

What Is the Real Value of RMB?

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A lot has changed since the day that King George III sent an envoy to congratulate Emperor Qianlong on his eightieth birthday. That marked the beginning of a formal East-West diplomatic relations, although King George's real agenda was for trade and permission for missionaries to preach Christianity in China.

However, misunderstanding and disparity remain unchanged.

300 years ago, European vessels sailed to China with a light load and returned with hundreds of thousands of pounds of tea, porcelain, silk, and other Chinese items. Today, ocean tankers from the U.S. sail to China, sell a few odds and ends, and return full with toys, home appliances, consumer electronics, and furniture.

The trade gap between China and the U.S. has skyrocketed to \$145 billion in the first seven months of this year and along with its trade surplus, China has accumulated a huge foreign reserve of \$2.65 trillion. Such a disparity compounded with a high unemployment rate in the U.S., in particular, in the manufacturing sector, has plunged global economic co-operation in disarray, and a currency war is imminent. In recent IMF meeting, the U.S. stepped up its warnings that manipulated exchange rates [by China] were standing in the way of global recovery, while Beijing said super-loose monetary policy in the advanced world [the U.S.] was creating destabilizing capital flows.

Is RMB undervalued and the cause of trade imbalance? Is China the scapegoat for unemployment in the U.S.?

From a historical and cultural perspective, U.S. companies have not focused on export. The U.S. is the largest consumer market in the world, and U.S. companies have been too busy in serving their domestic customers. Accordingly, the U.S. perennially had a trade deficit even before China emerged. For the U.S. to close the trade gap with China, U.S. companies must find something that the Chinese wants. But what can the U.S. sell to China? The answer is: technology. The U.S.'s biggest advantages are technology and management--- things that the U.S. should export to China. Unfortunately, the U.S. is not doing very well in this regard because of national security concern and fears that the technology will be stolen by the Chinese. The U.S. has a huge advantage in the cultural and entertainment sector. If China fully opens its cultural, agricultural sectors, the U.S. would have fewer complaints.

Although currency exchange rate might play a role in China's enormous trade surplus, the main factor is China's excess production capacity. Its competitive position is further enhanced by an aggressive investment campaign in its infrastructure. While the twin

engines driving the Chinese economy are exports and investments, the safest and quickest way for the Chinese to get rich is to invest in real estate. Many factory owners are de facto real estate investors, and factories are simply veils for their real estate activities. This leads to uncontrolled investments and excess capacities. Along the way, Chinese manufacturers have become efficient because of extensive investments in capital goods. Excess capacities, coupled with the urgency to keep 1.4 billion people employed and various aggressive government policies account for the low prices of Chinese products.

China's exports to the U.S. are usually low-value-added products. U.S. manufacturers cannot and should not compete with these low-value-added importers. Resources should be allocated to high-value-added sectors such as IT, healthcare, and R&D.

Even if the U.S. did not import goods from China, it would still be importing from other countries. Further, Chinese companies are not doing most of the exporting. Importing to the U.S. is mostly originated by U.S. companies. Thus, the situation is not one of the Chinese selling products to the U.S. but one of the Americans doing so.

The exchange rate may be a factor in the trade imbalance, but it is not the key factor. Whether in the end RMB is undervalued, it is difficult to judge. No one knows how much RMB should be worth.

China's foreign reserve in U.S. dollars has been a big headache for China. In order to keep the dollar from falling too low, China must continue to buy U.S. bonds. China is lending to America and selling cheap goods to American consumers. This allows the U.S. to have minimal inflation and at the same time maintain low interest rates. China's consumer market is not mature, so it must rely on exports; while the U.S., which has the most mature consumer market in the world, is China's largest export market. One day, when China's domestic consumption reaches a certain level, exports to the U.S. will no longer be so important. At that time, China will not need to purchase dollar assets to keep the dollar stable and maintain the value of its reserves.

Sino-U.S. relations is the world's most important bilateral relationship. Both countries must strive to understand each other's needs and the restraints under which the other is operating. U.S. companies need to focus on the higher-value-added sectors, and U.S. government needs to encourage more investments in R&D and capital goods. China needs to be more transparent; more diligent in enforcing intellectual property rights; and more willing to further open up the sectors in culture, sports, entertainment, and financial services for U.S. export. Most importantly, China needs to better allocate its resources to reduce excess capacities in low valued added manufacturing.

At the end, it is the consumers who will determine U.S.-China trade relations. Meanwhile, misunderstanding and disparity will continue.