Can a Revaluation of the Chinese Yuan Solve U.S. Economic Woes?

By Fred Hu

THE Chinese yuan has become a lighting rod of late in U.S. domestic politics. Critics, ranging from the U.S. Manufacturers' Association to members of the Congress attribute nearly everything that has gone awry in the U.S. economy to a supposedly undervalued Chinese currency, which, the argument goes, has unfairly boosted China's export competitiveness and led to a widening U.S. current account deficit and losses of tens of thousands of manufacturing jobs. The debate on the Chinese currency has become so politicized and so detached from the basic underlying facts that it is likely to yield nothing other than protectionist policies harmful to both the United States and the world economy. Some U.S. lawmakers have introduced a bill to impose punitive new tariffs on Chinese goods on the grounds of alleged Chinese currency manipulation. The bill, if passed, would mark an unprecedented and highly disturbing move for the United States to enact trade legislation specifically targeting another sovereign nation's exchange rate policy. Just as was the case in the 1980s when it was fashionable in the United States to bash Japan, now China has become the primary scapegoat for the current U.S. economic problems.

China and the United States now enjoy a robust and rapidly expanding trading relationship, to the great benefit of both countries. U.S. based multinational companies gain a competitive advantage by leveraging a vast pool of low-cost labor and access to the world's fastest growing market. U.S. consumers, especially working class families, enjoy greater purchasing power because of attractively priced Chinese goods from shoes and toys to microwave ovens. Critics, however, choose to ignore these tangible benefits from a blossoming trade relationship with China, and instead narrowly focus on the ballooning U.S.-China trade deficit, which rose to a record $103 billion in 2002. China's cheap currency, they contend, is responsible for the U.S. trade imbalance and manufacturing job woes, hence a substantial yuan appreciation must be the "key" to correct the current account deficit and raise the level of U.S. manufacturing employment.

International trade in general and trade with China in particular is not the main factor behind U.S. unemployment. The recent rise in the manufacturing jobless rate reflects sluggish U.S. domestic demand and rapid increases in productivity in the U.S. economy. The Department of Commerce data shows U.S. labor productivity expanded at a brisk 3% in recent quarters. Fast productivity growth plus weak domestic demand explains the lackluster performance in the U.S. labor market.

While it may be convenient to pin the blame on China, a careful examination of the data shows China is still a relatively small part of the problem and a yuan appreciation in isolation is unlikely to have a significant impact on the U.S. trade deficit, contrary to the claims of a protectionist coalition emerging in the United States.

First, the size of the U.S. bilateral trade deficit with China is exaggerated by the growing importance of processing trade as Asian and Western companies shift low-end manufacturing and assembly operations to China. Goods that used to be made in Taiwan or South Korea and exported to the United States, for example, are now made in South Korean or Taiwanese factories mushrooming across mainland China and exported to the United States. Even though the added value accruing to China is small due to the high import content, shipments of these finished goods from China to the United States are all recorded as Chinese exports.

It is important to note that the U.S. trade deficit with East Asia as a whole has remained remarkably stable over the past decade. The rise of China as a major manufacturing and export powerhouse in itself has not led to a substantial worsening of the U.S. overall trade imbalances. The dramatic jump in the headline U.S. trade deficit with China merely reflects the pronounced shifts in production and trade patterns within East Asia.

Conventional trade statistics also distort the true picture of U.S.-China trade yet in another significant way as they fail to capture the substantial and rising sales of U.S. companies within China. Companies like Motorola Inc. and General Motors Corp. generate billions of dollars in sales in China every year. If you add up sales by these companies, U.S. exports to China would have been far greater than the customs data show. Adjusting for processing trade and direct sales of U.S. companies' affiliates in China, the true trade deficit with China amounted to $36 billion last year, about two-thirds smaller than the headline figures and only 8% of the total U.S. deficit.

Second, there is little overlap between Chinese exports and goods produced domestically in the United States, and a yuan revaluation would not yield much of the hoped for effect of substitution expenditure-switching into U.S. goods. As China specializes in labor intensive manufacturing of products such as clothing, toys and low-end consumer appliances from which the United States has long exited, and U.S. manufacturing is concentrated on capital and technology-intensive sectors – aircraft, machinery, chemicals, motor vehicles, IT hardware, software and services, there is very little direct competition between China and the United States. If the Chinese yuan were to appreciate sharply, what would happen? Well, it could increase the U.S. prices of Chinese made textiles and toys and hurt middle class consumers. It may lead to a switching to increased imports of these products from India and Latin America, but is unlikely to have an appreciable impact on the overall U.S. trade deficit and on manufacturing sector output and employment. In other words, revaluing the Chinese yuan would not produce much bang for the buck.

