LOWY INSTITUTE
FOR INTERNATIONAL POLICY

NOVEMBER 2003

ISSUES BRIEF

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REVALUING THE RENMINBI: A CASE OF 'DÉJÀ VU ALL OVER AGAIN?'

EXECUTIVE SUMMARY

There are strong parallels between today's US-China tensions over trade, and US-Japan economic relations in the 1980s.

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US policymakers and politicians are debating how best to manage the external adjustment needed to reduce the US economy's gaping trade and current account deficits. In particular, their attention has focused on the rapid growth in the US's bilateral trade deficit with a major Asian trading partner. Politicians have expressed concern about the "unfair competition" they perceive as undermining US industrial performance and costing manufacturing sector jobs, and while some policymakers argue that what is needed is a strengthening of the trading partner's currency, there have also been calls for a trade policy response.

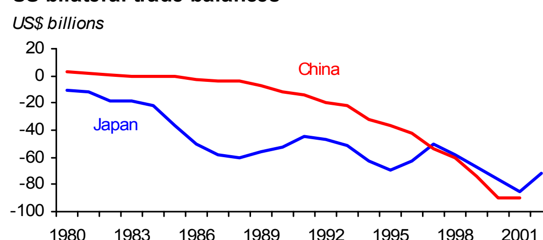
No. It's not China and the renminbi. It's the United States and Japan in the 1980s. During the Reagan presidency, when the US economy was labouring under large fiscal and current account deficits – the so-called "twin deficits" – public opinion became increasingly exercised about a growing US bilateral trade deficit with Japan. This had ballooned from around US$12b in 1980 to almost US$60b by 1987, and the objective of rebalancing US-Japanese trade became a key element of US economic policy, and a key political objective for the administration.

To understand what's happening now, it is worth looking back at that last example of American concern about Asian economic competition.

Initially, the US looked to trade policy solutions (for example the negotiation of voluntary export restraints). But by the mid-1980s Washington also began to press Japan to liberalise its domestic financial system and "internationalise" the yen, in the hope that this would lead to currency appreciation and a change in relative competitiveness. Currency adjustment was given further impetus in 1985, when the finance ministers of the G5 (US, Japan, France, Germany, UK) met at the Plaza Hotel in New York and agreed to co-ordinate financial policies in order to weaken the greenback. The result was a huge swing in the yen-US dollar exchange rate (along with a more general dollar depreciation on a trade-weighted basis), with the yen climbing from around 240 to the US dollar in 1985 to 144 to the dollar in 1987. Indeed, the success of this strategy prompted another meeting of finance ministers in 1987 – the Louvre Accord – to stabilise the greenback.

US bilateral trade balances

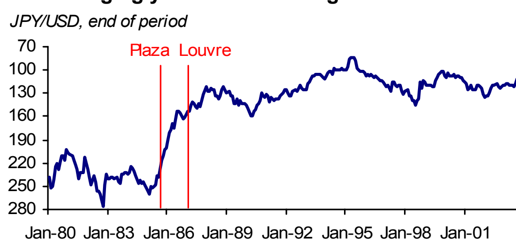
US$ billions



Source: IMF Direction of Trade Statistics Yearbook, various years

In the 1980s currency adjustment provided no immediate panacea to the bilateral trade imbalance. It took time for dollar depreciation to influence the external balance. The rising relative price of imports meant that the initial impact of a weaker dollar on the trade deficit was in the "wrong" direction (the so-called J-curve effect), and the deficit continued to rise until 1987. Even once the overall deficit began to decline, the degree of adjustment in the bilateral US-Japan trade deficit was relatively modest, and Japan's *share* of the overall deficit

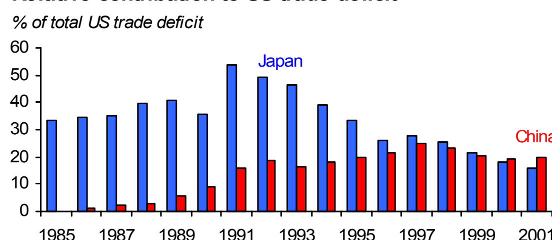
actually increased. So despite significant yen appreciation, the US again turned to trade policy to achieve its objectives – including the imposition of a 100% tariff on the import of some Japanese electronics goods in 1987 and the 1988 enactment of "Super 301" trade legislation allowing the US Trade Representative to target foreign trade practices. Washington also stepped up pressure on Japan to pursue a more expansive macroeconomic policy. Some economists now reckon that Japan's large asset price bubble and the economy's subsequent post-bubble problems originated in the yen appreciation and the external pressure to inflate domestic demand.



