Demand To ‘Float’ China’s Yuan Could Crash Dollar

by Mary Burdman

The second-biggest question in all the recent months’ hoopla, over the United States’ demand that China drastically revalue its currency upward against the bankrupt dollar, is whether U.S. Federal Reserve Chairman Alan Greenspan and Treasury Secretary John Snow, are really such fools as to think that all their bloviations before the U.S. Congress will have any effect where it matters, in Beijing. The biggest question is: Do they realize, that were China to do as they demand and succumb to another “Plaza Accord,” the biggest victim would be—the U.S. dollar.

The “issue” is, that China is one of the few nations which still maintains a government-fixed exchange rate and capital controls. Along with India, it is the only significant economy to do so. Internally, China’s currency is the “yuan”; calculations for international trade and exchange are made in “renminbi” (RMB). In 1994, the Chinese goverment took emphatic steps to curb growing internal speculation and external black-market operations, and set a fixed dollar-exchange rate at 8.28 yuan to the dollar, which it has effectively maintained ever since. The rate was held throughout the upheavals of the 1997-98 Asian financial crisis, although the costs to China, especially in its trade with other Asian nations, were great.

‘Plaza Accord’ for China Demanded

The hoopla is hardly new—in Spring 2002, the U.S. Senate Banking Committee was demanding China submit to a “Plaza Accord” (referring to the 1985 agreement by which Japan let the yen rise sharply against the dollar, and which sank Japan’s economy, which has not risen since).

The dollar has been falling for the past 18 months. As a result, the yuan has also declined in exchange value in relation to other currencies, during that time. In addition, the U.S. trade deficit balloons by the month, as the U.S. economy vanishes before the world’s eyes. Treasury Secretary Snow and company are demanding a 40% revaluation of the yuan—as if that would save the dollar or eliminate the $500 trillion U.S. trade deficit. This would hardly be the case: The Chinese currency’s value has remained *fixed* to the dollar, so the cost of Chinese imports for the United States has not changed greatly.

Since June, Greenspan, Snow—who will be going to China early in September—and the usual crew of U.S. “China-bashers,” with Japanese Prime Minister Junichiro Koizumi’s government chiming in, have been demanding that China end the fixed exchange rate and, as they put it, “allow the yuan to float.” So stupid a measure would be as “free” an action as those of the Californians who handed their state energy-supply system over to the rapacious pirates of Enron; the 1.3 billion Chinese are not quite so naive.

As one well-informed Asian financial expert, who understands China, recently told *EIR*, the Chinese leadership has a *fundamental* belief in the importance of the stability of their nation’s currency; the Beijing government considers it essential to maintain the population’s confidence in the currency. There is good reason for this: Uncontrolled hyperinflation and mass speculation dealt the death blow to Chiang Kai-Shek’s government in 1949. Secondly, Beijing saw one East Asian nation after another devastated by the 1997-98 Asian financial crisis. Third, in August 1998, Hong Kong—backed, in effect, by the financial power of China itself—fought and defeated the international speculators head-on. China is not about to surrender almost 55 years of strenuous economic construction to the demands of the George W. Bush Administration.

On Aug. 5, Chinese Prime Minister Wen Jiabao told two guests—former Clinton Treasury Secretary and current Citigroup Chairman Robert Rubin, and new Citigroup CEO Charles Prince—that China will definitely maintain its fixed exchange rate, for the sake of its own economic health and that of the world at large.

Already in mid-July, People’s Bank of China Governor Zhou Xiaochuan had stated that China would maintain a stable yuan, and warned that “an unstable currency value, inflation, and particularly runaway inflation, will seriously erode the interests of the masses.”

Wen Jiabao’s statement was the first by China’s highest-level government leaders. A *China Daily* commentary on Aug. 7 said that Wen Jiabao’s remarks have “put an end to the ongoing revaluation debate for the time being.” Wen asserted that the stable RMB exchange rate helps promote the economic development of China, its Asian neighbors, and the rest of the world economy. He said that China had certainly taken notice of the concern of the international community on the RMB exchange rate. “The Chinese government has always held a serious and responsible attitude towards the issue,” said Wen, including during the 1997-98 Asian financial crisis.

Wen told Rubin—who was in office during that debacle—that a nation’s exchange rate system and policy should be determined by the nation’s domestic economic situation and international income and expenses. “A regulated, floating-exchange-rate system based on market supply and demand—as implemented by China—complies with the country’s current situation,” Wen said. His remarks were backed up by Tang Xu, head of the Graduate School of the People’s Bank of China, who told Xinhua news agency in an interview Aug. 8, that China would not accept “shock therapy” for its exchange rate reform, and that any drastic changes would have adverse effects on China's national economy. The existing stable currency policy is appropriate for China's economy, Tang Xu said. "To a profound extent," the stability of the exchange rate safeguarded the country's daily financial operations. Were China to "free" its exchange rate, speculative "hot money" would move into its foreign-exchange market, and the RMB would "fluctuate severely," Tang added. This "would be a disaster, since China's financial capability to withstand the exchange-rate upheaval is so weak."

The Demise of the Dollar?

Snow, Greenspan, and Co. should try to think: What would happen were China to float the yuan in current conditions? As many economists in Europe and Asia recognize, if China were ever to revalue the yuan, other Asian nations would follow suit, blowing up the U.S. trade deficit even more. Worse—for the United States—all these nations would stop making big purchases of U.S. currency and low-yield U.S. Treasuries to keep their own currencies low. China alone has bought over $60 billion in the last year, giving itself (or burdening itself!) with an enormous sum of $346.5 billion in foreign-exchange reserves by June, a 42.7% increase over last year. Only Japan, with well over $500 billion in foreign-exchange reserves, has more. With Taiwan and Hong Kong, these nations hold by far the biggest dollar reserves in the world.

Given the extreme volatility of the U.S. Treasury bond market, what would happen to the dollar, were these nations to diversify significant amounts into gold, or even the euro? Already in November 2001, Guo Shuqing, then head of the State Administration of Foreign Exchange, told European Union officials that China had begun serious purchases of euros. "Over the past two months we have bought a lot of euros. In the coming months, we'll buy more."

A highly interesting commentary published in the *People's Daily* already a full year ago showed that some, at least, in Beijing have a very sober understanding of the risks of holding so many dollars. China, the Aug. 9, 2002 commentary stated, as the second-largest holder of U.S. Treasury bonds, is a "great supporter" of U.S. economic and financial stability. But given the United States' huge fiscal deficit and unsteady dollar, China has to think of the risks involved. With the fall of the dollar and subsequent increased growth rate of China's foreign exchange, "the resultant question is that the inevitably larger scale of U.S. T-bonds held by China, means the involvement of higher political and sovereign risks. . . . It is the inflow [to the United States] of China's foreign exchange that contributes to U.S. exchange-rate stability."

However, noted the *People's Daily*, "from an economic point of view, there is 'no permanent friend but eternal benefit'. . . . It is an eternal principle to strengthen caution against political and sovereign risks involved in international financial investments." Greenspan and Snow should think twice.