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Appreciate this: Chinese currency rise will have a negligible effect on the trade deficit

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The Chinese currency issue has roared back to life with a vengeance and once again threatens U.S.-China relations and the global trading system. Official dialogue has descended into an exchange of finger-pointing and tongue-lashings. And Washington is abuzz with sanctions talk, as lawmakers from both major parties throw their support behind legislation intended to compel China to revalue the Renminbi (RMB).

The catalyst for this latest flare-up is the impending Treasury Department report to Congress on currency manipulation, which is due on April 15. Although Treasury has never branded China as a currency manipulator-which is a label that would spark negotiations on an "expedited basis" and open the door to "remedial" legislation-there is increasing speculation that a new precedent will be set with the forthcoming report.

The president has expressed concern that an undervalued RMB "artificially inflates the price of U.S. goods" and, by extension, undermines the goal of his just-unveiled National Export Initiative to double U.S. exports in five years. Reducing imports-the perennial goal of America's very vocal import-competing industries and unions-seems to be the primary motivation for Congress in the currency debate.

Before they do something rash, the administration and Congress should take deep breaths and consider whether RMB appreciation would even lead to the outcomes they desire-namely, more balanced trade. The evidence does not support their objective. They also should consider the likely consequences of taking the provocative actions under review. Although the short-term political benefits may be all that matter to some politicians, real economic costs will be borne without any economic benefits to show.

There are less provocative alternatives for encouraging China to recycle its accumulated foreign reserves, which is probably a worthy objective. Unfortunately, policymakers' fixation on the politically charged, but economically meaningless, bilateral trade account only spells trouble.

The Renminbi Is Likely Undervalued

Many economists believe that the Renminbi is undervalued, but there is disagreement about the magnitude. Disagreement is to be expected. After all, nobody can know the true value of the RMB unless, and until, it is allowed to float freely and restrictions on China's capital account are removed.[1] Short of that, economists produce estimates of undervaluation-and those estimates vary widely. So that begs a practical question: How will we know when we are there?

That question is important because Congress is once again agitating to consider legislation to compel the Chinese to allow RMB appreciation under the threat of sanction. Of course, that approach assumes that China will respond more "favorably" to public condemnation and arm-twisting than it would if the issue were allowed to migrate to the back burner. But U.S. politics won't allow that.

Laser-like Focus on the Trade Deficit

For Congress, the issue is not that the currency is undervalued per se, but that the United States has a large bilateral trade deficit with China, which is popularly attributed to the

undervalued RMB.[2] Currency revaluation for many policy-makers is just a proxy for reducing the trade deficit to zero, or better still, turning it into a surplus. There should be little doubt that many will take the position that the RMB is undervalued as long as U.S. imports from China exceed U.S. exports to China.

Leaving aside the question of whether bilateral deficit reduction should even be an explicit objective of policymaking in the first place, there is reason to be skeptical that currency revaluation would have the "desired" effect. It is assumed that Americans will reduce their purchases of Chinese products and that the Chinese will increase their purchases of American products if the value of the RMB increases against the dollar. But whether those trends would work to reduce the U.S. deficit with China depends on the extent to which consumers in both countries are responsive to the relative price changes.

What matters for the trade account is how much Americans reduce their purchases of Chinese goods and how much the Chinese increase their purchases of U.S. goods. Import value equals price times quantity, so if the percent increase in price (appreciation of the RMB) exceeds the percent reduction in quantity of imports consumed (in absolute value), then import value will increase. For example, if the RMB appreciates by 25 percent and U.S. consumers reduce consumption of Chinese imports by only 10 percent, then the value of U.S. imports from China will be greater than before (adding to the trade deficit). The same 25 percent increase in RMB value, however, should lead to an unequivocal increase in U.S. exports to China because the dollar price charged (the price used to measure U.S. exports) remains the same, while the quantity sold to China increases because Chinese consumers, by virtue of RMB appreciation, face lower relative prices, and demand more goods. Thus, RMB appreciation should unambiguously increase U.S. export value, reducing the trade deficit. But its effect on U.S. import value is ambiguous.

Whether the aggregate change in U.S. import and export value results in a lower trade deficit depends on the relative responsiveness (price elasticity) of American and Chinese consumers to the price changes they face. If U.S. consumers are responsive (they reduce the quantity of their purchases by a percentage greater than the price increase), then the trade deficit will decline, regardless of the degree of Chinese responsiveness. If U.S. consumers are not responsive (they reduce the quantity of their purchases by a smaller percentage than the price increase), then import value will rise and Chinese consumers would have to increase their purchases of American goods by a large enough percentage to offset the increased U.S. import value, if the U.S. trade deficit is to be reduced.[3]

Weak Link between Currency Values and Trade Flows

Recent evidence suggests that RMB appreciation will not reduce the U.S. trade deficit and undermines the common political argument for compelling China to revalue. Between July 2005 and July 2008, the RMB appreciated by 21 percent against the dollar-from a value of $.1208 to $.1464.[4] During that same period (between the full year 2005 and the full year 2008), the U.S. trade deficit with China increased from $202 to $268 billion.

U.S. exports to China increased by $28.4 billion, or 69.3 percent. But how much of that increase had to do with RMB appreciation is very much debatable. Figure 1 shows that U.S. exports to China were already on an upward trajectory, increasing by $3 billion in 2001, $3 billion in 2002, $6.2 billion in 2003, and $6.1 billion in 2004, when the exchange rate was consistently at 8.28 RMB per dollar. Natural sales growth from the confluence of market penetration and cultivation of Chinese demand was already evident.

In 2005-the first year in which there was a slight RMB appreciation-the value of exports increased by $6.8 billion. Exports jumped another $12.5 billion in 2006, a year in which the RMB appreciated by 2.8 percent. But in 2007, despite an even stronger 4.7 percent RMB appreciation, the increase in exports was only $9.3 billion. And in 2008, the RMB appreciated by a substantial 9.5 percent, but the increase in exports fell to $6.8 billion. If currency value were a strong determinant, then export growth should have been much more robust than it was in

2007, and in particular, 2008.

On the import side, recent experience is even more troubling for those who seek deficit reduction through currency revaluation. The evidence that an appreciating RMB deters the U.S. consumption of Chinese goods is not very compelling. During the period of a strengthening RMB from 2005 to 2008, U.S. imports from China increased by $94.3 billion, or 38.7 percent. Not only did Americans demonstrate strong price inelasticity, but they actually increased their purchases of Chinese imports, in seeming defiance of the law of demand. One reason for continued U.S. consumption of Chinese goods despite the relative price increase is that there may be a shortage of substitutes in the U.S. market for Chinese-made goods. In some cases, there are no domestically produced alternatives. Accordingly, U.S. consumers are faced with the choice of purchasing higher-priced items from China or foregoing consumption of the item altogether.

It is doubtful that members of Congress, who support action to compel Chinese currency appreciation, would proudly announce to their constituents that they intentionally reduced their real incomes. But that is the effect of relative dollar depreciation.

Full story: Appreciate This: Chinese Currency Rise Will Have a Negligible Effect on the Trade Deficit | Daniel J. Ikenson | Cato Institute: Free Trade Bulletin [1]

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