth, while the inflow of foreign capital will continue to improve productivity at an astonishing rate, thereby attracting further overseas investment. I would say this is a "structural competitive advantage" that is unique to China.

At any rate, China has little incentive to raise the value of its currency. For the new leadership, other issues require more urgent attention. Ongoing banking reform, competition between private and state-owned enterprises, and falling import tariffs are conspiring to create deflation. A strong savings bias driven by rising unemployment, coupled with a lack of investment channels for consumers, hardly helps in this respect.

Even if the renminbi were to re-value higher tomorrow, the risk of global deflation is still on the high side due to Japan's persistent deflationary malaise, global asset price deflation following the collapse of the Internet bubble, and shorter product life cycles as a result of ongoing improvements in productivity. Amid these tough macro conditions, multinational corporations are recognizing the cost advantage that can be had from relocating factories to China. Re-exporting these Chinese-made products to the rest of the world, in turn, allows consumers worldwide to enjoy lower-cost products at a time when economies everywhere are performing poorly. From this perspective, it could even be argued that China is providing the world with some breathing space.

No. Revaluation could lead to a Japan-style investment bubble.

MICHAEL KURTZ
Non-Japan Asian Economist and Equity Portfolio Strategist, Bear, Stearns & Co., Hong Kong

Since late 2002, global markets have taken notice of increasing calls from U.S. and Asian officials for China to revalue its currency, the yuan. In November, the twelve-month non-deliverable forward yuan contract crossed over from devaluation expectations to revaluation expectations. And it is not only foreign officials making the case. Some of China's powerful ministries and state enterprises see benefits in a stronger currency—including large-scale importers and those undertaking overseas acquisitions.

At the root of the discontent is China's roughly US$200 billion annual trade surplus and perceptions that "cheap" Chinese exports are causing global deflation. But is this the correct diagnosis? China, after all, was one of the few regional economies not to devalue during the 1997–98 Asian crisis. Booming exports may be more effect than cause: U.S. dollar strength from the late 1990s caused global deflation; the resulting poor profitability drove global manufacturers to relocate to lower-cost China, boosting exports. Revaluationists also overlook the degree to which Chinese demand has helped lift many global prices, such as among commodities.

Off-mark diagnosis leads to misguided prescription. As Japan demonstrated in the strong-yen 1980s, revaluation could invite export-boosting new investment and increase competitiveness (inevitably fueling calls for further revaluation). Yuan revaluation thus could set China on a collision course with a Japan-style investment bubble.

Further, China is only just emerging from its own domestic deflation (2001–02), which largely resulted from the yuan's link to the too-strong U.S. dollar. A revaluation now—just as the dollar has shed some of that excess strength—could restart China's deflation, undercutting its domestic consumption take-off. This would prolong Beijing's costly reliance on government spending, complicating efforts to downsize the state sector and compounding state-bank bad debts.

A yuan revaluation could also seriously challenge China's already-tenuous rural economy. Cheaper imported foreign foodstuffs and falling domestic agricultural prices would severely strain incomes among the 70 percent of the country's population still residing in rural areas, possibly sparking political instability.

A more effective redress to China's trade surplus would be to support further Chinese consumption growth by empowering private-sector job creation and reducing import tariffs—a process, in fact, already underway. China ran a monthly trade deficit in January 2003, its first since December 1996. The $1.2 billion shortfall partly reflected high oil costs and holiday-related spending, and probably won't persist throughout 2003. But with rising consumption pushing China's trade account toward balance, diplomatic pressure from trade partners is increasingly unlikely to find an audience.

Maybe, but it's premature to do so.

HUGH PATRICK
Director, Center on Japanese Economy and Business, Columbia Business School

The Chinese renminbi is pegged to the dollar at a rate which has been generating ongoing current account surpluses and very large foreign exchange reserves. If these trends persist, it is in the national interests of China and the global economy that the RMB eventually be revalued. However, three uncertainties must be overcome. First, as China's accession to the WTO takes increasing hold and its current import barriers are reduced, imports will rise. Will that, combined with rapid GDP growth, virtually eliminate the current account surplus? Second, China's domestic political-economic environment is opaque and potentially subject to huge domestic shocks. China's holding of large foreign exchange reserves provides a form of insurance for foreign investors against domestic instability. Third, in the interest of efficiency, China's controls over foreign capital outflows (and inflows) almost inevitably will be eased in due course. That may well result in net capital outflows as firms invest abroad and investors diversify portfolios internationally, thereby reducing official foreign exchange reserves. Until we have a better understanding how these factors will play out, it is premature for the RMB to be revalued. In the interim, the world's consumers will benefit from China's low export prices.