Third, contrary to popular claims, the Chinese yuan is only moderately undervalued, in the order of 10-15% by our

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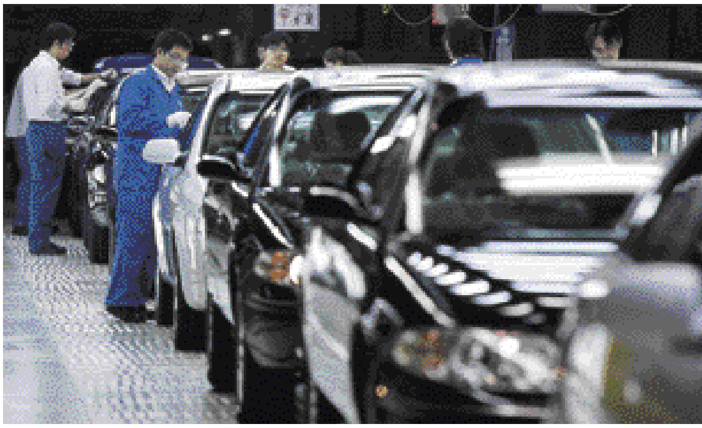

General Motors Corp. generates billions of dollars in sales in China every year

estimates. Such a degree of misalignment is fairly common even for floating currencies due to inherent inefficiencies of foreign exchange markets which often lead to deviations of the spot exchange rate from the long-run equilibrium value. While the headline U.S.-China bilateral trade surplus may appear excessively high, China's overall current account surplus has been modest, and is actually shrinking. China's booming economy and a strong surge in imports which have been growing much faster than exports, would almost certainly lead to a narrowing current account surplus and perhaps even a deficit down the road.

The oft-quoted foreign direct investment inflows number, last year a record $52 billion, demonstrates how intertwined China's manufacturing and, increasingly, service sectors are with the global economy. "Made in China" is now a pretty meaningless or even misleading label because more than half of exported Chinese products, whether a pair of Nike running shoes or a notebook computer, are produced by wholly-owned subsidiaries or joint ventures of multinational companies in China. Importantly, China has been making vigorous efforts to open its own markets to foreign goods and services.

Since China joined the World Trade Organization in 2001, the country has been undertaking sweeping trade reforms by lowering tariff rates to well below the average level of developing countries, and eliminating non-tariff trading barriers. China has pursued expansionary macroeconomic polices to stimulate domestic demand-led growth. It has spent a trillion U.S. dollars on public investment over the past five years alone to build a modern infrastructure, and it undertook far-reaching housing reforms to promote private home ownership and create a vibrant residential housing sector. Market opening plus China's robust domestic demand has provided tantalizing opportunities for China's trading partners. In the first eight months of this year, for example, imports into China grew a whopping 42% year on year, far outpacing China's export growth of 32%. As a result, China has quickly become the leading market for Asian economies such as Hong Kong, Taiwan and South Korea. China imported nearly as much as Japan from the rest of Asia last year, despite the fact that China's economy was just a quarter of the size of Japan's economy! China, now joining the United States, Japan and Europe, has emerged as a pivotal market for global exports.

Rather than pressing China for revaluing its currency, which would do little to reduce the U.S. trade deficit, the United States should review and relax its outdated export control regime designed in the Cold War era, which restricts almost all hi-tech goods to China. Instead, the U.S. authorities unduly rely on promoting exports of soybeans and wheat to China in the hope that U.S. agricultural produce would correct the "headline" imbalances with China. This is absurd. There may be a large scope for China to import more U.S. agricultural produce, but the theory of comparative advantage dictates that China exports mainly labor-intensive manufacturing goods to the United States and imports mainly capital goods – advanced machinery and equipment – from the United States. Indeed, capital goods make up the bulk of those China has imported from Japan, Europe and South Korea. U.S. companies have been penalized by an obsolete export control regime, not by an "artificially cheap" Chinese currency. If Congress and the Bush administration are serious about increasing U.S. manufacturing jobs, then it is time to relax the obsolete export control regime which disadvantages U.S. companies in exporting capital and technology-intensive goods to the world's fastest growing economy.

It is a dangerous self delusion if politicians and lobbyist groups think a more flexible yuan could miraculously reduce U.S. current account imbalances and boost employment. China is not central to the core economic problems facing the United States today and floating the yuan is not the solution. It is futile as well as unfair to point the finger at China.

While a stronger Chinese yuan can hardly solve the U.S. current account deficit or unemployment problem, I continue to believe China should move towards a more flexible currency and play its due part in the global adjustment process. It is in China's own interest to do so. Encouragingly, the Chinese policymakers have reaffirmed their policy goal of achieving greater exchange rate flexibility. In particular, China has been seeking to accelerate trade reforms, open markets more widely to foreign imports, and proceed to prudently relax restrictions over certain types of capital outflows. Increased exchange rate flexibility, even if it means a mild appreciation in the short term, would hardly impact China's export competitiveness, but would help China manage its monetary policy more effectively, cope with a myriad of structural challenges, and weather shocks stemming from sweeping trade reform and capital account liberalization. Importantly, a more flexible yuan would go a long way towards deflecting criticism from the United States. China needs to constructively respond to the currency complaints, however unjustified those complaints are, to ensure an open and thriving U.S. economy that is so important to China, East Asia and the rest of the world. The stakes are too high. Under no circumstances is it worth having a trade war with the United States over the yuan. JS

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