Examination of China’s Proposal for the Sino-U.S. Trade Surplus

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Abstract

This paper hopes to explore the causes of Sino-US trade friction and its impact on both sides from the perspective of finance, and finally discussed some of China’s countermeasures. First, we traced the history of trade between China and the United States, and pointed out what we think is the most prominent problem at the moment. Subsequently, we discussed the causes of the trade balance. And this paper believes that the trade surplus is a controversial event, and anyone cannot just focus on its strengths or weaknesses; in addition, the balance of payments includes many items, and trade is only one of them. Eventually, this article looks into China’s strategies in the face of Sino-US trade frictions and gives some opinions.

Keywords

Sino-U.S. trade Surplus; Trade Friction; Balance of Payment; China’s Strategy.

1. Introduction

1.1. History

1.1.1. Economic development of China

China has displayed a considerable current account surplus. In particular, the bilateral trade surplus with the United States has drawn attention in this regard [1]. In 1979, China established diplomatic relations with the US. From 1979 to 1984, the trade between China and the US was basically balanced. China exported less than it imported. Since 1985, China’s exports to the US has increased, with a surplus of $60 million. In 2018, China’s trade surplus was $320 billion.

1.1.2. How China protected foreign trade

To protect domestic firms, China introduced tariffs and quotas. Since China joined the WTO, the tariff on imported cars has been reduced year by year. At present, the imported tariff on cars is 25% plus 17% value added tax (VAT), and the consumption tax is added according to the displacement of vehicles.

1.1.3. International Trade

Analyzing the data shown in Figure 1, we find that the percentage of trade in GDP is basically below 30 percent, and in fact the United States has a huge domestic market. On the contrary, foreign trade accounts for an important part in China’s economic growth.

We get the trade balance curve, as shown in Figure 2, between China and the United States. It can be seen that the trade surplus between China and the US has a long history and the amount of the trade surplus is expanding. In addition, China’s surplus in goods trade mainly comes from North America and Europe. Since 1995, China’s surplus in goods trade with the United States has accounted for almost more than 50 percent of the total surplus, and in some years more than 100 percent or even 200 percent.

For historical reasons, in the 1970s, a large number of manufacturing industries in the United States shifted to “The Four Asian Tigers’, and in the 21st century, with China’s ‘reform and
opening up’ policy, the manufacturing industries of these regions began to shift to China. So the balance of trade is also accompanied by the process of industrial transfer to China. [2]

![Figure 1. Trade (% of GDP) between 1989-2019](image1)

![Figure 2. Balance of Trade between China and the U.S.](image2)

1.2. Current issues——What we are facing now?

Trump, the president of the United States, advocated that the Sino-U.S. trade surplus threatened U.S. interests and imposed four tax increases on imports from China after 2018.

What’s more, the new crown epidemic is still spreading overseas. In the short term, the risks and challenges in China's foreign trade development are unprecedented. “China’s Foreign Trade Situation Report (Spring 2020)” shows that the impact of the epidemic on foreign trade has shifted from supply-side to demand-side.

2. China’s trade surplus

2.1. What causes the huge surplus?

America’s trade deficit is caused by many reasons. The United States has deficits not only for China, but also for many countries; and, as the main payment currency, the United States objectively needs to maintain a certain deficit in order to maintain its status as an international payment currency.
2.1.1. The internal economic structure of China and the US is unbalanced

From American point of view, after the scientific and technological revolution, the economy grew too fast, it deteriorated the relationships between investment and savings [3]. Thus, the US had to introduce foreign capital to fill the gap. As a result, the imbalances in the US internal economy equals to its excessive consumption, fiscal deficits and imbalances in saving and investment.

From China’s point of view, the increase of fixed asset investment accelerated, and the saving rate remained high, but the growth rate of investment was lower than the saving rate. Since 2009, China’s saving rate has ranked first in the world [4]. However, the high saving rate means the lack of internal impetus for investment development, and the reduction of imports and consumption. The Chinese Government had to stimulate exports to promote economic growth. One main implication of the rebalancing of Chinese economy is the fall in the savings rate, which will raise the share of private household and government spending considerably, with the latter rising more than the former [1].

2.1.2. Comparative advantages

The U.S. has advanced technology. It mainly exports high-tech products with high added value. However, China has more advantages in primary and secondary industries, it always exports products such as clothes and toys. Also, the low labor cost will attract FDI, more foreign companies prefer to shift production to China. In light of the Principle of Free Trade, the United States can reduce the deficit by not buying Chinese products. In addition, if the United States no longer restricts the export of some high-tech civilian products to China, then balance of trade will also change.

