Reconsidering Revaluation

The Wrong Approach to the U.S.-Chinese Trade Imbalance

By David D. Hale and Lyric Hughes Hale

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Summary: Politicians in Washington are clamoring for currency revaluation in China to reverse China's trade surplus with the United States. But the trade imbalance is not the threat they make it out to be, and a stronger yuan is not the solution. Everybody should focus instead on properly integrating China into the global economy.

DAVID D. HALE is an economist and Chair of Hale Advisers LLC. LYRIC HUGHES HALE is Founding Publisher of www.chinaonline.com.

China's economy has grown dramatically in the last decade: it is more than twice as large as it was ten years ago. This spectacular rise means that Beijing can influence the global economy today in ways that would have been unimaginable in the 1990s -- a development that has led to widespread concerns in the United States. Many officials in Washington and small U.S. manufacturing companies allege that Beijing has deliberately undervalued its currency and manipulated markets in order to promote the growth of its exports.

Consequently, many U.S. politicians are clamoring for action to redress China's growing annual trade surplus with the United States, which currently stands at $250 billion. They assume that increasing the value of the yuan against the dollar will simultaneously decrease Chinese exports to the United States by making them more expensive and boost U.S. imports to China by making them cheaper. As the 2008 presidential election approaches, the U.S. Congress is actively discussing protectionist legislation and new tariffs that would punish China if its currency does not appreciate faster than the current rate of five percent.

But revaluation -- no matter how vehemently it is advocated -- is unlikely to achieve the desired result of reducing the U.S. trade imbalance with China. Taxation reform, the restructuring of the corporate and banking sectors, the gradual opening of capital accounts, and the encouragement of domestic consumer spending would each have a more measurable and lasting effect on China's current account surplus. There is also scant reason to believe that Beijing will accept the large-scale revaluation of 20 percent or more sought by certain members of the U.S. Congress. Such a policy could result in fewer exports, lost jobs, and capital flight to other emerging markets with cheaper labor costs, not to mention increased currency speculation and exchange-rate losses on hundreds of billions of dollars worth of U.S. Treasury debt now held by the Chinese government.

In addition, the trade imbalance that a revaluation of the yuan is supposed to fix is not the dire threat that many in Congress have made it out to be. The growing Chinese trade surplus has actually produced numerous benefits for the world economy and for U.S. corporations and consumers. It has handsomely rewarded U.S. companies, such as Wal-Mart, which have enjoyed record profitability as a result of low labor and production costs in China. Critics forget that China's central bank, the People's Bank of China, uses the surplus to buy U.S. debt, which benefits the U.S. economy. Furthermore, some 27 percent of China's exports are actually generated by U.S.-owned corporations, which pass on their savings to consumers back home.

Simply strengthening the yuan will not correct the U.S.-Chinese trade imbalance, much less bring China's dynamic economy into lasting equilibrium; at best, it is a flawed solution to an ancillary problem. The greater and far more critical challenge is to properly complete China's integration into the global economy. China is but one cog, and revaluation just one lever, in the complex machinery of international trade. Unfortunately, many U.S. politicians with little knowledge of economic theory, trade flows, or investment patterns have not grasped the intricacies of the Chinese economy and its place in the global marketplace. And so they seek a jingoistic, politically popular solution to a complex and multifaceted problem.

THE PERILS OF REVALUATION

This is not the first time Washington has sought to intervene in Beijing's monetary affairs. In the early 1930s, President Franklin Roosevelt's administration supported legislation to raise the price of silver in order to both garner support for the New Deal from western senators in silver-producing states and increase U.S. exports to China. But this proved to be a disaster for China, which was then on the silver standard rather than the gold standard. Unlike the rest of the world, China had experienced economic growth during the early years of the Great Depression due to low silver prices and rapid industrialization. The Silver Purchase Act of 1934 compelled China to revalue its currency, decreased its exports by almost 60 percent, and plunged the Chinese economy into chaos -- while failing to increase U.S. exports to China. In the twenty-first-century world of highly mobile capital, information, talent, and technology, similar policies of economic containment, such as those currently circulating in Congress, are even more likely to fail.

Nevertheless, Washington remains obsessed with China's exchange-rate policy. Labor unions and second-tier U.S. manufacturing firms insist that China has kept its currency artificially undervalued in order to boost its international competitive position. They point out that China has a trade surplus with the United States equal to nearly two percent of its GDP, compared with a peak of 1.2 percent for Japan in the 1980s, when the U.S. government last panicked about trade imbalances with Asia.

Washington has already taken punitive action. The U.S. Commerce Department shocked the financial markets on March 30, 2006, by announcing new trade measures against China's paper industry, potentially opening the door to many more attempts by U.S. companies to block Chinese imports. It introduced duties on Chinese paper imports because of allegations that the paper industry in China benefits from unfair subsidies, such as low tax rates and low-cost loans. This announcement broke with the 23-year-old U.S. policy of treating China as a nonmarket economy not subject to countervailing duties. Before this change, U.S. companies could only file antidumping cases against Chinese firms. The Bush administration's decision to pursue these sanctions reflects the new political mood inside the Beltway.

