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The Importance of Being Earnest in Defusing US–China Trade Tensions

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Introduction

It was no April Fool's joke when the *Wall Street Journal* of 1 April 2011 carried the headline 'China meeting highlights currency conflict'. The list of crimes against the US economy caused by the large US–China bilateral imbalances has now expanded from the loss of US jobs (Scott 2007) to the destabilisation of the US financial market (Guha 2009). The 'bad China' feeling is so strong that even *The New York Times* (17 March 2010) stooped to oxymoronic rhetoric, calling the *fixed* RMB–US dollar exchange rate 'a textbook example of the beggar-thy-neighbor competitive *devaluation*' (emphasis added).

The English language is not the only casualty in the discussion of the US–China economic relationship; history has also been given the wrong twist. According to Nicholas Lardy: 'The United States is the addict. We are addicted to consumption...China is the dealer. They're supplying the credit that makes it possible for us to over-consume' ('Winter institute: China and US joined at the hip', St Cloud State University News Release, 2 March 2009, <<http://www.stcloudstate.edu/news/newsrelease/default.asp?storyID=28126>>).

It is hard not to see this reference to the Opium War of the nineteenth century, with the identities of the aggressor and the victim reversed, as a transmogrification of history that is quite over the top. To continue the practice of historical analogies started by Nicholas Lardy, I will paraphrase the opening paragraph of the most famous work by Karl Marx—China's leading intellectual light—to describe the state of the world in April 2011 and my opinion of it as follows:

A spectre is haunting the World—the spectre of a currency war. All the powers of the Group of 20 (G20) are meeting in Cannes on 3–4 November 2011 to attempt a holy alliance to exorcise this spectre: the President of the United States and the General Secretary of the Chinese Communist Party, Timothy Geithner, Christine Lagarde, Japanese technocrats and German sherpas. This spectre is sustained by the prolonged swingeing trade imbalances of the United States and China. Will the G20 degenerate into a G2 with China defending its exchange rate against the protests of the rest? Can't the G20 show some statesmanship instead by putting global economic recovery on a new, environmentally sustainable path? If China can work out such an outcome with the other members of the G20, this will be China's and the G20's greatest contribution to global economic recovery—nay, global economic renaissance.

Beyond exchange rate monotheism

The large US trade deficit and the large Chinese trade surplus do not reflect Chinese economic conditions alone. Rather, each of them reflects the economic conditions in both countries (and in the rest of the world) (Woo 2008). It is indisputable from the constant intervention in the foreign exchange market by the Chinese central bank that the renminbi (RMB) is undervalued, but it is also indisputable that the low US savings rate predisposes the United States to borrow from abroad to finance its investment and its large government budget deficit, and that the US Government does not have a credible plan to reduce its budget deficit upon the recovery of the economy. The straightforward implication is that a fair solution to any desired reduction in the trade imbalance would require corrective measures to be implemented by both China and the United States.

Given that the trade imbalances are produced by a host of factors, another straightforward implication is that the efficient solution will employ more than only one policy instrument for the task. There would not just be an appreciation of the RMB against the US dollar, but also equally large changes in policy measures such as the lowering of Chinese trade barriers, the adoption of a budget deficit reduction by the United States, and expansion of the trade credit facilities of the Export–Import Bank of the United States.

It is instructive to remember that the now much-praised Plaza Accord of September 1985, which engineered a sharp appreciation of the Japanese yen, caused so much instability in global financial markets that it became a museum piece after only 17 months (!), with the hurried signing of the Louvre Accord in February 1987. As the world is only beginning to get over the trauma of the global financial crisis of 2008–09, it verges on irresponsibility to now impart a Plaza Accord-type of shock to the financial markets.

Table 11.1 US and Japanese trade balance during the 1985–88 period of yen appreciation

	Yen/US\$ (average)	Overall US trade balance (% of US GDP)	Overall Japanese trade balance	Bilateral Japan–US trade balance
			(% of Japanese GDP)	
1984	237.52	–3.13	2.64	2.63
1985	238.54	–3.51	3.43	2.98
1986	168.52	–3.80	4.12	2.60
1987	144.64	–3.61	3.29	2.17
1988	128.15	–2.75	2.61	1.61

Sources: Trade data are from Direction of Trade, the United Nations, New York City and GDP data from International Financial Statistics, the International Monetary Fund (IMF), Washington DC. Various years.

