Amid rising populism, the US-China economic relationship has become a major issue in the 2016 election. There are good reasons: the People’s Republic of China (PRC) is a poor partner in multiple respects. But the troubles caused by Chinese behavior and the economic relationship are not what most people think or what most candidates rail against.

It is frequently asserted, and more frequently during election years, that the large US trade deficit costs jobs. The next sentence is often that the sizable bilateral deficit with the PRC costs American jobs. The main culprit is then said to be Beijing’s exchange rate policy. None of those claims stands up well—the statistical relationship is very weak between the overall trade deficit and bilateral deficit on one side and unemployment on the other. The same is true for the exchange rate, with the kicker that China’s currency may have become too expensive over the last two years, not too cheap.

The PRC, however, deserves other, important criticisms. Politicians often vilify competition, but it is the key to prosperity. The problem is not too much competition in the US, but not enough competition of state-owned enterprises and equally intense theft of intellectual property.

The growing Chinese impact on the world and events in 2015 and 2016 make clear the opacity endangers the PRC’s partners and in some cases infringes American law. All this adds up to a far more accurate description of the trouble in Sino-American economic relations: China’s protections at home, IP theft, and lack of transparency have undermined US gains from China’s membership.
in the World Trade Organization. Such Chinese actions argue overwhelmingly against granting the PRC market economy status or completing a bilateral investment treaty.

Misdiagnosing an illness leads to the wrong cure. The US should not fall victim to trying to correct past problems, much less false ones. It should instead target Chinese actions that genuinely affect the American economy right now, using carrots and sticks to encourage better behavior. Otherwise, the Sino-American relationship may change, but it will not get any better.

Direct Impact: Trade

The common view is that the PRC’s main economic impact on the US is through trade. Beijing manipulates the value of the Chinese currency, contributing heavily to a huge bilateral trade deficit and thus stealing American jobs. This common view is mostly wrong.

The first mistake extends well beyond China: a trade deficit does not mean America lost jobs in total to any country. A look at the trade deficit and unemployment from 1975 to 2015 does not show a statistically significant relationship. This applies to a set of results including the raw trade deficit figure and the deficit as a percentage of gross domestic product (GDP) and for trade and employment measures during the same year and trade in one year and unemployment the next. Such simple correlations ignore variables such as domestic productivity or income growth that would explain both trade and job results and are just the first step in trying to establish that trade deficits represent lost jobs. The first step fails.

When jobs are plentiful and wages rise, Americans buy more of everything, including imports. When the economy is weak, Americans buy less of everything, including imports. Because the US is the world’s largest economy, changes in the US matter much more than changes in any partner economies. Nonetheless, the same principle applies to them: if trading partners are doing poorly, their people and companies buy fewer American goods and services.

Combining the two, when the American economy is stronger than its partners, as in 2014 and 2015, the trade deficit tends to rise.\(^1\) Going back a few more years, the overall trade deficit fell by $325 billion in 2009, a terrible year for the economy. Of course this did not create or protect millions of jobs; it happened precisely because jobs were lost and consumers spent less. The highest trade deficit on record was in 2006.\(^2\) Unemployment ended that year at 4.4 percent.\(^3\)

Protectionists might argue that boom times could be even better and down times not as bad if imports were somehow produced in the US. For most imports, this is a fantasy. America’s dependence on imported crude oil may be coming to an end—no thanks to any protectionist trade barriers. Prior to the boom in domestic energy production, though, cutting off crude oil imports would have killed millions of jobs, not created them.

After the shale boom, the biggest US trade deficit by product is consumer electronics—goods run through a global supply chain, most of them ultimately assembled in the PRC.\(^4\) The end-of-the-line assembly jobs are mind-numbing and poorly paid; most Americans would not take them without far higher compensation, which would send the price of the goods soaring. If cell phones were made entirely in the US, sales and production would plunge, and far fewer workers would be hired. Jobs would not come back to the US; they would simply disappear.

Since the trade deficit as a whole is not connected to unemployment, it is highly unlikely the bilateral deficit with China is truly connected. Bilateral trade numbers are misleading in two respects: (1) the supply chain phenomenon means the PRC gets credit for the full value of consumer electronics and textile exports to the US when it is only involved in final assembly, and (2) a change in a bilateral deficit typically means production moved among America’s partners, rather than left or returned to the US.

Illustrating this, the biggest percentage increase in the Sino-American trade deficit was in 2004. According to protectionists, this should have been a poor year for the US labor market. Yet unemployment fell.\(^5\) Nor was there a delayed effect; unemployment fell again in 2005. The bilateral deficit becomes sizable in 1985. From 1985 to 2015, there is again no statistically significant correlation between the bilateral trade deficit and unemployment, either in absolute
terms or as a percentage of GDP. The trade deficit continuously gets bigger once the US begins trading with China, while unemployment fluctuates.

