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China and the U.S. Trade Deficit: Why Does Appreciation of the Renminbi Matter More for China?

Since 2004, China's overall trade surplus has exhibited significant growth both in absolute terms and relative to the size of its economy. By 2006, the surplus had reached an estimated \$ 250 billion, accounting for 9 percent of China's GDP, and all the signs are that it is continuing to expand in 2007. At the same time, the U.S. bilateral trade deficit with China increased to \$233 billion in 2006, accounting for nearly a third of the overall U.S. trade deficit. The argument coming from the U.S. Congress is that the Chinese currency, known both as the yuan and the renminbi¹ (RMB), is being held artificially low by the Chinese authorities, causing a loss of manufacturing jobs in the U.S. and contributing significantly to the U.S. trade deficit. This has resulted in various calls for "China-bashing" legislation to be enacted by Congress, including the 2005 bipartisan bill of Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) which proposed a 27.5 percent tariff on all imported Chinese goods to offset undervaluation of the Chinese currency ([The Economist](#)).²

Recently the *Wall Street Journal* published a petition signed by 1,028 economists expressing concerns about the possibility that Congress will enact protectionist trade policies against China. The economists present the textbook argument that levying tariffs against China will increase "...the possibility of a futile

and harmful trade war. American consumers and businesses would pay the price for this senseless war through higher prices, worse jobs, and reduced economic growth..." ([Club for Growth](#)) While it is hard for any economist to disagree with these sentiments, it is also the case that the issue of China's external trade balance and the connection with its continuing phenomenal rate of economic growth is more than just an argument about the pros and cons of free trade. The argument put forward in this bulletin is that a revaluation of the RMB is actually in China's own best economic interests, and although such a revaluation might undercut anti-Chinese sentiments in the U.S., it will likely not do very much actually to reduce the U.S. trade deficit.

China's Economic Growth

Since Deng Xiaoping started China on the path to economic reform in 1978, its economy has been expanding at 10 percent a year in real terms, making it the fastest growing economy in the world. It is currently the world's fourth-largest economy and its third-largest trader, and is forecast to move up a position in each category by 2008. Despite this impressive record there are concerns within both China's political leadership, as well as the economics profession that the structure of its growth path is unsustainable and is contributing to current global, economic imbalances.

Expansion of any economy consists of the sum of the growth of private and government consumption, plus investment, plus net exports. In 2005 investment, private

¹ This translates as the "Peoples' Currency"

² Although this bill was subsequently withdrawn in 2006, in June 2007, Senators Baucus (D-MT), Grassley (R-IA), Schumer (D-NY) and Graham (R-SC) introduced The Currency Exchange Rate Oversight Reform Act of 2007.

consumption, government consumption and net exports accounted for 43, 38, 13 and 6 percent respectively of China's GDP. Importantly, the share of investment in China's economic growth is very high by international standards, while at the same time the share of private consumption is very low. In addition, the increased share of investment in China's GDP has also been driven by the very high rate of saving in China, which reached 50 percent of GDP in 2005.

Rebalancing China's Growth

Since the annual Central Economic Work Conference of the Chinese Communist Party in 2004, Chinese politicians, including Premier Wen Jiabao have emphasized the need for China to shift away from investment and export-led development to a growth path that is driven more by consumption. Nicholas Lardy of the Peterson Institute for International Economics, a long-time China analyst suggests several key reasons for the Chinese leadership wanting to rebalance its economic growth ([Lardy, 2007](#)). First, increasing investment has been actually accompanied by declining productivity, so that China has probably been growing more slowly than it should have been given the rate of investment. Much of the decline in productivity has been due to over-investment and the growth of excess capacity in key sectors such as steel, aluminum, and automobiles. Second, increasing private consumption, and relying less on export-led growth is expected to reduce the rate at which the level of income inequality is increasing in China, as well as rebalance regional economic development between China's coastal and inland areas, both of which are consistent with President Hu Jintao's focus on creating a more "harmonious society". Third, investment-based economic growth has disproportionately increased China's demand for energy particularly that produced from coal. In turn this has had a very negative effect on both China's and the global environment. For example, the International Energy Agency predicts that China could become the world's leading emitter of greenhouse gases by the end of 2007 ([The New York Times](#)). Finally, the People's Bank of China – its central bank – has argued that if China continues to rely on export-led growth, with the associated growth

in its trade surplus, this will create a "protectionist backlash" in the U.S. and Europe.

How Should China Rebalance?

Essentially, China has to slow down its rate of investment and at the same time increase the level of private consumption. Most observers believe this can only be achieved through China's fiscal and exchange rate policy. The Chinese government could do much to reduce private saving, thereby increasing private consumption, through significantly increased expenditures on provision of health care, educational services, unemployment benefits, workers' compensation and universal pension coverage. At the same time it should adopt a much more flexible exchange rate regime. This will have three effects: first, the expected appreciation of the RMB will aid in moving China to more of a consumption-driven growth path as it imports more and exports less which in turn should help reduce its trade surplus; second, appreciation of the RMB will help reduce inflationary pressures as Chinese households switch from savings to consumption; and third, as the Chinese central bank moves away from maintaining the RMB in the foreign exchange market, it will have greater flexibility in the setting of interest rates and hence the ability to moderate domestic investment and also impact the rate of inflation.

