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Hearing on The Extent of the Government's Control of China's Economy, and its Impact on the United States

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For most of the last 50 years, globalization has been a win-win proposition, making America richer while lifting hundreds of millions in the developing world out of poverty and despair. Recently, however, it has begun to operate differently, undermining U.S. welfare while creating imbalances likely to end in a global economic crisis.

In this new mode, globalization is tilting the world like a giant sliding board game on which the "flattening" of old barriers is accelerating the transfer of the supply side of the U.S. economy to the rest of the world, especially Asia. Take Boeing as an example. Long America's leading exporter, it symbolizes the kind of high-tech leadership on which the future of the U.S. economy is widely said to depend. After losing market share to the European Airbus in recent years, Boeing responded by developing the new 787 Dreamliner, which is gathering record orders. Yet these sales may not add a lot to the U.S. economy because much of the work—including production of the critical carbon-fiber wings that Boeing always insisted would be kept at home—will be done in Japan.

Even more telling is the example of the semiconductor king, Intel. When economists and political leaders say American industry should concentrate on producing very-high-technology products where it has a clear comparative advantage, Intel's chips are what they have in mind. Yet company executives recently told a presidential advisory panel that under present circumstances they must consider building more of their new factories abroad. Over the next 10 years, they explained, the cost of running a semiconductor factory in the United States could be $1 billion more than that of running it abroad.

That there is something odd here is not yet widely acknowledged. Indeed, most business, academic, media and political leaders continue to insist that globalization is proceeding smoothly, making the world rich, more democratic and more peaceful. President Bill Clinton called globalization America's strategy, and President George W. Bush describes the American economy as the "envy of the world." Nor is this view entirely unjustified. U.S. GDP and productivity growth are the highest in the developed economies, while inflation, unemployment and interest rates are among the lowest.

Nevertheless, a closer look reveals a dark side. The U.S. trade deficit is now more than $800 billion, or 7 percent of GDP, and grows inexorably as Americans continue to consume more than they produce. The trade imbalance is of unprecedented size and breadth. Economists typically expect the United States to import commodities and cheap manufactured goods while exporting high-tech products, sophisticated services and agricultural goods, for which its land and climate are well suited. In reality, the U.S. high-tech trade surplus of $30 billion in 1998 has collapsed to a deficit of about $40 billion. Agricultural trade is now also in deficit for the first time in memory, and the modest surplus in services is declining as global deployment of the high-speed Internet has made it possible for services to move offshore as easily as manufacturing. In short, U.S. exports are declining versus imports across the board, while its growth depends on foreign lenders (primarily in Japan and China) to finance the excess consumption.

Two factors explain these unexpected trends. The first has been at work for a long time. It is the gradual construction of the global economy in an asymmetrical form. For the United States, globali-zation has meant building its economy into a giant consumption machine. Easy consumer credit, home-equity loans with tax-deductible interest payments, markets largely open to imports, policies that emphasize growth through demand management and accommodative monetary policy, and myriad other incentives have led Americans to save nothing while both households and government borrow at record rates. This is often justly criticized as excessive. But it is important to understand that American buying drives most of the world's growth because the United States is virtually the only net consuming country in the world.

Globalization for most others has meant export-led growth. Particularly in Asia, "catch-up" development policies have focused on creating production and export machines. There are many flavors, but most Asian economies are characterized by relatively low consumption, savings rates of 30 to 50 percent of GDP, government intervention in markets, managed exchange rates, promotion of investment in "strategic" industries, incentives for exports and accumulation of chronic trade surpluses along with large reserves of dollars.

Indeed, the dollar is the key to this whole lopsided global structure. The dollar, of course, is not only America's money, but also the world's primary reserve currency. As long as others will accept it in payment, America can buy and borrow without concern for saving, investment or production. Thus, deficits—whether trade or budgetary—really don't matter and America can get away with fiscal irresponsibility. Oddly, the rest of the world can be just as irresponsible. By managing exchange rates to keep the dollar overvalued and their export prices low, other countries can oversave and overinvest because the excess production can be exported to the U.S. market.

This structure has grown for so long because it has great benefits for both sides. America gets to live above its means, as cheap imports and foreign capital keep inflation and interest rates down and home values rising. The rest of the world, especially Asia, gets to climb the ladder of technology faster than it would otherwise. By accumulating dollars, Asia also gains strategic leverage over the lone superpower—which, by outsourcing management of the dollar, has ceded a degree of control over its own long-term interest rates.

There is a downside, however. By keeping the dollar chronically overvalued and providing investment subsidies to attract strategic industries out of the United States, the Asian export-led-growth approach has long tended to shrink U.S. productive capacity. For some time, this was true mostly of commodity manufacturing, and the significance of the trend was discounted with the rationale that the U.S. economy was moving to the "higher ground" of high-tech and sophisticated services.

