Backgrounder

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The Facts About China's Currency, Chinese Subsidies, and American Jobs

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Abstract: *There is great concern in the U.S. about Chinese currency policy costing American jobs. But over two decades, there has been no evidence that a weak yuan causes high American unemployment. What American policymakers should focus on is other Chinese actions that do harm the U.S. and the entire global economy, particularly China's market-distorting and anti-competitive subsidies. Heritage Foundation Asia economic policy expert Derek Scissors explains why the U.S. must identify and measure Chinese subsidies as the necessary first step in reducing the damage they cause.*

There is persistent concern in the U.S. that Chinese currency policy is costing American jobs. The main argument is that jobs are lost because China's currency, the yuan, is weak—it is not worth enough as compared to the dollar, giving Chinese goods an unfair advantage.

There is no genuine evidence to support this claim. As shown below, over the past 20 years, U.S. unemployment has been low when the yuan is weak and high when the yuan is strong. It has been so because American, not Chinese, policies determine unemployment levels. The yuan is incidental. Congressional action to punish China for its exchange rate policy, such as that now being considered, will do nothing to create jobs in the U.S.

There are Chinese actions that do harm the U.S. These same policies also harm the rest of the world. The most damaging can be grouped under the mantle of subsidies.

Talking Points

- The annual hue and cry in the U.S. about China's exchange rate policy is unproductive. Over a full two decades, there is no evidence that a weak yuan causes higher U.S. unemployment.
- This debate has drawn American attention away from the more important problem of Chinese subsidies. The most important of these is regulatory protection against competition. Other large subsidies involve low-cost financing and land.
- Subsidies block exports to China, distort China's own exports, and inhibit the operation of foreign firms in China. They encourage investment and are made possible by the effective taxation of consumers, therefore contributing powerfully to global imbalances.
- It will not be easy to roll back Chinese subsidies. The first and necessary step is to identify and measure them. This will enable the U.S. to file a series of World Trade Organization cases and to make concrete bilateral proposals whose progress can be evaluated.

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The current government in Beijing is utterly committed to state dominance of the economy. To ensure this outcome, it has granted various kinds of subsidies to state-owned and state-controlled enterprises, effectively blocking access to most of the market, among other problems. If China is to become a good economic partner, it must cut these subsidies back.[1]

This is a daunting goal. The first step, however, is clear: The U.S. should identify and measure the extent of Chinese subsidies. This will strengthen the American case in multilateral discussions and any needed decisions by the World Trade Organization (WTO). It will also enable focused proposals in bilateral talks—an important change from the current situation—and a clear measurement of whether progress is being made.

All sides in the China conversation know subsidies are a serious issue. Substantial reductions will take years, not months. But the most important Chinese distortion of global trade can be reduced without breaking trade rules, if the U.S. focuses on what truly matters.

No Competition for State-Owned Enterprises

It is unwise to get into a battle of subsidies with the People's Republic of China (PRC). Beijing has myriad ways to intervene in the market, starting with simply telling companies and banks what to do. The ability to order firms to act, using laws made at the whim of the Communist Party, is the heart of the biggest of Chinese subsidies: protection against competition through tight regulatory control of market entry and exit.

There is a good deal of confusion about what constitutes "state-owned" or "state-controlled" but Chinese regulatory statutes make clear the state's true role.[2] By central government edict, the state must control nearly all major industries. For some—oil and gas, petrochemicals, electric power, and telecommunications—the state must own all the participating firms. In others—aviation, coal, and shipping—the state must control the sector as a whole. In yet others—autos, construction, machinery, metals, and information technology—the state's role is to expand until it controls the sector.[3] State-owned enterprises (SOEs) also control most of insurance, the media, railways, and China's powerful tobacco industry. Perhaps most important, nearly all banks are state-owned, providing a huge lever to control the rest of the economy.

