A Slippery Slope

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Before a
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"Currency Manipulation and Its Effects on US Businesses and Workers"

Committee on Ways and Means, Subcommittee on Trade
Committee on Financial Services, Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, and Commerce
Committee on Energy and Commerce, Subcommittee on Commerce, Trade, and Consumer Protection

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Congress is now moving into a critical phase in the ongoing deliberations over America's international trade policies. These tripartite hearings are a clear indication of the deep concerns that are shaping your efforts. Such angst is understandable. In a broad sense, this is a debate about America's commitment to globalization — the overarching force that is reshaping the US and the global economy. In a narrow sense, the focus is unmistakably on China — the world's most extraordinary development story and yet the largest slice of America's gaping trade deficit. Much is at stake as you grapple with these weighty issues. You cannot afford to get it wrong.

But I worry that may be the case. There can be no mistaking the momentum in Congress to tighten the noose on China. My own experience underscores this point: This is the third time I have testified on US-China trade policy in the past three months. You have framed the debate as a legislative response to America's outsize bilateral trade deficit with China. This point of view is seriously flawed — underscoring the risk of a policy blunder of monumental proportions. By going after China, you in the Congress are playing with fire.

Playing with Fire

For starters, the legislative "remedies" currently under discussion are based on faulty macroeconomic analysis. China bashing doesn't address the real problem that Congress believes is bearing down on American workers — a massive trade deficit that hit a record $836 billion in 2006. Since the Chinese bilateral deficit of $232 billion amounted to the largest slice of America's overall multilateral trade gap — 28% for all of 2006 and fully 34% in the final period of the year — Congress has concluded that China is the major culprit behind the trade-related squeeze on middle-class US workers.

That deduction overlooks one critical point: The United States runs trade deficits not because it is victimized by unfair competition from China or anyone else but because it suffers from a chronic shortfall of domestic saving. That's right, lacking in saving — as evidenced by a net national saving rate that plunged to a record low of 1% of national income over the 2004-06 period — the US has no choice other than to import surplus saving from abroad if it wants to keep growing. That means running current account and trade deficits in order to attract the foreign capital. China turns out to be the biggest piece in this equation not because it is unfairly undercutting American-made products but because it offers a menu of products that satisfies the tastes and preferences of a chronically saving-short US economy. China bashers continually overlook the macro context of America's bilateral trade deficits at great peril.

Consider the consequences if a bipartisan coalition in Congress gets its way and US trade with China is significantly curtailed: The immediate impact would be a tax on US multinationals like Wal-Mart, which sourced some $18 billion of goods from China in 2006. That would either squeeze profit margins or, if passed through to retail prices, raise the cost of living for American consumers. Over time, if the sanctions were onerous enough, the impact would be to divert US trade away from China. But here's where the problem gets especially thorny: Unless America increases its domestic saving, sanctions on Chinese products will do nothing to alleviate the overall trade deficit. The outcome would fit the "water balloon analogy" to a tee — squeezing the Chinese piece would simply redirect the deficit elsewhere. And most likely that would reallocate saving-short America's multilateral trade deficit away from low-cost Chinese producers toward higher-cost foreign sourcing. That would be the functional equivalent of a tax increase on American consumers.

Unfortunately, by going after China, Congress is also biting the hand that feeds it. China is one of America's most important external lenders. To a large extent this is an outgrowth of the same currency policy that has US politicians so up in arms — a "managed peg" that has allowed the renminbi to increase by only about 7% versus the dollar since July 2005. To keep the RMB in this range, China must recycle a disproportionate share of its massive build-up of foreign exchange reserves into dollar-denominated assets. As of February 2007, China held $416 billion of US Treasuries — second only to Japan and up nearly $100 billion from the level a year earlier. And there is good reason to believe that the Chinese hold another $300-400 billion in other dollar-based assets, such as agencies and corporate bonds. By continuing to allocate at least 60% of its ongoing reserve accumulation into dollar-denominated assets, China remains an important source of demand for American securities — thereby helping to keep US interest rates lower than might otherwise be the case. In effect, Chinese currency policy is subsidizing the interest rate underpinnings of America's asset economy — long the driver of the wealth effects that support the income-short US consumer.

