

February 21, 2014

Philip I. Levy, Ph.D.

Senior Fellow on the Global Economy, The Chicago Council on Global Affairs

Testimony before the U.S.-China Economic and Security Review Commission

Hearing on “U.S.-China Economic Challenges”

Chairman Shea, Vice Chairman Reinsch, and members of the Commission, thank you for the opportunity to appear before you today and discuss the economic challenges between the United States and China. It is an exceedingly important relationship. The vigorous public debate it has inspired provides fertile ground for careful economic reasoning.

With your indulgence, I would like to divide my remarks into two parts. First, I would like to take on some of the questions surrounding the effects of China trade on the number and composition of U.S. jobs. Second, I would like to address the ways the United States has pursued its interests in economic negotiations with China over trade rules.

China Trade and Jobs

It is hard to think of an economic policy question more pressing than the quality and quantity of jobs. The United States is suffering from a tepid economic recovery and the unemployment rate remains at an elevated level. The jobs picture looks even worse when one considers alternative measures, such as the labor force participation rate. Further, even among the employed, there have been steady shifts away from the sort of manufacturing jobs that have traditionally offered workers a stable middle class income.

If we had a firm grasp of the forces driving these changes, we might be in a better position to take remedial action. Unfortunately, such a firm grasp requires some very difficult disentangling. There are long term trends and short-term shocks that interweave to determine labor market outcomes. In an imaginary world of omnipotent economists – scary, I know – we could isolate the effects of individual changes by running history through both with and without. Thus, we could compare the experience of the last two decades with an alternate world in which Deng Xiaoping had never experimented with openness and China had remained largely closed to trade. In this alternate history, we could imagine that many things would be different. China would not have played the major role that it did in key industries such as electronics, or textiles and apparel. That could have meant that U.S. businesses in those sectors would have flourished. Or perhaps it would have meant that Mexican or Korean firms would have flourished and U.S. businesses would have been no better off. In this alternative history, U.S. consumers would have faced higher prices and thus enjoyed lower real incomes. U.S. inventors and entrepreneurs would have found it more costly to turn their visions into products. We could look and see what all that would have meant for the U.S. economy and employment.

I raise this scenario not just because of an excessive exposure to science fiction in my youth. Instead, it holds out an ideal for what a pure analysis might look like. We cannot possibly conduct such an analysis, but the idea can highlight the pitfalls of some of the shortcuts that have become popular.

The most popular – and deeply flawed – shortcut is to equate a given value of trade with jobs. It is understandably tempting. Not only do we have ample data on trade flows, but we have often had that data broken down by trade partner and commodity. If we could only construct a simple multiplier, we could jump right from this abundant data to predictions about jobs gained (exports) or lost (imports). Here one sees numbers such as that put forward by the U.S. Department of Commerce: \$1 billion dollars of exports associated with 6,000 jobs.¹

There is some sophistication behind the generation of these numbers. Both the Commerce Department (2010) and Scott (2012) use input-output matrices.² Rather than simply assuming that automobiles and t-shirt manufacturing use workers the same way, such a matrix allows each sector to employ workers at its own distinct rate. It is still averaging, but a collection of averages, rather than a single crude one.

There are at least two major pitfalls to this approach to estimation. The Department of Commerce is careful to describe the number of jobs “associated” with exports. This is a way to address the key challenge of *marginal vs. average*. The numbers provided are averages, but for policy, people generally want to know marginal effects. Policymakers are more likely to ask: if the U.S. imported \$1bn less, how many more jobs would the country have? The answer need have nothing to do with averages. To see this, just think of a factory operating below full capacity. For that factory, we might calculate that every \$1 million of orders is associated with 6 employees. But an additional \$1 million of output would not necessarily require the hiring of 6 more workers. Even if the firm needed to increase the hiring of assembly line workers proportionally, it would not necessarily need to hire additional accountants, janitors, or human resources staff (though those workers would have shown up in the averages).