It's 10–15 percent undervalued with moderate implications for the global system.

GERHARD FELS
Managing Director, Institut der Deutschen Wirtschaft, Cologne

Although it is always questionable to calculate a "natural" price or exchange rate without market test, which is impossible in the case of a pegged exchange rate, there is much consensus about the fact that the Chinese renminbi/yuan is undervalued—maybe about 10 or 15 percent against the U.S. dollar or the Japanese yen. This is obviously harmful for the economy of Japan, because exports to China are more expensive and imports from China are cheaper—compared with a "fair" exchange rate. It does not make it easier for Japan to recover from the ongoing deflation if one of the most important markets in the region is subsidizing its business with an artificially low exchange rate of the home currency. Nevertheless, the implications for international markets will most likely remain moderate. At present, there are probably more important threats to the global economy, especially the Iraq crisis, the oil prices, and the missing ability of many countries to implement structural reforms.

The G7 should forget any thought of revaluation.

YASUHIRO GOTO
Editorial Writer, Nihon Keizai Shimbun

The renminbi has been actually undervalued because of the Chinese strictly regulated foreign exchange market which allows just 0.5 percent change daily. If the Chinese government relaxed the market and made it fluctuate more freely, half of the problem would be solved. The renminbi would be revaluated to an adequate level. But the decision of forex market liberalization will cause severe opposition from relatively weak industries such as agriculture, steel, automobiles, chemicals, shipbuilding, and so forth, and will undermine the political base of the newly elected Fu administration. In other words, if we want a stable China, it is difficult to force it to revalue the currency at the moment. People in developed countries tend to think that China is now a global economic power and strong enough to choose its economic policies freely. I do not think so. China has huge number of non-competitive state-owned companies and unemployment. We also have to be aware that more than half of the Chinese exports are made by foreign companies. China now has $250 billion in foreign reserves but also has nearly the same amount of foreign debt. The Chinese economy has lots of weakness.

In another aspect, even if China revalues her currency, Asian rivals such as Indonesia, the Philippines, Malaysia, and Thailand cannot regain industrial competitiveness against China because global large firms have already shifted factories from other countries and established big manufacturing sites in China. They feel China is the best for manufacturing and the fastest growing market. G7 countries should give up the idea that we can adjust China's competitiveness by revaluation of renminbi. We should make full use of China as manufacturing site in order to strengthen our own competitiveness.

Not now. WTO demands and unemployment are already causing China enough trouble.

DAVID HALE
Chairman, Hale Advisors LLC & China Online Inc.

There is a growing debate about whether China's currency is undervalued. Japan is concerned about China's rapidly growing manufacturing industry. Other Asian countries fear that China is consuming too large a share of the region's investment. Many U.S. firms now regard China as a greater competitive threat than Japan. The Chinese will not revalue for three reasons. First, their economy is in the midst of a dramatic upheaval resulting from both WTO membership and privatization of many state enterprises. Unemployment is increasing rapidly and the government cannot afford to take any policy action which would jeopardize export growth. Second, China maintained a stable exchange rate through the Asian financial crisis of 1997–98 and thus helped to prevent the financial contagion from spreading. Many Asian countries improved their competitive position vis-à-vis China through the devaluations that occurred during this period. As only Hong Kong maintained a stable exchange rate, China does not have any need to help other Asian countries through a currency revaluation. Finally, China's emerging role is to serve as a manufacturing intermediary between the Asian countries and the old industrial countries.

If China's import trade data is decomposed into both domestic demand and imports for export reprocessing, it is easy to see how the country is changing its role in the global supply chain. Pan-Asian exports to China grew from $72.1 billion in 1995 to $160.6 billion in 2002. The imports for domestic demand grew from $42.2 billion to $78.7 billion. The imports for reprocessing grew from $29.8 billion to $81.9 billion. As a result, imports for reprocessing now account for 51 percent of China's imports from Asia compared to 41 percent in 1995. In the case of some Asian countries, the changes in the composition of trade have been dramatic. The re-export share of Singapore's exports to China has grown from 25 percent in 1995 to 53 percent in 2002. In the case of raw material exporting countries such as Indonesia, by contrast the re-export share of China trade has grown to only 24 percent from 11 percent in 1995. A similar trend is apparent in trade with other countries. American exports to China grew from $16.1 billion in 1995 to $27.3 billion in 2002. The share for reprocessing grew from 37 percent of the total in 1995 to 46 percent in 1998 and 44 percent in 2002. In the case of Europe, exports to China grew from $21.3 billion to $38.5 billion in 2002. The share for export reprocessing expanded from 40 percent in 1995 to 51 percent in 1998 and 47 percent in 2002.

