

The US-China Bilateral Trade Imbalance

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Introduction

Over the past 250 years, leading economists have debated extensively on the merits of trade imbalance. Adam Smith thought it absurd to think that if one nation ends up with a current accounts surplus or deficit, the wealth of the nation has grown or deteriorated by that amount.¹ Frederic Bastiat argued that not only were trade deficits not a cause for concern, but that they were a manifestation of profit. He argued that a successful growing economy should hold greater trade deficits, while an unsuccessful economy should have lower deficits.² Milton Friedman felt that most concerns about trade deficits were unfair and were promoted by domestic exporting industries that would profit from changes in macroeconomic policy. He believed that free markets would fix the trade balance, as a nation's currency gains value with increased exports and loses value with increased imports, making it harder for a debtor nation to maintain a current accounts deficit.³ However, John Maynard Keynes believed that the trade imbalance ultimately helped contribute to the Great Depression because international lending by the United States due to a current accounts surplus exceeded the capacity of sound investment. According to Keynes, this led to funding being diverted into non-productive and speculative uses which were more prone to default, causes a liquidity crisis and a sudden stop to lending.⁴

Many contemporary economists will argue similarly that, although the US-China bilateral trade imbalance may not have been a direct cause of the recent financial crisis and recession, it was a contributing factor.⁵ As we seek to learn from the recent financial crisis, we must first under-

1 Smith, Adam. *An Inquiry into the Nature and Causes of the Wealth of Nations*. Ed. Edwin Cannan and Max Lerner. Vol. Book 4. New York: Modern Library, 1937. Print.

2 Bastiat, Frederic. *Selected Essays on Political Economy*. Irvington-on-Hudson, NY: Foundation for Economic Education, 1848. *Library of Economics and Liberty*. The Liberty Fund Inc. Web. 03 Dec. 2010. <<http://www.econlib.org/library/Bastiat/basEss13.html>>.

3 Friedman, Milton, and Rose D. Friedman. *Free to Choose: a Personal Statement*. New York: Harcourt Brace Jovanovich, 1980. Print.

4 Crowther, Geoffrey. *An Outline of Money*. London: T. Nelson, 1948. Print.

5 Suominen, Kati. "Did Global Imbalances Cause the Crisis?" *Vox EU*. VoxEU.Org, 14 June 2010. Web. 03 Dec. 2010. <<http://www.voxeu.org/index.php?q=node/5175>>.

stand its underlying causes. In this paper, we will examine the roots and causes (reword “roots and causes”, repetitive) on both the supply and demand sides of the US-China bilateral trade imbalance. This paper is divided into three main sections, followed by a conclusion. First, the paper will examine the roots and causes of the US-China trade imbalance. It will explore the structural and political causes behind the imbalance, as well as the results of the imbalance in both China and the United States. Finally, it will discuss how best to address these problems and how to better balance trade between these two nations.

Understanding Trade Imbalance

For the purposes of this paper, the United States represents a typical debtor nation, and China represents a typical creditor nation. A trade imbalance occurs when a nation imports more than it exports or exports more than it imports. The funding for this deficit comes from foreign nations investing in the national debt. By buying American debt, creditor nations keep the American dollar strong; as long as the US dollar remains in high demand, a trade deficit can be sustained. If the deficit is not maintained, the dollar devalues. This decreases American imports and increases their exports as their prices become cheaper relative to the currencies of other nations. Additionally, having high net exports raises China's currency value, decreasing their exports. In this way, trade imbalances are not always an issue because the markets are capable of correcting themselves.

The problem with assuming the markets will correct themselves is that it relies on freely floating currencies and a free and open currency market. It is apparent that this is not the case, as governments and central banks are major actors in the currency market, manipulating exchange rates in accordance with monetary policy goals. When trade imbalances are sustained over long periods, it suggests that underlying structural issues in both the national economy and in the international architecture are creating these disturbances. In 1985, the United States ran a trade deficit with China of \$6 million. By 1990, the deficit grew to \$10.4 billion, and by 2008, the deficit had grown to \$268 billion.⁶ The trade deficit did not shrink until 2009 as imports from China declined at a sharper rate than American exports to China in the wake of the global financial

6 U.S. Census Bureau. “U.S. Trade Balance with China.” *Foreign Trade Statistics*. U.S. Census Bureau, 10 Nov. 2010. Web. 19 Nov. 2010. <<http://www.census.gov/foreign-trade/balance/c5700.html>>.

crisis of 2008.⁷ As global trade dropped 12% in 2009, we can expect this drop to effect imports and exports proportionately. Between 2007 and 2009, we saw global trade imbalances fall 26%.⁸ The United States' current account/GDP deficit alone was halved during the crisis, dropping from 6% in 2006 to 3% in 2009.⁹ This does not reflect a positive trend, as far as the logical mechanical result of the financial crisis' impact on international trade. Under these conditions, were trade to return to its pre-crisis rates, the imbalance would continue to grow at pre-crisis rates as well. When trade deficits not only maintain but grow, over a 23-year period, it is indicative of underlying structural problems of national economies.

Because these issues are structural, the policies that seek to correct them in the long term will need to be more than demand management tools such as tariffs or quotas. According to the Vox EU report on trade imbalance, shifts in expenditure patterns that are large enough to eliminate significant amounts of the current account imbalances will rely on inter-sectoral shifts in resources within economies.¹⁰ These shifts in the economy will have significant supply-side effects. Additionally, they must be followed up with incentives for other countries to reduce (the) accumulation of the US Dollar. A powerful tool for rebalancing trade in the United States would be to increase savings. This will reduce demand for imports, although statistics demonstrate that China would be far less affected than other nations that export to the United States.

