Calling Out China's *Mercantilism*

American jobs are at risk.

By Adams Nager

After more than a decade of classifying China as a currency manipulator, the International Monetary Fund announced last year that China's currency was fairly valued and moving toward an appropriate equilibrium with other currencies. Indeed, the renminbi steadily rose in value from 2005 to 2014, and more recently China has actually been working to keep the RMB from declining. So, after decades of accusations that it was serially distorting the global marketplace, is China finally vindicated?

Veteran journalist, author, and scholar Richard Katz seems to think so. In fact, in both the *Wall Street Journal* and in *The International Economy,* Katz interprets the IMF's announcement as proof not just that the RMB is fairly valued, but also that China did not manipulate the RMB over the past ten years. To him, talk of currency manipulation is a handy way of portraying China as a "scapegoat of America's lost jobs" when in fact the real cause is U.S. productivity growth allowing fewer workers to produce more goods. He is wrong on both counts.

First, the Chinese government still exerts control over the RMB. In 2005, China stopped pegging its currency to the U.S. dollar, and from 2005 to 2014, as Katz states, "the RMB has appreciated 33 percent against the dollar." But over the same period, China's foreign currency reserves grew 380 percent, from $830 billion to $3.9 trillion. This growth, a reflection of China's consistent trade surpluses, suggests that

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the RMB is in fact still overvalued, as the natural response to persistent trade surpluses is an increasing currency value. And while China has let its foreign reserves fall to around $3.3 trillion since 2014, this reduction was sparked not by a desire to strengthen the RMB, but to keep the RMB from falling too low as China enters a rough patch of economic uncertainty. In fact, since 2014, the RMB has fallen in value by about 3 percent as the government tries to prop up a troubled economy through even more exports.

Moreover, China has long buttressed its currency manipulation with industrial export subsidies to keep prices low. Indeed, China has the world's largest export subsidies, even on a per capita basis, which distorts international trade in many industries, including steel, wind turbines, solar cells, glass, paper, and auto parts. These subsidies contribute substantially to Chinese trade surpluses and to global overcapacity in these sectors.

So the truth is that China still is a currency manipulator, and in the past fifteen years it has strategically kept the RMB lower than market forces would dictate as the core of a "pricing below cost" policy to gain global market share in manufacturing. But today, as the focus of Chinese state industrial policy shifts toward higher-value-added industries, keeping the RMB artificially low is less important than it once was. China is instead ramping up other mercantilist tools to unfairly gain a foothold in the high-tech industries it is targeting. For example, in many cases, China has required companies to transfer intellectual property and enter into joint ventures with Chinese technology companies as a precondition for accessing its domestic market. It has aggressively enforced anti-trust rules to squeeze concessions from Western technology companies; it has used government-led technology standards to give advantage to Chinese producers; and it has used state subsidies to prop up hand-picked domestic champions in certain fields of technology.

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This array of unfair competitive practices has had a major impact on the U.S. economy, especially in manufacturing. Yet Katz refuses to acknowledge this is so. He instead relies on the standard, simplistic view that U.S. manufacturing job loss since 2000 has been the result of higher industrial productivity. Katz states: "Factory jobs have fallen for the same reason that farm jobs have fallen… While manufacturing jobs have declined by 30 percent since 2000, manufacturing output rose by 20 percent during the same period. Jobs declined because, back in 1987, it took more than seventeen workers to produce $1 million worth of manufacturing output per year; by 2000, it was down to eleven workers; now it takes just six."

As such, Katz ignores the significant body of scholarship that finds this has not actually been the case. He dismisses the work of the Economic Policy Institute's Robert Scott, who finds that more than half of the manufacturing jobs lost from 2001 to 2012 were tied to the trade deficit with China, leveling an *ad hominem* attack on EPI as being "union financed." Scott's findings, while a tad on the high side, are not much different from what other think tanks and academics have estimated. For example, the Information Technology and Innovation

Foundation found that a growing trade deficit was responsible for almost two-thirds of jobs lost in the 2000s (or 3.8 million jobs). Meanwhile, economists David Autor, David Dorn, and Gordon Hanson focus specifically on the cost to U.S. manufacturing from China and conservatively estimate that 982,000 U.S manufacturing jobs were lost between 2000 and 2007 as a direct consequence of exposure to trade with China.

There are other reasons to be suspicious of the easy answer that "it's all productivity growth." If productivity really was the culprit, why did U.S manufacturing employment decline eleven times faster in the 2000s than it did in the 1990s, even though productivity in both decades was essentially the same?

Katz can perhaps be forgiven for repeating these numbers because they reflect official data from the Bureau of Economic Analysis. But as ITIF and others, such as economists Susan Houseman and Michael Mandel, have shown clearly, BEA's manufacturing output figures are significantly overstated. This is partly because they incorrectly measure the real value of manufacturing imports (what is called "import price substitution bias"), but more importantly because they miscalculate the output of the computer and electronics sector (NAICS 334). In this industry, the U.S. government typically treats each new version of a product as a new good, which conflates price adjustments with year-to-year increases in productivity. According to the BEA, NAICS 334 output grew by 149 percent in the 2000s, compared to a 1 percent contraction for the rest of U.S. manufacturing. Given that actual domestic shipments of computers during this time fell, not increased, the numbers are a poor reflection of production reality. Excluding flawed measurements of computers, the U.S. manufacturing sector produces 16 percent less, as a share of GDP, in 2014 than it did in 2000.

To be sure, this should not be used as a protectionist excuse to claim that we should not have lost any jobs to trade. There are plenty of low-value-added goods for which China has a real comparative advantage, and the United States should not mourn the loss of these industries. But international trade theory—specifically, Ricardian division of labor—suggests we should run a trade surplus in higher-value-added industries. In fact, the United States now runs an $87 billion trade deficit in advanced technology goods, despite running a surplus in 2000. And, yes, we run a trade surplus in services, but it is only 30 percent the size of the trade deficit in manufacturing.

Katz's main failure is to equate all trade, even trade that is mercantilist on China's side, as welfare maximizing for both parties. This is not what either Adam Smith nor David Ricardo would say. Rather, their theories of why trade is good for both parties are based on the view that trade is "free"—and free is the last word one should use to describe China's trade policies. As ITIF wrote in "False Promises: The Yawning Gap Between China's WTO Commitments and Practices," China's aggressive innovation mercantilism has, if anything, grown stronger in recent years, as it has sought absolute advantage across a wide range of advanced technology industries. The international community, and especially China's trading partners, need to adopt a policy of "constructive confrontation" to press China into playing by the trade rules it has previously agreed to uphold. Calling out Chinese mercantilism and the damage it causes does not make one a protectionist. In fact, it makes one a free trader—one who insists that trade be market-based, not government-directed.

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China's distortionary, mercantilist policies rob the world of many of the benefits of free trade. Industries produce better products, see higher levels of innovation, and provide larger benefits to all consumers when they are allowed to locate themselves wherever the free market dictates.

As currency manipulation has begun fading from the global conversation on distortionary tactics, it is time to hold China accountable for the other major infractions it is guilty of perpetrating to unfairly gain market share. Whether or not the RMB is still undervalued, there is no doubt that China will continue to disregard the rules of global trade in order to further its own agenda. ◆