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Tough talk on China ignores economic reality

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In the past few weeks, Washington has upped the rhetoric concerning China and its currency. Coming at a time when there are a number of other sensitive issues facing the US-China relationship, it is not obvious to some of us why Congress is so excitable about this issue. With the biannual decision of the US Treasury on whether to name China as a currency "manipulator" due on April 15, it is far from clear that all this noise is helpful to anyone.

Indeed, from a macro-economic perspective, the timing could not seem more inappropriate. About four weeks ago, President Barack Obama announced a plan to double exports over the next five years. This is ambitious, but given the past weakness of the dollar and the strength of domestic demand in many big emerging countries, China included, the US has a chance of reaching its goal. So why go down a path of tit-for-tat retaliation that would take things in the opposite direction?

There are three fundamental issues that US policymakers should focus on: domestic demand in China, China's trade with the rest of the world, and exchange rates.

With respect to domestic demand in China, there is rather clear evidence that, if anything, it is currently too strong, and certainly not at a level to justify accusations that China is not doing its "bit" for the world economy. For about 13 years we have used our own proprietary gross domestic product indicator for China, the so-called Goldman Sachs China Activity index. At the moment, this is growing at an annual rate of more than 14 per cent. Indeed, and somewhat ironically, it is likely that if Washington and others could keep quiet, Chinese policymakers would probably be more eager to do things to ease the inflationary pressures arising from this growth, including introducing more flexibility to the exchange rate.

Looking at a number of indicators, whether they be anecdotal from domestic or global companies that do business in China, published data on consumption and investment, or, importantly, the trade data, all of this is clear. Speak to anyone involved at any level of the consumer business, whether it be **Tesco**, Walmart or **Louis Vuitton**, and their evidence backs up the data. Chinese consumption is probably growing at about 15 per cent, similar to a 2-3 per cent rate for the US consumer.

As far as China's involvement with the rest of the world goes, the real story since the worst of the crisis is not China's recovering exports but China's strong imports. The forthcoming trade release – interestingly due a few days before the Treasury report – is likely to demonstrate enormous import growth again, absolutely and relative to exports. This is seen not just in Chinese data, but in those from many other important trading nations. Indeed, quite remarkably, Germany's trade with China is showing such strong growth that by spring next year, on current trends, it might exceed that with France. China last year reported a current account surplus of 5.8 per cent of

GDP, significantly lower than apparently assumed as the current level by many people in Washington. In 2010, it could be closer to 3 per cent – incidentally below the 4 per cent level deemed as "equilibrium" by the Peterson Institute for International Economics.

Which brings me to the exchange rate. I have spent a lot of my career working on exchange rate models and am familiar with all the pitfalls. We have developed ours over the years at Goldman Sachs, including for the renminbi. At the moment, rather oddly, our model suggests that the renminbi is very close to the price that it should be. This has not always been the case. The model used to suggest the currency was undervalued by about 20 per cent, but it has moved by that degree in the past five years. We are, of course, less sure about the accuracy of this model than is usual with currency models, given the huge changes going on with China's growth dynamics and the world as a whole.

This brings us back to the irony of the question. Why are US policymakers pushing the protectionist buttons at the very time when there is growing evidence that events would otherwise play out in their favour? Moreover, it should and probably does seem obvious to those who matter in Beijing that keeping the renminbi rigidly pegged to the dollar has lost its post-crisis usefulness, something that the governor of the People's Bank of China has himself recently noticed.

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