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China will hold down the Rmb

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China will hold down the Rmb

Under pressure from military hawks and protectionists in the United States, China blinked and "reformed" its exchange rate regime on July 21. The governor of the People's Bank of China, Zhou Xiaochuan, and America's treasury secretary, John Snow, hailed these reforms as a positive first step. But in less than a week, the People's Bank issued a "Solemn Statement" (see page 52) that threw cold water on the notion that the first revaluation step would lead to others. Indeed, the People's Bank ruled out a large appreciation of the renminbi against the dollar.

There are good reasons to take the Solemn Statement seriously. A large appreciation against the dollar would generate deflationary pressures in China. For example, a 20% revaluation would generate a 16% deflationary impulse. With consumer prices rising at only 1.6% year-on-year, it's clear that China's central bank doesn't have much room to engineer a renminbi appreciation, unless China is willing to endure a deflation.

Why will Beijing try to avoid the revaluation-deflation trap? Although long forgotten in the United States, there is a bit of American-Chinese monetary history that remains fresh in China. In 1932, Franklin Delano Roosevelt was elected on a platform in which he pledged to do something for silver producers. And that he did. Using the authority of the Thomas Amendment of 1933 and the Silver Purchase Act of 1934, the Roosevelt administration bought silver. This and bullish rumours about American silver policies helped pull silver's price up from its 1932 all-time low.

One bizarre argument used to justify the Silver Purchase Act was that higher silver prices would benefit China. Because China was on a silver standard, proponents of the silver purchase programme argued that higher silver prices would translate into more Chinese purchasing power and more American-Chinese trade. Things didn't work according to Washington's scenario, however. The price of China's currency against the dollar went from 33 cents at the end of 1933 to 41 cents in 1935 – a revaluation of 24%. This pushed China from a moderate prosperity into a deep depression and a major deflation. It also spelt the beginning of the end for Chiang Kai-shek's nationalist government.

In addition to the lessons of history, there are current considerations that lend support to the Solemn Statement. If the renminbi appreciated significantly, agricultural imports would surge and exports would slump, and China's 800m rural residents would become even more restless. This would create a major problem for China's top leadership.

Appreciation would also push China's fragile banking system further into troubled waters. Deflation would result in more non-performing loans. These already total $988 billion, an amount that exceeds China's $711 billion in foreign reserves. Americans expecting a large rise in the renminbi will be disappointed.

This comment is contributed by Steve Hanke, professor of economics at Johns Hopkins University.