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China's exchange rate

Cock-a-doodle-doo

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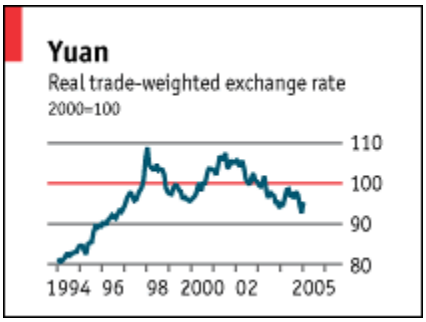
The cure for America's trade deficit lies with its economic policy, not China's exchange rate



ON FEBRUARY 9th the Chinese new year begins: the year of the rooster. Many western policy makers and businessmen hope that a new year will encourage new thinking in Beijing to revalue the Chinese yuan, which is pegged to the falling dollar. The yuan, it is widely argued, is grossly undervalued and represents the biggest obstacle to a reduction in America's huge current-account deficit. China has been invited to the G7 meeting of finance ministers and central bankers in London this weekend, where it is likely to come under pressure to adjust its exchange rate. But the G7 members should save their breath: not only would a revaluation of the yuan have little impact on America's deficit, but the more that foreigners pressure China to act, the harder it is for China do so.

To begin with, it is not obvious that the yuan is undervalued. The surge in China's foreign-exchange reserves suggests that the yuan is being held down, but this largely reflects short-term capital inflows from investors speculating on a revaluation; these flows could go into reverse. Moreover, if the yuan were set free and capital controls scrapped, the currency might fall as Chinese households and firms diversified into foreign assets. And while it is true that the yuan's trade-weighted value has recently fallen along with the dollar, this follows a period when the yuan was dragged up by a rising dollar: from 1994 to 2001 its real trade-weighted exchange rate gained 30%. Given the uncertainty about the yuan's correct level, it makes more sense to focus on how China can move to a flexible exchange-rate regime—to which its government is committed—than to insist on a specific yuan revaluation.

In any case, a revaluation is not, as commonly claimed, the vital element needed to shrink America's trade deficit. China accounts for only 10% of America's total trade, so a 10% revaluation would reduce the dollar's trade-weighted value by a mere 1%. More generally, although a fall in the dollar is necessary to reduce America's deficit, it is not sufficient. The real solution lies at home: the American government needs to borrow less and households must save more and spend less.

On the other hand, it is in China's own long-term interest to move to a more flexible exchange rate. This would give it more control over monetary policy. By fixing its currency to the dollar it is, in effect, being forced to adopt America's overly lax policy. Inflation is not currently a problem (it has fallen from 5% to 2.4% over the past six months), but ridiculously low real interest rates in a fast-growing economy are likely to cause a misallocation of credit and to fuel investment and property bubbles. A more flexible exchange rate would also help to buffer the economy against

shocks. But the timing of any change is tricky. A modest currency adjustment at a time of strong speculation could attract yet bigger inflows of hot money, as investors bet on further appreciation. Last week, Li Ruogu, the deputy governor of the central bank, made clear that China would adopt a more flexible exchange rate, but in its own time, not under pressure.

A first step towards flexibility might be for China to peg the yuan to a basket of currencies rather than to the dollar. One result would be China reducing future purchases of American government bonds. Yields on these would rise. This would, indeed, help to reduce America's trade deficit, but in a much more painful way than those who call for a yuan revaluation have in mind. The year of the rooster may yet deliver a wake-up call, but to America rather than to China.