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CUTTING THROUGH MYTHS ON CHINA TRADE SURPLUS¹

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Given a U.S. unemployment rate of almost 10 percent, many Americans see China's trade surplus with the United States as an urgent problem.

Some even argue that China is manipulating the exchange rate of its currency, the yuan or renminbi (RMB), against the dollar to boost Chinese export-related jobs at the expense of American workers.

The U.S. Treasury Department will shortly make a call on that issue. In light of the damaging effects that decision could have on our economic relationship with China, we urgently need to understand the causes of—and solutions for—our trade deficit with China.

Economic data indicate that, contrary to popular argument, RMB strength does not have a strong correlation to the U.S. trade deficit with China. This is partially because U.S. and Chinese goods are in different market segments—they generally do not compete head to head. So when the RMB rises, the United States simply imports less from China and more from other, higher-priced Asian producers—not from producers in the United States. The result is no net increase in U.S. jobs and higher prices at Wal-Mart for cash-strapped U.S. consumers.

Actually, changes in Asia's supply chain are a main driver of our trade deficit with China. With globalization and the dispersion of production, China is now doing final assembly of goods that the United States previously imported from companies based in Japan, South Korea, and Taiwan. As the final leg of the supply chain shifted to China, U.S. imports from China rose as the United States imported less from the rest of Asia.

Our trade deficit with China is also driven in part by national security concerns. The United States has set restrictions on exports to China three times, and it added several categories in 2007, such as computers, aerospace technology, and digital machine tools.

Another driver of the trade deficit—and one we have much more hope of changing—is a macroeconomic imbalance between savings and investment. The United States consumes too much and saves too little, with a record low national savings rate of minus-2.5 percent of national income last year. In contrast, China saves more than it invests.

With a modest pool of national savings and a larger pool of investment needs, including the financing of unprecedented fiscal deficits, the United States consistently needs to import surplus savings from abroad. Chinese excess savings have fit the bill, increasing the trade deficit with China.

The implication is clear: In order to make true headway in closing the trade imbalance, China must consume more and Americans must save more. China is already doing its part, with consumption up 15 percent in 2009 and wages expected to rise 10 percent in 2010.

Imports have surged in China, and, as a result, China's global trade surplus has shrunk from \$14.2 billion in January to \$7.6 billion in February. And last month, China's imports surged to \$119 billion, which caused it to run a global trade *deficit* of \$7.24 billion, the first monthly Chinese global trade deficit in 6 years.

Because of this, China may indeed choose to raise interest rates and let the RMB/dollar exchange rate rise. That choice is far more likely to happen as a result of rising consumption and inflationary pressure in China, though—not as a result of the trade war that would almost certainly be triggered by the United States accusing China of manipulating the RMB.

A trade war would endanger American gains. U.S. trade in services with China, for instance, rose almost 36 percent annually from 2004 to 2008—a rise which dwarfs the growth in China's surplus in merchandise trade with the United States.

We also benefit from \$62 million in U.S. investments and 58,000 U.S. projects in China. In fact, American and other foreign companies dominate China's high-tech and industrial exports. Profits for these products are thus not China's alone. For example, China only retains \$4 out of the \$300 final price for the iPods Apple produces in China. U.S. corporations benefit by recycling their profits back into the United States and other foreign companies. U.S. consumers benefit by getting lower prices, higher quality and greater variety.

In short, a strengthened RMB is hardly a silver bullet for eliminating China's trade surplus or for solving U.S. economic and unemployment woes. Accusing China of manipulating the RMB, then, would create not only a very costly trade war, but an unnecessary one. We should instead look at the real drivers of the trade deficit and pursue smart economic policy at home—and patient economic diplomacy abroad.

ENDNOTE

1. Originally printed as "Trade war with China would be costly, unnecessary," *St. Petersburg Times*, April 14, 2010, available from www.tampabay.com/opinion/columns/trade-war-with-china-would-be-costly-unnecessary/1087111.

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