U.S. Dabbles in Trade Protectionism, China Wallows

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President Obama and Europe share a problem: Both are being snubbed by China on trade. The President’s recent trip to the PRC included accusations by the Chinese of U.S. protectionism. This statement was the first attack of its kind by Beijing, and it came after American decisions to raise trade barriers against Chinese goods.

During the EU–PRC summit last weekend, Chinese Premier Wen then went on an outrageous offensive, claiming that the yuan’s peg to the dollar helps the world’s economy, attacking critics as trade protectionists themselves, and accusing them of trying to restrict Chinese development.\(^1\)

The EU’s reaction to Wen’s tirade was to cancel their final press conference. This response was at least an improvement over President Obama’s choice not to respond. The lack of a U.S. trade policy is truly a handicap. But even if he cannot bring himself to enunciate a full policy, the President should make it clear that China should not be lecturing anyone on free trade. The solutions in trade may be difficult to see, but the problem is manifest, and the bulk of it resides squarely on the western side of the Pacific.

**Why Wen Is Wrong.** In almost all of its statements, the PRC insists that it is not seeking a trade surplus. The facts, however, indicate otherwise. From 2005 to 2008, China reported a cumulative trade surplus of $837 billion. Its partners report an even larger imbalance.\(^2\)

Wen’s aggression on behalf of Chinese policy is equally at odds with reality. Those huge surpluses are one source of global imbalances thought to be a major factor in the financial crisis.\(^3\) The surpluses enter Chinese GDP as a positive, boosting the PRC’s growth. They enter the rest of the world’s GDP as a negative, detracting from growth. The yuan peg currently makes Chinese exports cheaper than they otherwise would be and their imports more expensive. This widens the trade imbalance and thus immediately reduces the rest of the world’s GDP.

Wen is technically correct that national critics of China are protectionist, since all countries engage in protectionism. And trade barriers have unfortunately risen with the global crisis. However, the PRC is far more protectionist than its major partners, heavily subsidizing domestic firms to compete against imports and in overseas markets.\(^4\)

Perhaps most disingenuous is the accusation that China’s trade partners, which have been utterly indispensable to its economic development, are plotting against the PRC. The Communist Party has been trotting out versions of this accusation—that the U.S. is trying to contain China—when useful for the past 15 years. It has been cited most recently with regard to climate change. In fact, Chinese trade practices harm China’s partners, so the PRC can be
accused of interfering with India’s rise, Vietnam’s rise, and the ascent of other trade partners.

**Two Crises.** Exchange rates in particular are a political focal point, and the yuan’s peg to the dollar has been vital in Asia-Pacific trade for over a decade. In 1997–1998, East Asia suffered a financial crisis, and the region was immensely relieved when China held to the peg, eschewing devaluation. It won a decade’s worth of gratitude and praise, particularly from its neighbors. But Beijing kept the yuan fixed entirely for its own reasons.

A wide trading band for the yuan was out of the question in 1997, as the exchange rate was seen as crucial in manipulating the economy. With regard to devaluation, in 1997 the PRC was still scarred by high inflation and terrified of capital flight overwhelming its weak financial system. Devaluation was seen more to threaten internal stability than to promise benefits for exporters.

Fast forward to 2008–2009, and Asia is again suffering a financial crisis. China again clutches the peg, on the basis of the same calculations as before. Beijing plainly is not ready to float the yuan—the peg was tightened before Lehman Brothers collapsed and the financial shock hit. While there are advantages to revaluation, the threat of further job losses among exporters was determined to be too great.

This time, Chinese policy has hurt its neighbors and partners around the world.5 For example, the yuan has fallen 17 percent against the euro in seven months. For Wen to label all the victims of Chinese currency policy as “protectionist” and accuse them of restricting China’s development is ridiculous. The global reaction is merely the natural one to an undervalued currency, just as the praise 12 years ago was a natural reaction to a (briefly) overvalued currency.

**Irresponsible Stakeholder.** So what changed between 1998 and 2008? Not the Communist Party’s overwhelming desire for control and apparent stability—which drove the decision to hold firm to the peg a decade ago and is driving the same decision today.

This decade’s crisis is different than last decade’s. This one is global and the previous one was regional, but that mainly has the effect of adding the EU to the group of countries now hurt by the yuan peg. The more important change is in China itself: This decade’s China is different from last decade’s. The PRC has become too big an economic power to be tied so tightly to the dollar.

At the end of 1997, China was the world’s seventh-largest economy, with a share of global GDP of a bit over 3 percent. As the end of 2009 approaches, China will soon pass Japan to become the world’s second-largest economy, and its GDP share is closing on 7.5 percent. In 1998, the PRC’s share of world trade was a bit under 3 percent. In 2009, it is over 8 percent and China is the world’s second-largest exporter.6

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When one of the 10 most important economies and trading states pegged its currency to the leader, it distorted the global economy. With China now the world’s second-most important economy, these distortions have become fundamental. The hope that the PRC might lift East Asia out of recession has given way to complaints about unfair currency competition. The EU is seeing its trade relationship with China warped by a cheap currency. The peg prevents a falling dollar from helping adjust Sino–American trade. China’s trade partners have very good reason to be critical.

A Helpful Nudge. The best way forward is not so easy to discern. It is tempting to decide that a protectionist counter-threat is the only means of moving the PRC toward more open trade. Yet American protectionism could push a teetering system disastrously toward trade blocs, the last instance of which preceded World War II.

One step that should be taken is for President Obama to clear the air. It is long past time for the President to present a comprehensive view on trade. Such a presentation would offer the opportunity to explain American anti-dumping and countervailing duties and point out that Chinese trade intervention is two orders of magnitude more extensive and seemingly permanent.

This will at least curb harmful rhetoric coming out of Beijing and perhaps help generate the necessary political will there. The PRC’s success in expanding its economy and trade means holding fast to currency policy now clashes with the party’s core principles of control and stability. The world’s second largest economic power cannot stay hidden behind the largest for long—the yuan peg must eventually break.

The question is whether it will be done by the PRC in relatively smooth fashion or whether it will occur in a crisis setting, with Beijing’s hand forced by foreign action. It would be better for all concerned if China started the process itself, and soon. President Obama should do all he can to convince the Chinese to take the initiative. At the least, he should not allow the PRC to continue to masquerade as aggrieved free traders.

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