

THE U.S. TRADE DEFICIT AND CHINA

Statement by
C. Fred Bergsten
Director, Institute for International Economics¹

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The Centrality of the Currency Issue

The US global merchandise trade and current account deficits hit annual rates of \$900 billion in the fourth quarter of 2005. This amounted to 7 per cent of our GDP, twice the previous record of the middle 1980s (as a result of which the dollar declined by 50 per cent over the three-year period 1985-87). The deficits could reach annual rates of \$1 trillion within the next year or so.

China's global current account surplus soared to about \$150 billion in 2005, about 7 per cent of its GDP. China has become the second largest surplus country in the world, slightly behind Japan and far ahead of all others. Its foreign exchange reserves have recently passed Japan's to become the largest in the world and will probably reach \$1 trillion by the end of 2006 (compared with \$38 billion for the United States).

¹ Dr. Bergsten has been Director of the Institute for International Economics since its creation in 1981. He was previously Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). He is co-author of the new book *China: The Balance Sheet: What the World Needs to Know Now About the Emerging Superpower*, prepared jointly by the Center for Strategic and International Studies and the Institute for International Economics and published by Public Affairs Press.

China's role in the global imbalances is even greater than these numbers might suggest. A substantial increase in the value of the Chinese currency, the renminbi, is essential to reduce the imbalances but China has blocked any significant RMB rise by intervening massively in the foreign exchange markets, buying \$15-20 billion per month for several years to keep market pressures from pushing its currency up. China apparently sees its currency undervaluation policy as an off-budget export and job subsidy that, at least to date, has avoided effective international sanction.

By keeping its own currency undervalued, China has also deterred most other Asian countries, from Japan to India, from letting their currencies rise against the dollar for fear of losing competitive position against China. Hence China's currency policy has taken virtually all of Asia out of the international adjustment process. This is critical because Asia accounts for about half the global surpluses that are the counterparts of the US current account deficit, has accumulated the great bulk of the increase in global reserves in recent years, enjoys the world's fastest rates of economic growth so can "afford" trade adjustment better than other regions, and is essential to the needed correction of the exchange rate of the dollar because it makes up about 40 per cent of the dollar's trade-weighted index.

These global imbalances are unsustainable for both international financial and US domestic political reasons. On the international side, the United States must now attract almost \$7 billion of capital from the rest of the world every working day to finance our current account deficit and our own foreign investment outflows. Even a modest reduction of this inflow, let alone its cessation or a selloff from the \$12 trillion of dollar claims on the United States now held around the world, would initiate a precipitous

decline in the dollar. Especially under the present circumstances of nearly full employment and capacity utilization in the United States, this could in turn sharply push up US inflation and interest rates, severely affecting the housing and equity markets and potentially triggering a recession.

The domestic unsustainability derives from the historical reality that dollar overvaluation, and the huge and rising trade deficits that it produces, are the most accurate leading indicators of protectionist trade policies in the United States. Such overvaluation alters the domestic politics of US trade policy, adding to the number of industries seeking relief from imports and dampening the ability of exporting industries to mount effective countervailing pressures. It was trade policy pressures of this type that prompted drastic policy reversals by the Reagan Administration, to drive the dollar down by 50 per cent via the Plaza Agreement in the middle 1980s, and by the Nixon Administration, to impose an import surcharge and take the dollar off gold to achieve the cumulative 20 per cent devaluation of the early 1970s. The escalation of protectionist pressures against China at present, despite the strength of the US economy and the low level of unemployment, is the latest evidence of this relationship between currency values and trade policies. Continued failure to correct the currency misalignments could have a devastating impact on the global trading system.

It is thus essential to reduce the US and China imbalances by substantial amounts in an orderly manner. The goal of US adjustment should be to cut its global current account deficit to about 3 per cent of GDP, less than half the present level, at which point the ratio of US foreign debt to GDP would stabilize. China's goal, accepted at least in

principle by its political leadership, should be to eliminate its global current account surplus and stop the buildup of foreign exchange reserves.

The United States should take the lead in addressing the imbalances by developing a credible program to convert its present, and especially foreseeable, budget deficits into modest surpluses as were in place as recently as the early years of this decade. Whether or not the United States effectively addresses its budget problem however, large changes in exchange rates are essential component of the global correction. A change in China's currency policy, in both the short and longer runs, is thus by far the most important issue in US-China economic relations.

In the short run, an increase of 20-40 per cent in the value of the RMB (and parallel appreciations of other key Asian currencies) is an essential component of an orderly correction of the global imbalances.² Such a sizeable change could be phased in over two or three years to ease the transitional impact on China.³ It could be accomplished either by a series of step-level revaluations, like the 2.1 per cent change of last July only much larger and with a substantial initial “down payment” of at least 10 per cent, or by a steady upward managed float of the RMB.⁴ An increase of 20 per cent in the RMB and other Asian currencies would reduce the US global current account deficit by \$60-80 billion per year.

