Dealing wth Exchange Rate Protectionism

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In this article, I first review protectionist allegations against China, particularly that its currency is undervalued and is being manipulated so that the renminbi (RMB) will not appreciate. Next, I discuss China's reasons for not changing its foreign exchange policies for the time being. Finally, I assess the U.S. position on the conditions it faces that have led it to pressure China to change those policies forthwith. In a postscript I mention what China must do before planning an exit from its present exchange rate regime.

The Complaint against China

Protectionism is expressed in two main forms: the traditional attack on a foreign country's trading practices, and the more recent attack on a foreign country's exchange rate policies. Both are a response to a deficit in the balance of trade with a foreign trading partner, but the first form of protectionism may be directed against a deficit in the balance of trade of a particular industry (e.g., steel or textiles).

The current prime target of protectionism is China. Previously Japan was the target. Complaints about China's trade practices allege that it is counterfeiting patented and copyrighted products, granting illegal subsidies on exports of agricultural products, and erecting non-tariff barriers against soybean imports. China in turn has faced restrictions on its textile exports under the Multi-Fiber Agreement. The Agreement expired at the end of 2004, and the prospect of larger textile exports by China in 2005 is leading textile manufacturers to demand "safeguard" provisions that importing countries obtained as one of the conditions for admitting China to the WTO.

The case for protectionist opposition to China's exchange rate policy is that it deliberately undervalues its currency to gain a competitive advantage for its exports. It is this policy in the view of the

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critics that contributes to the U.S. growing current account deficit. If the exchange value of the RMB were to appreciate relative to the dollar, Chinese goods would for a while become more expensive in the United States and its trade surplus with the United States would be reduced.

Since 1995 China has maintained its nominal exchange rate against the dollar within a narrow band at 8.28 yuan.[1] (The yuan is the unit of account. RMB translates as "the people's money.") Over the past two years China's real exchange rate has depreciated while a surplus in its balance of payments has strengthened. Its current account surplus in 2003 with the United States was more than $120 billion, much larger than its overall surplus with the world of $46 billion. Over the past decade capital inflows have produced a surplus in the capital account of about 4 percent relative to GDP, and a large inflow in 2003 in anticipation of expected appreciation of the renminbi. The current account surplus relative to GDP is something like 3 percent of GDP. In addition, China uses the surplus to purchase dollar assets. Its foreign exchange reserves, now more than $600 billion, have been accumulating over the past decade, and at a particularly rapid pace since 2003, suggesting that it is trying to hold down the real exchange rate. This is the ground for the charge that it is manipulating its exchange rate.

China's alleged currency manipulation has been the basis for the introduction of bills in Congress to impose a surcharge on its exports to the United States if it fails to end the practice. When U.S. Treasury Secretary John Snow visited Beijing last fall, he recommended that China immediately move to open its capital market and float its currency. John Taylor, Under Secretary of the Treasury for International Affairs, extended an invitation to China to attend a dinner meeting of finance ministers of the G-7 countries scheduled at the start of October 2004, with the implication that it might be admitted to the group provided that China ended its practice of pegging the yuan to the dollar. Treasury Secretary Snow was expected to press China on its currency at the dinner. It was anticipated that China would make some concessions on its currency at the October 1 dinner meeting of its central bank governor and finance minister with the G-7 country representatives. Instead, the Chinese officials told their U.S. counterparts that they intended to float or revalue the yuan without committing themselves to a date when the change would begin. Secretary

[1]Lardy (2005) gives an account starting in 1978 of the changes in the peg of the yuan to the dollar before mid-1995.

Snow found the Chinese position unsatisfactory, but acknowledged that progress was being made. Earlier Taylor also had expressed the administration's satisfaction with the steps China had taken to prepare for making its currency flexible.

This sentiment was not shared by an alliance of American manufacturing companies and labor unions. They recently petitioned the Bush administration to sue China at the WTO for keeping the value of its currency fixed against the dollar. Although it is the IMF's responsibility to resolve international currency disputes, the petitioners asserted that they had turned to the WTO for a remedy because the IMF was not doing its job. The administration denied the petition. The response of the managing director of the IMF to the critics was evasive, but he told the Chinese government that it should immediately adopt a more flexible exchange rate. On the eve of its annual meeting in 2004 the managing director of the IMF told journalists that China's currency, as well as the currencies of the rest of Asia, should be more flexible. The IMF *World Economic Outlook* (September 2004) also recommended greater exchange flexibility.

