

Critics inside and outside Congress contend that “currency manipulation” gives Chinese producers an unfair advantage against their American competitors.

Introduction

The recent visit of China’s president Hu Jintao to Washington failed to satisfy demands by the Bush administration and members of Congress that China move swiftly to allow its currency to appreciate against the U.S. dollar. Those demands may translate into trade sanctions and other actions against China in the months ahead if the perception continues that the U.S. economy is being harmed because China is not doing enough to liberalize its fixed-currency regime.

From 1994 to 2005, Chinese monetary authorities kept the value of the yuan (also called the renminbi) fixed at a rate of about 8.3 to the dollar. In July 2005, they announced a 2.1 percent appreciation of the yuan against the dollar and a new benchmark that pegs the yuan to a basket of major currencies rather than solely to the dollar. Since then, the yuan has appreciated another 1 percent. Despite those modest steps, critics inside and outside Congress argue that the government of China continues to intentionally maintain its currency at a rate that is far below what its value would be were it allowed to float freely in foreign currency markets. They contend that this “currency manipulation” gives Chinese producers an unfair advantage against their American competitors by making Chinese imports to the United States artificially cheap and by making U.S. exports to China more expensive, thus depressing U.S. manufacturing output and destroying U.S. jobs. A record \$202 billion bilateral trade deficit with China in 2005 has only fueled the already fiery rhetoric.

The rationale behind China’s currency policies and the impact of those policies on the U.S. economy are in reality quite different from the claims currently being made in Washington. A closer look at China’s exchange rate and its impact on trade shows that the fixed exchange rate has not given an unfair advantage to imports from China nor hindered the ability of American exporters to sell in China’s own growing market. Nor have the exchange rate and trade with China caused a

contraction of America’s overall manufacturing base. In fact, our booming trade with China has been a blessing for tens of millions of American families and a profitable opportunity for thousands of American companies and their employees.

Those conclusions are especially relevant because Congress may soon consider legislation that would impose steep tariffs on imports from China if that country does not allow its currency to float more freely and, presumably, gain value against the U.S. dollar. One bill, sponsored by Sens. Charles Schumer (D-NY) and Lindsey Graham (R-SC), claims that the yuan is undervalued by 15 to 40 percent. If the currency is not allowed to float toward its market value within six months, the bill would split the difference between 15 and 40 and impose a 27.5 percent tariff on all Chinese imports to the United States.

In a press release touting his bill, Schumer’s office claimed that

the Chinese undervaluation of its Yuan has played a major role in the loss of 3 million US manufacturing jobs over the last five years and is contributing to the migration of service and engineering jobs to China. . . . The practice of “currency manipulation” to gain a trade or competitive advantage violates World Trade Organization and International Monetary Fund agreements, of which China is now party. China’s emergence as a manufacturing powerhouse at the expense of the United States raises significant economic security concerns and the question of whether a country that loses its ability to produce tangible products will long remain an economic power.¹

Sens. Schumer and Graham backed away from any immediate threats to introduce their legislation after a visit to China in March, but they reserved the option of demanding a vote later this year should China fail to make progress toward a more market-determined currency valuation.

Another bill, sponsored by Senate Finance Committee chairman Charles Grassley (R-IA) and ranking Democrat Max Baucus (D-MT), would impose milder sanctions but broaden the definition of an offensive practice to include maintaining a currency that is in “fundamental misalignment.” Sanctions would include denying certain federal investment loan guarantees and opposing expanding voting rights in the International Monetary Fund for the offending country.² Yet another bill in the House would allow U.S. companies to petition for protective tariffs against imports allegedly being “subsidized” by intentionally misaligned exchange rates.³

Although it opposes higher tariffs on Chinese goods, the Bush administration has ratcheted up its complaints against China for not moving more quickly toward a more flexible currency. In a May report on foreign economic and currency policies, the U.S. Department of the Treasury declared its “strong disappointment” that “far too little progress has been made in introducing exchange rate flexibility for the renminbi” since its previous report in November 2005. Nonetheless, Treasury was “unable to determine, from the evidence at hand, that China’s foreign exchange system was operated during the last half of 2005 for the purpose (i.e., with the intent) of preventing adjustments in China’s balance of payments or gaining China an unfair competitive advantage in international trade.” Absent any evidence of intent, Treasury was unable to find China technically guilty of “currency manipulation.”⁴ As a means of pressuring China, the administration has endorsed the Grassley-Baucus legislation in the Senate.⁵

Before policymakers in Washington charge ahead with sanctions against China, they should re-examine the reasons for which a country at China’s state of development may chose a fixed currency and whether China’s foreign-currency regime is in fact damaging the United States. They should also consider the real damage that would be inflicted on the U.S. economy by some of the alleged remedies being proposed and consider policy alternatives

that would expand rather than disrupt the mutually beneficial trade relationship between the United States and China.