Washington may have forgotten how its silver policy affected China in the 1930s, but Chinese policymakers remember, and they do not want to undertake another massive revaluation that could produce domestic deflation and cripple exports, leading to massive job losses. Such caution is especially understandable given the experience of other Asian countries that heeded international advice. When China's neighbors followed the International Monetary Fund's prescription to liberalize their financial systems during the 1990s, they experienced a major crisis because of their large current account deficits and huge dollar debts. China was actually on the road to a freely floating exchange rate and full convertibility just prior to the East Asian financial crisis of 1998. But after the meltdown throughout the region, Beijing was convinced that in a world of hedge funds and rampant speculation, it was safer to protect one's currency.

In the aftermath of the Asian crash, there was a risk that China would devalue the yuan, leading to a cascade of other devaluations throughout Asia, which would have deepened the crisis. Instead, China took a long-term view. It exhibited regional leadership and left the yuan alone. After all, it did not really need to take the risk. In fact, due to forced devaluations elsewhere in the region, China's real exchange rate actually appreciated by 30 percent during the crisis. Nevertheless, its exports remained resilient due to high productivity growth. As late as 2002, Beijing continued to resist the temptation to devalue, even though doing so would have been to the country's immediate export advantage. China was unafraid to stand alone; its steadfastness proved to be its first act of global citizenship in the postwar period.

Traditionally, it has been China's banks that have opposed currency revaluation, out of fear that it might damage the financial sector. But today, resistance to a more flexible exchange rate is also coming from interest groups in China, such as industrialists and farmers, who fear losing their competitive edge in the export market. China depends on manufacturing employment for 109 million jobs -- compared with the United States' 14 million manufacturing jobs -- and the government is naturally concerned that a significant exchange-rate

appreciation could reduce manufacturing employment in China: export prices would rise, and markets for cheap Chinese products abroad could dry up. Some textile companies in the manufacturing hub of Guangdong Province are moving factories to Cambodia and Vietnam because of rapidly rising wages and uncertainty over Beijing's exchange-rate policy. Chinese farmers are also worried in the longer term about international competition now that World Trade Organization agreements have made the Chinese market more porous to imports. These farmers are a potentially powerful constituency given that two-thirds of China's population resides in the countryside and increased imports would have a major impact on the developing rural economy.

CHINA'S GLOBAL TRADE DEFICIT

Unlike many of their counterparts in Washington, officials in Beijing understand that U.S.-Chinese trade imbalances are a function of something much greater than exchange rates or even bilateral trade. Production has become so globally integrated today that very few manufactured goods are actually made in a single country from start to finish. Unlike Japan, for example, China does not have a vertically integrated domestic economy that can produce an entire product line from raw materials to finished goods. Instead, China is the last stop on the global assembly line. It imports components from other Asian countries, completes the manufacturing process, and then exports finished products to the United States. In 2003, intermediate goods produced by companies in Japan, Singapore, South Korea, and Taiwan accounted for 34 percent of all Chinese imports, compared with 18 percent in 1992 -- and the percentage is probably several points higher today. Also, because China serves essentially as a finishing shop, barely 20 percent of the value of the products it exports is actually captured by the Chinese economy. As a result, although China has a trade surplus with the United States, it has a trade deficit with the rest of Asia. In fact, China's trade deficit with East Asia grew more than threefold, from $39 billion to $130 billion, between 2000 and 2007, just as China's trade surplus with the United States increased nearly threefold, from $90 billion to over $250 billion, during the same period.

As these figures make clear, far too much emphasis has been placed on bilateral issues between the United States and China -- rather than on trade imbalances as a global issue. For one thing, they suggest that being on the short end of a trade imbalance is not necessarily an economic liability. China supporters in the United States, including the Club for Growth and a number of academic and Wall Street economists, have warned against anti-China protectionism precisely on the grounds that the Chinese trade surplus is not necessarily such a bad thing for the United States. Ballooning corporate profits have given China a savings surplus, which it recycles into U.S. Treasury securities as part of its foreign exchange reserves. U.S. firms have also shared in this boom: their profits from business in China rose to over $4 billion this year -- 50 percent more than a year ago.

Furthermore, as a recent study by the Hong Kong Institute for Monetary Research (the think tank of Hong Kong's de facto central bank, the Hong Kong Monetary Authority) shows, the yuan's value is a function of China's overall trade balance, not simply of its surplus vis-à-vis the United States. In fact, the HKIMR researchers argue, currency appreciation would not have the expected effect of decreasing China's exports. It could actually have the opposite effect by decreasing the cost of the imports China needs in order to create finished goods for export to the United States and Europe.