Congressional pressure on China could put its bid for dollar-denominated assets at risk for two reasons: On the one hand, if China accedes to US pressure and allows the RMB to appreciate a good deal more against the dollar, there would be less of a need to recycle FX reserve accumulation into dollar-based assets. Absent such buying, interest rates could rise for a saving-short US economy that still needs massive capital inflows. On the other hand, if Washington enacts onerous trade sanctions on China, the Chinese might understandably have less of an appetite to maintain their overweight in dollar-based assets. In fact, there is a good chance that the Chinese government would simply instruct its reserve managers to diversify incremental reserve accumulation out of dollars. In that case, the dollar could plunge and longer-term US real interest rates could rise sharply — a crisis-like scenario that could tip an already weakened US economy quickly into recession. Either way, by imposing sanctions on one of its major foreign lenders, Congress could be putting a saving-short US economy in a very precarious situation.

Trade sanctions might also subject China to intense internal pressure that extends beyond the impact on its exporters. Despite its rapid growth and increasingly important role as one of America's major suppliers of goods and financial capital, China is still a very undeveloped economy. That's especially the case with respect to its financial system, dominated by four large banks that are only just starting to go public. Banks and China's other international borrowers need to be able to hedge their currency exposure — especially in the face of the large exchange-rate fluctuations that Washington lawmakers are seeking. Lacking in well-developed capital markets, such hedging strategies are very difficult to implement in China. A large RMB revaluation could, as a consequence, deal a lethal blow to China's embryonic financial system.

There is also the distinct possibility that Washington-led China bashing could inflict major collateral damage on the rest of Asia. Contrary to popular folklore, China has not become the world's factory. Instead, it is functioning much more as the final destination of a huge pan-Asian supply chain — directly involving intermediate inputs and supplies from the region's other major economies like Korea, Taiwan, and Japan. China is, in fact, the largest export market for the first two of these externally-led economies and is rapidly closing in on the US as Japan's largest export market.

Academic studies emphasize the pan-Asian linkages to the Chinese export machine. Professor Lawrence Lau of Stanford and the Chinese University of Hong Kong has estimated that domestic PRC-based content accounts for only about 20% of the total value of Chinese exports to the US.[1] More recent research by economists at the central bank of Finland underscores how shifts in the RMB would reverberate throughout a vertically integrated pan-Asian production platform.[2] Congress is operating under the false presumption that trade sanctions would be a surgical strike solely on China. That is unlikely to be the case. Instead, there would undoubtedly be major cross-border spillovers that could quickly put pressure on the rest of a China-centric Asian supply chain.

There is a final misperception about the oft-feared Chinese exporter. It turns out that China has become an important efficiency solution for many of the world's multinational corporations. China's so-called foreign-invested enterprises — basically, Chinese subsidiaries of multinationals — have accounted for more than 60% of the explosive growth of overall Chinese exports over the past decade. That raises serious questions about the real identity of the all-powerful Chinese exporter. It may be less of a case of the indigenous Chinese company and more likely an outgrowth of conscious decisions being taken by Western companies. That poses the critical question: Who is the new China — is it them or us?

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[1] See Lawrence Lau's 2003 paper, "Is China Playing by the Rules?" presented as testimony in September 2003 before the US-China Economic and Security Review Commission.

[2] See Alicia Garcia-Herrero and Tuuli Koivu, "Can the Chinese trade surplus be reduced through exchange rate policy?" Bank of Finland, BOFIT discussion paper #6, 2007.

With all due respect, I worry that you in the Congress are seeing the China problem from a very narrow perspective. At the root of this approach are understandable concerns about increasingly acute pressures bearing down on American middle-class workers. But the link between this painful problem and China is based on flawed macro analysis — mistakenly focusing on a large bilateral piece of a major multilateral trade imbalance of a saving-short US economy. As is often the case, one error can beget another, and the real risk is that Washington-led China bashing could trigger a host of unintended consequences — not only taxing American consumers and US multinational corporations but also triggering currency and real interest rate pressures that could tip the US economy into recession. But the biggest tragedy of all could come from a United States that squanders an historic chance to engage China as a strategic partner in an increasingly globalized world. If Washington pushes China away, I fear the rest of an increasingly China-centric Asia won't be too far behind.

Protectionism and Inflation

At the same time, I also fear that disinflation could be at risk as Congress rushes headlong down the path of protectionism. The cross-border arbitrage of costs and pricing — one of the unmistakable hallmarks of globalization — could well turn unfavorable if China bashers get their way. This could be a recipe for the dreaded stagflation scenario — a perfectly awful outcome for financial markets and the functional equivalent of yet another tax hike on an already beleaguered American middle class.

