

# How I Learned to Stop Worrying and Forget the Yuan

by Jonathan Anderson



**N**O MATTER WHO you are or where you live, it's a safe bet that China has had a bigger impact on your life over the last 18 months than at any time over the past five decades. The mainland now sells more than \$500 billion worth of goods per year to the rest of the world, and exports have been expanding at a 35% annual rate. To put that figure in perspective, it means that Chinese exports are doubling every three years, which is nearly twice the growth pace of the nearest Asian competitors.

Virtually unheard of only a short decade ago, the "Made in China" label has pushed its way into U.S., European and Japanese retail markets with astonishing speed. One of the most heated debates over the last few years has centered on whether rich country jobs are disappearing into the Chinese hinterland, and whether global manufacturers will forever be forced to lower wages and living standards under

the relentless deflationary onslaught.

The U.S. dollar is also becoming a hostage to the mainland economy. The People's Bank of China is already the third-largest foreign holder of Treasury debt, and is the biggest source of financing for the growing U.S. budget and current account deficits, plowing more than \$100 billion a year into dollar markets.

At home, China has been fighting the most significant economic bubble since the early 1990s, with billions of dollars of wasteful and excessive investment in unprofitable steel mills, speculative property developments, redundant science parks and low-quality auto factories. This spending wave, in turn, has pushed global commodity prices to exorbitant levels, from crude oil to iron ore, from steel to cement, from soy beans to palm oil; even international shipping prices have

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skyrocketed when faced with the daunting task of delivering these raw materials to China's door.

It has been an astounding few years for China and the world—matched only, it seems, by the astounding amount of ink devoted to explaining how we got here. Since the mainland began its current economic run, we've seen arguments ranging all over the map, from 60-year-long wave expositions to far-out political conspiracy theories, and pretty much everything in between. Despite the diversity of views, however, if you look carefully you will find that most of them focus to a surprising degree on the following "culprit": The fact that China keeps its exchange rate pegged at a rate of 8.277 to the U.S. dollar.

For manufacturers, the case is simple. The Chinese yuan is undervalued, as evidenced by massive foreign exchange intervention and reserve accumulation by the PBoC. This keeps mainland wages artificially low in dollar terms, effectively forcing prices down and stealing developed country jobs. If the renminbi exchange rate were set by market forces instead of central bank manipulation, the currency would strengthen sharply, raising the price of Chinese exports and taking pressure off manufacturing margins and saving jobs elsewhere.

For governments, the case is equally simple. In order for global recovery to continue on a sustainable basis, the U.S. current-account deficit has to be reversed, which can happen in one of two ways: a significant weakening of the dollar, or a sharp U.S. recession. Currency markets have been trying to push the dollar down

over the past few years, but it hasn't worked very well. Not only is China the fastest-growing supplier into U.S. markets, it is also one of the few countries in the world with sufficient domestic growth potential to absorb higher U.S. exports. For the U.S. to meaningfully adjust, it needs the mainland to sell less and buy more—and this means revaluing the yuan.

For academics, the situation may as well have been lifted directly from a macroeconomics textbook. If you fix the exchange rate, you lose control of monetary policy and inflation, and this is precisely what has happened in China. After global markets collapsed in 2000-01, money began flowing into the mainland in ever-increasing amounts. Sure enough, Chinese banks went into an orgy of lending, speculative asset markets started rising, and headline inflation is already six percentage points higher than it was two years ago. The authorities have been taking domestic policy steps to slow the economy down, but it simply won't work unless they resolve the fundamental cause: the fixed exchange rate.

For investors, the arguments are very straightforward. The U.S. dollar is being propped up by China—but it can't go on much longer. Faced with the strains of managing an unruly domestic cycle, as well as a growing pile of forex reserves now approaching \$600 billion, the PBoC will soon decide to cut its losses and give up the peg. And when the yuan goes, most other Asian central banks will loosen their de facto dollar pegs as well. Even if China chooses to go slowly, for example by shifting to a trade-weighted "basket" arrange-

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ment in the near term, it still adds up to one thing: Sell the dollar.

In short, the yuan seems to hold the key to a surprising number of domestic and international issues. Is it any wonder that mainland exchange-rate policy is the focus of global attention, from G7 finance minister summits to Chinese senior leadership caucuses to heated hedge fund strategy sessions? Is it any wonder that Pulitzer Prize-winning journalists and Nobel laureate economists now weigh in on debates about the Chinese currency on a daily basis? Whether you think China is right or wrong, whether you think the peg should stay or go, you have to admit that the yuan “matters” in a way it never did before.

