# UNDERMINING THE CASE FOR A TRADE WAR BETWEEN THE U.S. AND CHINA

## 1. Introduction

In early 2005 two American senators brought a bill to Congress that threatened a tariff of 27.5 per cent on all Chinese imports unless the yuan was revalued by that percentage. On 3 April 2008 the China Currency Manipulation Act was introduced in the U.S. Senate and endorsed by presidential candidates Hillary Clinton and Barack Obama. And on 29 September 2010, the U.S. House of Representatives passed legislation that would allow the U.S. to use estimates of currency (yuan) undervaluation to calculate duties on imports from China. In response, China attacked the legislation on the grounds that it is inconsistent with the rules of the World Trade Organization (WTO) while accusing the U.S. of resorting to protectionism.

Passing the 2010 legislation came in response to pressure from groups and individuals believing that the undervalued Chinese currency is the cause of the U.S. trade deficit with China, a proposition that has been floated around by some economists. For example, Cline (2010) claims that

> "an undervalued renminbi is widely considered to have contributed to large Chinese current account surpluses in recent years and, correspondingly, to large U.S. current deficits".

More dramatically, a view has emerged stipulating that the undervalued Chinese currency is an 'illegal subsidy' that is hampering the recovery of the U.S. economy from the Great Recession (Bergsten, 2010). The main theme in a symposium hosted by the Bretton Woods Forum in March 2008 was that undervaluation of the yuan is the cause of a

> "significant injury to the United States in the form of lost jobs and exports" (Miller, 2008).

China is even held responsible for the economic misfortunes of the entire 'international community', including other developing countries, as some would claim that Chinese policies are impeding the recovery of the world economy at large (for example, Dunaway, 2010). China, therefore, is portrayed as an economic villain indulged in illegal activities that hurt the rest of the world.

The Obama Administration seems to be sympathetic to these views. President Obama expressed the view that

> "Beijing is keeping the yuan artificially low to give Chinese exports an unfair advantage".

The Treasury Secretary, Tim Geithner, declared that

> "China's unwillingness to allow the yuan to rise created a 'dangerous dynamic' of 'competitive non-appreciation' in emerging economies" and that "excess accumulation of reserves is leading to 'serious distortions' in the world economy" (The Economist, 2010a).

Since his appointment as Treasury Secretary, Geithner has been using this sort of hawkish language to win 'browny points' as economic misfortune has created a public opinion that blames others for the misfortune. The riding of popular sentiment by blaming others is what Miller (2008) refers to when he attributes the introduction of the 2008 Act to

> "politicians looking for quick fixes to perceived U.S. economic ills".

These developments could be a precursor to an unnecessary and unjustifiable trade war that will be harmful to the U.S., China and the rest of the world. Some skirmishes have already been witnessed. In February 2007, the U.S. filed a complaint with the WTO against Chinese subsidies, and in late March of the same year the U.S. Department of Commerce announced tariffs of 10-20 per cent on glossy paper imported from China to offset the impact of alleged government subsidies. The imposition of these tariffs reversed a 23-year-old policy of not imposing countervailing duties on a non-market economy (The Economist, 2007a). This is a reminder of what happened in 1930 when the Smoot-Hawley Act allowed the U.S. government to impose tariffs on foreign imports, thus triggering "tit-for-tat" measures that destroyed international trade and made the Great Depression even greater. According to Liu (2005a),

> "the real cause of the Great Depression… was the 1930 Smoot-Hawley tariffs that put world trade into a tailspin from which it did not recover until World War II began".

This is what the world needs to avoid in the aftermath of the Great Recession of the 21st Century. The fragile recovery that the world economy is experiencing now would be seriously jeopardized by a 1930s-style trade war.

The potential trade war is not inevitable if politicians are convinced somehow that the case for this war is rather weak and that the underlying arguments are flawed. These arguments are the following: (i) the yuan is undervalued, (ii) undervaluation is the cause of the U.S. trade deficit with China, and (iii) Chinese policies are illegal and immoral. The argument put forward in this paper is that these propositions are invalid and that blaming China as the alleged originator and maintainer of the U.S. trade deficit (as well as being the inhibitor of world recovery) is not only unfounded but also not in anyone's interest.

## 2. Undervaluation of the yuan: perhaps, perhaps not

It is often claimed that the Chinese currency is undervalued by as much as 40 per cent against the dollar and that China's exchange rate policy is designed to depress the value of the yuan and push cheap Chinese goods into U.S. markets. Some economists suggest that the yuan is grossly undervalued and that the Chinese surplus and massive foreign exchange reserves balances are indicative of exchange rate misalignment (meaning undervalued yuan). They also suggest that the yuan would appreciate sharply if it were not for the intervention of the Chinese authorities in the foreign exchange market (estimated at $1 billion a day). Furthermore, Goldstein and Lardy (2003) have suggested that

> "the Chinese leadership implicitly recognizes the yuan is undervalued".