The second great pitfall is the assumption that everything else holds constant. That rarely happens. In 1900, farmers made up 30.7% of the U.S. labor force. In 2000, farmers made up 2.4% of the labor force.³ If there were no other adjustments, this alone would seem to imply an unemployment rate of roughly 40 percent. Yet the actual unemployment rate was 4.0%. Clearly

¹ This is the number that emerges from U.S. Department of Commerce, “Exports Support American Jobs,” International Trade Research Report No. 1, May 2010.

<http://trade.gov/publications/ita-newsletter/0510/exports-play-vital-role-in-supporting-us-employment-0510.asp>

² Scott, Robert (2012), “The China Toll,” EPI Briefing Paper #345, August 23, 2012.

<http://www.epi.org/publication/bp345-china-growing-trade-deficit-cost/>

³ Carter, Susan B. (2005), “Labor Force,” in Susan B. Carter, Scott S. Gartner, Michael Haines, Alan Olmstead, Richard Sutch, and Gavin Wright, eds., Historical Statistics of the United States, Millennial Edition. New York: Cambridge University Press, 2005.

<http://economics.ucr.edu/papers/papers04/04-03.pdf>

there were other important shifts going on. These kinds of shifts occur not only over the broad sweep of history, but in the short term as well. Countries have “balance of payments” constraints, in which financial transactions have to offset trade in goods and services. If there were to be a large decrease in the value of U.S. imports from China, it would have to be offset either by an increase in imports from elsewhere, a decrease in U.S. exports, or a decrease in the amount that the United States borrows from abroad. Any of these shifts would have repercussions.

Scott (2012) effectively assumes away all such adjustment. Thus, any imports that do not come from China are assumed to be replaced with U.S. production. How realistic is this? It flies in the face of recent experience. From 1999 to 2012, China’s share of U.S. imports of goods and services increased from 7.4% to 17.4%. Over that same time period, the Asia-Pacific’s share of U.S. imports of goods and services stayed essentially constant (an increase from 35.9% to 36.0%).⁴ Thus, China’s rise as an exporter to the U.S. was achieved substantially by displacing its Asian neighbors. Presumably, any thought experiment that removes China from this experience should think very carefully about what would happen with those same displaced neighbors.

This is particularly true because we know that bilateral trade data contains an important distortion – it does not measure *value-added*, just the *final value* of goods. Thus, if a good were made entirely in Malaysia in 1999, it would have entered U.S. import statistics as a Malaysian good. If, a few years later, 90 percent of the value of that good was still produced in Malaysia, but the final 10 percent of the value was added in China, it would have entered U.S. import statistics as a Chinese good. This would have dramatically overstated the impact of trade with China. Nor is this just a theoretical possibility – the ability to take on bite-sized pieces of production was an important means by which China developed its export prowess. Kee and Tang (2013) find that from 2000 to 2006, the domestic value added ratio of China’s processing exports rose from 49% to 58%.⁵

More careful analyses try to account for at least some of these secondary effects using econometric analysis. They also move from exogenous changes in levels of trade to a more practical linkage to actual policy measures.⁶ Ray Fair, of Yale University, uses a macroeconomic model to consider the likely impact of an appreciation in China’s currency on U.S. employment. His findings demonstrate the importance of secondary effects:

⁴ Author’s calculations from Bureau of Economic Analysis data.

<http://bea.gov/international/index.htm>. The Asia-Pacific region, of course, includes China.

⁵ Kee, Hiau Looi, and Heiwai Tang, “Domestic Value Added in Chinese Exports: Firm-level Evidence,” mimeo, April 2013.

⁶ The work of Pierce and Schott (2014) seems to fall in between these categories. They associate actual changed employment in the United States with a hypothetical (but highly unlikely) increase in U.S. tariffs against China – the tariffs that would have applied had the United States not granted China Permanent Normal Trade Relations *and* had it not just rolled over existing Normal Trade Relations as it had done for more than a decade. It is not clear how to interpret this correlation. Pierce, Justin R.; Schott, Peter K. (2014), “The Surprisingly Swift Decline of U.S. Manufacturing Employment,” CESifo Working Paper, No. 4563.