Is China Manipulating Its Currency?

A threshold question is whether the government of China is “manipulating” the value of its currency to gain an economic advantage at the expense of other countries, or whether there are other, more benign reasons why a country at China’s stage of development would chose to peg its currency to one or more major currencies such as the U.S. dollar.

“Currency manipulation” is not a technical term with a precise and widely accepted definition. As the Treasury’s own November 2005 report on international exchange-rate policies noted, judging whether another nation is manipulating its currency “is inherently complex, and there is no formulaic procedure that accomplishes this objective.” Treasury also notes that the IMF Articles of Agreement “allow countries enormous latitude in selecting and managing exchange rate systems.”⁶

There is nothing inherently wrong with maintaining a fixed-rate currency. The major Western industrial countries, including the United States, fixed their currencies among themselves from the 1950s to the early 1970s under the Bretton Woods Agreement. Today, according to the International Monetary Fund, China is among the half of IMF-member countries (89 out of 187) that maintain a fixed currency, either against a single other currency or a basket of foreign currencies. Another third of IMF members maintain a managed float in which monetary authorities regularly intervene. Only 36 sovereign monetary authorities, about one in six IMF members, allow their currencies to float freely over a sustained period.⁷

China does stand out as one of the few major trading nations that maintain a fixed currency. The world’s top trading entities almost all allow their currencies to float more or less freely on international exchange markets, including the United States, Japan, Great

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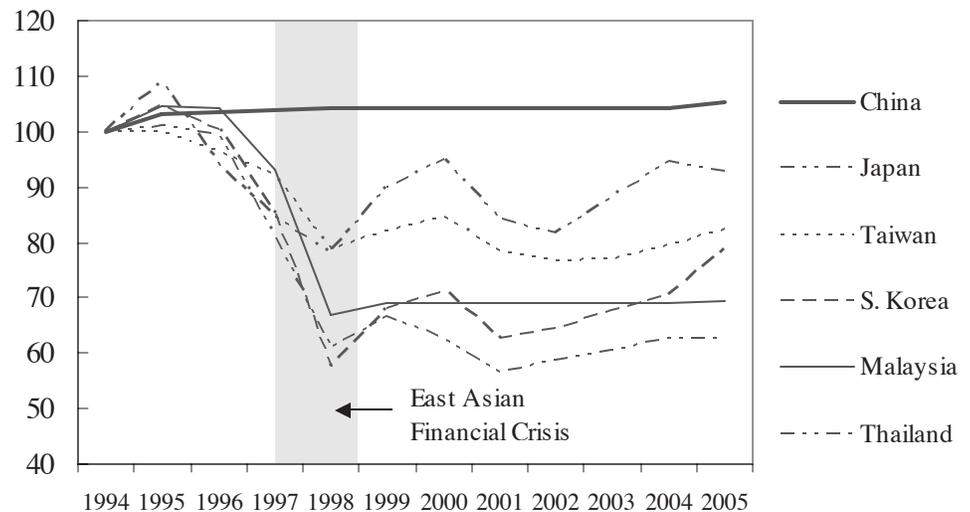
Britain, Canada, South Korea, Mexico, Australia, and the 12 members of the euro zone. Hong Kong and Malaysia maintain fixed currencies while the Russian Federation actively intervenes to keep its currency within a range. Among countries at a similar stage of development, however, China's fixed currency regime is more typical. To demand that China implement a freely floating currency regime in the next few months under penalty of trade sanctions is to ask of China what we are not demanding of any other country at its stage of development.⁸

China's fixed currency was not always viewed as a problem. In fact, in 1997 and 1998, as other currencies and economies in the region were crashing through the floor during the East Asian financial crisis, the Chinese monetary authorities were praised for holding their currency steady. They resisted the temptation to devalue in order to remain "competitive." As Figure 1 illustrates, the yuan remained steady and even appreciated slightly against the dollar during the crisis.⁹ In fact, the

real, trade-weighted value of the yuan appreciated by 30 percent from 1994 to early 2002.¹⁰ Policymakers in Washington need to ask themselves whether circumstances have changed so dramatically in the past eight years that what was seen as a globally responsible policy in the late 1990s now deserves punitive trade sanctions.

