San Francisco Chronicle

OPEN FORUM

Of Barbie, Chinese currency policy and the U.S. trade deficit

David Parsley, Helen Popper

Monday, August 8, 2005

One of the biggest stories in global financial markets this summer was China's switch from pegging its currency to the dollar, to tying the yuan to a basket of currencies. The switch also revalued the yuan by 2.1 percent in relation to the dollar.

This modest adjustment may, perhaps temporarily, appease those in Congress who have been calling for unilateral tariffs on Chinese imports with the goal of reducing the U.S. trade deficit and spurring employment. The reality, however, is that increasing the value of the yuan will have little meaningful impact on the trade imbalance and adding tariffs would not help much, either.

The congressional demands are based largely on a seductive supposition that a stronger Chinese currency will make Chinese goods more expensive, discouraging U.S. consumers from buying them. This supposition does not hold up to scrutiny. The United States has amassed a huge trade deficit because it spends more than it produces and is able to borrow low-cost money in international capital markets to feed its appetite for Chinese and other imports.

The reason that the revaluation (or even tariff changes) won't impact trade flows is because, in general, very little of any such change gets passed through to consumer prices. That's been true of changes in the euro, the yen, the peso and the pound. It would be no different for the yuan, because consumer prices of most internationally traded goods are largely a reflection of "local value-added," or the costs incurred in the importing market right up to the point of purchase. In the United States, as elsewhere, these costs include labor, rent and utilities, as well as marketing, distribution and transportation -- none of which is affected by international exchange rates. Only the initial component -- the import price -- is affected by exchange rates, and that component is often a small piece of a product's final cost.

A compelling look at the local value-added effect is provided by Mattel, which produces Barbie dolls in China. Much of a Barbie's ultimate price tag -- about $10 -- comes from transportation, distribution and retailing costs in the United States. The cost of actually producing the doll in China is about $1. That means the current revaluation of the yuan would increase the consumer retail price by only two cents. Even if Congress' exchange-rate mandates were met, or tariffs were imposed in the amount of 27.5 percent on Chinese imports -- the figure central to the proposed Senate Bill 1586 -- the price of a Barbie would only rise to about $10.28.

Other factors would undercut even this modest increase in Barbie's retail cost. The stronger yuan could enable Chinese manufacturers to purchase individual components such as nylon hair from Japan and plastic resins from Taiwan at lower cost. Also, should costs rise significantly in China, Barbie production can be shifted to lower-cost markets, as it was when Mattel originally migrated from Taiwan to mainland China more than a decade ago. In fact, Mattel already manufactures millions of low-cost Barbies in Indonesia. So, if Barbie is typical of U.S. imports (and research by us and others suggests it is), tinkering with tariffs or exchange rates will have little impact on the trade imbalance between the United States and China.

What, then, would it take to slim down our trade deficit? As a nation, our trade deficit is financed by borrowing. That is, running a trade deficit means we borrow from abroad. So, slimming down our trade deficit requires reducing international borrowing.

This is where Congress and the White House can play a key role. The government's budget deficit accounts for the lion's share of our nation's net borrowing, and it's a piece that is the responsibility of Congress and the White House. They may have temporarily extended their job descriptions to include managing China's exchange rate. But, doing what they, and they alone, can do -- managing the U.S. government's spending relative to tax collections -- would have a genuine effect on the trade deficit.

David Parsley is associate professor of management at the Vanderbilt Owen Graduate School of Management. Helen Popper is associate professor and chair of the economics department at Santa Clara University. They are co-authors of several studies investigating exchange-rate changes and domestic prices.