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Currency Controversy: Surplus of Politics, Deficit of Leadership

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Introduction

Earlier this month the U.S. Department of the Treasury issued its much-anticipated, semiannual "Report to the Congress on International Economic and Exchange Rate Policies." The report's key conclusion, that China is not a currency manipulator, was met with incredulity on the part of a number of members of Congress, some of whom suggested that Treasury's inaction would move them closer to enacting provocative legislation to compel China to allow the yuan to rise.

To them, it's simple. China's currency is purposely undervalued to encourage Chinese exports and discourage imports. Such "manipulation" explains much of the bilateral trade deficit, which is costing U.S. jobs. Thus, appreciation of the yuan is a matter of such urgency that any adverse consequences of compelling that outcome would be trivial by comparison.

Leaving aside the facts that U.S. employment growth has been robust during decades of rising Chinese imports and that today's unemployment rate is well below historic averages, the fixation on Chinese currency adjustment as a cure for the trade deficit is misguided.[1] Most economists agree that China's currency is undervalued, but opinions diverge on the relationship between the yuan and the trade balance. Conceivably, the deficit could grow even larger, as has been the case with nearly all of our major trading partners over the past four years despite a concurrent weakening of the dollar.

At a minimum, supporters of the Schumer-Graham bill, which calls for a 27.5 percent tariff on all imports from China unless and until the yuan appreciates by an amount deemed sufficient by Congress, should divert some of their energies from obsessing about this issue to assessing whether appreciation of the yuan would even accomplish the objective of reducing the bilateral trade deficit. If they are so convinced, they should then weigh the prospective benefits of a smaller deficit against the costs of a stronger yuan and the costs of threatening or imposing sanctions to compel China to act on this matter. Americans deserve greater circumspection and less demagoguery from their elected officials—particularly when the economic stakes are so high.

Currency and Trade Flows—The Real Story

Many members of Congress have adopted the view that an intentionally undervalued yuan is the primary cause of the U.S. trade deficit with China. Accordingly, revaluation of the Chinese currency is the central component of an attempt to restore greater balance of trade. As the yuan appreciates, the relative prices of Chinese-produced goods to American businesses and consumers will rise, reducing U.S. demand for Chinese imports. Simultaneously, the relative prices of U.S. products to Chinese purchasers will decrease, allowing U.S. exports to rise. At least, that is the theory.

But evidence suggests that the effects of other factors, such as changes in relative incomes and wealth, the availability of domestic and other foreign substitutes, and the real costs and opportunity costs of finding new suppliers, might play a more significant role than relative price changes in predicting trade flows. A review of the relationship between the dollar and trade with our major partners suggests that currency values have had little to do with changes in the trade balance in recent years.

The top 10 trade partners of the United States accounted for 75 percent of all U.S. trade in goods during 2005.[2] Eight of the 10 have free-floating currencies, while China's and Malaysia's currencies have been tightly managed. In January 2002 the value of the U.S. dollar peaked against the currencies of most major trading partners. Since then there has been a nearly continuous decline in the dollar's value against all of the major floating currencies with the exception of the Mexican peso. Thus, the dollar depreciated against the currencies of seven of our eight largest trade partners that float

their currencies. But with the exception of Taiwan, the bilateral U.S. deficits grew with each partner over the period.

Table 1 shows that the U.S. dollar depreciated against the Canadian dollar by 23 percent between 2002 and 2005. But what happened to the bilateral trade balance over this period? The deficit expanded from $48 billion to $76 billion, or by 58 percent. Yes, exports rose considerably, as theory might suggest, from $161 billion to $211 billion, or 31 percent. But imports increased by an even faster 38 percent, rising from $209 billion in 2002 to $288 billion in 2005.

The same is true for the 12 members of the European Union that have adopted the Euro as their official currencies. In 2005 the U.S. dollar had declined against the euro by 24 percent from its 2002 value. But did the trade deficit shrink? No, it increased by 39 percent over the period to $90 billion. Again, U.S. export growth, which was 30 percent between

