

## The Politics of Trade Frictions

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China is the scapegoat *du jour* for all that ails the American middle class. At least, that's certainly the conclusion that can be drawn from spending any time these days in Washington.

Unfortunately, the US body politic has long had a penchant for such "scapegoatism" when it comes to trade policy. Remember the Japan bashing of the late 1980s? And of course, just three years ago there was an outcry of concern over India as the lightning rod of the new threat of white-collar offshoring. Meanwhile, the Doha Round is dead, bilateral free trade agreements are going nowhere, Congress has allowed "fast-track" presidential negotiating authority to lapse, and public opinion polls show an American public with a serious distaste for trade liberalization and globalization.

The politics of congressional-led China bashing fit into this inflammatory climate all too neatly. While there is always a certain amount of bluster evident in Washington, this time the threats seem serious and worrisome. By my count, over 18 pieces of antitrade legislation have been introduced in the first nine months of the 110th Congress. And in almost all cases, the target—either explicit or implicit—is China.

Nor has this outbreak of China bashing appeared out of thin air. In the previous two years, the 109th Congress floated some 27 anti-China proposals. The difference between the two sessions of the US Congress is troubling. In the end, the 109th Congress was all talk and no action. By contrast, the 110th Congress seems highly likely to pass one of the measures currently in the legislative hopper—and with a large enough bipartisan margin to withstand the threat of a presidential veto.

Gary Hufbauer provides an insightful assessment of the potential ramifications of the three leading anti-China approaches currently under consideration by the US Congress—two very similar efforts in the Senate and a somewhat different approach in the House (see his "The US Congress and the Chinese Yuan" prepared for this conference). It's hard to say which version will prevail in the end—or what type of hybrid might emerge from a Conference Committee. But it's important to lay bare the assumptions embodied in Congress's penchant for China bashing in order to understand

where this approach is coming from—and what unintended consequences it may well trigger.

First and foremost, the debate is grounded in very legitimate concerns over the increased economic insecurity of middle-class American workers. Real wage stagnation is at the top of the list. In the second quarter of 2007, inflation-adjusted median weekly earnings for full-time US workers were unchanged from levels prevailing seven years ago in the second quarter of 2000. Yet over that same period, productivity in the nonfarm business sector recorded a cumulative 18 percent increase. Contrary to one of the basic axioms of economics, American workers have not been paid their just reward as measured by their productivity contribution.

As voters, workers are holding their elected representatives accountable for this extraordinary macro disconnect. And politicians are scrambling to come up with both reasons and solutions. At the top of the political answer column is trade and globalization. Congress is presuming that America's record foreign trade gap—namely an –\$838 billion deficit on merchandise trade in 2006—has been a decisive factor in squeezing both jobs and real wages of middle-class American workers. And that supposition has dictated the politically expedient solution—attacking the external imbalance by going after the so-called bad citizens among America's trading partners.

That's, of course, where China enters the equation. America's bilateral trade deficit with China accounts for, by far, the largest slice of the overall imbalance—28 percent of the total US merchandise trade deficit in 2006 and about 31 percent of the cumulative shortfall in the first eight months of 2007. Carrying the label of the Great Currency Manipulator seals China's fate in the eyes of Congress and in the view of many economists—some of whom are attending and even hosting this conference. End of story.

Not quite so fast, I'm afraid. It doesn't take a rocket scientist to figure out that America has a multi-lateral trade problem. Just count up the countries in deficit with the US in 2006, and you'll come up with a list of at least 40 of them. Yes, China has the biggest of America's bilateral trade deficits. But is that because of its currency policy? Or is it an outgrowth of a China-centric supply chain constructed by America's multinationals desperately in search of efficiency solutions in an increasingly competitive world? Or is it a reflection of the simple—and possibly related—fact that China happens to produce (or assemble, to be more accurate) a broad cross section of products that satisfy the tastes, pricing, and aspirational wants of American consumers?

Either way, the congressional math of the blame game is fatally flawed. Stripping out the China gap still leaves a US trade deficit of over \$600 billion in 2006—a number nearly three times as large as the shortfall with China. So assume for the moment that Congress “fixes” the Chinese piece of the US trade deficit—a dubious assumption, as I note below. But even if that were the case, that still leaves a rather large remainder for the US trade gap. What is the policy to address that? Is Congress telling us that China is merely first in line—that, one by one, they will go down the list of US trading partners imposing trade sanctions until the deficit has been eliminated?

It follows that the so-called currency fix now being contemplated by the US Congress is equally preposterous—presuming that pressure on a bilateral cross rate will solve a multilateral deficit. All that will do will be to send a relative price signal that will shift the mix of the deficit elsewhere—and most likely to a higher-cost producer. That’s like rearranging the deck chairs on the Titanic. And, of course, it is also the functional equivalent of a tax hike on Middle-Class America—the aggrieved victim in all this.

