Quit Bullying China
If the U.S. would stop its hectoring, China would probably revalue

There is not much to like about Treasury Secretary John W. Snow's frequent criticism of Chinese exchange-rate policy. His argument -- that maintaining the fixed rate between the yuan and the dollar constitutes currency manipulation -- is just wrong. The second dubious theme is that good guys who like free markets follow flexible exchange rates, and bad guys who like to control prices pursue fixed exchange rates.

It's not that simple. Flexible and fixed exchange rates each have benefits and costs, and one cannot label either system as superior at all times and places. The U.S. and many other countries have done well with flexible rates over the past two decades because their central bankers learned how to keep inflation low and stable. In contrast, fixed exchange rates severely limit government discretion on monetary policy -- sometimes a good thing. This constraint is particularly valuable for countries where monetary discipline is lacking -- Argentina, for example. Keeping a fixed exchange rate is not the same as controlling prices; the fixed rate serves only to anchor general price levels. Governments can pursue free markets, or not, under fixed exchange rates -- just as they can under flexible rates. And China's economic record has been outstanding under a nearly fixed exchange rate for 10 years.

NONETHELESS, THE CHINESE might benefit from adjusting their exchange rate. In fact, one thing I learned from listening to officials on a recent trip to China is that if the U.S. would cease its bullying, the Chinese would probably revalue on their own. They seem to realize that an undervalued exchange rate essentially leaves money on the table by selling goods too cheaply.

To think about a desirable exchange rate policy for China, start by noting that, when calculated at the current yuan rate of 8.28 per dollar, China's gross domestic product per person is $1,300. In contrast, when computed on a purchasing power basis -- taking into account the low prices of many nontraded goods and services in China -- the number is $5,200. In other words, the Chinese standard of living is four times as much as the conventional GDP number suggests. Although this kind of discrepancy applies to many developing countries, the Chinese gap is unusually large.

What does that mean for exchange rates? Suppose continued rapid growth in China for the next 30 years leads to substantial convergence toward the U.S. per capita GDP (currently $40,000). Part of this process would be the elimination of much of the 4-to-1 disparity between China's two GDP measures. One way to achieve this is for the yuan exchange rate to stay fixed and the ratio of Chinese to U.S. prices to rise fourfold. Another possibility is for the rate to appreciate by a factor of four while the ratio of prices remains unchanged. To put it another way, with a fixed exchange rate, the average Chinese inflation rate for 30 years would have to exceed the U.S. rate by 4% to 5% annually. Since the Chinese surely do not want this much inflation, the real choice is when and how to revalue their currency, not whether to do it.

Moreover, the yuan might be undervalued right now, with the discrepancy between the two GDP measures signaling that Chinese goods are too cheap. If so, economic reasoning predicts that the Chinese inflation rate would rise in response to high demand for Chinese goods. Economic theory also suggests China would have a large current-account surplus as other countries snap up low-priced Chinese exports. These two responses have indeed been occurring, but with a delay. China's inflation rate in 2004 rose to a still-moderate 4%. However, its current-account surplus has become large, exceeding 4% of GDP.

Although it is hard to divine the appropriate level, I think a near-term yuan appreciation of 25% to 30% is reasonable. From the Chinese perspective, the main reason to revalue is that the nation is selling goods too cheaply on world markets. China's real income would rise if it charged higher prices. The more difficult issue for China is what to do after an initial revaluation. Should it refix or go for a flexible rate? A benefit of flexible rates is they allow markets to figure out how much the appreciation should be now and in the future. But an offsetting cost is that businesses lose the stability and convenience provided by a fixed exchange rate.

The irony is that Snow may be correct in arguing that the Chinese currency is undervalued. Indeed, appreciation of the yuan and movement toward flexible exchange rates might be good for China even though the U.S. government thinks so.