

6. The US's massive and sustained trade deficit is long term macroeconomic problem that is caused primarily by China's currency manipulation. Hence, imposing protectionist measures against Chinese imports is not only fair but also effective and beneficial. Do you agree? [25]

Question interpretation

- What is meant by trade deficit and protectionism?
- Why is a large and sustained trade deficit a long term macroeconomic problem?
- How can China's currency manipulation cause the US to face large and sustained trade deficits?
- What are the other possible causes of US's large and sustained trade deficits?
- How can protectionism improve US's trade deficit and what are the limitations?
- How fair, effective and beneficial is it for the US to impose protectionism against China?

Introduction

- A trade deficit occurs when a country's import spending exceeds its export revenue
- Protectionism refers to the act of protecting domestic firms and workers from foreign competition and can be used as a form of expenditure switching to help correct a trade deficit
- The essay thus aims to explain why a trade deficit could be a long term macroeconomic problem and how the US deficit may be caused by China undervaluing the yuan against the US\$
- This is followed by an analysis of other possible causes of US's trade deficit, and the usefulness of protectionist measures in reducing such deficits
- It concludes by evaluating whether US protectionism against China is fair, effective and beneficial

Why is a large and sustained trade deficit a long term macroeconomic problem?

- A trade deficit means that the country is not earning enough from its exports to pay for its imports.
- Under a flexible exchange rate, this means that the country is financing some of its imports from either foreign borrowing or from selling of its domestic assets to foreigners.
- With greater foreign debt and foreign ownership of domestic assets, more of the country's future income flows out to foreigners in the form of interests, rents, dividends and profits
- Hence, a country that is facing a trade deficit is enjoying higher current consumption but at the expense of future welfare.
- A large and sustained trade deficit means that this sacrifice in future welfare is prolonged and substantial

How can China's currency manipulation cause the US to experience large and sustained trade deficits?

- China manages the yuan against the US\$, thus keeping the exchange rate stable in order facilitate trade and foreign investment
- To make its exports more competitive and also to accumulate foreign reserves which can be used to defend the peg if the need arise, China generally undervalues the yuan by selling it for US\$ in the foreign exchange market, thus keeping the value of the yuan below its free market equilibrium
- China's large BOP surpluses and continued accumulation foreign currency reserves are evidence of such currency manipulation
- From the US perspective, the undervalued yuan results in cheap imports from China which causes the quantity demanded for such imports to be high, while costly exports to China causes the demand for such exports to be low.
- As a result, US's import spending significantly exceeds its export revenue, thus giving rise to a large trade deficit
- As long as the yuan is significantly undervalued, the large trade deficit remains, which explains why the deficit is sustained

What are some other possible causes of the US's large and sustained trade deficit?

- US industries could be uncompetitive for a variety of other reasons
- Firstly, being much less developed and more populous, China is more labour abundant so labour costs tend to be much lower in China than in the US
- In addition, firms in the US may be facing significantly higher labour costs than China because it has stronger trade unions or higher minimum wages
- Secondly, the US could have under-invested in training and education, thus making it slow to adapt to changes in comparative advantage due the resulting lack of skills and labour mobility
- As a result, US is unable to export enough goods in which they have comparative advantage in, hence causing its export earnings to be insufficient to cover its import spending
- The US trade deficit can also be due to its savings and budget deficits
- Income (Y) is either spent on consumption (C), saved (S) or used to pay taxes (T) while AE consists of investment (I) government spending (G) and the trade balance (X – M)

At equilibrium, $Y = AE$

$$\Rightarrow C + S + T = C + I + G + (X - M)$$

$$\Rightarrow (S - I) + (T - G) = (X - M)$$

- A country that is facing a trade deficit i.e. ($X < M$), must hence be experiencing a savings deficit ($S < I$) and/or a government budget deficit ($T < G$), indicating that the households and/or the government are being too spendthrift and 'living beyond their means'.
- The US is known to have a culture of consumerism, resulting in excessive spending by households, thus leading to a savings deficit
- The US government has also been running large budget deficits for decades possibly caused by excessive spending on welfare programs and on fighting costly foreign wars

How can protectionism improve US's trade deficit and what are the limitations?

- Protectionism is a form of expenditure switching policy which work primarily by restricting imports
- By imposing tariffs and quotas on Chinese imports, this induces US firms and households to buy less imports from China so import volumes, expenditure and hence the trade deficit is reduced
- There are however various limitations of imposing protectionism
- China might retaliate by restricting imports from the US, thus causing the latter's exports and hence its trade balance to worsen
- Even if China does not retaliate, there are still beggar-thy neighbour effects as the decline in China's exports to the US leads to a decline in China's AD, output and income, thus causing China to import less from the US
- As China is probably quite a large export market for the US, the resulting reduction in US's exports arising from retaliation and beggar thy neighbour effects can be quite substantial
- Protectionism fosters inefficiency and hampers innovation as the reduction in foreign competition causes US firms to be complacent, which reduces the motivation to keep costs down and to developed new or improved products
- As protectionism raises the price of imports from China, cost push inflation arises
- Finally, protectionism can cause demand-pull inflation if it causes AD to rise when the US economy is near or at full employment

Conclusion

- The analysis has shown that there could be many other valid causes of the US's trade deficit besides China's currency manipulation, hence blaming China and imposing protectionism is arguably unfair
- Furthermore, the effectiveness of protectionism are likely to be limited due to beggar-thy-neighbour effects and potential retaliation by China
- Finally as imposing protectionism has large trade-offs in terms of fostering inefficiencies and causing inflation, the cost of such measures could arguably outweigh the benefits
- Hence my final opinion is that the imposition of protectionism by the US against China is neither fair, effective nor beneficial
- To manage its trade deficit, my view is that US should first clean up its own backyard by boosting its own competitiveness, savings and by balancing its budget, before pointing fingers at others.

L1: Define trade deficit and protectionism [1-3]

L2: Explain why a large and sustained trade deficit is a macroeconomic problem and the possible causes of such deficits in the US context [4-13]

L3: Analyze how protectionism can be used by the US to reduce its trade deficit and the limitations of doing so [14-21]

E: Evaluate the fairness, effectiveness and benefits of US imposing protectionism against China [+4]