Two other indicators, however, seem to support critics of Sino-American trade. Labor force participation and manufacturing employment do see a set of statistically significant correlations with the bilateral trade deficit from 1985 to 2015. The simple correlation with labor force participation is not particularly strong. And labor force participation is a function of many factors, with domestic forces more important than international forces. Given the flaws in any bilateral balance as a representation of trade, labor force participation is far better explained by demography, automation, and the like.

The correlation between the bilateral trade deficit and American manufacturing employment is stronger. In addition, the pronounced rise of Chinese manufacturing makes an international impact on the US more likely. This important connection is explored further below.

Finally, jobs could be falling victim to the dollar-yuan exchange rate. On the charge of currency intervention, Beijing is guilty in the first degree, But the Communist Party directs the currency to remain pegged because it is obsessed with stability, not trade advantage, and the results are not what protectionists claim.6

Compared with most exchange rate fluctuations, the yuan barely moves against the dollar, and it is highly unlikely that its values over time would prevail without intervention. For years, the PRC amassed enormous sums of foreign reserves in part because it was buying foreign exchange to keep the yuan from rising. This process began to reverse in late 2014, with Beijing selling foreign exchange to keep the yuan from falling.7 If the simple accumulation or expenditure of foreign exchange represents valuation, the yuan has been overvalued for nearly two years.8

A more sophisticated view is that the severity of distortions in the financial system makes it impossible most of the time to determine what the yuan’s value should be.9 If permitted today,
ordinary people would likely send money out of
the PRC, and the yuan would drop. But if
domestic banks actually lent for commercial
reasons and financial markets became more
transparent, money would flow into China, and
the yuan could rise. Claims that the yuan was 30
percent undervalued five years ago or is 10
percent overvalued now are usually based on a
market standard that has little meaning for the
PRC.

Moreover, the exchange rate does not have
anything like the relationship with the US labor
market that protectionists believe. Employment
conditions in the US improved immediately after
the PRC’s large 1994 devaluation, contrary to
what currency critics would insist. Even from
1995 to 2015, the dollar-yuan exchange rate
seems to have the opposite impact critics expect:
the yuan generally appreciates, yet measures of
the labor market generally weaken. The
ostensible result is driven largely by yuan
appreciation from 2005 to 2008 in the context of
deteriorating US labor conditions.

This is not a meaningful finding. While the
surprisingly reversed correlations are statistically
significant, they are not economically significant.
There is not enough variation in the yuan’s value,
and there are too many other plausible factors.
Still, the idea that the dollar-yuan exchange rate
is costing American jobs has no support at all.

Attacks on the yuan’s value and other aspects of
Chinese trade policy usually focus on its cheap
exports, which at least benefit American
consumers. Meanwhile, China has been defended
as a source of growing demand for US exports. In
fact, the latter is where most of the problem lies.
The PRC’s policy choices deliberately suppress
imports of American (and other countries’) goods
and services. With unwise policy now also
harming China’s own growth, American exports
to the PRC actually shrank in 2015. 10

The policy that most harms American exports is
Beijing’s subsidization of state-owned enterprises
(SOE s). 11 Even with hefty financial subsidies,
SOEs are not competitive exporters aside from
occasional bouts of steel dumping due to massive
overcapacity. At home, however, SOEs are
essentially guaranteed market shares by government decree. This unavoidably caps US import share, especially in services, where American firms would quickly drive many SOEs out of business if permitted. Unlike with cheap Chinese goods increasing the buying power of ordinary Americans, there is no balance of cost and benefit to blocked American exports—there is only cost. This is the biggest trade problem.

Direct Impact: Investment

Because of the flawed claims about job losses due to imports, trade receives the bulk of the attention in Sino-American economic relations. But investment flows matter as well. Trade and investment were bound together in the accession of China to the World Trade Organization (WTO) at the end of 2001.

Manufacturing employment has not seemed to respond negatively to the yuan devaluation in 1994 or a rising aggregate trade deficit. As noted, 2004 saw the biggest percentage rise in the bilateral trade deficit. Labor market indicators, including manufacturing employment, held their ground in 2004 and 2005. In stark contrast, neither the aggregate trade deficit nor the Sino-American deficit grew in 2001. The dollar-yuan exchange rate was stable. Yet in 2001 American manufacturing jobs experienced by far their sharpest plunge, and unemployment jumped from 3.9 percent to 5.7 percent. Without question, some of the reason for this was the domestic business cycle. There is also a China-driven explanation.

