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HEADLINE: China's alternative to revaluation

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Western pressure has been mounting on China to revalue the renminbi, from hardening rhetoric in the US Congress to recent calls by the Group of Seven leading industrialised nations for more flexibility from China. However, there is currently no credible evidence that the renminbi is significantly undervalued, and an adjustment in its exchange rate at this time is neither warranted nor in the best interests of China or global economic stability.

The two symptoms of undervaluation are a large multilateral trade surplus or high inflation. China's measured trade balance has been in slight surplus (a surplus no doubt exaggerated by over-invoicing of exports and under-invoicing of imports); but with the volatility of oil prices and the international economy more generally, this could quickly be reversed. And while China's trade surplus has grown, China's multilateral surplus is far from the world's largest.

America blames China for the bilateral trade deficit; but America's trade deficits are a result of its huge fiscal deficits and the fact that Americans do not save. America's defence that it is doing the world a service by consuming vastly beyond its means is self-serving and rings hollow: US fiscal policies and low savings have become the fun damental source of global imbalances.

China has experienced large capital inflows (beyond foreign direct investment), but these are symptoms of speculative pressures that have been so destabilising throughout the developing world. It would be a mistake - and only a temporary palliative - to reward the speculators by appreciating the currency.

Some in China would revalue the currency not because they believe there is a fundamental economic problem, but to get the Bush administration off their backs. But currency appreciation is not likely to reduce significantly the US balance of payments deficit with China or the world. Because the prices China pays for imports would be lowered, and because of the high import content of China's exports to America - as much as 70-80 per cent - even a 10 per cent revaluation would have miniscule effects. Moreover, China should receive some comfort from having joined the World Trade Organisation: there are the beginnings of an international rule of law. A unilateral

imposition by the US of import duties would most likely contravene WTO rules; it is hard to call a country that has adopted a fixed exchange rate system a currency manipulator.

If China were to contemplate a revaluation, it should consider as an alternative the imposition of a tax on its exports. Export taxes are generally permitted under WTO rules. Indeed, China has already moved in a limited way in this direction on textiles. There are several reasons voluntary imposition of a tax on its exports may be preferable to a renminbi revaluation. Both would have similar effects on Chinese exports - they would make them appear more expensive to the rest of the world. Because of this similarity, an export tax would provide an empirical answer to the question of whether a revaluation would work. But it would do this without some of the significant costs attendant on revaluation.

One of the advantages of an export tax is that, unlike a revaluation, it would not lead to financial losses for Chinese holders of dollar-denominated assets, such as the People's Bank of China or commercial banks and enterprises. China's central bank currently holds about Dollars 640bn (Pounds 334bn) in foreign exchange reserves. Assume that only 75 per cent is held in dollar-denominated assets. A renminbi revaluation of 10 per cent would result in a loss of Dollars 48bn or about 400bn yuan for the central bank.

Another cost of revaluation would be possible further deterioration in the distribution of income, including increasing the already large rural-urban wage gap. Revaluation would put downward pressure on domestic Chinese agricultural prices; an export tax would not. An export tax, by contrast, would have a beneficial side effect: it could generate substantial government revenue for China. Given the high import content of Chinese exports to the US, a 5 per cent export duty would be equivalent to a currency revaluation of some 15-25 per cent, generating about Dollars 30bn-Dollars 42bn a year.

Finally, an export tax would not reward currency speculators. It may even discourage the speculation that has complicated macro-economic management of China's economy. If potential speculators can be convinced that China would rather impose an export tax than revalue, less "hot money" will flow into China. By contrast, nothing encourages speculators more than a "victory", especially where, as here, it is likely to do little to correct the underlying problems.

An export tax can be easily lifted if and when Chinese balance of payments conditions so warrant. It could be stipulated that the tax would be reduced or lifted if the Chinese current account balance turned significantly negative. America's China policy has been driven more by domestic politics than hard economic reasoning or thoughtful, quiet diplomatic initiatives.

It would be better for the world if the international rule of law prevailed - and within those rules, China could unilaterally impose an export tax, while it is dubious whether America could impose an import duty. Most importantly, we should not let bad politics drive out good economics.

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