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New American Contract Policy Paper

Recalibrating U.S.-China

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June 11, 2009

The United States now confronts its greatest economic challenges since the Great Depression. In addition to resolving crises in financial and housing markets, trade deficits with China and on oil must be addressed for the U.S. economy to achieve robust growth.

Fixing credit markets and energy policy are largely domestic challenges, whereas recalibrating trade with China requires cooperation from Beijing. However, such cooperation requires fundamental changes in Chinese industrial policies and a departure from maintaining an undervalued yuan to spur industrial development.

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Eliminating the trade deficit with China by redressing currency manipulation would have a much greater stimulus effect on the economy than the stimulus spending approved by Congress.

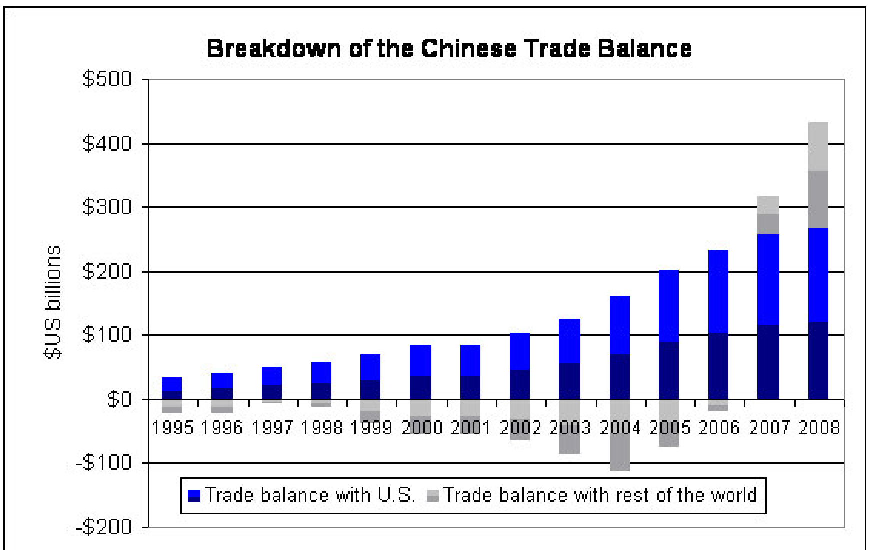
Related Programs:

Economic Growth Program, Smart Globalization Initiative

Chinese Industrial and Currency Policies

Since the late 1970s, China has transformed from a centrally-planned economy dominated by state enterprises to a public-private economy highly responsive to global market opportunities.

China has accomplished dramatic growth and modernization by empowering town and village enterprises, private businesses and foreign-invested enterprises, and delegating smaller, though still significant, roles to national state-owned enterprises. Exports are critical to this strategy.



source: International Financial Statistics, International Trade Commission

In addition to exploiting comparative advantages in labor-intensive manufacturing, China has applied industrial policies and regulation on foreign investment to ensure the rapid development of priority industries where it may lack the resources, technology and a comparative advantage.

For example, China lacks adequate metallic resources to produce large amounts of steel competitively, and modern capital equipment and technology were initially purchased on global markets. Yet, China exports steel even when transportation costs to destination markets are greater than total labor costs in those markets. Similarly, China should be importing many more automobiles to meet its requirements, but Beijing encourages foreign automakers to assemble cars and source parts in China, and to transfer technology to indigenous firms.

China maintains an undervalued yuan that makes exports cheaper in foreign markets and imports more expensive at home. The Chinese government persistently purchases dollars and other currencies with yuan to suppress its value, rather than permitting market forces to determine its value. It converts those purchases into U.S. Treasury securities and foreign assets.

In 2008, Chinese monetary authorities purchased more than $400 billion in U.S. and other foreign currencies-this was about 10 percent of China's GDP and 25 percent of its exports. China holds about $2 trillion in foreign exchange reserves, mostly in U.S. securities.

Undervaluation subsidizes exports and protects domestic industries from import competition, and contributes importantly to trade deficits in the United States and other countries. The Chinese people consume 10 percent less than they produce to finance China's large trade surpluses and production that exceeds consumption in the United States and elsewhere.

The rapid pace of modernization and productivity growth in China should rapidly drive up the dollar value of the yuan; however, in 1995, the Chinese government pegged the yuan at 8.28 per dollar.