The main international economic event of 2001 was China’s formal WTO accession late in the year. This was basically guaranteed in the US by the results of the 2000 elections, so the impact began to be felt the year before formal accession. The US was required to remove the annual review of China’s most favored nation status, which enabled a shift in trade and investment patterns. American and other companies that had been unsure they could invest and produce in China.

Figure 3. Manufacturing Employment, 1990–2015

and then sell back to the US got the permanent green light.

On the American side, transformative benefits from this helped make some clothing and consumer electronics much cheaper and more widely available than they otherwise would have been. It also caused a considerable dislocation in manufacturing due to sharply increased China-based competition. In return, the Chinese market was supposed to open far wider to American trade and investment. The range of subsidies for SOEs, especially, has prevented that.

The combined result has been competition intensifying more in the US and elsewhere than in the PRC. The lack of competition helped create the ongoing Chinese problem of excess investment and production to serve other markets compared with inadequate internal consumption due to unnecessarily high prices and low quality—macroeconomic imbalances. On the other side of the Pacific, this limited new opportunities in the Chinese market for American manufacturing and services firms. An ultimately unbalanced Chinese WTO accession meant the US quickly lost manufacturing jobs and did not receive equivalent economic opportunities even as a number of years passed.

In particular, in addition to blocking American exports, the immunity of SOEs to competition ultimately limited direct American investment in China. After grandiose pronouncements of an investment boom with WTO membership, the Bureau of Economic Analysis puts the stock of American investment in China at just 1.3 percent of total investment abroad through 2014. Chinese figures put new investment from the US at barely $2 billion in 2015. A more recent phenomenon has been noticeable Chinese investment here, which has set a string of records since 2012 and is on the way to another. Chinese firms recorded 29 investments of $100 million or more in the US in 2015. The annual total was close to $19 billion and will easily break that in 2016. While the stock of Chinese investment in the US is tiny as a percentage of American wealth, the potential for it to jump to a new level was illustrated by a record-shattering (for the PRC) $43 billion bid for Swiss firm Syngenta by ChemChina in February. This might still pale against the size of the American economy but can be vital to individual communities that see new businesses open or old ones remain in operation due in part to Chinese money. Mayors and governors travel to the PRC and welcome Chinese delegations for good reason.

Chinese investment in the US is largely beneficial, but there are two policy considerations. The home market for Chinese firms is not subject to the rule of law. As more and more Chinese firms operate in the US, the chances of illegal activity rise. The other risk is specific to SOEs: the level of state support they receive can undermine commercial competition. No Chinese company yet has a large enough share of any meaningful American sector for anticompetitive activity to be a major concern, but that is a growing possibility if not monitored.

Some Chinese investors have less interest in operating in the American market than in buying technology. Sensitive purchases are screened by the Committee on Foreign Investment in the United States (CFIUS), and it is easier to find examples of less sensitive technology being blocked than of more sensitive technology being sold. While the review process is not perfect and surging Chinese investment means it is under
scrutiny, the loss of advanced technology through legal sale has not been an issue to this point. The issue is theft. The most important US competitive advantage is in innovation. American entrepreneurs and companies of all shapes and sizes spend enormous sums on everything from new drugs to simpler web billing procedures. IP theft is not limited to violating patents or siphoning technical data from servers; it includes any attempt to steal information or brand value from competitors. China steals the most American IP of any country. Its size means broad disrespect for IP constitutes an attack on one of the foundations of the American economy, in a way that equivalent or even worse behavior by Costa Rica, for example, cannot match.

The expectation has been that China will better protect IP because it increasingly has its own IP to protect. This expectation is being dashed, in part by the ease of cybertheft and in part by China’s increasingly targeted attacks on foreign IP in particular. For the foreseeable future the US will face a large number of Chinese enterprises that prefer stealing over trying to create. This is the most harmful impact the PRC has on the US, far worse than Americans running up a trade deficit by buying and benefiting from cheap Chinese goods.

Indirect Impacts: Global Stocks and More

A third class of Chinese effects is less important but still claimed headlines over the past year: impacts through third parties. The US has less direct exposure to the PRC’s policies and performance than most countries because the size of the American economy means foreign trade and investment matter less in general. Despite endless hype, Chinese consumption has not materialized as important to the US economy as it has for commodities producers, for instance. Chinese production matters to the entire world but less so for richer countries that can afford goods from higher-cost substitutes, such as Mexico and Vietnam.

