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US-CHINA TRADE DISPUTES: RISING TIDE, RISING STAKES

Gary Clyde Hufbauer, Yee Wong,
and Ketki Sheth



INSTITUTE FOR INTERNATIONAL ECONOMICS

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Preface

Since its accession to the World Trade Organization (WTO), China has emerged as a major force in global production and trade. In 2005 China became the world's sixth largest economy at market exchange rates, ahead of Italy and just behind France. China is also the third largest trading partner for the United States. As China continues to rise as a great power, its bilateral merchandise trade surplus with the United States has exploded—to \$201 billion in 2005—while its global current account surplus has widened to \$160 billion in 2005, more than 7 percent of GDP. With China accounting for more than one-fourth of the total US trade deficit, and with Chinese foreign exchange reserves approaching \$1 trillion, US-China economic relations have become the focus of intense political debate.

These issues are analyzed in the context of China's overall economic prospects, along with US-China security and foreign policy issues, in *China, The Balance Sheet: What the World Needs to Know Now about the Emerging Superpower*, a recent book by the Institute and the Center for Strategic and International Studies published by Public Affairs Press. This new study addresses the trade policy disputes between China and the United States. It attempts to present a comprehensive view of the challenges facing the United States and China in their commercial relations and to suggest policies for managing disagreements over the next few years.

Overshadowing all trade disputes is the renminbi exchange rate. This issue has already been addressed in a number of Institute studies, primarily by Senior Fellows Morris Goldstein and Nicholas Lardy, and this new analysis focuses on the prospects for using trade policy instruments

(mainly via the WTO) to promote currency adjustment. Authors Gary Clyde Hufbauer, Yee Wong, and Ketki Sheth also offer an outside estimate that a revaluation of the renminbi and other Asian currencies by 20 percent, together with a sharp reduction in the US savings deficit, might reduce the US global current account deficit by as much as \$120 billion per year. Alternative estimates developed by other economists at the Institute, on the basis of more in-depth study of the currency misalignments, suggest a possible improvement in the US trade balance of \$60 billion to \$80 billion per year from such alterations in Asian exchange rates.

While the renminbi is the biggest lightning rod at the moment, it is by no means the only commercial dispute between China and other major countries. After the termination, in January 2005, of import quotas imposed under the Multi-Fiber Arrangement, followed by the rapid expansion of Chinese textile and clothing exports, both the United States and the European Union negotiated a fresh set of bilateral quotas with China. While the new quotas are set to expire in 2008, textile and clothing trade disputes are virtually certain to continue for a decade or longer. Disagreements over Chinese tax incentives, the violation of intellectual property rights, antidumping duties, and China's nonmarket economy status add to the litany of commercial disputes. The recent US decision to block CNOOC's bid to acquire Unocal and other investment issues compounded trade frictions.

This study is an expanded version of the Institute's Policy Brief, *China Bashing 2004*, authored by Gary Clyde Hufbauer and Yee Wong. This new publication is intended to reach a broader audience and provide an updated analysis of US-China commercial frictions, in response to requests from congressional staff and other interested readers. In their report, the authors offer specific proposals for both countries to jointly manage their foreseeable trade disputes in the years ahead.

The Institute for International Economics is a private, nonprofit institution for the study and discussion of international economic policy. Its purpose is to analyze important issues in that area and to develop and communicate practical new approaches for dealing with them. The Institute is completely nonpartisan.

The Institute is funded by a highly diversified group of philanthropic foundations, private corporations, and interested individuals. Major institutional grants are now being received from the William M. Keck, Jr. Foundation and the Starr Foundation. About 33 percent of the Institute's resources in our latest fiscal year were provided by contributors outside the United States, including about 16 percent from Japan.

The Institute's Board of Directors bears overall responsibilities for the Institute and gives general guidance and approval to its research program, including the identification of topics that are likely to become important over the medium run (one to three years) and that should be addressed by the Institute. The director, working closely with the staff

and outside Advisory Committee, is responsible for the development of particular projects and makes the final decision to publish an individual study.

