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China's exchange-rate policy

A yuan-sided argument

HONG KONG

Why China resists foreign demands to revalue its currency

PRESIDENT BARACK OBAMA, on his first visit to China this week, urged the government to allow its currency to rise. President Hu Jintao politely chose to ignore him. In recent weeks Jean-Claude Trichet, the president of the European Central Bank, and Dominique Strauss-Kahn, the managing director of the International Monetary Fund, have also called for a stronger yuan. But China will adjust its currency only when it sees fit, not in response to foreign pressure.

China allowed the yuan to rise by 21% against the dollar in the three years to July 2008, but since then it has more or less kept the rate fixed. As a result, the yuan's trade-weighted value has been dragged down this year by the sickly dollar, while many other currencies have soared. Since March the Brazilian real and the South Korean won have gained 42% and 36% respectively against the yuan, seriously eroding those countries' competitiveness.

Speculation about a change in China's currency policy increased in the week before Mr Obama's visit, after the People's Bank of China tweaked the usual wording in its quarterly monetary-policy report. It dropped a phrase about keeping the yuan "basically stable" and added that foreign-exchange policy would take into account "international capital flows and changes in major currencies". But exchange-rate policy is decided by the State Council, not the central bank. And many policymakers, no-

tably in the Ministry of Commerce, do not favour a revaluation right now.

Indeed, Chinese officials have become bolder in standing up to America. "We don't think that it's good for the world economic recovery that you ask others to appreciate while you depreciate your own currency...It's also unfair," said a spokesman for the Ministry of Commerce on November 16th. The previous day Liu Mingkang, China's chief banking regulator, blasted America for its low interest rates and for the falling dollar, which, he suggested, might be encouraging a dollar carry trade and, in turn, global asset-price bubbles. He strangely ignored the fact that China's own overly lax monetary policy, partly the result of its fixed exchange rate, risks fuelling bubbles in its domestic property and equity markets.

Foreigners argue that a stronger yuan would not only help reduce global imbalances, such as America's trade deficit, but would also benefit China. It would help China regain control of its monetary policy. By pegging to the dollar, it is, in effect, importing America's monetary policy, which is too loose for China's fast-growing economy. A stronger yuan would also help rebalance China's economy, making it less dependent on exports, putting future growth on a more sustainable path.

If a stronger exchange rate is in China's own interest, why does it resist? Beijing rejects the accusation that its exchange-rate

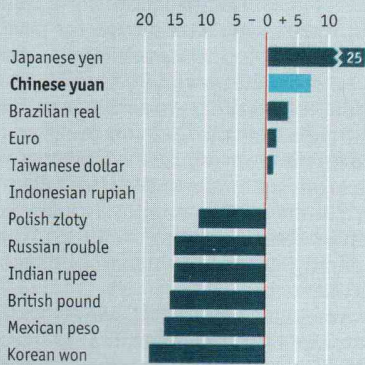
policy has given it an unfair advantage. It is true that other emerging-market currencies have risen sharply this year, but this ignores the full picture. Last year China held its currency steady against the dollar throughout the global financial crisis, while others tumbled. Since the start of 2008, the yuan has actually risen against every currency except the yen (see chart).

China also argues that it has done a lot to help global rebalancing. Thanks to its monetary and fiscal stimulus, domestic demand has contributed an remarkable 12 percentage points to GDP growth this year, while net exports subtracted almost four percentage points. Its current-account surplus has fallen by almost half, to around 6% of GDP from 11% in 2007. Chinese policymakers accept that the yuan needs to appreciate over the longer term, but say now is the wrong time, because Chinese exports are still falling, by 14% over the past 12 months.

Another reason for hesitation is that the

Far from the weakest

Exchange rates against the \$, % change
January 1st 2008–November 17th 2009



Source: Thomson Reuters

theory that revaluing the yuan will allow Beijing to tighten its monetary policy is too simplistic. China's experience since 2005 shows that a gradual rise encourages investors to bet on further appreciation; hot-money inflows then swell domestic liquidity. A large one-off increase might work, as it would stem expectations of a further rise. But the sort of increase required—perhaps 25%—is politically unacceptable because it would put many exporters out of business overnight.