The multilateral characteristics of the US trade deficit are the smoking gun to this problem. And it is painfully clear what the root cause is—an extraordinary lack of US domestic saving. America’s net national saving rate—the combined saving of individuals, businesses, and governmental units adjusted for depreciation—averaged a mere 1.5 percent of national income over the five years ending in 2006. That’s the lowest national saving rate for a five-year period in modern US history and apparently the lowest saving rate for the hegemonic power in world history. Lacking in domestic saving, the United States must then import surplus saving in order to grow—and run massive current account and trade deficit in order to attract the capital.

That, I am afraid, is the real end of this story. If America wants to fix its trade deficit and relieve the concomitant pressures that are bearing down on middle-class workers, it must address its seemingly chronic saving deficit. I am highly critical of my macro brethren—several of whom are sitting in this room today—who only pay lip service to this critical aspect of the problem when appearing along side me as expert witnesses in offering congressional testimony on these key issues.

Of course, in Washington, it has long been easy to duck the facts and weave a good yarn. China bashing, I am afraid, is largely a by-product of that predilection. But it’s actually far worse than that. Who is really to blame for inadequate saving—the root cause of the US trade deficit? Washington is at the top of that list, in my opinion, with its penchant for budget deficits, consumption incentives, and an asset-based saving mindset that has been underwritten by the Federal Reserve. But the same Washington is utterly incapable of taking a deep look in the mirror and accepting responsibility for problems such as these. It is much easier to indulge in scapegoating and point the finger elsewhere. China is but the latest in a long line of such targets. Just ask Japan what it was like some 20 years ago—or India just a few years ago.

China bashing is also emblematic of a deeper problem that grips the United States body politic—an unwillingness to embark on the heavy lifting of education reform and other investments in human capital that are required to equip American workers to compete and prosper in a Brave New World. Instead of investing in a hard-pressed work force, Washington apparently believes in shielding US workers from low-wage talent pools in the developing world. The doubling of the world’s labor supply that has occurred in the past two decades has evoked a response of fear and protectionism.

Sadly, that puts America at grave risk of becoming more insular and inward looking. Yet over the long sweep of US economic history, our workers have actually

done best when they are pushed to their limits by a risk-taking, entrepreneurial, and innovative society. By blaming others for our own shortcomings—especially on the saving and human capital fronts—America runs the very real risk of losing its most special edge of all, an indomitable economic spirit. By shirking its responsibility for putting US saving policy on a sound path, Congress is, instead, now veering toward the slippery slope of protectionism.

Finally, just a word about China, where I spend an awful lot of my time these days. China is a living miracle of economic development. The world has never seen anything like the transformation of the Chinese economy that has occurred over the past 15 years. This extraordinary development trajectory is based primarily on a steadfast commitment to market-based reforms—something that Washington as the bastion of capitalism should applaud, not criticize.

But China also has a new strength—one that takes a page right out of our own experience in the United States. Dynamic private companies are now springing up all over China; of the 16 new Chinese companies that Morgan Stanley has brought public so far this year, 15 of them are private. For China, the newfound spirit of its privately employed workers and businesspeople is contagious—and very reminiscent of that which has long been central to the American dream.

Yes, like any economy, China has its share of problems and risks—many of which have been emphasized in this conference today. Structural imbalances, environmental degradation, and income disparities are all openly debated in China these days—especially now as the Party Congress convenes in Beijing. Currency policy has long been a topic of discussion in official Chinese policy circles as well. But, despite its remarkable progress, China is still a very poor country with many other important things on its plate.

Therein lies a critical difference between the two perspectives: Washington's penchant for the quick fix singles out the Chinese currency as a lightning rod in the great middle class globalization debate. China, by contrast, views the currency issue not as an end in and of itself but as one of many pieces in the broad mosaic of financial reforms. That leads to a completely different perspective from both sides that has now boiled over in the form of trade frictions.

Ironically, in contrast to American intransigence on the saving issue and the multilateral trade deficit it has spawned, China is making important progress in relieving this source of tension. As China puts its financial system increasingly on a market-based footing, its leaders have given every indication the currency regime will follow. The shift to a managed float in July 2005 was an important first step in that direction. At the same time, China is taking dead aim on the imperatives of a consumer-led growth dynamic—a very different economic structure that will boost imports and thereby reduce its destabilizing trade surplus.

For China, the timing and sequencing of these moves are being considered with due deliberation—but mainly with an eye toward keeping its embryonic financial system stable. There are clear risks in this approach—excess liquidity and asset bubbles are most obvious in this regard. But these are China’s risks to accept and manage rather than our place to dictate the terms of engagement. China’s pace may not fit America’s political imperatives, but whose fault is that?

Globalization isn't easy. The win-win mantra long offered by the economics profession does this mega-trend a great disservice. It oversimplifies the problems and overlooks the inherent tensions of an IT-enabled globalization that is now proceeding at hyper speed. Globalization is full of opportunity and challenge, as well as fear and risk. But in the end, globalization is nothing more than trust—trust in economic partners to act out of collective interests in making the world a better and more prosperous place. I fear that a China-bashing US Congress has lost sight of this noble objective at great peril.