The very fact that the PRC matters more to other countries, however, suggests it can affect the US through those countries. On the positive side, the drop in global commodities prices, featuring more than a 50 percent drop in West Texas Intermediate crude in just three years, has reduced the cost of living for most Americans and is partly due to slower growth in China.

Against that, the deterioration in the PRC economy is one cause of global weakness. Countries from Angola to Zimbabwe became reliant on unsustainable growth in Chinese commodities demand and largesse in lending and investment. Brazil may be the best example. It rode high on the supercycle of rising commodities prices, ignoring needed reforms. The crash Brazil seemed to avoid in 2009 was merely delayed and is occurring now. Unsurprisingly, US goods exports to Brazil in 2015 were 25 percent below their 2013 peak. Globally, American goods and services exports fell 5 percent in 2015. Exports of goods alone fell below their 2012 levels.

One Chinese policy in particular had sharp, short-term effects in 2015 and 2016. The yuan’s peg to the dollar meant it mirrored the dollar’s rise against most currencies starting in mid-2011. This prompted Beijing to try to weaken the yuan in August 2015, but it did so without communicating clearly how far the yuan would fall. Fear of competitive devaluations and the destabilization of trade relationships caused regional stock markets to immediately plunge. The S&P 500 held up for a few days, then dropped 9 percent in 2 weeks. In January 2016, Beijing did the exact same thing, and the S&P dropped nearly 7 percent in 10 days. These were not trade events—the yuan only dropped a few percent.

It may be surprising that there is little discernible connection between the large movements in the yuan and American jobs, but a clear connection between small movements and American stocks, if only over a brief period. The main explanations are volatility and transparency. Long-term changes in the yuan’s effective exchange rate give the especially flexible American economy time to adjust, even if the yuan’s value is highly distorted. The US has more difficulty adjusting to surprise movements, whether justified by market forces or not, but most economies find it nearly impossible to adjust, causing immediate tremors in what are...
often shallow local financial markets and indirect pressure on the US.

Perhaps the most subtle way the PRC influences the American economy is through competition in third markets. This includes trade, investment, and contracting within these markets. The obvious effect is the added competition cutting into revenue for American companies and opportunities for American workers, such as Lenovo’s global computer sales cutting into Dell’s market share. On its own, this is just the way free markets work. The problem is the nature of the Chinese competition, which is often noncommercial.

Chinese lenders and builders in particular make cut-rate offers because they are often not trying to make a profit, instead staying in operation through government support. While many countries receive at least short-term benefits from over $500 billion in Chinese-backed power plants and railways over the past decade, American entities are priced out of financing and construction. This has made globalization less fruitful for the US. In an interesting, recent turn, with the drop in the PRC’s holding of foreign currency, the dramatic expansion of noncommercial Chinese activity around the world over the past decade is likely to ebb. There is no longer an infinite supply of money enabling Chinese firms to outbid American and other rivals.

Better American Policy

There is little evidence that the trade deficit or the value of the yuan costs American jobs. There is considerably more evidence that China’s WTO accession has not brought anticipated benefits to the US to compensate for manufacturing job losses, as Chinese IP theft and support for SOEs harm American companies and workers. It is also true that many American communities benefit from Chinese investment. To be effective, US policy must reflect the actual benefits and costs of

Figure 5. SP 500 vs. Exchange Rate, 2005–15

the Sino-American economic relationship. Here’s how:

1. **Do not try to “fix” the trade deficit.**

There is no right number for a trade balance. A large deficit could be due mostly to predatory behavior or, as in the US case, to a large and usually outperforming economy lying at the end of global supply chains. The supposed solutions to large trade deficits are awful. They would disproportionately harm the poor through tariffs or pick winners and losers through what boil down to tax and subsidy schemes. This would not only elevate one group over others, it would harm more Americans than it helps. US policymakers should choose the right policies at home (see below) and let trade deficits go where they will.

2. **Barring a large devaluation, ignore the yuan.**

The yuan cannot be the basis for American policy. It was almost surely undervalued in 2008, if by an unclear amount. It has probably been overvalued since 2014. If it is properly valued in 2020, it will most likely be accidental. The biggest driver of the yuan’s value is the PRC’s wildly distorted domestic financial system, which is beyond US influence. Moreover, the proposed policy responses to Beijing’s exchange rate policy are the same as the responses to the trade deficits: punish tens of millions of Americans in order to punish China.

3. **Do not grant market economy status.**

The WTO accession agreement indicates China should be treated as a market economy for the purposes of American trade starting in late 2016. Whatever the legal considerations, the PRC does not have a market economy or anything close to it. Its own statements about the state sector make that clear. Pretending Beijing has implemented the necessary reforms would undermine American domestic political support for economic engagement with China and can only make justified attempts to address noncommercial Chinese behavior less effective and more complicated. It would be doubling down on a flawed WTO decision.