For those who believe in the accuracy of The Economist's Big Mac index, the yuan is currently undervalued by 40 per cent against the dollar because a Big Mac costs 14.5 yuan in China and $3.71 in the U.S., which means that the equilibrium exchange rate should be 3.91, rather than the actual 6.58 (The Economist, 2010b). However, the Big Mac index is more like a source of entertainment than the rationale for a policy prescription or a trade war. We should not expect anything other than Big Macs to be cheaper in China than in the U.S. Average prices are higher in countries with higher GDP *per capita* because higher wages push up the prices of labour-intensive goods and services. Thus, it is natural for China's currency value to be below what is predicted by the Big Mac index, or any similar measure (The Economist, 2009). Cheap labour (and other things) produces cheap Big Macs: it is as simple as that. It is noteworthy that The Economist (2007a) once describes as a

> "myth" that "there is overwhelming evidence that the yuan is undervalued".

Arbitrary round numbers are typically used to describe the extent of the undervaluation of the Chinese currency, even though it has appreciated by some 24 per cent since June 2005 (and by twice as much in real terms). In reality, however, it is not easy and even hazardous to judge whether or not an exchange rate is misaligned, let alone trying to put a figure on the extent of overvaluation or undervaluation of currencies. The economic models used to estimate the equilibrium exchange rate, and hence the extent of misalignment, invariably produce results that are highly sensitive to the underlying assumptions. Hence obtaining the 'desired results' from these models is rather easy and even tantalizing.

Evidence on the misalignment of the yuan/dollar exchange rate (that is, undervaluation of the yuan) is a mixed bag and highly unreliable. While estimates of the yuan undervaluation have been put at 15-40 per cent, the appreciation of the yuan by 24 per cent since June 2005 has done little to change these estimates (it seems that the more the yuan appreciates, the more it becomes undervalued, which is counterintuitive). However, these results may be obtained by design without admitting that small changes in model specification, explanatory variable definitions, and the sample periods for estimation can lead to very substantial differences in the estimates. Some economists, on the other hand, have shown that the yuan is undervalued or reached a 'may be/may be not' conclusion (for example, Chinn *et al*. 2006). This variation in the results, and the views based upon them, leads to the inevitable consequence of 'cherry picking' by those who are committed to proving a point, one way or another.

Take, for example, the estimates of the undervaluation of the yuan in 2003 as reported by the Congressional Research Service (CRS) to Congress (Morrison and Labonte, 2008). The yuan was undervalued by 40 per cent according to Manufacturer's Alliance, by 15-25 per cent according to the Institute for International Economics, and by 9.5-15 per cent according to Goldman Sachs. The CRS report describes these figures as

> "back of the envelope calculations, none of them based on theoretically grounded, econometrically estimated economic models".

But even estimates based on 'sophisticated' theory and econometrics are not reliable because the underlying procedures lend themselves to significant subjective manipulation – after all, this is not a precise science. For example, Coudert and Couharde (2005) estimated, by using a 'sophisticated model', the yuan undervaluation in 2003 to be 44-54 per cent.

Cline and Williamson (2011) conclude that

> "in April 2011 most currencies appear to have been reasonably close to their FEERS [fundamental equilibrium exchange rates]", but "the most important exceptions are China, on the weak side, and the United States, on the strong side".

Compared to an actual exchange rate of 6.54 in April 2011, their calculations show that the FEER consistent rate is 5.09, meaning that the yuan was undervalued by 22.8 per cent. This estimate has been reached by starting from the ideological desire to prove that China has an undervalued currency. In another paper, Cline and Williamson (2007) reach the conclusion that between 2000 and 2004 the yuan was undervalued by 17 per cent but between 2005 and 2007, it was undervalued by 27 per cent. How could this have happened when the yuan appreciated by 12.3 per cent against the dollar between June 2005 and the end of 2007? Surely, one would expect appreciation of the yuan to reduce the extent of undervaluation. On the other hand, the CRS report to Congress refers to a 2004 study by Barry Bosworth in which he argues that, because of the high internal saving rate in China (which is more than adequate to finance domestic investment), the yuan may actually be overvalued.

While estimates of the yuan undervaluation (or overvaluation) are all over the place, there is no way of knowing what the exact or even the approximate figure is. Liu (2005b) simply argues that

> "since the yuan is not a fully convertible currency, there is no market basis to judge if the yuan is undervalued or overvalued".

Even those who hold hawkish views against China admit the difficulty of judging whether the yuan is overvalued or undervalued. For example, Williamson (2003) admits that

> "none of us has a satisfactory macroeconometric model at our disposal to back up our estimates or our guesses".

Likewise, Krugman (2010), who calls China a

> "really the bad guy in currency war", admits that "we don't know the RMB fair value".

U.S. policy makers contemplating the imposition of tariffs on Chinese imports must be facing a dilemma: which set of undervaluation estimates do they use to determine tariffs?

It is often concluded that the yuan is undervalued because China has massive foreign exchange reserves. It is, however, more plausible to postulate that China's rapid accumulation of reserves does not only result from trade surpluses but also from the capital inflows attracted by expectation of yuan revaluation. A vicious circle is involved in the process: U.S. political arguments for revaluation encourage speculative financial flows, initiated by those hoping to profit from such anticipated revaluation, which boost foreign exchange reserves. Moreover, a surplus with one trading partner does not prove that a country's exchange rate is 'unfair'. Then China's trade surplus with the U.S. is not big if measured relative to GDP – for example, Malaysia and Singapore outperform China in terms of the surplus to GDP ratio.