State-Dominated Industries in China. The combined market share of importers, foreign firms based in the PRC, and Chinese private companies is not permitted to expand beyond a certain, often minimal position. There are other examples of regulatory favoritism but there is no greater subsidy than assured market share, in this case of a large market. Further, while SOEs are said to compete with each other, the competition can be difficult to recognize. Under the current government, a group of protected national SOEs—very large and centrally controlled—and smaller but much more numerous provincial SOEs can never lose a competition because they are never permitted to go bankrupt.[4]

1. The U.S. would also be a better economic partner for the entire globe if U.S. subsidies were eliminated, though these are minuscule in comparison to China's.
2. Many foreign observers treat entities such as Bank of China as non-state because they have sold stock. This is a serious error, one Beijing does not make. Bank of China is both state-controlled and state-owned and the minority share it sold did nothing to alter that under Chinese law. Official Chinese statistics have the combined foreign and domestic private share of investment below 25 percent in 2010. The remainder was generated by different types of state-controlled firms. National Bureau of Statistics, *China Monthly Statistics*, Beijing, Vol. 1, 2011.
3. Zhao Huanxin, "China Names Key Industries for Absolute State Control," *China Daily*, December 19, 2006, at *http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm* (September 27, 2011).
4. Caroline Berube and Patrick Pu, "Bankruptcy and Insolvency in the PRC: A Myth?" *IPBA* Journal (March 2009), at *http://www.hjmasialaw.com/pdf/922541_Mar07-Berube_26_Pu.pdf* (September 27, 2011), and "China Exclusive: China Kicks Off Largest SOE Merger," *People's Daily*, December 1, 2005, at *http://english.peopledaily.com.cn/200512/01/eng20051201_224819.html* (September 27, 2011).

State Dominated Industries in China

Autos	Metals
Aviation	Oil and Gas
Banking	Petrochemicals
Coal	Power
Construction	Railways
IT	Shipping
Insurance	Telecom
Machinery	Tobacco
Media	

Source: Zhao Huanxin, "China Names Key Industries for Absolute State Control," *China Daily*, December 19, 2006, at *http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm* (September 27, 2011).

Table 1 • B 2612 heritage.org

Struggling SOEs are directed entirely by the relevant government arms, with effectively no obligation to creditors or other shareholders. They are typically merged with other SOEs, with no downsizing and thus no market share made available to non-state entities.[5] Indeed, the government now seeks to orchestrate consolidation of weaker SOEs while at the same time driving out non-state firms. This is occurring most famously in rare earths, but also in aluminum, autos, cement, steel, and many larger industries.[6] In all cases, the desired result is a few large firms, all state-owned. This is just one small step short of a state monopoly.

As with a monopoly, barring competitors allows SOEs to raise prices and lower quality. This effectively serves as a tax on Chinese consumers. Because it is a huge subsidy for firms, it also enables higher investment. The PRC's now infamous imbalance between investment and consumption did not exist before the current Chinese government came to power in late 2002.[7] It arises in large part from regulatory protection discouraging consumption and encouraging investment. Regulatory protection does not only block competition with state-controlled firms, it also contributes heavily to the daunting problem of an unbalanced global economy.

Traditional Subsidies

The second set of subsidies stems from a financial system rigged to boost SOEs. Access to domestic securities markets is heavily biased in their favor.[8] Due to government-controlled interest rates, ordinary depositors now receive less on their savings than they pay in inflation—negative real returns. Banks gain from this low payout but themselves can only charge for borrowing at roughly equal to the rate of inflation. Banks also must place reserves at the central bank, the People's Bank of China, at very low yields, costing revenue.[9]

For its part, the People's Bank faces a rapidly deteriorating balance sheet due to irresponsibly

5. Yan Qiong, "Mergers, Acquisitions, and Restructuring of State-Owned Enterprises," interview with Zhang Tianhui and He Ran, editors, King & Wood's Publication Group, October 2010, at *http://www.kingandwood.com/article.aspx?id=Mergers-Acquisitions-and-Restructuring-of-State-Owned-Enterprises&language=en* (September 27, 2011), and Nie Peng, "Steel Merger Will Become China's Biggest," *China Daily*, April 19, 2010, at *http://www.chinadaily.com.cn/bizchina/2010-04/19/content_9747309.htm* (September 27, 2011).
6. "China to Drive Consolidation of 8 Industries Over Next 5 Years," Xinhua news agency, July 7, 2011, at *http://news.xinhuanet.com/english2010/china/2011-07/07/c_13971925.htm* (September 27, 2011).
7. National Bureau of Statistics, *China Monthly Statistics*, Beijing, Vol. 12, 2002.
8. OECD Working Group on Privatisation and Corporate Governance of State Owned Assets, "State Owned Enterprises in China: Reviewing the Evidence," January 26, 2009, at *http://www.oecd.org/dataoecd/14/30/42095493.pdf* (September 27, 2011).
9. "Zhou Xiaochuan: Real Interest Rate to Stay Negative for Now," China.org.cn, March 14, 2011, at *http://www.china.org.cn/china/NPC_CPPCC_2011/2011-03/14/content_22133432.htm* (September 27, 2011), and Keith Bradsher, "China Move Could Counter Fed's Efforts," *The New York Times*, November 19, 2010, at *http://www.nytimes.com/2010/11/20/business/global/20yuan.html* (September 27, 2011).

