# Why the Yuan Should be Revalued
# -- A Stronger Yuan Should Benefit Not Japan but China Itself --

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The Chinese yuan has been under upward pressure in recent years, as shown by the dramatic increase in China's foreign exchange reserves. If the government turns a blind eye to this new situation and tries to delay an appreciation, negative effects, in the form of a misallocation of resources, a growing economic bubble, and increasing friction with trading partners, could result.

Meanwhile, the rapid pace of industrialization in China and the surge in exports accompanying it have been regarded as the main cause of global deflation. Led by Japan, major industrial countries have strongly requested that China allow the yuan to appreciate. However, for Japan, reflecting the fact that its economic relationship with China can better be characterized as complementary rather than competitive, the overall impact of an appreciation of the yuan on the Japanese economy is likely to be a negative one.

## 1. Rising Foreign Exchange Reserves Show Yuan under Pressure to Appreciate

China's foreign exchange reserves have been increasing sharply, reaching $609.9 billion at the end of 2004, a level that places China second in the world behind Japan. This has reflected huge surpluses in both China's current account as well as its capital account. So long as the international balance of payments remain in the black, foreign exchange reserves will also continue to rise. Such an expansion in the imbalance is leading to a decline in the efficiency of resource allocation, economic overheating and trade friction with other countries.

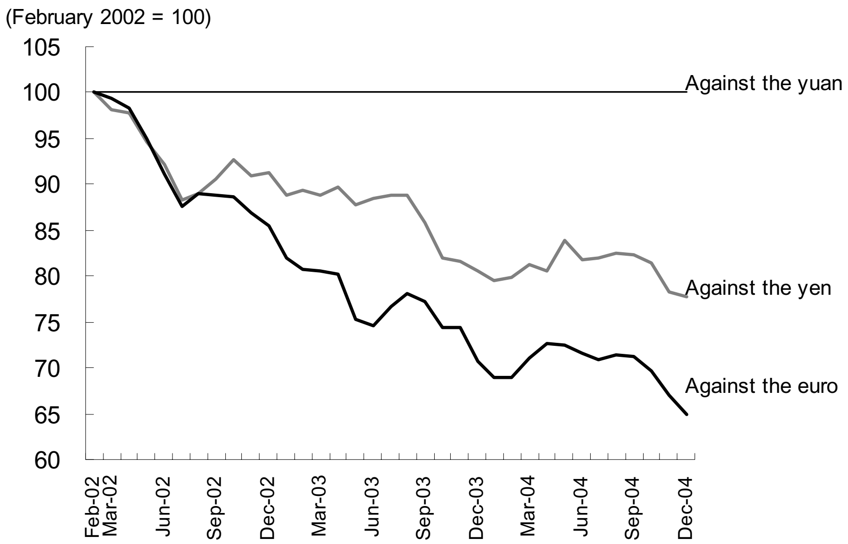
The increase in the external imbalance vividly shows that the current exchange rate is lower than its market equilibrium rate. China maintains that it has a managed floating system, but the focus of this policy has been on "management," and there has been virtually no "floating" of the yuan's exchange rate against the dollar since the Asian currency crisis of 1997. When, as is the case now, the yuan is undervalued against the dollar, the supply of dollars exceeds demand, and the authorities must issue more yuan to absorb the excess dollars in the market in order to stabilize the exchange rate. If China had a purely floating system, the central bank would not intervene in the foreign exchange market. As a result, the level of foreign exchange reserves would remain unchanged, while the exchange rate would rise so as to secure a balance between the supply of and the demand for foreign currency.

As a result of market intervention by the authorities, China's foreign exchange reserves have grown sharply, but because they have been invested in such foreign assets as U.S. Treasury bonds, the hard currency so painstakingly earned is not used to develop the domestic economy and instead flows to foreign countries. Meanwhile, the need to intervene in the foreign exchange markets has made it difficult for the authorities to control the money supply.

