Flash

Economic research | Economics | 21 March 2006 | No. 2006 - 120

The United States' endless demands for a revaluation in the RMB are incomprehensible

The US administration is repeatedly asking the Chinese government to revalue the Renminbi (RMB). Such demands are quite astonishing, even though, in real terms, the RMB is clearly undervalued.

In fact, a noteworthy point is that:

- ***a revaluation in the RMB would lead to an increase in US import prices in a situation where products imported from China are no longer, in practice, made in the United States. Accordingly, there would be a loss in US purchasing power without the support of real output and an inflation risk. As a result, there would be a rise in interest rates when US growth mainly depends on further increases in household indebtedness;***

- ***a revaluation in the RMB would appear because the Chinese central bank would reduce its accumulation of official reserves. Currently, this accumulation of official reserves ensures that the RMB/USD is virtually fixed. Therefore, there would be a problem in terms of financing the United States' external deficit and, thus, a rise in interest rates and a decline in US domestic demand;***

- ***a revaluation in the RMB would result in expectations of a depreciation in the dollar. This is extremely dangerous for a country like the United States that has a massive external debt given the risk of substantial sales of dollar-denominated assets.***

Therefore, overall, the US position is quite astonishing. In fact, economic analysis suggests that a country in the United States' situation, i.e. particularly high external debt, durably weakened smokestack industry, domestic production substituted for, on a huge scale, by imports, a need for low inflation to sustain purchasing power and growth dependent on household indebtedness, should choose a strong currency strategy in order to reduce import prices and attract investors. Perhaps the demands of the US administration are aimed at US public opinion to a greater extent than the Chinese government.

Author: *Patrick Artus*

IXIS
CORPORATE & INVESTMENT BANK
GROUPE CAISSE D'EPARGNE

The repeated requests of the US government

The US government regularly asks the Chinese government to revalue the RMB, because of its real undervaluation of 20% or 27%. The **RMB is** clearly **undervalued** against **the dollar by far more than 20% or 27%**, as is shown by the level of wages or unit wage costs between the United States and China **(Chart 1, Table 1)**.

Table 1
Average hourly labour costs in manufacturing
(USD per hour)

	1999	2000	2001	2002	2003
United States	19.1	19.5	20.3	21.1	22.0
China	-	0.5	0.5	0.6	0.6

Source: Eurostat, US Department of Labor, Bureau of Labor Statistics, May 2004.

However, **purchasing power parity**, i.e. PPP or the equalisation of traded product prices in a single currency, **is not a useful reference for determining the optimal exchange rate** between two countries of such different economic and social structures and levels of development **(Chart 2)**.

Moreover, twenty years after joining the European Union, Spain and Portugal still do not post the same purchasing power parity (PPP) as Germany **(Chart 3).**

Chart 1
China: Unit wage costs (United States = 100)

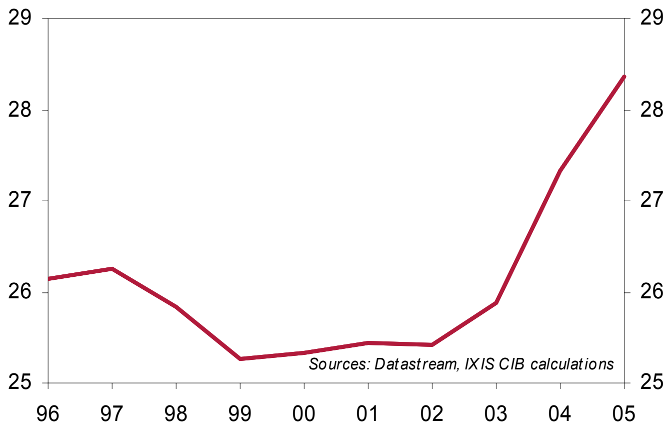


Chart 2
China: Per capita GDP in USD
(as % of per capita GDP in USD)

