

WebMemo



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China's Undervalued Currency Benefits Americans

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Politicians looking for quick fixes to perceived U.S. economic ills have focused yet again on trade. The China Currency Manipulation Act of 2008 was introduced in the United States Senate on April 3 by Senators Jim Bunning (R-KY), Debbie Stabenow (D-MI), and Evan Bayh (D-IN).¹ Presidential candidates Senator Hillary Clinton (D-NY) and Senator Barack Obama (D-IL) both endorsed the legislation while campaigning in Indiana.²

Legislative proposals to force revaluation of China's currency, the renminbi (RMB), pander to special economic interests and popular prejudice. Contrary to the expressed goals of the sponsors, such measures are unlikely to stop the loss of manufacturing employment in the United States, or hurt the Chinese. Their primary effect would be to spur inflation and hurt American consumers.

An Undervalued Renminbi? A recent event hosted by the Bretton Woods Forum highlighted what the sponsors termed "significant injury to the United States in the form of lost jobs and exports," as a result of the undervaluation of the renminbi.³

Though the conference sponsors assumed that the RMB was undervalued, the data are not so clear. The Congressional Research Service's (CRS) report for Congress on this issue,⁴ updated this past January, gives a variety of estimates for the currency's true value:

- An estimate by the Manufacturer's Alliance that the renminbi was undervalued by 40 percent in 2003.

- An estimate by the Institute for International Economics that the renminbi was undervalued by 15 percent–25 percent in 2003.
- An estimate by Goldman-Sachs that the renminbi was undervalued by 9.5 percent–15 percent in 2003.
- An estimate by Virginie Coudert and Cecile Couharde that the renminbi was 44 percent–54 percent undervalued in 2003.

The CRS reports that these are "back of the envelope" calculations, none of them based on theoretically grounded, econometrically estimated economic models.⁵ The CRS notes further that the first three estimates are based on an equilibrium exchange rate in which China actually runs a trade deficit rather than its current surplus. That's a strange assumption for an economy with a domestic savings rate of around 40 percent. In economics, if you tilt the assumptions, you can get any answer you want.

The CRS also reports a 2004 analysis by Barry Bosworth in which he argues that because of the high internal savings rate, which is more than adequate to finance China's domestic investment, the RMB may actually be overvalued.

This paper, in its entirety, can be found at:
www.heritage.org/Research/TradeandForeignAid/wm1919.cfm

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The CRS compares China's current account balance, presumably a major determinant of equilibrium exchange rates, with those of other Asian countries, and finds the levels broadly in line. Though China is running a trade surplus with the United States, it tends to run deficits with East Asian countries, some of which have floating exchange rates with the United States. Clearly, factors other than currency levels are driving China's trade balance.

Though the preponderance of this evidence suggests the RMB is undervalued compared to the dollar, it is impossible to say by exactly how much. We don't know what would happen to the exchange rate in a freely floating environment.

Does an Undervalued Renminbi Hurt U.S. Manufacturers? The China Currency Manipulation Act of 2008 accuses China of engaging in "protracted large-scale intervention in currency markets, thereby subsidizing Chinese-made products and erecting a formidable nontariff barrier to trade for United States exports to the People's Republic of China."⁶ This is a novel use of the term "subsidy," which normally refers to government payments to producers of an item. In this case, the government of China is purchasing U.S. dollars or U.S. government securities, so the Chinese government payment is ultimately going to the U.S. government. To the extent that the renminbi is undervalued as a result, the benefit goes to U.S. consumers and businesses, which pay lower prices for Chinese goods imported into the United States. Chinese manufacturers get less for what they sell as a result of the pro-

cess. If there is a subsidy here, the beneficiaries are U.S. consumers and taxpayers.

More well founded is the idea that renminbi undervaluation forms a non-tariff barrier to trade. If China's currency controls keep the dollar overvalued, then U.S. goods exported to China carry a higher price than they should, and may be uncompetitive as a result. It is important to remember, however, that the value of the dollar reflects America's trade and investment flows with the entire world, not just China. U.S. exporters to China are competing not just with Chinese firms, but with firms from Japan, Europe, and other Asian countries that import into China. The U.S. dollar has been in a broad decline against both the euro and the yen, keeping U.S. goods highly competitive from a pricing point of view. U.S. exports to China have grown more than 400 percent over the last decade.⁷

It is true that China's exports to the United States have risen rapidly over the last decade, too. However, that surge appears to have come at the expense of other Asian exporters, not U.S. manufacturers. In 1995, China and Japan together accounted for 23 percent of U.S. imports. In 2005, China and Japan together still accounted for 23 percent of U.S. imports. What changed was that in 1995, Japan accounted for 73 percent of those combined imports and China only 27 percent; by 2005, China's share had grown to 64 percent and Japan's had fallen to 36 percent.⁸