Some analysts believe that China's output growth is so dramatic that it is becoming a source of deflation in the global economy. The fact is China accounts for less than 5 percent of world trade, so it has an ability to influence prices in only a few sectors, such as textiles. China could also help to generate inflation in the world's commodity-producing countries by dramatically increasing its imports of raw materials. China already accounts for 30 percent of world steel consumption, and 15 percent of world copper consumption. But its per capita consumption is only 10–20 percent of American levels, so the projected growth in its future consumption could cause it to become the dominant influence on world prices during the next ten years.

If China had a convertible currency without capital controls, there would be growing speculation in the market about a currency revaluation. But as a result of the East Asian financial crisis, China is unlikely to liberalize its capital account quickly and accept the risk of currency revaluation. China will liberalize her capital account and accept the risk of currency instability only when her private sector enjoys enough growth momentum to solve the unemployment problem created by the contraction of state owned enterprises.

Yes, but not dangerously so.

YASUO KANZAKI
Special Adviser, Nikko Salomon Smith Barney Ltd., Japan

The renminbi is undervalued and should be revalued over time. But it is not dangerously undervalued to the point of causing economic harm. China now is the biggest trade partner of Japan—even larger than the United States—but it still accounts for only some 1.5 percent of Japan's GDP. A large share of Japan's import from China is still in products such as textiles, which have low weights in Japan's price indexes. I do not share the view that China exports deflation to Japan. Our primary worry remains that Japan's domestic economy may not be flexible enough to redeploy labor and capital that may become redundant as Japan's linkages with China deepen.

However, since China is now a member of the World Trade Organization, it must open its capital markets in due course. We have learned the lesson that the combination of more open capital markets, together with a fixed exchange rate, has created financial turmoil in many countries in the past. So, it would be better for China to shift to a floating exchange rate system, to provide some flexibility under more open capital markets. The exchange rate would then be set in the market at the time the shift is made. No one wants drastic and disruptive change of the currency. Therefore, China should take a step toward a more flexible exchange rate regime to prepare toward opening the capital market.

No, the argument is nonsense.

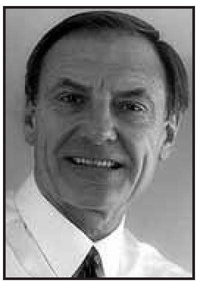
STEVE H. HANKE
Professor of Applied Economics, Johns Hopkins University, and Senior Fellow, Cato Institute

The notion that the renminbi is dangerously undervalued and that China is exporting deflation got legs during the May 1, 2002, hearings on the Treasury's "Report to Congress on International Economic and Exchange Rate Policy." Those hearings were chaired and carefully choreographed by Senator Paul Sarbanes (D-MD). The assembled panelists (except me) embraced the idea that China was exporting deflation. To use one of Frank Knight's favorite words, this is nonsense. Deflation is always and everywhere a monetary phenomenon, and in this day and age, it is a monetary area-specific problem.

China is exporting manufactured goods. Indeed, in the past twenty years, its share of world exports has increased from 1 percent of the total to 5 percent. In consequence, sector-specific or relative prices—not overall price levels—have been affected. This explains, in part, why the prices of services are increasing much more rapidly than those for goods—even in Japan. For example, the price changes for sector-specific categories in December 2002 (YoY) were: U.S. Durables -3.2 percent and Services +3.3 percent; Eurozone Goods +1.8 percent and Services +3.3 percent; and Japanese Durables -4.4 percent and Services +0.1 percent.

Changes in relative prices require no policy response. After all, relative price changes are an indispensable guide that gives a coherent direction to economic activity.

