CHINA'S TRADE SURPLUS WITH THE UNITED STATES

Background

China has run a bilateral trade surplus with the United States since the late 1980s. These surpluses increased steadily in the 1990s and China became the largest single source of the U.S. global deficit in 2003. In 2005, the U.S. bilateral trade deficit with China exceeded $200 billion – over one fourth of its total imbalance. U.S. imports from China are now almost six times as large as U.S. exports to China so its future exports would have to grow almost six times as fast as its imports grow just to keep the bilateral imbalance from increasing further.

Bilateral imbalances should not be a focus of national policies because of the multilateral nature of international trade. The China-U.S. bilateral position, however, reflects both countries' large worldwide imbalances. The United States is by far the world's largest deficit and debtor country, and its global current account deficit hit an annual rate of $900 billion in the final quarter of 2005 (7 percent of GDP). China's global current account surplus, after averaging only 1.6 percent of its GDP during 1993-2002, soared to about $150 billion (almost 7 percent of GDP) in 2005. These global disequilibria are a major source of concern: they could lead at virtually any time to a large and disorderly fall in the exchange rate of the dollar, pushing up U.S. inflation and interest rates with very negative effects on the U.S. and world economies, and/or to a sharp outbreak of trade protectionism in the Congress.

Why Is China's Surplus So Large?

1. Chinese officials frequently assert that the imbalance would be much smaller if the United States would approve more high technology exports to China. However, the Department of Commerce rejected only $12.5 million in potential sales in FY2005 and it returned applications, including for incompleteness, of only $550 million more. Approval of all these licenses would have cut the bilateral deficit by only 0.3 percent.

2. A common explanation, especially in the United States, is that China blocks access to its market for U.S. (and other foreign) products. But the effective tariff ratio in China, import tariff revenue collected as a share of the value of imports, was only 2.2 percent in 2004. Even China's average level of announced tariffs, at 10.4 percent in 2004, is among the lowest of any developing country. China eliminated all import licensing requirements and virtually all import quotas by 2005.

   More broadly, China's ratio of imports to GDP has soared from 5 percent in 1978 to 30 percent in 2005. By that measure, China is now twice as open to trade as the United States and three times as open as Japan. China has in fact been the most rapidly growing market for U.S. exports for the last 15 years: during 2000-2005, for example, U.S. exports to China grew by 160 percent while its exports to the rest of the world rose by only 10 percent. China needs to further open its markets for a number of products but its import regime does not explain much of the imbalance.

3. Another explanation for the imbalance is that the United States (and other high income countries) cannot compete with China's low-wage labor, which earns only about one thirtieth that of its American counterparts. However, Chinese productivity is also only about one thirtieth that of the United States. Moreover, wages account for only 5 percent of the total cost of producing semiconductors and no more than 20 percent of the costs for apparel. More broadly, many developing countries have lower wages than China but are not large exporters and the United States, with wages among the highest of any country, is the world's second largest exporter. "Low wages" cannot explain the large trade imbalance.

4. The most persuasive explanation of the growing bilateral deficit is the increasing role of China as the final assembler in Asia-wide production networks. Over the past two decades, the production process for a growing range of manufactured goods has become increasingly disaggregated on a geographical basis. Each country serves as the location for the portion of the process in which it has the strongest comparative advantage. Higher-income, more technologically advanced countries like the United States have come to specialize in producing high value-added parts and components. China, with its large pool of workers available for unskilled labor-intensive operations, has increasingly become the location of

choice for the final assembly of a broad range of goods, especially electronic and information technology products.

Goods that are assembled from imported parts and components now account for about 55 percent of China's total exports and about 65 percent of the goods China exports to the United States. When these goods are exported from China to the United States, their entire value is counted by U.S. Customs as imports from China. On average, however, about two-thirds of the value of these so-called "processed exports" in fact originate outside China, mostly in other Asian countries.

China's rise as the point of final assembly of a broad range of manufactured goods is reflected in the sharp <u>decline</u> over the past two decades in the share of the U.S. bilateral trade imbalance that originates in other Asian countries (especially Hong Kong, Taiwan, Korea and Japan). As these countries have moved manufacturing capacity to China – and, in the case of Japanese autos, to the United States – the share of the U.S. trade deficit that they account for has fallen by two-thirds, from more than 50 percent in 1985 to only 16 percent in 2004, while China's share has risen from nothing to about one quarter. The United States must understand that it will continue to run a sizable bilateral deficit with China, as recorded in the conventional statistics, largely because of the growing internationalization of production with China as the final assembly point for many products.

5. This structural source of China's burgeoning trade surpluses, especially its global imbalance, has been intensified in recent years by the growing undervaluation of China's currency, the renminbi (RMB). This issue has become a central point of debate between the two countries and is addressed in a separate one-pager.

   It is clear that the average exchange rate of the RMB is now undervalued by 20-40 percent (and that its bilateral rate against the dollar is undervalued by even more). China has intervened massively in the foreign exchange markets for several years to keep the RMB from rising in value, resisting market pressures for a much stronger currency, by selling RMB for dollars. As a result, its foreign exchange reserves are rising rapidly toward $1 trillion, by far the largest in the world. By maintaining its dollar peg as the dollar declined against most other currencies over the past few years, the RMB has in fact recorded a cumulative depreciation that has made China even more competitive. Its minor currency reform of July 2005 had no appreciable impact on the situation. A revaluation of the RMB by 20 percent, if accompanied by an equal appreciation of the other major Asian currencies, should reduce the U.S. global current account deficit by $60-80 billion per year.