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Policy Brief

SUMMARY

In Washington, politicians and pundits have settled on a single magical solution for the country's economic ills: getting China to revalue its currency, the RMB. By any reasonable economic measure, however, the RMB is not undervalued. China does have a trade surplus with the United States, but it has a trade deficit with the rest of the world. And China's accumulation of dollar reserves is not the result of trade surpluses, but of large investment inflows caused in part by speculators' betting that China will yield to U.S. pressure. Focusing on China's currency is a distraction. If the United States wants to improve its economy for the long haul, it had best look elsewhere beginning with raising the productivity of American workers.

China's Currency: Not the Problem

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In Washington, members of Congress, business representatives, and pundits of many stripes are falling over each other to demand that China revalue its currency, the renminbi (RMB). They blame the loss of American manufacturing jobs, lagging real wages, and the ballooning U.S. trade deficit on an alleged undervalued RMB, which they say gives Chinese imports an unfair advantage over goods made in the United States. Congress is threatening to impose a large 28 percent tariff on Chinese imports unless China makes the RMB more expensive.

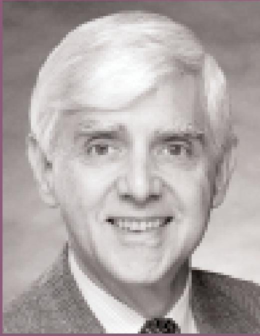
Forcing the Chinese to revalue the RMB might temporarily benefit some manufacturers—although they are most likely to be in other less developed countries that export toys and textiles to the United States. But it would not address the long-term needs of the American economy, which require improvements in worker productivity, mobility, and social insurance. Most important of all, forcing a revaluation of the RMB is unjustified by the prevailing rules of the international economic order. It would set a dangerous and destabilizing precedent.

International experts and specialized agencies, including the U.S. Treasury Department and the International Monetary Fund, agree that China's exchange rate does not provide it with an unfair advantage. Although China does have a trade surplus with the United States, it has a deficit with the rest of the world. China's rapid accumulation of foreign exchange reserves—often taken as a sign that the RMB is overvalued—does not result from trade surpluses but rather from large investment inflows, most of which, paradoxically, are speculative bets seeking to profit from the hoped-for success of diplomatic pressure on China to revalue the RMB.

What Does China's Trade Surplus Tell Us?

China's direct country-to-country trade surplus with the United States is large and growing fast. Thus, the U.S. Census Bureau reports that the U.S. deficit with China was $162 billion in 2004, or 24 percent of the total U.S. deficit. It increased by $38 billion from 2003, when it was already 23 percent of the total U.S. deficit. It is bigger than the U.S. direct country-to-country deficit with any other country.

However, a surplus with one trading partner does not prove that a country's exchange rate is unfair. No one thinks other countries should buy the same amounts from America



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that America buys from them. Economists all agree that in a well-functioning world market, any country will have deficits with some countries and surpluses with others. Some of these surpluses and deficits will be large. Yet a large deficit with one trading partner does not by itself prove that the partner has a bad exchange rate. The more meaningful statistic is a country's *global* trade balance, the total of *all* its partner trade balances—and China's global trade surplus is not excessively or unfairly large.

Two tests make this clear. The first test is a country's trade surplus as a share of its gross domestic product (GDP). A large share usually indicates unsuitably weak domestic demand. The second test is the size of a country's global surplus as a share of the total U.S. trade deficit. Given the tangle of global supply linkages, a country's world surplus, rather than its country-to-country share of the U.S. trade deficit, is the true test of its contribution to global imbalances.

Table 1 shows that, compared with many other countries, China's 2003 and 2004 world trade surpluses were not large as a share of GDP—both roughly 3 percent. These surpluses are smaller than those for Germany, the Netherlands, Thailand, Argentina, Malaysia, and Singapore.

China's share of the total U.S. trade deficit reveals similar results. Table 2 shows that China's *global* surpluses in 2003 and 2004 were, respectively, 7 and 8 percent of the U.S. deficit. These are similar to Singapore's share and much less than those for Japan, Germany, the oil exporters, and the entire euro currency area. The surpluses from Japan, the oil exporters, and the euro area together account for more then 60 percent of the U.S. trade deficit. China is only a minor factor.

How can China have such a large country-to-country surplus with the United States and not have a large global surplus? The reason is that some Chinese "exports" to the United States are really *re-exports* of large volumes of materials, parts, and kits imported from elsewhere, such as from Japan, South Korea, Taiwan, the Philippines, Indonesia, and even India and Europe. China is frequently the last stop in a long international supply chain. What *looks* like a computer coming from China can actually have had its screen, circuit boards, and other key components come from elsewhere for final assembly in China. When an American buys that "made in China" computer, it thus could have been made in Japan, South Korea, Taiwan, Hong Kong, and China. Indeed, exports from the rest of East and Southeast Asia directly to the United States declined between 2000 and 2004, as re-exports through China increased.

