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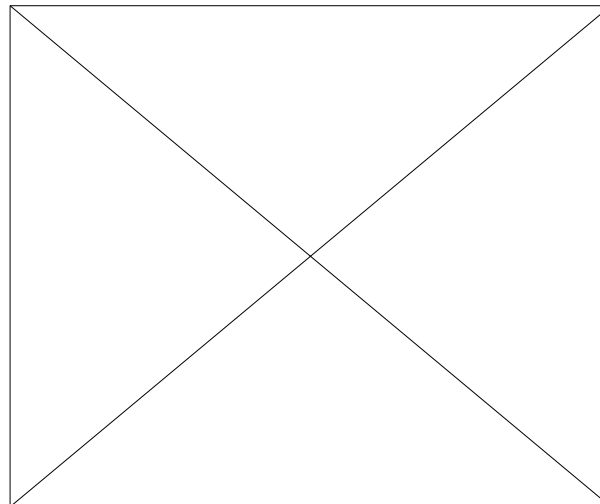
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Parsing China's Trade Surplus

Nicholas Lardy of the Institute for International Economics explains how it has become so huge and how it will affect the yuan's value

Some numbers just make you sit up and take notice. After seeing those out of Beijing on Jan. 11 -- showing China's trade surplus had topped \$101 billion last year, triple the 2004 figure -- the world definitely noticed. The big jump came in spite of a 2% revaluation of China's currency, the yuan, in July. With the latest figures, trade hawks in the U.S. and elsewhere are sure to call for a more significant appreciation of the yuan to slow the flood of exports from mainland factories.



But would that really help cut the surplus? *BusinessWeek* Asia Editor **David Rocks** on Thursday spoke with Nicholas Lardy, a senior fellow at the Institute for International Economics in Washington, to get some perspective on the numbers. Edited excerpts of their conversation follow:



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What's driving China's trade surplus?

The big driver isn't on the export side but on the import side. Export growth fell a bit, but import growth was barely half what it was in 2004, so there has been this ballooning of the trade surplus.

Based on the data available so far, it looks like the biggest decline in imports is in machinery and equipment. Parts and components that go into export processing are still growing at 25% to 30% annually. But machinery and equipment is running at about a third the rate of 2004 -- that's to say at 10% rather than the 30%-plus growth seen in 2004. So what we're seeing in 2005 was some slowing in the pace of domestic investment.

This comes against the background, you'll recall, of investment growth that began to accelerate in 2002 through early 2004. Then the government got worried about excess investment and overheating, so they started to put the brakes on the economy. This is evidence that the measures they took are starting to bite.

What are the strongest export sectors?

The big drivers of export growth have continued to be information technology, electronics, and telecom. Those have been the big drivers for the past few years, and it continued in '05.

And a lot of those goods are produced by Western multinationals exporting from China, right?

About 55% of all exports are from foreign-owned companies or joint ventures. That share has been growing about 1 or 2 percentage points annually in recent years but may be stabilizing now. It looks like foreign capital coming into China in 2005 is going to be down slightly -- the first time in many years that it will have fallen. That may mean the share of foreign-produced goods won't grow as fast as it has in the past.

But even if you take out all the foreign-owned exporters, Chinese domestic companies have been growing their exports. Their share has been declining, but many companies are exporting more and more. And a lot of people don't recognize that about half of all the goods produced by foreign companies in China are sold in China. The auto sector is the best example -- 95% of the autos sold there are made by foreign companies or JVs.

Will the trade surplus continue to grow?

The big question for the overall trade situation next year is whether import growth starts to pick up again. Some people thought they saw a resumption of import activities in the closing months of the year. If that trend strengthens, then the trade surplus may be lower next year. If the world economy slows, then China's export growth will slow, but if global growth is strong, we'll see export growth from China continue at maybe 20%.

How much would a further revaluation of the yuan affect the situation?

I've been in the camp that has said the Chinese currency is undervalued and that the adjustment last July was far too modest. But even if China were to revalue its currency significantly, it would continue to have a trade surplus with the U.S. The fact is, most of the goods that are produced in China used to be made somewhere else. If you look at the overall U.S. trade deficit, Asia's share has been declining.

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We have a huge growing deficit with Germany. They have slow growth, so their imports are down. And there's a lot of energy imported from the Middle East.

A revaluation would contribute to a reduction of the U.S. current account deficit. But what really has to happen is an increase in the savings rate in the U.S. and a simultaneous depreciation in the value of the dollar. It needs to fall further mostly against the yuan and other Asian currencies that have been heavily managed.

China's leadership is seeking to increase internal consumption. Will that have much of an effect on the trade surplus?

Not really. If you look at the composition of imports, there are almost no consumer goods. China has tremendous production capacity in most of the things people are buying -- consumer electronics, automobiles. So Dell ([DELL](#)) may sell more computers in China, or other foreign companies may sell more flat-screen TVs, but those will be made in China. I don't see a lot of that consumption demand coming from imports.

China's foreign currency reserves are heading toward \$1 trillion. What effect might this have on the U.S.? Does it give China greater control over the U.S. economy?

I don't think it gives them much clout. They're in the very unhappy position of being at risk of a significant decline in the value of their reserves. Eventually the dollar has to depreciate quite a bit, particularly against Asian currencies. So they're at risk of their reserves depreciating in terms of their domestic currency. They can't really diversify out of dollar holdings because the minute they start to do that they impose losses on themselves.

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Nickname: mys21

Review: Surplus is byproduct of government policy. China will restructure surplus to convince the USA and Europe there is no risk for them.

Date reviewed: Jan 16, 2006 9:40 AM

Nickname: Isat

Review: US dollars truly must devalue. Congress should encourage US companies putting investment in China for its internal consumption, by reducing corporate tax. Reversing the conventional wisdom, producing in China and selling back to US. To encourage their spending, the best way is to feed them in time. They need almost everything from us, hard to believe. Department of Commerce needs to do much more homework for US companies.

Date reviewed: Jan 16, 2006 2:33 AM

Nickname: Lance Olsen

Review: Lardy observes that "what really has to happen is an increase" of savings in the U.S. Although we come to that topic from a different perspective, we wholeheartedly agree. And we'd add that the lack of savings applies very broadly--e.g., Americans are no better at saving the likes of forests than we are at saving money. We have borrowed heavily from forests and lending institutions to create a homebuilding boom that has been the backbone of the U.S. economy. Now that backbone is at some risk, as are the forests themselves.

Date reviewed: Jan 14, 2006 6:05 PM

Nickname: Bob

Review: This seems to conclude that China makes what they consume right there: