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COMMENTARY

Yuan Worries

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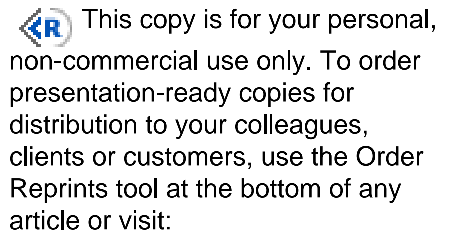
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By MATTHEW J. SLAUGHTER
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Fact 1: China runs a large and growing trade surplus with the United States. In 2006, the goods-trade surplus exceeded $232 billion. This was an increase from 2005 of $31 billion, an amount larger than the entire deficit just 12 years ago.

Fact 2: China focuses its monetary policy on fixing the exchange value of its currency, the yuan, relative to the U.S. dollar.

Many policymakers and pundits connect these two facts by asserting that an unfairly low value of the dollar-yuan peg is causing the massive bilateral trade imbalance. The 109th Congress introduced 27 pieces of anti-China trade legislation. The current Congress already has over a dozen such bills, many aiming to force an overhaul of China's exchange-rate regime. And late last week dozens of House members were poised to file a Section 301 petition, asking the U.S. Trade Representative to investigate undervaluation of the Chinese yuan.

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These misgivings about the dollar-yuan peg are misplaced. Economic theory and data are very clear here on two critical points. Controlling a nominal exchange rate is a form of sovereign monetary policy. And monetary policy, in turn, has no long-run effect on real economic outcomes such as output and trade flows.

Like all other central banks, the People's Bank of China uses its monopoly power over minting its money to control one nominal price. Since 1994 the PBOC has chosen to closely target the dollar-yuan price. In recent times, maintaining this target has required the PBOC to print yuan to buy dollars and thereby accumulate dollar-denominated assets on its balance sheet.

Many central banks today use their sovereign power to fix a nominal short-term interest rate rather than a nominal exchange rate. The U.S. Federal Reserve targets the federal-funds rate; the European Central Bank targets the main refinancing operations rate; and the Bank of Japan targets the overnight call rate. But exchange-rate targets are by no means uncommon. Indeed, in 2005, 55.6% of the world's countries fixed their exchange rates. And many countries have switched their targets over time. From 1945 to 1971, for example, the Federal Reserve targeted the value of the dollar at $35 per ounce of gold.

To select a policy target, each central bank must evaluate how alternatives might (or might not) influence its monetary-policy goals. Chinese capital markets today lack many of the microeconomic institutions that transmit changes in short-term interest rates into the broader economy: e.g., a primary-dealer market in government debt securities and, more generally, a deep network of investment and commercial banks allocating credit guided by risk-adjusted returns. This may well be one reason the PBOC maintains its exchange-rate target: An interest-rate target might weaken its linkages to the real economy. And just like other central banks, the PBOC has been adjusting its target nominal price gradually, without dramatic changes that can have adverse short-run impacts.

But hasn't the nominal dollar-yuan peg unfairly driven the long-run rise in trade imbalances? No. The exchange rate that matters for trade flows is the real exchange rate -- the nominal exchange rate adjusted for local-currency output prices in both countries. Supply-and-demand pressures in international markets can, and do, alter not just nominal exchange rates, but also nominal prices for goods and services. And these pressures driving the real exchange rate, in turn, reflect the deep forces of comparative advantage such as cross-country differences in technology, tastes and endowments of labor and capital.

To demonstrate this critical point, look to Europe. The yuan floats against European currencies such as the euro and the pound. If nominal exchange rates were driving trade flows as commonly alleged, then Chinese exports to the U.S. should have been growing faster than to Europe. The data show something completely different, however. In 1995, monthly Chinese exports to both destinations averaged about $2 billion. By 2006, monthly Chinese exports to both destinations were still the same, at about $17 billion. Plotted together over that entire decade, these two series look nearly identical. This is because the same real economic forces -- e.g., China's relative abundance of less-skilled labor -- have been driving both sets of trade flows.

Put it this way: In a counter-factual world where over the past decade China allowed the yuan to float against the dollar, the U.S. would still have run a large and growing trade deficit with China. The real economic forces of comparative advantage that drive trade flows operate regardless of which nominal prices central banks choose to fix.

This week the U.S. government hosts Chinese officials for the second round of the Strategic Economic Dialogue. Treasury Secretary Henry Paulson and Chinese Vice Premier Wu Yi have framed the SED as a forum to address complex policy issues associated with the links between our two countries. In China, further capital-market reform is needed to support economic growth via better risk management and capital allocation throughout all sectors of the economy. Here at home, the large aggregate gains the U.S. has realized from freer trade and investment with China have also generated hardship, too. Many American

workers, firms and communities have been hurt, not helped, by Chinese competition.

Issues like these are legitimate and real. But focusing on the dollar-yuan peg is a misplaced and counterproductive way to address them. Instead, let China continue to conduct its sovereign monetary policy and let the SED continue to engage the real challenges. Stop fixating on the fix.

Mr. Slaughter, a professor at the Tuck School of Business at Dartmouth and research associate at the National Bureau of Economic Research, was a member of the Council of Economic Advisers from 2005 to 2007.

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