The US economy has benefited greatly from an outbreak of "imported disinflation" over the past decade. Researchers from the IMF have estimated that the so-called import-price effect has lowered the US CPI inflation rate by an average of about one percentage point per year since 1997.[3] Such an externally-driven reduction in domestic US inflation is basically an outgrowth of rising import penetration from the low-cost developing world. US import penetration — purchases of foreign-made products as a share of domestic goods consumption — has risen from 22% in the early 1990s to about 38% today. At the same time, Morgan Stanley calculations suggest that developing economies have accounted for 58% of the surge in total US imports over the past decade. China and Mexico have led the way — making up nearly 60% of the cumulative increase of imports to the US from developing economies since 1995.

Nor have currency swings or business cycles altered the disinflationary forces of globalization. Over the past 12 years, prices of non-petroleum imports into the US have been basically unchanged, punctuated by brief cyclical breakouts that never exceeded 4% that were, in turn, followed by periodic declines of approximately equal magnitude. This compares with a cumulative increase in the so-called core CPI of 31% over the 1995 to 2007 interval. Even during periods of modest cyclical acceleration in import prices, spillovers from foreign to domestic inflation have been limited. That's due in large part

[3] See "How Has Globalization Affected Inflation?" Chapter III in the IMF's *World Economic Outlook,* April 2006.

to the still-wide disparity between price levels of foreign and domestically-produced goods — a disparity which has continued to open up in recent years. According to the US Bureau of Labor Statistics, prices of nonagricultural US exports, a good proxy for inflation of internationally-competitive goods produced within the United States, have recorded a cumulative increase of about 10% since early 1995. While that's hardly a major surge, it nevertheless stands in contrast with the stability of nonpetroleum import prices noted above. That only adds to the compelling arithmetic of imported disinflation the US.

I suspect there is an equally important productivity angle to this as well. Globalization and the record expansion of world trade it has engendered have played a new and important role in the execution of global efficiency solutions by US businesses. This arises from increasingly powerful synergies of cross-border supply chains available to US multinational corporations, as well as from the arbitrage between relatively antiquated high-cost facilities at home with newer vintages of low-cost production platforms abroad.[4] Similarly, there is compelling evidence of innovation-driven productivity spillovers from inward foreign direct investment.[5] To the extent that "imported productivity" growth dampens overall cost pressures in the domestic economy, globalization has created yet another powerful headwind holding back US inflation.

As a result of these trends, the sourcing of domestic consumption in the United States has shifted away from high-cost goods made at home to cheaper and increasingly high-quality products produced by low-cost developing economies. In one sense, these impacts are temporary — they reflect globalization-driven impacts on the US economy that have taken it from one state of "openness" to another. Consequently, as import penetration eventually levels out, the impacts of imported disinflation could ebb. At the same time, should forces come into play that arrest globalization — namely an outbreak of trade protectionism — there could well be a reversal of the external pressures of disinflation, thereby boosting overall inflation.

Unfortunately, that is precisely the risk today. As you in Washington now move to contemplate policies that could lead to trade frictions and protectionism, America's global sources of disinflation would be very much at risk. Tariffs and non-tariff duties are the functional equivalent of a tax on low-cost imports. Depending on pricing leverage, such taxes could be directly passed through to American consumers. At a minimum, they would boost cost pressures on US multinationals, with the potential to interrupt the shifting of high-cost domestic production to cheaper offshore locations. Moreover, such frictions might also diminish the productivity dividend offered by global supply chains. This latter possibility could well be reinforced by ongoing efforts of the US Congress to tighten up the so-called CFIUS (Committee on Foreign Investment in the

[4] See Federal Reserve Vice Chairman Donald L. Kohn, "The Effects of Globalization on Inflation and Their Implications for Monetary Policy," June 2006.

[5] See Jonathan Haskel, Sonia Pereira, and Matthew Slaughter, "Does Inward Foreign Direct Investment Boost the Productivity of Domestic Firms?" CEPR Discussion Paper No. 3384, May 2002. Available at SSRN: http://ssrn.com/abstract=317681.

United States) approval process for foreign direct investment into the United States — a development that has gathered considerable momentum in the aftermath of the aborted 2006 acquisition of US port facilities by Dubai Ports World.

