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

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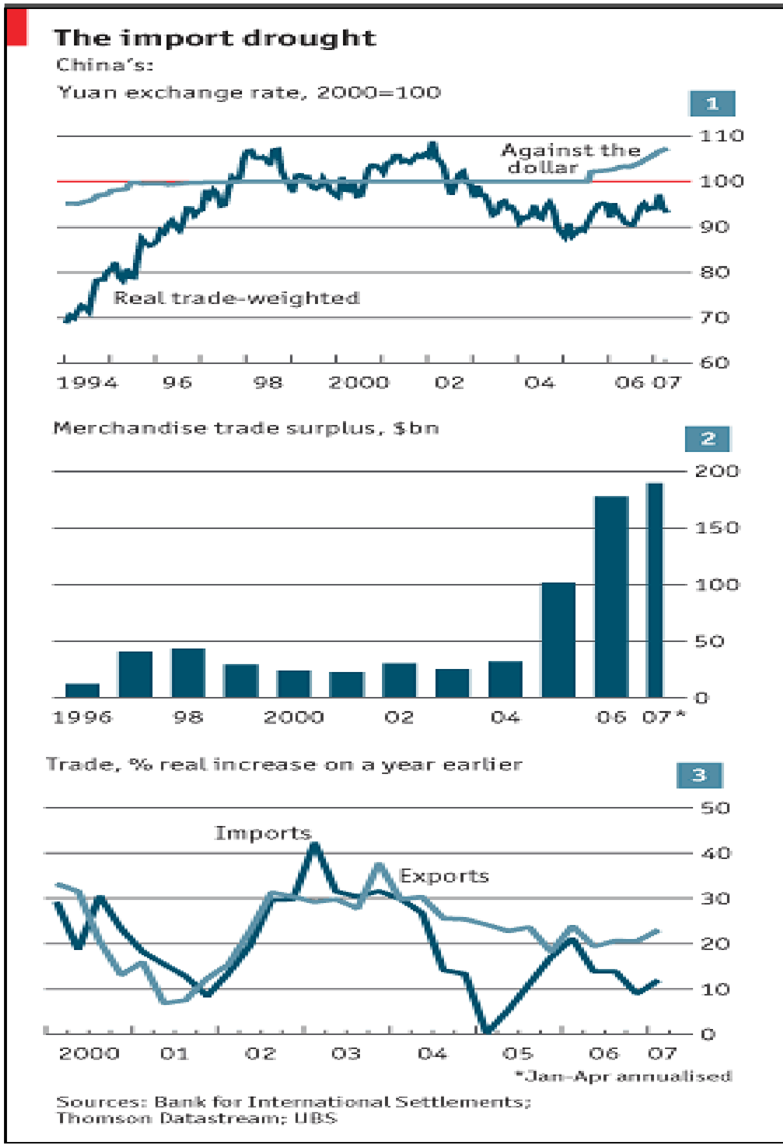
China's Growth