The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

C. FRED BERGSTEN
Director
June 2006

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Introduction

Ever since President Richard Nixon's celebrated trip to Beijing in 1972, the party out of power has chastised the White House for being "soft on China"—in security terms, economic terms, or both. In turn, the administration insists that it is both tough and diplomatic. In recent times, the backdrop of a growing bilateral trade deficit (\$201 billion in 2005), declining numbers of US manufacturing jobs (down from 17.3 million in 2000 to 14.3 million in 2005), and increased concerns about national security have made the familiar drama more acute. The nature of the relationship between the United States and China may be decades old, but the urgency of the disputes that arise between them is new.

As China continues its rise as a great power, Congress and the administration wrestle with one another over the proper tactics and strategies to shape US-China economic relations. Recent congressional legislative proposals have called for renminbi revaluation, import tariffs, and a larger congressional role in reviewing foreign takeovers. One of the recent bills (HR 4733) calls for the creation of a congressional "trade enforcer" to launch dispute resolution cases in the World Trade Organization (WTO)—a proposal clearly aimed at China.¹

The momentum in Congress in proposing bills regarding US-China relations has spurred the administration to offer its own proposals to head off unwelcome legislation. In February 2006 the United States Trade Representative (USTR 2006) released its *Top-to-Bottom Review of*

1. See "Democrats Offer Legislation with Eye Toward Trade Deficit Report," *Inside U.S. Trade*, February 10, 2006. Under this bill, the USTR could object to the case, but Congress could override the USTR.

US-China Trade Relations, which included a call to “strengthen the Executive-Congressional Partnership on China Trade.” The USTR promised regular briefings for congressional members and staff and emphasized opening a new phase of US-China relations, since China had implemented most (but not all) of its WTO obligations. The USTR review calls for additional personnel to create an internal China enforcement task force within the USTR (USTR 2006). While the review attempts to assuage Congress, it portrays the administration and USTR as the leaders in shaping US-China trade relations. In this sense, the USTR review in 2006 echoed the Treasury’s initiatives in 2005 on the renminbi exchange rate.

Forces Larger than China

The US bilateral deficit with China is only part of the US external imbalance with the rest of the world. The US global trade deficit in goods and services widened from \$375 billion in 2000 to \$725 billion in 2005.² In macroeconomic terms, when a country spends beyond its income—as the United States has done on a large scale for several years—imports must exceed exports to absorb the difference between national spending and national income. The widening US trade deficit between 2000 and 2005 thus reflects lower household savings and higher federal budget deficits. The rest of the world willingly provides the dollars to finance US spending habits because the United States is an attractive place to invest (see box 1.1)—so attractive that the dollar actually strengthened in foreign exchange markets for much of the time that the trade deficit grew. If the United States did not have a growing bilateral trade deficit with China, it would have experienced larger trade deficits with other countries.

Job losses in the manufacturing sector are part of an even longer trend as the United States increasingly becomes a services economy. Since 1950, the proportion of US jobs in the manufacturing sector has dropped from about 31 to 12 percent. But the absolute decline between 2000 (17.3 million workers) and 2005 (14.3 million workers) was particularly brutal, and many firms and workers laid the blame squarely on China.³

2. The US current account deficit in 2005 was wider still, at \$805 billion, since it includes unilateral transfers as well as commercial trade in goods and services.

3. For examples of US concern over China’s role as a manufacturing hub, see Shenkar (2004) and Morici (2006); see also Ernest H. Preeg, *The Emerging Chinese Advanced Technology Superstate*, Statement before the US-China Economic and Security Review Commission, Washington, April 21, 2005.

Box 1.1 US manufacturing and the US trade deficit

The main causes of the US trade deficit—or more precisely, the US current account deficit (\$411 billion in 2000, rising to \$760 billion in 2005)—are low national savings and a strong dollar. US household savings remain modest: 2.3 percent of disposable personal income in 2000 and –0.4 percent in 2005. Moreover, the federal budget surplus of \$230 billion in 2000 turned into a deficit of \$318 billion in 2005. When the United States has a trade deficit, it is concentrated in manufactured goods, mainly because manufactures are the most readily traded sector of the economy and account for about 80 percent of US exports and imports. In 2005 the US trade deficit in manufactures was \$541 billion.

