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REVIEW & OUTLOOK

A China Trade Primer

Trade with China is becoming a hot topic, as U.S. politicians in both parties deplore a \$103 billion bilateral trade deficit that is growing by about 25% a year. Before things get carried away, we'd like to put a few facts on the table that show just how much China trade helps the U.S.

*Why we needn't worry
about the bilateral deficit.*

First, even if Beijing is pursuing these rising trade surpluses, it is not succeeding. China did experience several years of growing surpluses in the mid-1990s, but that era is coming to a close. In the first half of this year, the country's overall trade surplus with all countries fell 70%, so that it represented just 1.3% of its two-way trade.

China's surplus with the U.S. is growing because companies *already* exporting to the U.S. have been moving their production into China. A study by Marc Noland of Washington's Institute of International Economics showed that in 1997 75% of the marginal growth in China's exports to the U.S. was the result of this "displacement effect."

This is particularly true for such labor-intensive goods as toys and footwear, which account for 18% of China's exports to the U.S. As China's share of the U.S. market in these goods has grown to about 60% from less than 10% over the past two decades, the combined market shares of South Korea, Taiwan and Hong Kong have fallen. The same pattern holds for computer accessories and other goods assembled in China. American consumers still get the benefit of the low-priced goods, the difference is that China makes them instead of other Asian countries.

The U.S. also benefits because *American* companies are playing a major role in this migration of factories into China. Neither country collects statistics on what proportion of China's exports are made by American-owned enterprises. But China says that the proportion of exports produced by foreign-funded enterprises has steadily grown to 52% last year, and U.S. companies account for about one-tenth of the more than \$50 billion in foreign direct investment flowing into China annually. So it's fair to say that U.S. shareholders and thus the U.S. economy are reaping a significant share of the profits from China.

To be sure, China's export growth is still going to cost some Americans their current jobs, and no one should make light of that painful ad-

justment. But other American jobs are being created by the rapid growth in U.S. exports to China—more than 15% growth the past couple of years, albeit from a low base.

The four biggest export categories—civilian aircraft, semiconductors, industrial machines and telecom equipment—accounted for \$6.9 billion in sales last year, up 37.4% in four years. These sales create high-paying jobs in the U.S. and help American companies maintain their competitive edge against European and Japanese competitors.

Chinese imports are if anything poised for explosive growth; they rose 42.9% year-on-year in the first six months of 2003. In joining the World Trade Organization, Beijing made major reductions in trade barriers to lock in the level of access to the world's major markets it already enjoyed. Wealth creation in Chinese coastal cities is driving the emergence of a new middle class hungry for foreign consumer items. Investment in factories and infrastructure is also fueling demand for capital goods.

The lesson here is that China today is not likely to be a repeat of Japan in the 1980s. China's record of compliance with the letter and spirit of its WTO promises has been surprisingly good, which would be hard to explain if it were following a mercantilist trade policy. Beijing puts emphasis on stable domestic growth, not racking up trade surpluses.

The current dislocation evident in the country's rapidly expanding foreign exchange reserves stems mainly from the huge amounts of global capital seeking healthy returns in China. Over time this is likely to lead to rising wages and trade *deficits*, a phenomenon that is normal and healthy for a country experiencing rapid economic growth.

Free trade, current account deficits, capital account surpluses, rising prosperity—do all of these sound familiar? They should, because they all describe America. That's right, in coming years the U.S. and Chinese economies will share much in common, despite their different stages of development.

Given how complementary the two are, American politicians who try to capitalize on fear of Chinese trade aren't likely to get very far. These two growth engines of the world economy can enrich each other if they allow their bilateral trade to flourish.