- 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**

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

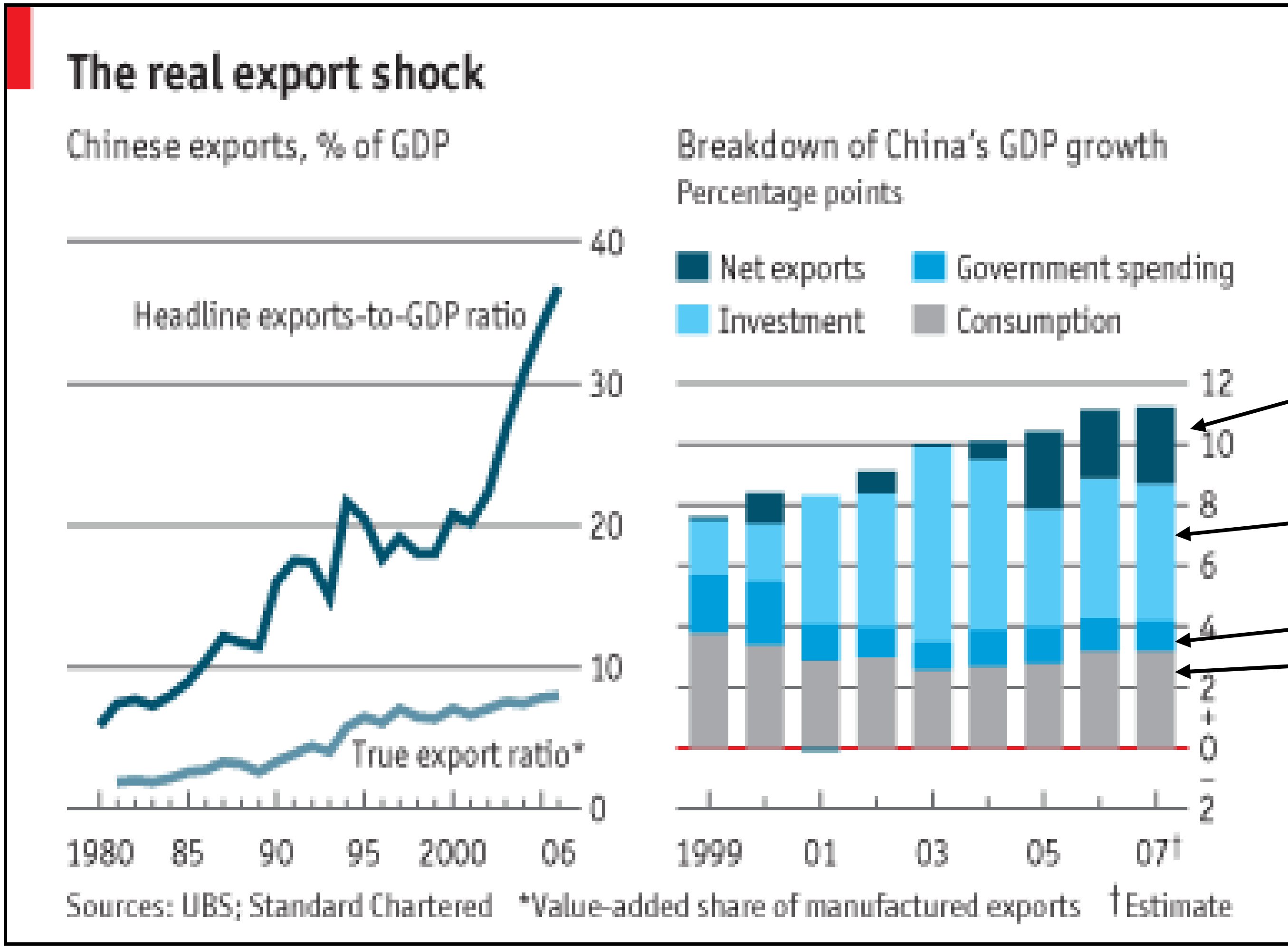
US Trade Deficit (%)	1985	2007
China	0	32
Rest of East Asia	52	17

- 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 $\Delta GDP = \Delta\{C+G+I+(X-M)\}$
- 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



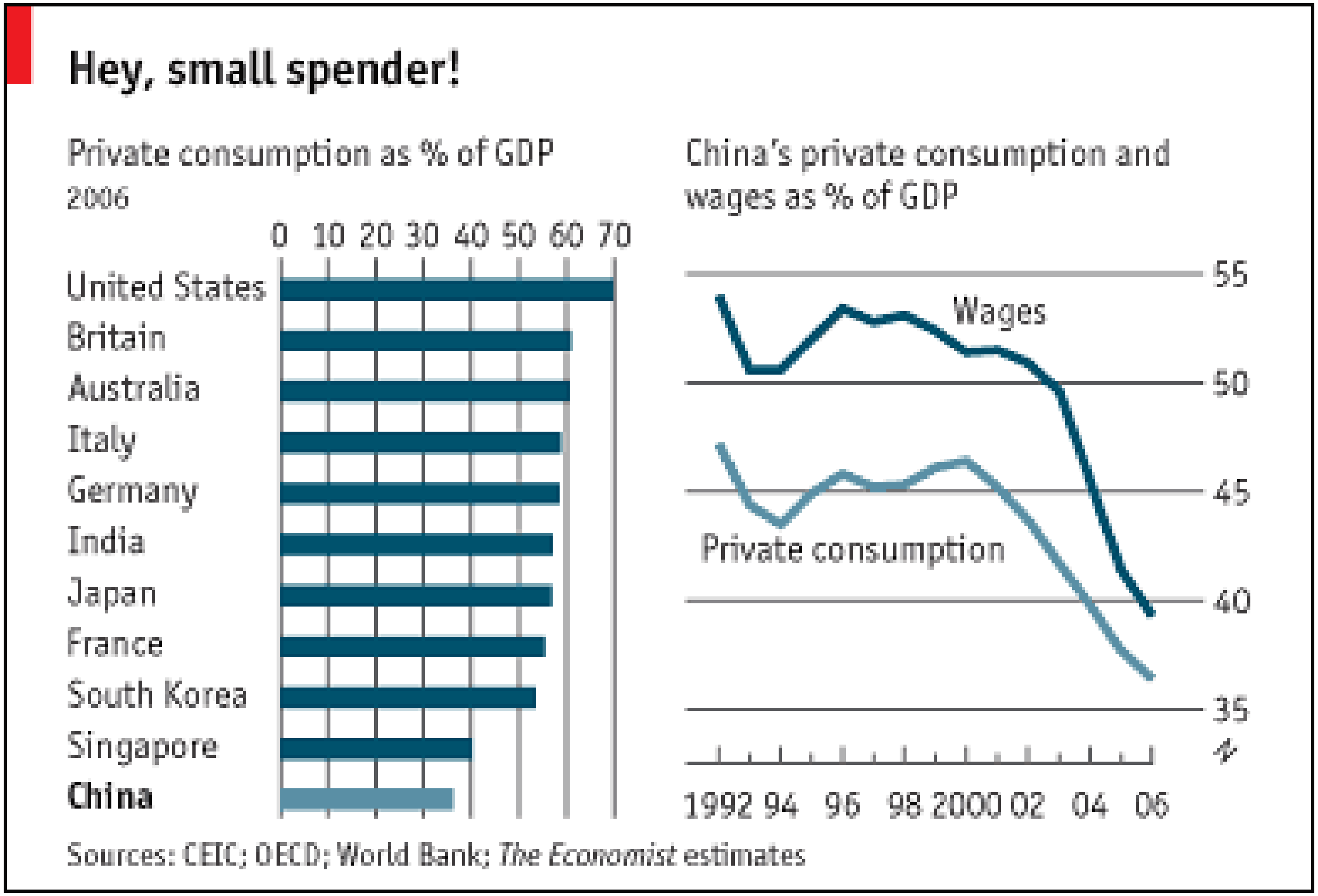
20% (X-M)