loose monetary policy. Finally, non-state enterprises receive a very small share of loans and often pay exorbitant rates.[10] This is in large part because, unlike SOEs, non-state firms can actually go bankrupt and are therefore seen as riskier.

In contrast to the hardships for all other participants in the credit system, SOEs borrow immense amounts at essentially no cost. The base one-term loan rate is below the rate of inflation, so that the real cost of borrowing is negative for those that qualify, all of which are state-controlled. Bank loans spiked past $1.4 trillion in the 2009 stimulus, another $1.2 trillion in 2010, and $550 billion in the first half of 2011, about 80 percent of which went to SOEs.[11] That is over $2.5 trillion in very low-yield financing in less than three years—a result to make even the U.S. government proud. At the level of individual enterprises, the numbers are equally astonishing. Huge loans are made to firms in designated strategic industries but also to firms having financial difficulties.[12]

The warped financial system is the second force creating the imbalance between investment and consumption. The ability to borrow at no cost drives up investment. The return on saving is negative. Yet people must still save for housing, education, health, and retirement, so savings rates are high and consumption correspondingly limited. Here, too, Chinese subsidies do not just cause massive problems for competing firms, they weaken the global economy.

Land has become a third important subsidy. Land is in principle state-owned, so that acquiring land for expansion is easy and comparatively cheap for most SOEs. The size of this subsidy is growing rapidly because land value in the PRC has soared in the past few years.[13] Acquiring land is, unsurprisingly, difficult and increasingly expensive for non-state companies. These also face the additional problem of insecure ownership rights—provincial governments can evict them from operating sites, sometimes in order to eliminate or reduce competition for their SOEs. Other inputs to production are also subsidized, with privileged access to low-cost power perhaps the most important of these.

Finally, China's currency policy also acts as a subsidy, but not an important one for the U.S. The yuan is pegged to the dollar, so the dollar cannot fall against the yuan at the same speed it has against other currencies. This is what is meant by the yuan being "artificially weak." However, the other currencies are most disadvantaged. Since the dollar is falling against most currencies, the yuan has been as well,[14] even though the PRC still runs the world's largest trade surplus. China has gained a competitive advantage against these countries due to the dollar peg, even while the yuan has risen against the dollar itself.

From the American perspective, the yuan's 24 percent rise against the dollar since June 2005 has coincided with a rising bilateral trade deficit, in stark contrast to the predictions of those calling for revaluation. More broadly, for nearly two decades, there has been no real connection between the value of the yuan and U.S. unemployment. This is not a surprise—American unemployment is naturally determined by American policies, not Chinese.

10. Gunther Schnabl, "The Role of the Chinese Dollar Peg for Macroeconomic Stability in China and the World Economy," Global Financial Markets Working Paper No. 13, October 2010, at *http://www.gfinm.de/images/stories/workingpaper13.pdf* (September 27, 2011), and Daniel Rosen and Yam Ki Chan, "Talk about China's Banks, Too," *The Wall Street Journal*, July 26, 2009, at *http://online.wsj.com/article/SB10001424052970204886304574306944034054288.html* (September 27, 2011).

