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Haste Makes Waste

A strong yuan is not good medicine for curing the U.S. economic imbalance

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Recently, the United States has been pressing China hard, urging it to strengthen its currency, the yuan. On October 11, the U.S. Senate passed the Currency Exchange Rate Oversight Reform Act of 2011, which requires the U.S. Government to impose penalty tariffs on the U.S. major trade partners whose exchange rates are undervalued. This act is clearly directed at China.

The act faces strong resistance in the House of Representatives. Speaker of the U.S. House of Representatives John Boehner reiterated on October 25 his opposition, saying that it is "a very dangerous policy."

According to Daniel Griswold, Director of the Center for Trade Policy Studies at the Cato Institute, it will be a huge mistake if the United States forces China to appreciate the yuan by raising tariffs on Chinese products. The most direct consequence will be price hikes, which will increase the burden on consumers and further affect the U.S. economy.

The United States should not keep accusing China, but actively adjust the economic structure, reduce its fiscal deficit and public debt so as to correct its serious economic imbalance.

An old issue

The United States raised the yuan exchange rate issue in 2003. It claimed the yuan exchange rate caused its huge trade deficit against China and led to the imbalance of the world economy.

The United States insisted that the yuan exchange rate hampered the depreciation of the U.S. dollar, making it difficult for the United States to adjust its current account deficit.

Further, it claimed undervaluing of the yuan impeded the appreciation of other Asian countries' currencies against the U.S. dollar, which directly or indirectly distorted prices, resulted in the imbalance of the world economy and further led to irrational allocation of the resources. Should this situation continue, the future adjustment would cost a great deal for China, the United States and the world.

In short, the United States blames its huge trade deficit and the loss of millions of jobs in U.S. manufacturing sector on the yuan exchange rate.

It regards China as a key country in adjusting the imbalance of the global economy, since China manipulates the exchange rate and hinders the global adjustment process. If the yuan does not appreciate, the global economy will face serious risks.

Some U.S. congressmen believe the undervaluing of the yuan proves that China's rise has formed a real threat for the United States. It is not a military threat, but a threat of employment replacement. The threat is not only directed at labor-intensive, low value-added manufacturing, but also at technology-intensive, high value-added manufacturing as well as the service sector. It is not only a threat for U.S. national security, but also for U.S. labor security.

Since 2003, the U.S. Congress has proposed dozens of bills on this issue. All these bills have a common goal—to push for a quick appreciation of the yuan. They only differ in the specific measures they propose to achieve this goal. So far none of these bills have passed.

False premise

In fact, the appreciation of the yuan cannot solve the domestic problems of the United States.

Exchange rate adjustment, especially between the United States and China, will not do much good to solve the U.S. multilateral trade deficit. Take textiles and clothing for instance. If the United States does not import from China, it may still import from other countries, such as Bangladesh, Pakistan and other countries. Therefore, the appreciation of the yuan will not enhance the U.S. status in global trade. Neither will it help with U.S. employment.

It should be noted that the yuan's appreciation will not save U.S. manufacturing sector; instead, it may affect the employment of other industries. Because the yuan's appreciation means China will dramatically reduce purchases of U.S. assets. With the reduction of the huge capital inflows from China, the United States will face the pressure of raising interest rates. At that time, the employment situation will deteriorate.

In June 2005, the Asian Development Bank released a report, forecasting the situation after the yuan's appreciation, based on the model of Oxford Economics Forecasting. The report showed that even if the yuan appreciates significantly, it will only affect the economies of China and its neighboring countries, but have little effect on global economic imbalances or the U.S. financial and trade deficits.

The result of the report has also been proved by reality since China's exchange rate reform.

China started its exchange rate reform in 2005. On July 21, 2005, the People's Bank of China, the central bank, abandoned the decade-long peg to the U.S. dollar and adopted a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies.

Since then, the yuan started its continuous appreciation process against the dollar. As of the end of September 2011, the yuan had appreciated 30 percent against the U.S. dollar. But the U.S. trade deficit has not decreased at all. Instead, the deficit keeps growing.

It can't be denied that trade imbalance does exist between China and the United States. But the key point is this imbalance results from the U.S. fiscal policy and consumption habits, from the two countries' different macroeconomic structures due to their different development stages, and from the U.S. hi-tech export restrictions against China.

The yuan exchange rate is not the root of the imbalance. It seems that Chinese products are competitive on the global market because of the undervalued yuan. In fact, the main reason for the low price of Chinese products is China's low labor costs.

Gradual pace

As is known by all, the rapid appreciation of a currency can bring great harm. The quick appreciation of the yuan will result in a rapid decline in China's exports. Export-oriented enterprises will go bankrupt. Along with this will come unemployment, lower family income and shrinking consumption.

Given the imbalance of the Chinese economic structure, if the yuan appreciates slowly, China's economic rebalancing can be realized smoothly. During the process, China's manufacturing industry can absorb new domestic customers to make up for its loss of overseas customers. And the unemployment rate can also be controlled.

Therefore, in the future, China's yuan exchange rate reform will adhere to the "active, progressive and controllable" principle, trying to minimize the possible negative effects.

To achieve this goal, first of all, China needs to ensure fluctuation range within control. China also needs to focus on its domestic situation, trying to make the fluctuation of the yuan in line with the demands of the Chinese economy.

A gradual approach must be adopted, too, so that enterprises can have enough time to make structural adjustments and conquer the negative effects. In this way, China can promote an orderly industry shift and upgrade, so as to maintain the overall competitiveness of its enterprises in the global market and guide employment toward the service sector.

Supervision and administration of short-term speculative capital should also be strengthened, so as to prevent the impacts of the large-scale inflow of hot money on the domestic financial system.

Moreover, it should be emphasized that, as the core of a country's monetary policies, the exchange rate should never be determined by other countries.