Studies differ widely on whether and how much China's currency is undervalued and the intent of the policy behind it. Conclusions reached in a number of studies range from a 50 percent undervaluation to a slight overvaluation.¹¹ Economists at the International Monetary Fund, the international agency charged with monitoring global exchange rates, have so far refrained from accusing China of manipulating its currency to gain a competitive trade advantage. IMF managing director Rodrigo de Rato has declared that he and the IMF staff see no evidence that China is artificially depressing its currency to gain a trade advantage. Instead, "There is a strong argument by the Chinese authorities that their main objective" in keep-

Figure 1
East Asian Exchange Rates, 1994–2005
 (nominal value of currencies vs. U.S. dollar, 1994=100)



Source: Federal Reserve Board.

ing the yuan steady against the dollar, he said, “is the stability of the economy.”¹²

There is widespread agreement inside and outside of China that a more flexible currency regime would be in China’s own long-term interest. A more flexible currency regime would allow the Chinese central bank to pursue a more independent monetary policy consistent with China’s long-term economic growth and stability. It would free the central bank of the need to intervene frequently and at times massively in foreign exchange markets to maintain a certain currency rate in the face of market pressure. It would also allow the Chinese economy to adjust more smoothly to internal and external shocks by allowing immediate and incremental changes in its exchange rate rather than requiring more difficult adjustments in overall price levels throughout China.

Toward that goal, China continues to lay the foundation for a more market-based currency system. Earlier this year, the government legalized currency trading between banks in China. The daily opening price for the yuan is now set by trading among 13 banks, so-called market makers who assume the risk of daily fluctuations. The Chinese government still limits daily movements of the currency to plus or minus 0.3 percent, but the mechanism is falling into place to allow larger movements. The government also allows futures trading so traders can hedge their risk against future movements of the currency.¹³ In a joint statement issued after a meeting of the U.S.-China Joint Economic Committee in Beijing last October, Chinese authorities committed “to enhance the flexibility and strengthen the role of market forces in their managed floating exchange rate regime.”¹⁴

Branding China a “currency manipulator” under threat of trade sanctions would be inconsistent with a more measured view of China’s exchange-rate regime. Such a move would fail to recognize China’s own interest in a more flexible currency and the modest but real steps its government has taken so far toward that goal.

Does China’s Currency Regime Threaten the U.S. Economy?

Everyone can agree that imports stamped “Made in China” have soared in the past decade. In 2005, imports from China reached \$243.5 billion, a huge increase from the \$38.8 billion in goods imported from China in 1994. During that same period, imports from China as a share of total U.S. imports rose from 6 to 15 percent. Since 1994, imports from China have grown more than twice as fast as imports from the rest of the world.¹⁵

Displacing Other Imports

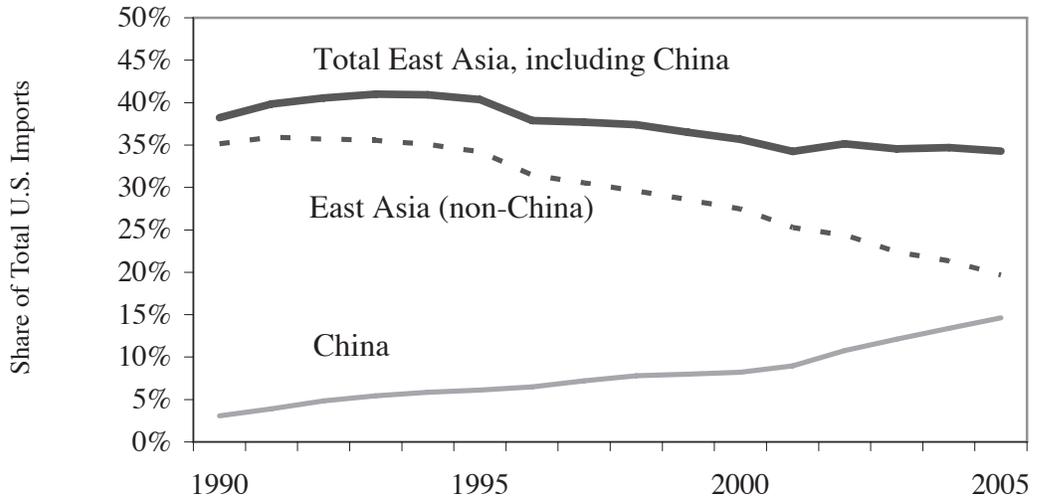
Despite their rapid increase, imports from China have not been a major cause of job losses in the U.S. economy. Chinese manufacturers tend to specialize in lower-tech, labor-intensive goods, in contrast to the higher-tech, capital-intensive goods that are the comparative advantage of U.S. manufactures. For example, the apparel and footwear industries in the United States have been in decline for decades, long before China became a major exporter of those goods. Rising imports from China have not so much replaced domestic production in the United States as they have replaced imports that used to come from other lower-wage countries.

