CHAPTER 1

THE U.S.–CHINA TRADE AND ECONOMIC RELATIONSHIP

SECTION 1: THE U.S.–CHINA TRADE AND ECONOMIC RELATIONSHIP'S CURRENT STATUS AND SIGNIFICANT CHANGES DURING 2010

Introduction

After three decades of growth averaging nearly 10 percent a year, China passed Japan in the first half of 2010 to become the world's second-largest economy, after the United States.[1] Although the gap between China's $5 trillion economy and the nearly $15 trillion economy of the United States remains very large, China's advancement is remarkable for a country whose gross domestic product (GDP) was just half as much five years ago. China's per capita income has increased from $930 in 2000 to $3,600 in 2009.[2] China is America's biggest trading partner in the Asia-Pacific region and its second-largest trading partner overall, after Canada.[3]

While the United States and the European Union (EU) are struggling in the wake of the global financial crisis, China has continued to grow: In the first quarter of 2010, China posted growth of 11.9 percent at an annualized rate.[4] Although growth has been moderating since (10.3 percent in the second quarter at an annualized rate), China's economy is forecast to expand about 10 percent in 2010—continuing a remarkable, three-decade streak of double-digit growth on average. As the holder of the world's largest stock of foreign exchange reserves ($2.65 trillion as of October 2010),[5] Beijing also questioned the role of the U.S. dollar as the global reserve currency and has led the drive for greater representation on global bodies, such as the International Monetary Fund (IMF) and the World Bank.[6] China's leaders have grown more confident on the international stage and have begun to assert greater influence in Asia, Africa, and Latin America with special trade agreements and multibillion dollar resource deals.[7]

Earlier this year, Beijing pointed to a series of smaller monthly trade surpluses, and even a highly unusual global trade deficit in March, as evidence that the Chinese economy was already rebalancing and was much less dependent on exports. However, more recent figures suggest that the global trade surplus in the second half of 2010 is likely to be much larger than in 2009. In July 2010, for example, China's overall trade surplus jumped to its highest level since January 2009 ($28.7 billion, a 170 percent increase year-on-year), reinforcing criticism that the country's currency remains substantially undervalued. China's economic growth remains reliant on expanding exports and investment.

In order to achieve a more balanced economy, China would need to shift its policies to encourage greater domestic consumption. But there is little evidence that such a shift is taking place; in fact, China's consumption as a share of GDP has fallen from 46 percent in 2000 to below 36 percent in 2009.[8] In contrast, personal consumption in the United States has hovered around 70 percent of GDP for the last decade.[9] China's government consistently favors policies, such as currency undervaluation and favoritism toward indigenous innovation and production, that promote its exporting industries to the detriment of its trading partners. China's Communist Party leadership sees its legitimacy and political monopoly as inextricably linked with the economy's good performance and full employment.[10] The party and the government are therefore reluctant to risk China's historically high growth rate with policies meant to encourage consumption instead of the export and investment growth model that has proven so successful over time.[11]

Chinese policymakers also continue to worry about the impact any policy change may have on "social stability." In a speech to top EU officials in Brussels, Chinese Premier Wen Jiabao said that if the renminbi (RMB) "is not stable, it will bring disaster to China and the world. If we increase the [RMB] by 20% or 40% ... many of our factories will shut down and society will be in turmoil."[12] Communist Party leaders are particularly concerned about the 100 million to 200 million migrant workers from rural areas who depend upon the entry-level manufacturing jobs in China's factories, many of which produce goods for export. For example, in an earlier speech, Premier Wen warned that "[w]e cannot imagine how many Chinese factories will go bankrupt, how many Chinese workers will lose their jobs, and how many migrant workers will return to the countryside" should China acquiesce to demands for an RMB gain. "China would suffer major social upheaval," he said.[13]

The U.S.-China Trade Relationship

For the first eight months of 2010, China's goods exports to the United States were $229.2 billion, while U.S. goods exports to China were $55.8 billion, with the U.S. trade deficit in goods at $173.4 billion, an increase of 20.6 percent over the same period in 2009 ($143.8 billion).

