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IDEAS -- VIEWPOINT

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## A Stronger Yuan Helps China

Beijing should use its reserves to update its infrastructure and fund education

In the past few years, China's trade and current account surpluses have surged. If recent trends persist, the current account surplus will roughly double, to around 7% of gross domestic product by yearend. Moreover, China will soon exceed the current account surplus of export behemoth Japan and is even on track to exceed Japan's foreign exchange reserves (long the world's largest) in the next few months. And while Japan stopped intervening in currency markets to influence the yen-dollar exchange rate in early 2004, China has continued to make big interventions to manage the yuan-dollar rate. So it's no wonder that China has displaced Japan as the focus of protectionist ire in the U.S., and Congress is threatening to impose a tariff of 27.5% on all U.S. imports from China unless it strengthens its currency.

Despite the howls from Congress, China's management of its exchange rate is not the reason America's current account deficit has soared in this period. As Morgan Stanley () economist Stephen S. Roach recently observed, it would take the current account surpluses of 10 economies -- including those of Japan, China, Russia, Germany, and Saudi Arabia -- to equal the U.S. current account deficit. America is running a massive current account gap not because of an undervalued Chinese currency, but because the U.S. is saving too little to finance its investment needs. America's net national savings rate has been hovering at a record low of 1.5% of GDP since 2002 -- and it's likely to get worse over the next several months because of a Hurricane Katrina-induced surge of deficit spending. The result: The U.S. has been relying on the rest of the world for funds to offset its extraordinary savings shortfall. That's why, if the U.S. were to eliminate its current account deficit with China overnight, it still would be forced to run trade and current account deficits with someone else.

**THERE ARE, HOWEVER, SOUND** economic reasons for a revaluation of China's currency. Beijing took a first step in July by adopting an exchange-rate policy that ended its firm peg to the dollar. But the resulting yuan revaluation of little over 2% since then is insufficient. China's currency remains highly undervalued, as evidenced by the fact that Chinese authorities must continue to intervene in foreign exchange markets, adding to their vast holdings of dollar reserves that already cover more than a year's worth of imports and that amount to nearly 40% of China's GDP. There is no economic justification for China to invest so much in such low-yielding assets that risk substantial capital losses in the future. Indeed, China should both diversify its reserves away from dollars and draw down some reserves to finance strategic investments in local infrastructure, education, and research and development that will bolster future growth.

A sizable yuan revaluation also would curb China's dependence on exports for economic growth and encourage more investment in nontradable goods and services, such as food and electricity, which have suffered from persistent inflationary pressure as domestic supplies have failed to keep pace with rising Chinese incomes. And Beijing has the luxury of a large budget surplus that it can use to stimulate domestic demand to offset any temporary adverse effects on growth caused by a reallocation of resources from exports to nontradables. For example, consumption spending in China accounts for only 42% of GDP. By comparison, consumption spending claims a record 71% of GDP in the U.S.

China remains a poor country -- one that should be running a current account deficit rather than a surplus. What size deficit can China sustain without running the risk of sudden outflows of capital, such as those that engulfed Asia in the late 1990s? No one knows for sure. But China should be able to finance an annual current account deficit at least equal to its annual inflow of foreign direct investment: about \$50 billion, or nearly 4% of its GDP. That means there's room for a meaningful yuan revaluation (certainly in the 10% to 20% range) that could bring substantial benefits to China. It could also trigger revaluations of other Asian currencies that together would reduce the risk of a damaging trade war between China and the U.S. Indeed, Beijing should revalue the yuan not because of America's charges of currency manipulation and not because it will reduce the U.S. current account deficit. China should revalue because it would be good for the Chinese economy.