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Why is the yuan so strong?

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EARLIER this month eight American senators proposed a law to punish China and other countries for keeping their currencies artificially cheap. Two of the bill's sponsors—Lindsey Graham, a Republican, and Chuck Schumer, a Democrat—have been complaining about China's weak currency for a decade: they wrote an angry letter on the subject to America's treasury secretary back in July 2003. But although their criticisms have not changed over the past ten years, China's currency, the yuan, has changed a lot. Long criticised for its cheapness, weakness and competitiveness, China's currency is now looking uncomfortably strong (http://www.economist.com/news/china/21579488-after-enduring-decade-criticism-its-weakness-chinas-currency-now-looks-uncomfortably) . Some economists even wonder if its overvalued. Why?

Back in 2003, you could buy 8.28 yuan for a dollar, making China's currency worth only about 12 cents. American politicians argued that the yuan's cheapness made Chinese goods overly competitive in America's market, and American exports unattractive to Chinese buyers. The natural result was a big trade deficit with China. Since then, China's authorities have allowed the yuan to rise against the dollar by about 35%.

But this is not the only, or the best, way to look at China's exchange rate. For one thing, China does not trade with America alone. If you compare the yuan to a basket of other currencies, weighted by their trade with China, its recent rise is far more striking. China's trade-weighted exchange rate has strengthened by 12.7% since 2010, according to the Bank for International Settlements, faster than the exchange rates of the other 60 economies it tracks. Yet the price of China's currency is not the only thing that determines the competitiveness of its goods. To an American buyer, the cost of a Chinese good is a combination of two things: the price of the yuan in dollars and the price *in* yuan of whatever it is that the American wants to buy. If the good's price falls, then it will remain competitive, even if the yuan itself rises. Prices and currencies can thus offset each other.

But their movements can also reinforce each other. Over the past ten years China's prices have risen faster than America's, even as its currency has strengthened. One price in particular has stood out: the price of workers. Unit labour costs in Chinese industry have risen by 41% since the first quarter of 2003, according to calculations by *The Economist*, much faster than their rise in American, European or Japanese manufacturing. We have calculated an alternative measure of China's exchange rate (http://www.economist.com/blogs/graphicdetail/2013/06/daily-chart-11) , which takes account of the change in unit labour costs in all four economies. By this measure, China's exchange rate has risen by almost 50% since 2003. That is one reason why China's exports have slowed recently, increasing by only 1% in the year to May. And it is the principal reason why the yuan now looks uncomfortably strong.