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The Growing U.S. Trade Imbalance with China

Thomas Klitgaard and Karen Schiele

Over the past decade, the United States has gone from enjoying a small trade surplus with China to grappling with an enormous deficit. Just to keep the gap from expanding in 1997, U.S. exports to China would need to grow at an extraordinary rate—four times as fast as Chinese exports to the United States. Despite recent U.S. gains and China's efforts at trade liberalization, growth on that order appears unlikely, and the trade imbalance can be expected to widen in the near term.

The trade relationship between the United States and China has changed dramatically in the past ten years. In 1987, the United States benefited from a small trade surplus with China. Today, the U.S.–China merchandise trade deficit is about $40 billion (Chart 1).[1] China's share of the total U.S. trade deficit is 25 percent, only slightly smaller than the 30 percent share held by Japan. Indeed, if recent trends continue, China will soon replace Japan as the largest contributor to the overall U.S. merchandise trade deficit.

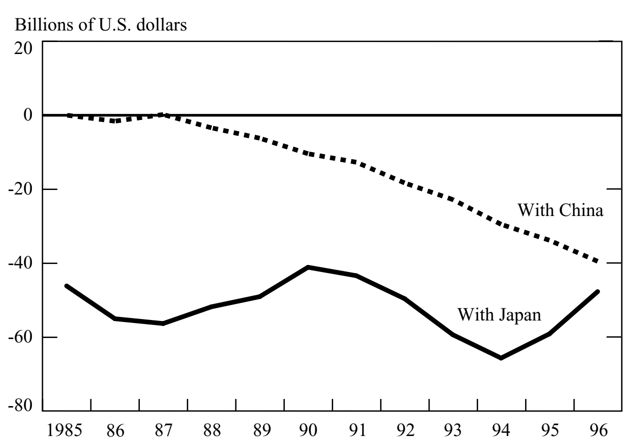
What accounts for this striking change in the U.S. trade balance with China over the course of a decade? And how will the trade balance evolve in the near future? This edition of *Current Issues* identifies several forces that have enabled China to gain a sizable advantage in trade with the United States—including high trade barriers, low labor costs, heavy foreign direct investment in Chinese industry, and a focus on less expensive consumer goods. The article also shows, however, that U.S. firms are making important inroads into Chinese markets in the 1990s. Despite the U.S. gains, the outlook for the U.S.–China trade deficit is far from favorable: imports from China so eclipse U.S. exports to China that even strong growth in U.S. sales is unlikely to prevent a widening of the deficit in the years ahead.

Trade with China: Barriers and Restrictions

U.S. trade tensions with China have heated up in the past year. In the summer of 1996, monthly trade data revealed that the U.S. deficit with China was poised to surpass that with Japan. In response, U.S. Commerce Secretary Mickey Kantor criticized China's closed markets, demanding "a level playing field for American workers and American business" (Greenberger 1996).

A recent report published by the United States Trade Representative reveals that many of China's trade policies remain restrictive despite efforts at liberalization.

Chart 1
U.S. Trade Deficit with China and Japan



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The *1997 National Trade Estimate Report on Foreign Trade Barriers* (pp. 43-59) provides detailed documentation of the limits placed on imports of U.S. goods:

- China's average tariff rate is 23 percent, and the maximum tariff is 120 percent.
- A quota system restricts the types of goods that can be purchased by domestic Chinese firms.
- U.S. firms operating in China must obtain permission to import goods, and even with permission they can sell to the domestic market only indirectly, through a Chinese trading company.
- U.S. firms exporting to China often face some form of licensing requirement, such as quality certification or "automatic registration requirements." China does not accept U.S. quality certification on most products, but instead requires separate inspections. Automatic registration requirements apply to about 400 products, typically electrical and machinery products.

U.S. officials have also had to contend with China's failure to adequately protect intellectual property rights. U.S. producers of computer software, video tapes, and compact discs in particular have suffered because their products are copied illegally in China, replacing U.S. exports both to China and to the rest of the world. In addition, U.S. machinery manufacturers have charged that China does too little to prevent the copying of computer software embedded in equipment, raising the long-run risks of selling these products in China.