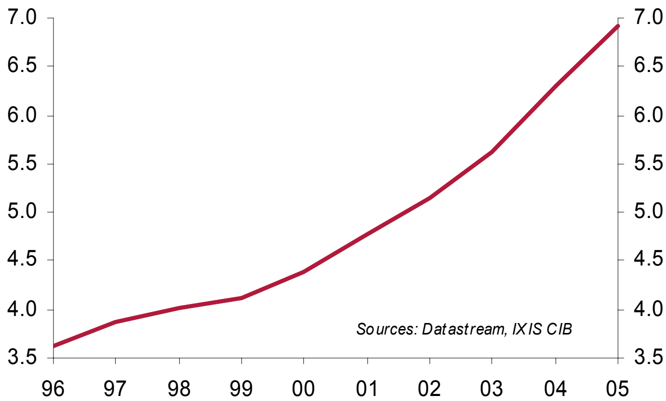
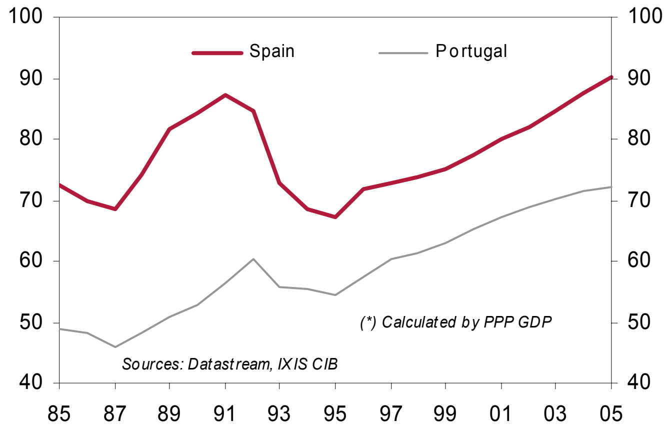


Chart 3
Unit wage costs* (Germany = 100)



Accordingly, from the United States' viewpoint, it would be more worthwhile to base their analysis of the optimal RMB exchange rate on an objective study of the impact of fluctuations in the RMB/USD on the US economy as opposed to PPP calculations.

Such an analysis shows that an appreciation in the RMB would be extremely dangerous for the United States.

The dangers of an appreciation in the RMB for the United States

According to our analysis, an appreciation in the RMB would have three types of negative effects on the US economy transmitted by:

- import prices;
- the financing of the external deficit;
- exchange rate expectations.

• Negative effect no. 1: An increase in import prices

A rise in import prices leads to an improvement in competitiveness and, normally, real external trade. Nevertheless, the competitiveness effect in the United States' case is outweighed by the negative import price effect.

Imports, in particular from China, meet a growing share of US domestic demand **(Chart 4A)**. In addition, this has implied the transfer to China of production that might have previously been located in the United States and the re-importing of such products into the United States — resulting in the trade deficit with China **(Chart 4B)** — as well as the stagnation in US industrial production ex IT **(Chart 4D).** We estimate that US companies produce 50% of US imports from China, in China. **Accordingly, this offshoring is irreversible** and, as a result, **the appreciation in the RMB would barely reduce real US imports, and hardly increase the already low US exports to China (Chart 4B)**.