² I have studiously refrained from mentioning the very large Chinese bilateral trade surplus with the United States, which should not be a focus of policy because of the multilateral nature of international trade and payments. Attached is a summary of the analysis of the bilateral imbalance from our new book *China: The Balance Sheet* that explains its causes and how it relates to the two countries' global payments positions.

³ See Morris Goldstein and Nicholas Lardy, *A New Way to Deal with the Renminbi*, Financial Times, January 20, 2006.

⁴ To offset the impact on its domestic economy of the resulting decline in its external surplus, China should simultaneously phase in increases in domestic demand through higher government spending on health care, pensions and education. Such new government programs are already needed for purely internal reasons because of the internal unrest in China that has resulted from the reform of state-owned enterprises that provided these benefits in previous times. See Chapter 2 of *China: The Balance Sheet*.

Over the longer run, China should adopt a more flexible exchange rate that will respond primarily to market forces. These forces would clearly have pushed the RMB to much higher levels by now in the absence of China's official intervention. There is some justification, however, for China's fears that an abrupt move to a freely floating exchange rate now, particularly if accompanied by abolition of their controls on financial outflows, could trigger capital flight and jeopardize their economy in view of the fragility of their banking system. Full-scale reform of China's exchange rate system will have to await completion of the reform of its banking system, which will take at least several more years. Hence the adoption of a flexible exchange rate regime in China, which is essential to avoid re-creation of the current imbalances in the future, can be only the second stage of the resolution of the currency problem.⁵

A US Strategy for China's Currency

It is obvious that China is extremely reluctant to make the needed changes in its currency policy. It is equally obvious that US efforts on the issue over the past three years, whether the earlier "quiet diplomacy" approach or the commendably more aggressive stance of the past six months or so, have borne little fruit. A new US policy approach needs to be adopted with considerable urgency in light of the upcoming visit of President Hu Jintao of China to Washington on April 20-21.

One cardinal requirement is for the Administration and Congress to adopt a unified, or at least consistent, position. To date, there has been something of "good cop (Administration) – "bad cop" (Congress, e.g., the threat of the Schumer-Graham legislation) bifurcation between the two branches. China has exploited these differences,

⁵ This two-step approach was initially proposed in Morris Goldstein and Nicholas Lardy, *Two-Stage Currency Reform for China*, Financial Times, September 12, 2003.

essentially counting on the Administration to protect it from the Congress – a bet that, to date, has paid off.

I would therefore suggest a new five-part strategy for US policy on the currency issue:

1. It is clear that China has aggressively blocked appreciation of the RMB through its massive intervention in the currency markets and that the Treasury Department will lose all credibility if it fails to carry out the requirements of current law to label China as a “currency manipulator.” The Administration should therefore notify the Chinese immediately that, if China fails to make a significant “down payment” appreciation of at least 10 per cent prior to the release of the Treasury Department’s next semi-annual report on currency issues in a month or so, it will be labeled a “manipulator.” This would trigger an explicit US negotiation with China on the currency issue.
2. The Administration should also immediately notify its G-7 partners and the IMF that it plans to make such a designation, in the absence of major preventive action by China, with the goal of galvanizing a much broader multilateral effort on the issue and reducing its confrontational bilateral character. The Europeans and Japan have a major incentive to join the United States because their currencies will rise much more sharply when the dollar experiences its next large decline if China (and other Asians) continue to block their own adjustment.
3. The Administration should also notify the Chinese that, absent acceptable correction in the RMB, it will be unable to oppose responsible Congressional initiatives to address the issue such as the legislation just introduced by Senators

Grassley and Baucus. That legislation would provide explicit sanctions against China (or other countries whose currencies are in “fundamental misalignment,” a far superior criterion to “currency manipulation”) including blockage of a larger Chinese quota at the International Monetary Fund⁶ and ineligibility for revocation of its status as a “nonmarket economy,” both of which the Chinese fervently desire.

4. The Congress should proceed with all due speed to pass the new Grassley-Baucus bill, whose currency sections are a highly desirable replacement for the similar sections of the Omnibus Trade and Competitiveness Act of 1988 in any event. If China continues to fail to cooperate, passage of the bill should be accelerated to provide the Administration with new tools to promote an acceptable outcome to the currency issue or to respond appropriately in the absence thereof.
5. If the first four steps in the strategy fail to produce the necessary results in the near future, Congress should pass the Schumer-Graham legislation to impose an across-the-board surcharge on imports from China. Such a step would be highly regrettable but must be envisaged as a last resort if all else fails to resolve the issue.

⁶ It would be highly desirable to increase the quotas, i.e. voting shares, of China and some other countries in the IMF to reflect their sharply increased role in the world economy as recommended in Edwin M. Truman, *A Strategy for IMF Reform* (Institute for International Economics, February 2006). However, this should be done only for countries that are living up to their obligations under the IMF Articles of Agreement, including the obligations to avoid “competitive undervaluation of their currencies” and “large, protracted, one-way intervention in the exchange markets.” The United States can block any increase in IMF quotas because they require a super majority of 85 per cent and the United States has about 17 per cent of all Fund votes.