China's Exchange Rate Regime

For nearly a decade prior to 2005, the Chinese currency was pegged at 8.28 RMB to the US dollar. Then on July 25 2005, following sustained pressure from the U.S. treasury, China announced a new regime where after an initial revaluation of 2.1 percent to 8.11 RMB per U.S. dollar, the currency would be set with reference to a basket of other currencies, and would be allowed to float within a daily band of ± 0.3 percent against this basket.³ Currently, the RMB is trading at 7.55 per U.S. dollar, a 9.7 percent appreciation since removal of the peg. In addition, recent research indicates that there have also been small steps towards placing more weight on

³ In August 2005, the Chinese Central Bank Governor Zhou Xiaochuan disclosed a list of 11 currencies in the basket, the major currencies being the U.S. dollar, the euro, the yen and the Korean won.

non-U.S. dollar currencies in the basket (Frankel and Wei, 2007).

Despite this movement towards flexibility, many observers believe there has been a lack of progress in China's improving its exchange rate policies, and that the RMB continues to be significantly undervalued.⁴ For example, Morris Goldstein of the Peterson Institute for International Economics argues there has been no significant improvement in either China's external imbalance or its exchange rate policies (Goldstein, 2007). In the context of China's growing trade surplus, Goldstein argues that the RMB remains undervalued by about 40 percent against the U.S. dollar and that the appreciation that has occurred is "...completely inadequate to make a real dent in this huge surplus..." In addition, Goldstein points to the fact that China continues to intervene in the foreign exchange market to prevent the RMB from appreciating, accumulating foreign exchange reserves of nearly \$250 billion in 2006 which amounts to 10 percent of its GDP. At the same time China's central bank is "sterilizing" these monetary inflows by selling low-yielding Chinese government bonds in order to prevent an inflationary increase in its money supply. Goldstein concludes, "...Whatever the rhetoric, the facts say that the RMB remains a heavily managed, quasi-fixed exchange rate..."

China's Currency and the U.S.

If the RMB is considered by many to be undervalued, would an appreciation do much to help reduce the U.S. trade deficit? Unfortunately for those in Congress who argue China is subsidizing its exports through its exchange rate policy, the answer is almost certainly no. Goldstein for example suggests that if there were a 20 percent appreciation of the RMB, it would only narrow the deficit by \$40-55 billion, which is very small relative to the total deficit which is running at \$823 billion based on the past twelve months. A key reason for expecting such a small effect can be found in the underlying explanation for the growing bilateral trade deficit between the U.S. and China, as well as the standard explanation for the U.S.'s overall trade deficit.

Between 1985 and 2004, China's share of the U.S. trade deficit went from zero to 24 percent, while at the same time the combined share of Japan, Hong Kong, Korea and Taiwan has fallen from 52 to 16 percent. A key reason for this has been the development of China as the point of assembly of a range of manufactured goods, including electronic products such as notebook computers. This change in the Asian supply chain has occurred due to high-income, more technologically advanced Asian countries specializing in producing high-value parts and components, which are then exported to China for assembly where there is a large supply of low-wage, unskilled labor. As a result, about 65 percent of the goods exported by China to the U.S. are assembled from imported parts and components. In other words goods the U.S. used to import from other Asian economies have simply been replaced by imports of the assembled goods from China. Therefore, it is probably the case that undervaluation of the RMB has reinforced China's development as the point of final assembly in the Asian production network.

While politicians focus on the bilateral trade deficit with China, most economists agree that the key reason for continued growth in the U.S. trade deficit is the fact that there has been a significant decline in U.S. national savings since 2000, the federal budget having gone from surplus to deficit, and household savings rates approaching zero. Of course this is in direct contrast to China which has a very high national savings rate. Consequently, while economists do not believe bilateral trade deficits matter very much, they are concerned with the global implications of the size of China's trade surplus and the U.S.'s large trade deficit.

China Needs the RMB to Appreciate

So why is reform of its exchange rate policies so important for China? As already noted, if China is to successfully rebalance its growth path, it has to address its external imbalance, and also develop a more independent monetary policy. For example, if investment is to be restrained, the Chinese monetary authorities have to be able to raise interest rates, but they are unable to do this at the moment without attracting large speculative inflows putting upward pressure on the RMB.

⁴ Estimates of undervaluation of the RMB range from zero to nearly 50 percent depending on the estimation method (Dunaway and Li, 2005).

Also, with an undervalued RMB, it is hard to get resources to move out of the Chinese export sector. In addition, while an appreciation of the RMB alone will do little on its own to help reduce the U.S. trade deficit if it were to happen in conjunction with appreciations in other Asian currencies such as the Japanese yen and the Taiwanese dollar, it would help the U.S. to achieve an "orderly correction" to its external imbalance. This follows from the fact that the value of the RMB affects the degree of competitiveness of other countries in the Asian region, so that if the RMB appreciates, it will be easier for these other countries also to let their currencies appreciate. Goldstein estimates that a 25 percent real appreciation against the U.S. dollar of the RMB, the yen, and the other currencies of emerging Asia would reduce the U.S. trade deficit by \$130-180 billion.

How to Get Global Adjustment

Although the Chinese leadership recognizes the need to rebalance its growth path, it also believes it has the right to move at its own pace on reform of its exchange rate regime. At the same time, politicians in the U.S. are convinced that the trade deficit is in part due to China manipulating its currency. Unfortunately, there is much to be lost if there is no multilateral cooperation in dealing with global imbalances. Such an agreement probably needs to be brokered by the IMF, whereby the US raises its savings rate and China, in tandem with other Asian countries, allows its currency to appreciate. Paraphrasing Frankel and Wei, "...(I), like many others, come down on the side that China should increase its exchange rate flexibility in its own interest, but that U.S. deficits should not be blamed on China..."

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