Table 1: U.S.-China Trade in Goods ($ billion), 2000–2009

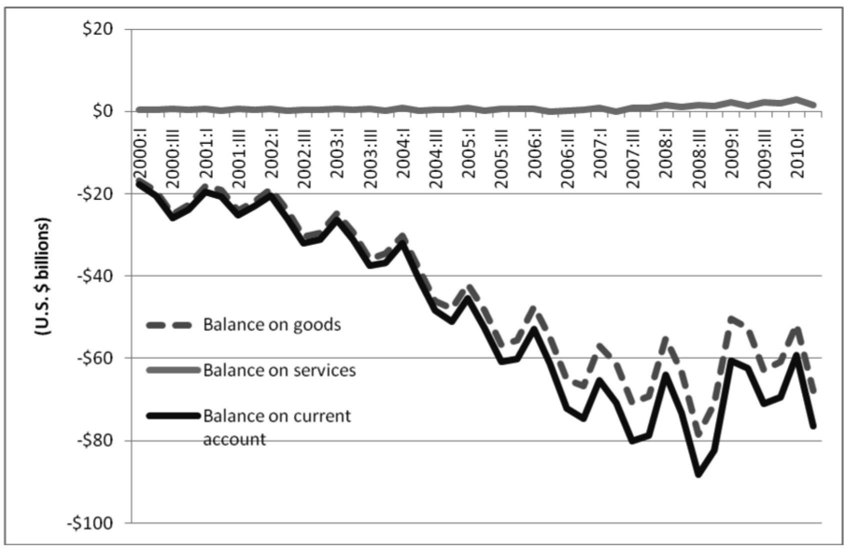
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
U.S. Exports	$16.3	$19.2	$22.1	$28.4	$34.7	$41.8	$55.2	$65.2	$69.7	$69.5
U.S. Imports	100.0	102.3	125.2	152.4	196.7	243.5	287.8	321.5	337.8	296.4
Balance	-83.7	-83.1	-103.1	-124.1	-162.1	-201.6	-232.5	-256.3	-268.04	-226.9

Source: Bureau of Economic Analysis, *U.S. International Transactions Accounts Data: China* (Washington, DC: U.S. Department of Commerce, June 17, 2010).

As the global recession reduced U.S. demand for imports, the U.S. trade deficit with the world and with China declined in 2009.

However, the relative portion of China's share of the U.S. global trade deficit actually grew. In August 2010, the U.S. trade deficit with China ($28 billion) hit its highest level on record.[14] The deficit in goods with China is by far the largest among U.S. trading partners, 45 percent of the total in 2009 and 41.5 percent of the total for the first eight months of 2010.[15]

Figure 1: U.S.-China Trade Balance (Quarterly), 2000–2010 (through 2010 QII)



Source: Bureau of Economic Analysis, *U.S. International Transactions Accounts Data: China* (Washington, DC: U.S. Department of Commerce, September 16, 2010).

The U.S. global manufactured goods deficit fell from $466 billion in 2008 to $319 billion in 2009, a decline of 45.9 percent.[16] However, China's share of the U.S. manufactured goods trade deficit jumped from 59.8 percent ($278.9 billion) in 2008 to 75.2 percent ($240.2 billion) in 2009. According to Chinese statistics, in 2009, foreign-invested companies in China accounted for 56 percent ($672 billion) of Chinese global exports ($1.2 trillion).[17] The U.S. trade balance with China in advanced technology products (ATP)[18] has also deteriorated: the bilateral U.S. trade deficit in advanced technology products has soared from $6.1 billion in 2001 to $72.5 billion in 2009.[19] In the first half of 2010, the United States exported $10 billion in ATP to China and imported $51.9 billion, for a six-month deficit of $41.6 billion.[20] The United States has an overall global trade deficit in ATP: $56.2 billion in 2009, and $38.9 billion for the first seven months of 2010.[21]

