

Use a scalpel, not a bludgeon

Indiscriminate tariffs are not the answer to the current US-China trade imbalance, especially as China's once overwhelming competitive advantage has dwindled, says Dilip Parameswaran

Since Deng Xiaoping's famous Southern Tour in 1992, when China's paramount leader rekindled the country's economic reforms, and particularly since China's entry into the WTO in 2001, American consumers have gained significant purchasing power from low-cost imports from China. At the same time US manufacturers have lost competitiveness and market share against Chinese suppliers. Although this conflict often colours views of the recent rise in trade tensions between the two countries, it represents just one facet of a complex trade relationship.

For much of the past two decades, the spotlight was on China's exchange rate policy. Despite repeated complaints, particularly from the US, China kept the renminbi-US dollar exchange rate fixed for 10 years until 2005. Throughout this period, the renminbi was widely assessed as undervalued and China's exports gained considerable advantage in the years leading up to and following its entry into the WTO. That said, China also won much praise for keeping its currency steady during the Asian financial crisis when other Asian currencies were devalued substantially.

Successive American governments threatened to designate China a currency manipulator, but none of them carried out the threat. Eventually, China allowed a gradual appreciation of its currency from 2005 to 2014, raising its value cumulatively by 27%. This deflated much of the earlier criticism and many observers, including the IMF, concluded that the renminbi was no longer significantly undervalued. Last year, even the Trump administration refrained from labelling China a currency manipulator. In fact, during much of 2015, 2016 and even 2017, China struggled to keep its currency from sinking as its foreign-exchange reserves declined by nearly a fourth from US\$4tr to US\$3trn. Thus, on the charge of currency manipulation, we can argue that, whatever advantage China might have gained from its exchange rate in the past, it is no longer guilty.

What, then, accounts for the massive and repeated trade surpluses that have turned China into the 'factory of the world' and inflated its massive foreign exchange reserves? The main reason is straightforward: China simply had a massive low-cost labour pool that could be moved to the urbanised coastal regions to support a huge build-up of manufacturing facilities. To that extent, it was a fair deal that lifted millions out of poverty in China and benefited western consumers through lower inflation and higher consumption. However, this cost advantage is no longer a given as rising wages in coastal areas and stricter implementation of environmental regulations have started denting China's competitiveness. Although the country still rules global manufacturing with entrenched advantages, particularly of scale and infrastructure, its cost advantage is no longer formidable.

Beside low labour costs, China has been accused of tilting the competitive field in favour of its own companies in a variety of ways. At a macro level, it has kept its financing costs low by trapping the savings of households at a low return. Through its dominant state-owned financial institutions, it has directed credit to sectors based not just

on their intrinsic viability but on the need to generate growth and employment. Over time, these practices have bestowed a fairly big advantage on its manufacturing industries, sometimes leading to overcapacity, as in steel.

Again, any complaints on that score must be balanced against the praise China earned when the same state-directed lending fuelled the building of infrastructure in the years after the global financial crisis, adding to global demand when there was a dire need for it. It may also be argued that it is the Chinese banks, government and people who will eventually pay for supporting unviable industries and the accompanying build-up in debt to the extent of over 300% of GDP.

Another common charge is that, while China has been eager to tap foreign markets for its exports, it has been reluctant to open up its own markets to competing goods and services, particularly in financial services, insurance and technology. Meanwhile, it has been aggressive in mandating partnerships with local companies and pushing for technology transfers, enticing foreign companies with dreams of access to its massive domestic market. As a result, China is now on the threshold of becoming a global competitor in some high-tech industries, such as high-speed railways. Still, it is not easy to measure to what extent these practices have resulted in an unfair advantage and to put a dollar value on them.

What is indisputable is that China has emerged as a manufacturing powerhouse, before subsequently losing some competitiveness because of various factors. Its current-account surplus, which rose rapidly from 2% of GDP at the time the WTO entry to a peak of over 10% in 2007, has now fallen below 1.5%.

What has brought trade issues to the fore is the Trump administration's focus on the loss of American manufacturing jobs, which it has blamed mainly on the trade deficit with China (and within NAFTA). Although US unemployment is at a 17-year low of 4.1%, lost trade has hit some sectors and geographies particularly hard and given the political impetus to threats of tariffs against a range of Chinese products.

Many of the criticisms against China, including undervaluation of currency, have lost their vigour, whether through change of circumstances or passage of time. While other complaints, particularly those related to the opening up of its markets, tilting the playing field through directed credit and aggressive acquisition of technology, have a kernel of truth, tariffs are a blunt instrument in seeking redress. It would be far better for the US administration to address these issues on a sector-by-sector basis, establish a system to filter technologies open for sharing, and adopt a firm stance in seeking access to the Chinese domestic market against transfers of technology. Such targeted measures, implemented in coordination with Europe and other countries, would be fairer and be more successful in nudging China towards being a more balanced and cooperative trading partner.

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