BEYOND REVALUATION

The real challenge, as Beijing well understands, is helping China integrate its booming economy into the international system. As China's growth rate continues to rise, many in China, including Zhou Xiaochuan, the head of the People's Bank of China, have begun to worry about inflation, which is now at its highest level in 11 years. China's foreign exchange reserves now exceed $1.4 trillion -- equal to approximately 50 percent of GDP. During the past two years, the Shanghai stock-market index has risen from 1,000 to 6,000. Last May, the trading volume on the stock markets in Shanghai and Shenzhen exceeded that on all the stock markets of the rest of Asia and Australia combined. Today, China accounts for five percent of all global stock-market activity.

So far, China's monetary policy alone has failed to curtail its very high growth rate, now over 11 percent. The

People's Bank of China cannot use one common tool to restrain the stock market, regulating margin debt, which allows investors to use borrowed funds in order to buy stocks: such debt does not exist in China. It has instead responded by steadily increasing bank reserve requirements and nudging up interest rates. But if it raises interest rates sharply, it could attract capital inflows from foreign investors, which would bolster the currency. Higher interest rates could also keep even more Chinese money at home. Neither outcome would slow down the economy. Chinese policymakers will therefore need to look beyond monetary policy and focus instead on reforming tax laws, increasing consumer spending, encouraging capital outflows, and changing the regulations governing Chinese corporations.

China traditionally refunded to producers the 17 percent value-added tax (VAT) on production inputs that was paid on exports. But last June, it announced that it would phase out the VAT rebates on 25 percent of the products it exports. It has eliminated rebates on energy-intensive goods such as coal, refined copper, primary aluminum, crude steel, and activated carbon, all of which are produced in industries suffering from overinvestment. China will maintain the VAT rebates on higher-value-added products, such as machinery, because it regards them as the locomotive for growth in the future.

Due to its growing domestic market and the sheer scale of its manufacturing activities, China has managed to accrue corporate and government savings at an unprecedented rate. But the transition to capitalism has been rocky and imperfect. China's failure to pay corporate dividends has swollen corporate treasuries, leading to a cycle of overinvestment in capital equipment and to a form of corporate speculation on the stock market that is similar to the Japanese practice of using surplus capital for short-term, high-risk investing, known as zaitekku. A change in the regulations governing Chinese corporations that would force them to pay dividends to all shareholders would cure a major distortion.

Ultimately, China will also have to shift to a new policy that boosts domestic consumption and reduces the country's dependence on exports. Consumer spending has not kept pace with overall GDP growth: its share of GDP has slumped from 50 percent in the 1980s to 36 percent today. Consumption has been eclipsed by huge gains in capital spending and exports. The government has made some moves to increase consumer spending, such as introducing measures abolishing the taxation of farmers and increasing government spending on health care and education. Nevertheless, Chinese households still have the world's highest savings rate -- between 23 and 25 percent. This is because the country's social safety net remains so inadequate that many people save more in order to pay for education, health care, and retirement. Ironically, to decrease the household savings rate and boost consumer spending, the government will have to reinstate some socialist policies that disappeared in the 1990s.

Beijing is also trying to slow the growth of its foreign exchange reserves by encouraging more capital outflows. Last May, Beijing changed the rules in this area, permitting Chinese special investment funds to invest in foreign equities and foreign firms to invest in Chinese equities. The change produced an immediate rally on the Hong Kong exchange, where Chinese institutions routinely buy "H" shares, shares of Chinese companies approved for listing in Hong Kong. (These sell at a significant discount compared with similar shares on the Shanghai exchange due to lower retail demand and a smaller market.) The Chinese government magnified the rally by announcing that it would give Chinese citizens more freedom to purchase Hong Kong equities and allow mutual funds to invest in a wider range of foreign markets. China hopes that this strategy of encouraging capital outflows will succeed in the same way that it did in Japan a few years ago -- by reducing bloated foreign exchange reserves and bringing the economy into lasting equilibrium.

A GLOBAL PLAYER

Despite Beijing's understandable reluctance to cave in to U.S. demands, the odds are good that China will eventually change tack and allow its exchange rate to appreciate more rapidly due to political pressure from Washington. But exchange-rate appreciation will have a far less significant impact on China's trade surplus than the economic policy changes China is already pursuing. For the past 30 years, China has been engaged in a

complex process of integration into the world economy. No matter how many sensible economic reforms are implemented in Beijing, much of the burden for integrating China into the global economy will fall on the international community. And this process will require more than unilateral efforts by the United States to protect its own interests; it should instead be approached as a multilateral issue that will affect almost every nation on earth.

The time has come for a broad international effort to integrate China into the global economy. The United States should reform the traditional G-8 summits to include China as its ninth member. The G-7 (the group of highly industrialized states) admitted Russia during the late 1990s, and China is a far more important economic player now than Russia was then. Indeed, there cannot be a serious discussion of global economic issues without the active participation of Beijing. The admission of China to the G-8 process would create a major global forum in which the leading industrialized countries could discuss the impact of China's export boom on other nations' economies and address the environmental impact of Beijing's growing demand for commodity imports and energy resources. In the end, only a skillful combination of structural reforms in China and coordinated multilateral efforts will create a more balanced economic relationship between Washington and Beijing.

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