Frustration with Chinese Policies Increases

The Chinese government's relations with foreign investors in China appear to be going through a profound change since Beijing announced its indigenous innovation policy, which explicitly favors domestic companies over foreign firms, particularly in government procurement. The American Chamber of Commerce in China reported in its 2010 annual survey that 31 percent of over 300 member companies polled (up from 28 percent in the 2009 annual survey) said their ability to participate and compete in China's market was impeded by discriminatory government policies and inconsistent legal treatment.[22] This issue has emerged as the top challenge to Chamber members in 2010. Furthermore, even before the full implementation of China's indigenous innovation policy, 37 percent of high-tech and information technology companies reported that they were losing sales as a result of policies already in effect, while 57 percent reported that they expected to lose business.[23] The Chamber said Beijing was attempting to squeeze foreign technology companies out of the lucrative government procurement market. "The AmCham-China survey shows that U.S. companies believe they face product discrimination in state-owned enterprise purchases, as well as in government procurement," a statement accompanying the survey results said.[24]

The European Chamber of Commerce in China reported similar complaints. An annual survey of 500 European businesses invested in China found that 36 percent believe Chinese government policies have become less fair in the past two years, pointing to selective enforcement of laws and regulations, poor protection of intellectual property, and the lack of market access for foreign companies.[25] In a strongly worded position paper for 2010–2011, the European Chamber of Commerce said foreign companies are losing market share in China across a broad range of industries because of discriminatory treatment by the government and regulators.[26] The Chamber president accused China of a "growing willingness and tendency to exclude foreign businesses from the Chinese market."[27]

In fact, some businesses have publicly declared that they gradually are being squeezed out of the Chinese market by government policies that first demand technology transfer in exchange for market access and then favor domestic companies.[28] In previous years, representatives of U.S. business made similar complaints to the members of the U.S.-China Commission only in private. In a January 2010 letter to senior Obama Administration officials, the heads of 19 U.S. business and industry associations cautioned against "[s]ystematic efforts by China to develop policies that build their domestic enterprises at the expense of U.S. firms and U.S. intellectual property."[29] In July 2010, two of Germany's most prominent industrialists attacked the business and investment climate in China during a meeting with Chinese Premier Wen Jiabao. Jürgen Hambrecht, chairman of BASF, complained of foreign companies facing the "forced disclosure of know-how" in order to do business in China. "That does not exactly correspond to our views of a partnership," he said.[30] In addition, Peter Löscher, chief executive officer of Siemens, said foreign companies operating in China "expect to find equal conditions in the fields of public tenders," referring to China's controversial procurement practices, and called on Beijing rapidly to remove trade and investment restrictions in sectors such as automobiles and financial services.[31]

Although Premier Wen insisted that China remains open to foreign investment and does not discriminate against foreign companies, the perception is growing among foreign businesses that after 30 years of market reforms, they are no longer welcome in China once their technology has been siphoned off.[32]

Changes in China's Exchange Rate Regime

China's manipulation of its currency remains one of the most intransigent issues in the U.S.-China trade relationship. China's deliberately undervalued RMB has unfairly conferred substantial economic advantages on China to the detriment of major trading partners, principally the United States and Europe. China's undervalued RMB makes China's exports cheaper and imports more expensive, and it encourages foreign direct investment into China, resulting in the loss of investment and jobs in Europe and the United States.

China's Foreign Exchange Controls

The People's Bank of China has maintained its strict control of the value of the RMB through several means. The government requires Chinese exporters and ordinary citizens to trade their dollar and other foreign exchange earnings for RMB through the system of state-owned banks. This keeps dollars in the hands of the government and prevents dollars from being used by the people for purchases of imported goods or services or for investments in the United States. It also makes it easier for the government to set a specific RMB-dollar exchange rate each day without having to worry about a secondary, grey market for dollars. Consequently, the exchange rate between the RMB and the dollar has stayed within a narrow trading band determined by Beijing, despite an announcement in July 2005 that the RMB's value would become "adjustable, based on market supply and demand with reference to exchange rate movements of currencies in a basket" of currencies.[33] The foreign currency gathered from the exporters is then collected by the State Administration of Foreign Exchange, with most invested in U.S. government debt. (For an in-depth analysis of China's holdings of U.S. debt, see chap. 1, sec. 2, of this Report.)

