

Is China Playing By the Rules? Free Trade, Fair Trade, and WTO Compliance
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Statement of
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Mr. Chairman, Mr. Co-Chairman, Distinguished Commissioners, Ladies and Gentlemen. It is a great honor for me to have the opportunity to testify before your Commission. As recommended by your Commission staff, I shall focus on the U.S.-China trade imbalance and whether the imbalance can be corrected by a revaluation of the Renminbi, the Chinese currency, vis-à-vis the U.S. Dollar.

The Chinese trade surplus in goods and services vis-à-vis the United States is large and growing. Official U.S. data overestimate the Chinese surplus and official Chinese data underestimate the Chinese surplus because of their different treatments of re-exports through Hong Kong and other trans-shipment points. Prof. K. C. Fung, of the University of California at Santa Cruz, and I have adjusted the data of both countries and derived adjusted estimates of the U.S.-China trade imbalance. For 2002, our best estimate of the Chinese trade surplus for goods and services combined is US\$74.3 billion.

However, despite the large Chinese trade surplus vis-à-vis the U.S., the overall Chinese trade surplus with the World as a whole has become relatively small, especially after Chinese accession to the World Trade Organization (WTO). It is projected to be approximately US\$10 billion for 2003, or 1.5% of total Chinese international trade. This implies that China will have a trade deficit with the rest of the World, which is projected to be on the order of US\$70 billion for 2003. The trade surplus vis-à-vis the U.S. is projected to be in the US\$80 billion range.

In contrast, Japan has a large trade surplus both with the U.S. and the World as a whole. For 2002, Japan has a trade surplus of US\$62 billion with the U.S. and a trade surplus of US\$80 billion with the World as a whole. Its balance of payments, on a current-account basis, is thus much more out of equilibrium than China's.

A large proportion, over 50%, of the Chinese export operations consists of "processing and assembly" activities—the final assembly/finishing of products using intermediate inputs produced elsewhere. What used to be exported from Japan, Hong Kong, South Korea and Taiwan to the U.S. are now increasingly finished and exported from China, using components and parts supplied by these economies and elsewhere. The continuing growth of the Chinese trade surplus with the U.S. is a direct consequence of the shifting of the location of final assembly/finishing of many goods from these East Asian economies to China. The finished goods are considered to have originated from China when they are exported to their final users from China. As a result, simultaneous with the rise of the Chinese trade surplus with the U.S., the trade surpluses of these economies vis-à-vis the United States decline, or stop growing, and the trade surpluses of these economies with China rise. In other words, a significant part of the trade surpluses that these economies had with the U.S. have been shifted to and "inherited" by China. For example, during the first half of 2003, China had trade deficits of US\$ 7 billion, US\$ 10 billion, US\$ 18 billion and US\$ 7 billion with Japan, South Korea, Taiwan and the ASEAN countries respectively. The Chinese trade deficit in goods and services vis-à-vis the rest of the World may be expected to continue to rise in the future because of the rapid growth of oil imports (driven by rapidly increasing domestic demand for automobiles) and outbound tourism.

However, precisely because the Chinese firms are mostly engaged in assembly/finishing operations, despite the high gross value of Chinese exports, the domestic value-added content of Chinese exports to the U.S. is low—it may be estimated at 20% (or equivalently, the import content of Chinese exports to the U.S. is a high 80%.) The domestic value-added content of Chinese exports to the World is higher, at 30%. Chinese exports to the U.S. may be estimated to be no more than 10% of Chinese GDP. (Chinese exports to the World are not quite 30% of Chinese GDP.) Thus, the Chinese GDP attributable to Chinese exports to the U.S. is no more than 2%. The percent of Chinese GNP attributable to Chinese exports to the U.S. is most likely even smaller because most of the profits from such exports accrue to the foreign shareholders and owners of the exporting enterprises.