**O**R DO YOU? The arguments above sound convincing—but a close look at the facts shows that most of them are wrong. In fact, the more detailed the analysis, the more inevitable the conclusion that the yuan really doesn't matter at all, or at least not nearly as much as the current hype and attention would suggest. Fixed or floating, up or down, renminbi exchange-rate policy simply doesn't have a significant impact on the global economy. Nor, for that matter, does the exchange regime have much effect on China at home.

Let's start with a few basics. What would you say if you opened the newspapers tomorrow to discover that Italy had reinstated its currency, the lira, and de-

cidated to peg its exchange rate to the euro or the dollar at a rate 15% more depreciated than the current one?

We suspect most people would scratch their heads at the move, and then conclude that it wouldn't have a substantial impact on their own lives. After all, Italy is still relatively small compared to the global economy, and 15% undervaluation doesn't seem like a lot in the grand scheme of things.

But if that's the case, then why all the attention on China? After all, at \$1.2 trillion, Italian GDP is roughly the size of China's, and Italy's total foreign trade value of \$750 billion is only slightly smaller than that of the mainland. And 15% is a reasonable estimate for the extent of medium-term undervaluation of the yuan.

First-world manufacturers love to point to artificially cheap Chinese wages as the most imminent threat on the global scene. However, the fact of the matter is that artificially cheap Italian wages would hurt them much more. Why? Because most Italian industrial workers are in sectors like autos, chemicals, machinery and technology—sectors competing head-to-head with those of Italy's wealthy neighbors, where even small changes in pricing could shift orders and production between one country and another. By contrast, Chinese export workers make textiles, toys, sporting goods and light electronics, i.e., industries the developed countries mostly gave up a long time ago.

You can see this in the global trade data.

Chinese exports have been penetrating European, Japanese and U.S. markets at a headline growth rate of 35% per year—but total Asian exports have not. Overall Asian market share has in fact grown very slowly, which means that for each additional dollar industrialized consumers spend on Chinese imports, imports from the rest of Asia actually fall. This is not because China is “outcompeting” its Asian neighbors; rather, Asian countries have simply moved low-end processing and assembly functions to China, as a final stop on the production chain before shipping off to Wal-Mart or Tesco.

Take the concrete example of a mobile handset assembled in the mainland and then shipped to the U.S. The final value of the handset could be \$200, but the actual value-added share accruing to Chinese parts and labor might only be around \$30; the remainder would be high-end components and equipment coming from Japan, Korea or Taiwan. What would happen if the yuan were revalued by 15%, or even 30%? The price of the handset would go up by some \$9, not nearly enough to have an impact on American producers and jobs, especially since there are very few American workers employed in electronics assembly in the first place.

What would happen if, instead, the yuan remained fixed and the Japanese yen, the Korean won and the Taiwan dollar revalued in its place? Here the price of the handset would rise by nearly \$50, a much more significant increase, and one that might actually provide relief to high-end manufacturers in the U.S. The lesson is that currency policies in more developed

markets “matter” to a much higher degree than they do in China.

Of course China benefits from the migration of low-wage assembly functions to the mainland—but this does not mean that the Chinese authorities are cynically manipulating their currency to extract maximum advantage over competitors. Quite the opposite; remember that the government introduced the renminbi peg to keep the currency from weakening in the post-Asian crisis years. In other words, the real effect of the peg was to stop Chinese wages from getting cheaper, which would have hurt other low-income economies. The yuan only came under significant strengthening pressure in the last two years.

What about all those forex reserves? Over the past 12 months, the People’s PBoC purchased more than \$170 billion in reserves, or roughly \$15 billion per month. And it didn’t do so out of some maniacal drive to accumulate a big pile of cash. Far from it; \$15 billion per month happens to be the current price of keeping the yuan constant. As long as it maintains a fixed exchange rate regime, the central bank is forced to intervene in the foreign exchange market to buy up excess dollars—or, alternatively, sell dollars if there is a shortfall in the marketplace. Five years ago, the forex market was roughly balanced, and the PBoC could manage the renminbi peg without buying or selling at all. Two years ago, the bank was buying up \$4 billion per month. Since then, the number has tripled.

This scares a lot of traders in the street. The People’s Bank generally parks at least two-thirds of its funds in U.S. Treasuries

## *Export competitiveness is simply not a driving factor in the mainland growth story.*

or other dollar assets; if China were to let the yuan strengthen, it wouldn't have to buy up as many reserves. Even if the authorities moved very gradually, for example initially shifting to a "basket" regime, they might want to move their reserves into other currencies like the euro and the yen. Either way, a change in the exchange rate regime means a drop in Chinese support for the dollar, at a time when China seems to be the main source of funding for overstretched U.S. consumers.

