Bluster Notwithstanding, China’s Bargaining Position Will Weaken

Charles W. Calomiris

The Trump administration began the year by pivoting in its stated approaches to trade with China and Mexico, backing off from threats to overhaul NAFTA, and “redefining” Chinese currency manipulation to focus on trade distortions. In an interview published in the Wall Street Journal several months ago (Baker, Lee, and Bender 2017), the president went further, saying that he might give up on his trade liberalization goals with China if the Chinese “solve the problem in North Korea.” Although a NAFTA overhaul has reemerged as a stated goal of the administration in recent months, President Trump’s recent trip to China, and his many conciliatory statements about President Xi Jinping, give further grounds for believing that geopolitical goals may trump economic ones in the current negotiations with China. That would be a mistake. China’s unfair practices in trade, intellectual property, and other areas need addressing, and the time has never been better. The president should not cede too much ground to achieve geopolitical goals. His bargaining power with China may be stronger than he thinks.

Currency Manipulation: Rhetoric versus Reality

At the same time, the movement away from rhetoric about currency manipulation is a positive change. Accusations of currency
manipulation by Chuck Schumer, Donald Trump, and others that were made regularly for the past two decades never made much sense as explanations for Chinese growth or for the persistent U.S. trade deficit with China. First, it’s impossible for monetary policy (including exchange rate policy) to produce long-run growth or trade consequences. Indeed, the principle of long-run “monetary neutrality” is one of few tenets in economics believed by virtually every trained economist. If a nominal exchange rate were set at an undervalued level, eventually differences in domestic and foreign inflation would make it correctly valued. This is the conclusion of every model used by economists of the “real exchange rate” (the ratio of the exchange rate between two currencies divided by the relative price level ratios in the respective countries).

Second, the facts of Chinese exchange rates show that the Chinese government has not been trying to keep its currency weak. Indeed, the opposite is the case. The renminbi (RMB), also known as the yuan, appreciated 26 percent on a trade-weighted basis from 1995 to 2014. And China’s real exchange rate (which captures the relative competitiveness of the prices of goods sold by China and its competitors) appreciated even more: 53 percent from 1995 to 2014.

An appreciating real exchange rate trend is understood by economists as reflecting high productivity growth (the Harrod-Balassa-Samuelson effect). Circa 1978, when China’s opening to global markets began, China’s total factor productivity stood at roughly 8 percent of the U.S. level. Starting from that very low efficiency level, China was able to grow quickly for more than three decades by removing some of the limits that communism had placed on its markets.

These same forces have propelled China’s growing share of world exports and foreign direct investment in recent decades, but it is also true that China kept its tariffs relatively high and uses government policies to favor its own producers and limit the ability of foreigners to compete, which also boost its trade surplus.

Since 2015 China’s currency has taken a new weakening direction, although recently the government has propped it up to counter market perceptions of a weakening trend. This is part of a long-term pattern. In the past, the government also has intervened to limit the depreciation of its currency, partly with an eye to the political backlash in the United States of a rapidly
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falling currency value. For example, on April 13, government intervention raised the RMB 1 percent against the dollar. Such interventions belie the view that China wishes to pursue a weakening currency strategy.

Despite such interventions, it will be hard for the government to resist RMB depreciation, which will be propelled by two powerful and related phenomena: (1) a long-term growth slowdown in China, and (2) China’s new financial fragility. That fragility reflects a combination of diminishing returns from investment (an inevitable slowdown after three decades of catching up) and China’s autocratic structure, which will make it very hard to sustain high growth during the new phase of economic development, where the efficiency of the allocation of investment will be more important than it has been in the past for promoting growth.

As Minxin Pei predicted in his 2006 book, China’s Trapped Transition, the Chinese Communist Party preserves its survival through the perpetuation of inefficient state-owned enterprises (SOEs), which fund its operations. Other political uses of the financial system include support of government-supported investments such as the infrastructure and construction boom the government orchestrated after 2007 to insulate the economy from the effects of the global slowdown. The financial system cannot truly liberalize because it must be an instrument for channeling credit subsidies to SOEs, and for meeting other government goals that necessarily conflict with efficient resource allocation.