<http://hdl.handle.net/10419/89626>

“The results show that a yuan appreciation has little effect on U.S. output. The main positive effect is that U.S. imports fall—mostly imports from China. But there are two negative effects that roughly offset this positive effect. The first is that the yuan appreciation leads to a decrease in Chinese output, which has a negative effect on Chinese imports, some of which are from the United States. The second is that the rise in U.S. import prices (from the rise in Chinese export prices) leads to an increase in U.S. domestic prices. The increase in U.S. domestic prices results in a decrease in real wealth and real wages, which have, other things being equal, a negative effect on U.S. aggregate demand and output.” Fair (2014, p. 23)⁷

When discussing manufacturing job loss, it is particularly important to consider other potential explanations. It is true that China’s burgeoning share of U.S. imports coincided with a sharp drop in U.S. manufacturing employment as a percent of total, from 14.4% in 2000 to 10.1% in 2010.⁸ This might seem to indicate a causal relationship. Yet consider the broader context: U.S. manufacturing employment share had been 24.8% in 1973 – the vast bulk of the drop occurred before China’s rise. Nor was this solely a U.S. phenomenon. The United States fall in manufacturing employment share from 1973-2010 was 14.7 percent, while the average fall across 9 advanced economies was 14.3 percent. Lawrence and Edwards (2013) conclude:

“We do not claim that international factors do not affect manufacturing...Over the long run, however, absent new product innovations, or a shift in consumer preferences, the basic forces leading to the declining share of manufacturing in overall employment are unlikely to abate. Just as rapid farm productivity growth combined with a limited demand for food has led to ever smaller shares of employment in agriculture, the combination of relatively rapid productivity growth and limited demand growth for goods will mean that more of the jobs in the future will be in services.” (p. 3)

Forces such as productivity growth are much more difficult to control than tariff levels or exchange rates. For practical purposes, the most fruitful approach is to focus analysis on the policy levers available to the United States and to China. My initial, alternative-history scenario was one in which China never opened itself up to trade. That was one policy option open to the Chinese, albeit an extreme one. Useful policy analyses of the U.S.-China economic relationship should be based on policies that China might plausibly adopt. Even if one strongly believes that a major Chinese currency appreciation would raise the well-being of U.S. workers, there is the essential question of how one can reap those benefits. How quickly could China actually boost the RMB without triggering counterproductive economic turmoil?⁹

⁷ Fair, Ray (2014), “Reflections on Macroeconometric Modeling,” January 2014.

<http://fairmodel.econ.yale.edu/rayfair/pdf/2013a.pdf>

⁸ Figures are from Robert Z. Lawrence and Lawrence Edwards (2013), “U.S. Employment Deindustrialization: Insights from History and the International Experience,” Peterson Institute for International Economics Policy Brief Number PB13-27, October 2013. Table 1, p. 9.

<http://www.iie.com/publications/pb/pb13-27.pdf>

⁹ I developed this argument in Levy, Philip I. (2010), “[U.S. Policy Options in Response to Chinese Currency Practices](#),” House Committee on Ways and Means, March 24, 2010.

Enforcement and Rules

Even if trade with China has, on balance, been beneficial for the U.S. economy, there are ample sources for concern about certain Chinese behaviors. The United States can be harmed by Chinese trade barriers, by the theft of intellectual property, or by predatory pricing practices. This naturally raises questions about how the United States can pursue its interests in negotiations and enforcement actions. As a way to shed light on the issue, this section offers some distinctions that can separate productive approaches from ineffectual ones. The section concludes with a consideration of China's record in accommodating U.S. economic concerns.