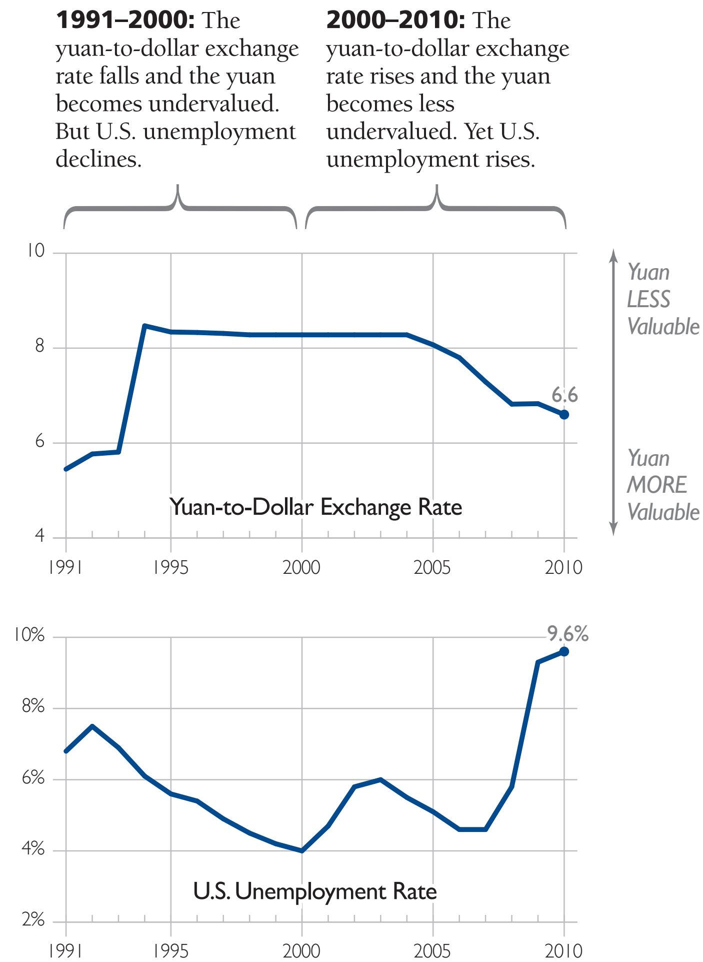
11. National Bureau of Statistics, *China Monthly Statistics*, Beijing, Vol. 1, 2010 to Vol. 7, 2011, and Jialin Zhang, "China Backpedals," *Hoover Digest*, No. 1 (January 12, 2011), at *http://www.hoover.org/publications/hoover-digest/article/62771* (September 27, 2011).

12. Philip Lagerkranser, "China's Banks Surge to World's Biggest May Be Too Good to Be True," Bloomberg, April 29, 2009, at *http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aueh06DOY37A* (September 27, 2011).

13. "China's Property Tax Debate Escalates," *China Daily*, January 15, 2011, at *http://usa.chinadaily.com.cn/business/2011-01/15/content_11866032.htm* (September 27, 2011).

14. "Real Effective Exchange Rate of RMB in Decline," *People's Daily*, July 24, 2011, at *http://english.peopledaily.com.cn/90001/90780/91344/7449501.html* (September 27, 2011).

A Weak Yuan Does Not Cause U.S. Unemployment



Sources: X-Rates.com, Historic Exchange Rates, at *http://www.x-rates.com/cgi-bin/hlookup.cgi* (June 6, 2011) and U.S. Department of Labor, Bureau of Labor Statistics, Labor Force Statistics from the Current Population Survey, at *http://www.bls.gov/cps/prev_yrs.htm* (June 6, 2011).

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Unfair Competition

China has multiple sources of genuine competitive advantage, but many firms do not profit from these. They are suppressed to ensure the dominance of SOEs, whose advantages are not market-based. When competing in the Chinese or global markets, private Chinese firms, multinationals based in the PRC, and foreign companies in home or third markets face an unbalanced fight.[15]

To illustrate, state giants are powerfully protected in oil and telecom, where the huge Chinese market should draw dozens of competitors. Instead, these are barred. As a result, industry leaders China National Petroleum Corporation (CNPC) and China Mobile reported 2009 profits greater than the 500 largest Chinese private firms combined.[16]

Multinationals may be doing better than domestic private firms but they still cannot share in what are reported to be huge profits in metals. There are only two domestic private banks and foreign banks have less than two percent of banking assets. The figure is similar for insurance premiums. There are no foreign majority-owned auto companies.[17] Much-discussed operating and other restrictions on multinationals are all secondary to this simple cordoning-off of most of the market.