Table 1
Currency and Trade Flow

	2002	2003	2004	2005	% Change (2002–2005)
			Foreign Currency per U.S.$		
Canada	1.57	1.40	1.30	1.21	-22.86%
Euro-12	1.06	0.89	0.80	0.80	-24.17%
Mexico	9.67	10.80	11.29	10.90	12.73%
China	8.28	8.28	8.28	8.19	-1.00%
Japan	125.27	115.92	108.16	110.14	-12.08%
United Kingdom	0.67	0.61	0.55	0.55	-17.49%
Korea	1250.49	1191.98	1145.90	1024.19	-18.10%
Taiwan	34.54	34.40	33.38	32.15	-6.94%
Malaysia	3.80	3.80	3.80	3.79	-0.34%
Brazil	2.92	3.08	2.93	2.43	-16.74%
			U.S. Import Value (U.S.$)		
Canada	$209,013,513,167	$221,466,228,899	$255,660,078,909	$287,533,544,304	37.57%
Euro-12	170,596,992,337	184,925,835,919	207,761,247,441	227,428,989,517	33.31%
Mexico	133,968,693,789	137,304,899,588	154,958,770,766	169,216,100,972	26.31%
China	124,815,376,396	151,673,786,019	196,159,513,413	242,637,963,605	94.40%
Japan	121,258,477,947	118,507,035,265	129,534,697,824	137,831,262,902	13.67%
United Kingdom	40,313,409,171	42,599,412,031	45,919,625,139	50,758,258,749	25.91%
Korea	35,276,186,305	36,898,966,577	45,064,176,904	43,154,534,938	22.33%
Taiwan	32,002,398,762	31,487,722,664	34,461,962,826	34,574,352,720	8.04%
Malaysia	23,954,477,267	25,323,513,657	28,070,070,294	33,694,595,446	40.66%
Brazil	15,577,289,911	17,741,787,819	21,097,656,888	24,345,863,267	56.29%
			U.S. Export Value (U.S.$)		
Canada	$160,922,640,899	$169,923,671,745	$189,101,254,591	$211,420,449,641	31.38%
Euro-12	105,837,618,595	113,131,816,957	127,139,775,685	137,380,396,288	29.80%
Mexico	97,470,271,485	97,411,793,347	110,775,284,845	120,048,914,393	23.16%
China	22,127,790,292	28,367,942,859	34,721,007,883	41,836,534,397	89.07%
Japan	51,449,297,862	52,004,277,225	54,400,163,011	55,409,625,490	7.70%
United Kingdom	33,204,699,178	33,827,929,642	35,959,848,306	38,628,657,086	16.33%
Korea	22,575,758,149	24,072,584,914	26,333,445,767	27,670,371,244	22.57%
Taiwan	18,381,828,531	17,447,883,485	21,730,876,295	22,049,556,108	19.95%
Malaysia	10,343,653,601	10,914,061,711	10,896,754,885	10,450,923,341\	1.04%
Brazil	12,375,977,777	11,211,008,059	13,863,015,212	15,345,488,862	23.99%
			U.S. Balance of Trade (U.S.$)		
Canada	-$48,090,872,268	-$51,542,557,154	-$66,558,824,318	-$76,113,094,663	58.27%
Euro-12	-64,759,373,742	-71,794,018,962	-80,621,471,756	-90,048,593,229	39.05%
Mexico	-36,498,422,304	-39,893,106,241	-44,183,485,921	-49,167,186,579	34.71%
China	-102,687,586,104	-123,305,843,160	-161,438,505,530	-200,801,429,208	95.55%
Japan	-69,809,180,085	-66,502,758,040	-75,134,534,813	-82,421,637,412	18.07%
United Kingdom	-7,108,709,993	-8,771,482,389	-9,959,776,833	-12,129,601,663	70.63%
Korea	-12,700,428,156	-12,826,381,663	-18,730,731,137	-15,484,163,694	21.92%
Taiwan	-13,620,570,231	-14,039,839,179	-12,731,086,531	-12,524,796,612	-8.04%
Malaysia	-13,610,823,666	-14,409,451,946	-17,173,315,409	-23,243,672,105	70.77%
Brazil	-3,201,312,134	-6,530,779,760	-7,234,641,676	-9,000,374,405	181.15%

Sources: Currency data come from the Federal Reserve Statistical Release H.10, Foreign Exchange Rates;
trade data are official U.S. trade statistics available on the International Trade Commission's website (www.usitc.gov).

2002 and 2005, was outpaced by U.S. import growth of 33 percent.

Of all of the other major U.S. trading partners whose currencies appreciated against the dollar—Japan, the United Kingdom, Korea, Taiwan, and Brazil—only Taiwan had a trade surplus with the United States that declined over the period. And that decline was a relatively modest 8 percent. In contrast, the U.S. deficit increased by 18 percent with Japan, 22 percent with Korea, 71 percent with the United Kingdom, and 181 percent with Brazil.

In each of those cases, foreign currency appreciation (in some cases quite substantial) was met by increased U.S. consumption. And in every case but Taiwan's, U.S. import growth exceeded export growth, leading to larger trade deficits over the period. Policymakers—in particular, those supportive of Schumer-Graham—should consider this real-world experience before committing to imposing sanctions against China.

Potential Consequences of an Appreciating Yuan

Much has been made of the Chinese trade surplus with the United States. That surplus reached $201 billion in 2005 and contributed to a record $100 billion Chinese trade surplus with the world. But these figures tell another relevant story, which has been largely ignored by policymakers and the media.

Factoring out its surplus with the United States, China ran a $100 billion trade deficit with the rest of the world in 2005. That fact in itself is a fairly strong rebuttal to the premise that Chinese currency policy deters imports. But like manufacturers in the United States, Chinese producers rely on imported raw materials and components to stoke their industrial machines. Appreciation of the yuan would only reduce the prices of those imported materials to Chinese producers, enabling them to lower their costs of production, and ultimately their selling prices, without denting their profits. Conceivably, lower Chinese selling prices made possible by cheaper inputs and higher U.S. prices caused by more expensive inputs could mitigate the impact of the yuan's appreciation on the bilateral trade account that many U.S. policymakers seem to expect.

