The non-issue of the RMB revaluation

2 November 2010 - Gilbert Van Kerckhove

Politicians in the USA and in the EU insist on a speedier revaluation of the RMB to lower the trade deficit with China. Their policy misses the real issues. For politicians it is an easy strategy to blame China for all their own internal problems.
Most Chambers of Commerce such as the EUCCC and Amcham have a better insight and they little mention the demand for revaluation and suggest their governments to moderate the call for a higher RMB. Amcham mostly urges Washington to calm down on the revaluation and is not expected to change its attitude.

Over 50% of exports in China are generated by foreign operations, who are represented by their chambers in China. The MNC are the first to profit from cheap “made in China”, alongside many foreign SME who export a massive amount of consumer and other products to their home markets; those exports have killed many manufacturing plants in the West. It is estimated in the USA that 13,000 jobs are lost for every 1 billion increase in the trade deficit - thanks to the flood of cheap goods. Those MNC and SME would be the first to suffer; a higher RMB would be a big problem for them, reducing their profits or forcing them to find other countries. But shifting to other locations is not always easy in manufacturing in view of logistic problems and sub-suppliers. Yes, some sneakers are now being made in Indonesia but FOXCONN that makes Apple, Dell, HP and other products cannot move so easily.

Most products assembled in China have a low local added value - many parts are imported from other Asian countries or even the EU or USA. Only local costs will increase. A higher RMB would mostly have a modest impact on total price; very low existing margins however on some consumer products could threaten exports as Chinese manufacturers have little flexibility left; they would be affected if other exporting countries could take over their role. Little benifit for Western manufacturing is expected, except for some isolated SME operations. The USA is not going to manufacture again microwave ovens, toasters and DVD players.
A recent example is the U.S. imposition of duty on Chinese copper pipe and tubes. The levy will also apply to Mexico, indirectly affecting China that has set up manufacturing there. With shrinking demand in the U.S. market, the Chinese companies are turning to the Chinese market where demand is robust. Of course the American consumer will end up paying more.

Western consumers have become addicted to ridiculously cheap consumer goods, typically made in China; they unwillingly killed local manufacturing and then blame China for making it cheap for them plus providing them with credit.

The real threat for EU and USA is China switching to higher-value exports and competing with Western core competences, at the same time it overly protects strategic industries (trains, cars, telecom, power generation & transmission, green technologies…). This is already happening and generating new trade complaints. For those goods the impact of a higher RMB will not be always a serious problem but it will certainly make competition more tough and some Chinese industries will suffer.

Of course, if the RMB goes up by 20 or 30% or more - unlikely - we can expect Chinese exports to suffer, but so will the MNC for whom China is now the main profit center. And there is a potential for a weakening of consumer markets in the West due to higher prices in a climate of already rediced spending. Motorola is a good example: it only survived because of its China operations. The only choice for China here is to continue the efforts it has started years ago:

- rely less on exports in general; China’s ratio of trade surplus to GDP is to drop from the pre-crisis level of 10% to below 5% in 2010; international economists recommend a maximum of 4% for both trade surplus or deficit.
- rely less on cheap goods for export
- promote internal consumption

- elevate the level of the industry, lower dependency on cheap goods exports.

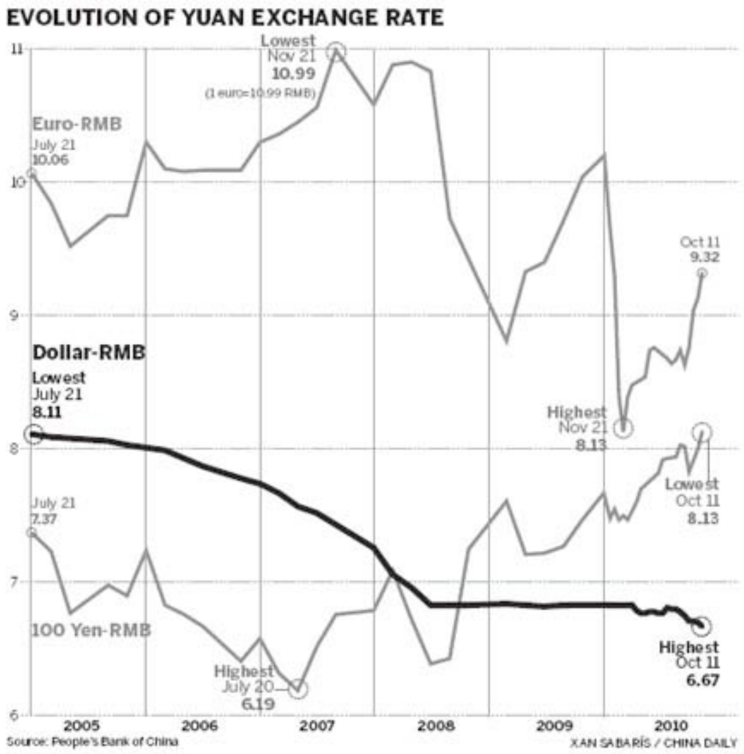
China seems unwilling to go beyond a 3 to 5% appreciation per year.
Another important consequence for China, in case it does drastically revaluates its currency against the USD: the value of its vast reserves in USD (U.S. Treasury Bills and others) will also plunge in RMB value.