40% (I)

9% (G)

31% (C)

China's Low Consumption



Why Rebalance China's Growth?

- Low productivity of investment
- Depressed wages
- Rural-urban income inequality
- Regional inequality
- Environmental damage

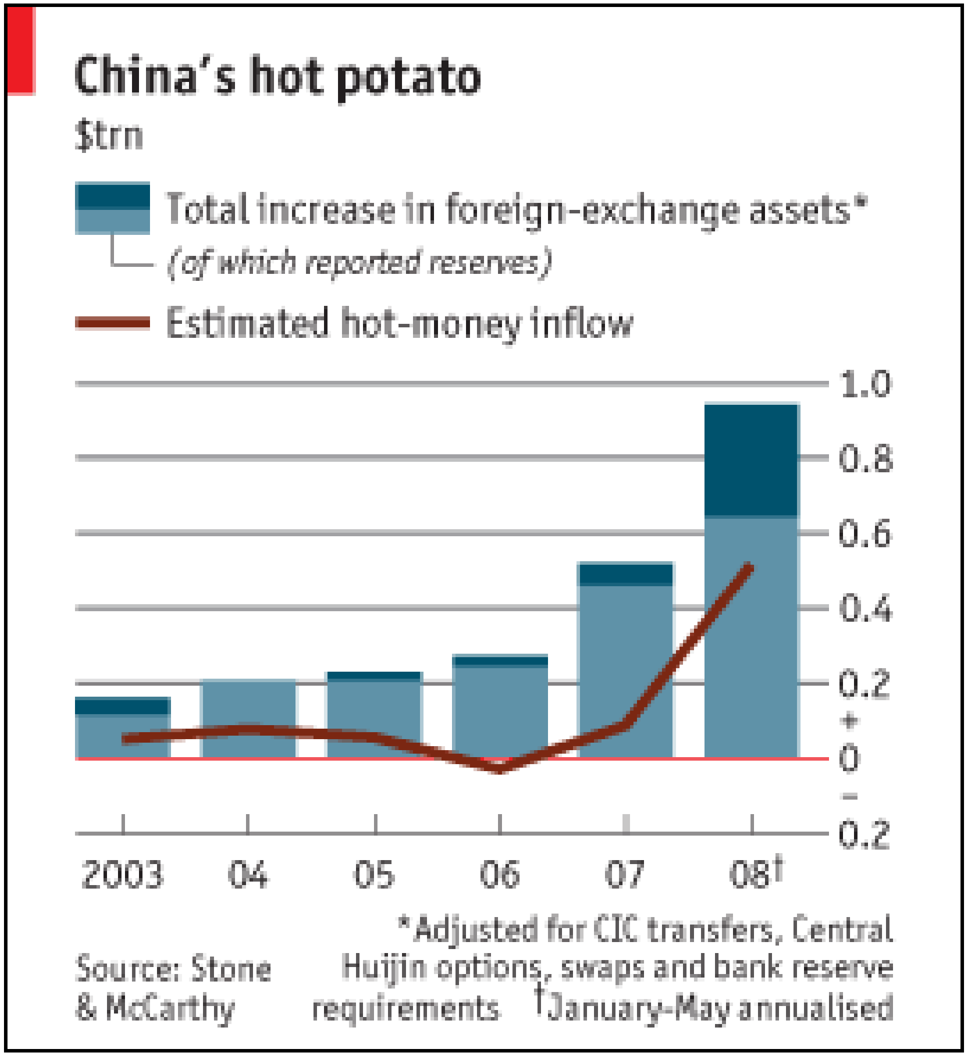
How to Rebalance?

- 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



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