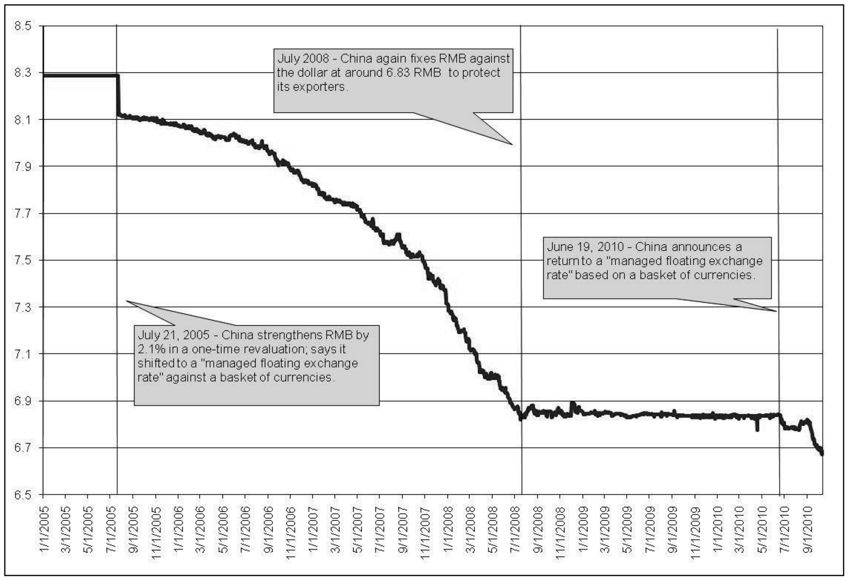
In August 2010, the State Administration of Foreign Exchange announced a one-year trial program, due to launch in October 2010, which will allow select exporters to keep some of their foreign currency earnings offshore. The program is very limited, with only 60 exporters in Beijing and the provinces of Guangdong, Shandong, and Jiangsu allowed to retain a designated fraction of their foreign exchange earnings overseas instead of surrendering all of them to the State Administration of Foreign Exchange.[34]

Between July 2005 and the summer of 2008, the RMB appreciated by about 20 percent. However, in July 2008, as the effects of the global economic crisis became apparent, to safeguard China's export advantage, Beijing stopped the appreciation of the RMB and returned to an effective peg at around 6.83 to the dollar (see figure 2).

As the global economic crisis has continued, China has become the target of ever-sharper criticism that its currency policies are causing widespread harm. U.S. Federal Reserve Chairman Ben Bernanke, answering questions at a Senate Banking Committee hearing, said Chinese currency effectively subsidizes China's exports.[35] C. Fred Bergsten, president of the Peterson Institute of International Economics, has called RMB undervaluation "a blatant form of protectionism . . . which subsidizes all Chinese exports 25 to 40 percent [and] places the equivalent of a 25 to 40 percent tariff on all Chinese imports."[36] Developing countries have joined the chorus of opposition to the RMB's undervaluation. Central bank governors of India and Brazil backed a stronger RMB during the June 26–27, 2010, Group of 20 nations (G–20) Summit in Toronto, Canada.[37]

China, meanwhile, denies that its exchange rate practices are to blame for the economic woes of its trade partners. In his annual news conference, Chinese Premier Wen said, "First of all, I do not think the [RMB] is undervalued," adding that China is "opposed to countries pointing fingers at each other or taking strong measures to force other countries to appreciate their currencies."[38] At the same conference, in a reference to President Obama's goal to double U.S. exports over five years, Premier Wen said that while he could understand the desire of some countries "to increase their share of exports," he could not understand "the practice of depreciating one's own currency and attempting to press other countries to appreciate their own currencies solely for the purpose of increasing one's own exports." He added, "This kind of practice, I think, is a kind of trade protectionism."[39]

Figure 2: China's RMB against the U.S. Dollar Exchange Rate, 2005–2010



Source: Oanda.com, "FX history: historical currency exchange rate" (October 14, 2010).

On June 19, 2010, a week ahead of the G–20 meeting in Toronto, China's central bank issued a brief statement that promised more flexibility in its currency while maintaining "the RMB exchange rate basically stable." [40] The announcement did not list any specific measures, but it was widely interpreted as meaning that China would let the RMB resume a gradual appreciation against the U.S. dollar for the first time since being repegged in 2008.

