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The Treasury Department's Currency Report and Dialogue with China

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In my comments today on the Treasury Department's currency report, I want to pull out and amplify some of its findings—especially the muted criticism of Germany and Japan. At the same time, I want to question and criticize other of the report's findings—especially its characterization of China. I also want to emphasize how important the Treasury Department's new dialogue with China could be for American competitiveness. But if the dialogue is going to play this important role, we have to use it wisely and avoid squandering its potential.

Let me start with the Treasury Report's coverage of global imbalances. The key statistic here is trade in goods and services, not the current account balance, which is stressed in the report. As a share of the U.S. trade deficit, global trade surpluses by Germany, Japan and the rest of non-China Asia have been large for many years and continue to be large. In contrast, until two years ago, China's trade surplus was quite small. I'll come back to China in a minute.

On this score, let me give you a user WARNING ALERT. When the U.S. Commerce Department reports each month how big the U.S. trade deficit is and says *which countries* make up *what share* of that deficit, you should ignore that latter part of the announcement; it is meaningless. A country could have a surplus with the U.S. and a deficit with the whole world. The bilateral–two-way–balance with the U.S. says nothing by itself about how much a country contributes to our deficit. This is especially true of China, which processes and re-packages exports from other countries for final shipment.

America has a large deficit with the global supply chain. Other countries have surpluses with the global supply chain. If we look at which rich countries are running large long-term surpluses with the global supply chain, the list includes Germany, Japan and the rest of non-China Asia.

Let me point out a second lesson on the U.S. trade deficit. We may think it's a problem, but the U.S. trade deficit is essential for the global economy. Poor countries need markets.

America wants to promote healthy growth and development in poor countries—not with aid, not with subsidized loans – but with trade. Somebody has to buy their products. America plays that role in the world. Other major industrialized countries are not helping—especially Germany and Japan. Germany and Japan are slackers. Instead of running modest deficits and sharing the burden with America, Germany and Japan are feeding off our deficit themselves. They shouldn't need to do that. They have per-capita GDP twenty times China's. We need to pressure them to get with the program. They should spur their own domestic demand, especially consumption. This is an important message – one stressed in the Treasury report – but the report's position is muffled. It is polite. I don't think it should be so muffled.

People say, "But Germany and Japan have foreign exchange markets. Their currencies must be at the right levels." This misses the point. Exchange rates won't fix this problem. Germany and Japan run surpluses because they have structured their economies, and their finances, to save rather than consume. Exchange rates won't fix this. Germany and Japan need to change those structures. And America needs to strongly encourage them to do so. Yes, I know, Germany and Japan host our troops and military bases on their soil—but that shouldn't be a Treasury report concern. From the perspective of global economic leadership – Germany and Japan are slackers and have been for a long time.

Let's turn to China. Until two years ago, China's global trade surplus was 8 percent of America's trade deficit. Only 8 percent! The Netherlands had the same size surplus! The European Currency Area's surplus was 27 percent that year, and non-China Asia had an even larger surplus. China's surplus was only 8 percent. Then, in 2005-06, its surplus jumped.

What happened? It was not an exchange-rate shift. China over the past 5 years has joined the WTO – a wrenching change to its trade relations with the world that has nothing to do with its exchange rate. And then the multi-fiber agreement ended. In the short term, the repercussions of these changes are certain to be unstable—and they have been. These are huge adjustments compared to any exchange-rate effect.

China's global surplus really took off a domestic credit tightening caused imports to grow less quickly. In 2005 China's surplus was slightly less than Germany's. In the first half of last year it was slightly more than Germany's—20 percent of America's deficit versus 19 percent for Germany.

This change over two short years did not reflect a sudden shift in China's exchange rate. At this preliminary stage in China's WTO adjustments, so many parameters are changing so fast that it would be foolish to insist they are caused by exchange rates. Let me repeat that point. China's global trade surplus has grown suddenly larger – putting it on a par with Germany's – but not because its exchange rate shifted.

Will China's WTO accession process eventually shake out to a more balanced trade pattern? We have to wait and see. WTO requirements that China open more to imports—for example by enabling foreign retail branches—haven't really matured yet. If we want to pressure China, this is one place to do it—not the exchange rate.

I have a second quick warning – don't look at China's foreign exchange reserves for evidence of exchange-rate manipulation. There is a speculation game going on out there—and the U.S. Congress may be an unwitting participant. When speculators hear U.S. government criticism of China's reserve levels, they are encouraged to think America will force China to revalue—so they speculate more. And China's reserves go up as a result. And then there is more criticism, and then more speculative flows, and then higher reserves, and so on. This all could have a bad ending for the speculators, but it is not a sign of exchange-rate misalignment.

My most important point for this hearing is that China is a legitimate commercial competitor. Its success does not rely on currency manipulation. And China will continue to be a legitimate commercial competitor. America's strategy has to be to focus here at home and strengthen our own fundamental competitiveness – education, labor force mobility, pension mobility, health care, and safe cities as attractive places to work so we can compete in the global market for technical and managerial talent. Visa reform would help.

Instead, if we pretend that our problems are because of China's exchange rate, or China's banking system, or China's low wages, that is like sticking our heads in the sand.

Treasury's China dialogue is a chance to move away from this misperception of our challenge. It is a terrific opportunity that has taken many years to get started. Let's not waste it on dead-end feel-good distractions like exchange-rates.