China’s Commercial Competitiveness and Misplaced U.S. Focus in its Exchange Rate

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For understandable, but hardly compelling, reasons, China’s exchange rate is getting a lot of negative attention. It is supposed to be a major factor in what are called “global imbalances”—mainly considered to be the U.S. global trade deficit. But broad-based analysis, presented more fully in my submitted written documents, argues that China’s exchange rate is not the culprit.

My testimony today, therefore, emphasizes that this negative attention is misplaced. More than that, the China-exchange-rate focus distracts us from other priorities and could actually harm American commercial prospects with China.

Instead of emphasizing exchange rates, American commercial negotiations with China should focus on real problems and opportunities. Congress and the administration should press for progress in two broad dimensions. The first is China’s WTO commitments. The second is a range of Chinese domestic structural adjustments that would significantly improve both China’s economic performance and U.S. commercial success in China. At the same time, American attention must turn just as urgently, if not more so, to our own domestic barriers to enhancing American competitiveness.

Yes, I know that widely quoted opinions make it seem that there is unanimity on the judgment that China’s currency is seriously undervalued and hence an impediment to fair trade. However, there is not unanimity in China’s case—hardly so. Many esteemed experts at prestigious institutions disagree with the exchange rate logic and rhetoric.

But as I have mentioned, it is understandable why negative voices have received the greatest amplification. Most importantly, exchange-rate explanations are *just* technical enough to carry what *sounds like* scientific legitimacy. They dredge up the most simplistic of freshman—if not high school—economics lessons about the prices of one country’s goods when sold in another country. But for today’s complex economies, this is pseudo-science. Most good economists would agree that it cannot apply willy-nilly to every circumstance. Other deeper, more structural, explanations must share the spotlight—if not command the spotlight.

Nevertheless, in an arena of information overload, simple exchange-rate explanations are appealing. Therefore, I propose both thinking and arguing about these issues in a three-point—or a three-punch—way. First, let’s stress how much China still needs to deliver to meet its WTO commitments, especially those that open its own markets. Second, emphasize the potential disservice to American interests of targeting the wrong issues, like exchange rates. Third, marshal resources and arguments behind pressing China to undertake a range of overdue domestic reforms and structural adjustments that will both benefit its economy and level the playing field with foreign competitors. U.S.-China collaboration, led by the Treasury Departments New Strategic Dialogue, can contribute enormously to this last process.

This proposed one-two-three punch has several advantages. Most importantly, it really focuses on what needs to be done to make a difference. Second, it helps inoculate popular opinion and the American body politic against addictive but harmful ways of thinking. Third, it demonstrates that one can be critical of the pace of China’s changing treatment of foreign trade without having to load our criticism on the exchange rate. In other words, this one-two-three punch approach addresses and helps resolve several critical issues all at once.

In my remaining minutes, let me emphasize a few supporting arguments behind the conclusion I have just presented—The conclusion being that we should handle Chinese commercial fairness issues by pushing hard for better WTO accession compliance, then criticize those with an overly simplistic explanation for American job losses in manufacturing, and finally, challenge China to work with America to strengthen its domestic systems so that fairer and more open trade can benefit both countries.

Why is China's exchange rate not the problem? On a technical note, let me warn you, when the U.S. Commerce Department reports each month how big the U.S. trade deficit is and says *which countries* make up *what share* of that deficit, you should ignore that latter part of the announcement; it is meaningless. China processes and re-packages exports from other countries for final shipment to the U.S. ports. China's *world* surplus was quite small until two years ago. What changed? Not the exchange rate. Rather, it was the convulsions of as-yet incomplete WTO accession. Don't be misled by Commerce department bilateral trade data. U.S. imports from all of East Asia have been basically stagnant this century, while U.S. exports have grown.

Let me also note that the U.S. global trade deficit should not be viewed as all bad at all. It is the major demand engine helping pull low-income countries out of poverty through foreign trade success, not foreign aid handouts. The catch here is that other rich industrial powerhouses, most notably Germany and Japan, are not contributing to this global demand pull. Instead they are also feeding off the U.S. deficit. Correcting this behavior by our rich allies should be a major focus of U.S. diplomatic energy—because exchange rates won't directly solve it either.

I have a second quick warning – don't look at China's foreign exchange reserves for evidence of exchange-rate manipulation. There is a speculation game going on out there—and the U.S. Congress may be an unwitting participant. When speculators hear U.S. government criticism of China's reserve levels, they are encouraged to think America will force China to revalue—so they speculate more. And China's reserves go up as a result. And then there is more criticism, and then more speculative flows, and then higher reserves, and so on. This all could have a bad ending for the speculators, but it is not a sign of exchange-rate misalignment.

If we pretend that our problems are because of China's exchange rate, or China's banking system, or China's low wages, that is like sticking our heads in the sand. It is widely acknowledged that a major revaluation of China's currency will not slow the long-term historic reduction in U.S. manufacturing employment—which is technologically driven and which helps companies afford higher pay and benefits for those who continue in employment.

My most important point for this session is that China is a legitimate commercial competitor. Its success does not rely on currency manipulation. And China will continue to be a legitimate commercial competitor. America's strategy has to be to focus here at home and strengthen our own fundamental competitiveness – education, labor force mobility, pension mobility, health care, and safe cities as attractive places to work so we can compete in the global market for technical and managerial talent. Visa reform would help.

But in handling this issue—both at home and abroad—let us remember the one-two-three punch formula. Hit China on WTO accession issues, we can be tough here in what are still constructive contacts with China. Second, criticize those who oversimplify the issue as an exchange rate problem—noting that this could hurt America in many ways. Third, aggressively seek ways to engage China in accelerated reforms that can benefit both countries. Thank you.