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COMMENTARY

Classical Theory vs. the Real World

By AMAR BHIDE and EDMUND PHELPS July 25, 2005

After extensive jaw-boning by the U.S., China has let its currency strengthen by about 2% against the dollar --its first official appreciation in a decade. The Bank of China said that the move would help "bring exports and imports into balance." Most observers said that the 2% revaluation was an important symbolic step -- the currency would have to appreciate by as much as another 30%.

Should the Bush administration continue to press China for a more substantial revaluation? Would the elimination of China's trade surplus with the U.S. do the U.S. any good? The received wisdom recognizes that U.S. consumers benefit from the subsidy China provides through an undervalued currency; furthermore, that China, in purchasing treasury bills to prevent appreciation of its currency, effectively subsidizes American borrowers by lowering interest rates. But critics claim these gains are more than offset by the inability of U.S. producers to export their goods to China because of the implicit tariff of an undervalued yuan. Moreover, China itself is also believed to be a net loser because its consumers have to pay high prices for imports. Therefore, eliminating the currency distortions that lead to imbalanced trade will benefit both countries.

Unintended consequences however could turn win-win into lose-lose. We fear that substantial yuan revaluations could do more than increase the prices of imported goods and borrowing costs. The expected offsetting benefit of higher exports might not materialize, since China's other trading partners may be better positioned to take advantage of its appreciated currency. Indeed, it is conceivable that if China refrains from accumulating reserves to strengthen its currency, its total purchases from the U.S in the long run may actually be less rather than more. And, from China's perspective, the pursuit of balanced trade may in fact hinder its development.

This received wisdom is certainly consistent with classical theories, which abhor trade-surpluses and regard the accumulation of large reserves as a pathology. But, as we see it, the classical theories overlook two reasons that can lead to "imbalances" in the trade between a technologically advanced country like the U.S. and a technologically backward country like China in the absence of misguided policies.

• First, the classical view of the gains from trade sees only the advantages arising from differences in natural endowments. It behooves Britain, where it rains a lot, to focus on rearing sheep and making wool and to let sunny Portugal grow grapes and make port. The comparative advantage of a backward country vis-à-vis its advanced trading partner, however, derives from its lack of know-how. Or more precisely, the comparative advantages of a country like China lie in activities such as making shoes and textiles, where the technology in the U.S. is the most rudimentary. Conversely, whereas the U.S. may have an absolute advantage on every front, its comparative advantage lies in activities where its technology has made the greatest advances, such as 747s and MRIs.

Now, although exporting shoes and textiles and importing goods that require advanced know-how improves living standards in China, it cannot raise them to U.S. standards. One of many reasons is that the costs, broadly defined, of shipping and selling goods across the Pacific limit what can be economically traded. Therefore, long-run development -- as opposed to a one-time gain from opening up the economy to trade -- requires China to acquire advanced know-how.

A trade surplus -- exporting more shoes than it imports 747s -- allows China to pay for this know-how. Moreover, it may be technically or contractually difficult, or economically undesirable, to buy know-how like salami -- on a piecemeal basis. Therefore it may benefit China to save up its surpluses to buy large lumps of knowhow in the future, or to make payments on the debts it previously incurred for its know-how purchases. In other words, wide disparities in economic development can engender imbalances borne of constructive rather than misguided mercantilism.

• Second, classical theories also ignore the ignorance of consumers. When China first opened up to trade, it is likely that the elite in Beijing and Shanghai craved Western goods that had previously been unavailable or unaffordable. But could there have been much pent-up demand for lipstick or shampoos among the collectivized peasants in remote provinces? How many such individuals would even have encountered such products or known how to use them? Marketing campaigns and word of mouth may "Westernize" Chinese consumers; but in the interim, relatively tepid demand for some of the goods in which U.S. producers have a comparative advantage may tilt China's trade balance with the U.S. into a surplus.

The interaction of the two considerations makes it difficult for both countries to formulate sensible policies. In principle, a rational constructive mercantilism is a fine strategy for China: If underdeveloped financial markets and weak institutions preclude the accumulation of the funds necessary to purchase advanced know-how, it may be desirable for China's central bank to maintain an exchange rate that generates surpluses and invest that surplus in dollar reserves. But the unfamiliarity of Chinese consumers with Western goods, which also dampens imports, may make a deliberate restraint unnecessary or even counter-productive. For instance, China may inadvertently over-restrain imports and accumulate more reserves than it really needs.

For U.S. policy makers, our analysis suggests considerable caution in pushing China to rapidly revalue its currency and stop its accumulation of reserves. It is very difficult for anyone to tell to what degree the large bilateral trade imbalances would respond to policy changes. Our analysis suggests that Chinese consumers have a higher natural propensity to consume goods from countries that are closer to China in their level of development than is the U.S., so exporters from these countries are likely to benefit more from a stronger yuan than are U.S. exporters. Worse yet, from the U.S. point of view, China's accumulation of reserves not only restrains interest rates in the U.S. and the whole world; it also represents a store of funds for future purchases of U.S. goods, services, know-how and companies. What good can it do to drive those funds away where they would be used to bid up the prices of someone else's exports, know-how and shares?

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