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China's Yuan: Manipulated, Misaligned, or Just Misunderstood?

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Members of the House and Senate have introduced legislation aimed at punishing China for unfair manipulation of its currency. They blame China's alleged currency manipulation for the $232.5 billion[1] U.S. trade deficit with China and the loss of American manufacturing jobs. Accordingly, their proposals include a wide variety of retaliatory measures, such as antidumping duties, punitive tariffs, countervailing duties, trade and investment restrictions, disciplinary action in international bodies, and even U.S. intervention in international currency markets. But these measures would do more harm than good. Many would only add to the cost of living for American households and to the cost of business for American companies. And none would provide a boost to U.S. manufacturing, exports, or jobs by making America more competitive. Congress should recognize that domestic policies affecting savings, government spending, and education have far more impact on America's trade imbalance and international competitiveness in the global marketplace.

Fundamentally, China's currency practices reflect the level of its economic development and progress in shifting toward a market-oriented economy. Currency reform is in China's own best interest and in the best interest of the global economy. And it is in the interest of all concerned that the reform comes sooner rather than later. But Congress must also understand currency reform in the context of the much deeper restructuring needed to liberalize the Chinese economy. The answer is not to penalize China, hamstring the American economy with costly policy measures, or put the U.S. in jeopardy of WTO-sanctioned retaliation. The only responsible approach is a vigorous engagement of China through the U.S.–China Strategic Economic Dialogue (SED), the U.S.–China Joint Commission on Commerce and Trade (JCCT), and other channels to advance and even accelerate the reform agenda.

China and the Yuan. In July 2005, China reversed its 11-year practice of fixing the value of the yuan to the dollar by immediately appreciating the value of the currency 2.1 percent and then allowing the currency to slowly adjust against a "basket" of currencies by as much as .3 percent per day. In May 2007, the band in which the yuan is allowed to move against the dollar was widened to .5 percent. Since moving from a fixed exchange rate regime to a "managed float" regime, the yuan has steadily and slowly appreciated by 8 percent, although it has never appreciated by the full amount allowed on any given day.[2]

The Treasury Department reported in its Report on International Economic and Exchange Rate Policies that there is no evidence of China intentionally manipulating the value of the yuan for economic gain. But if the yuan is currently undervalued rela-

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tive to the dollar, then China does indeed earn some benefit: China's exporters can sell goods to the U.S. at lower prices than if the value of the yuan were set by the market. Additionally, a managed float of the yuan allows China to reduce the exchange rate risk associated with investing in foreign markets, making China's export industries a more attractive destination for foreign direct investment.

But maintaining an artificially undervalued currency comes at a price. While exports may be sold more cheaply, imports of everything from food to energy to machinery become more expensive, depressing both household consumption and business activity at a time when China needs to become more reliant on domestic sources of economic growth. Moreover, China's monetary policy is effectively limited to continually expanding the money supply (by selling the yuan for dollar-denominated assets) in order to maintain the low value of the yuan against the dollar, fueling the risk of inflation and the growth of nonperforming loans in an already fragile banking system.

Aware of these risks, China recognizes the need to adopt an increasingly flexible currency regime. However, fear of destabilizing the export sector (a major source of jobs and economic growth), increased foreign competition, and the risk that speculative pressure on a freely floating yuan could have on the weak financial sector have kept the pace of additional currency reform slow.[3] Unfortunately, the longer China takes to prepare the domestic economy for a market-valued currency, the greater the distortions in the domestic economy that will need to be overcome. Thus, it is in China's best interest to move forward with an aggressive and comprehensive reform agenda that sets the stage for a market-based currency regime by advancing banking and financial sector reforms, dismantling trade barriers, continuing its infrastructure development, strengthening the rule of law and property rights, and undertaking other reforms.

America and the Yuan. Contrary to prevailing opinion on Capitol Hill, the impact on the U.S. of an undervalued yuan is not all bad. Importing lower-priced goods from China effectively increases the purchasing power of American families, allowing them to stretch their incomes farther. Households can consume more domestic or imported goods and services or choose to increase savings. Similarly, U.S. companies that purchase inputs from China enjoy a cost savings, helping them be more competitive.