A group of Democratic Party senators and House members signed a petition to the administration to sue China at the WTO for violating trade laws by failing to revalue its currency.

In Defense of China

The authorities of the central bank, the People's Bank of China, probably know all the arguments in favor of a flexible exchange rate but, at this juncture, given the problems in their economy, they are reluctant to make the move. To increase the dollar value of the RMB would solve their inflation problem but worsen the problem of the zombie banking industry and the problem of finding employment for the rural population.

Capital inflows have been so pronounced because the prospect of supplying the enormous Chinese population has been irresistible to worldwide exporters. Until some recent modifications,[2] Chinese firms were precluded by capital controls from purchasing foreign assets. They were required to convert the dollar proceeds of their exports into yuan. If the People's Bank did not acquire the dollars, the exchange value of yuan would appreciate. By purchasing dollars, how-

[2]The modifications in mid-October 2004 allow Chinese companies to invest overseas, thus encouraging outward flows of capital. The Ministry of Commerce ruled that it would accept applications to invest overseas and issue approvals without reviewing the feasibility of each project. Local insurers can also invest some hard currency holdings abroad. So far state-owned oil companies and mining companies have been ones that were allowed to invest abroad. The new regulation would extend approval to smaller firms to make such invest-

ever, unless the purchase is offset, the central bank increases the monetary base, which has been growing at a fast enough annual rate so that broad money balances in 2003 were growing at close to 20 percent.

GDP growth has been in the 10 percent range, and investment as a share of GDP is up to 47 percent (with savings at 44 percent). In this situation China has adopted measures to counter overheating, such as slowing credit growth, restraining investment in certain sectors such as steel, cement, and real estate. Local authorities have sponsored many of these investments, pressuring state-owned banks to lend money to provide finance for projects that zoning and environmental regulators have not approved. China began banning projects in overheated sectors in 2003 in order to rein in growth. Although fixed-asset investment slowed in 2004, GDP growth reached 9.5 percent, compared with 9.1 percent in 2003.

The central bank for its part is trying to restrain demand to curb inflation, which was running as high as 5.3 percent in July and August 2004, as measured by the consumer price index. The CPI measure, however, understates inflation beause of price controls and other distortions. Less regulated industrial prices rose 14 percent in the first half of 2004. To curb inflation, the central bank increased reserve requirements on deposits from 6 to 7 percent in 2003 and to 8 percent in 2004, relied on moral suasion to restrict commercial bank loans, particularly real estate loans, and recently increased the benchmark interest rate for the first time since 1995. The central bank has also tried to restrain the rate of monetary growth by selling interest-bearing central bank bills, which are unattractive at a low market rate of interest. At the same time the government's weekly auction of one-year Treasury bills in September 2004 was heavily subscribed at a 3.46 interest rate, an indication that the four troubled state-owned banks have large cash holdings.

To cut back the growth rate of the monetary base and bank loans, some way has to be found to lower the number of yuan per dollar. The undervalued RMB increases exports, the proceeds of which

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ments. Overseas direct investment abroad by Chinese firms, however, is miniscule compared with foreign direct investment in China. In addition, the new regulations allow Chinese tourists to take more hard currency when traveling. Chinese exporters are also permitted to retain more of their foreign exchange earnings. The State Administration of Foreign Exchange, which is in charge of cross-border capital controls, must grant approval along with the Ministry of Commerce, for offshore money transfers. China's National Development and Reform Commission announced new guidelines for soft-loan-funding overseas projects of some domestic firms, another move to encourage outward flows of capital.

the central bank uses to accumulate foreign exchange reserves. The accumulation in turn expands bank reserves, which enable the banks to lend freely. The undervalued exchange rate is the source of the banking and loan excesses that must be dealt with.