The trade deficit is not the main reason for job losses in the manufacturing industries. The main reasons between 2000 and 2003 were recession (a drop in quarterly US purchases of manufactured goods from \$479 billion to \$462 billion between 2000Q4 and 2003Q2) and rising manufacturing productivity (accelerating from 3.4 percent annually in 1990–95 to 4.1 percent annually in 1995–2000 to 4.9 percent annually in 2000–2005). Net US manufactured imports increased from \$396 billion in 2000 to \$541 billion in 2005. If one assumes that each additional \$1 billion of domestic manufacturing output creates 2,620 jobs and that each \$1 billion increase in net imports corresponds with a \$1 billion destruction of domestic manufacturing output, then the increase in the annual manufactures trade deficit (of \$145 billion) might be blamed for almost 400,000 manufacturing job losses between 2000 and 2005 (see appendix table A.1). Using a less mechanical methodology, Martin Baily and Robert Lawrence (2004) estimate that about 256,000 US manufacturing jobs (15 percent of the total) were lost due to rising net imports during 2000–2003.

Both estimates assume that a US manufacturing trade deficit causes a decline in US manufacturing output. However, this assumption is not validated empirically. In fact, our estimates, based on 1990 and 2005 quarterly data, reject the hypothesis that a deterioration of the trade balance is correlated with a contraction of manufacturing output at the 5 percent significance level. In fact, the negative coefficient reported in equation 2 in appendix table A.1 indicates that a larger US manufacturing trade deficit generally corresponds with higher, not lower, US manufacturing output. This can be readily explained by the dominant force of rising and falling national income in driving both US imports of manufactures and US output of manufactures. To summarize, the political arithmetic that equates trade deficits with job losses is either exaggerated or plain wrong (see appendix table A.1).

Source: Baily and Lawrence (2004).

China in Global Trade and Investment

China's role in global trade is often overlooked. In 2005 China surpassed Japan as the world's third-largest importer and became the world's sixth-largest economy, ahead of Italy and behind France.⁴ Also in 2005 China became the world's third-largest exporter, and two-way trade with China accounted for at least 13 percent of world trade expansion that year. The emergence of China as an economic power has been a boon for commodity producers. China is currently the world's second-largest consumer and importer of oil, after the United States and ahead of Japan, and its demand for crude oil is projected to grow by 4 percent annually over the next decade.⁵

Also not often appreciated is the openness of the Chinese economy, measured by the trade-to-GDP ratio, or imports plus exports divided by GDP. The current trade-to-GDP ratio for China is about 70 percent. By comparison, Japanese and US trade openness ratios were about 20 percent each in 2004.⁶ Another indication of Chinese openness is the ratio of foreign direct investment (FDI) stock to GDP.⁷ The figure for China in 2004 was 42 percent, for Japan, 2 percent, and for the United States, 20 percent.

US-China Bilateral Trade Friction

Since its accession to the WTO, China has become the United States' third-largest trading partner and the sixth-largest market for US exports. Between 2000 and 2005, US imports from China rose from \$100 billion to

4. In December 2005 the Chinese government revised its GDP growth estimates to better measure its rapidly growing services sector. According to its measures, the Chinese economy reached about \$1.98 trillion in 2004 at the market exchange rate. Andy Xie, a Morgan Stanley economist, believes that China's GDP could reach \$10 trillion and be as large as that of the United States by 2020. See Lardy (2005); James Areddy, "China Boosts GDP Rates to Reflect Services Gains," *The Wall Street Journal*, January 10, 2006; and Xie (2003a).

5. In 2005 China accounted for half of global consumption of cement and 27 percent of steel. China alone accounted for 30 percent of the growth in world oil demand in 2004. See "The Commodities Bonanza from China," *Asiamoney*, February 1, 2004; and "Asia's Oil Equation: Managing Demand Is As Important As Securing Supply," *Financial Times*, June 28, 2005.

6. Based on IMF's *International Financial Statistics* database, January 2006. See Yasheng Huang, *Is China Playing by the Rules? Free Trade, Fair Trade, and WTO Compliance*, Testimony before the Congressional-Executive Commission on China, Washington, September 24, 2003.

7. Based on GDP at current exchange rates from the IMF's *World Economic Outlook* database (April 2005) and UNCTAD's *World Investment Report* (2003). Yasheng Huang argues that the inefficiencies of the Chinese economy make China unusually open to foreign trade and FDI. See Yasheng Huang, *Is China Playing by the Rules?* Testimony before the Congressional-Executive Commission on China.