More importantly, the effectiveness of a large appreciation of the RMB–US dollar exchange rate in reducing the US trade deficit is suspect outside the textbook situation of a two-country world. When the Yen–US dollar exchange rate went from ¥238.5/US\$1 in 1985 to ¥128.2/US\$1 in 1988 (an appreciation of 86 per cent by the International Monetary Fund definition), the overall US and Japanese trade imbalances saw only small improvements (Table 11.1). The US trade deficit declined from 3.5 per cent of gross domestic product (GDP) to 2.8 per cent (a 0.7 percentage-point drop), and the Japanese trade surplus fell from 3.4

per cent of GDP to 2.6 per cent (a 0.8 percentage-point drop). The biggest change was in the bilateral Japan–US trade imbalance, which went from 3 per cent of Japanese GDP to 1.6 per cent (a 1.4 percentage-point drop).

The US trade deficit improved very little when direct Japanese exports became drastically more expensive in the US market after 1985 because, first, US customers reacted by switching their purchases to similar imports from third countries; and, second, Japanese businesses relocated their production to other Asian countries in order to service the US market from there. The Japanese trade surplus also did not change substantially because its new overseas production bases imported large amounts of capital equipment and intermediate inputs from Japan.

Since more than 60 per cent of Chinese exports are produced in factories with foreign investment, many of these foreign investors would relocate their operations to other parts of the world if the RMB were to duplicate the dramatic 1985–88 appreciation of the yen. Unless accompanied by US actions to raise its low private savings rate and to cut its budget deficit, a second Plaza Accord would not diminish the US trade deficit adequately and its primary consequences would be a reconfiguration of the sources of US borrowing from abroad, and a new round of global financial market instability.

The only economically meaningful definition of the equilibrium exchange rate is the market-clearing exchange rate produced in the absence of intervention by any central bank. This market-clearing exchange rate is characterised by the balance-of-payments position being zero and not by the trade account balance (or the current account balance) being zero or being at some *a priori* value. This means that the notion of exchange rate misalignment that is based on the proposed concept of the fundamental equilibrium exchange rate (FEER) is analytically vacuous because the FEER is not identical to the market-clearing exchange rate.

The proposal by US Treasury Secretary, Tim Geithner, at the G20 meeting in Seoul in November 2010 that every G20 country should prevent its current account imbalance from exceeding 4 per cent of GDP for sustained periods is an appropriately practical way to reduce the high trade tensions in an economic setting marked by severe under-utilisation of production capacity and high unemployment worldwide. The Geithner proposal makes good economic and political sense for the present global circumstances because it: 1) avoids the pseudo-science of FEER-based misalignment of the RMB and the inexact science about by how much the US trade deficit would be improved by a sharp RMB appreciation; 2) gives each country the freedom to choose its preferred combination of policy instruments to keep its trade imbalance under control; and 3) explicitly prevents beggar-thy-neighbour policies from appearing to torpedo the slowly recovering international economy.

What China should do

It is shockingly unusual for a developing economy such as China's to be lending its savings to the industrialised world, especially since all estimates suggest that the rate of return to capital in China is much higher than in the United States. This anomalous situation is the (perhaps mostly unintentional) outcome of: 1) the overriding economic and political

priority in China to create jobs for its vast labour force; and 2) the widespread belief in the efficacy of infant industry protection (ambiguously labelled as the ‘promotion of indigenous innovation’) in accelerating China’s movement up the value-added ladder. An undervalued exchange rate was useful in quickening the simultaneous growth of export firms and import-competing firms enabled by the movement of surplus labour from the countryside.

China’s simultaneous promotion of exports and suppression of imports is the basic reason behind the trade surplus. In the short run, the Government should reduce trade barriers to allow more imports, which would also raise the standard of living of the Chinese people. China should also increase imports by enabling new types of imports—for example, educational services and tourism. With its humongous foreign exchange reserves, China should have expanded its scholarship and student-loan programs tremendously to enable the large number of qualified Chinese to go abroad to receive better university-level training. It has been a failure of the imagination that China has failed to increase this type of import prodigiously for productive purposes.