If a sustained or growing imbalance is not indicative of an issue within the structure of an economy, it reveals distorted economic policies. Widely accepted as the cause of the US- China trade imbalance is the undervaluation of Renminbi (RMB).¹¹ When a government rec-

7 Freund, Caroline. "Adjustment in Global Imbalances and the Future of Trade Growth." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. Print.

8 *Ibid*

9 Aizenman, Joshua. "On the Causes of Global Imbalances and Their Persistence: Myths, Facts and Conjectures." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 23-30. Print.

10 Claessens, Stijn, Simon Evenett, and Bernard Hoekman. "Editors Overview." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 3-9. Print.

11 Williamson, John. "Exchange Rates to Support Global Rebalancing." *Rebalancing the Global Economy: A Primer for Policymaking*. Ed. William R. Cline. London: Center for Economic Policy Research, 2010. 77-80. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://>

ognizes a distortion in the market, it is logical to undertake distorting policies to correct the market imbalance. However, if a natural market balance fails to occur, the policy itself is a distorting factor in the global economy. To gauge the distortion China's monetary policy is causing, the undervaluation of the RMB was calculated at 30% in January of 2010.¹² Current distortions in the market are further discussed in the next section, where we go more in depth into how these problems are affecting the economies of both the United States and China.

The trade imbalance has a cyclical relationship with distorting capital flows. The United States has had a trade deficit for 34 years, but the problem significantly worsened in the wake of the Asian financial crisis of the 90's.¹³ As a result of the crisis, East Asian countries began consistently running larger current account surpluses, in the hopes that accumulated foreign exchange reserves could help buffer against speculative attacks on their currencies. Because the United States was the largest market for these exports and the dollar is the world's reserve currency, greater portions of Asian reserves were invested in dollar assets.¹⁴ This inflow, in combination with a low interest rate, kept the dollar strong and depressed the value of Asian currencies. This helped make Asian exports more competitive and helped the United States maintain and expand current account deficits. However, these trade imbalances increased the United States' economy's vulnerability to international capital flows. These imbalances reflected a global savings glut, which resulted in the underpricing of risk that in turn helped cause the recent global financial crisis. Papers by Bernenke, Obstfeld and Rogoff all credit the global imbalance as an important factor in the severity of the crisis, and state that a more stable financial system must involve more balanced capital flows.¹⁵

www.voxeu.org/>.

12 Mann, Catherine L. "External Imbalances: Costs and Consequences of Unsustainable Trajectories." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 43-49. Print.

13 U.S. Department of State. "History of the U.S. Trade Deficit." *Economics at About.Com*. About.Com. Web. 01 Dec. 2010. <http://economics.about.com/od/foreigntrade/a/trade_deficit_h.htm>.

14 Lim, Linda Y.C. "Rebalancing in East Asia." *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic Policy Research, 2010. 31-35. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

15 Freund, Caroline. "Adjustment in Global Imbalances and the Future of Trade Growth." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. Print.

Another contributing factor to the trade imbalance between the United States and China is the asymmetry in the structure of trade barriers. The United States has mostly liberalized markets, yet China's service sector, specifically their financial sector, remains heavily protected. Whereas China has a comparative advantage in the production of labor-intensive products such as tradable goods, the United States has a comparative advantage in the production of human capital, or non-tradable goods. The asymmetry in the structure of trade barriers within these two industries leads to the buildup of unsustainable, welfare reducing imbalances.¹⁶ The comparative advantage of these two countries in their respective strengths, and the stifling of the United States' advantage in the service sector by protectionist Chinese policies is a major contributor to the trade imbalance.¹⁷

In essence, the problem of trade imbalance is not as simple as over-consumption by the (in the) United States and under-consumption by (in) China. There are numerous structural causes of imbalance within both countries. The dollar is overvalued due in large part to it being the world reserve currency, but also because China invests heavily in US treasury bonds, thereby propping up the value of the dollar while suppressing the value of the Renminbi. Additionally, because the United States' economy relies more on service based industry, while China's economy is focused on export-oriented growth, the industries of these nations compete with each other in asymmetrical arenas as these two types of industry face different trade barriers. Now that we understand the basic issues behind the trade imbalance, let us examine the supply-side of this trade imbalance, as well as its causes and effects.

Causes and Effects: China

Since China's markets have opened, they have seen unparalleled growth. The Chinese economy has grown by an average of 10% annually, and its poverty rate has dropped from 53% to 2.5% within the last

16 Kowalski, Przemyslaw, and Molly Leshner. "A Commercial Policy Package for Rebalancing the Global Economy?" Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 127-37. Print.

17 Kowalski, Przemyslaw, and Molly Leshner. "A Commercial Policy Package for Rebalancing the Global Economy?" Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 127-37. Print.

30 years.^{18,19} China's foreign trade has steadily grown faster than its GDP over the last 25 years. In the second quarter of 2010, China became the second largest economy in the world by GDP at \$1.33 trillion.²⁰ In addition, exports composed approximately one-quarter of China's GDP in 2009, as opposed to approximately 7% in the United States.²¹ Throughout China's economic expansion, the government has maintained control of China's service sector. Most of China's financial institutions remain state-owned, as are 98% of the nations' banking assets.²² Although Chinese policy allows and enterprise or individual to obtain loans, over 75% of state bank loans are awarded to state-owned enterprises.²³ According to Przemyslaw Kowalski and Molly Leshner of the OECD, this disproportionately large amount of public ownership is indicative inhibitive regulatory barriers in the services sector.²⁴ Ultimately, this failure to liberalize Chinese non-tradables has led to the over development of China's industrial sector and exports.

