

U.S.-China Trade Issues

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The United States has long been the preeminent economic power, though in recent years China has been catching up at an unprecedented rate. A recent Goldman Sachs study projects that China will overtake the U.S. as the largest economy by 2027, and will be nearly twice as large by 2050. Regardless of how large the Chinese economy grows in the next 20-30 years, it is fact that the trade relationship between U.S. and China has never been more important to the world economy.

There exist nagging issues between the two nations that have often hampered trade and cooperation efforts. Perhaps the most talked about issue is China's currency policy, which many in the U.S. fault in creating our trade deficit. Likewise, it is alleged that decoupling the yuan would create balanced trade. Another issue causing much consternation is the significant amount of U.S. debt China owns in the form of U.S. Treasury securities, which many believe could be used to effectively manipulate the U.S. economy. These issues are often misunderstood and distorted by politicians. In this article, we attempt to debunk some of the myths surrounding a pegged yuan and China's increased holdings of US Treasuries, while outlining the need for a more coordinated and active dialogue between the two countries.

The Undervalued Yuan

Recently, China has been bombarded with criticism regarding its attempts to undervalue the yuan, which it does by using a fixed-exchange rate system to keep the currency valued at about 7 yuan per US dollar. China's central bank then buys dollars almost equivalent to the trade surplus with the U.S. to avoid increasing China's money supply in the world currency market, which would cause inflation. The central bank then sells off the purchased dollars through bonds sold to Chinese investors.¹

Many in the U.S., including representatives in Congress, believe that this artificial pegging of the yuan is directly related to the U.S. trade deficit with China, and believe that a free-floating yuan would be the solution for more balanced trade. However, a pegged yuan is only part of the story. It is true that a lower value yuan makes Chinese products cheaper and in turn makes its products more competitive versus other national currencies. However, allowing the yuan to appreciate by using a floating currency exchange-rate system (which is used to value the dollar, yen, and euro) will not necessarily have the beneficial impact on US trade with China that many hope.² In fact, appreciation of the yuan could actually make Chinese producers more competitive in certain areas, thereby denying any significant change in the U.S. trade deficit with China.

It is naïve to think that revaluation of the yuan alone would significantly shift the trade balance in the U.S.'s favor. While a floating currency may help balance some sectors, other considerations such as relative prices, domestic and foreign substitutes, and the costs of finding new suppliers, also have a large impact on trade flows.

Furthermore, revaluation alone could in fact be beneficial to the Chinese and backfire on those who believe it would help mitigate the trade imbalance. Daniel Ikenson, a trade policy analyst at the Cato Institute explains:

Yuan appreciation would reduce the relative prices of imported raw materials, enabling Chinese producers to lower their selling prices. So while the yuan appreciation is touted as a ‘cure’ to the bilateral U.S. trade deficit, the fact is that such appreciation would enable Chinese producers to lower their own costs of production, and hence their prices for export, possibly erasing the intended effect of the currency adjustment.³

Finally, it is important to remember that China has been using surplus from trade to buy U.S. debt. This is both beneficial to the U.S. and crucial to its economic recovery. Instead of agitating over the revaluation of the yuan, the more pressing issue for the future of bilateral trade could be whether China will continue to buy these U.S. Treasury bonds.

According to the U.S. Treasury Department, as of May 2009 China held \$801.5 billion dollars worth of U.S. Treasury securities, the highest number to date.⁴ This number grew from April 2009 despite the recession woes in the U.S., which may be a sign of future intentions. The most common conclusion drawn from these holdings is that they give China significant leverage over the U.S. and restrains some U.S. economic policies. This is true, but only to an extent.

The Chinese government remains trapped by the large scale of its current dollar holdings. For instance, if the People’s Bank of China moved significant amounts of money from dollars to other currencies, the dollar would most surely depreciate, causing losses on China’s residual U.S. debt holdings.⁵ China would essentially be sabotaging itself by creating a devaluation of its remaining investment holdings. Since this would deliver a major blow to both economies, not to mention the global economy, there is little reason to believe China will do this. No doubt, the mere image of such effects deters Beijing from acting rashly. John Maynard Keynes’ famous remark comes to mind when considering these issues between China and the United States: “If you owe your bank manager a thousand pounds, you are at his mercy. If you owe him a million pounds, he is at your mercy.”

