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Since economic reforms began in the late 1970s, China has enjoyed dramatic growth and modernization. Important structural changes have included a much greater role for town and village enterprises, private businesses and foreign-invested enterprises, and a smaller, though still major, role for large state-owned enterprises. Exports, in particular exports to the United States, have played a key role in driving growth.

Like many developing economies, China has employed a variety of trade barriers and industrial policies to steer investment and ensure the rapid modernization of domestic industries, for example, in the auto and steel sectors.

As in Japan and other Asian countries, monetary authorities have intervened in foreign exchange markets, consistently buying dollars, U.S. Treasury securities and other reserve currency assets, to maintain an undervalued currency.

Chinese monetary authorities purchase more than $200 billion in foreign, mostly U.S., currency and securities or about 9 percent of Chinese GDP and 25 percent of its exports. The resulting subsidy on exports distorts global trade by boosting Chinese exports and stunting Chinese imports, and contributes importantly to the large U.S. trade deficit.

Given rapid productivity growth and foreign investments in China, we would expect the dollar value of the Chinese currency to rise with its development progress. However, in 1995, the Chinese government began pegging the yuan at 8.28 per dollar.

In July 2005, China adjusted this peg to 8.11 and announced the yuan would be aligned to a basket of currencies. However the yuan still tracks the dollar quite closely, with little day-to-day variation, and is currently trading at about 7.97.

Since 1995, the U.S. trade deficit with China has grown from $34 billion to $202 billion in 2005. The overall U.S. current account deficit has grown from $113 billion to nearly $791 billion. In contrast, when China was granted most-favored-nation status by the Congress in 1980, the U.S. bilateral trade and global current accounts were in surplus at $2.1 billion and $2.3 billion, respectively.

Consequently, reduced sales and layoffs in U.S. import-competing industries caused by Chinese competition have not been matched by increased sales and new jobs in U.S. export industries at the scale a market driven outcome would require. The free trade benefits of higher income and consumption to the U.S. economy have been frustrated by currency market intervention.

Consequences for the U.S. Capital Markets and Economy

Massive foreign government purchases of U.S. securities affect both U.S. capital markets and trade flows.

In capital markets, these purchases reduce long term interest rates and provide the mortgage and credit card industries with funds to provide first mortgages, home equity loans and other forms of credit to U.S. consumers at very favorable interest rates and terms. In turn, this is one of several factors that have driven up U.S. home values, and caused nominal household savings rates to become negative. I say "nominal" household savings rates, because, factoring in unrealized capital gains, many households do not feel as though they are dissaving.

At the same time, foreign government purchases of U.S. securities sustain the value of the dollar against the yuan and other Asia currencies, reducing sales and precipitating layoffs in U.S. import-competing and exports industries. This deprives the U.S. economy of many of the benefits of free trade.

In a nutshell, increased trade with China and other Asian economies should shift U.S. employment from import-competing to export industries. Since export industries create more value added per employee and undertake more R&D than import-competing industries, this process would be expected to immediately raise U.S incomes and consumption and boost long-term productivity and GDP growth. These are the essential gains from specialization and comparative advantage increased trade should create.

Instead, growing trade deficits with China and other Asian economies have shifted U.S. employment from import-competing and export industries to nontradable service producing activities. Import-competing and export industries create about 50 percent more value added per employee, and spend more than three times as much R&D per dollar of value added, than the private business sector as a whole. By reducing investments in R&D, an econometric model constructed for the Economic Strategy Institute[*] indicates the overvalued dollar and resulting trade deficits are reducing U.S. economic growth by at least one percentage point a year - or about 25 percent of potential GDP growth. China accounts for about half of this lost growth.

Importantly, this one percentage point of growth has not been lost for just one year. The trade deficit has been taxing growth for most of the last two decades, and the cumulative consequences are enormous. Had foreign currency-market intervention and large trade deficits not robbed this growth, U.S. GDP would likely be at least 10 percent greater and perhaps 20 percent greater, than it is today. GDP and tax revenues would be higher, and other things remaining the same, the federal budget deficit would be smaller.

Individual industries are particularly hard hit. Since 2000, U.S. manufacturing has shed about 3 million jobs. Judging from past business cycles, it should have regained about 2 million of those during this recovery. Trade deficits were likely responsible for the loss of 2 million manufacturing jobs, and productivity growth the other 1 million.

Financing Trade Deficits

Finally, these mounting deficits have to be financed. For example, in the first quarter of 2006, U.S. investments abroad were $333.9 billion, while foreigners invested $491.5 billion in the United States. Of that latter total, only $33.3 billion or 6.8 percent was direct investment in U.S. productive assets. Most of the remaining capital inflows were foreign purchases of Treasury securities, corporate bonds, bank accounts, currency, and other paper assets. Essentially, in the first quarter, Americans borrowed more than $400 to consume 6.4 percent more than they produced.

Foreign governments loaned Americans $75 billion or 2.3 percent of GDP. That well exceeded net household borrowing to finance homes, cars, gasoline, and other consumer goods. The Chinese and other governments are essentially bankrolling the U.S. consumer.

The cumulative effects of this borrowing are frightening. The total external debt now exceeds $5 trillion and will likely exceed $6 trillion by the end of 2006. That will come to about $20,000 for each American, and at 5 percent interest, $1000 per person.

Revaluing the Yuan

Regarding Chinese options, several arguments have been made against letting the yuan rise to a value that balances its external trade but the underpinnings of these arguments are questionable.

It is true that permitting the yuan to rise 30 or 40 percent would impose difficult adjustments on Chinese state-owned enterprises, disrupt Chinese labor markets, and further stress the balance sheets of Chinese banks. However, adjustments of these kinds will only be larger if the yuan is revalued two or five years from now. To avoid such adjustments and sustain its current development model, China will have to purchase ever-larger amounts of dollars, and transfer ever-larger amounts of what it makes to U.S. consumers. Can that be sustained indefinitely?

A revaluation of the yuan would cause a productivity burst in China, wiping out the competitive gains for U.S. import-competing and exporting business. However, this would not be large enough to wipe out completely the competitive effects of yuan revaluation. Moreover, to the extent that a 30 or 40 percent jump in the dollar value of the yuan did not wipe out China's trade surplus and the excess demand for yuan in currency markets persisted, the dollar value of the yuan could be further adjusted without imposing additional hardships. Productivity gains in China would cushion inflationary effects all around, and Chinese living standards would likely increase by fifty percent or more.

The U.S. is dependent on Chinese and Japanese official purchases of Treasury securities (currency market intervention) to finance its federal budget deficit. However, absent this intervention, the exchange rate for the dollar and trade deficits would be lower, and GDP and tax revenue would be higher. To the extent additional tax revenue did not close the federal financing gap, the Fed could purchase additional Treasury securities to maintain interest rates - something it routinely does to expand and regulate the money supply. Instead of the Chinese and Japanese monetary authorities purchasing Treasury securities, the Fed could make those purchases.

*Peter Morici, *The Trade Deficit: Where Does It Come From and What Does It Do?* (Washington, DC: Economic Strategy Institute, 1998).