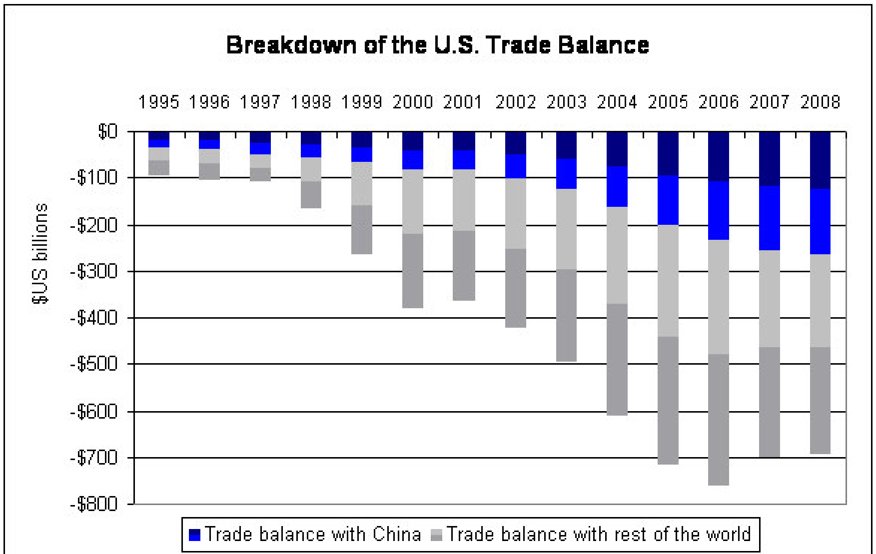
In July 2005, China adjusted this peg to 8.11 and announced the yuan would be aligned to a basket of currencies. Subsequently, the yuan still tracked the dollar quite closely, falling slowly to 6.83 it July 2008. Since, the yuan has fluctuated closely around that value-essentially, China has repegged the yuan.

From 1995 to 2008, the annual U.S. trade deficit with China grew from $34 to $266 billion, accounting for virtually all of the increase in the U.S. non-oil deficit from $44 to $282 billon.

Trade Deficits and U.S. Economic Growth

Imported oil petroleum contributes significantly to the U.S. trade deficits. From 1995 to 2008, the petroleum deficit increased from $34 to $386 billion. This huge deficit is caused primarily by the failure to impose higher mileage standards on automobiles, implement other fossil-fuel saving technologies, and to develop U.S. domestic oil and gas resources.

Together, imports of oil and from China account for 90 percent of the U.S. trade deficit, and that deficit has averaged more than 5 percent of GDP over the last five years.



source: International Trade Commission, Bureau of Economic Analysis

In theory, increased imports of manufacturers from China and petroleum should shift U.S. employment from import-competing industries to export activities. Since export industries create about 10 percent more value added per employee and undertake more R&D than import-competing industries, this would raise U.S productivity and GDP growth. Those are the expected gains from expanding trade based on comparative advantage.

Instead, large trade deficits shift U.S. employment from trade-competing industries into nontrade-competing industries. Trade-competing industries create at least 50 percent more value added per employee, and spend more than three times as much R&D per dollar of value added, than nontrade-competing industries. By shifting labor and capital into nontrade-competing industries, chronic trade deficits have reduced U.S. economic growth by at least one percentage point a year, or about 25 percent of potential GDP growth.*

Lost growth is cumulative. Had trade deficits been significantly smaller over the last two decades, U.S. GDP would likely be $3 trillion or 20 percent greater than it is today.

Trade Deficits and the Recession

Dollars spent abroad cannot be spent on U.S. goods and services.

With the trade deficit at 5 percent of GDP, Americans must spend 105 percent of what they earn, or the supply for U.S. goods and services exceeds the demand, inventories of new homes, cars and other goods mount, layoffs result, and the economy slips into recession.

During the recent economic expansion, purchases of U.S. securities by China, Middle East oil states and other foreign investors kept interest rates low on long-term bonds, even when the Federal Reserve raised its target rates on short-term paper. This permitted U.S. financial institutions to offer homebuyers and consumers very attractive term mortgages and other consumer loans. Many Americans spent more than they earned, and this kept the economic expansion going. When the credit bubble burst, consumer demand collapsed and the economy fell into recession.

Certainly, inappropriate lending standards, and aggressive marketing of loans packaged into securities to private and foreign investors, by U.S. financial institutions permitted the bubble to occur.

Even with lending and securitization practices reformed and credit markets restored, the demand for U.S. goods and services will not again be adequate, and the U.S. economy cannot again achieve robust and sustainable growth, unless *either* consumers spend more than they earn and Americans finance it all by borrowing from abroad *or* the trade deficit is significantly reduced to redirect more U.S. spending to domestic suppliers of goods and services.

The $789 billion stimulus spending approved by Congress will help lift demand for U.S. goods and services, temporarily, and help the economy recover. Essentially, government spending and borrowing from foreigners is replacing consumer spending and borrowing to prop up aggregate demand.

However, once the stimulus spending is through, consumers must again borrow and spend more than they earn to sustain demand for U.S. goods and services and keep the recovery going, or the trade deficit must be reduced significantly. Otherwise demand will flag and the recovery will collapse.

