THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com

# It Takes Two To *Tango*

*Why a big Chinese currency appreciation alone won't cut America's trade deficit.*

BY CHI LO

China's trade surplus grew 74 percent to US$177.5 billion and its foreign reserves added more than US$200 billion to reach US$1.07 trillion in 2006. These reports will add fuel for many China critics to cry foul of China's yuan policy, which in fact reflects a serious global economic imbalance problem. Some members of the public and politicians are confused in this yuan policy debate. Others have shown ignorance about, or chosen to ignore, the significant global impact of a forced yuan revaluation.

In my view, this ignorance reflects largely the denial of a fundamental excess demand problem in the United States that has contributed to the economic imbalance. There is no doubt that China needs to play its part to reduce excessive saving in helping to resolve the global imbalance. But that is only a half solution. Understanding the U.S. problem is crucial for setting the yuan policy debate on a proper course and arriving at a solution.

## DISTORTED VIEWS

The confusion about the economics behind China's currency policy has led to a wrong view that China's huge foreign reserve accumulation corresponds to its large trade surplus with America, achieved by an undervalued yuan policy. The reserve accumulation is a combined result of China's current account balance and other net capital flows, such as loans and portfolio investment. China had an estimated current account surplus of US$183 billion in 2006 and a net capital inflow of US$31 billion. Altogether, these US$214 billion inflows would have pushed up the yuan exchange rate sharply had Beijing not bought massive amounts of U.S. dollars and put them in the foreign reserves.

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We should not see the China-U.S. trade surplus in isolation. Despite China running a US$230 billion-plus trade surplus with the United States, it also runs a large trade deficit of over US$50 billion with other trading partners, notably Asia, due to its large demand for raw materials and capital goods. This deficit subtracts from China's surplus with the United States and makes its overall trade surplus smaller.

Arguably, the root cause of the China-U.S. trade surplus is not an undervalued yuan, which is more of an aggravating factor. It is the change in the international trade structure, combined with a chronic U.S. import demand problem (discussed next). A surge in investment in heavy industries in the 1990s gave China a huge production capacity to manufacture goods to replace imports, making it the world's low-cost factory. Because of this, China has become the last stop in Asia's production chain before goods are shipped to final markets. It has also become the last collector of export revenues. This is a natural international trade development, not a Chinese policy conspiracy.

When investment in the low value-added and export-oriented industries slows, and Chinese consumption picks up, China's trade surplus will shrink. All this makes it crucial for China to shift its growth model to consumption-driven from investment- and export-led to help solve the global economic imbalance. Beijing also understands that an undervalued currency will trap the economy in low-value-added production, hindering its long-term growth.

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So China's challenge is to let the exchange rate rise slowly, reduce domestic excessive saving, and stimulate consumption to replace investment and exports as the growth driver. Many China critics know this. They also understand that it would be unwise for China to open up the capital account before its financial system is reformed to handle free capital flows. So why is the yuan policy debate distorted?

### THE DENIAL OF THE U.S. PROBLEM

Understanding China's position is only half of the story. The problem lies in the other half, which rests with the United States. Many critics and politicians are in denial of the excessive consumption problem that is behind the U.S. trade deficit. As former Treasury Secretary Lawrence Summers has argued, the United States since the 1960s has had an import elasticity that is far higher than that of its trading partners.[1] To put it simply, this elasticity is a ratio of import growth to economic growth. It calculates how much imports rise or fall when income growth rises or falls by one percentage point.

The chronically higher U.S. import elasticity means that it imports a larger amount of goods and services for every percentage point of U.S. growth than its trading partners' growth taking in U.S. exports. The point is that America has a structural spendthrift problem and a bias for import demand that a change in the exchange rate alone cannot resolve.

The ultimate solution to this global economic imbalance has to come from both China and the United States working together. China needs to reduce excessive saving and the United States needs to cut excessive consumption. Recent policy initiatives show that Beijing is moving toward that direction. If America remains in denial and refuses to go through with its part of the structural adjustment, and just keeps forcing a large yuan revaluation by China, it will end up shooting itself in the foot and, potentially, brewing a world recession.

