The US-Sino Currency Dispute: New Insights from Economics, Politics and Law

Edited by Simon Evenett

"China's policy of keeping its currency, the renminbi, undervalued has become a significant drag on global economic recovery. Something must be done."

Paul Krugman, 14 March 2010.

"First I don't think the RMB is undervalued... We are opposed to the practice of mutual finger-pointing between countries, or even taking strong measures to force another country to appreciate its currency, because such practice is not in the interest of the reform of the RMB exchange rate regime."

Wen Jiabao, 18 March 2010.

"President Obama - backed by the conclusions of a broad range of economists - believes that China is manipulating its currency,"

Timothy E. Geithner, 21 January 2009.

"I'm of the opinion that the yuan is underpriced and that it should be revalued. It certainly has an impact on their exports and trade patterns. The complaint is legitimate,"

Karel De Gucht, Europe's new trade commissioner, 23 March 2010.

A VoxEU.org Publication

27. Absent revaluation, retaliation? Reactions to US restrictions on Chinese exports

Kati Suominen

German Marshall Fund

Should the US take action over China's exchange-rate policy? This paper argues "yes". But while China would be momentarily hurt by any tariffs, the longer-term sufferers would be US companies, workers, and consumers. The US should instead follow C Fred Bergsten's three-stage plan of engaging the IMF and WTO. The column adds that a long-run solution should be fleshed out within the G20.

Introduction

There is no question that Chinese currency is blatantly undervalued, and there is no question that it is undervalued because of deliberate measures by the Chinese government. There is also no question that in part because of the undervalued currency, China contributes to US trade deficit and global imbalances. By subsidising Chinese exports, the currency regime unfairly tilts the level playing field the GATT/WTO system has pursued for six decades.

US anguish must be judged against this backdrop. Action against China is warranted. But action requires analysis of its consequences and trade-offs. The purpose of this article is to weigh the repercussions of one plausible line of action, unilateral restrictions against Chinese commercial interests, and to recommend alternative ways of proceeding.

What would be the trade effects of US commercial restrictions?

The simplest way for the US to retaliate against China is by imposing a unilateral tariff. About a fifth of China's exports (almost $300 billion in 2009) go to the US market. Under one estimate, a 27.5% tariff on China, threatened by Congress in 2003 and approximating the 25% tariff recently proposed by Krugman, is estimated to cause a nearly 30% drop in Chinese US-bound durables and a 37% drop in non-durables, and a 3% drop in its real GDP (McKibbin and Stoeckel 2005). A recent analysis finds that a 25% tariff on China would cause a 1% drop in Chinese GDP (Business Monitor 2010).

The effects on China would unlikely be long lasting, as it would seek demand from elsewhere, such as Europe, to absorb the excess capacity. The measure would, however, have two counterproductive effects on the US.

First, nearly 60% of Chinese exports come from (and imports are bought by) foreign multinationals in China (Morrison and Labonte 2008). The tariff would thus penalise the many US and other foreign companies that export from China to the US. A tariff on goods imported from China that are produced in a global supply chain could also hurt American jobs in such areas as engineering, design, finance, marketing, and retail (Ikenson 2010). It might not do so to the same extent in China. On average, 50%-61% of the value of goods exported from China is added in countries other than China, including in the US (Ikenson 2010, Koopman et al. 2008, and Lau et al. 2006).

Second, a retaliatory tariff against China could hurt US consumers and retailers sourcing from China, such as Wal-Mart. Since China and the US hardly (or no longer) produce the same goods, a tariff would not entice Americans to purchase US goods (Bernand et al. 2006). If the tariff on China were prohibitive, it would shift the Chinese share of US imports to another, higher-cost producer, and only exacerbate US trade deficit. A lighter tariff might trap Americans into buying the still competitive yet now more expensive Chinese goods. In short, while a US tariff might momentarily hurt China, the longer-term negative effects would be on US companies, workers, and consumers.

What might China do in reaction to US restrictions, and with what effect?

China might do nothing in reaction to US restrictions. If it does react, there are two main scenarios.

