US-China Trade Policy: Who Gains from a Rise in the Yuan?

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China’s Growth

- China has grown at 10% a year in real terms since 1978
- By end of 2008, expected to be world’s 3rd largest economy, and 2nd largest trader
- Concern among Chinese leadership that growth path is unsustainable
- Outsiders also argue it is contributing to global economic imbalances
China’s Trade

- **Growth in merchandise trade surplus**
- **$262 billion in 2007 – 11% of GDP**
- **Some appreciation in yuan/$ - 18% since July 2005**
- **Trade surplus stable in 2008 – 9% of GDP**

Sources: Bank for International Settlements; Thomson Datastream; UBS
China - US Trade

- U.S. bilateral trade deficit with China running at over $230 billion in 2007
- Accounted for almost a third of total US trade deficit in 2007
- Members of US Congress argue this is due to Chinese “manipulation” of its currency
- However, appreciation of yuan will likely benefit China more than US
**US and China’s Currency**

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>US Trade Deficit (%)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>0</td>
<td>32</td>
</tr>
<tr>
<td>Rest of East Asia</td>
<td>52</td>
<td>17</td>
</tr>
</tbody>
</table>

- China at end of East Asian supply chain
- Only 20% of export value captured by China - has trade deficit of $130 billion with East Asia
- 20% appreciation of yuan would likely reduce US trade deficit by only $40-55 billion
Basis of China’s Growth

- Expansion of an economy based on $\Delta \text{GDP} = \Delta \{C+G+I+(X-M)\}$
- China’s growth, until recently, driven by investment *not* net exports
- Investment based on high total savings – 42% of GDP, households (16%), firms (20%), government (6%)
- Chinese consumption has been quite low by international standards
China’s Growth

The real export shock
Chinese exports, % of GDP

Breakdown of China’s GDP growth
Percentage points

- 20% (X-M)
- 40% (I)
- 9% (G)
- 31% (C)

Sources: UBS; Standard Chartered
*Value-added share of manufactured exports
†Estimate
China’s Low Consumption

*Hey, small spender!*

<table>
<thead>
<tr>
<th>Private consumption as % of GDP 2006</th>
<th>China’s private consumption and wages as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>Wages</td>
</tr>
<tr>
<td>Britain</td>
<td>1992</td>
</tr>
<tr>
<td>Australia</td>
<td>94</td>
</tr>
<tr>
<td>Italy</td>
<td>96</td>
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<td>Germany</td>
<td>98</td>
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<tr>
<td>India</td>
<td>2000</td>
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<tr>
<td>Japan</td>
<td>2002</td>
</tr>
<tr>
<td>France</td>
<td>2004</td>
</tr>
<tr>
<td>South Korea</td>
<td>2006</td>
</tr>
<tr>
<td>Singapore</td>
<td>Private consumption</td>
</tr>
<tr>
<td>China</td>
<td>Sources: CEIC; OECD; World Bank; <em>The Economist</em> estimates</td>
</tr>
</tbody>
</table>

Sources: CEIC; OECD; World Bank; *The Economist* estimates
Why Rebalance China’s Growth?

- Low productivity of investment
- Depressed wages
- Rural-urban income inequality
- Regional inequality
- Environmental damage
How to Rebalance?

- Reduce investment
- Fiscal policy to reduce precautionary savings and raise consumption:
  - provision of health care, education
  - universal pension coverage
- Change macroeconomic policy
  - flexible exchange rate regime
  - better able to set interest rates and control inflation
China’s Exchange Rate

- China continues to intervene in foreign exchange market – yuan/$ appreciation stopped July 2008
- Foreign exchange reserves still growing - $1.8 trillion by mid-2008
- Net result – increased liquidity in Chinese banking system
- People’s Bank of China (PBC) forced to “sterilize” inflows to prevent inflation
Capital Inflows to China

China’s hot potato

Total increase in foreign-exchange assets*
(of which reported reserves)
Estimated hot-money inflow

<table>
<thead>
<tr>
<th>Year</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008†</th>
</tr>
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<tbody>
<tr>
<td>Value</td>
<td>0.20</td>
<td>0.20</td>
<td>0.20</td>
<td>0.40</td>
<td>0.60</td>
<td>1.00</td>
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</table>

*Adjusted for CIC transfers, Central Huijin option, swaps and bank reserve requirements †January-May annualised

Source: Stone & McCarthy
Macroeconomic Policy

- Tying Chinese inflation to exchange rate will make sustainable growth harder.
- Independent monetary policy also inconsistent with exchange rate policy.
- As capital account becomes more open, harder to target inflation.
- Also requires reform of Chinese banking sector, i.e., proper use interest rates as opposed to financial repression.
Macroeconomic Policy

- China should switch from fixed exchange rate to inflation-targeting
- Targeted range for rate of inflation
- Key focus of monetary policy is inflation
- Benefits: price and employment stability, tying down of inflation expectations
- Requires strong fiscal, financial and monetary institutions
Inflation Targeting

- There has to be fiscal stability, i.e., no large government deficits
- If large deficits – either have to be underwritten through increase in money supply or eroded via currency devaluation
- Monetary policy cannot be subservient to fiscal policy – “fiscal dominance”
Inflation Targeting

- Also necessary to have a sound financial system, especially banking sector
- If banking sector is weak, central bank will be constrained in its ability to raise interest rates
- Fear of provoking a collapse of financial system – “financial dominance”
- Serious issue in many developing countries
Inflation Targeting

- Will policy work in China?
- No obvious problem of fiscal dominance – fiscal deficit and government debt low
- However – there are unfunded liabilities in banking system, i.e., non-performing loans
- Banking system requires further reform
China Needs to Rebalance

- To rebalance growth, China must address internal/external imbalances
- Independent monetary policy
- Allow exchange rate to appreciate
- Other Asian currencies will also appreciate – allowing for “orderly correction” of US external imbalance
How to Get Global Adjustment

- China wants to move at its pace
- US Congress convinced yuan/$ is being manipulated
- China and other Asian countries need to let currencies appreciate
- US should raise its savings rate
- Not clear what impact of current financial crisis will be