The claim that the yuan would appreciate significantly if it were not for intervention in the foreign exchange market is also flawed. It has been firmly established that, because of the sheer size of the foreign exchange market, intervention is ineffective unless it works in the same direction as an established market trend dictated by market forces. One can only recall the frustration of the central bankers of the G5 countries caused by the failure to stem the appreciation of the dollar in 1984, followed by what was claimed to be a 'spectacular success' in the second half of 1985 when the trend was reversed by a shift in market sentiment. One billion dollars, which is presumably the value of the daily Chinese intervention, is a drop in the ocean relative to the size of the foreign exchange market[1]. This means that if market forces dictate a stronger yuan, central bank intervention will be ineffective (recall the bitter experience of the Bank of England as it failed to defend the pound in September 1992). If, as it is claimed, the yuan is grossly undervalued, then intervention would be against market forces, in which case it should fail.

The yuan, therefore, may or may not be undervalued, and no one knows by how much. It is probably undervalued, but 'probably' is not good enough when a trade war is at a stake. We simply do not have the 'technology' that can be used to measure exchange

[1] According to the 2010 triennial survey of the Bank for International Settlements, the size of the global foreign exchange market in April 2010, measured by daily trading, was a massive $4 trillion.

rate misalignment beyond reasonable doubt. Not even the 'efficient' foreign exchange market can put a free floating exchange rate at the 'correct' level – that is, eliminating misalignment. Is it not the case that free marketeers – and most, if not all, China bashers are free marketeers – claim that no one knows better than the market? If so, the misalignment figures produced by human beings must be wrong!

## 3. The cause and cure

The U.S.-China trade imbalance is invariably attributed to exchange rate misalignment, which makes the revaluation of the yuan the optimal (or only) solution to the problem, a view that has little to do with sound economics. An alternative view can be rationalized in terms of the basic macroeconomic identity of national income, which tells us that the external balance is a reflection of the domestic saving-investment balance. The alternative view is that China's surplus and the U.S. deficit have less to do with the value of the yuan than with Chinese saving and American profligacy (The Economist, 2007b). In other words, the U.S.-Chinese trade imbalance is due to excessive U.S. consumption beyond its savings, on the one hand, and excessive Chinese production and savings beyond its own spending on the other. It is a combination of cheap money and weak regulation in the U.S. that has led to bubbles and temporary capital gains, changing the saving-consumption balance in such a way as to take consumption to an unsustainable level. On the Chinese side, cheap foreign money (combined with cheap Chinese land, energy, and natural resources) has driven down the prices of 'Made-in-China' products (Xiao, 2010).

McKinnon (2007) argues that U.S. politicians are targeting China on the basis of what he calls the 'mistaken presumption' that the appreciation of the yuan would reduce China's trade surplus with the U.S. He also argues that

> "blaming foreigners for misaligned exchange rates is easier than facing up to the problem of inadequate private saving and large structural fiscal deficits in the United States".

More importantly, however, McKinnon does not attribute this state of affairs only to 'political populism' but also to 'bad economic theorizing'. Roubini (2007) disputes the view put forward by McKinnon, arguing that while the U.S. fiscal deficit and the Chinese high saving rate have been important drivers of the growing

U.S. trade deficit, the Chinese exchange rate policy has also been a 'crucial factor'. He points out that

> "a persistently weak RMB has made [Chinese] imports expensive and exports cheap, which has reduced, in relative terms, both overall consumption and consumption of imports".

Macroeconomic theory suggests three ways to reduce a trade deficit (i) domestic recession (or weak growth), (ii) increased growth in the rest of the world, and (iii) domestic currency depreciation. Those arguing for China's currency as the cause and cure seem to believe that only currency depreciation works – that is, depreciation of the dollar or appreciation of the yuan. This simplistic prescription is based on the elasticities approach to the balance of payments, which is found in Macroeconomics 101, but in reality it does not work. Even in Macroeconomics 101, students are told that the elasticities approach ignores the income effect of depreciation. They are introduced promptly to the better explanation provided by the absorption approach that takes into account the income effect – that is, depreciation of the domestic currency boosts income, and hence the demand for imports, thus offsetting the effect of depreciation on the trade balance.

Unlike what Roubini (2007) thinks, the exchange rate is not a 'crucial factor' but rather a weak factor or a useless factor for at least two reasons. The first reason is that a host of other, perhaps more important, factors determine the trade balance. The second reason is that even if the exchange rate were the only factor affecting the trade balance, the transmission of the effect requires the satisfaction of an incredible set of assumptions that are unlikely to hold in practice.

Let us look at the second reason first. Real world complications hamper the process whereby changes in the exchange rate are transmitted to the trade balance. The process requires the following conditions to hold:

1. There is full (or at least high) pass-through effect from the exchange rate to the dollar price of exports and the yuan price of imports – that is, the translation of changes in the exchange rate to changes in prices. This condition does not hold because of local currency mark-ups and profit margins, and because China uses the dollar as the currency of invoicing exports to the U.S. The use of the dollar as the currency of invoicing by Chinese exporters means that changes in the exchange rate do not affect the dollar price of Chinese exports to the U.S.