This conclusion has been challenged. The argument offered is that credit expansion can be controlled without altering the RMB exchange rate. All would be well if the central bank increased the scale of its sterilization operations. The central bank's yield on its dollar reserves, it is claimed, exceeds the interest cost it incurs when it sells bills to offset the increase in bank reserves. Hence, sterilization could continue indefinitely. The solution for excessive credit creation would be at hand. The argument is unconvincing because the profit calculation on sterilization is a conjecture. The government's involvement in the banking system casts doubt on the estimate. The need for banking reform and purging their portfolios of nonperforming loans (NPLs) is too urgent to be sidetracked by a dubious conjecture. The need to adjust the exchange rate to rein in credit overexpansion cannot be gainsaid.

One suggestion is for China to float the RMB but retain controls on the ability of its people to hold foreign assets. The reason to retain such controls is that otherwise there would be a capital flight. To prevent the outflow the rate of interest on deposits would need to be raised. At the end of October 2004, the People's Bank of China announced a modest increase of 0.27 percentage points in the rate on deposits to 2.25 percent. A more substantial increase, however, would have produced a crisis for the Chinese banking industry, which is dominated by the four state-owned banks that intermediate between depositors and state-owned enterprises at low interest rates. Their loan portfolios are awash with NPLs. If loans to the state-owned enterprises, which employ half of all industrial workers, were cut back, it would be a calamity for the firms and the workers. The banks are already insolvent but permitted to continue in operation because the authorities do not know how to cope with the fallout. If higher interest rates actually took effect, it would be a further calamity for the banks and the authorities. The central bank also increased one-year lending rates by 0.27 percentage points to 5.58 percent.[3]

[3]Raising the upper band on bank lending rates to allow banks to charge about 14 percent for funds was another measure the central bank introduced. It was regarded by observers as ineffective in curbing lending because the banks are loaded with cash. Therefore, they will lend at the band's lower limit. Nevertheless, John Taylor of the U.S. Treasury spoke approvingly of the rate increase as a step to control inflationary pressures in China, to improve the sustainability of the ongoing economic expansion there, and to help move China toward a flexible exchange rate.

There is another complication. China is confronted with the problem of finding employment in the traded goods industries in urban areas for workers shifting from farms in rural areas. Robert Mundell (2004) maintains that if China appreciated its currency, the problem would worsen. The cities would be swamped with unemployed migrants because the export industries would be harmed by the currency appreciation. For the sake of social stability, China cannot change its exchange rate policy. This, of course, is a tacit admission that the RMB is undervalued.

By way of contrast, Morris Goldstein (2004) makes a strong case for RMB revaluation. It would strengthen domestic demand instead of export expansion as the source of economic growth, improve financial intermediation, strengthen the domestic banking system, and spare China a protectionist backlash against its exports. China's high saving rate would provide domestic funds for high investment. Increased imports into China would promote domestic efficiency, and spur competition and higher productivity growth. The bottom line for Goldstein is that a revalued RMB would be in the interest of China's sustainable noninflationary economic growth.

The U.S. Position

Two immediate concerns account for the U.S. critique of China's exchange rate. One is the size of its bilateral trade deficit with this trading partner. The U.S. textile industry has borne the brunt of Chinese competition. In general, however, Chinese exports to the United States compete with exports from other developing countries rather than with U.S. industries. The decline in demand for U.S. manufactures is attributable less to Chinese competition than to slow growth in other U.S. trading partners, and it is rapid U.S. productivity increases that fundamentally have contracted manufacturing employment. Thus, revaluation of the RMB by itself would not suffice to achieve balanced trade with China.

Nevertheless, the decline in profitability of U.S. firms and the loss of employment by its workers as a result of inexpensive Chinese exports create a political problem for the administration, particularly so in an election year. Disaffected firms and workers, one might expect, would gain some political payoff by clamoring for protectionist redress. That definitely happened in the case of the steel industry earlier in this administration. It did not happen until after the election in response to the plaintiffs in the present case against China.

The administration just days before the election agreed to consider a petition from a coalition of textile manufacturers and the textile

workers union that would limit some imports from China. The petition would challenge the lifting of all trade quotas on textiles and apparel on January 1, 2005, enabling goods to move freely around the world.

