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New ECIPE Jan Tumlrir Essay

That Chinese “juggernaut” – should Europe really worry about its trade deficit with China?

China’s exchange-rate policy has been under attack in the last years, especially in the United States. Now the critique of Beijing’s policy is coming from Europe as well. In a new Policy Brief, Professor Andreas Freytag discusses EU-China trade relations in the context of China’s exchange-rate policy. Freytag scrutinizes the assumptions underlying the link between China’s exchange-rate policy and Europe’s rising bilateral deficit. Freytag finds this link tenuous, and argues that a bilateral deficit cannot prima facie be viewed as a problem when the overall current account of Europe largely is in balance.

Europe’s increasing trade with China has become a politically sensitive issue. China’s exports to Europe are bigger than Europe’s exports to China: Europe thus has a trade bilateral deficit in its relation with China. The speed at which this deficit has grown has triggered criticism, increasingly alarmist in tone, and demands for action to be taken to correct this imbalance. The main culprit is by some perceived to be Chinese exchange-rate policy: Chinese authorities are boosting their own exports by keeping their currency below its real market value.

However, China’s trade pattern has changed fundamentally in the last 20 years. Exports of “hard” manufactures – consumer electronics, apparel, et cetera – have increased and agricultural products and soft manufactures, such as textiles, have declined considerably. This shift essentially reflects China’s comparative advantages and has led to a significant presence of *processing trade*: a considerable value of China’s export is made up of imports. This pattern fits with the broad trend of trade fragmentation experienced in the last decade; many multinational firms have broken up the supply chain and outsourced production to China to make use of its comparative advantage. Furthermore, this pattern also reflects a broad trend of trade replacement: China’s export to Europe has replaced export of other countries to Europe, not European production.

China is accused by European and American politicians to boost its export by a manipulated currency. But that viewpoint doesn’t hold for greater scrutiny. Europe’s bilateral trade deficit with China has primarily increased in sectors where China is strongly competitive, and Europe’s deficit with China has been accompanied by falling trade deficits with other countries. This should be applauded, not lamented, says Andreas Freytag.

Freytag sets out an alternative explanation to China’s huge trade surplus. By using simple balance-of-payment theory, he argues that the exchange rate should be viewed as an adjustment parameter rather than a policy variable for China’s macroeconomic policy. From such a perspective, the Chinese trade surplus seems rational. The policy implications drawn by Freytag do not support the new aggressive stance by some European leaders, they rather suggest a moderate approach, in particular as there are good reasons for China to change its macroeconomic policy in the future, leading to a reducing trade surplus.

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