Without the Asian re-export trade, China still has a considerable surplus with the United States, but it has a deficit with the rest of the world, from which it imports energy, raw materials, and equipment. The overall combination is a small global surplus.

Some critics say that China should run a large trade *deficit* to counterbalance investment inflows. This is an interesting proposal, but requiring a trade deficit as proof of a *fair* exchange rate does not meet the commonsense test for fairness. Nor is it U.S. policy to sanction a country because its world trade deficit is too small. The issue is whether that trade surplus is too large, and we have seen that China's is not.

What About China's Buildup of Foreign Exchange Reserves?

If China's trade patterns do not indicate an unfair exchange rate, what about its buildup of foreign exchange reserves? These reserves are a country's cash on hand, accumulated from trade surpluses and other inflows, like investments. This "cash" includes not only currency and coin but also liquid assets such as gold and high-quality bonds like U.S. Treasury bills, which are easily sold in the world's large bond markets.

Just as the Federal Bureau of Investigation looks for big increases in someone's bank account as a possible sign of embezzling, spying, or other illegal activity, economists look at a country's foreign exchange reserves as a sign that unfair trade practices, such as subsidies and

inflexible exchange rates, are resulting in excessively large trade surpluses. But in China's case, the buildup in reserves is a false scent.

By the end of 2004, China's foreign exchange reserves had gone from $200 to $600 billion in just three years. But this buildup in reserves was due not to China's trade surpluses but instead overwhelmingly to its investment inflows. Furthermore, the scale of China's reserves is not as extreme as it seems. See sidebar, Trade Balance versus Current Account Balance.

In preglobalization days, countries generally maintained enough foreign exchange reserves to cover three months of imports. But as investment flows have grown in an electronic age, with daily transactions worth billions and even trillions of dollars, the risk of sudden surges greatly complicates the determination of a safe level of reserves. Countries like the United States and those in the euro area do not need large reserves. They basically print their own reserves. But countries that cannot do this can find themselves pulled under by the swift currents of international exchange. For instance, during the Asian financial crisis of 1997–1998, countries that wanted stable exchange rates and large investment flows ran out of reserves. Several that had recently opened themselves up to large investment flows could not meet cash demands from sudden investment surges. The values of many currencies, and in some cases of whole economies, collapsed. Except for Hong Kong, these economies did not have enough reserves.

The need for foreign exchange reserves may be even larger if a country's reserves are not all freely available. Some reserves are matched by claims that could be made on them at any time. These reserves, if not explicitly spoken for, are "hot," in the sense

TABLE 1

World Trade Surplus, 2003 (percent of GDP[a])

Country	Value
UNITED STATES	–5
JAPAN	2
EURO AREA	2
CHINA	**3**
CHINA, 2004[b]	**3**
GERMANY	4
NETHERLANDS	5
THAILAND	6
INDONESIA	7
ARGENTINA	11
MALAYSIA	21
SAUDI ARABIA	21
SINGAPORE	33

Sources: International Monetary Fund, *International Financial Statistics*, May 2005; People's Bank of China and China State Administration of Foreign Exchange web pages, with estimates, adjustments, and calculations.

Note: Trade is defined as goods and services, free on board (f.o.b.).

a Gross Domestic Product

b Data are for 2004

TABLE 2

World Trade Surplus, 2003 (percent of U.S. Trade Deficit)

Country	Value
UNITED STATES	–100
THAILAND	2
INDONESIA	2
ARGENTINA	3
MALAYSIA	4
NETHERLANDS	5
SINGAPORE	6
CHINA	**7**
CHINA, 2004[a]	**8**
SAUDI ARABIA	9
JAPAN	15
GERMANY	20
OIL EXPORTERS	20
EURO AREA	28

Sources: See Table 1.

Note: Trade surplus in goods and services, f.o.b. Percent signs are reversed.

a Data are for 2004

TABLE 3

Foreign Exchange Reserves, End of 2003 (months of imports)

Country	Value
GERMANY	1
MEXICO	4
POLAND	5
MALAYSIA	6
HONG KONG	6
THAILAND	6
SINGAPORE	7
INDONESIA	7
CHILE	8
CHINA[a,b]	**8**
SOUTH KOREA	9
INDIA 2002	10
CHINA[a]	**12**
JAPAN	18

Sources: See Table 1.

a Data are for the end of 2004.

b Reserves for the end of 2004, less $225 billion "hot" reserves estimate

that they might leave the country on an electronic moment's notice. The recent dramatic reversal of capital outflows to inflows in China indicates that of the $400 billion in additional reserves from 2001 to 2004, something between $200 and $350 billion was "hot." These funds entered in a way that could let speculators pull them out quickly. Without these "hot" funds, China's reserves at the end of 2004 would have been under $400 billion rather than its officially reported $610 billion (see table 3). This lower level of available reserves would have covered no more than eight months of imports—or even less with a higher "hot" reserve estimate. Although eight months of reserves is large, it is smaller than those of Japan, South Korea, and even India (see table 3).