Furthermore, should China do nothing to correct its trade imbalance with its major trading partners, trade friction could worsen. The United States' trade deficit for 2004 reached $651.5 billion, equivalent to 4.6% of GDP. Against this backdrop, doubts are rising over the sustainability of the external balance of the U.S., and the dollar is plunging against major currencies such as the yen and the euro (Figure 1). In order to stabilize the dollar against other major currencies, the trade deficit needs to be covered by an equivalent amount of net capital inflow. However, foreign investors are slowing their dollar investments because of low interest rates in the U.S. and the risk of a decline in the currency, while the monetary authorities in countries such as Japan and China are intervening actively in the foreign exchange market to halt the dollar's slide. Reflecting this trend toward a weak dollar, the Chinese yuan, which is in essence pegged to the greenback, is weakening against non-dollar currencies. Although this boosts the competitiveness of China's exports, it could lead to trade friction as the country's trade surplus balloons. In fact, since 2000, China has overtaken Japan to become the largest source of the U.S. trade deficit (Figure 2). With the trade imbalance between China and the U.S. reaching $162.0 billion in 2004, Washington has stepped up pressure on China to allow the yuan to appreciate.

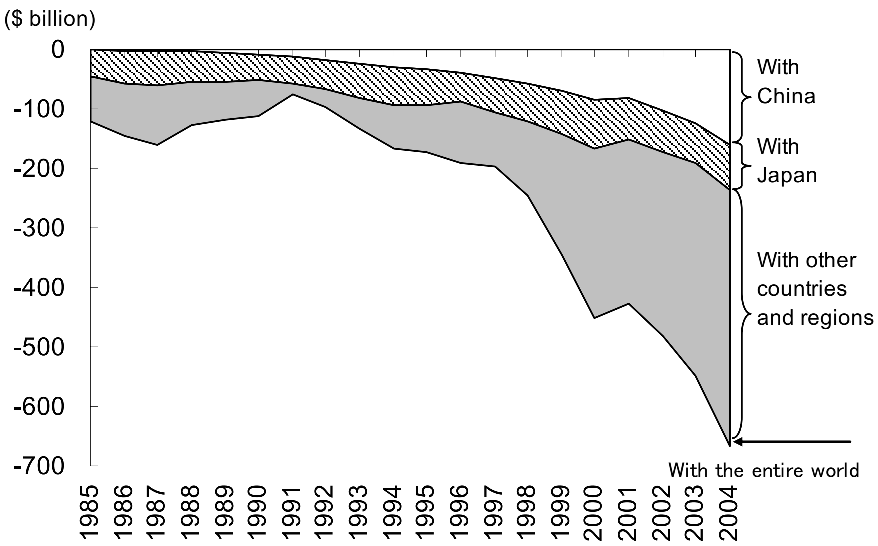
In order to restore monetary autonomy and to reduce friction with China's trading partners, the Chinese authorities should gradually shift to a floating exchange rate regime that keeps market intervention to a minimum. If a currency basket system is introduced during the transition phase, China will be able to limit the adverse effects of exchange rate fluctuations among major currencies such as the dollar, the yen, and the euro.

**Figure 1 The Dollar's Plunge against the Euro and the Yen**




Source: IMF

**Figure 2 The United States' Rising Trade Deficit**




Source: U.S. Census Bureau

## 2. Foreign Exchange Policy Needs to Change with the Times

However, the Chinese authorities repeatedly stress that there is no need for a stronger yuan, while the Chinese media have kept warning that such demands by Japan and other countries may be a "conspiracy" to block China's economic development. The time seems to be ripe for a revaluation of the yuan, so why does China continue to refuse to let it happen?

First, the successes of the past have turned into obstacles to new thinking. At the time of the Asian currency crisis of 1997-1998, China worked to stabilize the yuan using its abundant foreign exchange reserves, and thus prevented the crisis from affecting it. By keeping the competitive devaluation among Asian nations in check, this also won China global praise. The Chinese authorities have thus come to treat the pursuit of currency stability and the accumulation of foreign exchange reserves as ends in themselves rather than policy means.

