

Will a Re-Valued Yuan Reduce the Trade Deficit?

In recent years, the discussion in Washington regarding the U.S.-China economic relationship has focused in large part on China's currency policy. Many U.S. policymakers assert that an undervalued yuan makes cheap Chinese exports even cheaper, giving Chinese producers an unfair advantage over American companies and contributing to the U.S. trade deficit with China.

A market-determined yuan is important – for China and the rest of the world – and the United States should continue to encourage China to take meaningful steps to accelerate progress toward that goal. While doing so, however, we should not allow the currency issue to overshadow the broader potential of the U.S.-China economic relationship. In fact, because a higher-valued yuan would mean that imported Chinese goods would be more expensive, the short term effect of a significant appreciation would likely be to make the trade deficit *worse*.

Of far greater significance to the long-term policy goal of reducing America's trade deficit with China is helping to activate China's 1.3 billion potential consumers. A simple example illustrates the enormous potential impact of greater spending by Chinese consumers:

Last year, the United States exported to Japan goods and services worth \$60 billion – approximately the same amount exported to China (\$55 billion). But China's population of 1.3 billion is ten times Japan's population of 127 million. If U.S. exports are expressed in relation to population, the U.S. sold the equivalent of \$472 worth of goods and services to every citizen of Japan last year, but only about \$40 worth of goods and services to every Chinese citizen.

If China's citizens were to eventually consume American-made goods and services at the same rate that Japan's citizens did last year, the United States would export more than \$610 billion worth of goods and services to China, 11 times what America exported to China last year, an amount equivalent

to 5 percent of America's GDP, and more than twice what it imported from China last year – replacing the trade deficit with a significant surplus.

But in order to mobilize its 1.3 billion consumers, China needs a more open, competitive, and effective financial system. Chinese households historically save as much as 40 percent of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, and the economic consequences of accidents or disasters. Activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance products, and insurance intermediary services – that will reduce the need for such precautionary savings and facilitate consumption.

The fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth, allow for a more flexible currency, and increase consumer consumption is to import it – that is, by opening its financial sector to greater participation by foreign financial services firms. Foreign institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the forces of competition brought by foreign institutions would accelerate the development of modern financial techniques and methodologies by China's financial institutions.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and consume at higher levels, foreign financial institutions (including U.S. providers) would help create what every U.S. manufacturer and service provider wants – an unleashed Asian tiger hungry for U.S. products.