Trade Balance versus Current Account Balance

Most analysts consider *current account* balances when evaluating foreign commerce, mainly because they include trade in services, which does not show up in media headlines. Current account data also report other income and expenditures, especially transfers and repatriated profits. Current account transactions differ from *investment* flows, which make up the *capital and financial accounts,* reflecting how much a country borrows or lends abroad. A country's current account balance thus shows whether it is "paying its own way" in the world.

For China, however, transfers and repatriated profits have also recently become channels for investment flows. They are disguised financial account transactions, avoiding China's controls on speculative investment. Before 2002, what was a steady annual *outflow* of $10 billion in income remittances by foreign firms became by 2003–2004 a total *inflow* of nearly $30 billion just as other speculative inflows surged. This shift had nothing to do with an unfair exchange rate.

Flows of goods and services are directly sensitive to exchange rates, whereas transfers and profit remittances are not. The combination of current account distortions and exchange rate sensitivity explains why it is important to emphasize trade in goods and services. In any event, even China's current account surplus is reasonable by international standards at 3 and 4 percent of GDP in 2003 and 2004, respectively.

Does So Much Market Intervention by Itself Indicate a Bad Exchange Rate?

According to IMF guidelines, countries can intervene in exchange markets "to counter disorderly conditions," characterized by "disruptive short-term movements in the exchange value of its currency." As a member of the IMF, China *is permitted* to intervene under certain circumstances, and protracted intervention by itself is not proof of exchange rate malpractice. Significantly enough, the IMF has declined to pursue the issue with China. Still, many American policy makers contend that China's intervention to maintain a rigid exchange rate risks damage to both the Chinese and world economies. And they assume that China's intervention is really intended to maintain its trade surplus with the United States.

However, China's intervention has to do with investment flows and not trade, and China's actual circumstances indicate that the risks from intervention are exaggerated, if they exist at all. Investment flows are the potential tsunami of international business. In simplified terms, foreign financiers can invest large sums in a country, using them to buy local currency for local investments. Just buying so much currency tends to push its price up—that is, it pressures for currency *revaluation.* When investors decide the currency has gotten expensive enough, they resell their holdings for foreign cash. The currency's higher value yields them quite a profit, and the currency's value drops again.

This is exchange rate speculation. It causes up-and-down pressures on an exchange rate and, for everyday trade, costly uncertainty about future exchange rate levels. Modern-day "hedging" services allow a trader to pay a fee and be guaranteed a certain exchange rate

some time in the future. But such services have only recently appeared in China; they are an unfamiliar luxury for the small trading companies China wants to encourage. Instead of relying on such immature services for an unsophisticated clientele, China, like many countries, uses government intervention in currency markets to keep its exchange rate stable. Also like many other poor countries—and like many rich countries until recent decades—China, by using *capital controls,* restricts speculative investment activity. Capital controls do not work perfectly—they *leak* some speculative investments—but they work well enough for now.

As a result of intervention and capital controls, China has a stable exchange rate that is convenient for commercial purposes. Such stability is a high Chinese policy priority, because the country still has hundreds of millions of people eking out marginal livings and cannot afford, in economic, humanitarian, or political terms, the volatility of free capital flows and unstable exchange rate movements.

Currency market intervention can have domestic risks, but these risks can be minimized by combining intervention with capital controls. In principle, by buying foreign reserves with RMB, the central bank increases RMB circulating in the domestic money supply, threatening inflation. But in fact, the volumes are small enough that by selling domestic bonds for cash, China's central bank can take the cash back out of the economy. This process, called *sterilization,* has worked well for China recently.

An additional domestic risk is to interest rate policy independence. If, with a fixed exchange rate, capital flowed in and out—or leaked—freely, then China would be forced to match world interest rates to avoid large investment flows seeking higher returns. But in China's case, the general effectiveness of capital controls has protected interest rate independence. China's capital controls have thus largely insulated domestic finance from international pressures, with little risk that this situation will change any time soon.

Why Do Speculative Investment Flows Persist? A Vicious Circle

The controllable, but often illegal, speculative investment flow into China has been fueled by anticipation that China will be forced by U.S. political pressure and the investment flows themselves to revalue its currency. The prospect that China could give in to this pressure and revalue the RMB has attracted speculators.