Second, the fundamentals of the Chinese economy remain sound, and the authorities do not feel the need to alter macroeconomic policy. Rising foreign exchange reserves usually increase the money supply, leading to higher inflation. The usual prescription for such a situation is to have the currency appreciate in order to stabilize prices. However, in China's case, the increase in the price level has so far remained moderate. Furthermore, in contrast to a situation when a currency is forced to devalue under downward pressure, China's rising foreign exchange reserves mean that the authorities see no urgent need to take concrete action.

Third, even if the yuan's appreciation is beneficial for the nation as a whole, those groups that will be adversely affected by such a move will oppose it. Specifically, a stronger yuan means that Chinese products will become more expensive in dollar terms, and their international competitiveness will decrease. At the same time, because import prices will fall in yuan terms, sectors at a comparative disadvantage in competition with imports, such as agriculture, as well as inefficient state-owned sectors will likely be adversely affected.

Finally, demands from abroad, including Japan, for the yuan to appreciate have turned foreign exchange policy from being a domestic economic issue into an international political matter. The Chinese government would like to avoid giving its people the impression that a revaluation is being undertaken under foreign pressure.

However, now that economic circumstances both at home and abroad have greatly changed, the time has come for a review of the foreign exchange policy that has so far worked so well. By pointing out the errors of judgment in the points mentioned above, I would like to present my case as to why the yuan should appreciate.

First, at the time of the Asian currency crisis other countries wanted the yuan to be stable, that is, not to depreciate. However, at present, the international community is criticizing the yuan's stability - the fact that it is not appreciating. China will pay the price of its efforts to try to block the yuan's rise in the form of intensified trade friction.

Second, China's foreign exchange reserves have surpassed the $600 billion level, almost four times that at the time of the Asian currency crisis. When we also take into consideration the fact that the returns on its investments of those reserves are much lower than those on domestic investments, the amount of foreign exchange reserves China has is probably much higher than the "optimal level." In addition, a sharp increase in foreign exchange reserves is already making it difficult for the authorities to control the money supply and is aggravating the bubble in the real estate markets.

Third, growth in exports has remained solid since China's entry into the World Trade Organization, and it is unlikely that exporters would object strongly to the yuan's appreciation. Essentially, the aim of foreign exchange policy should be restricted to stabilizing the macroeconomy, especially balancing the external accounts. If it is forced to serve other purposes, such as the protection of inefficient sectors, the authorities must be prepared to accept huge side effects. Industrial policy and the creation of safety nets for the socially weak should be undertaken through more direct means such as budgetary measures.

Lastly, China must not become emotional over demands from other countries for a stronger yuan. Foreign exchange policy should be decided calmly, based on the interests of one's own country. In fact, up until 2002, calls for the yuan's appreciation were often seen in the Chinese media. However, as external pressure has mounted, such calls have completely been replaced by objections to the idea. Such government-led formulation of public opinion will only serve to restrict the policy options available to the authorities and will not serve China's own interests.

Generally speaking, there is a tendency in any country for a policy or system to continue to exist once implemented, even if it has become obsolete, and China's exchange rate policy is no exception. In an effort to put an end to this sort of inertia, the then Secretary General Jiang Zemin said in his report to the 16th National Congress of the Communist Party of China in the fall of 2002 that in order to implement reforms "we should continue to emancipate our minds, seek truth from facts and keep pace with the times." Indeed, this sort of spirit is also needed when reviewing China's exchange rate policy.

## 3. A Stronger Yuan Will Do Japan No Good

In recent years, Japan has called for a stronger yuan, hoping that the resulting increase in the prices of imports from China (in yen terms) would help it overcome domestic deflation and stimulate economic growth. However, this line of thinking has been based on the wrong presumption that the two countries compete strongly with one another in international markets.

