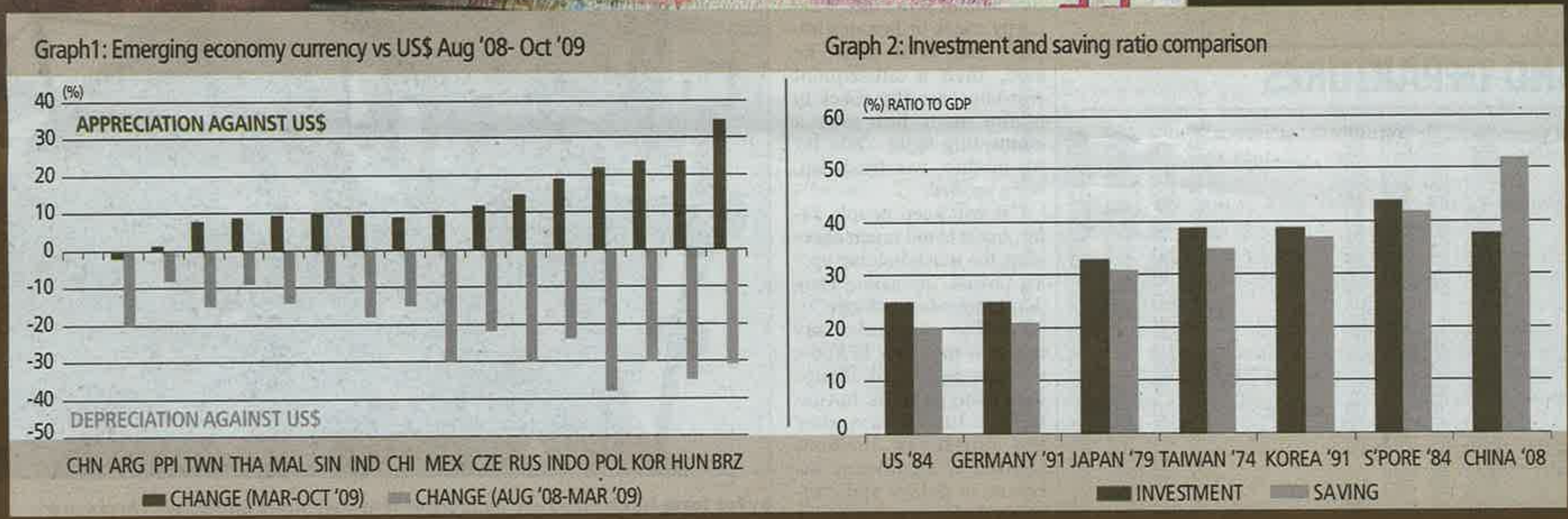

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At the right value for now: *So far, the perceived correlation between the exchange rate of the yuan and the financial crisis via global imbalances is at best a hypothesis; it is far from a robust theory, let alone a fact*

Criticism of China's yuan policy unjustified

All the arguments the West has advanced for a revaluation of the currency are flawed

By **WU ZHIJIAN**

IN THE last six months, China's foreign exchange policy has frequently been in the news. On the one hand, there is a lot of international pressure on the Chinese government to reconsider its policy of pegging the renminbi or yuan to the US dollar. On the other hand, Beijing continues to state firmly that its exchange rate policy is a domestic issue, which will not be affected by foreign pressure.

Before we make a judgment call on whether the yuan should be revalued, it is worth going through the main arguments advanced to justify a change in China's exchange rate policy.

Economists and journalists make three main arguments:

◆ The yuan has depreciated against most of the world's currencies in the last eight months, mainly due to the fact that the dollar has depreciated during the same period, and that the yuan is de facto pegged to the dollar. Such depreciation has hurt the competitiveness of other exporters such as Japan, Brazil and Germany, and therefore the yuan should be revalued.

◆ The revaluation of the yuan is a key policy needed to address the "global imbalance" problem, which involves China (among several nations) running huge current account surpluses and the United States running large deficits. Such an imbalance, mainly the result of overconsumption and indebtedness by America and underconsumption and oversaving by China, was one of the causes of the 2008 financial crisis. To avoid such a crisis from happening again, the imbalance needs to be corrected, and the revaluation of the yuan is needed for this to happen.

◆ China's economic growth is overdependent on investment and there is a dearth of domestic consumption. A consequence of such a growth model is that China's economy has to rely on the export sector to absorb the country's giant production capacity. To reduce its dependence on investment and exports, and increase its domestic consumption, China needs to de-peg the yuan from the dollar and let the market determine its fair value.

A close review of these arguments reveals that none of them is totally valid.

First, while it is true that the yuan depreciated along with the US dollar against most other currencies in the last eight months, if we extend the time scale back to August 2008 (when the financial crisis started to unfold), we see a completely different picture.

Due to the fact that the yuan was pegged to the dollar, the two currencies moved in tandem between August 2008 and March 2009. However, during that period, most other currencies, particularly those of emerging economies, depreciated 10-40 per cent against the dollar – partly due to the panic in the markets and flight of capital to the "safe haven" of the United States. Therefore the appreciation of other currencies against the dollar between March and October 2009 was merely a valuation correction after the depreciation between August 2008 and March 2009.

For example, (refer to Graph 1 above) the Brazilian real depreciated about 30 per cent from August 2008 to March 2009 before it appreciated about 35 per cent from March to October 2009. The net effect was that the Brazilian real was unchanged against the dollar from August 2008 to October 2009 – the same as the yuan. Thus, over time, the pegging of the yuan to the dollar achieved the same valuation as the Brazilian real, but with much less volatility.

What about the "global imbalance" argument? This also has its critics. For example, Zachary Karabell, the author of *Superfusion*, makes the good point that the world economy has never been in a "balanced" mode.

More evidence needed

It was unbalanced after World War II, it was unbalanced during the time of the Bretton Woods fixed exchange rate regime, and also unbalanced during the tech bubble of the late 1990s. Therefore we need more robust evidence to establish a strong causality between the global imbalance and the 2008 financial crisis, and also to establish a correlation between an undervalued yuan and the global imbalance.

So far, the perceived correlation between the exchange rate of the yuan and the financial crisis via global imbalances is at best a hypothesis; it is far from a robust theory, let alone a fact.

Last but not least, it is commonly believed that the investment ratio in China's economic sector is too high and China's GDP growth is excessively dependent on investment. However, such a view overlooks the fact that China's savings rate is among the world's highest as well. When a comparison is made between China's current savings and investment ratio and those of some of the fastest-growing economies in history, the interesting finding is that most economies during their fastest-growing periods experienced both high savings and investment ratios.

Given China's current savings ratio is more than 50 per cent, its investment ratio of 38 per cent is actually not that high, compared to other economies. For example, (refer to Graph 2 above) during the early 1980s, when Singapore went through a fast-growing period, its investment to GDP ratio surpassed 40 per cent and its savings ratio was slightly higher than 40 per cent. Similar scenarios can be observed in South Korea during the early 1990s and Taiwan in the early 1970s.

To summarise, none of the currently prevalent arguments to push for a yuan revaluation is robust enough to be convincing. This is not to say that the current system of pegging the yuan to the US dollar is flawless and fair. But justifying a revaluation of the yuan requires more in-depth research and better arguments.

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