Additionally, China's intervention in currency markets keeps U.S. interest rates low. China's purchase of U.S. bonds puts upward pressure on bond prices, pushing down interest rates and lowering the cost of borrowing for U.S. households and firms. Not only does this keep mortgage payments down and promote household consumption, also but U.S. companies are able to invest more.

If the yuan is undervalued relative to the dollar, then U.S. exports to China are more expensive than if the yuan's value were higher. Though this means that exports are lower and U.S. producers competing against China come under pressure in the U.S. market, it is not the case that the U.S. economy is harmed overall. Instead, the dollar–yuan relationship leads to a short-run production shift away from industries facing competition from imports and to those U.S. firms that benefit from the cheaper yuan. Some industries may lose in the short-run, but many gain as a result of higher investment, thereby promoting long-term economic and job growth. This result was born out in the 1990s, as it is today, with the U.S. posting low unemployment levels in conjunction with a high trade deficit.

The main culprit behind declining numbers of manufacturing jobs is not the value of the yuan but improvements in technology that have helped promote productivity and made it possible to produce more with fewer workers. Trade with China has indeed resulted in some U.S. job loss—an estimated 150,000 per year.[4] Putting this in perspective, this is

1. U.S. Department of Commerce, International Trade Administration, "Trade Stats Express," at *http://tse.export.gov*, August 25, 2007.
2. Congressional Research Service, "China's Currency: Economic Issues and Options for U.S. Trade Policy," *Report for Congress* No. RL32165, July 15, 2007, at *www.fas.org/sgp/crs/row/RL32165.pdf.*
3. Congressional Research Service, "China's Currency: A Summary of the Economic Issues," July 11, 2007.

roughly 1 percent of the 15 million jobs the Department of Labor estimates is eliminated each year as a result of the normal operation of the U.S. economy.

Retaliatory currency legislation may protect these 150,000 jobs, but only at the expense of the larger economy. To avoid that risk, Congress should consider more effective job assistance programs and improved training and educations policies to help America's labor market fulfill the long-term needs of the U.S. economy. It should also bear in mind that the U.S. produces more manufactured goods today than at any time in its history—"three times as much as in the mid-1950s, the supposed heyday of American industry," as *The Washington Post* recently noted. Last year, U.S. exports to China alone increased by 33 percent.

Even the U.S. trade deficit would not be reduced as a consequence of appreciating the value of the yuan. In the short-term, as the yuan gains in value, imported inputs become cheaper for China's producers, giving them a new cost advantage that could potentially offset the lost price advantage for exports from the undervalued yuan. U.S. consumers may also be slow to change to domestic substitutes (resulting in a higher trade deficit) or could continue to satisfy their demand from alternative foreign suppliers.

Fundamentally, America runs a high trade deficit because domestic savings consistently fall short of domestic investment. America has a healthy, productive, growing economy that demands more investment than is supplied by domestic sources—the government and U.S. households. As long as that shortfall exists, America must import surplus saving from abroad by running a trade deficit. Policymakers should provide a long-term solution to this shortfall by addressing the tax and spending policies that keep domestic savings too low. Imposing currency legislation that attempts to raise the prices of Chinese exports will only harm U.S. consumers and businesses without gaining any real, lasting benefit.

Conclusion. China appears to recognize the need for currency reform and to understand that it is an essential part of comprehensive economic reform. While China's concern for economic stability is understandable, it should be aware that it is sacrificing long-term prosperity and stability for short-term economic gain every day it delays. As China plays an increasingly critical role in the global economy, the need for effective, timely economic reform becomes increasingly important to China's trade and investment partners.

Congress should exercise patience and allow efforts on the yuan to work through the U.S.–China Strategic Economic Dialogue (SED), JCCT, the World Trade Organization, and other channels. Policymakers concerned about America's competitiveness in world markets, the U.S. trade deficit, or the changing structure of U.S. employment should address those concerns directly, through changes to tax, spending, education, and labor policies. Current legislative proposals aimed at punishing China for not reforming faster will only impose new costs on the U.S. economy without gaining any lasting benefit.

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4. Robert Scott, "U.S.-China Trade, 1989-2003: Impact on Jobs and Industries, Nationally and State-by-State," Economic Policy Institute, January 2005.

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