The move was widely praised by global leaders. Dominique Strauss-Kahn, the managing director of the International Monetary Fund (IMF), welcomed the news, saying a stronger Chinese currency "will help increase Chinese household income and provide the incentives necessary to reorient investment toward industries that serve the Chinese consumer." [41] U.S. Treasury Secretary Timothy Geithner said the United States welcomed "China's decision to increase the flexibility of its exchange rate" but promised to "watch closely" how much the RMB is allowed to appreciate.[42] President Obama responded that the "proof of the pudding is going to be in the eating." [43] So far, the global community's expectations for a significant RMB adjustment have not been borne out.

Although it was welcomed by global leaders, Beijing's June 19 announcement lacks any particulars on timing and mechanisms and is filled with contradictions. Beijing promises to reference "a basket of currencies" in determining the value of the RMB but does not identify the composition of the basket. The assertion that the People's Bank of China will "enhance the RMB exchange rate flexibility" is then followed by a promise to "maintain the RMB exchange rate basically stable." The new policy also specifically rejects the idea of widening the bands in which the RMB trades (currently ±0.5 percent per day), which is the litmus test of a move to a market-based exchange rate.[44] Instead, Beijing has reverted to its previous policy of each day setting a new value (i.e., a reference rate) that does not necessarily match the closing price of the previous day and then allowing some daily fluctuations within the band.[45]

Despite the Chinese government's minimal actions to revalue the RMB since the announcement, the Obama Administration declined to label China a currency manipulator in the Treasury's semiannual report to Congress on exchange rates (due on April 15, 2010, but delayed until July 8).[46] The report instead said that the RMB "remains undervalued" but called China's policy shift on the exchange rate "a significant development."[47]

The IMF produced a weak assessment of the Chinese currency that also avoided a judgment that China had deliberately undervalued the currency in order to gain an export advantage. The IMF's 2010 Article IV Consultations report on China * showed that the IMF staff concluded that the RMB "remains substantially below the level that is consistent with medium-term fundamentals" but went no farther in assessing China's goals in devaluing its currency.[48] The IMF's executive board was divided on the issue. Several directors agreed that the exchange rate is undervalued. However, a number of others disagreed with the staff's assessment of the level of the exchange rate, noting that "it is based on uncertain forecasts of the current account surplus," according to the IMF public information notice.[49] The disagreement among the board reduced the pressure on China to further revalue the RMB. Regardless, the IMF's tools to intervene in the currency debate are limited.[50] China is one of the IMF's bigger shareholder countries.[51]

Since the June 19 announcement, the RMB has appreciated by 2.3 percent (as of October 13, 2010).[52] The U.S. trade deficit with China in August 2010 hit its highest level on record, spurring Congressional pressure on Beijing to accelerate the appreciation of the currency. Eleven U.S. Senators wrote a letter to President Obama on August 4, 2010, urging the administration to take tougher measures to address "unfairly subsidized exports" by countries such as China.[53]

Responding to mounting international criticism of the insignificant appreciation of the RMB, China has defended its go-slow policy. "The [RMB] doesn't have a key role to play in rebalancing bilateral trade between the U.S. and China," Hu Xiaolian, a deputy governor of the People's Bank of China, said in an interview with the *Wall Street Journal*. "I don't think excessive argument and criticism on this issue will help."[54]

On September 29, 2010, the U.S. House of Representatives passed by a vote of 348 to 79 legislation that would allow the Commerce Department to penalize Chinese currency undervaluation.[55]

*Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the executive board. At the conclusion of the discussion, the managing director, as chairman of the board, summarizes the views of executive directors, and this summary is transmitted to the country's authorities. IMF, "Article IV—Obligations Regarding Exchange Arrangements," *Articles of Agreement of the International Monetary Fund* (Washington, DC). *http://www.imf.org/external/pubs/ft/aa/aa04.htm*.