Imports are also dramatically impacted. Imports of steel and ships, once important, are now trivial in overall production.[18] The requirement that SOEs, such as First Auto

15. Derek Scissors, "Chinese State-Owned Enterprises and U.S.–China Economic Relations," testimony before the U.S.–China Economic and Security Review Commission, March 30, 2011, at *http://www.heritage.org/Research/Testimony/2011/04/Chinese-State-Owned-Enterprises-and-US-China-Economic-Relations*.
16. "China State Giants Outstrip Private Firms," Channel News Asia, August 30, 2010, at *http://www.channelnewsasia.com/stories/afp_asiapacific_business/view/1077996/1/.html* (September 27, 2011).
17. Business China, "Foreign Banks Optimistic on Chinese Market This Year: PwC," June 23, 2011, at *http://en.21cbh.com/HTML/2011-6-23/Banking.html* (October 3, 2011); PricewaterhouseCoopers, "Foreign Insurance Companies in China," September 2010, at *http://www.pwc.be/en/china-desk-newsletter/Assets/Foreign-insurance-companies-in-China.pdf* (October 3, 2011); Lester Ross, "Choosing a China Investment Vehicle," *The China Business Review*, September 2010, at *https://www.chinabusinessreview.com/public/1009/ross.html* (October 3, 2011).
18. National Bureau of Statistics, *China Monthly Statistics*, Beijing, Vol. 1, 1999 to Vol. 7, 2011,

Works, come to control the domestic market has kept auto imports below five percent of total sales.[19] A large segment of machinery follows a similar track, and the current target for import displacement in favor of domestic production is information technology.[20]

Guaranteed revenue, domestic production subsidies, and yet more capital subsidies specifically targeted at expansion overseas[21] also make SOEs an increasingly formidable presence outside the PRC. The Heritage Foundation's China Global Investment tracker is the only public dataset on Chinese outward investment excluding bonds. Since 2005, this investment exceeds $250 billion, changing China from an afterthought to a direct and growing competitor in South America and Europe. State entities account for more than 90 percent of the spending.[22]

Beijing also selects sectors it considers ripe for commercial opportunity to receive subsidies—such as regulatory protection and capital—that enable Chinese firms to rapidly claim huge shares of the world market. Solar energy is the prime example at the moment, with Chinese production of solar panels soaring but most of the output heading overseas. There have been many others in recent years, including rare earths.[23]

The American Response

The reason the exchange rate receives so much political attention is it appears to be simple, while subsidies do not. The evidence makes clear, however, that there is no reason to expect American job creation from another 25 percent rise in the yuan against the dollar. Policies aimed at compelling the yuan to rise may seem simple, but they will accomplish nothing for the U.S.

Rather than wasting still more time, the U.S. should now turn to the true problem with Chinese policy. As should be expected in a huge economy with many forms of state intervention, Chinese subsidies will not be easy to roll back. The first step is not politically attractive but it is absolutely necessary: The U.S. should identify and measure—and continuously update the measurement—the extent of subsidies.

In this measurement, protection against competition must be included. This will be inexact and therefore controversial. It will also be difficult. However, if regulatory protection is not included, subsidies will be seriously underestimated and considerable harm will continue to be inflicted on American companies and the balance of the global economy. Including regulatory protection along with capital, land, and other subsidies means that initial estimates are likely to be somewhat imprecise. However, with a sustained effort, they will improve over time.

Measuring subsidies will have three uses. The *first* is within the WTO. The WTO will not fully accept American figures on Chinese subsidies, since some documented transfers will be beyond the scope of WTO rules. However, as measurements improve and become more sophisticated, the germane components will be increasingly accepted in WTO cases. While WTO decisions take a good deal of time to reach and implement, the U.S. can be permitted to counteract Chinese subsidies while the process is under way. In addition, the WTO process can serve as an instrument to induce the PRC to

19. "China to Promote Auto Imports in Next Five Years: Official," Xinhua news agency, December 26, 2010, at *http://news.xinhuanet.com/english2010/business/2010-12/26/c_13665288.htm* (September 27, 2011).

