The *Shifting Sands* of American Competitiveness

BY ERNEST H. PREEG

The need for a U.S. strategy toward China.

It would seem things are markedly improving for U.S. competitiveness, given the recent narrowing of the non-oil trade deficit. Yet the U.S. trade deficit in manufactures rose from $324 billion in 2000 to $499 billion in 2007, and is cause for political as well as economic concern. The manufacturing trade deficit means loss of several million jobs in the sector, including in the presidential election swing states of Michigan, Ohio, and Pennsylvania. It also poses a threat to U.S. leadership in technological innovation because 90 percent of civilian research and development and new patents derive from the manufacturing sector.

It is true that U.S. manufactured exports have been growing recently at an annual rate of 11 to 12 percent, and the deficit declined by $27 billion in 2007 and fell another 7 percent in January-April 2008. This is good news as an indicator of strengthening U.S. export competitiveness, but the overall outlook is more complicated. The sands of international trade in manufactures are shifting in far-reaching ways. There are five noteworthy aspects of this process of change:

- The declining U.S. manufactured trade deficit is making a positive contribution to overall U.S. growth;
- NAFTA is not the cause of the deficit;
- The U.S. trade deficit in advanced technology products (ATP) remains very large, with negative consequences;
- The rise of China as number-one exporter of manufactures transforms the regional orientation of trade; and
- The European Union has displaced the United States as the number-one market for Chinese manufactured exports.

What these five developments have in common is that they all result largely if not principally from changes in exchange rates over the past several years, and in particular from the

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large rise of the European, Canadian, and other floating currencies against the dollar and the Chinese yuan. Trade in manufactures is highly price elastic and, with a one- to two-year time lag, the quantities of trade respond strongly to price changes induced by movement in exchange rates.

The declining U.S. manufactured trade deficit is making a positive contribution to overall U.S. growth. This positive contribution to growth stands in sharp contrast with the series of years when an increasing deficit had a significant negative impact on growth. In recent quarters, the positive trade balance effect has helped to keep overall economic growth slightly positive and avoid the official label of recession. What is important to understand is that it is the change in the trade balance that causes the growth effect and not the growth rate in exports alone. U.S. exports can continue to grow at double digits, but if the trade deficit begins to rise again, there will be a negative impact on overall growth. The policy implication is that those calling for a strengthened dollar risk turning the positive trade balance effect on growth back into negative territory.

NAFTA is not the cause of the deficit. This has current political relevance in view of the primary discussions among presidential candidates who, with strong labor union encouragement, characterized NAFTA as harmful to American manufacturing jobs. The facts simply do not support such an assertion. In 2007, the United States had a $10 billion trade surplus in manufactures with Canada, thanks to the strong Canadian dollar, and a $49 billion deficit with Mexico, for a net NAFTA deficit of $39 billion, or 8 percent of the global deficit. During January-April 2008, thanks to the lagged effect of the strong Canadian dollar, the U.S. trade position strengthened further, to a $9.6 billion surplus with Canada, a $13.1 billion deficit with Mexico, and a net NAFTA deficit of only $3.5 billion, or less than 2 percent of the global deficit. In contrast, the deficit in manufactures with China in 2007 was $269 billion, or 54 percent of the global total. It is time for the presidential candidates to get the positive record straight for U.S.-NAFTA trade in manufactures.

The U.S. trade deficit in advanced technology products (ATP) remains very large, with negative consequences. In the mid-1980s, a new categorization of trade data for "advanced technology products" was developed for products with the highest shares of R&D and engineering content. Approximately six hundred products, amounting to about one-quarter of U.S trade in manufactures, comprise the ATP listing, which is periodically updated. The ATP account was comfortably in surplus through 1999, and then began a sharp decline into deficit to $44 billion in 2005 and $53 billion in 2007. The largest deficit sector is information and communications products, at $105 billion in 2007, while the largest surplus sector is aerospace, thanks mainly to Boeing, at $59 billion. The very large and continuing deficit in ATP is disturbing in terms of how these R&D- and engineering-intensive products relate to the industrial base for technological innovation in the United States. Also noteworthy is the dominant Chinese role in the deficit, surpassing the global deficit in 2007 at $68 billion, and continuing its relative rise in 2008. China, in fact, maintains a similar data series for "high-tech products," patterned on the U.S. model, which gives the same picture globally from their end: Chinese global exports of high-tech products doubled from $166 billion in 2004 to $348 billion in 2007, with a surplus of $61 billion in the latter year.

China is gaining market share just about everywhere.

The rise of China to number-one exporter of manufactures transforms the regional orientation of trade. The most dramatic shift in trade in recent decades has been the rapid rise of China to overtake the United States as the number-one exporter of manufactures. U.S. exports of manufactures in 2000 were more than three times larger than Chinese exports, at $690 billion compared with $224 billion. Only seven years later, in 2007, China had surged into first place, at $1,157 billion compared with $982 billion by the United States. Moreover, the Chinese trade surplus during this period increased tenfold, from $45 billion to $444 billion, while the U.S deficit, as noted above, was $499 billion in 2007. This Chinese export juggernaut in manufactures continues in 2008. The overall Chinese trade surplus in January–May 2008 was down 9 percent, but this was the result of higher oil and other raw materials prices. The trade surplus in manufactures, in contrast, was up by a stunning 32 percent, headed toward $600 billion for the year. Export growth for manufactures was 23 percent, double the growth rate for U.S. exports.

The European Union has displaced the United States as the number-one market for Chinese manufactured exports. For years, Europeans viewed the huge U.S. trade deficit with China as a bilateral problem of little direct concern, but this has now changed. In 2007, for the first time, Chinese exports to the European Union were larger than to the United States, as a result of the stronger euro, and the gap is widening. For January–May 2008, compared with 2007, Chinese exports to the European Union grew by 27 percent to $112 billion, compared with 9 percent growth to $96 billion for the United States. Moreover, in 2008, the Chinese trade surplus with the European Union will be close to parity with the United States. During January–May, the Chinese surplus was $59 billion with the European Union and $61 billion with the United States.

The Eurozone finds its divergence problem exacerbated by its bilateral trade deficit in manufactures with China. Italy and Spain are experiencing a relative decline in competitiveness *vis-à-vis* northerners within the Eurozone, especially Germany, and thus the prospect of lagging economic performance while locked into the euro exchange rate. Based on Chinese trade statistics for January-May 2008, compared with 2007, a small German trade deficit with China of $0.9 billion in 2007 shifted to a surplus of $0.4 billion in 2008. For the southerners, in contrast, the deficits rose sharply, from $4.4 billion to $5.2 billion for Italy and from $3.9 billion to $5.2 billion for Spain. Spanish imports from China were almost four times exports. We will likely hear from Mr. Berlusconi about the need for strong action against China, but will Ms. Merkel be listening?

Looking ahead, exchange rates will continue to play a crucial role in manufacturing competitiveness. One question is whether the dollar is presently under- or overvalued, and the answer is both. It is modestly undervalued relative to the euro and other floating currencies and greatly overvalued relative to some Asian currencies and to the Chinese yuan most of all. The G7 finance ministers have come to a *modus vivendi* with China involving a slow progressive strengthening of the yuan of undetermined duration and scale, but presumably until the burgeoning Chinese trade surplus starts to decline, at which point markets will presumably bring about a modest strengthening of the dollar *vis-à-vis* other currencies. The adjustment to domestically oriented growth in China, however, will be very difficult and the Chinese government will continue to resist any appreciation of the yuan that would imperil their trade surplus. Based on observations three to five above, however, most Europeans and the Canadians, among others, can be expected to take a much firmer stand in pressing China for trade-effective currency realignment.

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The bottom line assessment for U.S. export competitiveness in manufactures is thus of some short-term improvement and positive prospects in key relationships. Exports to NAFTA, which comprise 34 percent of global exports of manufactures, are on a balanced track with very large mutual gains from trade. U.S. exports are also highly competitive with European exports in all markets, thanks largely to the stronger euro. A very different picture emerges for Asian exporters, however, and most importantly by far for China. China has displaced the United States as number-one exporter of manufactures to the European Union and India over the past several years and is gaining market share just about everywhere. Chinese exports are also steadily moving up into higher technology industries in direct competition with U.S. exports. China is now the number-one global exporter of manufactures and U.S. export strategy by the next administration should likewise focus far more pointedly on strengthening export competitiveness relative to China. ◆