NEW YORK – China is now experiencing what Japan went through a generation ago: a marked slowdown in economic growth after demands by the United States that it restrict its exports. In the late 1980s and early 1990s, Japan was criticized by the US as an “unfair trader” by virtue of its soaring manufacturing exports. The US issued stern, and apparently credible, threats to restrict Japanese imports, and succeeded in pushing Japan to overvalue the yen, which helped to bring Japanese growth to a screeching halt.

That may be happening again, with China’s growth slowing markedly under the weight of an overvalued currency urged by the US. Figure 1 shows the yen's real (inflation-adjusted) exchange rate from 1964 (when the yen became convertible on
the current account) until today. A rise in the index signifies real appreciation, meaning that the yen became more expensive relative to other currencies after correcting for relative price-level changes.

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**Figure 1. Japanese Yen Real Exchange Rate (2007=100)**

[Graph showing the Japanese Yen Real Exchange Rate from 1964 to 2014]

Source: Darvas (2015), Bruegel

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As one can see, the yen appreciated gradually in the 1960s and 1970s, as one would
expect, given Japan’s rapid catch-up growth of those decades. Then came the trade pressures from the US, and Japan agreed to a major realignment of currencies in the mid-1980s, starting with the so-called Plaza Accord in 1985.

The yen appreciated substantially as part of that multi-country intervention, with the real appreciation reaching roughly 50% from 1984 to 1988. And, as Figure 2 shows, Japan’s export growth plummeted.

**Figure 2. Japan’s Annualized Export Growth (3-Year Moving Average)**

For a brief period, a domestic investment boom offset the export slowdown. With the yen seeming to have no place to go but up, foreign money flooded into Japan. A financial bubble developed. By 1990, the investment boom had become a bust, the asset bubble had burst, and Japan began two decades of stagnation.

Despite the Japanese economy's chronic underperformance, the US continued to press Japan to maintain an overvalued yen throughout this period. During the 1990s and 2000s, I repeatedly asked senior Japanese finance ministry officials why they...
allowed the yen’s real appreciation to persist, thereby shutting down export growth. The answer was always the same: Japan was afraid of US trade retaliation if the yen weakened.

It is only with the Bank of Japan's quantitative easing since the launch of “Abenomics” in 2012 that the yen’s real appreciation has been reversed somewhat. Predictably, some US industrial lobbies are again complaining that Japan is manipulating its currency, even though the yen’s real depreciation since 2012 has merely reversed the preceding growth-killing real appreciation.

China now confronts the risk of the same sequence of events. Its booming exports in the mid-2000s led US officials to threaten trade retaliation unless the Chinese authorities took steps to restrict exports, cause the renminbi to appreciate, and shift to “consumption-led growth.” This is the same message once given to Japan. The US insistence on renminbi appreciation intensified after the onset of the 2008 financial crisis.

The results to date can be seen in Figure 3, which maps China’s real exchange rate from the start of renminbi current-account convertibility (1996) until today. The currency began appreciating sharply in 2007. As in Japan, the appreciation sparked destabilizing capital flows into China on the assumption that the renminbi, like the yen before it, had nowhere to go but up.
As in Japan, a financial bubble accompanied the currency appreciation. Yet, as Figure 4 shows, the real appreciation led to a rapid collapse of China's annual export growth, from above 15% (smoothed over three-year intervals) to below 10%, and now to a financial slump as well.
From 2007 to 2014, the renminbi appreciated by 32% in real, trade-weighted terms; by May 2015 (the most recent month of the reported index), its total appreciation had reached 40%. This partly reflected nominal appreciation against the US dollar, together with effective appreciation against the euro, yen, Korean won, and other currencies as the US dollar strengthened relative to them.

The renminbi remains highly overvalued, despite August’s modest 3% nominal depreciation against the soaring US dollar. The renminbi’s real appreciation should be compared with the recent movements of the yen and won. As of May 2015, the yen had depreciated in real terms by around 7% since January 2007, and the won by around 3%, thereby exacerbating the cost pressures on China’s exporters relative to their Asian competitors.
Further depreciation of the renminbi seems necessary if China is to bolster its flagging economic growth and avoid a long-term “Japan trap.” It is important to note that many of China’s increased exports would find their way not to the US and Europe but to Africa and Asia, especially in the form of infrastructure equipment and other machinery. Nonetheless, political pressures from the US and Europe, manifested as charges of currency manipulation and unfair trade practices, as well as misguided ideas in China about the renminbi’s “prestige,” might lead China to resist any meaningful exchange-rate correction.

A month after the renminbi’s 3% depreciation, Chinese President Xi Jinping commented that, “Given the current economic and financial conditions at home and abroad, there is no basis for sustained depreciation of the RMB.” In recent weeks, the People's Bank of China has been defending the currency’s valuation through foreign-exchange sales.

Earlier this year, The Economist offered the conventional Western thinking. Don’t let the renminbi depreciate, it wrote, for four reasons: depreciation might provoke a currency war in Asia; China’s companies are awash in dollar-denominated debt; depreciation might lead to renewed US charges of currency manipulation; and depreciation might reverse China's progress in making the renminbi an international reserve currency.

Such misguided reasoning is precisely what led to a generation of unnecessarily slow growth in Japan. It could happen again in China.
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