A key to understanding our trade relationship with China is to see China as the final assembly and export platform for a vast and deepening East Asian manufacturing supply chain. Even in mid-range products such as personal computers, telephones, and TVs, rising imports from China have typically displaced imports from other countries rather than domestic U.S. production. Final products that Americans used to buy directly from Japan, South Korea, Taiwan, Hong Kong, Singapore, and Malaysia are increasingly being put together in China with components from throughout the region.

China’s more economically advanced neighbors typically make the most valuable components at home, ship them to China to be assem-

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Figure 2
China and the East Asian Supply Chain (imports to the United States as a share of total U.S. imports)



Source: U.S. Department of Commerce. Major East Asian sources of imports include Japan, South Korea, Taiwan, Hong Kong, Malaysia, Indonesia, Thailand, Singapore, and the Philippines.

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bled with lower-value-added components, and then export the final product directly from China to the United States and other destinations. As China imports more and more intermediate components from the region, its growing bilateral trade surplus with the United States has been accompanied by growing bilateral deficits with its East Asian trading partners.

While imports from China have been growing rapidly compared with overall imports, the relative size of imports from the rest of East Asia has been in decline. In 1994, the year China fixed its currency to the dollar, imports from East Asia accounted for 41 percent of total U.S. imports. Today imports from that part of the world, including those from China, account for 34 percent of total U.S. imports. In other words, the rising share of imports from China has been more than offset by an even steeper fall in the share of imports from the rest of Asia, as shown in Figure 2.¹⁶

The sharp rise in imports from China is driven not primarily by China's currency regime but by its emergence as the final link in

an increasingly intricate East Asian manufacturing supply chain.

What about Those Three Million Lost Manufacturing Jobs?

Contrary to the often-stated charge, imports from China are not the primary cause of the decline in U.S. manufacturing jobs since 2000. The primary reason why a net three million manufacturing jobs have disappeared since then is not imports from China but our own domestic recession of 2001, sluggish demand abroad for U.S. exports, and, most of all, soaring productivity gains by U.S. factories. After rising rapidly during the 1990s, U.S. manufacturing output peaked and began to fall in the summer of 2000 as rising interest rates and energy prices began to tip the U.S. economy into recession. The same recession in 2001 that hurt domestic manufacturing output also caused a 4.7 percent drop in the volume of imported manufactured goods that year.¹⁷

Meanwhile, sluggish growth abroad has hurt U.S. manufacturing exports. An analysis

by the Council of Economic Advisers determined that trade with China was not the primary cause of manufacturing job losses during the most recent recession. "With the exception of apparel, the largest job losses have occurred in export-intensive industries for the United States, and job losses in U.S. manufacturing have been mainly industries in which imports from China are small," the CEA reported in the *2004 Economic Report of the President*.¹⁸

The main reason for declining employment in manufacturing, however, is the dramatic rise in productivity. Despite the painful recession in manufacturing from 2000 to 2003, real output of U.S. factories has still increased by 50 percent since 1994. (See Figure 3.)¹⁹ American domestic manufacturers can produce so much more with fewer workers because remaining manufacturing workers are so much more productive.²⁰ Trade with China has probably accelerated the decline of more labor-intensive manufacturing sectors in the United States, such as footwear, apparel, and other light manufacturing, but it has not caused a decline in total manufacturing output or capacity.

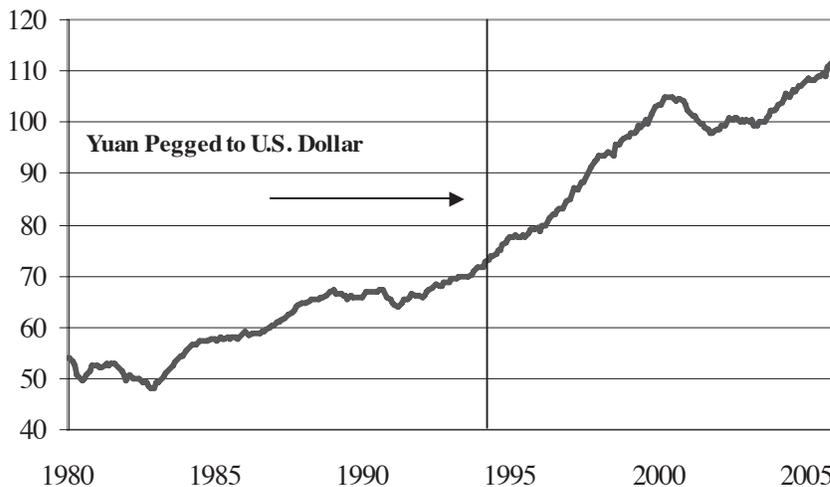
In fact, because of productivity gains, man-

