Headline: Ask NUS Economists: Best to let China revalue yuan gradually
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ASK: NUS ECONOMISTS

Best to let China revalue yuan gradually

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How would a revaluation of the yuan affect the economies of the United States and China?

A yuan appreciation would mean more expensive Chinese goods, raising the cost of production and dampening US exports to China, in turn affecting US jobs. PHOTO: REUTERS

VARIOUS studies indicate that the yuan is undervalued by anywhere from 25 per cent to 40 per cent, depending on the assumptions of the studies. Whatever the precise figure, few would disagree that the Chinese currency is undervalued, given that China has amassed US$2.4 trillion (S$3.3 trillion) worth of official foreign reserves.

The current account imbalance is a reflection of the macroeconomic imbalance or the savings-investment gap between trading nations. The exchange rate is one of many variables that determine that imbalance. If the burden of restoring the US-China current account balance were to be borne solely by the exchange rate, the yuan would probably have to be revalued by up to 40 per cent at least.

It is politically expedient for US politicians to point a finger of blame at China to explain America's large current account deficit and its dismal unemployment rate. But what US politicians and Americans in general must realise is that the impact of a yuan revaluation will not be as simple as they assume. It may not significantly reduce the current account deficit or create more US jobs.

The simplistic view is that an appreciation of the yuan against the US dollar would enable Americans to sell more to China and buy less from it. But how plausible is that scenario?

First, a significant yuan appreciation is more likely to cause multinational corporations to relocate their production from China to other low-cost locations in East Asia rather than the US. Consider: Between 2005 and 2008, when the yuan appreciated by 18 per cent, the US current account deficit rose – from US$202 billion to US$268 billion.

Second, it is also not clear how a yuan revaluation would create more US jobs. New York Times columnist Paul Krugman recently accused China of being a currency manipulator and argued that a 25 per cent revaluation would bring the current account to a reasonable balance and create up to 1.4 million new US jobs. How did he get this figure?

We suspect it is from a simple back-of-the-envelope calculation that goes like this: Assume a US$1 billion current account improvement yields 6,000 more jobs; a 25 per cent yuan appreciation that reduces the current account deficit by US$240 billion per year would mean 1.44 million additional jobs. Presto!

But the assumptions behind the calculation are suspect. First, it does not take into account that we live in a multilateral world where a yuan revaluation may shift Chinese jobs to other low-cost East Asian locations rather than to the US. Second, even if some jobs do return to the US, there are offsetting effects that Professor Krugman does not take into account.

Using a more complete and sophisticated empirical model to estimate the effect of a yuan appreciation on the US economy, Prof Ray Fair of Yale University saw the following offsetting effects: First, a yuan appreciation would adversely affect China's output growth. This in turn would lead to a decline in Chinese imports of US goods – and hence US jobs.

Second, a yuan appreciation would mean more expensive Chinese goods for Americans – and that imported inflation may raise the cost of production and dampen exports.

Third, a higher inflation rate also implies a higher nominal interest rate in the US, which would adversely affect investment and jobs.

Pressuring Beijing to appreciate the yuan may be politically expedient but it may not be the smartest thing to do. It may not create a significant number of US jobs and it would hurt China's growth.

China allowing the yuan to gradually appreciate in a non-disruptive manner, however, may be in the best interest of the global economy in the long run as it would allow a more wealthy China to buy more American goods.

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