4. **Reorient policy to focus on foreign barriers.**

Punishing China (or others) just for selling cheap goods Americans want to buy is self-defeating. The US should, however, consider sanctions for unacceptable barriers to exports. A prime example is China’s sheltering of SOE from competition. While Chinese SOEs are not major exporters, the sectors in which they are most protected likely experience excess capacity and dumping, and sanctions in those cases might encourage reforms that Beijing has failed to undertake until now. Moreover, SOEs want to invest in the US and can be reasonably restricted on the grounds they do not operate on a commercial basis.

5. **Sanction the beneficiaries of stolen IP.**

Criminal charges against IP thieves do little to protect American innovation. In contrast, spending time and resources to track the theft of brands and technology to final users could be extremely useful. Depending on the extent of their complicity, Chinese entities and their subsidiaries using stolen IP could be subject to limits on investment in the US all the way to being barred from any business, including export. This will not be easy but has been shown to be possible. It has the distinct benefit of shielding those who respect IP and therefore encouraging good behavior, which is indispensable for the US to gain from the economic relationship.

6. **Postpone any bilateral investment treaty.**

In light of IP theft and noncommercial operation by SOEs, the Obama administration’s pursuit of a bilateral investment treaty (BIT) is odd. American regulators need to be able to act freely against Chinese investors that have broken the law, and Beijing shows no interest in treating American firms better. A BIT is warranted only after years of better policy from Beijing. The American business community should have learned from WTO accession that the PRC has many ways to circumvent agreements it does not like. If the business community refuses to learn, the US government should recognize that difficult votes pertaining to globalization should be used more wisely than on a China BIT.
7. Improve the environment for good Chinese investors.

Chinese firms that obey American laws and operate on a commercial basis are valuable investors, and they are becoming more valuable as Chinese spending in the US soars. At the federal level, the CFIUS process should sort investments as quickly as possible into those requiring an investigation and the rest. In most cases, this would quickly reduce the uncertainty that surrounds seemingly every transaction. State and local governments will assign resources to attracting Chinese companies fitting the level of interest, where even the most basic steps to provide information about local laws and regulations will be helpful as less experienced firms arrive.

8. Enforce existing US laws.

This is less a China problem than an America problem. Branches of the US government appear unwilling to hold Chinese firms or firms involved in China-related business to the letter of American law, particularly with regard to disclosure. Chinese entities have cited obligations to their own government as overriding. If so, the operations of these entities should not be deemed as meeting regulatory requirements, and some should be banned from the US altogether. A looming issue as the Chinese presence expands is predatory pricing or other antitrust violations, where the accused may also seek to void American law.

9. Seek high-quality trade and investment agreements with like-minded partners.

A year ago this may have been a vacuous statement; now it is controversial. The quality of particular agreements and partners is obviously debatable, but there are two compelling reasons to at least try to reach sound agreements: (1) to persuade Beijing that the status quo is changing and the PRC must change or be left behind and (2) to help protect friendly countries, and ourselves indirectly, from questionable Chinese economic and financial decisions. It should be a permanent, bipartisan position that the US will negotiate with any country that truly embraces open, competitive markets, with the battles only over which countries qualify.


Because the US economy is so large, policy choices at home are more important than any regarding international trade and investment. This is not a paper on the domestic economy, but the overarching goal is to make American workers and firms more competitive. One such policy change would be replacing the payroll tax revenue with taxation that does not discourage working and hiring. American companies are heavily taxed on domestic activity, and replacing the payroll tax would encourage production in the US. It would also reduce the cost of hiring American workers while actually increasing their take-home pay. And there are certainly other possibilities for pro-competitive tax reform.

High Stakes

American manufacturing employment plunged in 2001–03. Popular anger over this seems to be growing rather than waning as time passes. It will not return American manufacturing jobs or assuage that anger to implement policies now that might have worked before 2001 but no longer make any economic sense. The US can improve its commercial relationship with China, but only by casting aside myths about the trade deficit and exchange rate and focusing on export barriers and intellectual property theft, as well as the benefits of Chinese investment.

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Notes

2. US Census Bureau, “U.S. Trade in Goods and Services—Balance of Payments (BOP) Basis,”


question-chinas-forex-dilemma-just-how-low-should.


37. It is worth noting that the CFIUS link (https://www.treasury.gov/offices/
international-affairs/cfius/) still provided by the Department of Commerce is broken.