To reduce the trade deficit, the United States will need several strategies to reduce dependence on foreign oil. The increase in automotive mileage standards to be implemented by 2016 and Obama Administration initiatives to develop alternative energy sources will help. However, abundant domestic oil and gas resources remain untapped, and with oil likely to head above $100 or even $150 a barrel, these resources will be needed in addition to conservation and alternatives to fossil fuels.

Regarding nonenergy trade, no solution is possible without recalibrating trade with China, and that requires revaluing the yuan dollar exchange rate to a level consistent with more balanced trade. That entails raising the value of the Chinese yuan, administratively or letting market forces revalue the yuan to a level that does not require Chinese monetary authorities to consistently purchase and accumulate dollars and other currencies to sustain its value.

Engaging China

The United States has engaged in high level talks with China since negotiations for its entry into the World Trade Organization. Most recently, the Strategic Economic Dialogue was launched in 2007.

Throughout this process the United States has encouraged China to more substantially raise the value of the yuan, which would require Beijing to purchase fewer dollars and other currencies to sustain its value. Instead, China has increased its foreign exchange market intervention as the gap between the official value of the yuan and its fundamental value has widened. This has exacerbated the damage to the U.S. economy and China's other trading partners.

The United States has three broad policy options to leverage change.

First, the United States could bring a complaint in the World Trade Organization. China's currency policy policies create a WTO illegal subsidy on exports, and subvert the benefits its trading partners expected when they acceded to China's entry into the world trade body.

Were the United States to bring such a suit, other WTO members would likely join the petition. If they prevailed, either China would have to stop intervening in currency markets, or face tariffs--approved by the WTO and imposed by WTO members participating in the complaint--to redress the trade imbalance. Those tariffs would be strictly temporary and removed when China complied with the WTO decision, ended currency market intervention, and let the yuan rise in value.

Second, the United States, consistent with its WTO obligations may impose tariffs on imported goods that receive government subsidies, if those goods harm U.S. industries when they enter U.S. markets. Until 2006, the United States did not apply the subsidy and countervailing duty law to commerce with China, but in a case regarding imports of Chinese paper, the Bush Administration changed that policy. However, in addressing the domestic industry's petition, the Bush Administration denied application of the subsidy and countervailing duty law to China's undervalued currency.

Bills sponsored by Senators Jim Bunning (R-KY) and Debbie Stabenow (D-MI) in the Senate and by Representatives Tim Ryan (D-OH) and Tim Murphy (R-PA) would make more likely the subsidy implicit in an undervalued currency were included in the computation countervailing duties in both dumping and subsidy cases, when a "fundamental and actionable misalignment" is present. Such circumstances would be determined by a standard consistent with International Monetary Fund guidelines.

Third, Americans need to accommodate to the fact that China is much less a market economy, either by design or by policy, than North American and Western European economies.

Its financial system may not be able to sustain an unmanaged floating exchange rate; however, China can manage the value of the yuan at 4 as easily as it does 6.8. In fact, it would be a lot easier to manage a value closer to balance of payments equilibrium.

Simply, the United States could offer China an opportunity, with a hard deadline, to manage down its trade surplus with the United States, either through meaningful and complete currency revaluation-complete means raising the dollar value for the yuan to a level that reduces China's trade surplus to zero-or through other mutually acceptable changes in China's domestic policies.

If China declines, the United States should simply tax dollar-yuan conversion in proportion to its official and surrogate currency market interventions. The United States should impose a tax equal to the quarterly value of China's intervention divided by its exports of goods and services. China would then have a strong incentive to reduce and then stop intervening.

If China does not reduce and eliminate intervention and chooses for the United States to tax currency conversion, then the benefits from a revalued yuan of higher prices for Chinese imports that should go to Chinese businesses would instead go into the U.S. Treasury. If China reduces and then eliminates one-way intervention and lets its currency rise to a value that balances trade, Chinese businesses would capture those benefits in the form of higher dollar prices for their goods.

Eliminating the trade deficit with China by eliminating or at least redressing currency manipulation would have a much greater stimulus effect on the economy than the stimulus spending approved by Congress. It would permanently increase aggregate demand for U.S. goods and services, whereas the benefits of the stimulus spending are temporary. As importantly, it would restore incentives for the efficient use of labor and capital that free trade would normally provide.

Affirmative policies to redressing the trade deficit with China would not be protectionist. China's currency policies are protectionist, and efforts to obtain a revision of these policies would restore balance to their trading system and permit both economies to grow and prosper, consistent with their resources and comparative advantages.

*Peter Morici, *The Trade Deficit: Where Does It Come From and What Does It Do?* (Washington, DC: Economic Strategy Institute, 1998).