20. Joachim Ihrcke and Krystina Becker, "Study on the Future Opportunities and Challenges of EU–China Trade and Investment Relations, Study 1: Machinery," Emerging Markets Group and Development Solutions, February 2007, at *http://trade.ec.europa.eu/doclib/docs/2007/february/tradoc_133301.pdf* (September 27, 2011), and Jiang Zemin, *On the Development of China's Information Technology Industry* (Central Party Literature Press: Shanghai, 2009).

21. Japan External Trade Organization–Institute of Developing Economies, "China in Africa: The Role of China's Financial Institutions," October 2009, at *http://www.ide.go.jp/English/Data/Africa_file/Manualreport/cia_11.html* (September 27, 2011).

22. Derek Scissors, "China Global Investment Tracker Interactive Map," The Heritage Foundation, at *http://www.heritage.org/Research/Projects/China-Global-Investment-Tracker-Interactive-Map*.

23. Matt Daily, Christoph Steitz, and Leonora Walet, "Special Report: Is a Solar Trade War About to Flare?" Reuters, January 17, 2011, at *http://mobile.reuters.com/article/topNews/idUSTRE70G2C620110117?i=2&irpc=932* (September 27, 2011), and "China Tightens Controls on Rare Earths," *Xinhua news agency*, June 2, 2010, at *http://news.xinhuanet.com/english2010/business/2010-06/02/c_13329263.htm* (September 27, 2011).

share information on its subsidies.

Second, in the bilateral relationship, America presently approaches China in the Strategic and Economic Dialogue (S&ED) and other forums with numerous, scattered, and ultimately vague demands, which have little chance of ever being met.[24] A comprehensive measurement of subsidies gives the U.S. both the ability to make concrete proposals and, even more important, an objective way to measure progress on those proposals over time. Without this innovation or one similar, bilateral talks will continue to be frustrating, with almost no progress on major issues for a second decade.

And *third*, if appeals to the WTO are ultimately seen as inadequate and properly conducted bilateral negotiations fail, a measurement of subsidies is necessary to determine the best further response. Barring such evidence, American action could be seen as arbitrary and protectionist, rather than corrective. U.S. actions should therefore include the following:

- **Congress should not focus on the U.S.–China exchange rate, as this will accomplish nothing positive for the American economy.** Legislation will not bring the results Congress desires.
- **The United States Trade Representative (USTR),** with assistance as necessary from the Department of the Treasury, International Trade Commission, and Department of Commerce, **should immediately begin the process of measuring the extent of subsidies** provided by Chinese regulatory protection, non-market loans, land grants, and other actions.
- **The USTR should inform the WTO of any Chinese failure to disclose these subsidies,** as the PRC is required to do by the WTO.
- **In preparatory talks for the 2012 S&ED, the Department of the Treasury,** with any necessary assistance from the USTR, **should notify the Chinese side that the U.S. will be exclusively discussing subsidies in this round** of the economic side of the dialogue.

Conclusion: First, Assess Subsidies

There is a long-running debate over where the U.S. should focus its efforts on encouraging China to resume market reform of its economy. The debate has caused American policy to be distracted and ineffective, and it is past time for it to end. The yuan-dollar exchange rate is not important to the performance of the U.S. economy. Issues such as protection of intellectual property certainly matter but subsidies, when properly defined and understood, are the core problem. They block exports to China, distort imports from China, harm foreign companies operating in China, and unbalance the entire world economy.

What to do first should also be an easy decision. No action will be successful until the U.S. has a reasonable and formalized understanding of the full set of Chinese subsidies, especially protection against competition. The evaluation should start as soon as possible. With that, multilateral and bilateral negotiations at least gain the prospect of being fruitful. If both the PRC and the WTO prove unable or unwilling to act to curb subsidies, the U.S. will then face the truly difficult decision of how best to limit their damaging effects.

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24. Derek Scissors, "Tools to Build the U.S.–China Economic Relationship," Heritage Foundation *Backgrounder* No. 2590, August 8, 2011, at *http://www.heritage.org/Research/Reports/2011/08/Tools-To-Build-the-US-China-Economic-Relationship*.