Yet, this global out-sourcing of the assembly/finishing operations, which require relatively low skill levels, to the lowest-cost sub-contractors, also strengthens the competitiveness of U.S. firms in their home markets and helps them to not only maintain their existing markets but also open new markets for U.S. products in the rest of the world. For examples, Dell may not have been able to compete with Acer without the cost savings resulting from the final assembly of its personal computers in China (typically by its contractor); Motorola may not have been able to compete with Samsung without its production and export base for mobile telephones in China; and Hewlett-Packard may not be able to compete with Epson without manufacturing overseas. Competition is worldwide today and not just limited to U.S. markets. However, as mentioned previously, the Chinese value-added is very low because almost all components and parts, especially the high-value ones, are imported. Thus, while China may have the dubious honor of being the world's largest shoe manufacturer, Nike has become the world's most profitable footwear firm without manufacturing a single pair of shoes. More generally, the global outsourcing enables U.S. firms to both maintain their domestic market shares and expand their global market shares and thereby maintain, create and expand better-paying job opportunities in the U.S. The bulk of the jobs won by Chinese workers as a result of global out-sourcing, were from the other East Asian economies, and not from the U.S.—we lost them decades ago.

The fact that Chinese exports have a low domestic value-added content has a couple of important implications. The first has to do with the relative gains from trade. The domestic value-added content of Chinese exports to the U.S. is only 20 percent. The domestic value-added content of U.S. exports to China is much higher. (The top 5 U.S. exports to China in 2002 are: 1. Aircraft and associated equipment; 2. Thermionic, Cold Cathode and Photocathode Valves; 3. Telecommunication Equipment; 4. Oil Seeds and Oleaginous Fruit; and 5. Measuring/Checking/Analysing Instruments.) The adjusted Chinese exports to the U.S. is approximately US\$105 billion, f.o.b. and the adjusted U.S. exports to China is approximately US\$27.5 billion, f.o.b. If we assume the U.S. domestic value-added content is 60 percent, then the domestic value-added of Chinese exports to the U.S. is US\$21 billion and the domestic value-added of U.S. exports to China is US\$18.5 billion. These two numbers are not that far apart and 60% may well be an under-estimate of the domestic value-added content of U.S. exports to China. In terms of value-added created in each country, the gains from trade between U.S. and China seem not to be too inequitably distributed.

The second has to do with the potential effectiveness of a revaluation in the exchange rate of the Renminbi, the Chinese currency, in reducing Chinese exports to the U.S. and thereby stemming the loss of jobs. The low domestic value-added content of Chinese exports to the U.S. implies a high import content. Thus, a revaluation of the Renminbi, while it raises the cost of processing and assembly in China, it also lowers the cost of the imported intermediate inputs, which constitute 80% of the total cost of the product, at the same time. A 10% revaluation will therefore increase the cost of Chinese exports by approximately 2%. It is therefore unlikely to have a significant effect in reducing Chinese exports to the U.S. The postwar Japanese experience is hardly encouraging on this question. The Japanese Yen appreciated from 360 Yen/US\$ in the early 1960s to its current 115 Yen/US\$, but the revaluation did not seem to have reduced the Japanese trade surplus vis-à-vis the United States. Mere revaluation of an exchange rate seldom works and will not in this case. It is far more important, and effective, to change the mercantilist mindset.

There are also additional reasons why a revaluation of the Renminbi is unlikely to help very much. Most macroeconomists will tell us that the trade deficit is the direct consequence of a savings-investment imbalance, that unless we save more and consume less, the balance of payment deficit is likely to continue. Even if the Renminbi is significantly revalued, and the revaluation is effective in raising the prices of Chinese exports, it may merely lead to diversion of processing and assembly activities from China to third countries with similarly low costs.

China and the U.S. do not compete in any export markets. The U.S. does not export anything that China exports. Similarly, China does not export anything that the U.S. exports. The two economies are actually quite complementary. In terms of reducing the U.S. trade deficit, it is far more effective to have a revaluation of the currencies of countries that compete directly with the U.S. in export markets, which should increase U.S. exports. For third countries like China, it is not the values of their exchange rates vis-à-vis the U.S.\$ that determine whether they will buy from Airbus or Boeing, it is the Euro/US\$ exchange rate. Finally, a precipitous revaluation of the Renminbi may lead to a flight from the US\$ by Chinese nationals, possibly driving up the rate of interest in the United States.

We may note that both Dr. Glenn Hubbard, the former Chairman of the Council of Economic Advisers, and Dr. Gregory Mankiw, the current Chairman of the Council of Economic Advisers, have said that a revaluation of the Renminbi is unlikely to be very effective in reducing job losses in the U.S.