Distinction #1: Actual vs. Aspirational Rules

When China acceded to the World Trade Organization in 2001, it agreed to an extensive range of commitments that had been negotiated over the previous 15 years. China committed to drop barriers, permit investments, and adopt global rules across a range of sectors. As extensive as these commitments were, they did not cover every economic concern that trading partners might have. This incompleteness reflected the incompleteness of the WTO agreements to which China was acceding. In some cases this incompleteness reflected unfinished work by global negotiators; in other cases it reflected serious disagreements between countries that precluded strong rules. Two examples –in areas of actual controversy – can illustrate the point.

Currency.

GATT Article XV addresses “Exchange Arrangements.”¹⁰ Paragraph 4 says: “Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement...” This would seem to forbid the manipulation of exchange rates to counteract trade liberalization commitments. But the clause is exceedingly vague and refers all questions to the International Monetary Fund. It is the economic equivalent of a law that says “Don’t misbehave.” It is either unenforceable or it is a grant of enormous discretion to a judicial process to fill in the blanks. Chinese currency practices may deviate from those the United States would favor, but it is very difficult to point to clear agreed-upon rules that they contravene.

Subsidies.

The World Trade Organization puts some limits on the use of subsidies, but the determination of which subsidies are prohibited and which are permitted can be frustratingly complex.¹¹ There are clear examples of prohibited measures – subsidies directly linked to export performance. Then there are principles that help determine whether a subsidy is problematic. Most importantly, the agreement covers “specific” subsidies – those that apply only to a particular industry or group. This restriction would seem to exempt broad subsidies, such as general macroeconomic policies, public education, or infrastructure. The United States may have legitimate concerns about Chinese subsidy practices that are general rather than specific, but these are not covered by the existing agreement on subsidies.

The point of the distinction is that existing trade law does not forbid every trade practice that may harm U.S. interests. In considering the efficacy of the current system, enforcement

¹⁰ http://www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm - articleXV

¹¹ http://www.wto.org/english/tratop_e/scm_e/scm_e.htm

questions should be posed only about objectives clearly covered by existing agreements. For concerns not covered by agreed-upon rules, the appropriate questions concern effective negotiating strategies.

Distinction #2: Unilateral vs. Multilateral Approaches

The United States has pursued its economic objectives with China through multiple approaches. The United States was a leader in establishing the multilateral trading system under the WTO and in negotiating China's accession to that body.¹² The United States is currently engaged in discussions among 12 trading nations across the Asia-Pacific to establish a Trans-Pacific Partnership (TPP) that would set new standards on topics like the treatment of State-Owned Enterprises. While China is not a party to those talks, the successful implementation of new standards would have an inevitable influence on the evolution of future rules.¹³

In parallel, the United States has pursued a series of bilateral dialogues with China, including the Joint Commission on Commerce and Trade (JCCT), the Strategic Economic Dialogue (SED), and its successor the Strategic & Economic Dialogue (S&ED). In a recent study, the General Accounting Office identified 298 trade and investment commitments made by China since through these dialogues since 2004.¹⁴ While interesting, it is difficult to tell what that tally signifies. To make a meaningful statement, one would have to have a measure of the scope of each commitment – commitments can have widely varying economic impacts – and an assessment of whether the promises had been fulfilled. The GAO study had particular difficulty on the latter point and called for better tracking.

Each approach to negotiation offers its own costs and benefits. The WTO offers the advantage of a well-developed dispute settlement mechanism. The United States has used this system 15 times to press cases against China.¹⁵ That number certainly understates the benefits the United States has derived from the system, since the threat of a WTO case can suffice to resolve a concern. The system also has the virtue of legitimacy and impartiality – the rules are agreed by consensus and dispute decisions are made by panels of trade experts from third countries. This dramatically reduces the likelihood that a charged bilateral political relationship will inflame a dispute. Further, along these lines, the WTO dispute settlement approach prevents disputes from escalating by specifying a set level of retaliation, should an offending party prove unwilling to bring its practices into line with its WTO commitments. If we consider China's incentives to make concessions and to comply with decisions in the WTO system, they are relatively high.

