

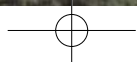
# Yuan Revaluation Debate Shows Link Between Economics, Politics

By Devin Stewart

Asia's growth is impacting global financial relations, but the debate about the Chinese currency, like that about the Japanese yen two decades ago, may be oversimplified

**T**he battle over revaluing the yuan has big implications for the U.S. economy, U.S.-China relations, and the U.S.'s global leadership role.

As China's overall trade surplus continued to exceed market expectations and reach record highs through 2006, U.S. Treasury Secretary Henry Paulson, picking up where his predecessor John Snow left off, began a campaign of trying to persuade China to increase





the value of its currency. The argument is that China is keeping the value of its currency low so that it can boost its exports. China allowed its currency to strengthen by 2.1 percent in 2005 as a response to these calls.

Not only does this debate mirror U.S. concerns during the 1980s about the Japanese yen, but it is also riddled with the same oversimplifications. U.S. pressure on Japan during the 1980s caused resentment in Japan toward the U.S. but did little to improve the U.S. trade deficit. Some

the pretext of fair trade, are equally vocal today on China. But the very argument that a Chinese revaluation will take care of the U.S. trade deficit is dubious.

Several economists, including Nobel Prize winners Robert Mundell and Joseph Stiglitz, as well as Johns Hopkins professor Steve Hanke and New York University professor Edward Lincoln, have noted the similarities between the two debates. While politicians blamed Japan for U.S. trade deficits in the 1980s, the blame has shifted

to China today. But, in comments in a 2006 article in the *Wall Street Journal*, Stiglitz said: "The problem of our trade deficit is not going to be solved by China's exchange rate."

That same article reported on Stanford University economist Ronald McKinnon's trip around China, during which he urged the Chinese to resist U.S. pressure for a devaluation, telling

them: "Don't let what happened to Japan happen to you by letting go of the exchange rate."

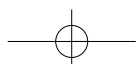
"Conventional wisdom seems to think that yuan revaluation would reduce the trade surplus and bring jobs back to the U.S.," says Jason Kindopp, Asia director at the Eurasia Group. "Nonsense. It may displace some manufacturing from China to other low-cost countries, but the jobs aren't coming back to the U.S." If Chinese

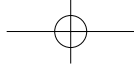
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even blamed the U.S. for the subsequent real estate bubble that occurred in Japan.

The current debate, though, is another sign of how rapid growth of the Asian economies is having a huge impact on global financial relations, and, in turn, how this financial impact has significant political implications.

Some organizations, such as the National Association of Manufacturers in the U.S., that weighed in on Japan under





products became less competitive, manufacturing, assembly and textile production would move to poor countries in Southeast Asia and Africa.

Indeed, the U.S. and Chinese economies are at very different levels of economic development, so one would expect China to manufacture goods that the U.S. no longer produces. The gap between the Chinese and U.S. economies of today is greater than that between the Japanese and U.S. economies of one or two decades ago, making the case even stronger for the U.S. to take advantage of existing complementarities.

Kindopp, who was recently in China researching the Chinese currency issue, believes that no amount of pressure from Washington will make China's leaders act against Chinese interests. Therefore, he says, a large revaluation is extremely unlikely. U.S. leverage over Beijing is limited, given China's massive dollar reserves and the "balance of terror" it would create, according to Kindopp.

Some economists and policymakers worry that ending the flow of Chinese investments in T-bonds could drive up U.S. interest rates, to the detriment of U.S. economic growth. Others dispute this conclusion, but it may explain the reluctance of some officials to press harder on China for a revaluation.

The highly integrated nature of the U.S. and Chinese economies – and a growing portion of the world for that matter – makes predicting the effect of a revaluation difficult. Some analysts believe that a revaluation would help cool down the Chinese economy, increase the buying power of the Chinese consumer, allow Southeast Asian nations to compete with China in areas such as textiles, and reduce China's overall trade surplus. Others believe that revaluation would reduce China's growth rate, increase the number of China's bad loans, increase unemployment, reward currency speculators, and set into motion a deflationary and recessionary spiral similar to that of Japan in the 1990s.

If a revaluation resulted in significantly lower Chinese growth, the prospect of improving the U.S. trade deficit with China would dim because the Chinese would consume less. If revaluation put upward pressure on interest rates, the U.S. real estate market could crash, sending many into bankruptcy and severely hurting U.S. growth.

According to his calculations, Jonathan Anderson, chief economist for Asia at UBS, believes the yuan is indeed

undervalued. But he said that even for a large revaluation, the impact would be felt mostly among U.S. consumers in terms of higher prices.

Overall, Anderson does not view the yuan as the determining factor for Chinese growth. With a revaluation, he says: "The Chinese would grow somewhat slower, while the rest of the world would probably see a little bit of growth stimulus. But not really anything exciting."

The currency debate may be less about economics and more about politics. Edward Lincoln, director of NYU's Center for Japan-U.S. Business and Economic

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Studies, has been observing the U.S.-Japan currency and trade debate for decades: "Capitol Hill politics are at play here as a way for Democrats to beat up on the administration. Politicians take simple indicators and they look back at history and use the yen as an example. They try to simplify the issue for public consumption."

And politics includes a look at the military dimension and the possibility of real conflict, however remote that may seem now. Lincoln feels that the level of overall perceived threat will determine how the U.S. will approach China on trade and currency issues. "It could be that Japan and the U.S. are adjusting to the rapid rise of the Chinese military," he says. "It is interesting that we are not beating up on the Japanese now. Even in 2004 when the Japanese were intervening, we didn't scream. China is now in a different basket. Japan supports us in Iraq. Japan is an ally. China is not."

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