This argument was never entirely satisfactory because of the exchange-rate management and the investment subsidies used by export-led-growth countries to attract high-tech production to their shores. For instance, Boeing is outsourcing much of the 787's construction to Japan in part because an overly strong dollar reduces yen-based costs, and in part because the Japanese government will provide production subsidies unavailable in the United States while "encouraging" Japanese airlines to buy the planes if the work is done in Japanese factories. For Boeing, this is all of critical importance as a way to offset the launch subsidies provided by the EU to archrival Airbus.

But if it was always flawed, the argument is now in tatters in the face of the second aforementioned factor: the entrance into the global economy of China and India. Not only

do they offer low costs, which the strong dollar further reduces, but—contrary to common assumptions about developing countries—significant portions of their populations are highly skilled. They can thus be competitive across the entire range of manufactured goods and services. The negation of time and distance by the Internet and air-express services makes this all the more true.

Further, the potential size of these markets attracts investment in anticipation of growth, even if the initial production cost is not fully competitive. This is particularly true of China, where national pride and an authoritarian government willing to offer large investment incentives create an environment in which foreign companies are encouraged to engender "trust" by transferring factories and technology to China, regardless of the fact that the comparative cost advantage lies elsewhere.

This, combined with the asymmetric global economic structure, is why the U.S. trade balance is collapsing even in advanced-technology products and serv-ices. The growing trade imbalance, in turn, makes the current mode of globalization unsustainable. To finance the deficit, the United States is already absorbing about 80 percent of available world savings. The value of U.S. imports is now more than double that of exports. To merely stabilize the deficit at its current rate would require that exports grow more than twice as fast as imports.

But this cannot happen if the supply side continues to move offshore. If it doesn't happen and the deficit keeps growing, world savings will eventually be insufficient and a financial crash will be inevitable. Of course, U.S. consumption and imports could be cut, but if that were to occur without a commensurate increase in consumption elsewhere, the whole world economy would suffer recession, if not depression.

Some economists speak bravely of a "soft landing." In this scenario, the United States reduces its budget deficit and excess consumption, while a gradually falling dollar results in rising exports to foreign markets where governments are stimulating consumption. While desirable, this will not occur automatically. Interest groups in all the key nations will defend the status quo.

UNFAIR TRADER?

China and East Asia play by different rules

To show it means business with Beijing on trade, the Bush administration recently threatened duties on imports of some Chinese paper and formally charged China with violation of World Trade Organization rules. The reaction has ranged from euphoric predictions of a reduction of the Himalayan U.S. trade deficit to warnings of a disastrous trade war. In fact, neither will occur because the White House measures are not new, not tough and not relevant.

A U.S. trade negotiator in the Reagan administration, I am familiar with this old ritual. In the background is the U.S. trade deficit that is setting new records and is especially large with a particular country – yesterday Japan, today China. Imports from these countries and elsewhere are flooding the American market, causing complaints of “unfair trade” from U.S. companies and workers losing business and jobs. The administration – Republican or Democratic, makes no difference – emphasizes the benefits of “free trade” and the dangers of “protectionism” and pledges to “open” the offending foreign market to competitive U.S. exports while also monitoring for any violation of trade rules. A high-level bilateral dialogue on trade, currency and broader economic issues is launched with the big surplus country. The

Americans urge their partner to abandon currency manipulation and other strategic practices and to further "liberalize" markets for the good of their own economy. The talks go nowhere as the partner country blames the problems on lazy, incompetent American companies and U.S. policies that result in excess consumption and negative savings.

Congress and the administration then do a dance within the dance. Some congress persons threaten trade-restrictive legislation if the trading partner doesn't shape up. The administration publicly condemns such "protectionist" talk but privately urges Congress to keep it up as a way of providing leverage to U.S. negotiators who warn their dialogue partners of possible dire acts by the "crazies" in the U.S. Congress if the foreign market is not opened satisfactorily.

Some congressional members, however, mean it, and there is usually some just completed Free Trade Agreement that needs ratification by Congress. With the high-level dialogue going nowhere, the administration du jour announces some formal trade complaint or the imposition of some countervailing duty to stop dumping or some other infraction. This sounds tough and the trading partner obligingly howls as if in pain and hints at possible trade war. The items involved, however, are a trivial part of overall bilateral trade and there is no possibility of trade war because that's the last thing either side wants. The real objective of the whole exercise is to buy time and get the trade agreement passed by Congress while "market forces" hopefully operate to correct the effects of the imbalances: closed factories, and lost jobs.

Thus are the recent White House statements and actions not new. Nor are the Chinese necessarily being unfair, and even if they were the proposed measures will amount to no more than pin pricks in the overall context. So it is misleading to talk about being tough. Most important, however, is the fact that whatever is done will in no way change the situation that increasingly threatens the long-term health of the U.S., Chinese and global economies. The reason is that the whole process is based on false premises and a profound error of conventional economic wisdom. The trade negotiators are busy discussing the last war even as weapons of mass destruction are about to explode.