The result is a kind of vicious circle: U.S. political arguments for revaluation encourage speculative financial flows from those hoping to profit from just such a revaluation. The speculative flows increase foreign exchange reserves, and these larger reserves tend (unjustifiably) to strengthen political arguments for revaluation, which in turn encourage even more speculation. Hence, even though China's trade surplus indicates an exchange rate that basically reflects underlying market forces, this vicious circle perpetuates speculative investment behavior. Speculative behavior on such a scale, in turn, dissuades China from experimenting with one of its medium-term objectives: introducing greater flexibility in its exchange rate regime.

The U.S. Treasury Department and the IMF agree that China's exchange rate does not provide an unfair advantage.

Global Risks and China's Need for Exchange Rate Flexibility

As shown most recently by the U.S. Treasury's May 17 report to Congress, experts at both the Treasury and the IMF have long recognized that China's exchange rate is not unfair for trade. But maintaining this conclusion is politically difficult because of media attention on loss of U.S. manufacturing employment and outsourcing. Consequently, U.S. diplomatic pressure shifted in 2003 to emphasize China's need for exchange rate *flexibility.*

To the American media and laypeople, this strategy of promoting flexibility *sounds like* pressure for revaluation. But once again, the issue is capital flows, not trade. Even China agrees that in the long run, when its capital controls are relaxed, exchange rate flexibility will be necessary to encourage orderly investment flows. But until that time, flexibility is not needed.

Nevertheless, U.S. diplomacy again confuses the distinction between trade and investment by claiming that China's inflexible exchange rate system poses risks for China's commercial partners and for global imbalances. To a general audience, it sounds as if China's inflexible exchange rate threatens to create global imbalances by increasing the U.S. trade deficit —even though U.S. officials know that China's global surplus is a minor part of these imbalances.

Instead, the only potential risk to global balances from China's inflexible exchange rate would appear if China relaxed its controls on short-term investment flows without first introducing exchange rate flexibility. This is because shifting exchange rates nullify expected profits from investment flows seeking to take advantage of higher interest rates in another country. Without flexibility, speculative flows could quickly become large, as they did during the Asian financial crisis, and threaten economic stability and orderly world trade.

Such a risk is low for China because its policy makers appear to have no intention of relaxing capital controls until after they have modernized its financial system and implemented a more flexible exchange rate system. Actual conditions in China, Asia, and the world economy thus indicate that the various risks stressed by U.S. diplomats might come not from China maintaining exchange rate stability but rather from abandoning capital controls.

Many Chinese exports to the United States are really *re-exports* of materials China imports from somewhere else.

Asian Neighbors and China's Exchange Rate Risks

U.S. diplomats and media commentators emphasize an additional risk from China's inflexibility: the continuation of large non-Chinese Asian trade surpluses. Although we have seen that China's global surplus accounts for only 8 percent of the U.S. deficit, the world surplus from the rest of East and Southeast Asia was equivalent to 34 percent

of the U.S. deficit in 2003. Many Asian economies also intervene to keep their currencies from appreciating.

These diplomats and commentators claim that if China were to revalue the RMB as a result of greater exchange rate flexibility, its Asian competitors would feel more relaxed about revaluing their own currencies, and their global trade surpluses would decline. But that is not necessarily so. Global surpluses from the rest of Asia stem from long-standing export-led growth strategies. In contrast to China's domestic-led growth, these export-led strategies reflect chronic weaknesses in domestic demand and reliance on U.S. economic growth cycles. They are not in competition with China. Chinese revaluation—or greater flexibility, if you will—would not correct either these weaknesses or Asia's export-led strategies.

The Bottom Line

China's exchange rate system poses no risk to itself, to its neighbors, or to the global system. If there is any fundamental risk to the global economy, it is from weak demand in Europe and Japan. These industrial economies could be providing greater effective demand for imports from poor countries around the world. Instead, they are striving to maintain their own large surpluses with the United States and the world. They have left the United States to go it alone as the world's engine of growth for poor economies in need of support for market reforms and internal restructuring.

China's foreign exchange rate reasonably reflects market forces. Exchange rate flexibility appears unnecessary for the foreseeable future, as long as Chinese policy makers maintain their successful combination of capital controls, currency market interventions, and the independent monetary and investment policies that capital controls make possible. Instead of decrying China's exchange rate, Washington policy makers should turn their attention to the fundamental task of permanently raising U.S. worker productivity, the only solid basis for long-lasting increases in worker incomes and benefits.

Instead of decrying China's exchange rate, Washington policy makers should turn their attention to the task of raising U.S. productivity.

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Exchange-Rate Regimes and Capital Flows in East Asia, Albert Keidel, June 2004, available at www.carnegieendowment.org/publications/index.cfm?fa=view&id=16730.

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A Modest Proposal for China's Renminbi, Morris Goldstein and Nicholas Lardy (*Financial Times,* August 26, 2003), available at www.iie.com/publications/papers/goldstein0803.htm.

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