To see how lower import prices from China affect the Japanese economy, we need to differentiate between "good deflation" that leads to an expansion of output, and "bad deflation" that brings about a fall in Japanese output.

Needless to say, the Japanese media tend to focus on the "bad deflation" scenario. In other words, if the export prices of Chinese products fall, it is assumed that Chinese goods will take the place of Japanese goods, not only at home, but also in third country markets. This is deflation in the sense of its effect on prices, and it will also have a negative impact on Japan's output.

However, there is also a side to "made in China" deflation that is "good deflation." In the case where a Japanese company imports various parts and intermediate goods from China, lower prices of Chinese products signify a drop in production costs, and, as a result, prices fall, but it is still of benefit to output.

The conclusion as to which of the effects – bad deflation or good deflation – is greater will differ depending on whether the economic relationship between Japan and China is viewed as being competitive or complementary. If the relationship is seen as competitive, the effect on the demand side will be greater, and there will be a larger negative impact. However, if the bilateral relationship is complementary, the positive impact on output will be greater because there will be a big effect on the supply side. When we look at the actual export structures of Japan and China, we see that the former focuses on high value-added high-tech products, while the latter concentrates on low value-added, low-tech goods. As a result, only a small part of their economic activities actually compete with each other, and the two countries are in a complementary relationship. Indeed only 21.9% of Japan's products compete with Chinese products in the U.S. market (Table 1), sharply in contrast with the ASEAN countries, which have over 60% of their exports competing with China. It is therefore likely that, for the majority of Japanese producers, the supply effects outweigh the demand side effects so that deflation in China is "good deflation" that brings about an increase in output.

**Table 1 The Degree to Which Asian Countries Compete with China in the U.S. Market**

(%)

| | 1990 | 1995 | 2000 | 2003 |
|---|---|---|---|---|
| Japan | 3.2 | 8.5 | 16.2 | 21.9 |
| South Korea | 24.8 | 28.4 | 37.3 | 40.9 |
| Taiwan | 27.5 | 40.2 | 49.5 | 68.8 |
| Hong Kong | 43.8 | 51.5 | 58.4 | 71.7 |
| Singapore | 14.7 | 19.2 | 34.8 | 40.1 |
| Indonesia | 48.5 | 59.7 | 68.0 | 66.8 |
| Malaysia | 37.4 | 36.8 | 47.3 | 65.0 |
| Philippines | 41.9 | 45.6 | 45.9 | 60.7 |
| Thailand | 36.4 | 47.5 | 55.7 | 69.8 |

Notes: The degree to which Japan competes with China is calculated as the value of U.S.-bound exports from the two countries that are classified as belonging to the same product categories, divided by total Japanese exports to the United States.

Source: Calculated from U.S. import statistics based on the 10-digit Harmonized System (HS) classification.

Moreover, while the above analysis is based on the viewpoint of Japanese companies, for the Japanese consumer there is no need to differentiate between whether deflation is good or bad. For the Japanese economy as a whole, just as in the case of a fall in oil prices, the decline in the import prices of Chinese goods means an improvement in its terms of trade, and is thus an increase in real income.

By contrast, an appreciation of the yuan will likely have a negative impact on the Japanese economy through the "income effect," brought about by the deceleration of the Chinese economy, and the "price effect," caused by a surge in the prices of Chinese goods in international markets.

First, let us consider the income effect. If the yuan strengthens, the competitiveness of Chinese products in international markets will decline, and the Chinese economy, which is fueled by exports, will probably slow down. Yet, because processing makes up a great proportion of China's trade, Japan's exports to China will decelerate as a result. For Japan, whose export dependency on China is rising, this will be a big blow to such industries as machinery .