2. The volume of Chinese exports to the U.S. falls as a result of the rise in the dollar price of Chinese exports. Volume must fall more proportionately than the rise in price, so that there is a net decline in Chinese export revenue. U.S. addiction to Chinese imports from China means that volume will not change significantly.
3. The volume of Chinese imports from the U.S. rises as a result of the fall in the yuan price of these imports. Volume must rise more proportionately than the fall in price, so that there is a net increase in Chinese import expenditure. This is unlikely to happen because Chinese goods will remain cheap after revaluation of the yuan.
4. The U.S. supply of exports to China (that is, Chinese imports from the U.S.) is infinitely elastic, in the sense that any increase in demand by the Chinese for U.S. goods can be met by utilizing excess capacity. In reality the opposite is true because the U.S. no longer produces labour-intensive, low-tech goods that can compete with Chinese goods. Furthermore, restrictions are imposed by the U.S. government on the exports of high-tech goods to China.

Let us now look at the first reason. Revaluation of the yuan will work only if there are no offsetting effects from other factors, but the reality is that many other factors affect the trade balance. In their survey of the empirical literature on the determinants of the trade balance, Bahmani-Oskooee and Ratha (2004) identify the following determinants of the trade balance (apart from the exchange rate): domestic real income, foreign real income, relative price of exports, growth rate, ratio of base money to output, ratio of government consumption to output, world income, money supply, world base money, import prices, import volumes, export prices, export volumes, terms of trade, general price level, consumption, investment, and volume of world trade. Furthermore, most of these studies point to factors other than the exchange rate as the influential determinants of the trade balance. In a survey of the world economy and based on the results of empirical studies, The Economist (2003) reached the conclusion that

> "the most effective engine of adjustment [of the U.S. trade balance] would be an autonomous increase in demand abroad for American goods, perhaps through faster growth in customer countries". It is also stated that "for any given rate of economic growth, America's imports tended to grow faster than those of other countries (and faster than America's exports)", which means that "if all countries were growing

at the same speed, and exchange rates remained stable, America's trade deficit would worsen inexorably".

Chinn and Wei (2009) examined more than 170 countries with flexible exchange rates over the period 1971-2005 and found little evidence to support the proposition that countries with flexible exchange rates reduced imbalances more quickly than countries with rigid exchange rate regimes.

An alternative view on the 'cause and cure' proposition has been put forward by Liu (2010) who attributes the U.S. trade deficit with China to disparity in wages and (consequently) the terms of trade. He attributes disparity in wages to the

"politically induced restriction on cross-border mobility of labor", which is the reason why "globalized trade has been primarily driven by cross-border wage arbitrage".

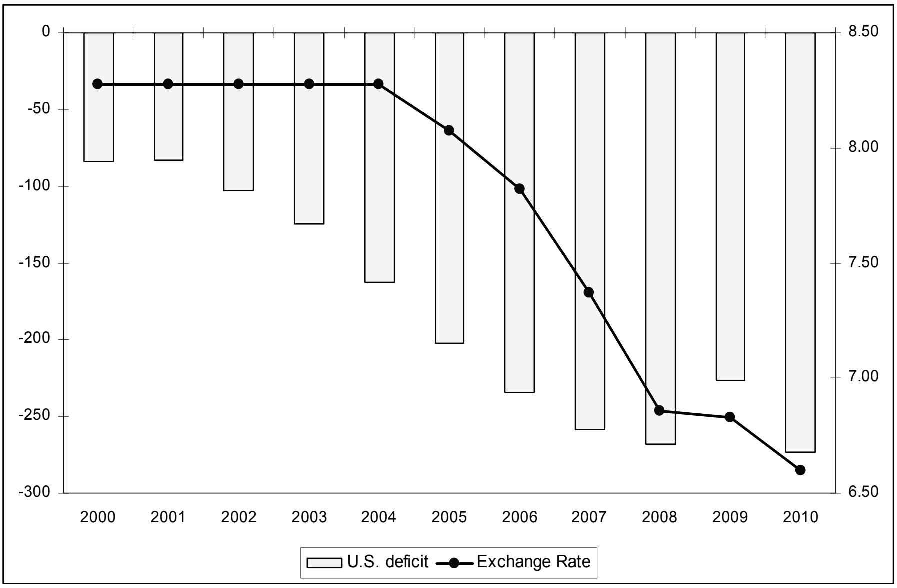
Liu (2005b) points out that a nominal wage gap (between the U.S. and China) of 35 to 1 is based on 'unbalanced terms of trade' and that 'until wage parity is attained, free trade will continue to be driven by cross-border wage arbitrage in favor of China'. In another paper Liu (2005a) argues that

"when bilateral trade is temporarily unbalanced, it is generally because one trading partner has become temporarily uncompetitive, inefficient and unproductive". Liu, therefore, attributes trade imbalance to "a number of socio-economic factors, such as the terms of trade, wage levels, return on investment, regulatory regimes, shortages in labor or material or energy, trade-supporting infrastructure adequacy, purchasing power disparity, etc". Furthermore, he makes the interesting observation that "a trading partner that runs a recurring trade deficit earns the reputation of being what banks call a habitual borrower, i.e. a bad credit risk, one who habitually lives beyond his/her means".

For Liu, the most effective way to correct trade imbalance is to change the terms of trade, which can be accomplished, among other means, by regulating cross-border wage arbitrage (thus raising Chinese wages) and by a more effective Chinese environmental protection regulation. Recent empirical evidence shows that while the U.S. trade deficit with China is not related to the exchange rate, it is very closely related to the terms of trade (for example, Moosa, 2011).