Unfortunately, U.S. Treasury Secretary John Snow has already fallen into the trap set by those who wrongly assert that China is exporting deflation—read: China is a super-competitive exporter of manufactured goods, one that's robbing its U.S. counterparts of pricing power. In written responses to members of the Senate Finance Committee, prior to his confirmation, Snow indicated that he might put pressure on China to revalue its currency. This represented the first of Snow's missteps in the exchange-rate sphere. Indeed, the evidence to date suggests that he, like his predecessor, is ill-equipped to handle these matters properly.



No question. It's seriously undervalued.

JERRY JASINOWSKI
President, National Association of Manufacturers

There is no question that the renminbi is seriously undervalued and that this is a prime factor in the $100 billion trade imbalance between China and the United States. China's currency was devalued in 1994 and has been kept at that level despite China's fast economic growth, rapidly rising productivity, soaring exports, and huge foreign investment inflows—all factors that would normally cause a currency to appreciate. China has bought $74 billion of dollars just in the last twelve months to keep its currency from appreciating. I am not, however, advocating any particular value as an appropriate exchange rate. My point is more fundamental. As a major force in world trade, the time has come for China to begin adopting market-oriented mechanisms, particularly by allowing the value of its currency to be determined by an open market free of intervention. This is the foundation for the present post-Bretton Woods system, and China needs to become part of that system. We should trust the market. I am convinced that such a move would indeed result in a sharp upward valuation of its currency, and that this would have a salutary effect on our trade—and on reducing demands for protectionism in the United States.

It's undervalued but no real threat.

TEH KOK PENG
President, GIC Special Investments Pte Ltd

I think the renminbi is undervalued, but not dangerously so. It is an issue in the management of the global economy rather than a threat, and should be discussed and resolved with the Chinese in a way that is consistent with the continued development of the Chinese economy and the stability of the global economy. There are many issues that are far more threatening to the global economy right now than the renminbi exchange rate.

Yes. That's why a harmony of economic interests is needed.

JOHN WILLIAMSON
Senior Fellow, Institute for International Economics

The renminbi is clearly undervalued. A country with vibrant growth does not run a large current account surplus ($17.4 billion in 2001) despite a large inflow of foreign direct investment ($37.3 billion net in 2001) and hence large reserve accumulation ($47.3 billion in 2001) unless its currency is undervalued. The global economy would be better off with a substantial revaluation (or upward float) of the renminbi: demand in the rest of the world would get a much-needed boost, and there would be less threat of price deflation. And China too could benefit, if the resources now devoted to accumulating U.S. treasury bills with a derisory yield were to be redeployed into high-return investment in China, or the present generation of Chinese were allowed to increase consumption and thus share more fully in the fruits of China's impressive growth. This is not to endorse the exaggerated view that the undervalued renminbi is a threat to the global economy or that China is going to out-compete everyone else in everything imaginable. It is to recognize that in this case, there can be a fundamental harmony of economic interests among countries that should be reflected in policies that embrace reality and adapt to changing circumstances if unnecessary conflicts are to be avoided.

China represents no global economic threat.

WENDY K. DOBSON
Former Deputy Minister of Finance, Canada

The dramatic stock adjustment in foreign direct investment allocated to China last year in the wake of China's accession to the WTO tempts one to fall for the argument that China is now a global economic threat. But there are significant reasons why this is not the case. True, China is now a major manufacturer and exporter, but it is also a major importer—particularly of regional goods and services. Its export advantage is based on its endowments of currently unlimited supplies of low-cost labor and a willingness to promote structural adjustment. Indeed, a fixed RMB is an instrument of domestic adjustment, forcing coastal producers faced with rising costs to move low-end production to the lower-cost, less productive hinterlands. True, Japan (once a source of a similar "shock to the system") and the southeast Asian economies are concerned that the RMB is undervalued, but there is a certain political economy argument here that would diminish if they were as willing as the Chinese to undertake painful structural reforms instead of using currency management as a convenient alternative. Globally, consumers (never very well organized) are major beneficiaries of China's low-priced exports. And the global financial system is well served by China's relatively closed capital account. The non-performing loans problem in Chinese banks and the immature financial system are sources of potential risk best kept localized until the banks are fixed and the financial system is modernized and strengthened to provide resilient intermediation of international capital flows. When that happens, the issue will not be revaluing the RMB, but letting it float.

No. China's contribution to global deflation is insignificant.

HONGYI LAI
Research Fellow, East Asian Institute,
National University of Singapore

My brief answer is no. Just observe the small gap between the official exchange rate of the renminbi and the black-market rate in China. In contrast, the gap was hefty in the 1980s when China was exercising control over hard currencies.

