China and the world economy

Tilting at dragons
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China is being blamed for too many of the rich world's economic problems

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WORRIED about the loss of manufacturing jobs? Anxious about America's huge trade deficit? Trying to explain the cause of deflation in Japan? In tough economic times, politicians need someone to blame. And today the rich world's scapegoat of choice is China.

When George Bush met China's president, Hu Jintao, at the APEC summit in Bangkok this week, he was under intense pressure from manufacturers and congressmen back home to persuade China to revalue its currency, the yuan, currently pegged at 8.28 to the dollar. Bosses in industries from clothing and toys to furniture and consumer electronics are complaining about "unfair" Chinese competition. They claim that, by keeping the yuan artificially low, China is stealing jobs from America and causing a record trade deficit. Legislation has recently been proposed in Congress to levy big tariffs on imports from China.

The relocation of manufacturing jobs to low-wage economies has been happening for years. But concerns are intensifying now that service-sector jobs, such as software programming and call centres, are shifting too, as firms take advantage of cheap telecommunications to use workers in India and, more recently, China.

China-bashing is also popular in Japan, where the country is widely blamed not only for the hollowing-out of manufacturing, but also for deflation, as cheap imports push down prices. In the euro area too, politicians
and businessmen are complaining that because China refuses to let the yuan rise against the dollar, the euro is bearing an unfair share of the burden of dollar depreciation. The euro has risen by almost 40% against the dollar over the past two years. This week, Giulio Tremonti, Italy's finance minister, called for protectionist measures against China.

Is China guilty as charged? It is true that it is running a $120 billion trade surplus with America, but China's total surplus is small—it runs deficits with some other countries—and many economists forecast that it may turn into a deficit in 2004. China's current-account surplus is expected to be only 1% of GDP this year. Despite foreigners' complaints about the country's rampant export growth, imports have grown even faster (see chart). In the year to September, China's exports rose by 32% and its imports by 41%.

At a time when developed economies remain fragile, China's robust demand should be welcomed. America's exports to China rose by 21% during the past year, compared with an increase of 2% in sales to the rest of the world. According to HSBC, China accounted for 70% of Japan's export growth in the first eight months of this year, boosting GDP growth by 0.7 percentage points. Moreover, inexpensive Chinese imports have benefited consumers (and hence workers). Wal-Mart, which has been a big job creator, relies on China for many of its cheap products.

American manufacturers accuse Chinese firms of stealing global market share. Yet Stephen Roach, chief economist at Morgan Stanley, points out that two-thirds of China's export growth since 1994 has come from the subsidiaries or joint ventures of foreign multinationals. China's export boom is partly due to efforts by rich-world firms to remain competitive. Had these firms not invested in China, they would have been less profitable and might have hired fewer workers at home. A large revaluation of the yuan could hurt them.

What of the claim that China's artificially cheap currency has exported deflation to Japan? The prices of some goods have clearly fallen in price thanks to cheaper imports, but this cannot cause overall deflation. Imports from China equate to only 1.5% of Japan's GDP. Deflation is primarily a monetary phenomenon, not a structural one: Japan's over-tight monetary policy is the real culprit.

It is particularly hypocritical of Japan to criticise China for its cheap-currency strategy. The Japanese yen was much more clearly undervalued in the 1970s, when Japan began to export in large quantities. China is far from perfect: it still has high trade barriers in some sectors, but it is more open to trade and investment than Japan was three decades ago.

A final reason why America should welcome and not bash China is that Chinese money is helping to prop up America's economy. To prevent its currency rising, the Chinese central bank has bought huge amounts of American Treasury bonds and mortgage securities (see chart). Its willingness to provide cheap credit to the American government to finance tax cuts and, indirectly, to home buyers has thus underpinned America's recovery. If China dumped those dollars, American bond yields would rise further, halting the mortgage-finance boom that has buoyed consumer spending.

On the other hand
China may not be guilty of all the charges: nor is it completely innocent. Even if critics exaggerate the extent to which China is to blame for job losses, the yuan is clearly undervalued. In theory, countries with faster productivity growth, such as China, should see their real exchange rates climb, through either a rise in the nominal rate or increase in wages, or both. China's exchange rate has been pegged to the dollar since 1994, while wages have been held down by China's pool of surplus labour.

The clearest evidence that the yuan is undervalued is China's large surplus on its “basic balance” (the current-account surplus plus net foreign direct investment), and its build-up of official reserves, which jumped by $19 billion in September, the biggest monthly gain on record.

The Chinese are right to argue that the yuan cannot be allowed to float freely until their wobbly banking system is reformed. But they are wrong to say that pegging the yuan to the dollar is best for China and for everyone else. By preventing the yuan from rising, China has allowed an excess of liquidity to build up in the domestic economy, at the risk of a financial bubble, especially in property. The longer the overheating continues, the sharper the eventual correction will have to be.

By holding its currency down, China risks inflaming global protectionism. A rise in the yuan would not halt the long-term structural shift of manufacturing jobs out of rich economies, argues Martin Barnes of the Bank Credit Analyst, a research firm, but slow it, making adjustment less painful; it would also reduce the risk that the euro would overshoot hugely, and help to defuse trade tensions.

Mr Hu this week rebuffed Mr Bush's demands for revaluation, but said his officials would set up a study with American government experts to consider ways of gradually making the yuan convertible. The best short-term option for China might be to tie the yuan to a broader basket of currencies, including the euro and the yen as well as the dollar, and then widen its band to allow an appreciation. This would ensure that the yuan did not simply follow the dollar downwards.

The heart of rich countries' complaints is an unwillingness to accept responsibility for their own economic faults. It is easier to point the finger at China. But the real cause of America's trade deficit is its low saving rate, the result of surging household borrowing and a big budget deficit. Similarly, Japan and Europe should not be tempted to use the cheap yuan as an excuse to postpone much-needed reforms. The proper cure lies at home.