A Review of the Renminbi Issue from the Perspective of Owning Responsibility for Adjusting the International Currency System

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The G20 finance ministers' meeting held in late October forthrightly opposed "competitive devaluation of currencies." However, the fundamental conflicts in the international currency system, as well as the weakening or strengthening of national powers resulting from the U.S. trade deficit and China's trade surplus, will continue to fuel the furor over exchange rates.

The fundamental conflict in the international currency system lies in the difficulty for deficit nations and surplus nations to concurrently own responsibility for adjustment. In principle, there should be a "real exchange rate depreciation" in deficit countries, which involves reductions in commodity prices and currency depreciation, so as to decrease imports and increase exports, namely to lower domestic demand. These currencies include the U.S. Dollar and the British Pound. There may also be a "real exchange rate appreciation" in surplus countries, which indicates inflation or currency appreciation, to boost imports and reduce exports, namely to raise domestic demand. These currencies include the renminbi, the Japanese yen, and the currencies in other East Asian nations. Such measures could effectively ease global trade imbalance.

In reality, however, as deficit countries will continue to lose foreign reserves, their domestic demand will naturally decrease. In contrast, surplus countries have no incentive to increase domestic demand. As a result, while global effective demand continues to shrink, deficit and surplus countries bear unequal responsibility for adjusting trade imbalance. This phenomenon may be tolerable when the economy performs well, but it would breed conflicts and frictions once global economic recession or depression takes place and could even impact the global currency system and financial order, which had happened when the gold standard completely collapsed in the 1930s and is a situation we are facing now after the global financial crisis in 2008 and 2009.

On the eve of the end of the Second World War in 1944, American and British delegates met to discuss the international economic order after the war. British economist John Maynard Keynes, who had an insight into the abovementioned problem and tried to solve it, proposed that trade surpluses or deficits should be capped at a certain percentage of GDP. Regrettably, the suggestion of Keynes,

a delegate from a deficit nation, was not accepted by the U.S., which had a trade surplus at the time. Ironically, the U.S., now a deficit nation, has recently proposed the plan that Keynes put forward nearly sixty years ago and has similarly encountered opposition from surplus countries, especially Germany, Japan, and China.

What's more, as the U.S. and China have respectively emerged as the major deficit country and the major surplus country, the issue of adjusting global trade imbalance has become even more complicated. This issue has to do with the slow and painful process of adjusting trade imbalance through reducing or raising commodity prices. A reduction in commodity prices means deficit nations will face deflation or economic recession, while a rise in these prices signals inflation in surplus nations. Therefore, both deficit and surplus nations resist such measures.

As far as America is concerned, with the U.S. dollar as an international reserve currency, the country does not have to immediately tighten its expenditures, even though it has run a huge trade deficit for many consecutive years. Theoretically speaking, the U.S. can delay its adjustment schedule for an indefinite period of time. Besides, the primary function of the International Monetary Fund (IMF) has been to provide macroeconomic management consultations regarding currency and exchange rate issues, and it would directly intervene in a member country's economic policy only when the individual member needs short-term financial aid. Nonetheless, because of the special status of the U.S. dollar, America would not face short-term liquidity problems. Therefore, the U.S. is unlikely to follow the steps of countries that have long-term trade deficits or suffer insufficient foreign reserves and that, under IMF conditions, have been forced to tighten government or domestic expenditures in order to ease trade deficits. But the U.S.'s prerogative has also aggravated the problem of global trade imbalance.

In fact, the U.S. Federal Reserve will act to loosen monetary policy in order to stimulate the economy, because the unemployment rate in America has hit 10 percent, with the unemployment rate among men aged between 25 and 55 spiraling to as high as 20 percent. It often happens that taking care of short-term domestic problems would cause the neglect of long-term international responsibility.

On the other hand, China is expected to achieve double-digit economic growth rate again this year. It continues to enjoy a trade surplus and has accumulated colossal foreign reserves of over US$2.6 trillion,

forming a strong contrast to America with its trade deficit. As stated before, the present international currency system or the IMF does not impose any responsibility on surplus nations to adjust the global trade imbalance. Moreover, with its controls of cross-border flows of capital and state-owned banking system, China can effectively implement sterilization policy; that is to say, through issuing government bonds, China can buy back the renminbi currency supply released for the continuous purchase of foreign exchange due to the RMB/USD peg, thereby suppressing the inflation that is supposed to emerge because of a long-term trade surplus.

In other words, as China's sterilization policy has blocked the abovementioned avenue to adjust trade imbalance, pressure has been focused on the appreciation of the renminbi exchange rate as one way to adjust the imbalance. But quite a few circumvention strategies have recently appeared in America's opinion pieces, namely that these articles do not directly ask for significant appreciation of the renminbi exchange rate, but rather request China to liberalize its capital account and to allow free capital inflows and outflows across its border. The emphasis of these articles is to weaken China's ability to simultaneously maintain fixed exchange rate and suppress inflation. Some opinion pieces even suggested that unless China liberalizes its capital account or permits other countries to purchase Chinese government bonds, restrictions should be placed on China's purchase of these countries' government bonds so as to indirectly reduce China's motive to run a long-term trade surplus.

In conclusion, since the Lehman Brothers crisis broke out in 2008, the U.S. economy has become like a wounded giant, and consequently trade protectionism in America has been on the rise. In addition, as the international monetary system's capacity to adjust trade imbalance is limited, problems regarding the renminbi exchange rate will only intensify in the future. How to handle these challenges properly will test various nations' wisdom. TBT