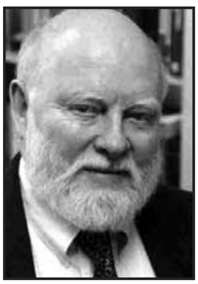
Why doesn't China's currency appreciate despite its large foreign currency reserve and a surging inflow of foreign direct investment? Theories on international balances of payment and foreign exchange suggest that the renminbi should appreciate if China wants to restore balance of payment and when supplies of foreign currencies surpass demands (as seen in China's large foreign reserves). Two other theories can better explain this "anomaly." First, China's domestic supplies in the form of savings and taxes exceed domestic demands, composed of investment and governmental spending. Fiscal stimulus and exports help to overcome this gap. Still, domestic demands play a much larger role than exports in China's growth. The Chinese save heavily instead of spending out of economic insecurity. With deepening reforms and intensifying foreign competition, urban Chinese fear losing their jobs yet receiving scant welfare benefits from the state. Meanwhile, other options for investment and spending are also dire: stock and financial markets are hampered by frauds, and a significant portion of consumer goods are defective. Second, some wealthy Chinese may still favor the U.S. dollar over the renminbi because of China's low interest rates, inefficient state enterprises and state banks, problematic institutions, and the illegal nature of their income. These Chinese transfer their assets abroad and finance their children's education overseas.

Foreign direct investment is escalating simply because Taiwanese, Hong Kong, Japanese, and Western assembling firms take advantage of China's large and competitive labor supplies and political stability. China's contribution to worldwide deflation is insignificant, though. China accounts for about 5 percent of the world's exports; foreign producers of raw materials as well as transporters and distributors pocket a lion's share of the earnings on products made in China. Given this, what the G-7 can do is to help China reform state firms and institutions, stimulate domestic demands and open up its markets, and ask the economies that invest heavily in China to import more.

No, and China should not be an international scapegoat.

N.T. WANG
Director, China International Business Project, Columbia University

During the 1997 Asian financial crisis, many economists advised China to devalue to protect itself. I argued that the best contribution of China to the neighboring countries was to maintain the existing exchange rate. As 2003 begins, there is some upward pressure on the renminbi. I am on record in dissuading China from liberalization of capital movements in the immediate future or appreciation of its currency, although a minor widening of the range of currency fluctuations may be considered. The main reasons are that the world economic situation, as well as the Chinese developments, are highly uncertain, and international institutions and measures for dealing with crises are inadequate. The best Chinese contribution to world economic and financial health remains to project a sense of predictability. Moreover, the so-called "concerns" attributed to China merely reflect nations unwilling and unable to adopt appropriate measures.



China's influence is not deflationary but the key is the Fed.

RONALD MCKINNON
Professor of Economics,Stanford University

China's influence on the world economy, on net balance, is not deflationary. However, if the world were now on a gold standard, as in the 19th century up to 1913, there would be a problem. Under a gold standard, China's rapid growth and demand for base money would necessarily be satisfied by a gold drain from other countries. And this certainly would impose deflation on the rest of the world—much like the rapid growth of the United States and Germany in the late 19th century caused worldwide deflation from the 1870s to 1896.

However, for better or for worse, most of the world is on a dollar standard—with the European part being on a euro standard. In Asia, the dollar standard predominates where exports and imports are overwhelmingly dollar invoiced—as are capital flows. Governments strive (not always successfully) to keep their exchange rates stable against the dollar. And the meta central bank for the system is the U.S. Federal Reserve. Fortunately, Fed Chairman Alan Greenspan does not lack the means to keep feeding indefinitely large amounts of base money into the world system through open market operations in the United States. Thus, the fact that China engages in a huge buildup of dollar exchange reserves, with Japan showing an even bigger buildup, need not reduce the supply of base money anywhere else.

Worldwide deflationary pressure now mainly arises from the end of the American bubble economy and deflationary pressure in the United States—the center country. The nature of the world dollar standard makes it difficult for any country on the dollar's periphery to take independent action—with the extreme case being Japan mired in its liquidity trap. So let us hope that the Fed can pull everybody out without falling into a liquidity trap itself!

Eliminate exchange controls and move to a convertible currency.