Let us look at what has happened in reality by examining the bahaviour of the U.S. deficit with China as the exchange rate changed over the period 2000-2010, as shown in Figure 1. At the end of 2000, the exchange rate was 8.277, while the U.S. trade deficit with China over the entire year was $83.8 billion. By the end of 2004, the exchange rate had barely moved, but the deficit almost doubled to $162.3 billion. During the period 2005-2008, the yuan appreciated persistently against the dollar, yet the deficit widened to $268 billion. In 2009 the deficit shrank to $227 billion although the exchange rate did not move. That happened entirely because of the global financial crisis and the recession that came with it. Between 2009 and 2010, the yuan appreciated further against the dollar, yet the deficit went to a record level of $273, as the U.S. economy emerged out of the recession. These observations illustrate the dominance of the income effect over the exchange rate effect.

FIGURE 1 - *U.S. Trade Deficit with China and the Yuan/Dollar Exchange Rate*




While Cline (2010) attributes the 2009 improvement in the U.S. trade balance to the delayed effect of exchange rate adjustment following the appreciation of the yuan against the dollar since 2005, he admits that

"the global recession also influenced the 2009 outcome".

If Cline was right about the effect of the exchange rate, the U.S. trade deficit with China should have narrowed in 2010. On the contrary, the recovery of the U.S. economy pushed the trade deficit with China further into the red (another record of $273 billion in 2010 compared with $227 billion in 2009). Some economists might say that what matters is the real exchange rate, but this observation is counterfactual. According to The Economist (2010c), the yuan has appreciated in real terms by about 50 per cent since July 2005, in which case there should have been a more pronounced improvement in the U.S. trade balance with China, but this improvement is not to be seen anywhere.

## 4. Are Chinese policies immoral and/or illegal?

It has been suggested that the Chinese exchange rate and growth policies hurt the rest of the world (hence they are immoral) and could be illegal as judged by the IMF and WTO rules. Spruk (2010) describes what he calls

> "China's mercantilism based on persistently low exchange rate" as follows: "the partial fixation of the exchange rate... stimulates export-led growth model and, consequently, results in a large trade surplus which translates into foreign exchange reserves, thus enabling China's central bank to foster exchange rate intervention to defend the targeted yuan exchange rate".

Tim Geithner has gone as far as claiming that

> "China's exchange rate policy is harmful even for the Chinese economy" (Dennis, 2011).

In a speech at the Johns Hopkins University in January 2011, Geithner suggested that

> "China's unwillingness to allow its currency to rise in value is hampering U.S. competitiveness... and harming the Chinese economy"; that "[undervaluation of the yuan] is not a tenable policy for China or for the world economy"; and that "[failure to revalue the yuan] could cause a jump in inflation for China and a damaging rise in asset prices, both of which will threaten future growth"[2]. He even threatened

[2] While Geithner urges China to let its currency appreciate, he is worried about a surge of inflation in China. This makes no sense because inflation has the same effect on competitiveness as currency appreciation. As a matter

> that failure of China to follow his recommendation will be "too costly – both for China and China's relations with the rest of the world".

Some economists have accordingly suggested that China should change its policies in such a way as to serve the interest of the rest of the world. However, it seems that this obsession with China is unjustified by the prevailing rules of the international economic order – that is, there is no legitimacy in putting pressure on China to change its policies. Bergsten (2010) claims that the

> "competitive undervaluation of the Chinese currency" is a "blatant form of protectionism"

because it subsidises Chinese exports by the amount of the misalignment, hence it is equivalent to a tariff on imports. Thus he argues against the characterization as 'protectionist' a policy response to the Chinese actions by the U.S. and for viewing such actions as 'anti-protectionist'. This ideologically-driven claim stretches the meaning of 'protectionism' far beyond any reasonable limit. Williamson (2003) has suggested that China should deliberately run a current account deficit of some 2.8 per cent of GDP (to please the rest of the world). This is just like asking your local butcher to spend more than he earns because you have a deficit with him. I am sure that the butcher will not be very happy about such a request, particularly if it is supplemented by the threat of a trade war.

The critical question is whether or not what China is doing (including foreign exchange market intervention) is illegal as judged by the IMF and WTO rules, and whether or not the U.S. is justified in threatening China with retaliatory actions. Using the trade deficit as a 'smoking gun' that proves an 'unfair' exchange rate does not meet the common-sense test for fairness. No country should be sanctioned because its trade surplus is big, just like no one should punish Bill Gates for accumulating a massive 'surplus' by selling goods that people want to buy[3]. Does it make sense to threaten the

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of fact, some economists believe that wage-driven inflation will be more effective in narrowing the Chinese surplus (thus making Geithner's wish come true) than currency appreciation. The Economist (2011) argues that rebalancing the Chinese economy through (moderate) inflation is preferable to either a sudden or gradual exchange rate adjustment.

[3] Without Bill Gates accumulating massive reserves, I would not have the luxury of typing this paper using WORD.

local butcher with trade sanctions because you buy more meat from the butcher than the butcher buys meat (or whatever) from you? The problem then is that if you shift from this butcher to another butcher, you will still run a trade deficit with the new butcher. The only way to eliminate your trade deficit with any butcher is to become vegetarian, in which case you would probably do the right thing (if you were health conscious) for the wrong reason.