ufacturing employment has been falling in a wide range of countries, including China itself. According to a 2003 study by Alliance Capital Management in New York, while the number of manufacturing workers in the United States dropped by 11 percent from 1995 through 2002, the number in China dropped even further, by 15 percent, for a net job loss of 15 million. While Western companies were opening new factories in China, creating better paying jobs for Chinese workers, even more manufacturing workers were losing their jobs as old, inefficient state-owned enterprises went out of business.²¹

Certainly some U.S. workers have lost their jobs because of America's expanding trade with China, but the number is not large compared with the total size of the U.S. labor force and the normal, healthy "churn" in the labor market. Even if we accept the estimates put forth by critics of trade with China, the number of jobs eliminated because of Chinese imports would be in the neighborhood of 150,000 a year.²² Although not insignificant, that number is a small fraction of the number of people involuntarily displaced from their jobs each

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Figure 3
U.S. Manufacturing Output, 1980–2005
(monthly index, 2002 = 100)



Federal Reserve Board.

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year in the United States, even during years of expansion and healthy job growth. According to the Department of Labor, about 15 million jobs in the United States are permanently eliminated each year.²³ In a related indicator, about 300,000 workers apply each week for unemployment insurance.²⁴ By either measure, job losses caused by trade with China account for only about 1 percent of overall job displacement in the United States. Rather than impose trade sanctions in a misguided effort to save a small number of jobs lost each year because of trade with China, policymakers should focus on removing barriers to job creation and on retraining and relocation to help those workers find the new jobs that are being created in our dynamic economy.

Misplaced Hope

Just as critics of China's currency regime tend to exaggerate its negative impact, they also typically exaggerate the positive impact of increased flexibility or an upward revaluation of the yuan. If China were to move toward a more freely floating currency, evidence and experience suggest it would not have a noticeably positive effect on U.S. manufacturing, employment, or the bilateral trade balance with China, for three main reasons.

First, it is not certain that a more flexible yuan would mean a significantly stronger yuan. If a more flexible currency regime were accompanied by greater freedom of capital to move in to and, more important, out of, China, Chinese savers could choose to invest more of their savings in other countries, including in the United States. That would put downward pressure on the yuan, dampening any appreciation or perhaps even causing a depreciation of the currency relative to the U.S. dollar.

Second, even if the yuan appreciates significantly, its rise may not translate into significantly higher prices for Chinese goods sold in the U.S. market. Producers in China may choose to keep their prices in the U.S. market close to current levels and accept smaller profits on U.S. sales to maintain market share, at least in the short run. An appreciating yuan would also translate into lower prices paid by producers in

China for imported energy, raw materials, and intermediate components, which account for a third or more of the value of exports from China.²⁵ Lower production costs would thus partially offset the lower earnings abroad from exports, allowing Chinese producers to maintain their competitiveness in the U.S. market.

Third, even if prices rise for Chinese imports to the United States, U.S. consumers may be slow to switch to competing products from other countries. Indeed, if prices paid for Chinese imports rise faster than demand for those imports falls, total spending on imports from China may even rise in the short run, leading to a temporarily larger bilateral trade deficit with China (just as rising oil prices have caused larger bilateral deficits with oil-exporting countries).

For all those reasons, even sharp changes in exchange rates do not always translate into a desired change in bilateral deficits. For example, the United States runs a large and persistent bilateral trade deficit with the 12 European countries that use the euro as a common currency.²⁶ Since 2001, the euro has appreciated by approximately a third against the dollar, from \$.90 to \$1.20—just the kind of medicine called for by the deficit doctors who want to cure our bilateral deficit with China.²⁷ During that period of a sharply appreciating euro, our bilateral deficit with the euro zone countries has actually grown larger, not smaller. In 2001, the deficit was \$54.0 billion, but after four years of a generally rising euro, the bilateral deficit had actually climbed to \$91.4 billion—a 69 percent increase.²⁸ Obviously, the prescribed medicine did not have the desired effect.

