

Competition Matters: China's Exchange Rate and Balance of Trade

Dr. Anwar Shaikh

New School for Social Research

UNITED STATES

The US has run a massive trade deficit for over 30 years. In recent times there has been a growing chorus of commentators who seek to place the blame on our trading partners, most notably China, just as in an earlier time others had targeted Japan and Germany. It is said that the problem stems not from our reduced international competitiveness, but rather from the manipulation of exchange rates by our more successful trading partners.

This claim is not based on any direct evidence, but rather on an inference derived from standard international trade theory which predicts that free trade will automatically lead to balanced trade. From this particular theoretical perspective, our large and persistent large trade deficit must be rooted in some obstacles to free trade. The large surpluses of our trading partners such as China then make them natural candidates for our opprobrium. Of course, if the standard theory is incorrect, this line of inference collapses. I wish to argue that the standard theory is wrong, on both theoretical and empirical grounds, and that free trade does not automatically eliminate trade imbalances. On the contrary, free trade *reflects* international competitiveness, and persistent trade deficits are symptoms of persistent competitive weakness.

The theory of international trade is actually a subset of the general theory of competition. In a business driven world, international trade is largely conducted by *businesses*. Domestic exporters sell to foreign importers who in turn sell to their residents, while domestic importers buy from foreign exporters and sell to us. At each step in the chain, it is profit that motivates the business decision. Standard (comparative cost) theory rests on the proposition that a trade deficit in a country will drive down the real price of its currency, which in turn will reduce the deficit, until at some point both the balance of trade and the balance of payments are automatically

reduced to zero. A trade surplus would have the opposite initial effect, bringing once again back to this double balance. When the nominal exchange rate is fixed, as it was during the Bretton Woods era, a trade deficit generates a money outflow, and this is assumed to lower the national price level, thereby making the country's goods more competitive on a world scale. When the exchange rate is flexible, as it has been since the collapse of the Bretton Woods agreement in the early 1970s, a trade deficit is assumed to depreciate the currency, once again making the country more competitive on the world market. In either case, the process is supposed to operate until the trade deficit has been eliminated.

In his book *International Economics* (1957), the eminent Oxford economist Roy Harrod came to a rather different conclusion: in a trade deficit country, the resulting money outflows decrease liquidity and increase interest rates, while in the trade surplus country the opposite effect obtains and interest rates decrease – all through the normal reactions of financial markets. Neither of these substantially alters the trade balance. Instead, they induce short term capital flows, which are highly sensitive to interest rate differentials, into the high interest rate (trade deficit) country from the low interest (trade surplus) country. Such a process will continue until the overall balance of payments in each country is in equilibrium. In other words, the normal operations of free markets tend to cover trade deficits with international debt, and offset trade surpluses through international lending¹. As long as neither side does anything to intervene, the differences in trade balances arising from differences in international competitiveness are maintained. This is why successful countries have always known that one must first build up a country's competitiveness. In earlier times this was the policy of the UK, Germany, France and the US. In more recent times, it has been that of Japan, South Korea, and China.

In a recent article on China, David Leonhardt says that "there is ... no question that China's currency remains undervalued"² because "the huge demand for Chinese goods should be driving up the price of its currency". Since China's large trade surplus has not driven up its exchange rate, he concludes that "Beijing has been intervening to prevent that". Note that this explicitly relies on the standard theory. Leonhardt also cites estimates of the extent to which China's exchange rate is supposedly undervalued. Yet all such estimates are also derived from models that assume that balanced trade is the normal outcome of free trade. The renowned trade theorist and Nobel Laureate Paul Krugman takes the same stance, accusing China of obstructing the "automatic mechanisms" of international trade which would otherwise bring about automatic balance.³ He too explicitly links his inference to the underlying expectation that free trade will automatically lead to balanced trade – a proposition which he has elsewhere called a 'sacred tenet' of standard theory.

It is precisely this tenet that Harrod disputed. He was well aware that the absolute

level of a country's trade balance is also affected by (domestic and foreign) output levels, and vice versa. But this feedback does not imply that trade will be automatically balanced through output effects alone. Indeed, in the real world, persistent trade balances are perfectly normal even in the post Bretton Woods era of flexible exchange rates. A central implication of this argument is that competitiveness matters. A country's terms of trade is a relative price, the price of its exports relative to the price of its imports expressed in common currency. On the argument of standard trade theory this will adjust automatically to ensure trade. But within the alternate framework I propose, a country's terms of trade is regulated by relative real costs – in much the same manner a relative price within a country. This can be demonstrated at an empirical level, and it explains several patterns which appear puzzling to standard theory. Most importantly, it provides an empirical benchmark for the real exchange rate which could be highly relevant for policy purposes.⁴

The foregoing argument does not exclude the possibility that China pegs its exchange rate below the free market level. What it does tell us is that we cannot simply make any such inference from the mere existence of China's trade surplus and our trade deficit. And then, having consulted different stars, we may find that some part of the fault lies in ourselves.

1 Roy Harrod, *International Economics*, pp. 90-96, 112-116, 130-138

2 David Leonhardt, "The Long View of China's Currency", *New York Times*, September 21, 2010)

3 Paul Krugman, various articles in the *New York Times*, 2007, 2009, 2010. See for instance "China, Japan, America" in 2010.

4 Shaikh, Anwar and Rania Antonopoulos. 2012. "Explaining Long-Term Exchange Rate Behavior in the United States and Japan " In *Alternative Theories of Competition: Challenges to the Orthodoxy*, ed. J. Moudud, C. Bina and P. L. Mason. Abingdon: Routledge.