ECONOMICS

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Steady on the Renminbi

NEW HAVEN – Currency wars are raging worldwide, and China is bearing the brunt of them. The renminbi has appreciated sharply over the past several years, exports are sagging, and the risk of deflation is growing. Under these circumstances, many suggest that a reversal in Chinese currency policy to weaken the renminbi is the most logical course. That would be a serious mistake.

In fact, as China pursues structural reforms aimed at ensuring its continued development, forced depreciation is about the last thing it needs. It would also be highly problematic for the global economy.

On the surface, the situation certainly appears worrisome – especially when viewed through the currency lens, which captures shifts in Chinese prices relative to those in the rest of the world. According to the Bank for International Settlements (BIS), China's real effective exchange rate – an inflation-adjusted trade-weighted average of the renminbi's value relative to the currencies of a cross-section of China's trading partners – has increased by 26% over the last four years.

China's currency has appreciated more than any of the other 60 countries that the BIS covers (apart from dysfunctional Venezuela, where the figures are distorted by multiple foreign-exchange regimes). By comparison, the allegedly strong US dollar is up just 12% in

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real terms over the same period. Meanwhile, China's emerging-market counterparts have experienced sharp currency depreciations, with the Brazilian real falling by 16%, the Russia ruble by 32%, and the Indian rupee by 12%.

This currency shift is, of course, the functional equivalent of a large hike in the price of Chinese exports. Add to that continued sluggishness in global demand, and the once-powerful Chinese export machine is suffering, with total exports down by 3% year on year in January. For an economy in which exports account for about 25% of GDP, that is not a trivial development.

At the same time, a stronger renminbi has made imports less expensive, putting downward pressure on China's price structure. Unsurprisingly, this has exacerbated the fear of deflation, with the consumer price index (CPI) rising by just 0.8% year on year in January, and the annual decline in producer prices steepening, to 4.3%. While these trends are undoubtedly being amplified by plummeting world oil prices, China's core CPI inflation rate (which excludes volatile food and energy prices) was near 1% in January.

Against this background, it is easy to see why many anticipate a tactical adjustment in China's currency policy, from appreciation to depreciation. Such a move would certainly seem appealing as a way to provide temporary relief from downward pressure on growth and prices. But there are three reasons why such a move could backfire.

First and foremost, a shift in currency policy would undermine – indeed, undo – the progress that China has made on the road to reform and rebalancing. In fact, a stronger renminbi is consistent with China's key objective of shifting from export-intensive growth to consumer-led development. The generally steady appreciation of the renminbi – which has risen by 32.6% against the US dollar since mid-2005 – is consistent with this objective and should not be reversed. It strengthens Chinese consumers' purchasing power and reduces any currency-related subsidy to exports.

During the recent financial crisis, the authorities temporarily suspended China's renminbi-appreciation policy, and the exchange rate was held steady from mid-2008 through early 2010. Given that current circumstances are far less threatening than those in the depths of the Great Crisis, the need for another tactical adjustment in currency policy is far less acute.

Second, a shift to currency depreciation could inflame anti-China sentiment among the country's major trading partners – especially the United States, where Congress has flirted for years with the prospect of imposing trade sanctions on Chinese exporters. A bipartisan
coalition in the House of Representatives recently introduced the so-called Currency Reform for Fair Trade Act, which would treat currency undervaluation as a subsidy, allowing US companies to seek higher countervailing duties on imports.

Similarly, President Barack Obama’s administration has just brought yet another action against China in the World Trade Organization – this time focusing on illegal subsidies that China provided to exporters through so-called “common service platforms” and “demonstration bases.” If China intervenes to push its currency lower, US political support for anti-China trade actions will undoubtedly intensify, pushing the world’s two largest economies closer to the slippery slope of protectionism.

Finally, a renminbi-depreciation policy would lead to a sharp escalation in the global currency war. In an era of unprecedented quantitative easing, competitive currency devaluation has become the norm for the world’s major exporters – first the US, then Japan, and now Europe. If China joined this race to the bottom, others would be tempted to escalate their actions and world financial markets would be subject to yet another source of serious instability.

Just as China resisted the temptation of renminbi depreciation during the Asian financial crisis of 1997-98 – a decision that may have played a pivotal role in arresting regional contagion – it must stay the course today. That is all the more important in a disorderly climate of QE, where China’s role as a currency anchor may take on even greater importance than it did in the late 1990s.

Strategy is China’s greatest strength. Time and again, Chinese officials have successfully coped with unexpected developments, without losing sight of their long-term strategic objectives. They should work to uphold that record, using the strong renminbi as an incentive to redouble efforts at reform and rebalancing, rather than as an excuse to backtrack. This is no time for China to flinch.

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