As for intervention in the foreign exchange market, China is permitted by IMF rules to intervene because intervention does not constitute any malpractice. Rather, it is a means for preserving the exchange rate regime chosen by a country in accordance with the post- Bretton Woods IMF rules. Then why is it that China is singled out as the perpetrator of abuse of the international economic order by intervening in the foreign exchange market, when other countries have been working much harder to hold their currencies down via intervention and otherwise. In terms of the tendency to accumulate foreign reserves, Singapore, Korea, Thailand and Malaysia have outperformed China (The Economist, 2010d). The post-crisis prevailing conditions have put enormous pressure on the currencies of emerging countries to appreciate rapidly, hence these countries have every right to use all necessary means, including intervention, to protect their economies from the adverse effects of rapid currency appreciation. This is by no means 'competitive devaluation' as it is portrayed by China bashers.

China is also accused of 'currency manipulation', which is preposterous and indicative of extreme naivety. Of course China manipulates its currency because it has chosen to adopt a system of fixed exchange rates, which is allowed by international rules. Until 1971, the Bretton Woods Agreement of 1944 required all countries to have fixed but adjustable exchange rates while floating was outlawed. That did not prevent some countries, such as Canada, from experimenting with floating exchange rates[4]. What is important here is that it was a requirement for all countries to 'manipulate' their currencies to be compliant with the agreement. In 1971 the U.S. dismantled the Bretton Woods system by abolishing the convertibility of the dollar into gold. After a period of turmoil (during which countries did what they thought was best for their

[4] As a signatory to the Bretton Woods Agreement of 1944, Canada violated the international rules prevailing at that time. However, no one complained.

economies), the Jamaica Accord of 1976 gave countries the freedom to choose from a menu ranging from the very fixed to the very flexible regimes. China chose to use the very fixed regime, which requires 'manipulation' – that, is maintaining the regime via intervention and other means. Unless there is a new international agreement that outlaws fixed exchange rates, no one should complain about the so-called 'manipulation'.

Mussa (2007) insists that China's exchange rate policy violates Article IV of the IMF Articles of Agreement. This Article stipulates that the IMF has the responsibility to

> "oversee the international monetary system in order to insure its effective operation" and also to "oversee the compliance of each member with its obligations under Section 1 of this Article". The Fund, therefore, has to "exercise firm surveillance over the exchange rate policies of members", and "adopt specific principles for the guidance of all members with respect to those policies". Mussa refers to the "catastrophic failure of Fund surveillance in the critical case of China" because "since 2002, the Chinese authorities have used massive, largely sterilized, official intervention to resist substantial, economically-warranted appreciation of the yuan".

Therefore, according to Mussa, the Chinese have an undervalued currency that is kept artificially weak by intervention.

This travesty, which involves an unnecessary dramatization of a normal state of affairs, is motivated by Mussa's dissatisfaction with the performance of the IMF's Managing Director with respect to telling China what to do. He describes as 'incomprehensible incompetence' the Managing Director's agreement with the Chinese view that a government has unilateral authority to determine its exchange rate. As argued before, the IMF rules allow countries to choose their exchange rate regimes and take the necessary measures (including intervention and interest rate policy) to preserve the regime. One has to realize that out of the exchange rate regimes available, only free floating does not require intervention, but free floating exists only in theory. Even countries with flexible exchange rate regimes intervene so that their currencies are neither too strong nor too weak. Not even China wants its currency too weak. Furthermore, IMF surveillance is carried out for the purpose of providing advice, not to indict 'offending' countries and punish them, for example, through trade sanctions.

Countries may also target certain values for their currencies but they have to deal with the consequences of trying to oppose market forces: some would succeed while others fail, in which case they abandon the target that they cannot maintain or change the regime altogether. This is a legitimate choice that cannot be dictated by the IMF or another country. In reality countries go as far as declaring one exchange rate regime while following another, but this has been accepted as a common practice resulting from the so-called ‘fear of floating’ or ‘fear of pegging’ (for example, Calvo and Reinhart, 2002). Declaring an exchange rate regime while practicing another one is more like a violation of IMF rules than China’s fixed exchange rate regime.

It has also been suggested that China’s exchange rate policy is as much a violation of the WTO rules as the Chinese violation of intellectual property rights (for example, Palley, 2005). This is the same idea that an undervalued currency works as an import tax and export subsidy. It follows from these arguments that China is violating the WTO rules as enshrined in the Agreement on Subsidies and Countervailing Duties (SCM Agreement). However, for China to violate the SCM Agreement, its exchange rate policy must constitute a subsidy under Article 1 of the SCM, which requires the following conditions to be satisfied: (i) there must be a financial contribution by the government, (ii) benefit is conferred, and (iii) the subsidy must be specific. This means that the financial contribution is made by a direct transfer of funds, foregone government revenue, the provision of or purchase of goods or services other than general infrastructure, or payment to a funding mechanism (Ahn, 2010). Obviously, none of these conditions are satisfied, and it will be rather hard to convince anyone with any degree of objectivity that China is indeed violating WTO rules by pursuing a particular exchange rate policy. The possibility that China may be violating WTO rules in other ways, such as intellectual property rights, is a different matter that we are not concerned with here. While it may be legitimate to complain about Chinese pirating of DVDs and CDs, restrictions on the sale of foreign firms and music in China, and Chinese environmental standards, arguing that the alleged undervaluation of the yuan is a deliberate policy that is tantamount to subsidies is way off the mark.