U.S. negotiators always assume that WTO-member countries are playing the same free-trade game as the United States. That game focuses on maximizing consumer welfare, it allows the dollar's value to float in response to currency markets, seeks market-based results as ends in themselves, has Americans saving nothing while they consume more than they produce, and preaches specialization of production based on what a country's resources enable it to do best while trading for the rest. As one top U.S. economist has said; "potato chips, computer chips. What's the difference? They're all chips."

In fact, this is not at all the game China, Japan, Korea, Ireland, Israel, Taiwan and many others are playing. Their focus is production and technological "catch-up," not consumption. They compel their citizens to save at very high levels, pursue export-led growth, foster development of target industries such as semiconductors, aim to accumulate large trade surpluses as a matter of national security, use markets as tools rather than as ends in themselves, and strive to change their resource endowment in order to achieve broader ranges of production and targeted economic structures. They see a big difference between computer chips and potato chips.

While Americans often see this kind of "strategic trade" as unfair, it is important to emphasize that this is the Asian miracle formula and that it has long been accepted as fitting within the technical rules of the WTO. So it is not always clear that there is unfairness. But for sure the two games are quite different. In effect, the Americans are playing soccer while the others are playing football. None of the teams is playing its game

unfairly. But the football players have helmets and pads and love to hit each other while the soccer players are nearly naked and try to avoid contact.

Not only is the same-game premise false. So is another set of economic premises. Conventional U.S. trade doctrine is based on the theoretical assumption that most markets are perfectly competitive, that economies of scale are non-existent or largely unimportant, that labor, capital and technology don't easily cross borders, that market entry and exit are essentially costless, and that currency values are not strategically managed. On the basis of these assumptions, conventional economic wisdom holds that if countries subsidize their industries, engage in dumping, or protect their home markets, they are only hurting themselves. The proper reaction is thus deemed to be to avoid retaliation in favor of persuading them to open their markets.

Most of these assumptions obviously are wrong. Recent work by former IBM chief scientist Ralph Gomory and Nobel Prize-winning economist William Baumol has demonstrated that in today's real world, the industrial and currency management and other market-distorting policies of an American trading partner can be very damaging to the long-term health of the American economy as well as to the world economy. Economies of scale, rapid technological change and instant mobility of technology, capital and, increasingly, even labor change the situation dramatically.

As a result, the combination of the soccer/football games in the current mode of globalization is moving American providers of tradable goods and services off-shore. Manufacturing as a percent of U.S. gross domestic product has fallen from about 20 percent to 11 percent of GDP in the past 15 years. Recently, high-tech services and R&D have also begun to move abroad. This could be harmful to long-term U.S. productivity. It is also helping to create an unprecedented trade deficit that has now reached 7 percent of the American economy's total annual output of goods and services, the U.S. gross domestic product.

At the same time, China and the other countries of East Asia have accumulated nearly $3 trillion in hard-currency reserves. The United States has become the world's biggest debtor nation and the health of its economy is dependent on constant and growing lending from Asia to finance the trade deficit. Both sides are locked in an unsustainable embrace. Americans cannot indefinitely spend more than they earn and Asia will not be willing indefinitely to accumulate American paper. Both former Federal Reserve Chairman Paul Volcker and Warren Buffett have warned of the high risk of a global crisis that could make the Great Depression look like child's play. If and when the crisis comes, China and the United States and many others would all suffer damage. One can argue about who would suffer the most, but the real issue is how to prevent the crisis.

For starters, currency management by East Asia (not just China) has to stop. The dollar will have to be devalued by 30-50 percent against most of the East Asian currencies. Ideally that could be achieved through negotiation, but if not, Washington might consider seeking action from the WTO to identify chronic currency undervaluation as an illegal export subsidy or as a nullification and impairment of tariff concessions.

By the same token, the subsidies and tax incentives widely used in both Asia and Europe to entice companies to invest in particular countries must be disciplined along the lines that already exist for export subsidies, and Washington could request similar action by the WTO. Cartels and buy-national policies are common in much of the world and U.S. negotiators should also seek to have the WTO classify them as illegal and subject to sanction.

If the United States cannot obtain adequate action from the WTO and the International Monetary Fund, it might consider declaring a balance of payments emergency under WTO rules. This would enable U.S. authorities to impose temporary measures aimed at achieving adjustment in the trade deficit.

At the same time, Washington should undertake to balance the federal budget, match foreign investment incentives, and reverse American incentives for saving and consumption by such steps as a curtailment of the tax deduction for interest paid on home equity loans and the introduction of a reverse income tax that would progressively tax consumption instead of income.

This won't be easy but if we don't do it now, the markets will do it for us later in what could be the biggest crash of all time.