



Any belief that the Chinese will allow the yuan to appreciate meaningfully beyond their pre-determined framework belies a certain naiveté, in our view. Export growth stoked by a weak yuan helps soothe two sources of serious internal pressure.

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## Currency Wars: View From Beijing

By Douglas Clark Johnson

Pomp and circumstance was in high gear in Washington last week. Amid the ongoing frustrations of jump-starting the US economy and sorting out the mortgage mess, President Hu Jintao's state visit was a public relations victory for the Obama administration. The awkwardness of the Free Tibet demonstrators in Lafayette Park was a distant sideshow.

By carefully nurturing ties with one of America's most important creditors, Secretary of the Treasury Geithner may have avoided any public eruption over currency issues. But there remains an underlying tension to Chinese foreign-exchange policy. Pundits dissecting most of President Hu Jintao's language during his state visit hoped for some sort of currency-related headline, but no grand statement was forthcoming. Rather, policy analysts had to settle for the absence of terms like "basic stability" and "balanced level" as a sign that the Chinese may shift to a more flexible exchange-rate regime. Perhaps the Chinese simply didn't want to be rude, or they wager that domestic inflation will mitigate the stress.

### China: Return of Inflation Battle (Consumer Price Index Year-on-Year Change)



Source: National Bureau of Statistics of China.

**Just as the Great Depression may influence the Federal Reserve's approach to jump-starting the US economy, the Chinese seem to be operating with their own version of economic anxiety centered on deep-rooted concerns about civil unrest and retirement uncertainty. China also has a host of special interests that want to avoid the efficiencies afforded by a change in the currency regime.**

The value of the yuan may be the definitive economic battleground of our time. The Chinese see a weaker yuan as a sovereign right to sustain export-led growth, while the US sees a stronger yuan as essential to a fair competitive field for American exporters. The balance of conviction may favor Beijing. Chinese merchandise trade represents 45% of GDP, while the number for the US is closer to 20%, according to the most recent available annual tabulation from the World Bank. The dimensions and complexity of this issue are beyond the scope of this short commentary.

Certainly the intensity of the issue has dampened since a year ago. The Chinese adopted incremental flexibility in the currency starting in June 2010, and it has appreciated about 3.5% against the US dollar over the past seven months. The US would like to see much faster movement.

Any belief in Washington that the Chinese will allow the yuan to appreciate meaningfully beyond their pre-determined framework belies a certain naiveté, in our view. First, of course, is the ancient Chinese stance that any such directives constitute meddling in internal affairs. We also see two overriding themes that provide more contemporary context for Chinese economic decision-making:

**Civil Stability.** While the rate of increase in disturbances peaked in 1998, more recent absolute figures are astonishing. In 2005, there were some 84,000 mass disturbances involving more than 15 people, up from 8,700 in 1993, according to Carnegie Endowment estimates based on data from the Chinese Ministry of Public Security. (See [http://carnegieendowment.org/files/pb48\\_keidel\\_final1.pdf](http://carnegieendowment.org/files/pb48_keidel_final1.pdf)) The effort to divert this underlying turbulence drives the Chinese government to sustain economic activity at as high a rate as realistically possible.

**Social Security.** China has one of the least effective retirement income systems, among countries whose data is readily available for comparison. A 2010 study by Mercer, in conjunction with the Australian Centre for Financial Studies, ranked China the worst among 14 countries in terms of sustainability, integrity, and adequacy of its pension benefits. (See <http://www.globalpensionindex.com/pdf/Mercer-Global-Pension-Index-Report-2010.pdf>) There may be an income race taking place, as officials worry about providing for China's aging population.

Just as the Federal Reserve's approach to jump-starting the US economy may be deeply influenced by Chairman Bernanke's academic study of the Great Depression, the Chinese seem to be operating with their own version of economic anxiety. Deep-rooted concerns about civil unrest and retirement uncertainty go far beyond the understanding of objective intellect.

China also has a host of special interests that want to avoid the efficiencies afforded by a change in the currency regime. If the outcome of a stronger

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yuan is an economy more focused on consumption, then policymakers on both sides of the Pacific have to overcome the inertia cultivated by the construction and export sectors. The US Treasury's penchant for dangling the inflation-fighting benefits of a stronger currency in front of Chinese officials may not resonate against this backdrop.

Despite traditional analysts' near-term concern about weaker activity, we think economic growth in China may be better-than-expected for longer-than-expected. This suggests that longstanding investment themes related to Asian regional growth, such as commodity price strength, will remain intact for the foreseeable future. On the other side of the table, the Chinese will remain a primary source of incremental liquidity for international investment—especially in geographies like the Middle East, Africa, and South Asia—given their relatively high comfort with risk-laden opportunities.