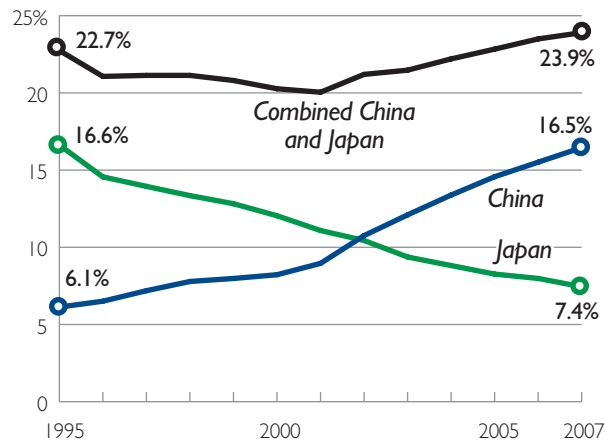
Winners and Losers. Assuming, for the sake of argument, that the renminbi is undervalued com-

1. China Currency Manipulation Act of 2008, S. 2813.
2. Peter Cohn, "Clinton, Obama Both Throw Weight Behind Chinese Currency Legislation," May 2, 2008.
3. Event flyer, "China's Currency Misalignment & Congressionally Mandated Trade Sanctions Symposium," March 14, 2008, at <http://www.brettonwoods.org/events.html#sccm> (May 7, 2008).
4. Wayne M. Morrison and Mark Labonte, "China's Currency: Economic Issues and Options for U.S. Trade Policy," *Congressional Research Service*, RL32165, January 9, 2008, at <http://www.fas.org/sgp/crs/row/RL32165.pdf>.
5. *Ibid.*, p. 17.
6. China Currency Manipulation Act of 2008, S.2813, Sec. 2 (3).
7. Calculations made with data from the U.S. International Trade Administration, TradeStats Express, "National Trade Data," May 6, 2007, at <http://tse.export.gov/>.
8. Calculations made with data from the U.S. International Trade Administration, *TradeStats Express*, "National Trade Data," May 6, 2007, at <http://tse.export.gov/>.

U.S. Imports from Japan and China

The total share of U.S. imports coming from Japan and China combined has remained remarkably constant over time.

Percentage of Total U.S. Imports



Source: Heritage Foundation calculations made with data from the U.S. International Trade Administration, *TradeStats Express*, "National Trade Data," May 6, 2007, at <http://tse.export.gov>.

Chart 1 • WMI1919  heritage.org

pared to the dollar, the question is whether this is as bad for Americans as politicians assert. It's true that a U.S. producer of a product that is in demand in China will normally sell more in China if the renminbi appreciates against the dollar. Similarly, a U.S. producer of goods for domestic consumption competing against Chinese imports will also normally sell more if the renminbi appreciates.

There aren't very many such firms, however. Chinese and Americans don't generally produce the same things. Indeed, it is through specialization, not competition, that both countries reap the benefits of trade. As noted above, Chinese exporters to the U.S. compete with other Asian economies for market share in the U.S. American firms compete with Europeans, Japanese, and Asians for market share in China. Changing the renminbi/dollar exchange rate will not significantly affect those trade flows.

Changing the exchange rate will, however, affect U.S. producers who use intermediate goods imported from China in their U.S. production processes. Renminbi appreciation will increase their costs of production. U.S. consumers of basic com-

modities like oil will also be hurt, as renminbi appreciation will make dollar-denominated commodities like oil cheaper for the Chinese. Chinese demand, already rising rapidly, will drive up the dollar price of such commodities worldwide, forcing American consumers to pay even more at the pump.

U.S. consumers have the most to lose by congressional efforts to force revaluation of the renminbi. Chinese goods in the U.S. are cheap because the renminbi is cheap. Revaluation will weaken the purchasing power of the American consumers, mostly from the middle and lower economic strata, who depend on Chinese products to maintain their standard of life.

It's Not About China. The measures proposed by some in Congress to pressure the Chinese to inflate the value of their currency would help some Americans—those few manufacturers that compete directly with Chinese firms—and hurt many others, including producers who use Chinese imports in their U.S. production processes, and American consumers buying Chinese goods. An inflated renminbi won't punish the Chinese; it will, on balance, punish Americans.

For the American economy as a whole, the currently undervalued Chinese currency brings a double benefit. We get both more goods and services, and more investment capital to help our economy grow and keep our unemployment rate low.

Politicians like to say that the playing field is not level. That's true. The playing field, as foreigners are all too aware, is tilted radically in our favor. Leveling that playing field may indeed provide benefits for some producers in the U.S., but it will hurt many more. We are all consumers.

The U.S. occupies a unique and beneficial position in the international economy. Goods and investment capital are flowing into America at unprecedented levels. Other countries generally hope for only one or the other. Many get neither. We get both. Measures that would change that by manipulating exchange rates to inflate the renminbi or deflate the dollar are short sighted in the extreme.

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