Xi and Trump miss a chance to expand markets

The conclusion of the China-US trade negotiations has been postponed. Jeffrey Frankel argues that the US-Japan agreement three decades ago serves as a template

The supposed deadline for a conclusion to China–US trade negotiations has been postponed until late April. This column argues that the structural reform aspect of the negotiations is reminiscent of US negotiations with Japan three decades ago, and that the Structural Impediments Initiative between the two countries could, in theory, serve as a useful model for the current US–China negotiations. The question is whether Presidents Trump and Xi have as firm a grasp on economic principles as their predecessors.

Donald Trump has postponed until late April the supposed deadline for a conclusion to China–US trade negotiations. A good outcome for both sides would have China agree to better protect private property rights and to reduce the role of the state in its economy, the US agree to strengthen national saving and public investment, and both sides agree to reverse their recent tariff increases and the resulting shrinkage of international markets. Unfortunately, this deal is not likely to happen.

What does the US want?

Trump focuses intently on the bilateral US merchandise trade deficit with China. Beijing could probably deliver on the verifiable – but worthless – step of reducing the bilateral balance by committing to buy more soybeans, natural gas and other commodities from the US. But this would have little or no effect on the overall trade balance, as the US would export less soybeans and natural gas to other trading partners.

Congressional Democrats would point out that the gain was illusory. They would be right, which is just another illustration of the irrelevance of bilateral trade balances (Melitz and Klein 2017).

Overall trade balances are more meaningful. But as economists always explain, the overall trade balance is determined not by trade policy, but by national saving and investment. That the deficits widened in 2018[1] was the predictable result of Trump's $1.5 trillion tax cut (Frankel 2018a).

The US and other trading partners have more legitimate complaints against China when it comes to technical knowledge transfer and intellectual property rights. But the effective way to pursue such negotiations would have been in cooperation with allies, via such multilateral institutions as the WTO (Frieden and Trachtman 2018) and the Trans-Pacific Partnership (Frankel 2015a). Trump has gone far out of his way to pursue the opposite of this cooperative multilateral approach, making progress difficult.

The Structural Impediments Initiative was a success not because it eliminated the bilateral Japan-US trade balance, but because it made some small steps toward mutually beneficial reforms at the same time that it avoided the political alternative of destructive tariffs and quotas

Asking China to reduce the role of the state

Deducing a coherent rationale for US trade policy is a challenge. But one might discern in the demands that have been placed on China the theme of pushing it to restructure its economy in the direction of a greater role for the market, shrinking the size of the state sector, and lessening pervasive government control. Certainly, this has been the tenor of US demands in previous administrations.

The interesting thing is that pro-market reforms, generally speaking, would tend to be in the interest of the Chinese economy. This is recognised by many economists, not just American or foreign, but Chinese as well. For that matter the plan to shift emphasis from the state sector to the private sector was enshrined in the Third Plenum of the 28th Party Congress in 2014.

The programme called for a reduction in the role of inefficient state-owned enterprises to allow more dynamic private firms more room to grow, among other things. The rhetoric has not been disavowed. But little or no progress has been made on these reforms.

To the contrary, it has become clear from his actions that President Xi Jin Ping is not interested in reducing the size or role of the state, even in the gradual measured way of his predecessors. Inefficient state-owned firms continue to benefit from easier access to bank loans than the more dynamic private firms. Indeed, as Nicholas Lardy of the Petersen Institute for International Economics points out (Lardy 2019), Xi has rolled back market reforms[2].

The Chinese president is said to be closer in spirit to Mao than to the intervening leaders. It is not clear whether Xi lacks appreciation for the potential economic advantages of freer markets or whether he has decided he is willing to sacrifice some economic performance for the imperative of maintaining political control over Chinese society (Economy 2018).

To say that reforms would be in China's interest is not to say that they would not also benefit the US and other trading partners. The game is not in reality zero-sum (Frankel 2015b).

A good example is government subsidies for heavy industry such as steel mills, particularly in the form of cheap loans from state-directed banks. This was one component of China's fiscal expansion in response to the global recession of ten years ago. The counter-cyclical timing of the 'Keynesian' stimulus was excellent; the resource allocation of the spending was poor.

The programme left China with tremendous excess capacity in steel – bad for the efficiency of the economy, bad for foreign competitors (and bad for the environment, to boot). Subsidies to steel and other heavy industry are 'exhibit A' in the argument for shrinking the footprint of the government, including local government.

Does the US want a market-determined exchange rate?

A different kind of example of free-market rhetoric concerns the history of US demands over the yuan. Trump, as candidate and as president, has attacked China for manipulating its exchange rate (Frankel 2017a, 2018b).

The charge – which has been made by American politicians ever since 2003 (Frankel and Wei 2007) – is that the Chinese authorities intervene in the foreign exchange market to keep their currency unfairly undervalued (by buying dollars and selling yuan, to dampen its appreciation). The US objective was to help its producers compete against low Chinese prices, but the campaign was justified in the name of allowing the foreign exchange market to work freely.

For ten years, this position made sense. But in 2014, market forces changed direction. Since that year, China's central bank has had to spend almost $1 trillion (easily a world record) in trying to resist the depreciation of its currency (Frankel 2015c). If it had acceded to the demands of American politicians to let the market work, the yuan would have depreciated even more than it has.

