A peaceful resolution of renminbi politics

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After a two-year hiatus, renminbi politics is back. On April 15, the US Treasury Department will release its semi-annual report on international currency regimes, and Congressional pressure is mounting for the Treasury to label China a "currency manipulator" – a term one former Treasury official calls "the Scarlet M".

The renminbi's undervaluation is also likely to be a hot topic at the next US-China Strategic and Economic Dialogue in May, and at the upcoming G20 summit in Toronto in June. It is not just the Americans who are upset: virtually every member of the G20, as well as several of China's south-east Asian neighbours, has told China (either publicly or privately) that the renminbi ought to rise.

Is this the beginning of a currency war that could broaden into a trade war? The risk is clearly higher than it was a few months ago, but the odds still favour a peaceful resolution. US political calculus suggests that Treasury is unlikely to apply the "Scarlet M".

The renewed focus in Washington on China's currency has two main sources: anxiety over America's dire employment situation, and increasing desperation by Democrats who fear they will be pummelled in November's congressional elections.

The decision whether to label China a currency manipulator is ultimately one for the White House. But the need for the Obama administration to use China-bashing as an election tool plummeted dramatically with the **passage** of landmark **healthcare legislation** on Sunday.

With this signal achievement in hand, the administration can enter the election season with a positive message that it can make government get things done, rather than a negative anti-China message. Moreover, as the legislative agenda shifts to financial-service reform, Wall Street is likely to replace China as the popular villain in the American political psyche.

There is little likelihood that any of the anti-China bills introduced in Congress will get anywhere near passage. An across-the-board tariff, as suggested by economist Paul Krugman, would violate WTO rules. So would a decision to apply countervailing duties – tariffs on particular imports aimed at neutralising foreign-government subsidies – on all Chinese imports.

The only remedy that could potentially pass WTO muster would be selective application of countervailing duties to specific imports directly subsidised by currency manipulation. But such an action would have little effect other than to infuriate China and invite retaliation.

Instead, the US administration will likely adopt a smarter strategy: refrain from calling China a manipulator in the April Treasury report and then let China hang out to dry at the G20 meeting, where it is almost certain to come in for widespread criticism on its currency policy.

Beijing is not susceptible to bilateral pressure on its exchange rate. But it fears diplomatic isolation, and the recognition that its currency policy is turning China into a global bad guy could help nudge it into action.

In any case, domestic economic conditions make the resumption of renminbi appreciation likely before the end of this year. Inflationary pressure is rising sharply, and is unlikely to abate until the government curbs credit, allows the renminbi to rise, or both.

A final reason for optimism is that the trade data formerly used in Washington to support calls for a renminbi revaluation is now telling a different story. The US-China bilateral trade deficit shrank by -15 per cent in 2009 on the year before, according to US figures. US exports to China rose 65 per cent in January on the year before – a larger increase than for China's other major trading partners.

With US consumer demand structurally weak and Chinese investment demand structurally strong, this trend toward a narrower bilateral deficit is likely to continue, although it may moderate somewhat.

By mid-year, it may become evident even to members of Congress and the inexplicable Mr Krugman that whatever America's economic problems may be, the renminbi is not one of them.