The real fight the Chambers support is to lower unfair trade barriers for access to the Chinese markets. They call for:

- to fight market entry barriers of all kinds;
- for fair market access, transparency in public bidding;
- opening of the Government Procurement market in the spirit of the GPA, not according to present Chinese proposals that still exclude SOE;
- foreign-funded entities manufacturing in China should not be discriminated against; definition of “domestic product” must be genuinely respected according to the promise of the Chinese top government
- oppose Indigenous Innovation Registration
- oppose protectionism of key industries (e.g. in clean energy, through government financial and regulatory support, see the petition from the United Steelworkers on “unfair subsidies”)

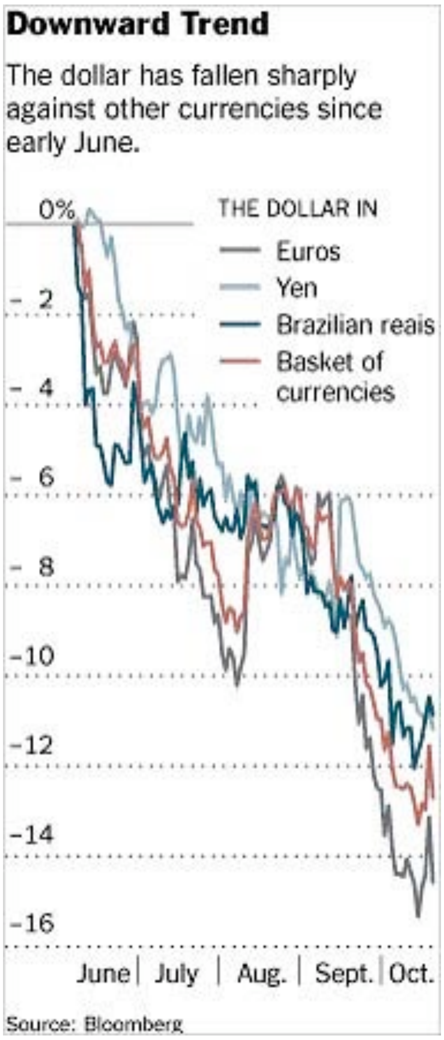
The USA feels betrayed, after approving “permanent normal trade relations” with China in 2000 and paving the way for China’s WTO membership. The expectation was that Chinese consumers would be able to buy lots of American products but “nothing of the sort happened”, as said senator Sherrod Brown; “It was all a cynical ploy on the part of many MNC, they lobbied Congress to support open trade, promising a boost to U.S. exports but then, once it passed, they closed domestic plants and moved production overseas - and imported their products for American consumers. Instead of a billion customers they were excited about a billion inexpensive workers.”

The RMB rate is further complicated as it depends on the USD - Euro exchange rate. China should diversify its reserves and set the exchange rate using a basket of currencies, not only on the USD. The exchange rate volatility is clear in the following chart (source: China Daily):



The USA is seeking support of other wealthy countries to pressure China on the RMB, but the EU and Japan have their own problems. All agree China is manipulating its currency but are reluctant to antagonize China. We witness a cycle of “competitive non-appreciation” where several countries attempt to keep the value of currency low to compete for exports: Thailand, South Korea, Indonesia, Brazil, Malaysia, Japan, etc. That puts those countries in the same boat as China, maybe not at the same scale, except for the USA.
For the USA, branding China alone as a currency manipulator has become more difficult. President Obama also favors dialogue over confrontation. Even in the USA, many business agree the currency debate distracts from the more important issues to discuss with China: market access and IPR. An indication: from July 2005 to July 2008 the RMB went up 21% but the USA trade deficit with China went also up by US$ 66 billion to 268 billion: so far for the impact.
Now many countries realize the exchange rate problem is not only with China. Other countries are also manipulating their exchange.

The following chart point the finger at the USD instead. Who is devaluating? Reason why the peg RMB - USD is unsustainable.



(source: IHT)