This is a compelling story, but probably a misguided one. To see why, ask yourself the question: Where do those billions in reserves come from every month? Over the past year, roughly half of China's forex reserve inflows came from portfolio capital, including so-called hot money flows. In effect, Chinese banks and firms have been drawing down their asset positions abroad, or borrowing money in foreign markets, and bringing these funds back to the mainland, in part to speculate on a possible renminbi move.

But this means that as private agents move out of dollars and into yuan, the PBoC is buying up the dollars and pumping them right back into the U.S. The net effect on U.S. markets from these transactions is ... virtually zero! This is an overly simplified explanation, but very close to the mark. Despite the size of the headline reserve accumulation, China's true support for the dollar is much smaller.

Because of these distorting factors, economic theory doesn't pay much atten-

tion to what central banks are doing; instead, the crucial gauge is relative current account positions. If the U.S. is running a large current account deficit, then someone else must be running a large surplus—and it is these surplus economies that really "matter" for the dollar at the end of the day. What do the numbers look like? This year the U.S. current account deficit is expected to reach \$600 billion. Meanwhile, China is running a current account surplus of \$40 billion, i.e., only one-fifteenth the size of the U.S. imbalance.

Who accounts for the most of the U.S. deficit? Japan, Taiwan and Korea together should recorded a surplus of around \$230 billion this year; throw in Singapore and Malaysia for good measure and the figure increases to \$275 billion. You get the picture: China is a relatively small player on the global scene, and its neighbors are much more important in determining the fate of the U.S. economy.

This still leaves us with the undisputed fact that the People's Bank of China already holds a large pile of dollar assets (estimated at \$350 billion or more). If the PBoC woke up tomorrow and decided to sell its holdings and buy euro or yen instead, the negative impact on the dollar would be enormous. But why would they? They already hold a fairly diversified asset portfolio, including a sizeable amount of euro instruments, so an adjustment in the renminbi peg away from the dollar should not require a big rebalancing of positions. And keep in mind that central banks are

conservative policy institutions, not hedge funds, and it doesn't serve China's interests in the least to be seen shaking up G3 currency markets.

The bottom line? It's surprisingly difficult to argue that the Chinese renminbi exchange rate—or the exchange regime—has had any substantial impact on the way the rest of the world works. Whether we look at jobs, trading patterns or global currency markets, China still shows up as a relatively small economy, and certainly not one that is “driving the show,” now or in the near future. And whether the peg stays or goes is a sublimely unimportant issue in the large scheme of things.

Before leaving off, however, we need to turn to China at home. Renminbi policy might not matter so much for the rest of the world, but it certainly must have a huge impact on domestic jobs, prices and growth, no? The answer is yes—but only a very qualified yes. It turns out that even within China's borders, the role of the exchange rate is far less than most observers might suspect. There are three important points here:

First, the argument that China grows by keeping the yuan hypercompetitive is hogwash. Export manufacturing wages are around \$80 per month today; if the authorities decided tomorrow to let the market determine the value of the yuan, those wages might rise to \$100 per month. Any published survey of foreign investors will tell you that wages levels rank very low on the list of factors that make manufacturing in China attractive, far behind items such as infrastructure, proximity of suppliers, political stability and the size of the

domestic market. And remember that on a value-added basis, exports account for perhaps 8% to 9% of GDP, far less than in China's neighbors. Export competitiveness is simply not a driving factor in the mainland growth story.

Second, despite what you might read elsewhere, the sharp overheating of the past two years has had virtually nothing to do with the exchange regime. Yes, hot money has been pouring into China, and yes, the central bank has had to print lots of yuan as it buys up dollars on the market. However, the PBoC has effectively “sterilized” those foreign inflows by locking up the resulting domestic liquidity increase in borrowing arrangements at home. In other words, banks never really saw the cash.

Why, then, were banks lending so much? Very simple: they had a enormous amount of free liquidity to start with—money that was created by the PBoC long before the exchange rate and foreign inflows became an issue. In short, China's mini-bubble has been a domestic problem, and is already being successfully resolved through domestic actions.

Finally, the policy authorities are not interested in radical changes. In the last 18 months, every single public statement about renminbi policy has stressed the same points: China wants “basic stability” in the currency, but is actively looking at ways to adjust the exchange regime at the margin. There's no reason to think they won't be successful in a gradual strategy. Simply put, the current level of the yuan is not causing undue problems at home, and there's nothing looming on the horizon to force a move.