Table 1.1 US trade with the world and current account balance, 1999–2005 (billions of dollars)

Year	Total merchandise trade		Total services trade		Goods and services trade balance	Current account balance ^d
	US imports ^a	US exports ^b	US imports	US exports		
1999	1,017	642	184	266	–293	–300
2000	1,205	712	209	285	–417	–416
2001	1,133	666	206	275	–398	–389
2002	1,155	630	212	282	–455	–475
2003	1,250	651	228	296	–531	–520
2004	1,460	727	263	328	–668	–668
2005 ^c	1,662	804	322	378	–802	–725

a. Imports for consumption.

b. Domestic exports.

c. According to Bureau of Economic Analysis statistics, which differ from US International Trade Commission statistics, US merchandise imports for 2005 were \$1,675 billion and exports were \$896 billion.

d. The current account balance differs from the goods and services trade balance mainly because of unrecorded flows of goods and services.

Sources: Merchandise trade: USITC Dataweb, 2006; services trade: Bureau of Economic Analysis, 2006.

\$243 billion, while US exports to China climbed from \$16 billion to \$42 billion.⁸ The steady reduction of Chinese trade barriers over the last two decades facilitated the growth of Chinese exports as well as imports.⁹ The expansion of US-China commerce delivers lower prices to American consumers and producers and enables both countries to use their resources more efficiently. Despite the benefits on both sides of the trade equation, most US politicians view the bilateral deficit in purely negative terms.

Several caveats apply to evaluating the size and balance of US-China trade. Even though China runs a large bilateral trade surplus with the United States—about \$201 billion in 2005—according to US statistics it runs a trade deficit with the rest of the world, most notably about

8. US merchandise exports to the rest of the world rose from \$697 billion in 2000 to \$765 billion in 2005 (USITC Dataweb, March 2006).

9. In unweighted average terms, Chinese tariffs declined from 55.6 percent in 1982 to 12.3 percent in 2002 (IMF, *World Economic Outlook*, 2004). In accordance with Lerner's (1936) teaching that import tariffs act as export taxes, the progressive reduction of Chinese import duties facilitated the rapid growth of Chinese processing industries using imported inputs.

Table 1.2 US-China trade, 1999–2005 (US statistics, millions of dollars)

Year	Merchandise trade		Services trade		Goods and services trade balance
	US imports ^a	US exports ^b	US imports	US exports	
1999	82	13	3	4	–68
2000	100	15	3	5	–82
2001	102	18	4	6	–82
2002	125	21	4	6	–102
2003	152	27	4	6	–123
2004	196	33	6	7	–162
2005 ^c	243	39	7	7	–201

a. Imports for consumption.

b. Domestic exports.

c. Services trade estimated using 2000–2004 growth trend.

Sources: USITC Dataweb, 2006; Bureau of Economic Analysis, summary data for private services trade by area and country, 1992–2004.

\$48 billion in 2005 with its Asian partners (tables 1.1, 1.2, and 1.3).¹⁰ China's deficit with its Asian partners reflects its growing role as a final assembler in Asian production networks, one direct consequence of which is that the US bilateral trade imbalance with China rises as its trade imbalance falls with other Asian countries, especially Hong Kong, Taiwan, Korea, and Japan. Goods assembled from imported parts and components account for about 55 percent of China's total exports and 65 percent of Chinese exports to the United States.¹¹ In 2005, according to its own official data, China's trade surplus represented only 2 percent of China's GDP. However, US observers are skeptical of official Chinese trade statistics; unofficial US sources put China's trade surplus at 6 to 7 percent of GDP (Goldstein and Lardy 2005, Bergsten et al. 2006).

Another common explanation for the rising US bilateral trade deficit with China is that China limits market access. Although China's tariffs are higher than those of its peers in the Organization for Economic Cooperation and Development, its tariffs remain among the lowest of any developing country. In 2004 the average level of tariffs was about 10.4 percent, but the effective tariff ratio was only 2.2 percent (Bergsten et al. 2006).

The comparison between China and Japan is instructive. Since 1981, Japan has run global current account surpluses, often very large. Begin-

10. The rise in Chinese imports from the surrounding region reflects its growing importance as a manufacturing hub for reexports (IMF, *World Economic Outlook*, 2004).

11. C. Fred Bergsten, "Clash of the Titans," *Newsweek*, international edition, April 24, 2006.