Because China is perceived as inflicting damage on the world economy and the international monetary system, some economists have suggested that China should proceed to change its ‘harmful’ policies, proposing ways to proceed. The problem here is that a recommendation is made for a change of policy in country A because the change is (or believed to be) beneficial to country B. For example, it has been suggested that China should move away from heavy reliance on investment and exports to generate growth towards greater reliance on consumption. We seem to forget the historical fact that, in its early stages of development, America relied on investment as a source of growth. Economic growth models emphasize the importance of investment, while the export-led growth model depicts the role of exports as an engine of growth. I have not yet come across anything that remotely resembles a consumption-based growth model. Then how would China do that? By announcing that saving is illegal to force its citizens to save less and consume more? Increasing saving and falling consumption is symptomatic across 'catching-up economies', and China is one such economy. The Chinese justifiably indulge in precautionary saving due to the need to provide for healthcare, basic education and retirement, given the lack of sufficient public provision of these services (Cappiello and Ferrucci, 2008). Chinese parents need to save for many years or decades to pay for their children's expensive overseas education. In any case, the saving-consumption balance is a domestic macroeconomic issue on which China has the last say in accordance with its national economic interest.

There is nothing illegal or immoral about pursuing a policy of export-propelled growth, which was the model followed by Japan, Korea and even Britain when it was the 'workshop of the world'. Even today, the reason behind Germany's success and resilience is that Germany still makes things that foreigners want to buy rather than following the Anglo-American tradition of proclaiming the supremacy of financial services as an inevitable outcome of an evolutionary process that sees the extinction of manufacturing industry[5]. Germany does a lot of trading with China but neither of the two countries complains about the bilateral trade balance or the exchange rate. Vistesen (2010) does not see anything wrong with export-propelled growth – rather, he thinks it is the way forward for the U.S. Vistesen's argument is as follows:

> "we are all rapidly ageing and soon will hit the threshold where we effectively become dependent on external demand in order to achieve economic growth, pay pensions, build roads etc".

In addition to the demographics, Vistesen argues, the U.S. economy has over-spent and over-borrowed to the extent that the amount of private sector and public sector leverage means that

[5] One reason why Germany was less affected by the global financial crisis is that, unlike the U.K for example, Germany has not abandoned manufacturing industry in preference for 'services'.

> "they [the two sectors] are simply tapped out" meaning that "we cannot rely on the US consumer anymore" and that "the US economy now needs to export more than she imports in order to turn the boat around".

The export-led growth model is disliked by some on the grounds that it contributes to trade imbalances. Spruk (2010) argues that

> "China's export-led growth model has tremendously affected the macroeconomic performance of developing nations".

This is because, the argument goes, the exports of developing nations are substitutes to those of China, which means that Chinese exports to the U.S. and E.U. are squeezing out the exports of other developing countries. However, Spruk himself admits that evidence provided by the OECD indicates that

> "developing countries would be hurt significantly if the renminbi exchange rate were allowed to appreciate".

It is because of the export-led growth model that China has become a global manufacturing powerhouse. In this capacity, China has contributed to the suppression of world inflation and to the emergence of the so-called 'great moderation', which is typically claimed as an outcome of global capitalism.

Those holding the 'blame it on China' banner seem to forget that China's rapid growth is underpinned and sustained by a number of factors that play a more important role than the exchange rate. China's rapid growth is attributed to reduction in trade barriers, low wages, available supply of unskilled labour, low cost of communication and transportation, the flow of foreign direct investment, the large-scale potential of the Chinese domestic market, opening up to world markets, better policies and cultural factors, and the diversification of exports (Liu and Xin, 2011). While some of these factors are not the outcome of deliberate policy actions of the Chinese, others are hailed as the product of the celebrated globalization of the world economy and the move toward free trade. It is therefore strange and indeed perplexing that the holders of the 'blame it on China' banner are also those who defend the very global capitalism that has contributed to making China the economic giant it is now.

Some people would deny China the right of choosing its exchange rate regime, going as far as calling for the Chinese to float their currency immediately. Others are more humble, suggesting that China switches from a dollar peg to a basket peg. Some observers call for the removal of the lack of transparency surrounding the yuan's exchange rate management (for example, McNally, 2010). To be sarcastic, I would argue that China should have the right to call on the U.S. to abandon floating and peg the dollar to the yuan, because that serves the interest of China.

What we can see, however, is an attitude of blaming one's problems on others. In the October 2010 meeting of the G20 finance ministers held in Gyeongju, South Korea, Tim Geithner 'urged' countries with persistent current account surpluses (meaning China) to

> "undertake structural, fiscal and exchange rate policies to boost domestic demand" and those with significantly undervalued currencies (meaning China) to allow them to "adjust fully over time" (Bloomberg News, 2010).

