Daily Policy Digest

Trade Issues

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Economists Ignore the Facts in Supporting Chinese Currency Legislation

The recently passed Currency Reform for Fair Trade Act of 2010 rests upon the faulty premise that Yuan appreciation will significantly reduce the bilateral trade deficit, says Daniel Ikenson, associate director of the Center for Trade Policy Studies at the Cato Institute.

The premise seems plausible enough. At least, the economics textbooks tell us that as a nation's currency appreciates, its people will consume more imports and foreigners will reduce consumption of that nation's exports. Hence, a stronger Yuan vis-à-vis the dollar would mean that the Chinese buy more from the United States and sell less to the United States, reducing the bilateral deficit.

But in March Cato published a short paper titled "Appreciate This: Chinese Currency Rise Will Have a Negligible Effect on the Trade Deficit." The central argument of that paper was that our national obsession with the value of the Chinese currency is misplaced, says Ikenson.

- Historical data shows that despite a 21 percent increase in the value of the Yuan between July 2005 and July 2008, the U.S. deficit with China increased from $202 billion to $268 billion, or by 33 percent.
- U.S. exports to China increased (as would be expected) by $28 billion, but U.S. imports from China increased, as well, by $94 billion, or 38.7 percent.
- In other words, in the face of a 21 percent increase in the Yuan's value, the U.S. bilateral trade deficit with China increased by 33 percent.

It seems that the textbook discussion of currency and the trade account needs to be updated to account for the compelling facts of globalization.

Source: Daniel Ikenson, "Economists Ignore the Facts in Supporting Chinese Currency Legislation," Cato-at-Liberty.org, October 1, 2010.

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