Be careful what you wish for

Further appreciation of China's currency would deliver positive and negative results for US

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On 29 September 2010, the US House of Representatives passed the Currency Reform for Fair Trade Act by a margin of 348 to 79 (http://www.govtrack.us/congress/billtext.xpd?bill=h111-2378). The bill seeks to amend the Tariff Act of 1930 and allows punitive tariffs to be imposed on goods imported from countries deemed to have currencies that are "fundamentally undervalued." The bill comes as House members, many of whom face a hard fought election in less than a month, work to bolster their credentials as protectors of American jobs and economic interests. Washington has followed up on the Currency Reform for Fair Trade Act with pressure on Chinese officials during the 9-10 October 2010 IMF meetings and will almost certainly continue pressing Beijing to appreciate the renminbi (RMB) in the months ahead, particularly if US jobs data remain week.

However, if China were to substantially revalue the RMB, the effects would likely disappoint US voters, to whom RMB revaluation is being billed as a key tool for reviving the fortunes of the US manufacturing sector. This analysis will examine several key economic realities of a continued RMB appreciation of 15% or more in value relative to the US Dollar. The bottom line: for Washington, a sustained clash with China over the RMB would at best result in a small economic and political perception victory for the US. Confrontation would likely render China less willing to engage wholeheartedly on other strategic priorities for the US such as managing North Korea, containing or rolling back Iran's nuclear program, energy and climate diplomacy, and maritime security in the East and South China Seas and beyond.

Disappointing effects of continued RMB appreciation versus the Dollar

1) **Don't expect RMB appreciation to bring the US manufacturing sector back to its glory days. The labor and operating cost gap is too wide for even a major exchange rate increase to bridge.** A prominent expert on US-China trade issues tells us he thinks appreciation of the RMB could create a few hundred thousand jobs—very meaningful to workers who get them, but only a fraction of the number of jobs that the bill's supporters claim have been lost to Chinese currency manipulation. Based on average wage data from the US Bureau of Labor Statistics (2009), the US full-time worker earns approximately US$45,000 per year. By comparison, the average Chinese worker made slightly over US$2,600 per year in 2009, according to the National Bureau of Statistics. Electronics maker Hon Hai's recent response to labor cost increases in its core Southeast China factory zone gives a more accurate indication of what further RMB appreciation might do to manufacturing. Hon Hai is preparing to spend billions of dollars to construct

manufacturing bases to tap a lower cost workforce near the inland Chinese cities of Chengdu, Wuhan, and Zhengzhou, which could eventually employ nearly two-thirds of the firm's workforce, according to the *Wall Street Journal*. In addition to moving to China's interior, manufacturers facing higher labor costs from RMB appreciation would also likely relocate portions of their operations to countries such as Vietnam with even lower average wages than China's. As such, the US would likely experience a diversification of its trade deficit, as opposed to a significant reduction.

Negative effects of continued RMB appreciation versus the Dollar

2) **Inflation from higher commodity buying in China will likely put pressure on US consumers as commodity prices rise and potentially restrain US and global growth outside China.** A more valuable RMB would make it less expensive for Chinese industrial firms and traders to purchase commodities that China needs such as crude oil, corn, coal, iron ore, and copper, which are often sold in dollar-denominated terms. Over the longer-term, a stronger RMB is also likely to boost domestic consumption in China, which stands to unleash sustained higher demand for oil (through rising vehicle ownership), electricity, grains (through higher meat consumption), as well as paper and aluminum as the domestic demand for goods packaging expands. This would be great news for Exxon and Alcoa as well as US farmers, but not for US consumers more generally.

3) **China might purchase fewer dollars or rebalance its foreign exchange portfolio, creating downward pressure on the dollar and causing challenges for managing the US national debt and maintaining the dollar's position as a key global reserve currency.** In a recent piece in *Caijing*, Fudan University economist Sun Lijian points out that continued US pressure to increase the RMB's valuation could force China to trim its US debt holdings, which could destabilize financial markets and reduce confidence in the dollar as a stable international currency. (如果美国这种强权的举措导致贸易货币国, 比如中国人民币大幅升值, 那么, 中国政府很可能不得不减持价值收到日益侵害的美国国债的比例, 这样也不利于美国金融市场和国际金融市场的稳定和作为世界信用货币的美元的稳定.)

Key positive impacts of continued RMB appreciation versus the Dollar

4) **The bill draws a line in the sand with respect to mercantilistic Chinese economic policies and is a first step toward re-establishing the credibility of US economic diplomacy with China.** The bill's overwhelming passage through the House, combined with growing anti-trade sentiment in the US, is garnering attention in China. Over the

past few weeks, Chinese media outlets have published many news and opinion pieces on the issue. By putting Beijing on notice that its key partner is ready to take tough action, Washington can help tip the internal debate in China in favor of those leaders who support a more free market economic policy approach.

5) **Chinese companies would likely become more active in acquiring hard (i.e bricks and mortar) assets outside China, opening a new avenue of global investment and advisory opportunities.** A stronger RMB would increase Chinese corporations' ability to buy dollar denominated assets overseas. Sectors likely to see the most activity include natural resources, IT, and possibly real estate. Outbound investment would likely become more focused on North American and European assets than in the past, when frontier markets offered more attractively priced assets and a more welcoming posture concerning Chinese investment. In certain areas, this could introduce Chinese competition into the business and real estate sectors that American firms and property owners did not have to face previously.

6) **A stronger RMB will be good for US companies that export to China.** Many Americans don't realize that the U.S. still has the largest manufacturing sector in the world, and that China is only now poised to assume the #1 global manufacturing position. US factories produced US$1.7 trillion worth of goods in 2009, while Chinese manufacturers produced US$1.6 trillion of goods, according to IHS Global Insight. A stronger RMB and its positive effects on Chinese consumers' purchasing power will be positive for companies such as Caterpillar and Boeing that export high quality, high cost equipment.

7) **A stronger RMB can help China move its economy onto a more sustainable path in which domestic consumption occupies a larger portion of GDP and higher value-added sectors such as IT receive more investment.** More robust growth in value-added sectors with greater reliance on intellectual property can drive development of stronger rule of law in China, as inventors seek legal protection for the fruits of their labor.

The net effect for US consumers and the US economy from the Currency Reform for Fair Trade Act is likely to be neutral or even negative, which could leave voters disappointed and drive US economic diplomacy down a more protectionist path. Americans from all economic strata are casting an increasingly skeptical eye on trade, with 53% of respondents in a recent *Wall Street Journal* poll saying free trade agreements hurt the US (up from 46% in 2007 and 32% in 1999). Currency valuation is important but US economic and trade diplomacy with China should also strive to ensure that fair competitive practices are followed (i.e that state interference is minimized) and that the intellectual property of US-based firms operating in China is protected. It remains to be seen whether the Senate will pass the Currency Reform for Fair Trade Act, but the immediate concrete effects in terms of job creation and reductions in the US trade deficit would likely leave voters disappointed when the smoke cleared.

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China SignPost™ 洞察中国 *founders Dr. Andrew Erickson and Mr. Gabe Collins have more than a decade of combined government, academic, and private sector experience in Mandarin Chinese language-based research and analysis of China. Dr. Erickson is an associate professor at the U.S. Naval War College and fellow in the Princeton-Harvard China and the World Program. Mr. Collins is a private sector commodity specialist focused on China and Russia.*

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