Revaluation of the Renminbi is also likely to pose some risks to the financial institutions and enterprises in China because of the requirement of “marking to market”. For example, the People’s Bank of China (PBOC), the central bank, holds approximately US\$360 billion of foreign exchange reserves, with perhaps 70% of which denominated in US\$. It will have to take a massive write-down in Renminbi terms upon revaluation. (PBOC holds approximately US\$126 billion of Treasury securities, and also Fanny Mae and Freddy Mac securities.). It has been estimated that an additional US\$150 billion are held by enterprises and households as deposits at Chinese commercial banks. A full-fledged banking crisis may ensue if Chinese commercial banks have to write down their currency losses.

It is probably counterproductive for the United States to demand that China do something that is costly to China but does not do the United States any good. Forcing China to revalue does not really help us solve our job problem fundamentally.

We next address the question of whether the market for foreign exchange in China is in equilibrium (a related question is whether the Renminbi is undervalued). There actually has been a cumulative real exchange rate appreciation of the Renminbi versus the U.S. Dollar of approximately 15% since January 1, 1994. The Chinese current accounts are at the present time approximately balanced vis-à-vis the World as a whole despite large surpluses vis-à-vis the United States, with only a small surplus of approximately US\$10 billion. However, the Chinese overall balance of payments is in disequilibrium with a significant surplus, mostly because of the large capital inflow on account of the inbound foreign direct investment (FDI), currently running at a rate of US\$60 billion a year. But the capital accounts are in surplus also because of controls on capital outflows. Only inflows of capital but no outflows of capital are permitted (with some exceptions) in China. Thus, while it is true that the Renminbi exchange rate is not “market-determined” by spot supply and demand, whatever exchange rate that may emerge from simply eliminating the government intervention in the foreign exchange market is not a truly market-determined exchange rate either, because many potential buyers of foreign exchange and sellers of Renminbi have been excluded. If capital controls are lifted to-morrow, it is not clear that the Yuan will appreciate. Dr. Nicholas Lardy of the Institute for International Economics, Dr. Stephen Roach of the Morgan Stanley, and Dr. Weijian Shan, a General Partner of Newbridge Capital all seemed to believe that the value of the Yuan in terms of U.S. Dollars will go down, not up, if capital controls are lifted. I personally do not share their view. However, lifting capital controls abruptly is extremely risky--it may trigger a massive financial crisis in China. If Chinese depositors withdraw

their deposits from the Chinese commercial banks and exchange them into U.S.\$ en masse, the commercial banks may be faced with an illiquidity and insolvency crisis, because of the extraordinarily high proportion of non-performing loans in their portfolios. Standard and Poor, the rating agency, supports the decision of China not to revalue the Yuan on the grounds that a floating of the currency will damage China's credit rating.

One can of course also try to correct the disequilibrium through quantity adjustments rather than price adjustments, i.e., revaluation. Quantity adjustments imply increasing the imports of goods and services, promoting outbound direct and portfolio investment, and financing inbound direct (and even portfolio) investment with Renminbi-denominated loans. But above all, it means changing the mercantilist/fish-trap mentality.

First, China can afford to run a significant trade deficit, given its substantial foreign direct investment inflow, and it can and should import more from the United States. The trade imbalance can be corrected in two ways—decreasing imports or increasing exports. Rather than making the Chinese sell less to us, it is far better for us to encourage them to buy more from us. Given the levels of Chinese exports and imports and external debt levels relative to its GDP, there is no need for the Chinese central bank to continue to accumulate foreign exchange reserves. One caricature of what has been happening for the last few years is the following: Chinese firms exchange goods for greenbacks, pieces of paper that can be printed at virtually zero cost; they sell the greenbacks to the Chinese central bank for Renminbi; and the central bank in turn exchanges the greenbacks for other pieces of paper, call bonds, which can also be printed at virtually zero cost. Holding too much paper is not without risk. At some point the Chinese should turn back some of the pieces of paper for some real goods. Special high-end consumer products, such as Harley-Davidson motor cycles and Corvette cars, can have a significant market in China, but require promotion. There is also always a high demand for high technology capital goods, and perhaps an expedited procedure for processing applications for export control waiver can help. U. S. firms can also provide more services to China, in the areas of telecommunications, transportation, logistics and distribution activities, financial services, and e-Commerce. Leisure time activities and entertainment—sports exhibition, movies, etc.--are another promising area. There is also a great deal of room to grow in the provision of invisible/intangible “exports” of services—tourism (China has really opened up tourism in a big way—travelers are permitted to take US\$5,000 out of the country per person per trip; individuals can now have passports that are valid for years as opposed to just a single trip; and individual tourism is now a legitimate reason for traveling abroad); education (more Chinese students for universities and graduate schools in the U.S.), and healthcare (medical treatment) in the United States. Finally, enhanced intellectual property rights protection in China can greatly augment U.S. exports of goods and services to China.