Chart 4A
United States: Imports

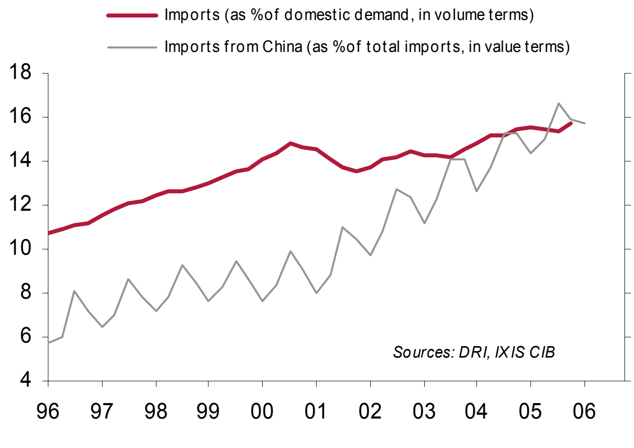
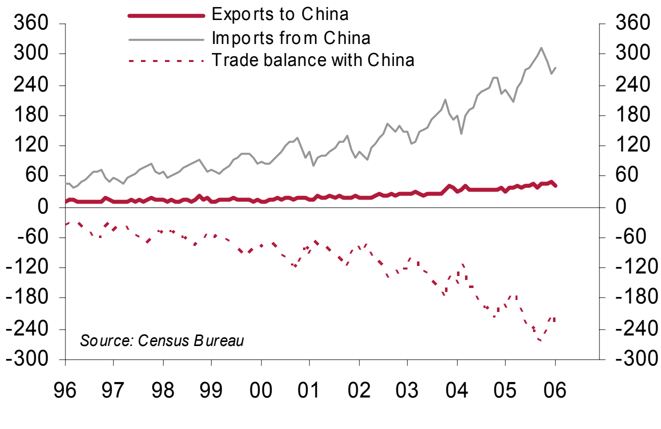
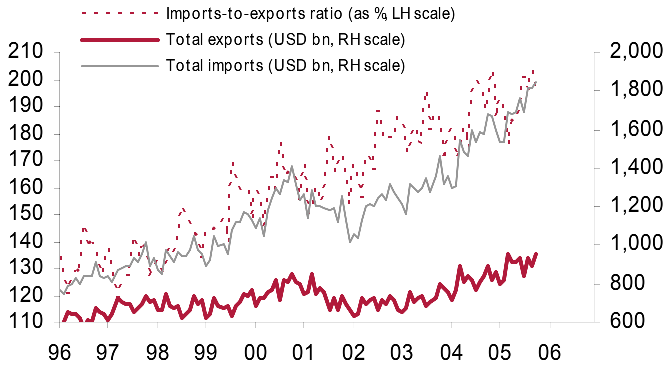


Chart 4B
United States: External trade with China (USD bn per year)



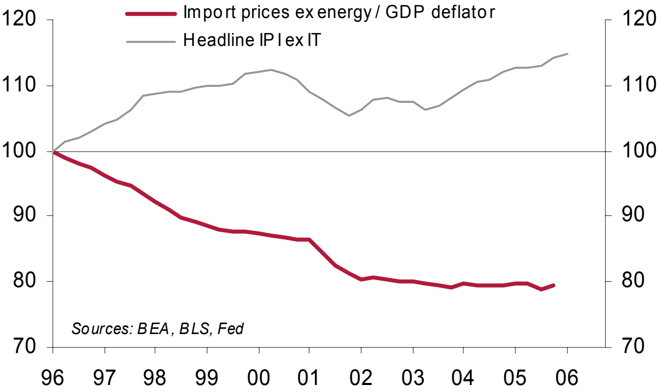
In the United States, as imports are noticeably larger than exports **(Chart 4C)**, and they cannot be substituted for by domestic production, **the main effect of a revaluation in the RMB versus the dollar would be an increase in the US import price deflator, hence:**

Chart 4C
United States: Imports, exports and imports-to-exports ratio



Sources: Datastream, IXIS CIB

Chart 4D
United States: Import prices / GDP deflator and industrial production (1996 = 100)



Sources: BEA, BLS, Fed

– a further deterioration in the US trade balance. The estimated elasticity to the real exchange rate of US exports is – 0.22 and imports 0.12. Such elasticities are far too low to offset the effect of import prices,

– a loss in real income in the United States through the deterioration in terms of trade,

– an inflationary effect: a 20% appreciation in the RMB would lead to an automatic rise of 0.4% in consumer prices in the United States under the hypotheses of a 20% increase in prices of imports from China. This hypothesis is reasonable if, in the United States, there is no output to substitute for Chinese products.

The rise in US domestic prices would lead to a rise in interest rates and a loss in labour's purchasing power. Note that such a decline has already begun to a large extent due to the rise in energy prices since 2002 **(Chart 5)**.

• Negative effect of the appreciation in the RMB, no. 2: A difficulty in the financing of the United States' external deficit.

The virtual stability of the RMB/USD, i.e. despite the minor revaluation in the RMB since July 2005 **(Chart 6),** requires further accumulation of official reserves in China **(Chart 7)** because of the Chinese current-account surplus, and direct investment inflows **(Chart 8)**.

