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Open markets will relieve political tensions

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Washington and Beijing are in a war of words. At a "Town Hall" meeting last week, President Obama complained that China had not complied with its promise to allow the renminbi to appreciate faster. He used a two-hour New York meeting with Chinese prime minister Wen Jiabao last Thursday to lecture him on the urgency of his demand. On Friday, the US House Ways & Means Committee passed a bill naming China a "currency manipulator". The move could result in the entire House passing the bill on Wednesday unveiling new tariffs against imports from China.

While European officials have not been as vocal as their American counterparts, emissaries from the European Union have travelled to Beijing to encourage a faster renminbi appreciation.

Chinese officials have responded with their own verbal volleys, suggesting that the US fiscal deficit is the main problem, and repeatedly pointing out that the global financial crisis originated in the US. Insisting that the 20 per cent strengthening of the renminbi demanded by US legislators would bankrupt Chinese exporters, Prime Minister Wen insisted last week that the renminbi would not move much.

Beijing's pointed message: "The US is the source of its current problems, and should make the necessary adjustments rather than lecture China."

The rising tensions come at a time of growing uncertainties about the global economic recovery. In the US, President Obama has lost much of his erstwhile popularity with voters who see little sign of a recovery in employment despite the $787bn stimulus programme. Even worse, the rise in the US trade deficit to $289bn during January – July compared with $204bn during the same period in 2009 was largely due to a worsening trade position with China. This has led to criticism that US taxpayers are incurring a huge tax liability in future years essentially to boost output and employment in...China! If you embrace this line of reasoning, it is easy to conclude that the persistence of high US unemployment is due to the undervalued renminbi. The Chinese view is quite different: like many economists, Beijing points to historically low interest rates under the Greenspan and Bernanke Feds which, when combined with lax US financial regulation, encouraged speculation and overconsumption, boosting the US trade deficit. The magnitude of the eventual bust had nothing to do with the renminbi exchange rate.

By understanding better how to bring about equilibrium in international trade, US and European negotiators can go a long way toward improving their competitive position, as well as reduce the political heat on both sides. In pioneering work on exchange rates done during the 1960s, my Columbia University doctoral dissertation adviser, Robert Mundell, showed that if exchange rates are fixed, adjustment by the trading economies occurs in terms of changes in domestic costs and prices. The inflationary pressures evident in China validate Professor Mundell's theories. There is, therefore,

nothing “manipulative” about simply maintaining fixed exchange rates. Keep in mind that under the Bretton Woods system of exchange rates from the end of the second world war until the early 1970s, keeping the rates fixed with respect to the dollar was a sign of good economic housekeeping!

What needs to be improved is foreign exporters’ access to Chinese markets. This was clearly lacking during 2006–08 and was a main reason why the US did not achieve a significant reduction in its trade deficit despite a 20 per cent appreciation of the renminbi. One instance of market opening is the decision by the Chinese government in July to expand its government procurement efforts. Companies from both EU countries and the US will likely benefit from the move. Another development is a gradual opening that is taking place in the Chinese insurance market – the sixth largest in the world measured by premiums – to foreign competition. But a lot more has yet to happen. For example, the world’s largest wind energy operators have not won a national development project in China. If the US and the EU would shift their focus from the exchange rate to prying open the lush Chinese domestic market, they would benefit more in terms of increased exports, economic growth and jobs.

Freer access to China’s fixed income and equity markets will enable foreign investors to participate in the growth of what will become the world’s largest economy. They can take advantage of the coming strengthening of the Chinese currency by investing in renminbi-oriented exchange traded funds, and by buying indices which are proxies for the Shanghai Stock Exchange index. And as foreigners are allowed to buy into more Chinese companies over time, they should increase their exposure to Chinese equities.

What will the increased foreign investment do to the future value of the renminbi? The currency will appreciate substantially without any jawboning by Washington. Implications for US exporters and the stock market would be positive as well. The growing Chinese affluence and stronger renminbi will go a long way toward achieving President Obama’s goal of doubling US exports in five years. And if this is the path the US administration takes, expect shares of US companies involved in China-based projects to surge in price.

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