China can offer to finance the inbound foreign direct investment (FDI) of foreign direct investors with Renminbi-denominated loans, providing a natural hedge to foreign direct investors but at the same time reducing the inflow of foreign exchange, which China, with a savings rate of 40%, does not need (such loans, however, must be with recourse to the ultimate parents in order to avoid moral hazard). China can also make it easier for foreign direct investors to repatriate their principal and profits. Outbound foreign direct investment, especially strategic foreign direct investment, should be promoted and encouraged. For example, Chinese textile firms may be encouraged to invest in the U.S. textile industry. There may well be complementarities and synergies between industries on the decline in one country but on the rise in the other. Many of the benefits and costs of international trade can be internalized. In particular, the potentially displaced workers can be compensated by the potential beneficiaries of the trade, who can, in turn, pass the cost to the general public by charging slightly higher prices. Chinese firms can also be encouraged to make strategic investments in listed and unlisted companies in the U.S. and elsewhere. Tax treaties should be concluded between China and the U.S. and other countries so as to facilitate Chinese outbound foreign direct investment. China can also increase foreign aid and foreign loans to multilateral organizations and low-income developing economies—e.g., loans repayable in the local currency.

Instead of floating their shares on the overseas markets, good Chinese firms should be encouraged to offer their shares domestically (China does not need any more foreign exchange), where in fact the price/earnings ratio is much higher. China should also begin to relax its capital control by allowing regulated orderly outflows of portfolio investments through approved instruments or vehicles, e.g., qualified domestic institutional investors (QDIIs), closed-end outbound publicly listed and traded mutual funds (e.g., S&P500 index funds), and China Depositary Receipts issued by U.S. and other foreign publicly listed companies and listed and traded on the Chinese Stock Exchanges.

Are there other promising alternatives for reducing the disequilibrium in the overall balance of payments to a revaluation? The answer is yes. First, an acceleration of the World Trade Organization (WTO) commitments on tariffs, market access and opening can be extremely helpful. Second, the imposition of import tariffs by the U.S. However, this may not be very effective, because the supply of imports can simply come from another country. And import tariffs may not be permitted under WTO rules.

A potentially interesting idea is that of “Voluntary Export Tax (VET)”. Export taxes are generally permitted under WTO rules (either vis-à-vis the U.S. or vis-à-vis the rest of the World). An export tax is better for China than a revaluation because while it raises the terms of trade in the same way as a revaluation but it does not lead to losses for holders of the U.S. dollars, e.g., the People’s Bank of China or other commercial banks and enterprises that may have to recognize the foreign exchange losses and also does not encourage pure speculation in the currency. For the U.S. and other importers of Chinese goods, an export tax of 2% is equivalent to a revaluation of 10%. An import subsidy also has the same effects on trade flows as a revaluation or an export tax. However, from a fiscal point of view, an export tax is preferable because it generates revenue whereas an import subsidy requires expenditure.

Volatility of the exchange rate is not conducive to long-term trade and investment relations—long term effective hedges are hard to find and expensive. However, a wider band of fluctuation around a stable mean exchange rate is a good idea but should be introduced and implemented only when expectations of future exchange rates are more neutral and diffuse. If expectations are all one-sided, introducing a wider band does not help because the top of the band will be reached immediately, possibly leading to expectations of even further movements in the same direction. China should not revalue now, because then it will encourage continuing speculation and pressure to revalue. Moreover, it is always easier to revalue than to devalue. Devaluation is likely to face much more opposition than a revaluation. The U.S. may object, assuming that it continues to be in a net deficit position. Objections and competitive devaluation by other exporting countries competing in the same markets can be expected with a devaluation but not with a revaluation. Finally; the domestic population may object because the currency is also regarded as a store of value and devaluation may be regarded as a sign of weakness of the economy or mismanagement. When the long-term value of the currency is uncertain, as is the case for the Renminbi, it is better to stay put rather than revalue.