¹² Note that many of the measures that are unilateral in implementation, such as Anti-Dumping and Countervailing Duty procedures, are shaped by WTO agreements governing their use.

¹³ This idea is developed in Levy, Philip I. (2013) "Bargains among Behemoths: TPP and TTIP Implications for Developing Countries," October 4. SSRN Working Paper *forthcoming*.

¹⁴ General Accounting Office (2014), "U.S.-China Trade: United States Has Secured Commitments in Key Bilateral Dialogues, but U.S. Agency Reporting on Status Should Be Improved," GAO-14-102, February 2014. <http://www.gao.gov/assets/670/660824.pdf>

¹⁵ United States Trade Representative (2013), "2013 Report to Congress on China's WTO Compliance," December. <http://www.ustr.gov/sites/default/files/2013-Report-to-Congress-China-WTO-Compliance.pdf>

The benefits to China of being a member in good standing of the WTO extend throughout its global trading relationships.

The downside of addressing U.S. concerns through a multilateral approach is that it has proven exceedingly difficult to reach a consensus on new agreements. The Doha Development Agenda was launched in 2001 with the goal of wrapping up within a few years. It has yet to conclude. The Obama administration is to be commended for concluding a deal in Bali in December, 2013, but that agreement covered a small fraction of the issues that were on the initial agenda – and an even smaller fraction of the issues that would be on an agenda if it were to be created anew in 2014. When the United States pushes to address concerns in multilateral settings, be it the WTO or the TPP, it must necessarily reach compromises with other countries who perceive their interests differently.¹⁶

In contrast, a unilateral approach allows U.S. negotiators to pursue an unfiltered set of objectives. However, China's incentive to comply is significantly less than it would be in the multilateral setting. Prior to 2008, there was, to some extent, a dynamic by which China might accede to U.S. demands as a student might accept instruction from a more accomplished teacher. Subsequent to the global financial crisis, this dynamic was lost. That left a more straightforward bargaining environment between the two countries. In such an environment, the United States could induce China to change either by offering concessions in turn, or by threatening retaliation for failure to accommodate U.S. concerns. In terms of concessions, the United States has been relatively reluctant to concede on issues such as permitting the export of high technology products, relaxing security constraints on Chinese FDI into the United States, or granting China "market economy" status. With little to offer, it is hardly surprising that the United States should receive polite but modest concessions in return.

This does leave the option of pursuing U.S. interests with China through threats of retaliation. It is an option that received heightened interests amidst accusations of currency manipulation and suppression of global demand. There are at least two serious downsides to such a course of action.

First, this approach likely misreads Chinese politics. On issues such as the undervaluation of the Chinese currency, there have been vigorous debates within China. There are strong arguments that it would be in China's own interest to appreciate the RMB. Whatever the merits of this policy choice, if it is perceived as succumbing to U.S. intimidation, it will garner new opposition from Chinese nationalists. The optimal U.S. strategy should be one that understands political dynamics and furthers our national interests, not one that bolsters the opposition.

Second, the danger is that without the structure and impartiality of the WTO, such a conflict could escalate into a damaging trade war. Some advocates suggested that the United States could

¹⁶ As one example, the U.S. push to include enforceable currency measures in trade agreements was rejected by Canada, normally a staunch ally. See Carmichael, Kevin (2013), "Leave Currency Manipulation out of Trade Talks, Ed Fast Urges," *The Globe and Mail*, September 27, 2013. <http://www.theglobeandmail.com/report-on-business/economy/leave-currency-manipulation-out-of-trade-talks-ed-fast-urges/article14563787/>

win such a war – after all, if we value exports over imports, does the bilateral trade deficit not suggest that China has more to lose than the United States? This reasoning fundamentally misunderstands modern international trade. Modern manufacturers distribute production throughout global value chains. Breakdowns in those production chains damage not just the consumers of final goods, but producers. We saw a demonstration of this when the Fukushima nuclear disaster in Japan resulted in the closure of a key parts factories. The result was not a shift in demand to U.S. producers – it was serious trouble and closure for U.S. factories missing the key parts.¹⁷ A strategy that would inflict serious damage on U.S. consumers and producers should have limited appeal.