As a result, the Chinese economy has been over-reliant on exports to promote economic growth. Approximately one-quarter of all Chinese exports are exported to the United States.²⁵ Due to inconsistencies in trade calculation, this number is probably higher as exports routed through

18 Staff, CNNMoney.com. "China's Economic Growth Eases to 10.3 Percent - CNN.com." *CNN.com International*. CNN, 15 July 2010. Web. 19 Nov. 2010. <<http://edition.cnn.com/2010/BUSINESS/07/14/china.gdp/index.html>>.

19 *Poverty Statistics in China*. Rural Survey Organization of National Bureau of Statistics, China, Sept. 2006. PDF.

20 "China's Gross Domestic Product (GDP) Growth." *China Economic and Business News, Statistics and Analysis*. Chinability, 27 Dec. 2009. Web. 19 Nov. 2010. <<http://www.chinability.com/GDP.htm>>.

21 Data derived independently based on GDP and export data from the two countries. Raw data was obtained from U.S. Census Bureau. "U.S. Trade Balance with China." *Foreign Trade Statistics*. U.S. Census Bureau, 10 Nov. 2010. Web. 19 Nov. 2010. <<http://www.census.gov/foreign-trade/balance/c5700.html>>.

22 Chiu, Becky, and Mervyn Lewis. *Reforming China's State-owned Enterprises and Banks*. Cheltenham, UK: Edward Elgar Pub., 2006. Print.

23 *Ibid*

24 Kowalski, Przemyslaw, and Molly Leshner. "A Commercial Policy Package for Rebalancing the Global Economy?" Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 127-37. Print.

25 U.S. Census Bureau. "U.S. Trade Balance with China." *Foreign Trade Statistics*. U.S. Census Bureau, 10 Nov. 2010. Web. 19 Nov. 2010. <<http://www.census.gov/foreign-trade/balance/c5700.html>>.

major ports such as Hong Kong or Singapore may be counted as Hong Kong or Singaporean exports. Additionally, goods that are exported from China and then used for manufacturing in other East-Asian economies are exported in large part to the United States.²⁶ In order to keep the US economy consuming Chinese exports, the Chinese government needed to ensure that the United States could sustain a running debt. As a result, the Chinese government has engaged in buying large amounts of American debt. Although reports from the US Treasury indicate that China's holdings of US Treasury bonds is \$883.5 billion these numbers likely understate how much US debt China actually owns.²⁷ MIT economist Simon Johnson reported to Congress in March that "a great deal" of last year's \$170 billion increase in Treasury holdings by the United Kingdom were likely due to "China placing offshore dollars in London-based banks", using the funds to purchase Treasury debt.²⁸ Figures from the Treasury Department do not reveal the ultimate country of ownership when debt is held through an intermediary in another jurisdiction.

Through the acquisition of foreign debt, the People's Republic of China has kept the currency of importing countries relatively strong. To rephrase this, the PRC has managed to keep the Renminbi undervalued, for economists estimate that the RMB is undervalued by as much as 30%.²⁹ This acts as an export subsidy and furthers the trade imbalance. This negatively affects China's economy in two ways. First, as China accumulates more American debt, their return on that investment diminishes. Ultimately, it is an inefficient use of funds. Second, since the Chinese economy relies disproportionately on exports, and the current global trade imbalances cannot be maintained, a continuation of this practice could lead to an even greater global economic collapse than the 2008 financial crisis and subsequent recession.³⁰

26 *Ibid*

27 "Major Foreign Holders of Treasury Securities." *Major Foreign Holders of Treasury Securities*. United States Treasury Department, 16 Nov. 2010. Web. 03 Dec. 2010. <<http://www.ustreas.gov/tic/mfh.txt>>.

28 Staff. "China Holds More U.S. Debt than Indicated." *The Washington Times*. The Washington Times, 2 Mar. 2010. Web. 19 Nov. 2010. <<http://www.washingtontimes.com/news/2010/mar/02/chinas-debt-to-us-treasury-more-than-indicated/>>.

29 Mann, Catherine L. "External Imbalances: Costs and Consequences of Unsustainable Trajectories." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 43-49. Print.

30 Lee, Jong-Wha. "Asia's Role in Global Rebalancing." *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic

The law of diminishing returns is a fundamental rule of economics. Applied here, it states that for each unit of debt that China buys from the United States, China will get less benefit out of it. Taking into account that the world economy cannot maintain pre-crisis trade imbalances, and China's consequent need to shift towards a more service-based economy, we can see a clear negative impact for China in its continued investment in American debt. China currently faces numerous economic problems that must be fixed in order for the country to sustain long term growth. For example, China faces major problems in disparities of wealth. Today, they face their largest disparity since liberalization began, with over half of China's population holding 12% of its wealth.³¹ The average income in a Chinese city is over three times the average income in the Chinese countryside. Chinese economists expect this disparity to keep growing as current Chinese investments focus on urban sprawl rather than rural development. By investing in rural development, the Chinese government could mitigate what they openly admit is a "serious threat to social stability".³²

Education and employment are also significant problems in China. In regards to education, China faces problems with the public's access to and the cost of education.³³ These problems are indicative of a misallocation of funds, and have detrimental effects in the long run on China's economic growth. Even today we see the effects of these education problems, as multi-national firms operating in China struggle to find qualified workers to help their companies expand.³⁴ Somewhat paradoxically, China also faces problems finding jobs for much of their population. Publicly, China's unemployment rate is 4.1%, with 9.05 million

Policy Research, 2010. 97-101. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

31 Moore, Malcolm. "China's Wealth Gap the Widest since Economic Reforms Began." *Telegraph.co.uk*. Telegraph Media Group Ltd, 02 Mar. 2010. Web. 03 Dec. 2010. <<http://www.telegraph.co.uk/news/worldnews/asia/china/7350677/Chinas-wealth-gap-the-widest-since-economic-reforms-began.html>>.

