

III. Question: Is a Rise in the Value of the Renminbi Necessary?

“Pro” Viewpoint: A rise in the value of the renminbi is necessary.

Reason: *Appreciation of the renminbi is necessary to eliminate inflationary overheating in China’s domestic economy.*

- a) An undervalued renminbi contributes to the expansion of China’s external imbalances and the acceleration of inflation in its domestic economy. A rise in the value of the renminbi is required to alleviate these problems. [Kuroda]

“Con” Viewpoint: A rise in the value of the renminbi is not necessary.

Reason 1: *Inflation is being controlled by appropriate economic policies.*

- a) Overheating in China’s economy is being properly managed. Most notably, Chinese policymakers are employing not only routine monetary policies, but also credit allocation to correct structural distortions inherent in their country’s economy. [Keidel, Ito]
- b) When the Chinese economy overheats, there is a tendency to apply textbook economic theories. However, it is also beneficial to alleviate overheating by correcting structural distortions. For example, the curbing of loans to state-owned enterprises from state-owned banks is effective both in preventing the creation of non-performing loans and in bringing overheating under control. During the quarter century that has elapsed since China began reforming itself and opening up to the world, its integration into the international community has progressed markedly. At the same time, an examination of the Chinese economy as a whole reveals this to be still fragmented in the sense that flows not only of labor, but also of capital and goods across provincial boundaries are restricted. If Chinese domestic markets were better integrated, this alone would unleash latent economic potential that could in turn increase China’s growth by 2-3 percent. [Liu, Yoshitomi]

- c) China's entry into the WTO was accompanied by tariff reductions that had a negative effect on this country's rural regions. Appreciation of the renminbi would increase imports of cheap agricultural goods and deliver yet another blow to Chinese farmers. In contrast, making improvements to China's underdeveloped rural areas would stimulate domestic demand. [Yoshitomi, Liu]

Reason 2: Taking into consideration China's trade structure, both the necessity and effectiveness of currency adjustments are in question.

- a) A distinguishing characteristic of China's trade structure is the fact that processed goods account for such a large proportion of this country's total exports (approximately 55 percent in 2002). However, since so many of those processed goods are made from sophisticated parts and semi-finished goods that were imported, it is estimated that manufacturers inside China probably add no more than approximately 15 percent to the value of final products being exported. If that is the case, then an appreciation of the renminbi is unlikely to contribute much at all to improvements in China's balance of trade. [Lemoine]
- b) China's current account surplus is equal to approximately 2 percent of GDP and has essentially stabilized at this level. In fact, it is quite possible that the process of trade liberalization that WTO membership has triggered will reduce this surplus in the future. [Lemoine]
- c) When the renminbi rises in value, how does this affect the price-setting activities of foreign companies? Walmart supposedly absorbs an eighth of China's total exports. It will probably react to an appreciation of the renminbi by leaving dollar-denominated prices in the U.S. domestic market as they are, and work instead to cut costs in China. In addition, since China holds large masses of unemployed and surplus workers in reserve, such a limitless supply of labor is, as the Lewis Model of developmental economics would predict, generating downward pressures on wages. There is also the politically salient problem faced by the Chinese government of ensuring that at least 10 million new workers are absorbed into the active labor force each year. The power that Walmart has to control prices by, for example, creating pressures for lower wages, will

function effectively. [Liu, Garber, Brook]

Remaining Issues:

- 1) What about the sustainability of the triangular trade pattern? How will the upgrading of China's trade structure change the triangular trade relationship? What about the current state and future prospects of the division of labor relationships between China and countries in ASEAN (and the activities of multinational enterprises located there)?

- 2) If productivity increases, but wages follow the Lewis Model and fail to rise, will the share of capital income in national income continue to expand? Is a large gap observed between traded and non-traded sectors in terms of how the relationship between productivity and increasing wages functions in each? (Debate on the presence or absence of the Balassa-Samuelson Effect.)

(Editors: Hiroya Tanikawa and Masaru Yoshitomi)