Another parallel issue that needs to be addressed between US-China trade relations is whether China will continue to buy U.S. Treasury securities in the future. Although holdings went up in May of this year, U.S. Treasury Secretary Timothy Geithner has had to make numerous diplomatic visits to reassure China’s government that the holdings are safe. Even if the U.S. begins to recover from the economic downturn, unless the national debt is reduced, the Chinese may decide not to purchase in the same quantities going forward. This would be detrimental to the U.S. economy and put a serious hurdle on the road to economic recovery. The U.S-China Strategic Economic Dialogue has been utilized as one vehicle to coordinate trade policies, particularly

regarding U.S. Treasury securities, and ensure no drastic measures are taken on either side.

U.S.-China Strategic and Economic Dialogue

Beginning in 2006, then U.S. President George W. Bush and Chinese President Hu Jintao created the Strategic Economic Dialogue (SED) as a way to annually discuss important bilateral trade, financial, and economic issues. Led by then U.S. Treasury Secretary Henry Paulsen, the SED was convened semi-annually.⁶ Issues aside from mere economics began to be discussed during these meetings, such as the six-party talks with North Korea, which prompted the Obama administration to change the format to the U.S.-China Strategic and Economic Dialogue (S&ED). The goal was to foster two separate channels for annual discussion with clearly delineated goals.

The reasoning behind the U.S.-China S&ED was summed up by Secretary of State Hillary Clinton and Secretary of the Treasury Timothy Geithner in an op-ed published in the Wall Street Journal, “Simply put, few global problems can be solved by the U.S. or China alone. And few can be solved without the U.S. and China together.”⁷ Together, China and the U.S. have vowed to use the S&ED to promote sustainable and balanced economic growth; foundations for a strong financial system; mutual trade and investment; and continued use of international economic and financial institutions.⁸ They have also promised to take steps domestically to help their economic relationship.

The U.S. has said it will take measures to increase the national savings rate and pursue financial reform and regulation to help stabilize its economy. It also will seek to reduce the fiscal deficit to a “sustainable level” by 2013, which they acknowledge will mean “a smaller role for the U.S. consumer in driving global growth than in the past half decade.”⁹ China has affirmed its intentions of promoting interest rate liberalization and consumer finance; continue to allow foreigners to invest in China’s capital markets; further decentralize approval authority and eliminate unnecessary barriers for foreign investment; and take continued measures to fortify a more market-based financial system.^{10 11} The S&ED could prove to offer a realistic view of the current issues while dispelling misconceptions and resolving outstanding problems such as those involving exchange rates and foreign exchange reserves. The hope remains that it will aid in encouraging a more collaborative U.S.-China trade relationship going forward.

¹ Navarro, Peter. “How China keeps yuan undervalued (why we care).” San Francisco Chronicle. 15 Feb 2009. 11 Aug 2009. <<http://www.sfgate.com/cgi/article.cgi?f=/c/a/2009/02/15/IN8215SV9J.DTL&feed=rss.opinion>>.

² Ibid

³ Ikenson, Daniel. “Chinese Currency Issue is a Red Herring.” *Cato Institute*. 03 May 2005. 11 Aug 2009. <<http://www.freetrade.org/pubs/articles/di-05-03-05.html>>.

⁴ United States Department of Treasury. *Major Foreign Holders of Treasury Securities*. U.S. Department of the Treasury. 11 Aug 2009. <<http://www.treas.gov/tic/mfh.txt>>.

⁵ Eichengreen, Barry. “The dollar dilemma: The world’s top currencies faces competition” Foreign Affairs. September/October 2009

⁶ United States Department of the Treasury. *FACT SHEET: U.S.-China Strategic and Economic Dialogue*. U.S. Department of the Treasury. 11 Aug 2009. <<http://www.ustreas.gov/press/releases/reports/sed%20fact%20sheet.pdf>>.

⁷ Clinton, Hillary Rodham and Timothy Geithner. "A New Strategic and Economic Dialogue with China." *The Wall Street Journal*. 27 July 2009. 11 Aug 2009. <<http://www.state.gov/secretary/rm/2009a/july/126455.htm>>.

⁸ United State Department of the Treasury. *The First U.S.-China Strategic and Economic Dialogue Economic Track Joint Fact Sheet (TG-240)*. U.S. Department of the Treasury. 28 July 2009. 11 Aug 2009. <<http://www.ustreas.gov/press/releases/tg240.htm>>.

⁹ United States Department of the Treasury. *U.S. Fact Sheet: Cabinet-level Meeting of Economic Track of U.S.-China Strategic and Economic Dialogue (TG-241)*. U.S. Department of the Treasury. 28 July 2009. 11 Aug 2009. <<http://www.ustreas.gov/press/releases/tg241.htm>>.

¹⁰ Ibid

¹¹ *The First U.S.-China Strategic and Economic Dialogue Economic Track Joint Fact Sheet*.