Some Chinese economists warn that the benefits to America from yuan revaluation are much exaggerated. In particular, a

stronger yuan would not significantly reduce America's trade deficit. There is little overlap between American and Chinese production, so American goods could not simply replace Chinese imports. Instead, consumers might end up paying more for imports from either China or other producers, such as Vietnam. This would be like imposing a tax on American consumers.

These arguments help explain why China is dragging its feet. Nevertheless, in the long run, a stronger yuan would benefit China's economy—and the world's—by helping shift growth from investment and exports towards consumption. It would

boost consumers' purchasing power and squeeze corporate profits, which have accounted for most of the increase in China's excessive domestic saving in recent years. China will probably allow the yuan to start rising again early next year. This will not be the result of foreign lobbying—indeed, China is more likely to change its policy if foreign policymakers shut up. But by early next year China's exports should be growing again, its year-on-year GDP growth could be close to 10% and its inflation rate will have turned positive. The arguments in favour of revaluation will then loom much larger. ■

Buttonwood | Something's gotta give

Either central banks are wrong to keep rates low, or markets are wrong to expect recovery

LIKE a truck rolling downhill, the rally in risky assets is proving hard to stop. Good economic news causes share prices to rise because it indicates the recovery is robust; bad economic news also causes prices to rise because it signals that central banks will keep interest rates near zero.

Those low interest rates have probably been the main driver of the rally, encouraging investors to put their cash to work in search of higher returns. But other factors have been at play. Forecasts for corporate profits have been revised steadily upwards as analysts anticipate the benefits of economic recovery.

This has been a revival in the bottom, rather than the top, line. According to Morgan Stanley, non-financial stocks in the S&P 500 beat third-quarter earnings growth estimates by an average nine percentage points. But the companies' sales fell around a point shy of forecasts. A similar pattern was seen in Europe.

In short, companies have used the crisis to achieve a remarkable expansion in margins. Tim Bond of Barclays Capital reckons that, on one measure, the improvement over the last two quarters has been the best since the second world war. The trick has been the corporate sector's success in controlling labour costs; in the third quarter, operating costs for non-financial S&P 500 companies were down by 32% from the previous year.

But the weakness in earnings and the job market means that consumer confidence is far from robust; the University of Michigan sentiment survey has fallen in each of the last two months. Nor are consumers borrowing to maintain their spending; instead they have been repaying their debts.

American retail sales were stronger than expected in October, thanks largely to the car industry. Even so, they were still



down on the same month last year. The decline might have been worse had homeowners not benefited from the sharp fall in mortgage rates.

Against such a background, how long can an improvement in corporate profits be maintained? Cutting costs makes sense at the individual company level but not in aggregate; one company's sacked worker or pay freeze translates into another company's sluggish demand.

That may explain why the improvement in profits is not translating into a spurge of capital expenditure. Nevertheless, in the short term the revival in corporate profits is adding to the sense of recovery. Companies seem to be taking the chance to improve their balance-sheets, building up cash reserves instead of repaying bank debt; commercial and industrial loan books are still contracting. And with companies having little need for more debt, banks are indulging their appetite for buying government bonds.

This strategy (with the help of central banks' purchases of bonds) is helping to hold down yields, making it easier for governments to finance their deficits. With in-

flationary pressures still very low (American core producer prices rose just 0.7% in the year to October), there is very little need for the Federal Reserve to raise interest rates in the near future. The cost of borrowing for six months in dollars is now lower than the cost in yen, something that would have been unimaginable just five years ago.

Instead, the main threat to the rally seems likely to be disappointing growth, at least in the developed world. American industrial production rose just 0.1% between September and October and a number of other industrial-activity figures have been disappointing. The Economic Cycle Research Institute's leading index slipped to an eight-week low in the week to November 6th.

Meanwhile, the Chinese boom that seemed to revive the global economy is showing its dark side. Commodity prices are rising across the board, acting as a further tax on hard-pressed Western consumers (oil has roughly doubled since the start of the year). In some countries, particularly in Europe, actual taxes are starting to rise as well, as governments grapple with their fiscal deficits.

At some point, the central dilemma at the heart of this rally will have to be resolved. Low interest rates seem like good news for investors. But why are central banks holding rates so low? Either they are correct in assessing that the economy is still fragile, in which case corporate profits will ultimately disappoint. Or they are underestimating the strength of the recovery, in which case inflationary pressures will start to emerge (and bond yields will rise sharply). Markets will have a tricky time navigating between this Scylla and Charybdis in 2010.