The Currency Reform for Fair Trade Act (H.R. 2378) would allow the administration to use estimates of currency undervaluation to calculate countervailing duties on imports from China and other countries whose currencies are undervalued.[56] The U.S. Senate is also considering currency legislation.[57]

Further Developments in the RMB Internationalization

Several advantages accrue to a country that conducts trade and settles accounts in its own currency. Due to the global use of the dollar as a reserve currency, the United States, for example, can borrow in dollars (through the sale of dollar-denominated U.S. government bonds) without fear that a fall in the dollar's value will increase U.S. debt. The United States also can trade in dollars in the international markets. China aspires to these benefits. In a recent essay, People's Bank of China Deputy Governor Hu Xiaolian wrote that "wider use of the [RMB] in foreign trade and investment can help importers and exporters control costs and reduce exchange-rate risks."[58]

Transforming the RMB into an international, or at least regional, reserve currency, thus challenging the dominance of the U.S. dollar, may take years. But China is slowly introducing policy changes and reforms to move in that direction. Last year, Beijing signed currency swap agreements worth around 800 billion RMB (about $117 billion) with seven countries and regions.[59] This year, China followed with more steps in that direction, including a currency swap deal with Iceland, worth more than $500 million, and RMB exchanges with the Malaysian ringgit.[60] To date, less than a hundredth of a percent of China's international trade is conducted with RMB.[61]

In June 2010, China's State Council approved a plan to expand the RMB trade settlement program to 20 provinces and municipalities.[62] The RMB-settlement program, started in July 2009, initially allowed companies in Shanghai and the southern province of Guangdong to use RMB instead of U.S. dollars when trading with companies in Hong Kong, Macau, and Association of Southeast Asian Nations (ASEAN) countries.

In July 2010, Chinese regulators lifted restrictions blocking the free flow of RMB in Hong Kong. Any foreign company now can open a RMB bank account in Hong Kong and exchange currency for any purpose, while Hong Kong can create investment products denominated in the Chinese currency. Restrictions on the type of corporation that can be granted RMB loans or the type of loans that can be extended have also been removed.[63]

On August 17, 2010, the People's Bank of China said that to "encourage cross-border [RMB] trade settlement" and "broaden investment channels for [RMB] to flow back [to China]" it has launched a pilot program that will allow some RMB held offshore to be invested in China's interbank bond market, where most government and corporate debt trades.[64] Foreign financial institutions, including central banks and overseas lenders, are currently only able to invest the RMB they already hold onshore and are not allowed to participate in the 19.5 trillion RMB ($2.87 trillion) interbank bond market.[65] This program may allow companies outside of China, which are receiving payments in RMB but have few places to hold the currency, to direct the funds back into the local bond market.[66]

A number of the world's biggest banks—including Citigroup and JPMorgan—have launched international "road shows" promoting the use of the RMB instead of the U.S. dollar for trade deals with China. HSBC and Standard Chartered, for example, are offering discounted transaction fees and other financial incentives to companies that choose to settle trade in the RMB.[67] Moreover, Chinese central bank officials accompanied Standard Chartered bankers on a road show to Korea and Japan in June 2010.[68] Taking advantage of the new rules, McDonald's became the first foreign nonfinancial company to sell RMB-denominated bonds (though the amount was quite small, 200 million RMB, or $29 million).[69]

However, none of these pilot programs undertaken by China to promote the use of the RMB is likely to have a significant immediate effect on either the dollar or the RMB. Hu Xiaolian dampened expectations of a substantial change, noting that less than 1 percent of China's trade is currently denominated in the RMB and that the RMB "has a long distance to go before it can become an international currency."[70] Indeed, by the end of June 2010, about $10 billion worth of China's crossborder trade was denominated in RMB, 0.004 percent of the country's $2.8 trillion in total trade last year.[71] Many international companies remain reluctant to hold the RMB because it has limited utility outside of China. However, by far the biggest impediment to the RMB's internationalization is the Chinese government's unwillingness to relax capital controls and allow the RMB to react to the laws of supply and demand.

U.S.-China Bilateral Dialogues and Multilateral Engagement

The U.S.-China Strategic and Economic Dialogue

The United States and China have a variety of approaches, both formal and informal, to resolve problems. The two countries raise bilateral concerns through high-level government exchanges such as the Strategic and Economic Dialogue (S&ED) and the Joint Commission on Commerce and Trade, and the World Trade Organization's (WTO) dispute settlement process (see chap. 1, sec. 3, for a look at China's WTO compliance).