32 Jia, Chen. "Wealth Gap Poses Threat to Stability." *China Daily Online*. China Daily, 9 Jan. 2010. Web. 03 Dec. 2010. <http://www.chinadaily.com.cn/china/2010-01/09/content_9292221.htm>.

33 Staff. "Three Major Problems in China's Education System." *People's Daily Online*. People's Daily Newspaper, 9 Jan. 2009. Web. 03 Dec. 2010. <<http://english.peopledaily.com.cn/90001/90781/6571410.html>>.

34 Rein, Shaun. "China's Surprising Unemployment Problem." *Forbes.com*. Forbes, 7 Sept. 2010. Web. 19 Nov. 2010. <<http://www.forbes.com/2010/09/07/china-economy-unemployment-leadership-managing-rein.html>>.

urban Chinese reportedly unemployed.³⁵ This may not seem high because China's population is over 1.3 billion, and only 9.05 million claim unemployment in urban areas, meaning there are tens of millions of workers in rural areas without employment who are looking to join the growing urban economy. Job development programs need to be created to integrate these unemployed rural workers into the urban workforce. The lack of such programs, or at least effective programs to handle this many workers is further indicative of a misallocation of funds. An added benefit of these improvements in education and job training is that they help eliminate the need for precautionary savings by Chinese households.³⁶

Although a current accounts surplus may not seem problematic, it can be demonstrative of neglect. China faces numerous challenges in the future to its economic growth, and there is worry that it is not adequately preparing itself. By continuing to invest in US Treasury Bonds, they are not readying themselves for necessary changes in the international economy or domestic changes in Chinese society. Although continued investment in promoting exports may not be directly responsible for any of these issues, they are all problems that could be fixed with the proper allocation of funds that are currently being spent on American securities.

Causes and Effects: United States

The Chinese government, in order to maintain its growth in exports, has spent trillions on United States Treasury securities. As a result, the dollar has remained over-valued and United States interest rates have been kept low. Many economists feel that this relaxation of America's credit constraints encouraged borrowing and contributed to the housing bubble.³⁷ The growth of this bubble led to the undervaluing of risk, which ultimately led to the sub-prime mortgage crisis. This liquidity shock is what ultimately crippled the global financial system.

The Chinese government is not entirely to blame for the American trade deficit or its overvalued dollar. Between 1996 and 2004, the US's current account deficit grew from 1.6% of GDP to 5.5%, whereas the in-

35 *Ibid*

36 Lim, Linda Y.C. "Rebalancing in East Asia." *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic Policy Research, 2010. 31-35. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

37 Krueger, Anne O. "Persistent Global Imbalances." *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic Policy Research, 2010. 185-90. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

vestment rate remained largely unchanged at approximately 19% of GDP and the savings rate declined by only about 2.5% of GDP.³⁸ The increase in spending is accounted for by a large increase in capital inflows from abroad. Because the US dollar is the standard currency for global trade, it is the currency of choice for foreign investment. Globally, over the eight-year period leading up to the financial crisis, we saw emerging markets increase their capital account surpluses. In developing Asian countries excluding China, there was a \$150 billion increase in external surplus by 2006.^{39, 40} In addition, like the emerging Asian markets, oil-exporting countries increased their current account surplus by \$140 billion in the same period. In these expanding markets and oil producing countries, we saw an overall decline in domestic development and an increase in investments in foreign capital markets.⁴¹ There are two underlying causes of this swing from moderate capital account deficits to substantial capital account surpluses. First, in oil producing nations, increases in oil prices boosted oil exporters' incomes by more than those countries were able or willing to increase spending, thereby leading to higher saving and current account surpluses. Second, the Asian financial crisis led to a series of policy changes in these emerging markets such as resistance to currency appreciation and accumulation of foreign exchange reserves.⁴²

Growth in the United States' export-oriented sectors has been restrained by this over-valuation of the US dollar, rendering American-made goods overvalued as well. This has negative effects on the United States in two ways. First, this leads American companies to outsource jobs to nations where capital is less expensive. The loss of American jobs and American manufacturing lowers the nation's GDP while strength-

38 Bernanke, Benjamin. "FRB: Speech--Bernanke, Global Imbalances: Recent Developments and Prospect." *Board of Governors of the Federal Reserve System*. The Federal Reserve Bank, 11 Sept. 2007. Web. 03 Dec. 2010. <<http://www.federalreserve.gov/newsevents/speech/bernanke20070911a.htm>>.

39 This is somewhat counterintuitive, as developing nations should be the recipient, not provider of funds. Developing economies have higher ratios labor to capital. They are also farther away from the technological frontier, which means investment in these nations has greater potential for higher returns.

40 Lardy, Nicholas. "Parsing China's Trade Surplus." *BusinessWeek*. Bloomberg L.P., 13 Jan. 2006. Web. 03 Dec. 2010. <http://www.businessweek.com/bwdaily/dnflash/jan2006/nf20060113_8659_db053.htm>.