Furthermore, China should recognise that its large indigenous innovation program to incubate high-tech industries has, in fact, been an inequitable mechanism that transfers income from the customers to the makers of the products covered in the program. The global experience with indigenous innovation programs has mostly been a negative one. Most of the industries they spawned never became internationally competitive, showing that most indigenous innovation programs are based either on a misguided sense about the possibilities of ‘learning by doing’ or on rent-seeking motives. Another unfortunate outcome of such misguided indigenous innovation programs is that they accentuate foreign dissatisfaction with China’s import barriers and violations of intellectual property, and hence raise the probability of a protectionist backlash against Chinese exports. Given that most protected industries would not grow up into competitive world-class industries, and are mostly rent-seeking operations enabled by protection from foreign competition, China could drastically reduce the size of its extensive indigenous innovation program without hurting its capability in technological upgrading.

For the long run, the basic task for China is to reform its monopoly state banking system so that most of China’s savings could be intermediated into domestic investment. China is also anomalous in that foreign private banks actually face fewer legal restrictions and far fewer informal prohibitions on their activities than domestic private banks. Without the proliferation of domestic private banks, it will continue to be hard to meet the financing needs of small and medium enterprises, which are more labour intensive in their operations than large enterprises. A modern, diversified financial sector is a key part of the solution to ending the spill-over of Chinese savings to foreign countries, and to the continued fast creation of new jobs.

The too often made recommendation that China should now switch to consumption-led growth by cutting investment and raising consumption is nonsensical.¹ This type of consumption-led growth means a lower growth rate for China because, with lower investment, there would be slower expansion of production capacity. This particular advice to China is in effect a recommendation that China delays its catch up to the level of the industrialised countries. This flawed recommendation of rebalancing is based on the uncritical use of the GDP accounting identity where GDP equals the sum of the different

components of demand. The proponents do not realise that when more of GDP is consumed and less of it is invested, only the full utilisation of existing capacity is guaranteed, and not the growth rate of production capacity. The level of GDP in the next period is determined by how much investment is undertaken in this period to increase the capital stock that is used in the next period.

The only type of economic rebalancing that makes sense for China has two components. The first is to increase consumption at the expense of the trade surplus and not at the expense of domestic capital accumulation. For the situation in April 2011, the implication is that the Chinese Government should stop relying on the reduction of investment as the primary instrument to curb inflation, and begin appreciating the RMB much faster instead. Using RMB appreciation as the primary tool to fight inflation means, however, accepting a temporarily higher unemployment rate now in exchange for a permanently lower unemployment rate in the future. This is because manufactured exports are typically more labour intensive than investment projects. As a result, a RMB1 billion reduction in exports would create more unemployment than a RMB1 billion reduction in investment spending. Tomorrow's capacity expansion from today's investment would, however, mean a permanent increase in the number of jobs created from tomorrow onward. China should also lower import barriers because cheaper imports will stimulate consumption and help keep inflation in check.

The second component of an economically sensible method of rebalancing is to help switch the composition of investment away from the export sector towards investments that aid human capital formation and accelerate urbanisation of the rural population. Urbanisation can become as important and as durable a driver of growth as the export sector has been (Woo and Zhang 2010). China should base its urbanisation on the principle of affordable future homeownership. The fast growth of the real estate sector—not only recently but also over the past decade—reflects not just speculative demand but also genuine pent-up demand for housing and genuine accommodation of the high rate of the joint industrialisation–urbanisation process.² The bulk of the new arrivals from the countryside cannot qualify for bank mortgages, so many investors have been buying multiple housing units to rent to new arrivals with the intention of raising the rents over time in line with the income growth of the renters. In this sense, much of the recent housing demand has been speculative.

We propose that China studies the low-cost public housing schemes in Hong Kong and Singapore and establishes a national housing program in which the new arrivals would rent homes for seven years and then have the first right to buy these units at a price based on construction costs. This 'future ownership' form of urbanisation would prevent the problem of empty housing held for speculative reasons from escalating into non-performing loans. China can afford a massive public housing program because the expensive part of such programs in other countries is the cost of land and not the cost of the structures—and land in China is mostly owned by the state.³

The required sense and sensibility for common prosperity

It cannot be overstressed that important reforms are also required in the United States in order to keep protectionist sentiments under control. It is well known that the inflation-adjusted take-home wage of blue-collar workers has shown little or no growth in the past 20 years, and this stagnation has fuelled protectionism because many have identified increased competition from globalisation to be the cause. The reality is that US firms have been paying more and more for the services of their blue-collar workers, but this has not been translated into higher take-home wages for the workers because the increases in labour compensation have been mostly absorbed by the rapidly rising medical insurance premium! If not for medical insurance inflation, the take-home pay of the working class would have been pulled up significantly by the rapid labour productivity growth created by the transformational technological innovations of the past two decades. US President, Barack Obama, has extended healthcare coverage to more workers but he has not introduced any potent cost-containment measures on health care. Until the next phase of healthcare reform brings cost under control, it will be hard to cut the budget deficit, and hence the trade deficit.