Source: RBA Quarterly Bulletin, various issues

There are clear parallels between the US economic situation today and in the 1980s.

The US is again running large fiscal and current account deficits, with the IMF projecting a current account deficit of around 5% of GDP this year and a general government deficit closer to 6% of GDP. And once again, with the US facing the need for broad-based external adjustment, attention has focused on one particular bilateral trading relationship. The US bilateral trade deficit with China has risen from US$11.5b in 1990 to US$90b in 2001, and is currently running at an annual rate of over US$100b. Moreover, China has now overtaken Japan as the largest single bilateral contributor to the overall trade deficit.



Source: IMF Direction of Trade Statistics Yearbook, various years

Currency adjustment, this time either though a move by China to a floating currency or, more realistically, via a one-off revaluation of the renminbi, is again being proposed as a way to rebalance bilateral trade, and there has even been an (admittedly fairly feeble) attempt to resurrect a currency steering role for the G7, with this year's Dubai communiqué calling for greater flexibility in exchange rate management.[1] At the same time, in the run-up to next year's presidential elections, some US politicians are warning that in the absence of an adjustment to Chinese exchange rate policy, trade policy options will be considered. The US Senate is reviewing a bill that would impose 27.5% tariffs on Chinese imports, along with a proposal to eliminate China's Permanent Normal Trading Relations status, while the House of Representatives is considering measures including tariffs of up to 40%. Given the lagged response of trade to exchange rate moves as seen in the earlier case of Japan, there

[1] Shortly after the Louvre Accord the G5 became the G7 with the addition of Italy and Canada.

is a risk that even if China did agree to some exchange rate adjustment, the pressure for trade sanctions would remain, and perhaps even grow.

Are current Sino-US economic tensions a case of "déjà vu all over again"?

It seems fair to say that while one of the players may have changed, the overall economic game remains the same. China's current international economic policy – pegging its exchange rate to the greenback at a competitive rate and pursuing export-led growth by selling into the all-important US market – is very much the same growth strategy that was pursued by Japan, and subsequently by South Korea and Taiwan, and after them the South East Asian "Tiger" economies. Indeed, a variant of the same policy was also adopted by some of the countries of Western Europe after the Second World War.

But while a broad similarity is evident in the US-Japan and US-China stories, several significant differences exist.

Japan in the 1980s was already a leading industrial economy, while the Chinese economy – for all its recent strength – remains an emerging market, with serious economic and financial vulnerabilities. As a result, proposals that would be appropriate for a developed economy with mature financial markets – for example, a floating exchange rate – look much less sensible for China, at least in the near term.

Another difference is that while in the 1980s some commentators argued that Japan's relatively closed economy (Japan's ratio of imports to GDP in 1985 was about 11%, while the ratio of trade to GDP was about 25%) meant that Japan was somehow taking "unfair advantage" of the global trading system, China now boasts a relatively open economy, especially for an emerging market. China's ratio of imports to GDP (about 25% last year) and its ratio of trade to GDP (about 52%) are significantly higher than Japan's, either in 1985 or indeed today.

A third difference relates to the changing role of foreign direct investment (FDI) in the world economy. In the 1980s the role of overseas FDI in the Japanese export machine was of little significance. Instead, following the appreciation of the yen against the US dollar, some US commentators started to worry that *Japanese* FDI into the US was swallowing up US corporate assets in a "fire sale". In marked contrast, many of the exports that China is now pushing into the US are manufactured in foreign-owned companies, with other East Asian economies in particular now using China as their export platform into the US.

The risk is that the pressures of an election year and the rapid growth of the US-China trade imbalance will see the US tempted to apply to China the same policy responses that were earlier used in the case of Japan. The historical record suggests that the effectiveness of these policies in dealing with the US-Japan trade imbalance was limited at best, and at worst contributed to Japan's economic malaise. There is little reason to expect that, if repeated, they would have any better consequences this time around, and some grounds for fearing that the economic costs could be greater.