Furthermore, increased Chinese purchasing power stemming from appreciation of the yuan could inspire even greater demand for commodities such as copper, iron ore, and oil as the relative prices of those inputs decrease in China. That might be good for China and for the companies around the world that export the products that Chinese businesses and consumers want to purchase. But increased demand in China—particularly for commodities prone to supply constraints—might also drive up U.S. prices beyond levels normally associated with a depreciating dollar. And that could present serious problems for a U.S. economy that is trying to digest near-record oil prices without contracting.

With investment in U.S. Treasury bills, bonds and notes in the range $262 billion to $321 billion, China is the second-largest holder of U.S. government debt.[3] Any appreciation of the yuan vis-à-vis the dollar will reduce the value of those holdings. By demanding that the Chinese currency be allowed to rise, by say 27.5 percent, U.S. policymakers are effectively telling the Chinese that their loans will be repaid at 72.5 cents on the dollar. That is clearly not in China's interest.

Furthermore, an abrupt shift in holdings by the Chinese from the dollar to the euro, for example, could cause a rapid decline in the value of the dollar and a steep increase in U.S. interest rates. If the dollar declines dramatically, the value of Chinese holdings of U.S. debt will drop commensurately. If the United States is forced to raise interest rates precipitously, the economy could slow or contract, reducing U.S. demand for Chinese products.

This is a delicate issue that will require gradual adjustment. Ultimately, it is in China's interest to have a free-floating currency and to remove controls on the flow of capital, but as that process takes shape, U.S. policymakers should try to comprehend that currency adjustments affect more than just bilateral trade flows.

In the grand scheme of things, the trade balance has precious little to do with trade policy. It has everything to do with habits of saving and consumption. Americans save very little—around 0 percent at the household level—while Chinese savings rates are among the highest in the world. Excess Chinese savings finds its way into the U.S. Treasury, which must borrow from abroad to fund the U.S. budget deficit. The willingness of the Chinese to invest their savings in the United States helps to keep interest rates lower, the dollar higher, and American consumers feeling wealthier.

If the objective of policy is balanced trade, then policymakers should focus their attention on tax and fiscal policy to incentivize different patterns of savings and consumption. If U.S. policymakers exercised greater restraint in their own spending decisions, so that the government did not have to borrow so much from abroad, and less time scapegoating the Chinese, the trade account would likely move toward greater balance.

Conclusion

It is unclear how appreciation of the Chinese yuan would affect the balance of trade between the United States and China. Yet, many U.S. policymakers are so convinced—at least rhetorically—that appreciation would reduce the U.S. trade deficit that they would even support sanctions to compel that outcome. Not only does that position reflect ignorance of the factual record that shows rising U.S. deficits with nearly all of our major trade partners despite a continuous decline in the dollar's value, but it fails to reflect adequate consideration of other likely consequences.

A stronger yuan would reduce the relative prices of materials and components imported by Chinese producers, thereby enabling them to reduce their own selling prices. And greater Chinese demand for commodities would likely drive up prices for those products in the United States. That would constitute a double whammy for U.S. consumers and businesses, whose purchasing power will have already been reduced by the declining value of the dollar.

Finally, if the sanctions that are being threatened were ever to be imposed, it would not take long before the economy felt the pain of a 27.5 percent tax on imports from our second-largest foreign supplier. And likely retaliation from China would make matters worse.

On matters of international trade, Americans should be

concerned about surpluses and deficits. We suffer from a surplus of politics and a deficit of real leadership. Policymakers can start to remedy the imbalance by acting more fiscally responsible and carefully reassessing their positions on the currency issue.

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1. The Civilian Unemployment Rate, as tabulated by the Department of Labor, Bureau of Labor Statistics, was 4.7 percent in April 2006. That compares favorably to averages over the most recent five decades: 4.8 percent in the 1960s; 6.2 percent in the 1970s; 7.3 percent in the 1980s; 5.8 percent in the 1990s, and; 5.2 percent since 2000.
2. The top ten trade partners in descending order of trade are Canada, the European-12 (the 12 members of the European Union that use the Euro: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain), Mexico, China, Japan, the United Kingdom, Korea, Taiwan, Malaysia, and Brazil.
3. U.S. Department of the Treasury, "Major Foreign Holders of Treasury Securities," May 15, 2006, indicates that China held $321 billion of U.S. government debt at the end of March 2006. But in a speech before the Senate Finance Committee on March 29, 2006, Timothy Adams, under secretary for international affairs, U.S. Department of the Treasury, indicated that China's holdings amounted to about 3.2 percent of the total U.S. public debt of $8.2 trillion, which equals roughly $262 billion.