Apparently keeping the value of the Chinese currency high is still a key US demand in the current negotiations. The Chinese authorities, for their part, have no desire to let the yuan fall freely. But after five years, it has become apparent to all that the goal of stabilising the exchange rate is inconsistent with the rhetoric of reducing government influence and letting the market work.

The precedent of the Japan-US Structural Impediments Initiative

As in so many other respects, the structural reform aspect of US negotiations with China is reminiscent of negotiations three decades ago with Japan. In June 1990, under the Structural Impediments Initiative (Matsushita 1991), the Japanese government agreed to a detailed set of structural policy reforms, requested by the US government under the administration of President George HW Bush.

The background behind the initiative was Congressional anger at a large bilateral trade deficit with Japan. The objective of the Structural Impediments Initiative was to respond to the issue in ways that would be more fundamental and effective than tariffs. Japan, for example, agreed to tighten enforcement of competition laws, to loosen ties among its keiretsu (industrial groupings), to make it easier for large-scale retail chains to open stores, and to reduce the bias toward using land for rice farming.

At the same time, the US agreed to reforms on its side, designed for example to increase its rates of household and public saving (Frankel 2018c), reduce the tax bias toward debt-financed homeownership (Frankel 2017b), and strengthen investment in education and training. Such reforms would work to reduce the countries' trade imbalances (particularly by narrowing the gap in the two countries' national saving rates).

But it was noteworthy that the US asked Tokyo to do things that would improve the efficiency of the Japanese economy while Japan asked Washington to do things that would improve the efficiency of the US economy (Frankel 1990).

As it happened, the 'Japan threat' began to melt away soon after the Structural Impediments Initiative, but not because of US or Japanese trade policy. A three-year Japanese financial bubble burst in 1990, and the economy has never quite recovered since. The rapid ageing of the Japanese population plays a large role.

For one thing, ageing reduced the national saving rate – as economists had predicted (Horioka 1992). In turn, Japan's trade balance fell as a share of GDP (Frankel 2012a). (Similarly, China's trade surplus peaked in 2008, and subsequently fell (Frankel 2012b).)

The Structural Impediments Initiative was a success not because it eliminated the bilateral Japan-US trade balance, but because it made some small steps toward mutually beneficial reforms at the same time that it avoided the political alternative of destructive tariffs and quotas (Branstetter 2017).

In theory, it could serve as a useful model for China–US negotiations, if they were in similarly competent hands. But the two countries' leaders may not have as firm a grasp on economic principles as their predecessors. ■

Jeffrey Frankel is Harpel Professor of Capital Formation and Growth at Harvard University's Kennedy School of Government

Endnotes

1. *https://www.nytimes.com/2019/03/06/us/politics/us-trade-deficit.html*
2. *https://www.ft.com/content/3e37af94-17f8-11e9-b191-175523b59d1d*

References

Branstetter, L (2017), "Do Trade Restrictions Work? Lessons From Trade With Japan in the 1980s", EconoFact, 20 November.
Economy, E (2018), The Third Revolution: Xi Jinping and the New Chinese State, Council on Foreign Relations.
Frankel, J (1990), "The SII Outcome: In Whose Interest?", The International Economy IV(5): 70-72.
Frankel, J (2012a), "Japan Adjusts", Views on the Economy and the World blog, Belfer Center, 28 March.
Frankel, J (2012b), "China Adjusts", Project Syndicate, 23 March.
Frankel, J (2015a), "Be open-minded about TPP", The Korean Herald, 12 October.
Frankel, J (2015b), "Asian Games Are Not Zero-Sum", Project Syndicate, 23 April.
Frankel, J (2015c), "Congress, China, and Currency Manipulation", China-US Focus 6 (April-May): 36-38.
Frankel, J (2017), "Mnuchin's Mission", Project Syndicate, 22 March.
Frankel, J (2017b), "The Case against Subsidizing Housing Debt", blog, 30 May.
Frankel, J (2018a), "Making America's Deficits Great Again", Project Syndicate, 15 January.
Frankel, J (2018b), "Trump wrong to brand China a currency manipulator", Nikkei Asian Review, 21 September.
Frankel, J (2018c), "The Lesson from George H.W. Bush's Tax Reversal", blog, 13 December.
Frieden, J and J Trachtman (2018), "U.S. Trade Policy: Going it Alone vs. Abiding by the World Trade Organization", EconoFact, 15 June.
Frankel, J, and S J Wei (2007), "Assessing China's exchange rate regime", Economic Policy 51: 576–627.
Furceri, D, S A Hannan, JD Ostry and AK Rose (2018), "Macroeconomic Consequences of Tariffs," CEPR Discussion Paper 13389.

Horioka, C (1992), "Future trends in Japan's saving rate and the implications thereof for Japan's external imbalance", Japan and the World Economy 3(4): 307-330.

Lardy, NR (2019), "The State Strikes Back: The End of Economic Reform in China?", Petersen Institute for International Economics.

Mastanduno, M (1992), "Framing the Japan Problem: The Bush Administration and the Structural Impediments Initiative," International Journal XLVII, Spring.

Matsushita. M (1991), "The Structural Impediments Initiative: An Example of Bilateral Trade Negotiation", Michigan Journal of International Law 12(2): 436-449.

Melitz, M and M Klein (2017), "What Do We Learn from Bilateral Trade Deficits?", EconoFact, 25 May.

Author's note: this is an extended version of a column that appeared on Project Syndicate on 21 March. This article was originally published on VoxEU.org