Chart 5
United States: Wage and inflation (Y/Y as %)

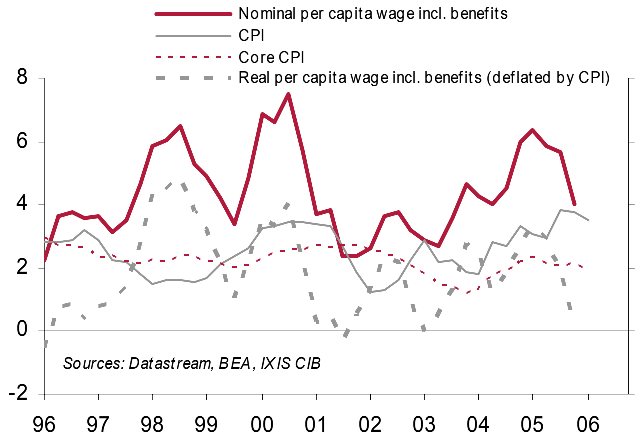


Chart 6
RMB / USD

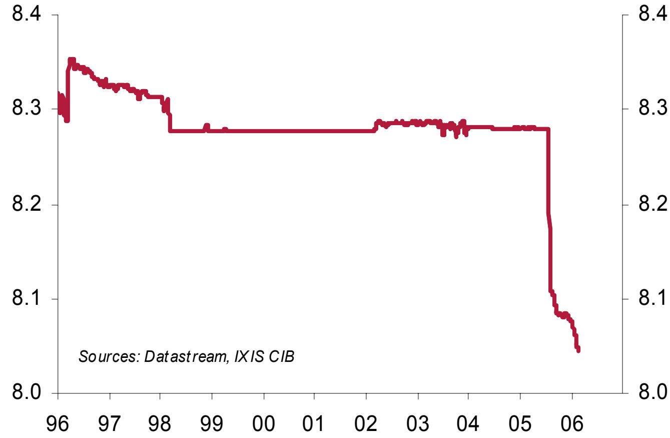


Chart 7
China: 1-year change and level of official reserves (USD bn)

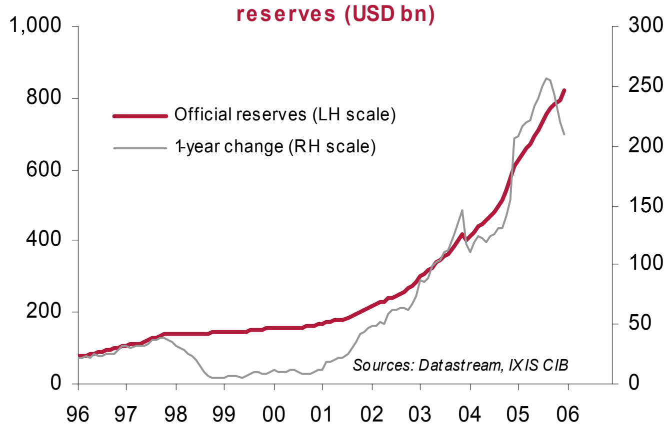
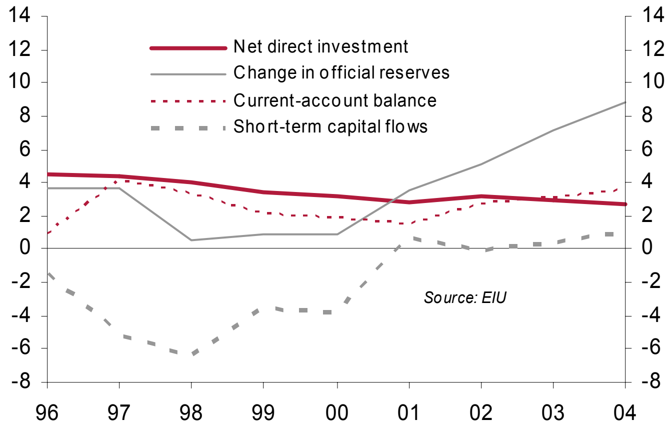


Chart 8
China: Capital flows (as % of GDP)



The accumulation of official reserves by China, and we can estimate 75% to 80% of these reserves are denominated in dollars, plays a crucial role in terms of financing the US external deficit. It finances approximately 25% of this deficit **(Chart 9)**.