2.1.3. Deregulation

In order to promote economic growth, the China Government took measures to stimulate exports. For example, simplifying the process of foreign trade settlement, and reducing the central bank’s intervention in the RMB exchange rate. Since the influence of exchange rates on trade flows is significant and that currency depreciations do in fact lead to export growth and trade balance improvement [5].

2.1.4. Investment on infrastructure

The Chinese Government has invested on infrastructure in recent years, as shown in Figure 3. The increase on infrastructure investment growth rate means the increase on convenience. It was beneficial to trade between different areas.

![Figure 3. Growth rate of infrastructure investment](image-url)
2.2. Trade surplus is a controversial issue

2.2.1. From the perspective of China

Advantages of trade surplus:

a) Foreign trade includes plenty of labor-intensive processing trade, which is conducive to stimulating national economic growth and promoting employment.

b) Certain products of our country (such as high-speed railways) have strong competitiveness in the international market and have produced a large export volume. China may have more influence in global affairs.

c) Maintaining a certain scale of foreign exchange reserves and current account surplus is conducive to resisting the financial crisis and maintaining national economic security.

Disadvantages of trade surplus:

a) The foreign exchange reserves may not provide a good return. Whenever the dollar depreciates and inflation occurs in the United States, the foreign exchange reserves will decrease in value, resulting in the loss of foreign exchange reserves.

b) As trade surplus increases, China faces increased currency appreciation pressures.

c) The accumulation of foreign assets has an expansionary monetary effect and poses a challenge for domestic macroeconomic management. As a response, the People's Banks of China sterilizes the increase in foreign assets by taking offsetting actions with domestic assets. The sterilization process may increase the domestic money supply and thus the inflation problem may occur.

d) Trade surplus leads to high economic external dependence and difficult adjustment of export structure.

2.2.2. From the perspective of the U.S.

In terms of advantages, the trade imbalance between China and the United States can not be viewed from the point of view of the goods trade surplus alone. According to the statistics, more than 50% of China’s foreign goods trade deficit is contributed by foreign-invested enterprises, while the large profits made by American enterprises in China are not reflected in the U.S. trade data. Combined with China’s role in the production chain, the conclusion is clear: China has the trade surplus but American enterprises take more profits, which increase the gross national income of the United States and increase the national wealth of the United States. Moreover, we should look at the entire balance of payment (BOP). Although the U.S. has a large trade deficit, the U.S. maintains a surplus in the service account and income account.

In addition, the employment rate problems need to be solved. Manufacturing-dominated countries generally maintain trade surplus. Tertiary industry-based countries, so-called industrial hollowing-out countries, often have trade deficits. These countries tend to look for countries with cheap labor resources and build factories there to produce products. One of the consequences of this has been a large employment gap. In other words, it is difficult to meet the employment needs of the grassroots in the United States.

3. China’s new strategy for trade balance

After the outbreak of the international financial crisis, China renewed its strategy of expanding domestic demand, which is undoubtedly the correct choice. However, in order to solve the problem of my country’s excessive trade surplus, especially the imbalance of trade between China and the United States, the Chinese government adopted the expansion of imports in 2011. But can the expansion of import strategy achieve the purpose of promoting industrial upgrading and improving the quality of my country’s opening up?
3.1. Structural imbalance and the hidden worries of expanding import strategy

Most of China’s industries are at the low end of the division of labor in the global value chain. The basic feature of the import and export trade structure is "exporting low-end products and importing high-end products". This trade structure is due to "exporting products with diminishing returns in the country". And importing products with increasing foreign returns", so it is regarded as "bad trade". This kind of trade structure is actually the target that we want to change in foreign economic development, but the expansion of import strategy first expands the import of advanced technology and equipment, and there is no strategic consideration of import substitution, which will undoubtedly further solidify the low-level trade structure. In addition, the expansion of the import strategy will also bring about negative effects.

a) It cannot solve the problems of deteriorating terms of trade and deteriorating ecological environment endogenous to the over-exporting of manufactured products at the low end of the industrial value chain.

b) It will not only be unable to solve the unemployment problem caused by the continuous shrinking of the overseas market of China’s export products in the future, but will increase the unemployment problem, because imports will impact the production of domestic related product manufacturers, thereby reducing domestic employment.

c) The strategy of expanding imports will likely bring far-reaching adverse effects to China’s trade structure and balance of payments. The reasons are as follows: Firstly, because China's trade surplus is mainly generated by processing trade, general trade and other Trade has always been in a state of deficit, so the expansion of import strategy will lead to China's dependence on processing trade, which is contradictory to China's established goal of vigorously compressing processing trade. Secondly, China's trade surplus is mainly processed by multinational companies in China. Figure 4 shows share of import and export balance of domestic and foreign enterprises in trade surplus. As a result of trade, if the expansion of imports is implemented as a long-term strategy, not only will it not be able to reduce the dependence on multinational companies in China, but it may also lead to a foreign exchange crisis at some point in the future.