41 Bernanke, Benjamin. "FRB: Speech--Bernanke, Global Imbalances: Recent Developments and Prospect." *Board of Governors of the Federal Reserve System*. The Federal Reserve Bank, 11 Sept. 2007. Web. 03 Dec. 2010. <<http://www.federalreserve.gov/newsevents/speech/bernanke20070911a.htm>>.

42 *Ibid*

ening its demand for exports.⁴³ Second, as the trade imbalances correct themselves, resources will have to be shifted from the non-tradable to the tradable sector, and this transition can be costly and painful.⁴⁴ New, expensive training programs will have to be put in place and vast amounts will have to be spent on employee training.

The overconsumption and underproduction of tradable goods in the United States led indirectly to the recent financial crisis and subsequent recession. In the course of the recession, private consumption in the United States has fallen for the first time in over 20 years.⁴⁵ From the beginning of the recession until March 2009, over 5 million American jobs were lost, the largest jump in unemployment since the 1940's.⁴⁶ Although the recession officially ended in June 2009, it was the most dramatic and longest recession since World War II.⁴⁷ Numerous economic analysts consider the trade imbalance to be a handmaiden for the recession and financial crisis.⁴⁸

How to Fix the Trade Imbalance

This section will address the three main causes of the trade imbalance. The first is the unequal levels of liberalization between the tradable

43 Cook, John, and Paul Nyhan. "Outsourcing's Long-term Effects on U.S. Jobs at Issue." *Seattle Pi Business*. Hearst Seattle Media LLC, 10 Mar. 2004. Web. 03 Dec. 2010. <http://www.seattlepi.com/business/164018_outsource10.asp>.

44 El-Erian, Mohamed A., and Michael Spence. "Global Governance: Pre and Post Crisis." *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic Policy Research, 2010. 165-72. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

45 Buczynski, Richard. "Economic Crisis: When Will It End?" *IBISWorld USA*. IBISWorld. Web. 03 Dec. 2010. <<http://www.ibisworld.com/recession2009/>>.

46 Bureau of Labor Statistics. "Bureau of Labor Statistics Data." *Databases, Tables & Calculators by Subject*. Bureau of Labor Statistics. Web. 03 Dec. 2010. <http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNU04000000&years_option=all_years&periods_option=specific_periods&periods=Annual Data>.

47 Aversa, Jeannine. "The Recession Is Over! So Where's the Party?" *ABCNews.com*. ABC News, 20 Sept. 2010. Web. 03 Dec. 2010. <<http://abcnews.go.com/Business/Savings/wireStory?id=11681510>>.

48 Suominen, Kati. "Did Global Imbalances Cause the Crisis?" *Vox EU*. VoxEU.Org, 14 June 2010. Web. 03 Dec. 2010. <<http://www.voxeu.org/index.php?q=node/5175>>.

and service sectors. Because American economic growth relies disproportionately on its service industry, China's protection of these markets hurts US output while having almost no effect on Chinese growth. We will then discuss what can be done to address the trade imbalance in regards to these policies. The second cause is the Renminbi's distorted dollar-rate and how fixes in the exchange rate may fix the trade imbalance. Finally, this paper will examine protectionist measures as a possible solution for the US-China trade imbalance. While all of these paths may have positive effects on increasing American output and Chinese consumption, they have the potential to be damaging as well. The best approach to addressing the imbalance is likely a hybrid of all three of these approaches.

The sustained trade imbalance with China is both a cause and result of numerous structural issues in the US economy. The structural problems that promote the imbalance are over-investments in US Treasury securities that in turn are exacerbated by the US dollar being used as the world's reserve currency. Due to the dollar's strength, American export-based industries have been stifled. Because the United States is not profiting from tradable goods but private expenditure continues to grow, the difference comes from foreign capital inflows. This inflow perpetuates the strength of the dollar, and helped expand the housing bubble and lower the value of risk. China's market is export-based, with very little liberalization of its service and financial sectors. Additionally, their savings glut and lack of domestic investment keeps the Renminbi weak. Solving the trade imbalance requires both reversals of the negative effects of this imbalance and a correction of the structural flaws in the American and Chinese markets that lead to these imbalances.⁴⁹

Service industries make up over 70% of the global GDP, suggesting that global trade rebalancing will need to center on services.⁵⁰ Boosting manufacturing in high-income deficit countries such as the US can only make a marginal difference in creating employment and helping to generate a present accounts surplus, as tradable goods only account for a small share of the total value-added. In addition, manufacturing competitiveness in an economy is determined largely by their access to low-cost, high-quality services such as telecommunications, transportation and distribution, and financial intermediation.⁵¹ Policies that improve the ef-

49 Claessens, Stijn, Simon Evenett, and Bernard Hoekman. "Editors Overview." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 3-9. Print.

50 *Ibid*

51 Lee, Jong-Wha. "Asia's Role in Global Rebalancing." *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic

iciency of services should be a major goal in order to provide the boost in competitiveness that is necessary for the United States to grow. China shares similar interests in this regard. China's savings glut means domestic consumption must be expanded. Education, research and development services, health insurance, and other service industries are necessary to for broader economic growth. Growth in these industries not only boosts consumption, but studies have shown that improving productivity and efficiency of national service industries contribute to sustaining high rates of economic growth.⁵²

As discussed in the section on the causes and effects of the imbalance in China, China's service industry and financial sector remains largely overprotected and state-owned. While manufacturing has been liberalized, China still has some of the world's most restrictive policies in regards to service growth.⁵³ The Chinese government recognizes that it cannot continue to maintain economic growth solely through production. As part of the current 5-year economic plan being undertaken by the PRC, numerous structural changes that address these issues are being implemented. From 2005 to 2010, service industry has grown 8% as a percentage of GDP.⁵⁴ Additionally, the service industry share of national employment has increased nearly 13%. As a percentage of GDP, research and development spending has increased approximately 54%. The Chinese urbanization rate is also up from 43% to 47%.⁵⁵ Furthermore, since the financial crisis, China has started to invest in a basket of other currencies for foreign reserves.⁵⁶ This puts less pressure on the US dollar and is

Policy Research, 2010. 97-101. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

52 Francois, J. and B. Hoekman (2010) "Services Trade and Policy," *Journal of Economic Literature*, forthcoming (CEPR Discussion Paper 7616)

53 Kowalski, Przemyslaw, and Molly Leshner. "A Commercial Policy Package for Rebalancing the Global Economy?" Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 127-37. Print.