Recently, however, China has taken significant steps to protect intellectual property rights. These measures have been prompted in part by U.S. threats of retaliation. In June 1996, the United States, citing violations of the Intellectual Property Rights (IPR) Enforcement Agreement signed by the two countries in February 1995, threatened to impose duties on more than $2 billion worth of Chinese goods.[2] China agreed to start closing factories manufacturing illegal copies of U.S. products, to shut down spaces showing pirated movies, and to punish individuals involved in piracy. China also increased the quotas on imports of audiovisual items and permitted joint U.S.–Chinese ventures to reproduce and distribute these products throughout China. The U.S. government estimates that continued Chinese efforts to enforce IPR laws could result in an additional $500 million in U.S. exports (*1997 National Trade Estimate Report on Foreign Trade Barriers,* pp. 52-3).

Efforts to protect intellectual property rights are consistent with China's other efforts to address U.S. concerns. For example, because of recent reforms, China's licensing and quota restrictions now apply to roughly one-third of all items imported into China, down from nearly one-half in 1992. Moreover, the average tariff rate, while still high at 23 percent, has fallen from almost 36 percent in 1995.

China's attempts to ease trade restrictions are driven, in part, by the government's bid to join the World Trade Organization (WTO). The key benefit for China would be greatly improved access to the markets of other member countries. To maintain its impressive export growth, China needs to extend the reach of its products beyond the United States to WTO members that are now free to put up significant trade barriers to Chinese goods. As a member of the WTO, China would also benefit from the organization's commitment to eliminate quotas on imports of textiles and apparel over the next ten years. If China's bid for membership is denied, Chinese manufacturers of these items will end up at a significant competitive disadvantage in world markets. The United States is encouraging China to accelerate trade liberalization in exchange for its membership in the WTO (see box).

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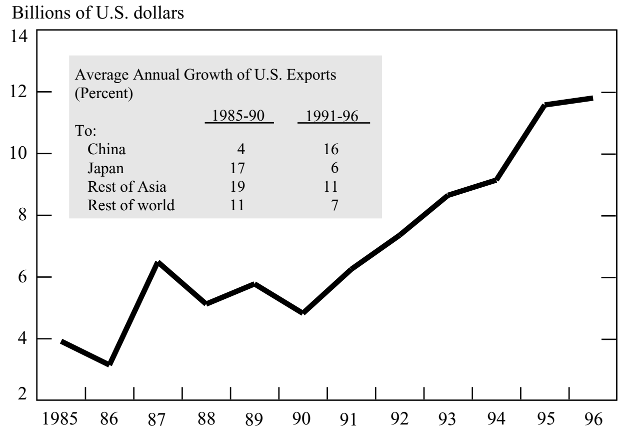
U.S. Exports to China: A Market Improving

Despite the presence of trade barriers, the United States has made significant headway in penetrating the huge Chinese market. In the second half of the 1980s, a period when the Chinese economy was growing close to 10 percent a year, U.S. exports to China were growing at a meager average annual rate of 4 percent (Chart 2). The situation has improved considerably so far in the 1990s. Even with the pause in growth last year, U.S. exports to China grew at an average annual rate of 16 percent from 1991 to 1996, compared with U.S. export growth of 11 percent to the rest of developing Asia and 7 percent to the rest of the world.[3] Exports of capital goods, including industrial machinery, aircraft, and telecommunications equipment, which make up nearly half of U.S. sales to China, doubled in that period. Industrial supplies, mostly chemicals, which make up another 35 percent of U.S. exports to China, also doubled. Food exports, particularly wheat and corn, which account for most of the remainder of U.S. sales to China, roughly tripled.[4]

The moderate success of the United States in serving Chinese markets can largely be attributed to the nature of its exports and to China's establishment of free-trade enterprise zones. U.S. firms tend to sell goods that are either too technologically advanced to be made in China (for example, aircraft) or produced in insufficient quantities in China (for example, wheat). The lack of domestic competitors reduces the incentive for authorities to place import restrictions on these goods. In addition, China's free-trade enterprise zones have spurred the development of an industrial sector that has few or no restrictions on imports of capital goods, materials, and parts as long as the goods are used to produce exports.

Although specific data are not available, the bulk of all goods exported from the United States to China appears to go to firms operating in these free-trade enterprise zones. By comparing China's average tariff rate, 23 percent, with its actual tariff revenue from

Chart 2
U.S. Exports to China, 1985-96



Source: U.S. Department of Labor, Bureau of Economic Analysis.

China's Bid to Join the World Trade Organization

The United States advocates China's membership in the WTO in the interest of accelerating trade liberalization. Because China already has relatively easy access to U.S. markets, membership would help U.S. exports to China without having much, if any, impact on U.S. imports from China. Moreover, the WTO would impose a legal framework on a country that is often criticized for its underdeveloped legal system. China's membership would also eliminate some of the need for bilateral trade negotiations between the two countries because complaints about trade barriers could be resolved through the WTO's strong dispute-settlement process. The WTO's multilateral panels would in turn reduce the political tensions related to confrontations over trade barriers.

One of the most important points of contention between the United States and China on the issue of WTO membership is the pace at which China will conform to WTO trade laws. The measures required to gain membership will adversely affect domestic Chinese firms that currently rely on trade protection and government subsidies to survive. As a consequence, China wants WTO status as a developing economy and some flexibility in the time it will take to conform to WTO standards. The United States, however, does not view China as a typical developing country, given its status as one of the world's major exporters, and is pressing for a relatively short time period for substantial trade liberalization.

A compromise can be worked out that would allow China compliance flexibility in the early years in exchange for a commitment to a program of reforms over a specific time period that can be monitored and enforced. China has recently made important concessions. At the WTO meeting in November 1996, China pledged to reduce the average tariff rate to 15 percent by the year 2000. In addition, at talks in March 1997 China vowed to grant all Chinese enterprises the right to trade directly with foreign companies three years after joining the WTO. U.S. firms would then be free to market their goods directly to Chinese customers. China has also promised to adopt WTO standards for protecting intellectual property rights as soon as it gains membership.

These commitments by China suggest that optimism is warranted. Some U.S. exporters might be skeptical about granting immediate membership in exchange for promises of trade liberalization over time, but their skepticism would be short-sighted. The WTO can be a powerful force in opening up the world's most populous country to U.S. goods.*

* Lardy (1996) discusses issues surrounding China's membership in the WTO.

imports, 5 percent, we estimate that most goods flow into China without any tariff being paid on them. Indeed, the difference between the average and the actual tariff rates implies that roughly 80 percent of all goods enter China duty-free. The demand from firms in free-trade enterprise zones has made China one of the fastest growing export markets for U.S. goods.

Most products that enter these zones, however, are used only for exports. Thus, the flip side of this calculation is that just 20 percent or so of all Chinese imports appear to make it to China's domestic markets. More broadly, tariffs, quotas, licenses, and other trade barriers on goods sold for domestic use severely limit the level of U.S. exports to China. In 1996, U.S. exports to China totaled only $12 billion, or 2 percent of total U.S. exports.[5] This share is less than the share of U.S. exports to much smaller countries in Asia, including Korea, Singapore, and Taiwan. Overall, the growth in U.S. exports to China has been more than healthy in the 1990s, but it has not come close to China's striking gains in U.S. markets.

The moderate success of the United States in serving Chinese markets can largely be attributed to the nature of its exports and to China's establishment of free-trade enterprise zones.

U.S. Imports from China: A Surge in Demand

U.S. demand for Chinese goods surged in the 1980s, when U.S. firms were making few advances in China. From 1985 to 1990, while U.S. exports to China were rising a mere 4 percent per year, U.S. imports from China jumped 32 percent per year (Chart 3). From 1991 to 1996, U.S. imports slowed, but maintained an average annual growth rate of 19 percent, with sales in the last few years climbing 10 to 15 percent. The inflow over the past decade has been so rapid that China has become the fourth largest supplier of goods to the U.S. market, rising from the fifteenth largest in 1985. Today, it trails only Canada, Japan, and Mexico.

How has China achieved such rapid growth in exports? Low wages, a relatively skilled labor force, heavy government subsidies, and economies of scale created by focusing on less expensive consumer goods have driven China's advances in world markets. Consumer durables (such as appliances, toys, cameras, and home entertainment equipment) and nondurables (such as apparel and shoes) account for 70 percent of all U.S. imports from China. Capital goods, the next largest category, represent only 15 percent, though recent rapid growth suggests that these goods will figure more prominently in the U.S. marketplace over time.