Second, let us look at the price effect. The rise in the prices of China's exports will simultaneously apply upward pressure on both the input and output prices of Japanese industries, but the combined effect differs from one industry to another. Generally speaking, in industries that compete with China on the output front, the greatest influence will be on output prices, and both profit and production will increase. In other words, the industries that would benefit from a stronger yuan would be limited to those labor-intensive industries in which Japan no longer has a comparative advantage. In contrast, for industries that are in a complementary relationship with China on the input front, the increase in input prices would be greater than that of output prices, meaning a decline in both profit and output. From the viewpoint of individual Japanese firms, companies whose products compete with those from China in both domestic and international markets will see their competitiveness increase with a stronger yuan, but companies that procure intermediate goods from China will be adversely affected through an increase in production costs.

When the price effect of a stronger yuan on the Japanese economy is considered as a whole, total output would increase (the demand curve would shift to the right) if most industries are in a competitive relationship with China (Figure 3). However, in reality, there are more industries that are in a complementary relationship with China so that the negative effect on output is likely to dominate (because the supply curve shifts more sharply to the left). When the aforementioned negative income effect (the shift to the left of the demand curve) is also taken into account, a stronger yuan would have a negative, rather than positive, effect on Japanese output. Indeed, according to the results of a *Nihon Keizai Shimbun* questionnaire survey of major Japanese firms conducted in September 2003, 37% of respondents said that an appreciation of the yuan would have a negative impact on their business. This figure was much larger than the 16% of respondents who replied that such a situation would have a positive effect (Table 2).

**Figure 3 The Effects of a Stronger Yuan on the Japanese Economy**

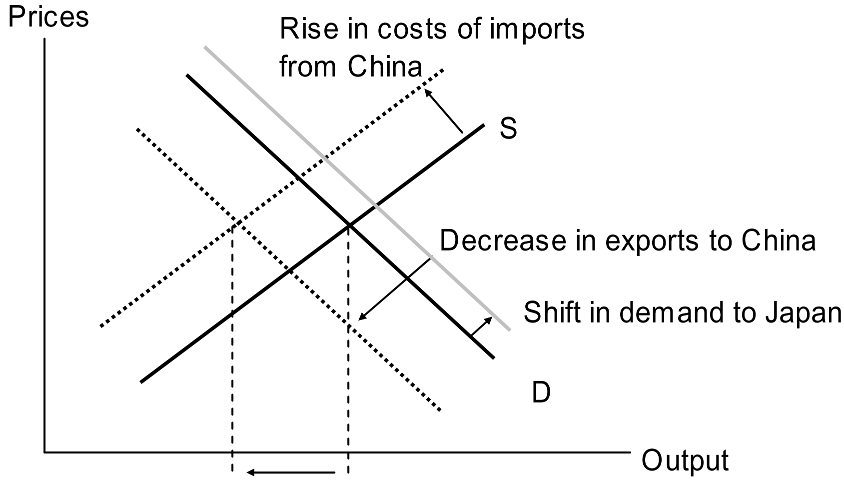


**Table 2 The Effects of a Stronger Yuan on Japanese Companies**

| | |
|---|---|
| Positive (16%) | A rise in exports to China can be expected<br>The competitiveness of Chinese products will decline<br>The value of our yuan holdings will rise |
| More or less neutral (47%) | The scale of our China-related business is small<br>Our imports from and exports to China are balanced in value terms<br>We have the ability to absorb currency rate fluctuations |
| Negative (37%) | Prices of imports from China will rise<br>The competitiveness of our production facilities in China will decline<br>The cost of Japanese staff in China will rise<br>A strong yuan may have a dampening effect on the Chinese economy |

Source: *Nihon Keizai Shimbun* (September 20, 2003)

Thus both the diagnosis that China is the main source of Japan's lackluster economic performance and the prescription that the situation can be corrected through a stronger yuan are wrong. As long as the real cause behind deflation in Japan remains the delay in structural reforms and the accompanying domestic economic slump, it is clear that unless such problems are solved, there can be no real economic recovery in Japan no matter how strong the yuan becomes.