In sum, a multilateral approach requires accommodation of partner country interests and patient effort, but substantially greater rewards. A unilateral approach frees the United States to make whatever demands it pleases, but offers distinctly limited prospects of success.

Distinction #3: Trade-Specific vs. Economy-Wide Concerns

The discussion above treated negotiating objectives generically. In fact, the likelihood of success in pursuing U.S. objectives with China can vary greatly with the nature of the request. The list of U.S. concerns can easily encompass both some very specific requests (e.g. permission to open a financial services operation in a particular sector or province) and some very general ones (e.g. broad shifts in macroeconomic, SOE, and exchange rate policies). In some cases, it can be difficult to tell the difference. The United States has repeatedly expressed concerns about China's unwillingness to enforce intellectual property rights and has even pressed a case at the WTO. While the Chinese government may be making objectionable decisions in individual IPR cases, this problem also involves a much larger economy-wide issue about the rule of law in China.

There is no reason to prevent United States negotiators from pursuing economy-wide concerns, but as a strategy we must be cognizant that these will be substantially larger “asks.” To be effective, they must be coupled either with an explanation why the change would be in China's interest (true in the case of currency) or with a commensurate offer of U.S. policy shifts in exchange.

To conclude, rather than offering any definitive verdict on the effectiveness of U.S. enforcement actions against China, the three preceding distinctions are meant to suggest reasons why some approaches have been more effective than others in the past and are likely to be so in the future.

Conclusion

The United States has a broad range of economic interests in its relationship with the People's Republic of China. Over the last 15 years, China has emerged as a major trading power and it has been a major goal of U.S. foreign economic policy to shape China's role as a constructive

¹⁷ Clark, Don and Yoshio Takahashi (2011), “Quake Disrupts Key Supply Chains,” [*Wall Street Journal*](#), March 12, 2011.

member of the international economic community – a responsible stakeholder. This period has also witnessed a continued decline in the share of U.S. employment in manufacturing. While China’s emergence as a trading power has played some role, it is important to put it in the context of shifts in manufacturing productivity and the development of other emerging markets.

The assessment of China’s effect on the U.S. jobs market plays directly into concerns about the enforcement of trade rules. If we believe that Chinese economic malfeasance is the primary cause of American economic woes,¹⁸ then it is natural to look for enforcement remedies. If, however, Chinese practices are a secondary or tertiary cause of low wages or lost jobs, then there is a dual risk to a focus on enforcement. First, it risks distracting from the more important task of creating a well-trained and flexible labor force. Second, it risks provoking economically damaging disputes that could still leave the initial concerns unaddressed.

Even with the effects of U.S.-China trade put in proper perspective, there will certainly remain a range of concerns that need to be addressed. The United States faces some important choices as it constructs the agenda for this diplomacy. I would suggest that a multilateral approach, while fraught with difficulties, is more likely to be successful in achieving U.S. aims than a unilateral or bilateral approach. This does not mean that the bilateral dialogues are worthless – communication is valuable and there have been some results – just that we should be realistic in our expectations and our strategy. As we pursue bilateral talks, we need to be judicious in the prioritization of our requests and match asks with commensurate offers. Wherever possible, we should make the case that the changes under discussion are beneficial for both the United States and China.

¹⁸ See, e.g., the “China Cheats” campaign by the Alliance for American Manufacturing. Walker, Charlie (2012), “US: China’s Cheating on Trade Rules Undercuts American Manufacturing,” *Manufacturing Weekly*, September 18. <http://www.manufacturingweekly.com/us-chinas-cheating-on-trade-rules-undercuts-american-manufacturing/>