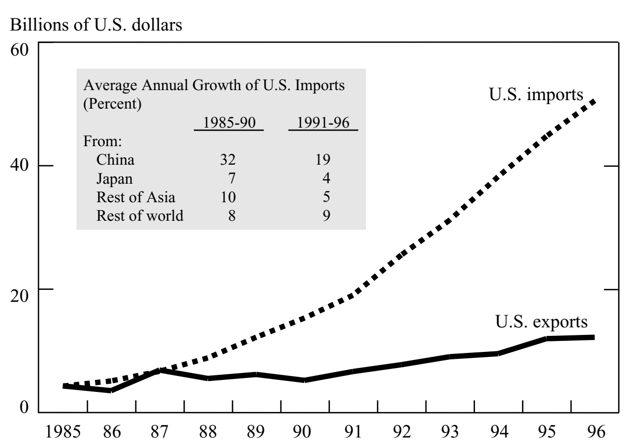
China's success has come largely at the expense of other Pacific Rim Asian countries.[6] Chinese goods have increased from less than 4 percent of total U.S. imports from Asia in 1985 to 18 percent in 1996. The trend in the consumer goods market is a good illustration of this shift. Of all U.S. consumer goods imports in 1996, Chinese products accounted for 27 percent, up from 12 percent in 1990. During the same period, Japan's share fell from 12 percent to 7 percent, while Taiwan and Hong Kong's combined share dropped from 18 percent to 9 percent.

The shift in Asia's production of consumer goods sold to the United States is due, in large part, to heavy foreign direct investment in China by other Asian manufacturers. The impact of this investment on export growth is evident in the share of Chinese exports that are produced by plants either fully or partly owned by foreign enterprises. In 1985, products from these plants represented only 2 percent of China's exports. By 1990, the share reached 12 percent, and by 1996, the share was up to 48 percent of total exports (*China Statistical Yearbook, 1996;* China Statistical Information and Service Center 1997).

Hong Kong has been the major source of foreign capital in building up China's production capacity. China's State Statistical Bureau reports that about 60 percent of investment in China from 1985 to 1995 originated from Hong Kong. By multiplying this 60 percent share by the 48 percent of total exports from

Chart 3

U.S. Imports from and Exports to China



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

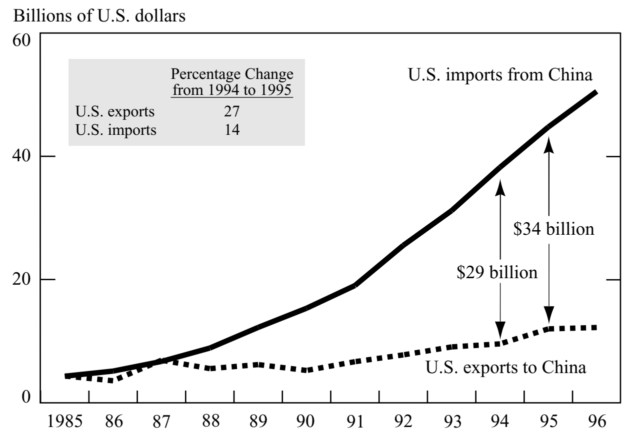
foreign-owned plants, we arrive at the estimate that roughly 30 percent of total Chinese exports, or $40 billion, are tied to Hong Kong firms. We estimate that firms tied to Taiwan, which represent 8 percent of total foreign direct investment, are responsible for another $5 billion in exports. Altogether, roughly $45 billion of total Chinese exports are traceable to investments by Hong Kong and Taiwanese firms.[7] The percentage of this $45 billion that goes to the United States, while unknown, is probably quite high, making the investment in China by Hong Kong and Taiwan a substantial contributing factor in the U.S.–China trade deficit.

Japanese investment, so far, has been relatively modest. Chinese data indicate that Japan accounts for slightly less than 8 percent of total foreign direct investment from 1985 to 1995, implying that roughly $5 billion of Chinese exports are tied to Japanese multinationals (*China Statistical Yearbook, 1996,* pp. 581, 596). Thus, to date, investment by Japanese firms appears to have been only a modest contributor to the increase in the U.S. trade deficit with China.

Low wages, a relatively skilled labor force, heavy government subsidies, and economies of scale created by focusing on less expensive consumer goods have driven China's advances in world markets.

Chart 4

The Math of the U.S.–China Trade Deficit



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The Outlook for the U.S.–China Trade Imbalance

In the years ahead, U.S. exports to China should continue to grow rapidly. Growth in China's economy of about 10 percent per year combined with continued trade liberalization will make China a rich market for U.S. exports. Even though sales to China stalled in 1996, growth in the range of 15 to 20 percent is plausible over the rest of the decade. As for U.S. imports, growth in the demand for Chinese goods should hold its recent pace of about 10 to 15 percent, down from the near 30 percent rate recorded in the 1980s and early 1990s.