Besides what the United States and China can each do independently to reduce international tensions over the trade imbalance, they should also work together to prevent the World Trade Organisation (WTO) free-trade regime from weakening. Specifically, China has benefited immensely from the WTO system, and yet it has, up to this point, played a very passive role in pushing the Doha Round negotiations forward to completion. By default, Brazil and India have assumed the leadership of the developing-economies camp in the trade negotiations. At the Group of Four (G4: the United States, the European Union, Brazil and India) meeting in Potsdam in June 2007, Brazil and India retreated from their earlier offers to reduce their manufacturing tariffs in return for cuts in agricultural subsidies by the industrialised economies because of their concern for increasing Chinese imports.

With the United States now seemingly weaker in its resolve to protect the multilateral free-trade system, China should now become more active in the Doha Round negotiations to further deregulate world trade. Such a role will be very much in China's interest because Brazil is now bypassing multilateral trade liberalisation by entering into free-trade agreement (FTA) negotiations with the European Union. The fact is that a growing number of nations such as Brazil are increasingly cautious about a multilateral deal that would lower tariffs to all and hence benefit low-cost producers such as China disproportionately and are seeking bilateral trade agreements with rich countries that are tailored to both their conditions. It is definitely time for China to show that it has the sensibility of a responsible stakeholder by joining in the stewardship of the multilateral free-trade system.

What the world economy especially needs now is an invisible handshake between the United States and China to start economic policy coordination on a number of fronts (such as exchange rate policy, budget deficits, bilateral and global trade deregulation, intellectual piracy, and social safety nets) to keep their current account imbalances below 4 per cent of GDP. It is not naive to predict that if the two countries are unable to arrive at an invisible handshake on the solution of the trade imbalances then we are unlikely to see at any time soon visible handshakes (multilaterally) on an accord on global climate change, a strengthened

treaty on nuclear non-proliferation or a compact to end absolute poverty globally. In short, if statesmanship is lacking on the less contentious issue of trade then progress on these even more important objectives will not occur. And, if progress is made on any one of these other problems, it might be only after a highly confrontational process.

The outcome of a highly confrontational process need not be progress, however. Mutual paralysis or open conflicts have also been common outcomes of confrontations. After all, many pundits have pointed out that the rise of new powers in the twentieth century (Germany and Japan in the first half, and the Soviet Union in the second half) led to disastrous wars with the existing powers. This pessimistic presumption about the emergence of China as a world power in the twenty-first century overlooks the fact that the strongest power to rise in the twentieth century was the United States (not Germany, Japan or the Soviet Union), and that the United States was generally a force for global stability. There is, in short, ground to expect that if the existing powers could accommodate the concerns of an emerging China adroitly (without appeasement), China could become a responsible stakeholder in the global system. We should therefore not give up the reasonable hope that enlightened self-interests (when repeatedly pointed out by analysts such as the *ANU China Update* participants) could guide the United States and China to be earnest in defusing their bilateral tensions and ensure that the picture of the future is not grey.

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Endnotes

1. For example, Lardy (2007:10) wrote that the more desired growth path is one marked by 'a reduction in China's national savings rate', and by a reduction in 'China's excessive rate of investment'. The latter 'is a prerequisite to a successful transition to a more consumption-driven growth path'.

2. If speculative demand had been the overwhelmingly dominant cause for the property boom then house rents would not have risen substantially (because the speculative investors would tend to rent out their extra units). Instead, rent in Beijing in March 2010 was 19.6 per cent above that in March 2009. See 'Survey shows house prices still too high', *China Daily*, 12 May 2010, <http://www.chinadaily.com.cn/metro/2010-05/12/content_9839054.htm>
3. It should be noted that housing construction is relatively labour intensive and that home decoration is highly labour intensive.