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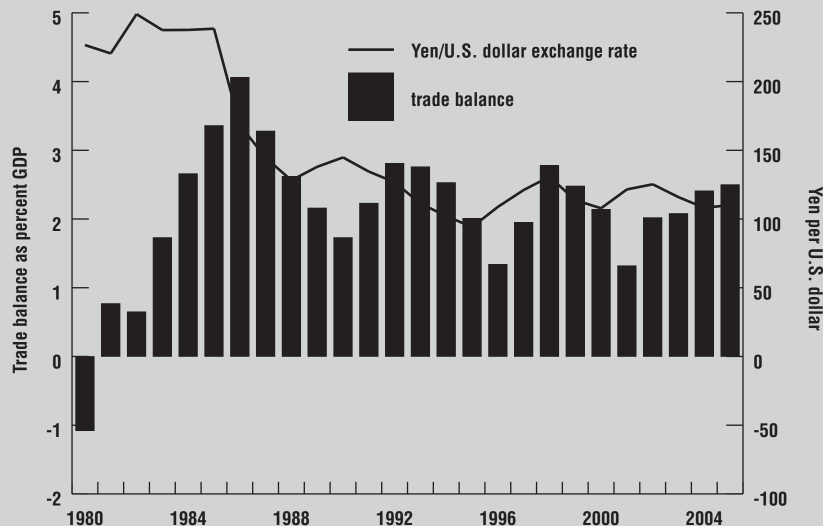
## Rising Yen Didn't Cut Japan's Trade Surplus




Source: CEIC

Japan, and the deflationary curse that plagued it throughout the 1990s and the early 2000s, can attest that the consequences of such a wrong policy for China's future growth could be dire.

When Japan had a huge bilateral trade surplus with the United States in the 1980s, the United States also pressed Japan to push up the yen exchange rate in the same belief as now that a higher exchange rate for its trading partner would shrink the U.S. trade deficit without structural adjustment on the United States' part. The yen indeed rose sharply by 70 percent between 1980 and 1995.

But the high yen aggravated Japan's deflationary slump after its asset bubble burst in 1991. The Japanese economy fell into a liquidity trap, despite the Bank of Japan's zero interest rate and quantitative easing policies to flood the domestic system with massive cash. An economic quagmire followed in the 1990s and the early 2000s. However, the higher yen had no obvious impact on shrinking Japan's trade surplus (see figure), as the fall in imports from the sluggish economy more than offset the fall in exports from the high yen.

*—C. Lo*

China's 1.5 percent inflation rate is already below the 3 percent U.S. inflation rate. A large yuan revaluation could be extremely deflationary for China and the world system. It could begin by pushing China into deflation, thereby disrupting the world growth. If the economic shock prompts China and other savers—notably Japan—to stop recycling their saving to the United States, that will force up U.S. interest rates and crush U.S. debt-financed demand growth. The U.S. current account deficit will reverse abruptly, but the process will be painful and cause serious economic dislocation in the United States along the way.

### ARMAGEDDON FOR CHINA, TOO

The chronic U.S. over-consumption problem argues that a large forced yuan revaluation would be a deadly wrong prescription for a misdiagnosed U.S. current account deficit problem. Japan, and the deflationary curse that plagued it throughout the 1990s and the early 2000s, can attest that the consequences of such a wrong policy for China's future growth could be dire.

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All this is relevant to China's yuan policy. China fixed its exchange rate at 8.28 yuan per U.S. dollar between 1994 and July 2005. The purpose was to keep inflation

under control by anchoring China's price level on a credible hard currency at a time when financial liberalization made the domestic monetary environment unstable. The policy has been successful in reducing inflation and economic volatility. China's high inflation of the mid-1990s has come down sharply and converged with the U.S. level, just as the principle of relative purchasing power parity under a fixed exchange rate regime would suggest.

Given the feeble pricing environment, any sharp rise in the yuan exchange rate could easily push China back into deflation. If China is forced to revalue the yuan sharply because bad economic analysis suggests that a higher yuan would cut its trade surplus with the United States, odds are high that a Japanese-style economic quagmire could result in China.

### IT TAKES TWO TO SOLVE THE PROBLEM

In a nutshell, without a structural change in U.S. spendthrift behavior, its trade deficit will not go away. If the U.S. saving rate does not rise to fund domestic spending, and if the yuan rises sharply to make Chinese exports dearer, America will simply run a deficit with other trading partners instead of China.

Pushing for a large yuan revaluation alone will not cut the U.S. trade deficit. China has to do its bit to reduce saving and boost consumption. The United States has to be realistic and do its part to cut spending and increase saving. This adjustment process will be slow, and the U.S. dollar will need to weaken gradually along the way to facilitate it. Beijing's policy of a slow yuan appreciation is realistic. Shock treatment—like a big yuan revaluation or sudden drop in the dollar exchange rate—will not work. ◆

### NOTE

1. See Lawrence Summers, "The U.S. Current Account Deficit and the Global Economy," The 2004 Per Jacobsson Lecture, October 23, 2004, Washington, DC.