A consenting China

In this scenario, Beijing would relent and agree to revalue its currency. Recent Chinese comments have signalled a greater willingness to consider exchange rate adjustments, and in Beijing's bureaucratic politics, the central bank favours a revaluation. China's July 2005 revaluation, albeit small at 2.1%, was triggered by similar pressures by US Congress as are simmering today (Eichengreen and Irwin 2007 and Obstfeld and Rogoff 2005). The measure also reflected Beijing's worry about the fallout on US-China relations and efforts to show deference to Washington in world affairs. In trade-weighted terms, the renminbi ended up rising by some 20%-25% against the dollar until July 2008, when it was again fixed. It has since depreciated, so that the net rise in the past five years is 15% (Bergsten 2010).

To start closing the US-China trade gap or boost US jobs, Chinese revaluation would have to be large, 25%-50% (Bergsten 2010 and 2007, Cline and Williamson 2009a, Ferguson and Schularick 2009). Bergsten argues that a 25%-40% revaluation would reduce the US trade deficit by $100-150 billion annually and add between 750,000 and one million US jobs (Bergsten 2010, Cline and Williamson 2009b).

A large-scale overnight appreciation could, however, have negative effects. It would exacerbate US trade deficit and stunt Chinese growth. It would also be a political non-starter in China. The undervalued currency is rooted in Beijing's self-made political economy trap where instead of stoking domestic consumption, China recycles profits in the state-owned enterprises. Absent domestic demand, foreign markets are necessary for the Chinese leadership to sustain growth - its political lifeline. The road to currency reform has to travel through, and be accompanied by, reforms that increase consumption.

Gradual economic impact

A consenting China that enacts a gradual revaluation starting at 10%-15% - perhaps converging to a floating regime - would, however, be in US and Chinese interests (Mussa 2007). The economic effects would, to be sure, be gradual; the exchange rate is only one factor affecting trade balances, and changes in it seldom have immediate effects (Engel 2009, Lee and Chinn 2006, Broda 2004, Chinn 2004, Chinn and Wei 2000, and Hooper et al. 2000;). Besides, even if China were subsequently to increase imports, US exports per se would unlikely benefit. Over time, revaluation should have positive effects: reducing pressure on the US current account and dollar, and reducing China's massive reserves and dollar exposure that makes Beijing criticise US fiscal management. It should also defuse inflationary pressures in China. The dollar peg makes China import US monetary policy, which is inflationary for its fast-growing economy (see also McKinnon and Schnabl 2009). Commitment to a staged revaluation would also soothe Congress in a way not achieved by the 2005 token revaluation. Moreover, it would signal China's willingness to at last become a responsible stakeholder in the world economy, practically the US aim ever since Nixon went to China.

A cantankerous China

US action could alternatively bring about a cantankerous China - something that is already taking shape. In the wake of the financial crisis, China has become more assertive on the global stage and in its relations with the US. Beijing has so far refuted accusations of currency mercantilism (Wines 2010, The Economist 2009).[1] Eked on by the commerce ministry eager for exports, it might only grow more antagonistic in the face of US action, especially if domestic political pressures, strategic considerations, and the leadership's sensitivities about loss of face prove compelling enough.

One way in which a cantankerous China might react is by counter-retaliating against US commercial interests. Protectionist ricochet would not be out of character for Beijing. Although China has made great strides in its trade and investment regimes since joining the WTO in 2001, it still implements measures - counterfeiting, export subsidies, standards, taxation policies, and the like - that unfairly favour domestic companies (USTR 2010).[2] Beijing retaliated against the US anti-dumping

1 During President Obama's visit in November 2009, the Chinese argued they had done enough to propel global growth and marshaled numerous arguments against the claims of an unfair exchange rate. See The Economist (2009).

2 China has also imposed various seemingly arbitrary investment barriers. For example, in March 2009 Chinese regulators cited new anti-trust rules in rejecting Coca-Cola Company's $2.3 billion bid for China HuiRMB Juice Group Ltd., China's largest juice company. (See Hufbauer and Suominen 2010).

tariffs on Chinese tires in September 2009 with a 36% tariff on US nylon products, followed by preliminary anti-dumping duties of up to 105% on US broiler chicken.

