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Seeing Red: What Are the Costs of China's Currency Policy?

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In the depths of the recession, many critics of China's currency policy held their tongues. After all, that policy -- which keeps the yuan artificially low in value -- allowed other countries, especially the United States, to borrow from China the vast sums they needed to stimulate their economies.

But now that the world economy is improving, some are resuming the call for China to let the yuan gain strength, and eventually to float freely -- as the dollar, euro and yen do. That would make Chinese exports more expensive, allowing other nations to better compete.

New York Times columnist Paul Krugman, a Nobel Prize-winning economist at Princeton, summarized the complaint in a January 1 column: "China has become a major financial and trade power. But it doesn't act like other big economies. Instead, it follows a mercantilist policy, keeping its trade surplus artificially high. And in today's depressed world, that policy is, to put it bluntly, predatory." According to Krugman's "back-of-the-envelope" calculations, China's weak-yuan policy cost 1.4 million American jobs, many in manufacturing, as American producers find it hard to compete with cheap Chinese goods.

Getting the exchange rate right for China is also viewed by many observers as the key to avoiding a global financial meltdown similar to what has occurred over the last two and a half years. According to this line of thinking, China's vast savings held in foreign reserves contributed mightily to a global savings glut that allowed many Western countries, most notably the U.S., to hold interest rates too low for too long. That allowed for an overabundance of easy credit, which fueled housing bubbles in many countries and also other forms of over-borrowing by investment bankers, consumers and governments. Critics of these policies say this global imbalance must be gradually unwound in order to dodge a new financial crisis. And that suggests that borrowing, credit and exchange rate policies need to change.

What is the best currency policy? Are China's interests really at odds with those of the rest of the world? Wharton faculty and other experts agree that in the long run, China would be better off with a stronger yuan and a floating-rate policy. But getting from here to there is difficult, and could have some unpleasant consequences for all concerned.

"I believe that it is in China's interest to resume the appreciation of the yuan," says Wharton finance professor Richard Marston. "Appreciation helps hold down inflation. And it forestalls protectionist measures by Europe and the U.S."

Allowing the yuan to float would relieve China of the need to keep enormous foreign-currency reserves -- currently about $2.4 trillion, with two-thirds estimated to be in U.S. dollars. That would free the money for other uses, says Wharton finance professor Franklin Allen. "I think it's probably counterproductive to try to coax them. They have to make a decision about what they want to do.... In the long run, they need to convert ... to a [floating] currency."

Prior to 2005, China pegged the yuan to an exchange rate of just over eight to the dollar. "They wanted to make it easy for their exporters to know what kind of income they would get if they produced for foreign markets, in particular for the U.S. market," Allen notes. Freezing the exchange rate meant Chinese manufacturers did not have to worry that a weaker dollar would make it harder for Americans to buy Chinese products, allowing them to expand with greater confidence.

"It's a very mercantilist type of approach, but not unusual for developing economies," says Mark Zandi, chief economist and cofounder of what is now Moody's Economy.com. Brazil, Indonesia and other developing nations intervene in currency markets to influence exchange rates, he adds. Even Switzerland, a developed country, does so from time to time.

Distorting the Markets

Most economists believe that in the long run, floating exchange rates work best for all concerned, Zandi says. "It's kind of a shock absorber. It helps the economy suffer smaller ups and downs than would otherwise be the case.... I think the broad consensus is that a freely floating regimen is the most desirable. It imposes the best economic outcome."

When an economy weakens, for example, its currency tends to weaken as well. That makes goods cheaper for foreigners, stimulating exports and helping the economy recover, Zandi notes. As an economy strengthens, the currency also tends to get stronger, helping to prevent overheating.

Although a fixed-currency policy can help a developing country like China to grow its exports, it can distort the markets. The country's goods may be attractive to foreigners because they are cheap, not because they are the best. And critics generally feel that keeping goods artificially cheap is unfair to competitors in other countries. China's policy has resulted in a large depreciation of the yuan against the euro, making it extremely hard for European firms to compete with Chinese ones. "It's the Europeans who should be most concerned by Chinese policy, and they have complained loudly," Marston says.

Maintaining an artificially low exchange rate "is equivalent to a set of import tariffs [and] export subsidies, as far as the trade account is concerned," he notes, adding: "In the last 30 years, we have made great strides in lowering trade barriers. But we have not found a way to keep countries from promoting trade through foreign currency intervention."