TIM CONGDON
Chief Economist, Lombard Street Research

China is on a long march from the isolation of the 1970s to the status of a global financial leader in the early 21st century. The foreign exchange reserves of mainland China have soared from just $200 billion in October 2001 to almost $300 billion today. If Hong Kong's reserves are added, China's total reserves come to over $400 billion, not far from Japan which—at $450 billion—has the world's largest reserve holdings. Remarkably, this surge in the reserves has been consistent with moderate monetary growth and the price level may be falling. The combination of a significant trade surplus, massive inflows of direct investment, booming exchange reserves, and a little deflation argue that the renminbi is undervalued. Obviously, an exchange rate appreciation would dampen exports. But it would encourage Chinese producers to focus on complex, specialized and branded exports, which are relatively price-inelastic, rather than commodity-type exports of basic materials and semi-manufactures. This would be seen as part of China's move towards greater economic maturity.

Policymakers should also consider using a strong currency as part of an argument for eliminating exchange controls and making the renminbi one of the world's foremost convertible currencies.

The IMF should publicize the impact of China's policies.

RICHARD ERB
Former Deputy Managing Director, International Monetary Fund

It is not very surprising that these two questions are being asked with greater frequency given China's very large accumulation of official reserves over the past five years and its relatively stable exchange rate. When a country signs the IMF Articles of Agreement, it explicitly commits itself "to avoid competitive exchange depreciation" and "to avoid manipulating exchange rates in order to prevent effective balance of payments adjustment or to gain unfair competitive advantage over other members." The Articles also explicitly assign the IMF responsibility for surveillance over member exchange rates and related policies.

Unfortunately, China does not allow publication of the IMF's annual surveillance report on the Chinese economy and policies. However, China did allow a public information notice (PIN No. 02/97) summarizing the Executive Board's August 5, 2002, discussion of the staff's surveillance report. The Executive Board Assessment strongly encouraged China to move toward "greater exchange rate flexibility" and stated that "the present strong external position and favorable growth outlook provide an important opportunity for China to make such a move from a position of strength." In IMF talk, that is direct and firm guidance!

In their September IMF Committee communiqué, IMF member finance ministers and central bank governors failed to say anything about China's policies and thus missed an opportunity to reinforce the Executive Board's assessment. At the same time, the ministers and governors exhorted the IMF to strengthen its surveillance of member economic policies. Hopefully the ministers and governors will play their part in strengthening IMF surveillance by discussing China's economic and exchange rate policies at the upcoming April 12 IMF Committee meeting.

If the IMF Committee is not prepared to take a stand at that time, it could ask the IMF Executive Board and staff to conduct a supplemental consultation and prepare a report and assessment for consideration by the September 2003 IMF Committee meeting. The IMF Committee should also ask the IMF staff to prepare a supplement to the fall 2003 *World Economic Outlook* analyzing the impact of China's policies on the world economy, including but not limited to countries in the region.

By tradition, the *World Economic Outlook* report would be published. The IMF committee should make it clear that it would also expect the supplemental consultation report to be published. China may be reluctant to do so, but in the end publication would be to China's advantage. The world community and markets should be apprised of the many interrelated policy issues that need to be addressed when assessing China's balance of payments and exchange rate policy.

Any significant WTO member should have a convertible currency.

JACK COPELAND
Investment banker

China aspires to dominate Asia economically, politically and militarily. Members of the Chinese Communist Party watched what happened in the former Soviet Union when its leaders decided to abandon communism. The Party retains the full support of China's military forces, which was not the case in the former Soviet Union.

China possesses an unlimited, cheap labor force that has no pricing power and exports deflation throughout the world. Unless a sector of the work force has the opportunity to evolve into a middle class, then two-way trade with the rest of the world would appear to be difficult.

In order for China to grow it must have adequate supplies of energy. Indonesia will continue to be an important supplier, but its reserves will not be sufficient. Therefore, China will depend upon the Middle East, Russia, Venezuela, Sudan, Australia, and other oil producers for additional supplies. However this will be a huge drain on foreign currency reserves, thereby hindering China's ability to import technology needed to develop economically and militarily.

Other issues to watch include:

- An aggressive military build-up;
- Widespread copyright infringement and weak laws for protecting intellectual property rights;
- Rampant corruption, especially within the CCP.

The potential for social unrest is high as workers from money-losing, state-run enterprises lose their jobs, and insolvent banks (due to unpaid loans made to the same state-run enterprises) find it difficult to repay depositors.

I believe any significant member of WTO should have a convertible currency.