He even suggested setting numerical targets for the current account as a percentage of GDP. Well, if an agreement on numerical targets is reached and an accord is signed and implemented, any country not abiding by the agreement will be violating international rules. Until that happens, no country should accuse China of violating international rules by running an external surplus just because the Chinese are in a better position to manufacture the labour-intensive, low-tech goods needed by the rest of the world. However, I doubt very much that an agreement on numerical targets for the current account will ever be reached. The Japanese Finance Minister, Yoshihiko Noda, reacted to Geithner's proposal by telling journalists that

> "setting numerical targets would be unrealistic" (Bloomberg News, 2010).

I have always thought that in the spirit of the free market doctrine, current accounts should be determined by market forces (like everything else).

There is no doubt that China needs a policy change (for example, a move to free floating) as its economy becomes more integrated with the rest of the world. The Chinese acknowledge the need for a policy change (including a move toward a consumption-based economy) but they want to introduce the change slowly, in a process that is closer to an ultra marathon run (and walk) than a sprint, and justifiably so. The Chinese are aware of the harm that can be inflicted on their economy by the sprint as was the case when Russia became a market economy over night, inflicting excruciating pain on its citizens. They are, for example, concerned that a premature end to the peg would bring about financial instability (destabilising capital flows), bearing in mind what happened in Japan as a result of the significant appreciation of the yen in the period following the Plaza Accord of 1985. Furthermore, a stable exchange rate between the dollar and yuan may be in the interest of both countries (the U.S. and China), given the potential for cross-border investment.

Pegging the yuan to the dollar has been an important element of the stabilization policies pursued since China opened up to the rest of the world. This is because a dollar peg provides a monetary anchor for price stability by linking domestic monetary policy to the inflation rate of a large, non-inflationary economy (the U.S.). But pegging has its costs too. In the case of China it requires sterilized intervention, causing overheating of the economy. Furthermore, a hard peg reduces the range of policy options available to respond to real shocks and poses the policy dilemma of choosing between controlling inflation and limiting foreign capital inflows. In the mean time, China is allowing its currency to appreciate against the dollar, but only gradually. All the signs indicate that the Chinese central bank will ensure that the yuan appreciates gradually, say by between 2 and 5 per cent a year. In the long run, the yuan is likely to be an international currency when it becomes fully convertible while the Chinese economy has undergone full transformation into a market economy. At that time, floating will make a lot of sense.

## 5. Conclusion

The *status quo* is as follows. The U.S. wants to see significant and rapid appreciation of the Chinese currency, hoping that it will boost American exports and employment. China, on the other hand, regards the pressure to revalue the yuan quickly as unfair and may be detrimental to China's development. The arguments presented earlier and the available empirical evidence leads us to believe that the yuan may or may not be undervalued, particularly because it has appreciated by about 24 per cent in nominal terms and some 50 per cent in real terms since June 2005. This appreciation has done nothing to reduce the U.S. trade gap with China, as a new record deficit was registered in 2010. Two facts of life are invariably overlooked by those calling on China to revalue its currency for the sake of humanity: (i) China is price competitive, not because it has an undervalued currency but because it has cheap factors of production; and (ii) real life complications render exchange rate adjustment an impotent tool for correcting trade imbalances. The U.S. trade deficit with China is mostly an American problem that America must deal with decisively.

There is indeed no solid argument to support a trade war that will hurt the world economy when it is just emerging from the Great Recession. The fact of the matter is that the threat of a trade war is promoted by what Tabones (2010) describes as

> "pundits and politicians" and "fear mongers" who are on a mission "to scare the general public". He correctly argues that that the U.S. and "like-minded countries" should not "risk mutually assured destruction in order to fix what others refer to as non-existent problem, or at worst, one that is overblown".

The potential trade war is, therefore, unjustifiable and not inevitable.

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## ABSTRACT

Arguments are put forward to challenge the case for a trade war between the U.S. and China. The threat of a trade war against China is based on three pillars: (i) the Chinese currency is undervalued, (ii) undervaluation of the yuan is the cause of and cure for the U.S. massive trade deficit, and (iii) Chinese policies are illegal and immoral because they hurt not only the U.S. but also the rest of the world and China itself. It is suggested that no one really knows whether the Chinese currency is undervalued or overvalued, that revaluation of the yuan will not eliminate or reduce significantly the U.S. deficit with China and that Chinese policies are neither illegal nor immoral.



Keywords: China, Misalignment, Trade Deficit, Trade War

JEL Classification: F13, F31, F32



## RIASSUNTO

*Una critica all'ipotesi di una guerra commerciale tra Stati Uniti e Cina*

Vi è un acceso dibattito sulla ipotesi di una possibile guerra commerciale tra Stati Uniti e Cina.

La minaccia di una guerra commerciale contro la Cina si basa su tre pilastri: i) la valuta cinese è sottovalutata; ii) la sottovalutazione dello yuan è sia la causa sia la cura dell'enorme deficit commerciale degli USA; iii) le politiche cinesi sono illegali e immorali poiché danneggiano non solo gli USA ma anche il resto del mondo e la Cina stessa. Lo studio evidenzia che in realtà non si può affermare con certezza se la valuta cinese sia sopra- o sottovalutata, né che la rivalutazione dello yuan ridurrebbe significativamente il deficit USA con la Cina e inoltre che le politiche cinesi al riguardo non sono né illegali né immorali.