In testimony before Congress last year, former Federal Reserve Board chairman Alan Greenspan warned lawmakers against viewing a change in China's exchange rate as some kind of magic bullet for the real and imagined problems of the U.S. manufacturing sector. As Greenspan testified, "Some observers mistakenly believe that a marked increase in the exchange value of the Chinese renminbi (RMB) relative to the U.S. dollar would significantly increase manufacturing activity and jobs in the United States. I am aware of no credible

evidence that supports such a conclusion.”²⁹ A recent report issued by U.S. companies doing business in China reached a similar conclusion: “We do not believe that RMB appreciation will solve the U.S. bilateral or global deficit problem, nor will it ameliorate the long-term structural decline in U.S. manufacturing jobs.”³⁰

Bilateral trade balances are driven by a complex range of factors, including differing rates of national savings and investment, wealth, demographics, economic growth, consumer tastes, and comparative advantage enjoyed by each country’s producers. As long as the people of China continue to save hundreds of billions of dollars more each year than what is invested in China, and as long as Americans continue to invest hundreds of billions of dollars more than we save, capital will continue to flow from China to the United States, producing a large bilateral deficit with China.

Focusing on the bilateral trade deficit with China as the central problem, and the exchange rate as the solution, is a recipe for frustration. Even if a major appreciation of the yuan can be engineered, and even if the bilateral deficit with China were to grow more slowly or contract, evidence does not indicate that U.S. manufacturers would reap any sort of windfall.

Overlooked Benefits of Trade with China

While the critics of trade with China mistakenly focus on the alleged harm it causes, they tend to overlook the benefits. Those benefits include lower-priced imports for U.S. consumers and businesses, expanding export opportunities to China, and the economywide benefits of Chinese capital flowing to the United States.

A Variety of Affordable Imports

Producers in China specialize in goods that are especially attractive to consumers in the United States. Most of what we import from China fits in the category of consumer goods that improve the lives of millions of Americans every day at home and in the office. Of the \$243 billion worth of goods we imported from

Table 1
What Americans Imported from China in 2005
(in thousands of U.S. dollars)

Furniture, appliances, household goods	\$51,893,087
Clothing and shoes	\$40,808,765
Computers and accessories	\$40,187,903
Industrial machinery	\$23,383,028
Toys and sporting goods	\$20,586,117
TVs, radios, VCRs	\$19,103,404
Industrial supplies	\$16,616,789
Telecommunications and business equipment	\$14,046,150
Jewelry, artwork and miscellaneous	\$6,734,159
Transportation equipment	\$6,144,783
Food and energy	\$3,958,146
Total	\$243,462,331

Source: U.S. Department of Commerce.

China last year, more than 80 percent were computers and computer accessories; cell phones and other telecommunications equipment; furniture, appliances and other household goods; clothing and shoes; toys and sporting goods; and TVs, radios, and other consumer electronics. The remaining 20 percent of imports from China last year were industrial supplies, industrial machinery, transportation equipment, food, and energy.³¹ (See Table 1.)

Those imports allow Americans to stretch their paychecks further, raising real wages for millions of workers. Money saved because of lower prices for Chinese imports allows U.S. consumers to spend more on other, non-Chinese goods and services, including those produced in the United States. Those savings are especially important for low- and middle-income American families who spend a relatively larger share of their budgets on discount-store shoes, clothing, and other products made in China.

A Growing Market for American Products

American producers and workers have gained tremendously from growing export opportunities to China. China’s fixed currency has allegedly discouraged exports to China, but that is not supported by the trade numbers. Since 2000, U.S. exports of goods to China have increased by 158 percent, from \$16.2 billion to

A tax on imports from China would mean higher prices for shoes, clothing, toys, sporting goods, bicycles, TVs, radios, stereos, and personal and laptop computers.

\$41.8 billion in 2005. The rate of growth of U.S. exports to China since 2000 is more than 12 times the rate of growth of U.S. exports to the rest of the world (other than China) during the same period.³² Our leading exports to China are soybeans, cotton, and other agricultural products; plastics, chemicals, wood pulp, and other industrial materials; civilian aircraft; and semi-conductors, computer accessories, industrial machines, and other machinery.³³

China's market has also created expanding opportunities for U.S. investors and service providers. In 2003, according to the most recent figures, U.S. companies sold \$48.8 billion in goods and services in China through majority-owned affiliates located in China.³⁴ In addition, U.S. companies exported \$7.2 billion in private services to people in China, making China our third-largest service customer in Asia.³⁵

Large multinational companies have not been the only beneficiaries of expanding exports to China. According to the U.S. Department of Commerce, more than one-third of U.S. exports to China are produced by small and medium-sized enterprises (SMEs) in the United States. In 2003, the most recent year for figures, a total of 16,874 U.S. SMEs exported to China, more than five times the number of SMEs that were exporting to China in 1992. China is now the fourth-largest export market for American SMEs and the fastest-growing major market.³⁶ An undervalued yuan does not appear to have dampened the ability of U.S. companies, large, small, or in between, to sell in China's rapidly growing market.