The changeover to a policy of gradual appreciation in the RMB against the dollar would entail the**, total or partial, end of the accumulation of official reserves in China. In the case of a complete interruption, purchases of US bonds by non-residents (Chart 10) would decline 25%**, thus resulting in an inevitable increase in long-term interest rates.

Chart 9
United States current-account balance and change in Chinese official reserves (USD bn)

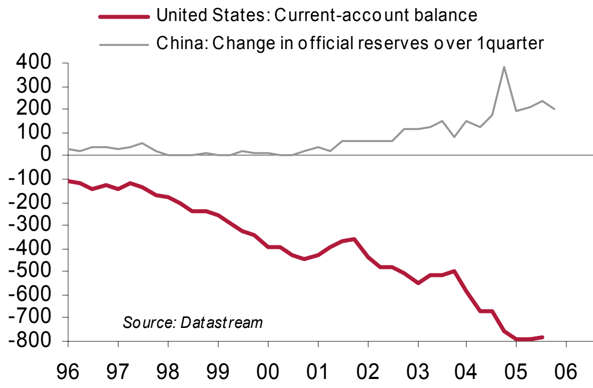
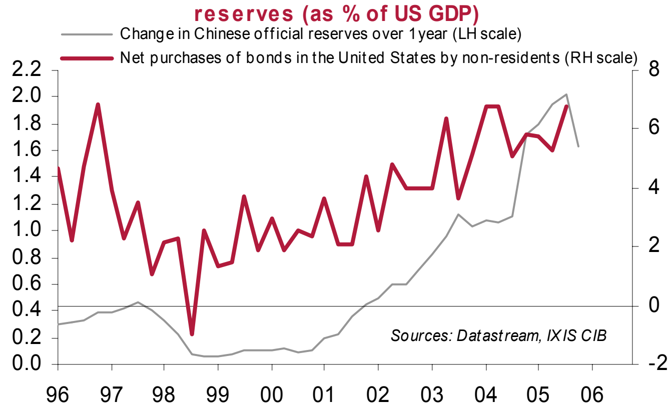


Chart 10
Purchases of bonds in the United States by non-residents and change in Chinese official reserves (as % of US GDP)



At this stage, a noteworthy point is that **US growth depends to a significant extent on the increase in household indebtedness (Chart 11),** which explains more than half of GDP growth, and is made possible by the low level of interest rates. **An increase in long-term interest rates, therefore, could have a dramatic impact on US growth**.

• Negative effect of an appreciation in the RMB, no. 3: Exchange rate expectations that are negative for investment in US external debt

A significant appreciation in the RMB against the dollar and the concomitant slowdown in China's exchange rate interventions would undoubtedly lead the markets to change over to **negative expectations about the dollar's exchange rate.**

Currently, the markets expect, in a year's time, a 6% to 8% depreciation in the dollar **(Charts 12A** and **12B)**, but this expected depreciation could become far more significant should the Chinese stop propping up the dollar.

Such a situation would be very risky in a country like the United States that posts a substantial external debt (Chart 13). Note that it accepts all the more easily this burden because expectations are positive for the dollar's exchange rate.