54 "Facts and Figures: China's Main Targets for 2006-2010." *NPC and CPPCC National Committee Annual Sessions 2006*. Government of the People's Republic of China, 6 Mar. 2006. Web. 03 Dec. 2010. <http://www.gov.cn/english/2006-03/06/content_219504.htm>.

55 Government of the People's Republic of China. "The 11th Five-Year Plan." *GOV.CN*. Government of the People's Republic of China. Web. 03 Dec. 2010. <http://english.gov.cn/special/115y_bt.htm>.

56 Staff. "China Diversifies Foreign Reserves Basket." *New China Daily Website*. Tencent, 19 Aug. 2010. Web. 03 Dec. 2010. <http://www2.chinadaily.com.cn/imqq/bizchina/2010-08/19/content_11176022.htm>.

a step forward in helping adjust the exchange rate.

In order to achieve global rebalancing, domestic spending in countries that have payments deficits must be undertaken. To achieve this without causing inflation or deflation, gradual steps towards what John Williamson of the Peterson Institute for International Economics refers to as an “immaculate adjustment” must be taken. Williamson, using a model developed by William R Cline, investigated G20 countries and their surpluses and deficits. Using IMF forecasts, they adjusted exchange rates in trying to achieve an account balance that was, at most, 3% of the nation’s GDP away from balance. The model uses export price elasticity to estimate the needed changes in effective exchange rates, and then translates those effective rates in regards to a bilateral change against the dollar.

Cline and Williamson’s modeling made obvious the need for a 15% adjustment in the real effective exchange rate of the RMB, which translates to a 24% increase in its dollar rate.⁵⁷ In conjunction with these numbers, the model found that the US dollar needed to devalue by approximately 8% in terms of the real effective exchange rate. Of the G20 countries, it was found that China had the largest current undervaluation of its currency, while the United States has the second highest overvaluation of its currency.⁵⁸ Empirically, the major disequilibrium in the global economy is the overvaluation of the dollar and the undervaluation of the Renminbi.⁵⁹ Because China’s exchange rate is pegged to the US dollar, it is largely up to the Chinese government to reverse this disequilibrium if the mechanism of exchange rate adjustment is to be utilized.⁶⁰

In devising policy to help correct the trade imbalance, there is a fear that policymaking may be “hijacked” by corporations or other special interest groups. This hijacking can lead to inefficiencies in the market

57 Williamson, John. “Exchange Rates to Support Global Rebalancing.” *Rebalancing the Global Economy: A Primer for Policymaking*. Ed. William R. Cline. London: Center for Economic Policy Research, 2010. 77-80. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

58 Second to South Africa. Considering that the United States’ economy is over 49 times the size of the South African economy, we can see how the United States’ overvaluation of 8% is far more distorting of global markets than the 14% overvaluation of the South African Rand.

59 *Ibid*

60 Cline and Williamson’s paper also found that when China does correct its exchange rate, other Asian countries such as India, Japan, Indonesia, and Korea will need to as well in order to avoid becoming undervalued.

while helping to prop up industries that are increasingly uncompetitive.⁶¹ The American auto industry is often cited as an example of such “policy hijacking” by playing to political fears of the United States no longer being a “producing” nation. From a producer’s standpoint, it would make sense to lobby the government for protectionist measures to limit competition. Because the undervaluation of the Renminbi acts as both a subsidy to Chinese producers and to American consumers of Chinese goods, protectionist measures are often brought up in the discussion of how to tackle the trade imbalance.

Protectionist measures, although generally damaging, are not necessarily inconsistent with economic rebalancing. As seen in regards to Chinese chicken imports or switchblades, or more recently, Chinese tires, it is politically feasible to put up trade barriers between the United States and China. In doing so, domestic output expansions can arguably increase national income and savings,⁶² helping narrow the trade imbalance. In addition to imposing trade barriers to assist domestic output expansion, the government has sometimes distorted markets by propping up failing industries or companies. Companies such as Chrysler and General Motors receive subsidies from the government that distort competition and supposedly help American output and private sector earnings and savings.