A Chinese blanket tariff could bite

China is America's third largest export market after Canada and Mexico, absorbing some 7% of total in 2009. If resulting in a 1% of lost American exports, Chinese retaliation could cost 6,500 US jobs.[3] Beijing could also make life harder for US companies in China, something increasingly frequent (Anderlini 2010).

A cantankerous China might also play a game of chicken and only further devalue the renminbi, and/or promote exports by other means. China used to promote tradables with trade and industrial policies, but since WTO rules bar such practices, it has turned to the exchange rate instead. Sufficiently garrulous, Beijing might resurrect some of the old practices, even at the risk of a WTO case.

A cantankerous China might also project its wrath onto other policy arenas - set hurdles to the US-sponsored G20 framework for balanced growth, torpedo the Doha Trade Round as in July 2008, or turn more antagonistic global climate change talks. It might also step up efforts to diversify away from dollar-denominated reserves. This is less likely: by divesting, China could plausibly undermine the dollar and make long-term US real interest rates rise, but it cannot shed dollars without undermining its remaining dollar assets and exports. However, in a measure taken to herald a trend, Beijing did sell some Treasury holdings in early 2010 (Rappeport 2010).[4] This could be positive to the extent that it compelled the US to pursue fiscal discipline. However, ideally China reduces US Treasury purchases *because* it implements a more flexible exchange rate.

What might other countries do in the face of such US action?

US tariff retaliation against China could have thorny global implications. First, it would place America's Asian allies, Japan and Korea, in an uncomfortable position. Japan's new government has moved closer to China, its trade partner and next-door future military power, and refrained from criticising Beijing's exchange rate policies. Korea is disposed to Washington and eager for the trade agreement, but careful not to antagonise China. If pressed, Tokyo and Seoul might have to take sides in ways that have lasting geo-economic implications for the US in the Asia-Pacific.

Second, unilateral US retaliation would likely violate US obligations at the WTO and undermine the rules-based multilateral trade regime the US has championed in the post-war era (see Levy 2010 for a similar argument). If brazenly opportunistic, China could bring a WTO case against the US. US tariff would also give other nations, especially China and India, a license to claim that Washington is uninterested in Doha.

3 The result by Hufbauer and Schott (2009) is from a more general, not China-specific, study.

4 Of funds raised by the United States in 2009, China provided 4.6%, down from 20.2% in 2008 and a peak of 47.4% in 2006. (See Ferguson 2010).

Third, a US tariff could make unilateral currency retaliation more acceptable around the world. Washington should not underestimate the extent to which its trade policies are both emulated and employed as convenient excuses abroad. Many nations have qualms with China: in 2009, 58 countries imposed trade measures against it (Evenett 2009). They could now be keen on currency retaliation. Similar measures might become directed against the other Asian nations - Hong Kong, Malaysia, Singapore and Taiwan - that peg their currencies to the renminbi to remain competitive with the Chinese juggernaut. If currency mercantilism leads to a proliferation of currency protectionism, the global trading system would suffer.

What alternative policies should Washington consider?

US policy toward China's currency mercantilism should be assertive, but it must also be constructive rather than self-defeating. Two lines of action could be pursued.

The first is to target China's currency practices. Instead of unilateral action, Washington should tap the global discontent with China's trade practices and engineer a coalition in the global trading system. As proposed by Bergsten (2010), the US should label China as a "currency manipulator", launch bilateral negotiations with China, and call for a WTO dispute settlement panel to judge whether China violates its obligations under WTO Article XV ("frustration of the intent of the agreement by exchange action"). WTO rules on currency matters are long overdue, notwithstanding the methodological difficulties in assessing currency manipulation (see Subramanian 2010 and Staiger and Sykes 2009 and 2008). Moreover, a US-China case would set a powerful precedent. The risk of losing would, however, need to be weighed beforehand. Washington and other nations should simultaneously request a special IMF consultation to secure action from China (Bergsten 2010).