Figure 4. Share of import and export balance of domestic and foreign enterprises in trade surplus

Since the trade surplus formed by foreign-invested enterprises actually represents the right of foreign capital to claim China's assets, it is China's indirect hidden debt to foreign capital. If foreign capital left China, foreign-invested enterprises would no longer hand over U.S. dollars to the Chinese Central bank through the exchange settlement system, and China's import ratio cannot be compressed, so that there would be a foreign exchange crisis.
3.2. **New Theory on Balanced Growth of National Economy**

From the perspective of historical comparison, we introduce a theory put forward by Nurkse [6], he once divided the development strategies of developing countries into three types. The first is the export-oriented strategy of primary products such as raw materials. The second is the use of low-wage labor in developing countries to pursue labor-intensive. Nurkse also believes that this strategy requires the support of developed countries. For this reason, he proposes a third strategy in which industrial output is produced in the domestic market, which is a domestic demand-led industrialization strategy.

The ultimate goal of China's domestic demand expansion strategy is to shift to this domestic demand-led industrialization strategy. So, what are the decisive conditions? Nurkse argued that the key factor that determines the size of the domestic demand market, which is the income level of people, is capital formation. "Capital" is not capital as we understand it from the perspective of currency, but refers to all kinds of machinery and equipment that can greatly enhance the effect of productivity.

Therefore, one reasoning for Nurkse's thought is: whether to have a developed capital product. The industry or capital goods creation sector is a key factor in determining the size of the domestic demand market. An independent and developed capital goods industry is the engine of national wealth growth. We can observe that the real wages of farmers, hairdressers and taxi drivers in developed countries are many times higher than their counterparts in developing countries with the same productivity. The reason is that the system synergy created by the advanced capital goods creation sector in developed countries through the national innovation system has produced and diffused industrial technological innovation and its productivity gains within the country.

The second decisive condition: Balanced growth of the national economy. According to Nurkse's logic, underdeveloped countries can simultaneously make capital investment through the re-capital goods creation sector and the capital goods use sector, thereby simultaneously increasing the productivity of each sector, and their income levels will also increase at the same time. Through mutual provision of demand among various departments, the problem of insufficient domestic market capacity faced by industrialization has been solved.

3.3. **Policy recommendations**

As explained above, the expansion of imports strategy has a relatively large side effect in solving the trade surplus, and it cannot solve the deterioration of trade terms, the deterioration of the ecological environment and the depletion of resources. To solve these problems, we need to reduce the export scale of low-end industrial products. There are five measures:

a) The export tax rebate should be greatly reduced and the export tax rebate should be cancelled as soon as possible. The export tax rebate not only runs counter to China's stated goal of reducing processing trade, but also mainly subsidizes foreign-funded enterprises. However, due to the monopoly structure of multinational companies in international trade, they may increase the export price to the United States or other countries, so the effect of "surplus reduction" may not be immediate. Even so, reducing or even phasing out export tax rebates will still improve China's fiscal situation to a large extent. For example, China's social security in 2019 The total fund assets are 26285.66 and the export tax rebate in 2019 reached 1,574 billion yuan. China could use the surplus of the central fiscal funds to supplement social security funds, increase education funds, invest in farmland water conservancy infrastructure, and build free highways, etc., and allocate a considerable part of it to issue consumer vouchers to directly subsidize businesses and low-income groups. Make them buy consumer goods that are overproduced in the export sector of private enterprises. More importantly, due to the increasing global protectionism, china must accelerate structural adjustment.
b) Cancel the preferential treatment for foreign-funded enterprises, and adopt relevant measures to substantially increase the minimum wage of workers in foreign-funded enterprises, and limit the transfer of resources and environmental pollution by multinational companies to China. Increasing the minimum wage of workers in foreign-funded enterprises is an important measure to start domestic demand. Similarly, due to the monopoly structure of multinational companies in international trade, they may transfer to foreign consumers by raising prices without reducing worker employment.