Chart 11
United States: Household debt load

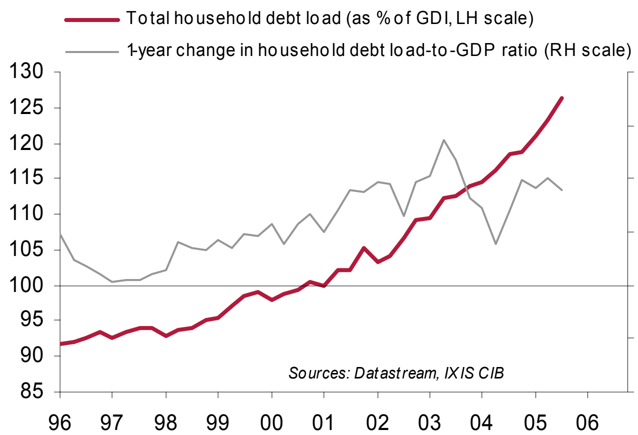


Chart 12A
USD / EUR and consensus forecast

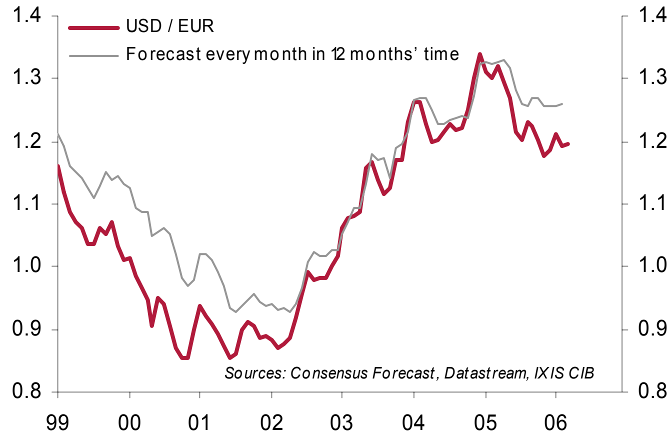


Chart 12B
JPY / USD and consensus forecast

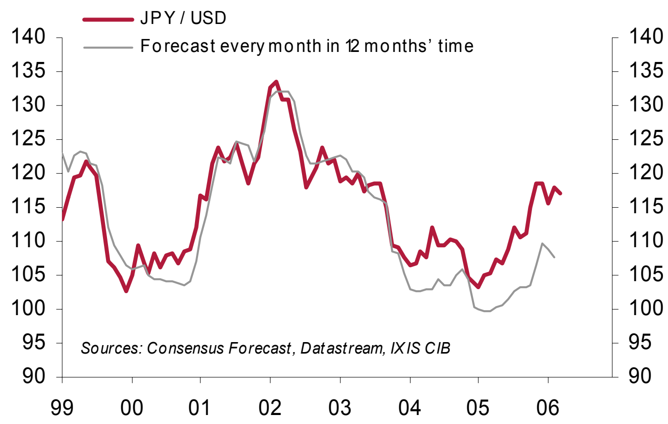
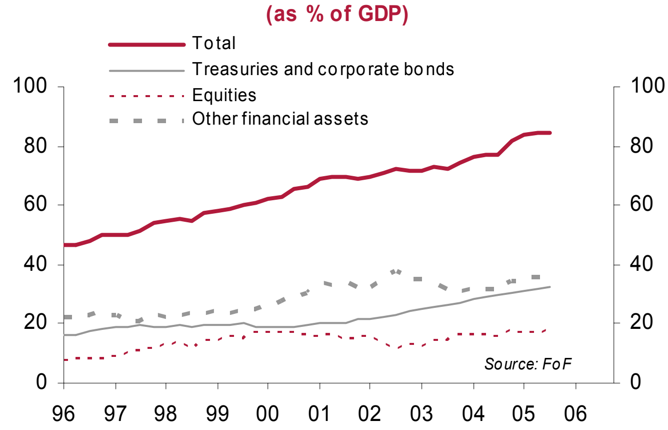


Chart 13
United States: Assets held by non-residents
(as % of GDP)



The cost of a shift to negative expectations about the dollar would be a decline in demand for US assets among non-residents and, therefore, a decline in asset prices, i.e. a downturn in stock market prices and an increase in long-term interest rates.

Conclusion: The astounding point — a country in the United States' situation should have a strong currency policy

A country with:

- weak industry that cannot be rebuilt, and therefore has growing external deficits;
- purchasing power sustained by the improvement in terms trade due to the rise in imports from emerging countries;
- growth that depends on further increases in household indebtedness and, therefore, on interest rates remaining low;
- a massive external debt

should choose a strong currency strategy in order to reduce import prices, interest rates and inflation. Moreover, it should avoid expectations about its currency that have a negative impact on investment in its external debt. **Perhaps the US administration does not really want the RMB to be revalued?**