However, there are numerous problems with protectionist measures, the first being that subsidizing failing industries is generally considered a misallocation of funds. There are major issues with moral hazard, and propping up these failing industries does not necessarily guarantee that these companies will improve in the future. Aside from subsidizing failing corporations, putting up trade barriers may also be problematic. While technically, imposing tariffs on Chinese imports may solve the bilateral trade deficit, given the Chinese government’s propensity for retaliation, this could easily trigger a trade war, which would greatly damage the American consumer. Another more fundamental issue is that

61 Aggarwal, Vinod A., and Simon Evenett. “Rebalancing Will Require Supply Side Policy Changes, But Pitfalls Abound.” *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic Policy Research, 2010. 139-45. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

62 Aggarwal, Vinod A., and Simon Evenett. “Rebalancing Will Require Supply Side Policy Changes, But Pitfalls Abound.” *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic Policy Research, 2010. 139-45. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

unless raising these trade barriers triggers savings and investment, it will have little effect on the trade balance.⁶³,⁶⁴ Opening markets facilitates the movement of resources to their most productive uses, raising income levels. Liberalization also raises income growth by expanding returns to investment in high-productivity firms and sectors. Because international trade has expanded both with and without growing imbalances, evidence shows that liberalization does not necessarily have an impact on imbalances.⁶⁵ In fact, as discussed earlier, a major cause for the imbalance is a lack of liberalization. More helpful than raising trade barriers on exports from China would be for China to lower trade barriers on American services. As previously stated, asymmetric trade barriers are a major contributor to the imbalance. This asymmetry could be solved by raising trade barriers on goods or lowering trade barriers on service. Given the clear benefits of liberalization, lowering trade barriers on services in China seems to be the most desirable path.

Problems with the trade balance between the United States and China are three-pronged. First, there is a structural difference between the two economies that contributes to the imbalance. Because China developed as an export-oriented market and the United States' economy has already developed and is now largely service-based, there are asymmetries in trade. As China has developed, it has yet to liberalize its service industries to foreign firms to the extent that the United States has liberalized its markets for foreign goods. This structural difference is a major cause of imbalance. In addition, China's deliberate undervaluation of the Renminbi acts as a subsidy for Chinese exports while propping up the American dollar. This not only makes Chinese exports cheaper but causes American exports to be more expensive. Moreover, the dollar's value is propped up by a large international demand for dollar reserves. Because international demand for the dollar is high, American exports are kept overvalued, harming American export growth. Both the undervaluation of the Renminbi and the overvaluation of the dollar are major components to the trade imbalance.

One possible way to help correct the imbalance would be to impose a tariff on Chinese exports; however, this may not be particularly helpful in the long run. As some imbalance may be desirable, it is difficult

63 Similarly, liberalization will not have an effect on trade imbalances if it does not have an effect on savings and investment.

64 Freund, Caroline. "Adjustment in Global Imbalances and the Future of Trade Growth." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. Print.

65 *Ibid*

to determine the extent to which trade barriers should be imposed. As discussed by Kowalski and Leshner, the uncertainty surrounding the benefits of reducing imbalances have to be weighed against the benefits of trade and investment.⁶⁶ Improvements in efficiency related to specialization according to comparative advantage, economies of scale, access to a wide variety of intermediate and final products, and technology transfer associated with international commerce would all be limited by the imposition of trade barriers.⁶⁷

The best approach then would then be to fight the problem of imbalance on all three fronts: liberalization of the service industry in China, a devaluation of the US dollar in conjunction with a raise in value of the Renminbi, and resistance to protectionist pressures. By pursuing an adjustment in the values of both currencies, we minimize the problems caused by a unilateral adjustment by spreading the costs of this market distortion across both nations. While debtor nations are typically to blame, it is undeniable that the Renminbi has been deliberately kept undervalued by the Chinese government, so Chinese help in correcting this distortion, although unlikely, is not unreasonable. Additionally, by fighting protectionist measures in China's service sector and resisting protectionist pressures in the United States, we can promote higher levels of trade and fight against the issues caused by the US and Chinese currency revaluations. Trade liberalization does not necessarily go hand in hand with growing imbalances. Our goal should be to expand trade while removing structural asymmetries in competition. In doing so we can improve the welfare of both nations while reducing the trade imbalance, creating a more profitable and stable global economy.

Conclusion

There are numerous structural issues to blame for the imbalance. First, there is the issue of developing companies maintaining trade surpluses, which they do in order to boost savings and to invest in American treasury securities to ensure their currency against shocks.⁶⁸ In doing so,

66 Kowalski, Przemyslaw, and Molly Leshner. "A Commercial Policy Package for Rebalancing the Global Economy?" Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 127-37. Print.

67 *Ibid*

68 Lee, Jong-Wha. "Asia's Role in Global Rebalancing." *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic Policy Research, 2010. 97-101. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>.

this practice forces capital to flow from areas where there is much opportunity for good investment into areas where there is little opportunity for investment. As a result, in a manner similar to what happened during the Great Depression, money was invested into riskier and more speculative holdings, which ultimately defaulted and led to the liquidity crisis that caused the financial crisis.⁶⁹

Additionally, complications are caused by deliberate Chinese macro-economic policies aimed at expanding their developing economy. First, there was their undervaluation of the Renminbi, which is estimated to be undervalued by about 30%. This means that Chinese goods cost 30% less than they should, giving them an advantage over American-made goods. Additionally, whereas the American economy is largely service-based, China's service industry still has numerous trade barriers in place. The asymmetric competition between the two countries prevents bilateral trade from being more balanced by canceling out the principal of comparative advantage.⁷⁰ By giving their own exports a 30% subsidy and preventing the United States from being able to be economically competitive in China, China has all but ensured a trade imbalance that is guaranteed to grow as the Chinese economy expands.

Though the trade imbalance has declined since the crisis, this is a natural result of a recession.⁷¹ There is no evidence to suggest that as the global economy recovers, the trade imbalances will continue to shrink.⁷² As structural adjustments to the American and Chinese economies have not been made, we can expect these imbalances to grow. Both the global financial crisis as well as domestic economic problems caused by the imbalance in China and the United States has shown that China cannot

69 Aizenman, Joshua. "On the Causes of Global Imbalances and Their Persistence: Myths, Facts and Conjectures." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 23-30. Print.