More Capital, Lower Interest Rates

The dollars earned by producers in China by selling in the U.S. market are not stuffed under mattresses. They either come back to the United States to buy our goods and services or are used to invest in the United States through the purchase of U.S.-based assets. The large majority of Chinese investment in the United States comes through official purchases of U.S. Treasury bills by China's central bank. As of December 2005, Chinese monetary authorities held \$262 billion in U.S. Treasury bills.³⁷

China's investment in the United States,

although a relatively small share of the total U.S. securities market, does put upward pressure on bond prices and thus downward pressure on U.S. interest rates. Lower rates, in turn, mean lower mortgage payments for American families and lower borrowing costs for U.S. businesses. Lower borrowing costs have also stoked demand for durable goods such as cars and appliances, benefiting U.S.-based manufacturers. And, of course, lower interest rates paid on U.S. Treasury bills means less spending by the federal government and greater savings for U.S. taxpayers.

A one-sided view of trade with China—a view that considers only the alleged harm while ignoring the real benefits—will likely result in misguided policies that would put those benefits in jeopardy.

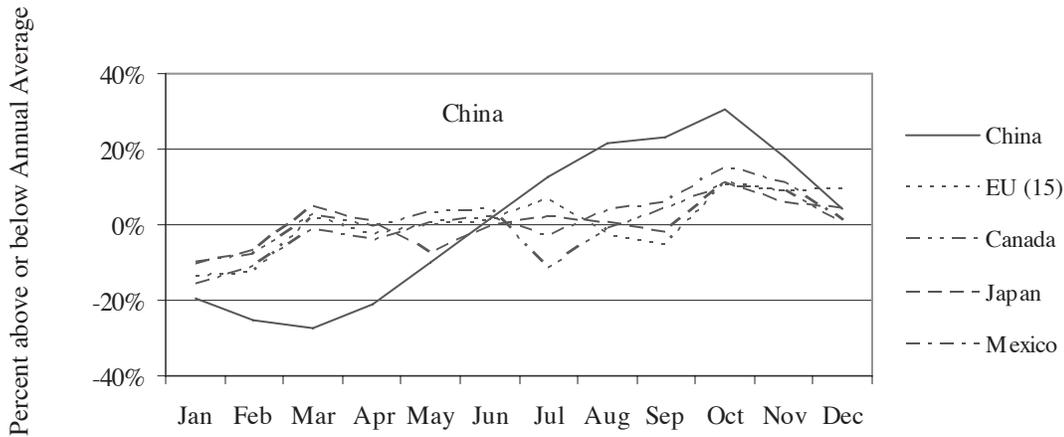
Backfire from Trade Sanctions

Imposing punitive, unilateral sanctions against imports from China because of its foreign currency regime would be a colossal policy blunder. Trade sanctions would, of course, hurt producers and workers in China, but they would also punish millions of American consumers through higher prices, disrupt supply chains throughout East Asia, invite retaliation, and jeopardize sales and profits for thousands of U.S. companies now doing business with the people of China. Sanctions of the kind being contemplated in Congress would also violate the same set of international trade rules that members of Congress accuse China of violating.

Tariffs on imports from China would amount to a direct tax on tens of millions of U.S. households that buy those \$200 billion in consumer goods we imported from China last year. A tax on imports from China would mean higher prices for shoes, clothing, toys, sporting goods, bicycles, TVs, radios, stereos, and personal and laptop computers.

Imports from China are just the kind of consumer goods that millions of low- and middle-income families buy at discount stores throughout the year, but especially during the holiday season. Imports from China tend to

Figure 4
'Tis the Season for Chinese Imports



Source: U.S. Department of Commerce; averages for 1986–2005

spike upward in August through November compared with the rest of the year as importers rush to fill orders from U.S. retailers in anticipation of the holiday shopping rush. While imports from our other major trading partners also typically rise 10 to 15 percent on a seasonal basis, peaking in October, imports from China surge an average of 20 to 30 percent from August through October each year compared with average monthly imports throughout the year.³⁸ (See Figure 4.) The Grinch who tried to steal Christmas could not have devised a more fitting trade policy than a steep tariff on Chinese imports to dampen the spirits of holiday shoppers.

American consumers and retailers could not easily escape the impact of those tariffs by simply sourcing those goods from other low-wage producers abroad. As explained above, existing supply chains throughout East Asia depend on China as the final assembly point in a complex, deeply integrated production process. A tariff aimed at China would require producers throughout the Pacific Rim to readjust their whole systems of production, potentially disrupting employment not only in China but in factories and offices throughout the region. With 60 percent of China’s exports made in foreign-owned plants, producers would not be

expected to quickly abandon their China-based production facilities.³⁹ American consumers would then be forced to pay a significant share of the tariff imposed on Chinese imports.