Multilateral pressure might still result in a cantankerous China. However, when pursued through rules-based global institutions, such an approach would be broad-based and legitimate, and reinforce US commitment to the post-war multilateral trade and financial order also in the 21st century. Even if China agreed to a small revaluation, concerted action should be pursued until Beijing credibly commits to and carries out substantial revaluation.

Second, longer-run policy needs to pursue realigning global consumption, primarily via the G20 framework for balanced growth. Washington needs to ensure that the G20's agent, the IMF, has powers and resources for the task, and that the G20 leaders regularly monitor each other's progress and single out laggards. Particularly useful would be to agree on imbalance thresholds, which, if surpassed, would trigger concerted action. Success, to be sure, presumes unilateral adjustments: toward domestic consumption in China, and fiscal discipline in the US. In addition, the US and others need to advance market access in China. Unilateral retaliation would do little to further President Obama's goal of doubling US exports, but an open Chinese trade and investment regime might help. Part of the answer lies in the Doha Round.

References

Anderlini, Jamil (2010), "US companies find China less welcoming", *Financial Times*, 22 March.

Bergsten, C Fred (2010), "Correcting the Chinese Exchange Rate: An Action Plan," Testimony before the Committee on Ways and Means, US House of Representatives, March 24.

Bergsten, C. Fred (2007), "The Global Imbalances and the US Economy", Testimony before the Subcommittees on Trade, Ways and Means Committee: Commerce, Trade and Consumer Protection, Energy and Commerce Committee; and Domestic and International Monetary Policy, Trade and Technology, Financial Services Committee of the House of Representatives, 9 May.

Bernard, Andrew B, J Bradford Jensen, and Peter Schott (2006), "Survival of the Best Fit: Exposure to Low Wage Countries and The (Uneven) Growth of US Manufacturing Plants", *Journal of International Economics*, 68, 219-237.

Broda, Christian (2004), "Terms of Trade and Exchange Rate Regimes in Developing Countries", *Journal of International Economics*, 63:31-58.

Business Monitor Online (2010), "Implications of a Potential China-US Trade War," 18 March.

Chinn, Menzie and Shang-Jin Wei (2008), "A Faith-Based Initiative: Does a Flexible Exchange Rate Regime Really Facilitate Current Account Adjustment?", NBER Working Paper 14420, October.

Chinn, Menzie (2004), "Incomes, Exchange Rates and the U.S. Trade Deficit, Once Again", *International Finance* 7(3):451-469.

Cline, William and John Williamson (2009a), "Equilibrium Exchange Rates", VoxEU.org, 18 June.

Cline, William and John Williamson (2009b), "Estimates of Fundamental Equilibrium Exchange Rates", Peterson Institute for International Economics Policy Brief 09-10.

Dunaway, Steven (2009), "The US-China Economic Relationship: Separating Facts from Myths", Council on Foreign Relations, 16 November 2009.

The Economist (2009), "A yuan-sided argument", 18 November.

Eichengreen, Barry and Douglas A Irwin (2007), "The Bush Legacy for America's International Economic Policy", Paper prepared for the conference "American Foreign Policy after the Bush Doctrine", Miller Center, University of Virginia, June 7-8.

Engel, Charles (2009), "Exchange Rate Policies." Federal Reserve Bank of Dallas Staff Paper 8 (November).

Evenett, Simon J (2009), The Unrelenting Pressure of Protectionism: The 3rd GTA Report - A Focus on the Asia-Pacific Region, Centre for Economic Policy Research.

Ferguson, Niall (2010), "The End of Chimerica: Amicable Divorce or Currency War?", Testimony, US House Ways and Means Committee Hearing on China's Exchange Rate Policy, 24 March.

Ferguson, Niall and Moritz Schularick (2009), "The End of Chimerica", Harvard Business School Working Paper 10-037 (October).

Hooper, Peter, Karen Johnson and Jaime Marquez (2000), "Trade Elasticities for G7 Countries", Princeton Studies in International Economics 87.

Hufbauer, Gary Clyde and Kati Suominen (2010), *Globalization at Risk: Challenges to Finance and Trade*, New Haven: Yale University Press.

Hufbauer, Gary Clyde and Jeffrey Schott (2009), "Buy American: Bad for Jobs, Worse for Reputation", Peterson Institute for International Economics Policy Brief 09-2.

