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## The Minimal Impact of a Chinese Revaluation

A trade deficit means that a nation's spending on foreign-produced goods and services exceeds the value of its production shipped abroad. In 2004, U.S. imports exceeded exports by \$618 billion. Much public attention has been focused on the major component of this trade deficit—the bilateral deficit with China. U.S. imports from China exceeded exports to China by \$162 billion, 26 percent of the total U.S. deficit. Year-to-date figures comparing 2005 with 2004 indicate that this bilateral deficit continues to increase.

One common suggestion is that China revalue its currency so that fewer yuan are required to purchase a dollar. In fact, on July 21, China announced that it had revalued its currency by 2 percent. This revaluation will initially make Chinese-produced goods slightly more expensive for U.S. consumers and firms and make U.S.-produced goods slightly less expensive for Chinese consumers and firms. It is expected that these price changes will ultimately reduce U.S. imports from China and raise U.S. exports to China, shrinking the U.S. bilateral trade deficit with China.

But will this revaluation, or even a substantially larger one, shrink the overall U.S. trade deficit? Two arguments suggest that any shrinkage stemming from reduced imports is unlikely. First, Chinese revaluation will likely push U.S. purchases away from China toward other low-cost countries in Asia and Latin America rather than toward relatively high-cost producers in the United States.<sup>1</sup> Thus, *overall* imports will be unlikely to fall much.

Second, a Chinese revaluation initially will lower the price paid for imported oil in China—which will likely increase Chinese consumption of oil. Increased Chinese purchases of oil in international markets will then raise the price (in dollars) of oil. A reasonable expectation is that the higher price of oil would cause only a small decline in U.S. oil consumption. Consequently, the value of U.S. oil imports will rise, increasing the U.S. trade deficit.

The preceding discussion reflects the fact that overall trade deficits are not due to deficits with one country, but rather are macroeconomic phenomena. The \$618 billion deficit is due to U.S. imports being greater than exports across numerous countries. In fact, the U.S. bilateral deficit exceeded \$45 billion for four other countries: Japan, \$75.2 billion; Canada, \$66.8 billion; Germany, \$45.9 billion; and Mexico, \$45.1 billion. Changing one price—the yuan/dollar exchange rate—is unlikely to have a substantial effect on the U.S. trade balance.

—Cletus C. Coughlin

<sup>1</sup> This idea was expressed by Alan Greenspan in response to a question at the Economic Club of New York on May 20, 2005.