c) Slow down the introduction of foreign direct investment that squeezes the market space and transformation and upgrading of China’s national enterprises, and uses excess foreign exchange reserves to buy back some foreign-funded enterprises in China. The repurchased foreign-funded enterprises will be auctioned to private enterprises to provide private enterprises with profitable investment opportunities. Any diversified investment strategy, including the purchase of gold and resources, is not as good as the repurchase of foreign-funded enterprises in China. It is far less successful than the repurchase of foreign-funded enterprises in China to increase foreign direct investment overseas. The power is in hand, and it has fundamentally solved the problem of foreign capital’s control of my country’s real economy. For example, in 2010, half of the enterprises that enjoyed China’s rare earth export quotas were foreign-funded enterprises.

d) Gradually implement the strategy of restricting the export of non-renewable resources. When China is worried about the devaluation of its huge foreign exchange reserves, there is no need to increase the trade surplus by exporting natural resources.

e) In terms of financial structure, continue to implement capital account controls, and strictly approve domestic companies to list overseas.

If the above measures are implemented, how to deal with the unemployment problem?

First, the value of China’s export commodities is seriously underestimated in the international market. Although many of our export commodities will not be priced like building ceramics, they will be twice as cheap as Indian products. However, there is still considerable room for price increases for most products. Second, multinational companies have obtained several or even ten times the profits of China’s export enterprises through monopoly trade. The abolition of export tax rebates and higher wages are forcing them to make concession to Chinese workers. Third, because developed countries have varying degrees of rigid demand for Chinese exports, sales will not drop significantly. Three years after the United States imposed a 25% tariff on Chinese exports, the Sino-US trade balance in 2019 once again reached a record high. Fourth, after the export tax rebate is cancelled, the funds originally prepared for this purpose can be paid to the unemployed. Fifth, due to the substantial increase in the wage level of workers in the export sector, especially in foreign-funded enterprises, the increase in worker consumption will stimulate domestic production, thereby expanding Employment, these measures will at least not lead to an increase through inflation, but may lead to a decline in prices, because these measures will generally supply domestic net exports.

While implementing the above measures, the implementation of import substitution for high-end products of the capital goods industry will not only provide a broad platform for independent innovation in China’s capital goods creation sector, but also, because the development of high-end capital goods products is the foundation for the development of the productive service industry, the productive service industry will also develop faster.

In addition, the measures only solve the various problems caused by the increase in foreign exchange reserves. So how to solve the huge U.S. debt problem, it is certain that it is definitely not possible to increase the holdings of U.S. debt. Since the depreciation of U.S. debt is inevitable, the reduction of U.S. holdings is inevitable. Debt is the only option. If you immediately sell a large amount of money, even if China can accept some U.S. debt and U.S. dollar cash and foreign
exchange losses of 20% each, because it does not solve the deep-seated trade structure and financial structure problems, the selling will not solve the problem.

One solution can be to accelerate the implementation of the above measures to solve the problem of the rapid increase in foreign exchange reserves, and continue to reduce U.S. debt by small scales from now on, especially to effectively solve the problem of domestic wealth disparity, accelerate the adjustment of the real economy, and start from export. The oriented economy has turned to the domestic economic cycle. After 3-5 years of adjustment, we will gradually increase the sale of U.S. debt, and use the U.S. dollars obtained to purchase suitable commodities and resources required for the adjustment of the domestic economic structure, so as to get rid of U.S. dollar hegemony.

It is worth noting that at the first step of the above measures, fiscal and financial reforms will also require two key supporting measures. First, the Ministry of Finance has begun to implement sovereign credit, based on the reduction in foreign exchange reserves and economic development. The amount of currency is needed, and the Ministry of Finance gradually increases the amount of base currency input through the issuance of treasury bonds to provide free financing for infrastructure investment; and through the central bank to issue treasury bonds to individuals and companies, providing them with a broad investment space until the excess foreign exchange reserves are completely eliminated, the task of recovering the right to issue currency will be completed, and complete sovereign credit will be implemented. Only then can interest rate market reforms begin. Secondly, through RMB settlement, RMB financing, the use of RMB to invest abroad, and the issuance of RMB bonds to the outside world. Ways to gradually promote the internationalization of the RMB.

4. Conclusion

The main cause of the trade imbalance between China and the U.S. is the difference in economic structure, comparative advantages and different policies. In response, China has taken a series of measures to reduce its trade surplus, as we have mentioned above. However, trade conflicts between China and the U.S. will hurt both sides. Avoiding hegemonic politics and promoting the fairness of bilateral trade are the mainstream of international trade, so as to better promote the development of international trade. Therefore, when it comes to Sino-U.S. trade, both China and the U.S. should fully and objectively understand the causes of the conflicts, and further analyze the interest demands and structural reasons, thus realize the sustainable development of bilateral economic and trade exchanges.

References