Furthermore, the Chinese government has permitted the recent spending on buildings and infrastructure to be mainly funded with debt of various kinds, which is explicitly or implicitly guaranteed by the state. Household, government, and nonfinancial corporate debt now stands at roughly two and a half times GDP. In 1999, China paid off its banks’ bad debts, but since then a combination of slow growth and booming debt now imply a bailout bill of about $3 trillion (some observers claim it is much higher), which is ten times the cost of the 1999 bailout. The likely path of least resistance would be for China to raise inflation as part of the means to address nonperforming debts (enabling them to be repaid with cheaper currency).

However China’s economic problems are addressed, a combination of slower growth, debt write downs, and inflation will continue to weaken the RMB and reduce capital inflows. Foreign reserves, which grew for decades, have declined since 2014. The Chinese elite
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is cognizant of these problems, hence their increasingly desperate attempts to smuggle their own wealth out of China in recent years.

Capital Controls

If China’s core problems are so likely to produce long-term currency depreciation, why haven’t market speculators already piled on to force the hand of the government? The answer is simple: China’s capital controls prevent large-scale speculation against its currency. The small offshore market in the RMB is regularly manipulated by the Chinese government, by varying the supply of currency that is sent to that market, in order to cause losses whenever short positions become too embarrassing. Hence, there is no point in shorting the RMB in the offshore market.

Note the consequent inconsistency between China’s current prop-up its currency—to instill confidence in its economy—and its desire to make the RMB a global reserve currency. Capital controls like those maintained by China make reserve currency status impossible under the current regime. And once the inevitable inflationary surge and depreciation occur, reserve currency status will be even less likely in the future.

Slowing Growth and President Xi’s Rising Power

The declining economic prospects of China also provide much of the explanation for recent political changes that have consolidated President Xi’s power. If they happen, falling growth, debt defaults, and rising inflation will make the Chinese regime increasingly unpopular domestically, and that is a scary prospect for Beijing, which is already facing other major challenges, such as an aging population, a lack of pension funding to support the elderly, and life-threatening levels of pollution. Protests of government policy shortcomings have been common, and it is wrong to see the government as immune to public pressures.

It is best to see President Xi’s recent purges, threats to party subordinates, and consolidation of power at the 19th Party Congress in this light. Autocracies that crack down on parts of their crony elite usually do so as the economic rents from political power that are available for sharing get scarcer. Crackdowns are a sign of weakness, not strength. It is strange to see so many journalists, business leaders, politicians, and academics viewing the
recent crackdown as a preamble to a new phase of strong Chinese growth and expanding geopolitical power. If we have learned one thing from the history of autocracies, it is that they cannot sustain efficient growth or the projection of political power, and the more they rely on one-man rule the more fragile and temporary they will be. The vision of a newly invigorated and centralized CCP rule that will solve the daunting growth and indebtedness problems that plague China today is a chimera. Belief in that vision by so many business and political leaders outside China shows how little leaders of the West understand the basis for Western Civilization’s remarkable historical success.

It is true that China’s autocratic system can mobilize resources to pursue an end that its leaders identify as a priority, whether that be artificial intelligence, quantum computing, or the development of a cutting edge payment system. But that is not what produces sustainable economic development. As Charles Lindblom (1977) noted, government policy can be a useful force for thumb-like pushing, but without the dexterity of the market’s fingers, the thumb is of little use to create sustainable development.

One consequence of all this is that continuing negotiations between China and the United States may actually produce something interesting, if President Trump’s team does not buy in to President Xi’s propaganda. Xi would like to convince everyone that he can personally produce economic development without creating the strong institutions and incentives that every other successful economy has depended upon in the past.

Conclusion

It is not clear when the long-term problems China is facing will manifest themselves in a visible slowdown and inflation. But one thing is clear: because of China’s vulnerability, Chinese leaders cannot afford a significant drop in exports, which implies weakening Chinese bargaining power and an opportunity for the United States to gain ground in its dealings with China. If the Trump administration plays its cards wisely and deliberately, it should be able to succeed better than its predecessors with respect to trade policy, and other geopolitical issues, such as securing China’s help to limit North Korea’s belligerence, and limiting China’s attempts to expand its control of international waters.
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References