70 Kowalski, Przemyslaw, and Molly Leshner. "A Commercial Policy Package for Rebalancing the Global Economy?" Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. 127-37. Print.

71 One effect of the financial crisis that is long term, however, is the decline in demand for the dollar. Emerging markets are now diversifying their foreign reserves holdings since the crisis in to currencies besides the dollar. This should lead to a decline in capital inflows which help raise the US interest rate, thereby increasing American savings and reducing American consumption.

72 Freund, Caroline. "Adjustment in Global Imbalances and the Future of Trade Growth." Print. Rpt. in *Rebalancing the Global Economy: A Primer for Policymaking*. London: VOX EU.Org, 2010. Print.

continue to expand solely with export-oriented growth. China cannot sustain current rates of growth based on exports, as the rest of the world has shown they cannot continue to sustain the levels of demand required for that particular economic strategy to work.⁷³ Additionally, the United States' consumption must be reduced as well. The United States, with a population of around 300 million people, which is less than 5% of the global population, was consuming more than 20% of the world's output until the crisis. China, with about 20% of the world's population, was consuming between 2-3% of global output.⁷⁴ These figures are at the root of the imbalance, and measures to bring them more into balance could help lay the foundation for sustainable economic growth.

The trade imbalance is caused by competitive asymmetries in the Chinese and American economies. These asymmetries can be remedied two ways: by bringing down unfair trade barriers, or by raising trade barriers in previously open markets. China could help fix these asymmetries by revaluing its currency to more accurately reflect the demand for the Renminbi. By ridding itself of what amounts to a 30% export subsidy, the country could help bring about better global economic balance. Additionally, by opening up their markets for services, they can help increase American exports to the region to bring about better trade balance. Whereas these would be the best-case-scenario options because they fix the trade imbalance through economic expansion, trade barriers may also bring about trade balance. If China does not go about fixing the structural asymmetries on their own, the United States has reason to impose an across-the-board tariff on all Chinese goods to help counteract the undervaluation of the Renminbi.

The financial crisis of 2007-2010 was sparked by an international shortage of liquidity caused by a savings glut in developing and oil producing nations and, domestically by an undervaluation of risk in conjunction with low domestic interest rates.⁷⁵ Whereas typically interest rates rise as debt increases, this was not the case in the United States. Inter-

73 *Ibid*

74 O'Neill, Jim. "Does the Rise of the BRICs and the Credit Crisis Make It Easier to Rebalance the World Economy? Yes!" *Rebalancing the Global Economy: A Primer for Policymaking*. London: Center for Economic Policy Research, 2010. 73-76. *Vox EU*. Center for Economic Policy Research, 23 June 2010. Web. 3 Dec. 2010. <<http://www.voxeu.org/>>

75 Bernanke, Benjamin. "FRB: Speech--Bernanke, Global Imbalances: Recent Developments and Prospect." *Board of Governors of the Federal Reserve System*. The Federal Reserve Bank, 11 Sept. 2007. Web. 03 Dec. 2010. <<http://www.federalreserve.gov/newsevents/speech/bernanke20070911a.htm>>.

est rates were depressed through consistently large amounts of capital inflows. These inflows came from both developing and oil producing nations hoping to use the U.S. dollar to back their domestic currencies. Large amounts of capital inflows also came from China, who had a vested interest in keeping the US interest rates low to support the consumption of Chinese exports. As a result, the economy of the United States, and the rest of the world, was poorly poised to handle the financial crisis. In the crisis, US and European banks lost over \$2.8 trillion in assets.⁷⁶ Since June 2007, Americans have lost an estimated \$14 trillion of their household wealth,⁷⁷ and by November 2008, the S&P 500 was down 45% from its 2007 high.⁷⁸ Total retirement assets dropped by 22% from 2006 to 2008, and savings and investment assets lost \$1.2 trillion while pension assets lost \$1.3 trillion.⁷⁹ The unemployment rate increased to its highest rate since 1983 (10.1%), and the average hours per workweek declined to its lowest level since the government began collecting data in 1964.⁸⁰

These figures help illustrate how important it is to bring the world economy back into balance. Although achieving this through open markets is likely the best option, there is little reason to believe China's service markets will open within the next few years, or that they will undergo a currency revaluation on a large enough scale to bring about genuine rebalancing. While all economists can agree that putting up trade barriers is expensive, it seems that the benefits of avoiding another financial crisis may outweigh the costs of slower economic growth.

76 Reuters. "U.S., European Bank Writedowns, Credit Losses." *Reuters Online*. Thomson Reuters, 05 Nov. 2009. Web. 03 Dec. 2010. <<http://www.reuters.com/article/idCNL554155620091105?rpc=44>>.

77 Luhby, Tami. "Americans' Wealth Drops \$1.3 Trillion." *CNN.com*. Cable News Network, a Time Warner Company, 11 June 2009. Web. 03 Dec. 2010. <http://money.cnn.com/2009/06/11/news/economy/Americans_wealth_drops/?postversion=2009061113>.

78 Altman, Roger C. "Detailed Record Title: The Great Crash, 2008: A Geopolitical Setback for the West." *Foreign Affairs* 88.1 (2009): 2-14. Print.

79 *Ibid*

80 Herbst, Moira. "Even the Employed Lose with Hour and Wage Cuts." *BusinessWeek*. Bloomberg L.P., 10 July 2009. Web. 03 Dec. 2010. <http://www.businessweek.com/bwdaily/dnflash/content/jul2009/db20090710_255918.htm>.