The best strategy for us is probably to focus on achieving the outcome that we want, e.g., an overall Chinese balance of payments of approximately zero, and not on the method for achieving it. We should hold China to the achievement of the outcome, but leave the choice of instrument, or combination of instruments, to China. We have advised the Japanese Government to revalue the Japanese Yen quite a few times, which it dutifully did each time, but the revaluations never achieved the desired outcome—a reduction or elimination of the large Japan-U.S. trade surplus--the trade surplus only became bigger. We should have asked the Japanese Government to simply reduce the trade surplus, in whichever way that it thinks it can.

Chinese economic policy makers are committed to the gradual evolution to a market based exchange rate determination mechanism. Going forward, the most important task facing the Chinese economic policy makers is to lay the groundwork for the orderly and regulated relaxation of the controls on the different types of capital outflows, with the objective of achieving an equilibrium in the overall balance of payments. Then gradually, with the overall balance of payments continuing to be in approximate equilibrium, additional types

and higher volumes of capital outflows can be liberalized until the ultimate objective of free convertibility is achieved.

Appendix Tables

| Year | Our estimate of U.S. imports from China fob adjusted for re-exports and re-export markups (Official U.S. data) | Our estimate of U.S. exports to China fob adjusted for re-exports and re-export markups (Official U.S. data) | Estimate of U.S. exports of services to China (Official U.S. data) | Estimate of U.S. imports of services from China (Official U.S. data) | Our estimate of U.S.-China trade balance of goods and services (Official U.S. data) |
|------|----------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------|----------------------------------------------------------------------|-------------------------------------------------------------------------------------|
| 1995 | 33.7 | 16.0 | 2.5 | 1.7 | -16.9 |
| 1996 | 38.7 | 17.1 | 3.2 | 1.9 | -20.3 |
| 1997 | 48.2 | 18.0 | 3.6 | 2.2 | -28.8 |
| 1998 | 56.3 | 18.9 | 4.0 | 2.3 | -35.7 |
| 1999 | 65.1 | 17.7 | 3.9 | 2.7 | -46.2 |
| 2000 | 80.3 | 21.4 | 4.6 | 2.8 | -57.1 |
| 2001 | 83.5 | 24.7 | 5.3 | 3.0 | -56.5 |
| 2002 | 104.0 | 27.4 | 5.3 | 3.0 | -74.3 |

Sources: Fung and Lau "Adjusted Estimates of United States-China Bilateral Trade Balances: 1995-2002, *Asian Economic Journal*, Vol. 14, May/June 2003, pp. 489-496.

Note: The official 2002 U.S. data on exports and imports of services are not yet available. We make the assumption that the values of export and import service trade between the United States and China are the same in 2002 as in 2001.

| Billions of US\$ | 2000 | 2001 | 2002 | 2003H1 |
|------------------|----------------|----------------|----------------|----------------|
| World | (\$487) | (\$448) | (\$509) | (\$268) |
| China | (\$90) | (\$90) | (\$111) | (\$54) |
| Japan | (\$85) | (\$72) | (\$73) | (\$32) |
| Hong Kong | \$3 | \$4 | \$3 | \$2 |
| S. Korea | (\$14) | (\$14) | (\$14) | (\$5) |
| Taiwan | (\$15) | (\$15) | (\$14) | (\$7) |

| Billions of US\$ | 2000 | 2001 | 2002 | 2003H1 |
|------------------|------|------|------|--------|
|------------------|------|------|------|--------|

| | | | | |
|------------------|---------------|---------------|---------------|---------------|
| World | \$43 | \$23 | \$30 | \$3 |
| U.S. | \$30 | \$28 | \$43 | \$23 |
| Japan | \$0 | \$2 | \$6 | (\$7) |
| Hong Kong | \$35 | \$37 | \$26 | \$27 |
| S. Korea | (\$12) | (\$11) | (\$11) | |
| Taiwan | | (\$12) | (\$36) | (\$18) |