The retail apparel industry, which endorses the lifting of the quotas, charges that the manufacturers ignore the savings for consumers in lower cost clothing and household goods like sheets and towels that open access to Chinese factories will make possible.

The unions and manufacturers contend that China uses unfair trading practices to keep costs low, like manipulating its currency and subsidizing the industry. The Ministry of Commerce responded by filing a protest on the possible imposition of quotas in the United States on given categories of garment imports.

The National Council of Textile Organization seeks limitation of Chinese imports to a 7 percent increase over 2004 imports. A U.S. interagency task force (the Committee for the Implementation of Textile Agreements) was appointed to consider the petition.[4]

The immediate political problem for the United States, however, is how to respond to the plight of manufacturers in general and the textile industry and its workers in particular that Chinese exports have produced. Protectionist measures and government subsidies will not prolong the life of an industry facing low-cost competitors. U.S. moderate priced textiles may be doomed by developing country proficiency. The U.S. industry would have to restructure itself as specializing in the production of expensive high-fashion goods. Younger displaced workers should be offered compensation and retraining under the federal Trade Adjustment Assistance program for manufacturing. Retraining is probably not a solution for older workers, but they should be given financial aid for a transitional period. Regions in North and South Carolina where textiles are concentrated will need to attract new industries to replace the losers.

A further U.S. concern is the size of its current account deficit, to which the bilateral trade deficit with China contributes. Some observers believe the current account deficit is unsustainable, and for many years have been predicting an imminent catastrophic disruption of the American and then the world economy. Dissenters regard the current account deficit as sustainable for the next decade at least.

Economists at the Washington, D.C., Institute of International Economics have been prominent among those who find the current

[4]It accepted a similar petition earlier for quotas on China's exports of cotton trousers. Six U.S. apparel, textile, and fiber-producing trade associations and a union expect to file petitions on 13 categories of imports.

account deficit unsustainable. The depreciation in the exchange value of the dollar since 2002 is an indication to them that investors are beginning to balk at adding more dollars to their portfolios. For investors to retain dollar assets, higher yields would have to be offered them, which would result in a reduction in economic activity. An uncontrolled fall of the dollar exchange rate would ensue. At least one member of the Institute, Catherine Mann, is reported to have revised her view. She now regards the current account deficit as likely to persist for many years. Obstfeld and Rogoff (2004) do not concur. They contend that the U.S. current account deficit, now more than 5 percent of GNP, is not likely to be sustainable, and that a sharp depreciation of the dollar could be a problem for the world economy.

Protectionism has not served to narrow the current account deficit. The United States on its own could do so by conducting inflationary monetary policy. That would induce foreigners to shun dollar assets in their portfolios. This is hardly likely. Otherwise, so long as foreigners choose to export their goods and services to the United States and accept payment in dollar assets, the current account can continue at its present or a higher level, The scenario that predicts withdrawal of European exporters from the U.S. market and their shift from dollar to euro assets envisages Asian exporters as inheriting the European share of exports to the United States and acquiring the European share of dollar assets. The U.S. current account deficit would remain undisturbed despite the displacement of European by Asian investors.

What is unclear at this date is whether Asian central banks have decided to reduce their dollar buying. Dollar weakness as far as it has occurred is helpful in correcting the trade deficit. Even if the Asian central banks no longer buy enough Treasury bills or notes to fully cover the U.S. current account deficit, and the dollar continues to weaken at a moderate pace, the path of adjustment for the United States and the world will be positive.

An Exit Strategy for China

China's problem is complex. On one level, it involves freeing the economy from the control of the communist party. Reform of many institutions must precede changing the exchange rate regime. In particular, China must decide how to reform its financial industry, including privatizing state-owned banks, eliminating NPLs, recapitalizing them, and permitting market allocation of loans free of government dictate; how to privatize state-owned enterprises; how to guarantee independence to the central bank in the conduct of

monetary policy; and how to reform fiscal policy. Then China can plan an exit strategy from a fixed exchange rate to a floating rate and ending capital controls. It is up to China to undertake this awesome program of transforming itself. Neither the IMF nor the United States should act as China's overseers.

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