Ikenson, Daniel (2010), "China Trade and American Jobs," *Wall Street Journal*, 2 April.

Koopman, Robert, Zhi Wang, and Shang-Jin Wei (2008), "How Much of Chinese Exports is Really Made in China? Assessing Domestic Value-Added When Processing Trade is Pervasive," NBER Working Paper 14109.

Krugman, Paul (2010), "Taking on China," *New York Times*, 14 March.

Lau, Lawrence J, Xikang Chen, Leonard K Cheng, K C Fung, Jiansuo Pei, Yun-Wing Sung, Zhipeng Tang, Yanyan Xiong, Cuihong Yang, and Kunfu Zhu (2006), "The Estimation of Domestic Value-Added and Employment Generated by US-China Trade," Working Paper No. 2, Institute of Economics, the Chinese University of Hong Kong.

Lee, Jaewoo, and Menzie Chinn (2006), "Current Account and Real Exchange Rate Dynamics in the G7 Countries", *Journal of International Money and Finance* 25, 2, 257-74.

Levy, Philip I (2010), "U.S. Policy Options in Response to Chinese Currency Practices", Testimony, US House Ways and Means Committee Hearing on China's Exchange Rate Policy, 24 March.

McKibbin, Warwick and Andrew Stoeckel (2005), "What if the US imposes a Tariff on China's Exports to Force a Revaluation?", *Economic Scenarios* 11.

McKinnon, Ronald and G. Schnabl (2009), "The Case for Stabilizing China's Exchange Rate: Setting the Stage for Fiscal Expansion", *China & World Economy* 17, 1,1-32.

Morrison, Wayne M and Marc Labonte (2008), "China's Currency: Economic Issues and Options for U.S. Trade Policy", Congressional Research Service, 9 January.

Mussa, Michael (2007), "IMF Surveillance over China's Exchange Rate Policy", Peterson Institute of International Economics Working Paper 10/07.

Obstfeld, Maurice and Kenneth Rogoff (2005), "The Unsustainable US Current Account Position Revisited", Draft (30 November).

Rappeport, Alan (2010), "Foreign Demand falls for Treasuries", *Financial Times*, 16 February.

Scheve, Kenneth F and Matthew J Slaughter (2007), "A New Deal for Globalization", Foreign Affairs 86, 4 (July/August).

Staiger, Robert W and Alan O Sykes (2009), "Currency 'Manipulation' and World Trade: A Caution," VoxEU.org, 30 January.

Staiger, Robert W and Alan O Sykes (2008), "Currency Manipulation and World Trade." NBER Working Paper 14600.

Arvind Subramanian (2010), "The Weak Renminbi is Not Just America's Problem," *Financial Times*, 17 March.

US Trade Representative (2010), National Trade Estimate Report on Foreign Trade Barriers 2010, Washington, DC: USTR.

Wines, Michael (2010), "Chinese Leader Defends Currency and Policies," *New York Times*, 14 March.

About the author

Kati Suominen is Trans-Atlantic Fellow at the German Marshall Fund in Washington, where she focuses on US and global financial policies and is currently writing a monograph on US role in the coming global financial order. In 2004-2010, Kati served as Trade Economist at the Inter-American Development Bank in Washington, where she managed Bank's global and Asia-Pacific trade policy research and partnerships, including with the WTO and the Asia-Pacific Economic Cooperation (APEC) senior officials. She has published seven books on global finance and trade, most recently *Globalization at Risk: Challenges to Finance and Trade* (Yale University Press, 2010) and *Economics of Free Trade* (Edward Elgar, 2010) with Gary Hufbauer from the Peter G. Peterson Institute for International Economics, and *Sovereign Remedy? Trade Agreements in the Globalizing World* (Oxford University Press, 2009) *Regional Rules in the Global Trading System* (Cambridge University Press, 2009), and *Bridging Trade Agreements in the Americas* (IDB, 2009). She is May 2009 graduate of the Wharton School's MBA Program for Executives, and holds a joint PhD in Political Science and International Relations from the University of California, San Diego (2004).