Although more than 200 U.S. officials converged on Beijing for the May 24–25 Strategic and Economic Dialogue, the United States failed to secure any significant outcomes. The U.S. Treasury Department issued a joint fact sheet summarizing major points of agreement between the two countries, but it contained few specifics.[72] Following the talks, both sides claimed victories on China's exchange rate regime. U.S. Treasury Secretary Timothy Geithner said the United States "welcome[d] the fact that China's leaders have recognized that reform of the exchange rate is an important part of their broader reform agenda," adding that it was "of course, China's choice."[73] At the same time, Chinese Assistant Finance Minister Zhu Guangyao said the United States "understands that China will independently decide on the specific steps of its exchange rate reforms, based on its own interests, taking into account world economic conditions and China's own development trends."[74] The next month, China made a currency policy announcement a week before the G–20 Summit.

China's policy of encouraging "indigenous innovation," a facet of China's overall industrial policy, was another major topic of discussion at the May 24–25 Strategic and Economic Dialogue. China and the United States committed to innovation policies "consistent with strong principles, including nondiscrimination, intellectual property rights protection, market competition, and no government interference in technology transfer," but this phrase directly contradicts China's promotion of "indigenous innovation." For example, Undersecretary of Commerce for International Trade Francisco Sánchez said China did not agree to a U.S. request to suspend its indigenous innovation policy.[75] (For a detailed look at China's indigenous innovation policy, see chap. 1, sec. 3, of this Report. For a discussion of China's policies for promotion of its green technology sector, see chap. 4, sec. 2, of this Report.)

The Group of 20 Summit in Toronto, Canada

Prior to the Group of 20 Summit in Toronto on June 26–27, 2010, discontent over China's currency, trade, and industrial policies had been growing. In a letter to the rest of the G–20, leaders of Canada, South Korea, the United Kingdom, the United States, and France called for better cooperation to avoid future crises and a return to sustained growth and employment. They also stressed the need "to ensure that our fiscal, monetary, foreign exchange, trade and structural policies are collectively consistent with strong, sustainable and balanced growth."[76] Coming in the middle of a debate about slow progress toward reducing trade imbalances, the letter was interpreted as a veiled rebuke to China for backsliding on economic agreements and continued RMB undervaluation.[77] In the U.S. Congress, renewed calls were made and several bills were introduced to address concerns about China's currency policy.[78]

Beijing responded to growing censure by saying that the G–20 meeting should not be used for "finger-pointing" or as a platform to criticize China's currency policy.[79] A Foreign Ministry spokesperson, for example, said that in China's view, "it would be inappropriate to discuss the [RMB] exchange rate in the context of the G–20 meeting."[80] Tension was defused for the moment, however, when, a week ahead of the G20 summit, China announced a change in its currency policy (see the section on China's exchange rate regime, above).

Implications for the United States

The U.S. trade deficit with China poses unprecedented challenges to U.S. economic health and security. The openness of the U.S. market, coupled with the lack of market access to China, means that while Chinese exports have streamed into the United States, the reverse movement of goods and services has not happened. At the same time, China required, first through law and now through practice, technology transfer in exchange for market access, which has led to a transfer of research and development facilities and technological know-how from the U.S. companies.[81] In recent years foreign companies have expressed the concern that they are gradually being marginalized by Chinese government policies that favor domestic Chinese companies once technology has been extracted. To the extent that foreign companies are able to gain access to the Chinese market, they do so under the conditions set by the Chinese government, and they have repeatedly complained of inconsistent rules and regulations, government procurement biased toward local companies, and insufficient intellectual property rights protection.

The U.S. trade deficit is a drag on the U.S. economy, which is made especially acute when combined with the effects of the global financial crisis. For example, in the second quarter of 2010, the U.S. global trade deficit subtracted 3.5 percentage points from U.S. GDP growth, which totaled just 1.7 percent at an annual rate.[82] Without the drag from the global trade deficit, the U.S. economy would have been growing at an annualized rate of more than 5 percent in the quarter.[83] China plays a major role in this problem: The U.S. trade deficit in goods with China in the second quarter was $67.8 billion, 40 percent of America's overall trade deficit in goods of $169.6 billion with the world.[84]