Nor is the cyclical timing of all these developments exactly ideal. The imposition of trade and investment barriers could lead to the return of the closed-economy inflation dynamic at just the time when slack has diminished in America's labor and product markets. And, of course, the dreaded dollar-crisis scenario — hardly a trivial consideration in a protectionist climate — could lead to a much sharper spike in import prices than has been evident in a long time. All in all, such an unfortunate confluence of circumstances could exacerbate domestically driven inflationary pressures at precisely the wrong point in the business cycle — in sharp contrast to a globalization that has acted increasingly to offset such cyclical pressures over the past 15 years.

There is great irony to Congressional attempts to "fix" globalization: The odds are that the most extensive damage will be inflicted on the very constituency in the US economy that the politicians are trying to assist — America's middle-class. One of the most important lessons of the 1970s is that inflation is the cruelest tax of all. And yet that lesson now seems all but lost on Capitol Hill today. There is no refuting the reality of pressures already bearing down on American labor. In the current economic upturn, Morgan Stanley calculations suggest that the cumulative gains in private sector worker compensation remain about $430 billion (in real terms) below the trajectory of the typical expansion. Moreover, according to the US Bureau of Labor Statistics, the median wage — inflation-adjusted weekly pay for the worker in the middle of the wage distribution — has risen a cumulative total of just 0.9% over the seven years ending in the first quarter of 2007; that's an especially disturbing development in a period of accelerating productivity growth — very much at odds with the long-standing conclusions of economic theory and experience. As an outgrowth of these developments, the labor share of America's national income has fallen sharply in recent years and remains near its post-1970 low of 56%. Sadly, Congress now appears to be contemplating a response to these pressures that would impose the functional equivalent of an inflation tax on US workers at precisely the time when they can least afford it.

America's beleaguered middle class deserves better. Due to under-investment in education and human capital over the past 25 years, American labor is lacking in many of the skills required to face the new competitive challenges of an IT-enabled globalization that is bearing down on white- and blue-collar workers, alike.[6] Moreover, by failing to save and to embrace pro-saving policies, the US has set itself up for chronic current-account and trade deficits. This is a lethal political and economic combination that has injected a new sense of urgency into the globalization debate. And Washington politicians, rather than taking a hard look in the mirror, have embarked on a dangerous course of "scapegoatism" — blaming China for all that ails the American worker. That

[6] See Stephen S. Roach, "Unprepared for Globalization," Morgan Stanley *Investment Perspectives*, February 3, 2007.

has taken the Congress to the brink of moving beyond the rhetorical bluster of the past few years and enacting legislation that would impose severe trade sanctions on China.

In looking back over the past quarter century, few accomplishments in the economics sphere match the successes of the battle against inflation. Globalization and trade liberalization have become important in insuring the post-inflation peace. Yes, for many, this has been a mixed blessing. There is no question that workers in the developed world have borne a disproportionate share of the cross-border arbitrage that lies at the heart of globalization. At the same time, I have little doubt that the ensuing disinflation has been key in fostering improvements in purchasing power that boost living standards of the same hard-pressed workers. Protectionism raises the risk of squandering this critically important disinflationary dividend — thereby eroding inflation-adjusted purchasing power. That is the very last thing America's middle class needs.

Losing Asia?

There are also important geopolitical consequences of the recent shift in US trade policies. The more America resists the rise of Asia — precisely the risk in light of mounting protectionist pressures in Washington — the greater the chances the region will go its own way. Signs of such a development are already apparent — especially in the form of a new rapprochement between Asia's two economic powerhouses, Japan and China. That raises the worrisome possibility of disengagement between the US and the world's most rapidly growing region. If that turns out to be the case, America will have squandered one of the greatest opportunities of globalization.

The emergence of a China-centric Asian supply chain has been a major feature of the region's recovery from the wrenching financial crisis of 1997-98. Up until recently, Japan has been on the outside looking in. That is now changing. Japan's overall trade volume with China has doubled during the last five years, with shipments from the PRC and Hong Kong, combined, having surged from 5% of total Japanese imports in the early 1990s to close to 21% today.

These trends may well be an important precursor of a new stage of pan-Asian economic integration — growing linkages between China and Japan. Collectively, these two nations — the world's second and fourth largest economies — account for 82% of pan-Asian GDP as measured by the IMF's purchasing-power-parity metrics. If they come together, the implications for Asia — as well as for the rest of the world — would be enormous.