Such a favorable shift in import and export trends, however, will not prevent a further widening of the U.S.–China trade gap. Because imports from China are four times the size of U.S. exports to China, U.S. exports to China would need to grow four times faster than imports just to keep the deficit at its current level.[8] The problem created by such a large imbalance is illustrated by the U.S. experience in 1995 (Chart 4). In 1994, the U.S. trade deficit with China was $29 billion. In 1995, U.S. exports to China grew 27 percent, while U.S. imports from China rose 14 percent—yet the bilateral deficit increased $5 billion that year. Without a dramatic acceleration in U.S. export growth, the U.S.–China trade deficit will continue to widen in the near term.[9] And aggressive moves by the United States to promote its exports to keep the gap from expanding further can only fuel trade tensions between the two countries.

Conclusion

Since 1985, the United States has gone from enjoying a small trade surplus with China to coping with a widening deficit. U.S. imports from China have grown rapidly, with Chinese goods replacing U.S. imports from other Asian countries. However, U.S. exports, largely because of China's restrictive trade policies, have not kept up. Although U.S. exports to China have grown roughly twice as fast as U.S. exports to the rest of the world in the 1990s, they remain well below the level of exports to smaller economies in Asia.

Over the near term, strong growth of U.S. exports to China will likely continue, boosted by the strength of the Chinese economy and lower trade barriers. At the same time, U.S. imports from China will likely maintain their recent pace, which will help stem the growth in the trade gap. To reduce the U.S.–China trade deficit in 1997, however, U.S. exports will need to grow more than four times faster than U.S. imports from China—an unlikely scenario. The recent defusing of conflict over intellectual property rights and the efforts by China to join the WTO will work to moderate tensions between the two countries. The potential for troublesome disputes remains, however, as the U.S. trade deficit with China threatens to surpass that with Japan.

Notes

1. The trade data used here are from the U.S. Commerce Department. Legitimate questions have been raised about whether U.S. data accurately capture exports to China that are shipped through Hong Kong. Fung and Lau (1996) claim that correcting for this and other errors lowers the U.S.–China bilateral deficit. For example, they estimate that the deficit was $7 billion in 1990 (compared with the U.S. estimate of $11 billion) and $24 billion in 1995 (compared with the U.S. estimate of $35 billion). Although their estimates are significantly lower than the official U.S. estimates, the deterioration in percentage terms is essentially the same.

2. This dispute occurred around the time of the annual U.S. debate on China's most favored nation (MFN) status. Arguments against continuing China's MFN status—which gives that country trade treatment "no less favorable" than that given the most favored nation—usually center around questions of human rights violations. Nonetheless, the United States has consistently renewed China's MFN status.

3. For the period 1990-95, average U.S. export growth to China was even more impressive—20 percent according to the U.S. Commerce Department. Fung and Lau (1996) estimates put U.S. export growth at 22 percent from 1990 to 1995.

4. Consumer goods accounted for 4 percent of U.S. exports to China in 1996; autos made up another 1 percent.

5. Fung and Lau (1996) add roughly $5 billion, raising China's share of total U.S. exports from 2 percent to 3 percent.

6. The U.S. experience with Chinese imports differs from that with Japanese goods in the 1980s. U.S. firms view Chinese imports as less threatening because they are largely replacing items from other Asian countries rather than goods produced in the United States. By contrast, Japanese exports competed much more directly with U.S. goods.

7. Because of strained relations between China and Taiwan, it is likely that some of the investment attributed to Hong Kong originated in Taiwan (see Lardy [1995]).

8. The alternative calculations of Fung and Lau (1996) yield a different ratio of imports to exports. Their numbers suggest that U.S. exports need to grow two and a half times faster to keep the deficit unchanged.

9. Over the long term, the gap will eventually close if U.S. exports to China continue to grow faster than U.S. imports from China. For example, if U.S. exports to China were to grow 20 percent each year and U.S. imports from China 10 percent, the gap would disappear in seventeen years. The mathematics are such, however, that the deficit would not begin to decline until 2006 and would not fall below its 1996 level until 2010.

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About the Authors

Thomas Klitgaard is a senior economist and Karen Schiele an assistant economist in the International Research Function.

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