A unilateral tariff against Chinese imports would also invite retaliatory tariffs from the Chinese government against U.S. exports to China. That would jeopardize U.S. exports to our fourth-largest and fastest growing major export market. The resulting trade war would drag down economic growth in the world’s two most dynamic major economies. Disrupting commercial relations between the two most important engines of the global economy would have negative reverberations throughout the world.

Finally, if Congress were to impose tariffs on Chinese goods unilaterally because of China’s currency regime, it would almost certainly be a violation of our commitments under existing WTO rules. Advocates of a get-tough approach have argued otherwise. The U.S.-China Economic and Security Review Commission, a congressionally established body whose members have been critical of trade with China, urged Congress in a 2005 report to consider imposing “an immediate, across-the-board tariff on Chinese imports at the level determined necessary to gain prompt action by China to strengthen significantly the value of the RMB.”

The Grinch who tried to steal Christmas could not have devised a more fitting trade policy than a steep tariff on Chinese imports to dampen the spirits of holiday shoppers.

The Chinese government should continue to move steadily toward a more flexible currency, with the goal of allowing the value of the yuan to be set freely in global foreign-exchange markets.

The commission claims the unilateral sanction would be warranted under Article XXI of the WTO charter, which allows members to take necessary actions to protect their national security. The alleged link to national security is that an undervalued currency has “contributed to a loss of U.S. manufacturing, which is a national security concern to the United States.”⁴⁰

The national security argument contains two central flaws. First, there is no evidence that trade with China has caused an absolute decline in U.S. manufacturing output and capacity. In fact, in the dozen years since China fixed its currency, U.S. manufacturing output has expanded significantly, as the evidence above shows. Second, the narrow sectors of the U.S. manufacturing base that arguably have been negatively impacted by trade with China—namely footwear and apparel—cannot be plausibly linked to any reasonable definition of U.S. national security. And even if they were, a far less damaging policy would be to directly subsidize their domestic production, not to impose WTO-illegal sanctions against a major foreign producer.

Another argument for taking action against China’s currency regimes is that it constitutes an illegal “export subsidy” in violation of WTO’s Agreement on Subsidies and Countervailing Measures. If the U.S. government decides that a case exists and that the United States is being harmed, the proper course would be to file a petition through the existing WTO dispute settlement process, not to act unilaterally outside the process. Unilateral action against China outside the established process of international trade rules would undermine the very rules-based system that the United States has worked for decades to establish.

Policy Response

America’s commercial relationship with China is not a crisis that demands urgent action on the part of the U.S. government. People in both nations are benefiting from rapidly growing and generally normal trade and investment relations. For Americans, our

expanding commercial ties with the people of China mean more variety and lower prices for everyday goods, translating into higher real wages for millions of American workers, huge opportunities for U.S. companies and their workers to sell their products, and downward pressure on the rates we pay for home mortgages, consumer and business loans, and financing of the federal debt. In light of those benefits, Congress and the Bush administration would be wise to follow the long-standing dictum in medicine, “First, do no harm.”

Of course, room exists in both countries to improve our bilateral trade relationship. The Chinese government should continue to move steadily toward a more flexible currency, with the goal of allowing the value of the yuan to be set freely in global foreign-exchange markets alongside the currencies of most other major trading nations. China’s government should also continue to liberalize its own domestic economy and to fulfill and exceed its international commitments to further open its market to global competition. It should also reform any policies that artificially discourage consumption in China and add unnecessarily to the growing excess of savings over investment that largely drives the politically sensitive trade deficit with the United States.

The U.S. government, for its part, should continue to offer technical support and encouragement to China’s monetary authorities as they implement a more flexible currency regime. Charges of “currency manipulation” and threats of trade sanctions do nothing constructive to help China make that transition. At home, the federal government should reduce its huge budget deficit, preferably through spending cuts, which would reduce the demand for foreign savings to finance it, putting downward pressure on the dollar and at least somewhat mitigating the overall current account deficit. Changes in the U.S. tax code should be made to reduce the bias against private-sector savings, further reducing the inflow of foreign savings to fill the gap between domestic savings and investment.

All of those policy reforms would move the United States and China toward an even more beneficial commercial relationship based on

freer markets at home and freer trade between our nations. Those policies should be implemented, not through the heavy-handed threat of trade sanctions, but through diplomacy, cooperation, and negotiation based on a firm understanding of the mutual gains from trade.

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