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Targeting the Yuan: A Feel-Good but Futile Response

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The likelihood of congressional action targeting China for pegging its currency to the dollar is increasing at an alarming rate. The precise form of legislation is not yet clear, and some possible outcomes are better than others for the American economy. But the core claim is the same: The Chinese yuan is sharply undervalued against the dollar, undervaluation is a major factor in the bilateral trade deficit, it costs the U.S. millions of jobs, and punishing China for the value of its currency will solve all.

This ostensible logic fails at every step. The extent of the yuan's misalignment is unclear, and so designing real remedies is almost impossible. More importantly, undervaluation is not a major factor in the bilateral deficit and not a factor at all in the overall trade deficit. And there is very little evidence that the yuan's undervaluation costs the U.S. a large number of jobs. China is often a poor economic partner, but retaliation aimed at the exchange rate will not fix anything.

Cannot Quantify the Undervaluation. At this point, the legislative focus is on classifying an undervalued currency as an illegal subsidy and permitting protection against that supposed subsidy in the form of countervailing duties (CVD) or something similar. The immediate problem with such a proposal is that even the loudest proponents of CVD cannot determine the exact amount of undervaluation of the yuan and therefore cannot properly set the size of CVD in this case.

Protectionists typically use phrases like "as much as 50 percent undervalued." This is understandable, because China is a non-market economy suffering a slew of state-imposed distortions, making it very difficult to determine the correct level for the exchange rate. However, this level of imprecision is not useful in responsible trade policy.

Typical ranges for undervaluation from institutions such as the International Monetary Fund are 5–30 percent, which is also unhelpful. Moreover, the extent of undervaluation changes each month—will the duties applied be changed each month?

Will Not Cut the Bilateral Deficit. Even if CVD or an equivalent mechanism could be properly constructed—and done so without harming America's other trade partners or triggering major World Trade Organization decisions against the U.S.—these measures will do little to reduce the bilateral trade deficit. There are simple and more complex reasons for this but, both point to the same conclusion.

The simple reason is that the American economy is much bigger than the Chinese economy, and U.S. policies therefore matter much more to the trade deficit than do Chinese policies. The more complex reason is that trade balances are a direct reflection of national consumption and saving. The U.S. runs a trade deficit with the rest of the world because Americans consume more than they save and the rest of the world saves more than it consumes. The level of the exchange rate bears only indirectly on savings and consumption, so it has little effect on the trade deficit needle.

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Both arguments lead to the same conclusion: By far the most effective method of reducing the trade deficit is for the U.S. to save more. And the American people have saved more in the past two years. The main reason the trade deficit has barely budged is that the federal government has countered the increase in American private saving by spending over $2.5 trillion it did not have.[1] This is not the only factor behind the continued bilateral trade deficit, but it is easily the most important.

Will Not Create Jobs. Even if the exchange rate mattered a great deal to the bilateral deficit, a lower bilateral deficit would not actually lead to a lower total American trade deficit. If CVD or other American trade measures did make Chinese exports to the U.S. prohibitively costly, production of those goods would not shift to the U.S.

Instead, it would shift to other low-cost areas, such as Vietnam or Bangladesh. Applying duties to Chinese goods would not suddenly make the American textile, toy, furniture, or even computer-assembly industries globally competitive, and these are the primary imports from the PRC. Globalization means the U.S. can punish China, but it cannot simply turn Chinese losses into American gains.

Finally, even if retaliating against Beijing for pegging the yuan to the dollar somehow did noticeably cut into the aggregate U.S. trade deficit, there is little reason to believe this would create more and better American jobs. The idea that a smaller trade deficit means more American jobs is simplistic to the point of being useless. The U.S. trade deficit peaked in 2006, when unemployment was 4.6 percent. By 2009, the deficit in goods and services had fallen by half from 2006, yet the unemployment rate had doubled.

The reason is the consumption orientation of the American economy. When consumption is strong, growth is high and jobs are created. Because strong consumption leads to a trade deficit, high growth and low unemployment occur in times when the trade deficit is sizable. In terms of quality, the jobs American demand creates in China are in clothing, toys, and assembly operations. It is not obvious that these positions are superior to the port handling, distribution, and retailing jobs involved in importing these goods.

Change the Focus. The PRC's trade behavior makes it a tempting target. The June announcement of an end to the dollar peg was fraudulent, and the exchange rate is only one part of China's non-cooperative policy. Beijing is now taking important action to liberalize its balance-of-payments regime, which is necessary before the dollar peg can genuinely be broken, but the process has begun late and will be slow.

Nonetheless, congressional action targeting the peg will not work. The level of CVD, for example, cannot be set properly. The exchange rate is not a major factor in the trade deficit. A successful effort to push production out of the PRC would only move it to other low-cost sites. And it is not at all clear that a smaller trade deficit would translate to more and better American jobs. More fruitful policy steps are:

- Cutting the federal budget deficit by cutting spending, thereby giving a boost to net U.S. saving and putting a real dent in the trade deficit;
- Making Chinese balance-of-payments liberalization the primary American goal in bilateral economic relations, for example in the Strategic and Economic Dialogue[2]; and
- Rather than taking stabs at the extent of exchange rate undervaluation, the Departments of Treasury and Commerce should estimate the extent of subsidies for state-owned enterprises, another tough task but a much bigger harm to American firms.

Feel-Good Policy. Legislation targeting the yuan may feel good, but it will not accomplish anything.

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1. Financial Management Service, "Monthly Receipts, Outlays, and Deficit or Surplus, Fiscal Years 1981–2010," at *http://www.fms.treas.gov/mts/mts.xls* (September 8, 2010).
2. See Derek Scissors, "U.S.–China Economic Dialogue: In Need of Tough Love," Heritage Foundation *Backgrounder* No. 2200, October 21, 2008, at *http://www.heritage.org/Research/Reports/2008/10/US-China-Economic-Dialogue-In-Need-of-Tough-Love.*

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