The possibility of such a new thrust to pan-Asian economic integration is more than just idle curiosity. China's Premier Wen Jiabao just completed the first mission of a senior Chinese official to Tokyo in over six years. That followed shortly on the heels of last October's trip to China by Prime Minister Shinzo Abe — the first foreign excursion of the then newly elected head of the Japanese government. Both leaders appear to be putting great personal stake in forging a new future for one of history's more volatile relationships. Premier Wen's speech to the Diet — the first time a Chinese leader has ever addressed the Japanese legislature — put the economic relationship between the two nations in an important context: By stressing complementarity and interdependence, Wen spoke of a China that appears willing to embrace Japan as a strategic economic partner rather than as an adversary.

Japan has certainly come a long way in the past five years in rethinking its approach toward China. As recently as 2002, leading Japanese government officials were still casting China in the role of a major source of Asian instability — accusing the PRC of not only exporting deflation but also being responsible for a "hollowing out" of Corporate Japan.[7] The Koizumi government subsequently turned that attitude around — pushing proactive strategies of corporate restructuring that welcomed offshore efficiency solutions for high-cost Japanese manufacturers. China is now a prime beneficiary of this approach, as Japanese multinationals turn aggressive in pursuing offshore options. Japan's foreign direct investment into China hit US$6.5 billion in 2005 — greater than China-bound flows from all of Europe ($5.6 billion) and more than double those of the United States ($3.1 billion).

The significance of further momentum to economic cooperation between Japan and China cannot be minimized. These two economies — one a surplus-labor behemoth and the other a labor-short island — are a formidable combination. As China now faces the imperatives of migrating from a long-standing fixation on the quantity of growth to a newfound focus on the quality of growth, what better partner could it ask for than Japan to provide technological assistance for energy conservation and pollution abatement? And as a rapidly aging, high-cost Japanese economy faces increasingly intensive competitive pressures, who better could it turn to than China to offer offshore options with both the scale and the quality control its production model needs? China needs Japan just as much as Japan needs China — precisely the complementarity that Wen Jiabao alluded to in his recent address to the Japanese Diet. Yet that same complementarity raises important questions for the rest of the world — especially for a US economy that may find itself increasingly marginalized by a new strain of pan-Asian integration.

Globalization at Risk

By embracing protectionist remedies and going after China, Congress is reacting to symptoms of much deeper problems — especially skillset disadvantages of American workers and an extraordinary shortfall of domestic saving. Absolutely nothing is gained on either front by blaming China for problems such as these that originate at home. To the contrary, much could be lost — in the US, the global economy, and world financial

[7] See Haruhiko Kuroda and Masahiro Kawai, "Time for a Switch to Global Reflation," a December 12, 2002 op-ed piece in the *Financial Times*. Note: Kuroda was then Japan's Vice Minister for International Affairs at the Ministry of Finance and Kawai was his deputy.

markets — if Congress makes a major blunder on US trade policy. Wrong-footed macro analysis is a clear risk in this regard — especially holding a bilateral deficit with China accountable for what is truly a multilateral manifestation of America's chronic saving problem. At the same time, unwinding the disinflationary benefits of globalization would borrow a painfully familiar page from the stagflationary script of the 1970s. And the consequences of pushing Asia away from the US sphere of influence cannot be minimized. All in all, the outcome of a protectionist tilt to US-China trade policy could be treacherous — both for financial markets and the US economy.

None of this is to say that there shouldn't be active and direct negotiations with the Chinese on more legitimate conflicts over trade policy — especially those issues that bear directly on broad constituencies of the US workforce. The area of intellectual property rights is especially important in that regard, particularly since it directly affects the core competencies of America's vast legions of knowledge workers — the professionals, managers, executives, sales workers, and office support staffs who, by our calculations, collectively account for 61% of total US employment. The US Trade Representative's recent decision to initiate IPR complaints against China with the WTO is a far more appropriate course of action than misdirected congressional scapegoating over the currency and bilateral trade deficit issues. Unfortunately, you in Washington are having a hard time making this critical distinction.

Globalization isn't easy. It puts pressure on developing and developed countries, alike. As the world's leading economic power, it falls to the United States to assume the special role as a steward of globalization. China bashing is tantamount to an abdication of that responsibility. It is not in America's best interest, and it could quickly take the world down a very slippery slope. Globalization, itself, may have an exceedingly difficult time recovering. You in the Congress must heed these risks — before it is too late.

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