Several economists have attempted to quantify the jobs lost to protracted trade deficits with China, although their conclusions vary. C. Fred Bergsten, director of the Peterson Institute for International Economics, estimated that if China were to eliminate its currency misalignment:

> *that would reduce the U.S. global current account deficit $100 billion to $150 billion. Every $1 billion of exports supports about 6,000 to 8,000 (mainly high-paying manufacturing) jobs in the United States. Hence, such a trade correction would generate an additional 600,000 to 1.2 million jobs.*[85]

Nobel Prize-winning economist Paul Krugman stated that China follows a "mercantilist policy, keeping its trade surplus artificially high," which gives Chinese manufacturing "a large cost advantage over its rivals, leading to huge trade surpluses."[86] Dr. Krugman wrote that his "back-of-the-envelope calculations suggest that for the next couple of years Chinese mercantilism may end up reducing U.S. employment by around 1.4 million jobs."[87]

China's management of its exchange rate regime is a major contributing factor to the U.S. trade deficit with China. The undervaluation of the RMB effectively subsidizes all Chinese exports and places a de facto tariff on all Chinese imports and also incentivizes U.S. companies to outsource production to China. Skeptics argue that because the U.S. trade deficit with China did not improve from 2005 to 2008 despite the rise in the RMB, appreciation of the RMB is therefore not an effective remedy for the U.S. trade deficit. However, this interpretation ignores several important considerations. By undervaluing the RMB, the Chinese government suppressed household wealth formation, curbing Chinese consumption and pushing down the demand for imports. During 2005–2008, as the RMB finally started appreciating, China counterbalanced the appreciation by lowering real interest rates and expanding credit, which "[decreased] household income faster than raising the [RMB] [increased] it."[88] In fact, during 2005–2008, consumption as a percentage of the overall economy dropped. There were other important considerations at play. Although the 20 percent rise in the RMB over three years was significant, China maintained its capital controls and refused to allow the currency to float freely, which would have caused an even faster appreciation, given the ballooning trade surplus. In addition, currency movements are subject to a time lag for the price of the currency to affect the deficit.[89]

A research paper by William R. Cline, senior fellow at the Peterson Institute for International Economics, shows that the strength of the RMB has a predictable effect on the bilateral trade balance with the United States. According to Dr. Cline's calculations, a 10 percent real effective appreciation of the RMB would lead to a reduction in the U.S. current account deficit of between $22 billion and $63 billion per year, depending on whether China's regional trade partners (who frequently track China's exchange rate moves) follow China's example.[90]

Conclusions

- For the first eight months of 2010, China's goods exports to the United States were $229.2 billion, while U.S. goods exports to China were $55.8 billion, with the U.S. trade deficit in goods at $173.4 billion, an increase of 20.6 percent over the same period in 2009 ($143.8 billion). This constitutes a four-to-one ratio of Chinese exports to its imports from the United States.
- The U.S. trade deficit with China is a major drag on the U.S. economy. Despite the global financial crisis, China gained an even greater share of the U.S. trade deficit, while the overall U.S. trade deficit declined. The deficit in goods with China is by far the largest among U.S. trading partners: 45 percent of the total in 2009 and 41.5 percent of the total for the first eight months of 2010.
- China's government policies limit the ability of foreign companies to obtain Chinese government procurement contracts and to make sales to China's state-owned enterprises, most recently through China's new "indigenous innovation" policy. Companies in the United States and Europe have protested this discriminatory treatment.
- Since June 19, 2010, the RMB appreciated by just 2.3 percent against the dollar (as of October 2010). The RMB remains substantially undervalued against the dollar, which subsidizes Chinese exporters to the detriment of U.S. domestic producers. China's undervalued currency also helps attract foreign companies to locate production in China.
- China continues to pursue a long-term goal of making the RMB a more international currency, starting with the introduction of several policies designed to make trade and bond issuance in the RMB easier, particularly among China's Asian neighbors. China's reforms thus far have had little effect on the RMB's use in international trade.
- As in previous years, the United States engaged China at several bilateral and multilateral negotiations, including the Strategic and Economic Dialogue and meetings of the Group of 20, to address China's discriminatory trade policies, but again failed in 2010 to secure any significant agreements or Chinese policy changes.