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The US-China currency affair

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THE US treasury report ostensibly aimed at decreeing China a currency manipulator, has not been released as was scheduled for the 15th of April this year. The repeated postponement of the release is to avoid the tumult that may follow the US assuming an explicit stance on the currency issue and imposing tariffs on Chinese imports. Such tumult would be a natural outcome given that the Chinese are likely to retaliate with an escalation of tariff walls with adverse implications for the Americans economic activity.

The delay may be good for the US, China and even the rest of the world since it buys all parties some time to reflect on a way out of the delicate imbalance in regard to 'balance of payments' involving the Americans and Chinese.. Even if the mentioned report never sees the light of day, it is time for a serious rethink on global currency regimes and their regulation, as explained below.

The spectre of the economic crisis still haunts the US economy, which is charaterised by high rates of deflation and unemployment, low asset values and economic stagnation. With Congressional elections round the corner, bashing the Chinese is obviously a sound strategy. Several members of the US congress have been blaming the undervalued yuan, pegged to the US dollar for the last two years, for America's economic difficulties. However, this might not be the complete picture. Over time, an imbalance between the real and the financial side of the economy has emerged in the US with financial values of assets assuming magnitudes not based on values of underlying real assets. In turn, this has meant that traditional linkages such as that between productivity and wage have been broken. This has led to distortions in the economic structure with adverse ramifications.

One major outcome is the reliance of recent American growth on creation of demand through debt and asset price inflation. This in turn has also resulted in external imbalances. It deserves mention in this regard that US consumers consume and invest more than they produce and the associated deficits have to be financed by surpluses generated by other countries.

The American financial markets chased these surpluses which favoured formation of speculative bubbles. Asset prices rose to unrealistic levels and as the money flowed, people were willing to make even riskier investments. Finally, there was an implosion in the US securities market that precipitated the global economic crisis.

There is tangible pressure to correct this anomaly by the US cCongress which is of the opinion that the Chinese policy of foreign reserve accumulation for influencing its currency valuation is a form of manipulation which makes its exports cheaper and imports expensive. The Congress contends that this has created a trade deficit in recent years and has been a major factor behind the loss of manufacturing jobs in the USA.

Although there is some truth to what the Ccongress is crying foul over, it is equally true that the US consumers and corporations have for years gained from the supply of low-cost Chinese goods and material inputs, with the latter providing US a global competitive advantage in the market for certain high-end products. The Chinese have in turn accumulated dollar reserves and benefited from unprecedented growth, high employment and the status of having 'arrived' in the global economic power club.

The Chinese yuan or renminbi., pegged to the dollar, was modestly reformed in 2005 though the US Congress does not consider it enough. The Chinese dilemma emerges from the fact that a strong and stable US economy is in China's interests as its largest export market. Hence it is willing to continue funding the US debt though aware of the possibility of inflationary ramifications for the US and the depressing effect on China's holding of US securities caused by the associated depreciation of the dollar. On the other hand, if China stops buying US debt or sells it off significantly the same economic destabilisation of the US from a weakening dollar could result.

Even if China accedes to the US demand to raise the value of its currency or make it float, it might not help either country: US inflation and market-based interest rates will go up and Chinese goods would suddenly become more expensive for Americans, necessitating a reduction in profit margins associated with Chinese exports, which, according to their vice commerce minister Zhong, are less than 2% per cent. A Chinese slowdown characterised by income losses, reduced employment and social instability is likely under this scenario.

To summarise, the US and China can neither do with nor do without each other. Tradeoffs are inevitable, regardless of whether the yuan has a stable and low dollar value or appreciates. Even if the Chinese give shape to the latter possibility, the approach has to be gradual. The US Congress's demands for coercion to fix a certain high exchange rate is anything but sound economic reasoning especially as it has implications for other economies whose fortunes are governed by a sparsely regulated global currency system based on a diversity of currency regimes and systems.

The issue of Chinese appreciation of its currency and possible imbalances is thus a global issue requiring multilateral discussions instead of a simple bilateral approach. The lack of an appropriate forum for such discussions is a stumbling block in this regard, given a weakened IMF and doubts raised about its neutrality by the South. A potential forum might be the WTO as undervalued exchanged rates are often construed as smacking of protectionism, an area covered by the WTO mandate. However, its ability to broker effective rules and agreements in this regard needs further examination.

The current currency spat between the US and China raises several issues for global economic stability and welfare. It begs raising the salutary influence of multilateralism in the trade and currency markets to the pedestal it was idealised to be. From a development perspective, the world community must get assertive on assessing how the current imbalance between US and China would impact their own economic welfare and initiate discussions on the 'institutions' which will ensure economic security in the context of present financial fragility.

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