In 2005, China officially removed the peg to the dollar, and the yuan gradually became stronger, moving from 8.35 to the dollar to about 6.8 in July 2008. While Chinese leaders deny currency manipulation and say they want the yuan to get stronger over time, most Western experts say the policy resumed during the financial crisis, and the yuan remains at the 6.8 peg. Zandi believes the yuan would appreciate another 20% to 30% if it floated freely.

Because the policy gives China a trade surplus -- exporting more than it imports -- it has created enormous reserves of foreign currency. China has invested much of that in the U.S. through securities sold by the Treasury and other government agencies. With those purchases, China is lending money to the United States, helping the U.S. fund its massive budget deficit and mushrooming debt. High demand from China props up prices of fixed-income securities, and that keeps interest rates low, since prices and rates move in opposite directions. That has made it cheap for the U.S. government to borrow, and has helped keep rates down on mortgages and other consumer loans. Chinese currency and trade policy has therefore helped stimulate the U.S. economy, as well as others, at a time when they desperately needed it.

An 'Anchor' During the Crisis

According to Zandi, when the global financial crisis struck in 2008, China suspended its three-year-old policy of allowing the yuan to strengthen. "They stopped during the crisis, and I think it wasn't unreasonable given the turmoil and uncertainty," he says. "To some degree, they have been vindicated. They were very important to providing stability during the Asian [financial] crisis in the 1990s, and I think they've also provided some stability in the current period as well. They were kind of an anchor in the global financial system, and that has been important." The Chinese, he adds, are correct in pointing out that their economy was one of the first to start recovering from the recent crisis.

Zandi does agree, however, with Krugman's calculation that keeping the yuan weak costs about 1.4 million American jobs. Now that the worst of the financial crisis appears to be over, reducing high unemployment levels is a top priority in the U.S. -- hence the new surge in complaints about China's currency practices and trade surplus.

But even if the U.S. and other Western countries could get China to change its policy, doing it too quickly could backfire, Allen says. China could strengthen the yuan by reducing its currency reserves, but unloading vast amounts of U.S. securities would drive securities prices down, raising interest rates. "That would obviously cause the U.S. long-term problems, if rates went up 1% or 2%," he notes. It would be more expensive for the U.S. to finance its deficit and debt, and consumer borrowing rates could rise as well.

Having these enormous foreign currency reserves gives China great political clout, Allen adds. "It means that when [President] Obama goes to China to talk to them, he can't be as forthright as he would like, because they might start selling, and that will affect the dollar and cause problems for the U.S."

Domestic Downside

Still, many observers believe Chinese leaders recognize they eventually need a floating exchange rate to tackle various domestic problems. Zandi predicts that China will start to allow the yuan to strengthen further sometime this year.

While the weak-yuan policy has been good for China's exporters, it has a downside for the Chinese people, says Wharton management professor Marshall W. Meyer. Keeping the yuan low requires locking the foreign currency reserves in investments like Treasury securities rather than spending them on domestic needs like education, health care and some sort of Social Security program. Social security and greater productivity will be important as the Chinese population ages, which will reduce the workforce by about a sixth between 2015 and 2045, Meyer notes.

Currently, he adds, the Chinese economy is based on low-cost exports, while developed economies emphasize domestic consumption. That requires more imports, which would benefit from a stronger yuan.

"If it were feasible, China would use its resources to invest in people," Meyer says. "They've got to become more productive, but you cannot make them more productive without investing in them."

Yet another dilemma for China: the risk of suffering big losses on U.S. Treasuries and similar instruments purchased with currency reserves. Because many securities are being purchased while interest rates are low, those securities could lose value when the world's economic recovery causes rates to go up, notes Kent Smetters, professor of insurance and risk management at Wharton. "They're paying inflated prices," he says. Inflation, unusually low in recent years, is likely to rise over the next decade as the U.S. government prints money to pay down its debt, Smetters argues. In effect, China will have paid a premium for U.S. securities and will be paid back with dollars that are worth less -- a bad deal for any investor. That's another reason for China to change its currency policy: to curb the size of its reserves.

"They are starting to get smart about this," Smetters says, noting that China is gradually moving more of its reserves into securities with shorter maturities, which are less vulnerable to rising interest rates and inflation.

For China, unwinding the longstanding weak-yuan policy may be necessary but difficult, Marston says. "China is reluctant to resume [yuan] appreciation because it will worsen the employment problems brought on by the collapse of exports during the recession," he says. "It's true China is growing rapidly, but that's mainly because of stimulus measures. The further we get into the world economic recovery, the more likely it is that the Chinese [yuan] appreciation will resume."