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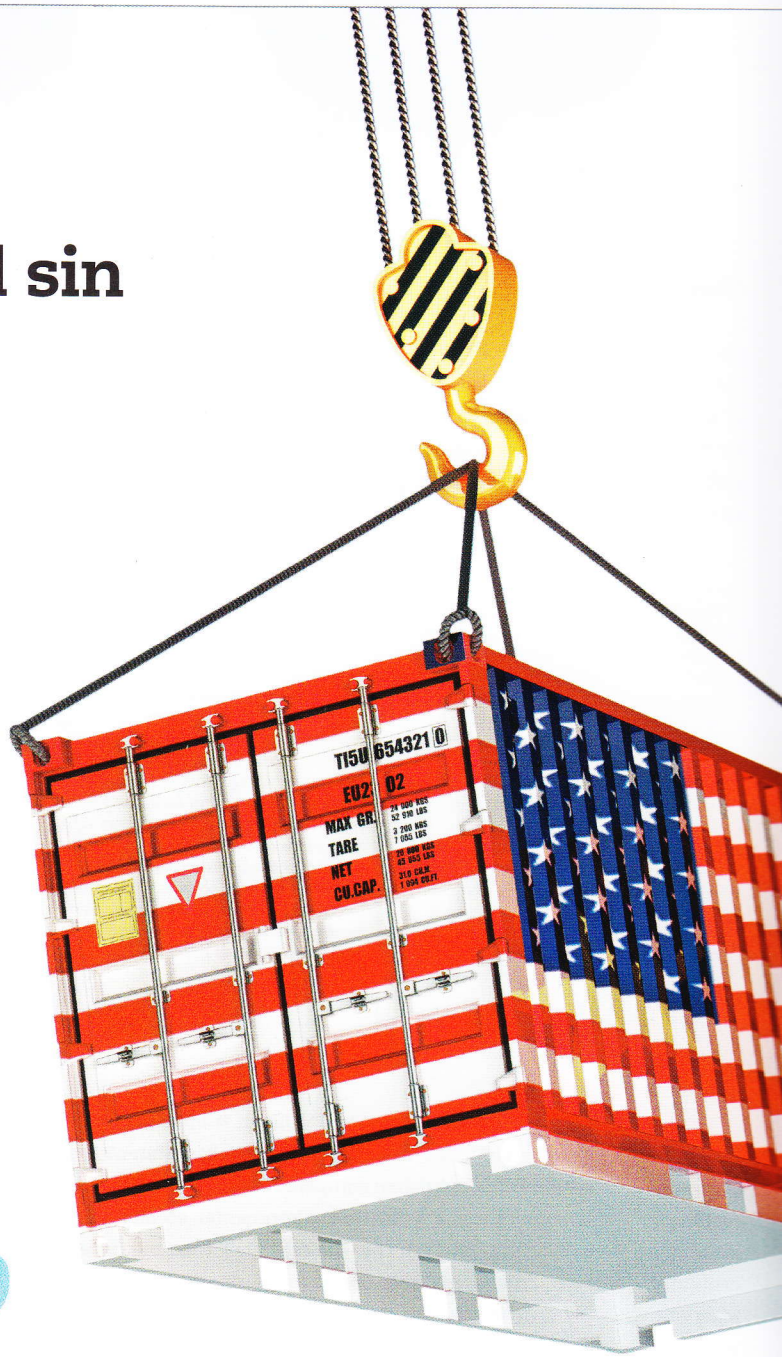
The original sin



The trade war with China has its roots in that country's manipulation of its currency, its original trade-related sin. On Dec. 11, 2001, China formally acceded to the World Trade Organization, and in the next year, 2002, the United States' trade deficit with China was "only" $103 billion. By 2017, however, that deficit had more than tripled to $375 billion. What was the problem that created the dreaded "China Price," typically 30 percent below the U.S. price for the comparable good, allowing China to undersell its American competitors? By 2002, it was clear to all that the primary engine of China's export explosion was its undervalued currency, the yuan. China was clearly manipulating its currency to obtain an unfair competitive advantage against the United States and other countries.

Currency manipulation was being accomplished through a state monopoly over foreign currency run by its State Administration of Foreign Exchange (SAFE). China required that foreign exchange proceeds be handled by SAFE, which resulted in the state's purchasing the foreign exchange earnings of firms at the established rate of 8.28 yuan to the dollar. SAFE continued to intervene in the forward exchange market by buying dollars with the yuan in order to bid up the price of the dollar and suppress the value of the yuan.

The question was not whether China was manipulating its currency but by how much. At the low end of the scale was the Goldman Sachs calculation, which estimated the undervaluation at 15 percent. The estimate by the Manufacturer's Alliance and Ernest Preeg was 40 percent. And the purchasing power parity scale represented by The Economist's Big Mac index (indicating what a Big Mac served by McDonald's would cost around the world) was 56 percent, about the same level as the World Bank estimate. According to *The Economist*, the yuan was the most undervalued currency in the world.

The loss of 2.2 million U.S. manufacturing jobs over the 32 months before 2003 was clear evidence of the burden this unfair trade practice was placing on U.S. commerce.

On Sept. 4, 2004, a group of associations and companies known as the China Currency Coalition filed a complaint against China's currency manipulation with the Office of the United States Trade Representative pursuant to Section 301 of the Trade Act of 1974. The purpose of a Section 301 complaint is to allow the U.S. government to unilaterally enforce its rights under trade agreements, and to counter the unfair acts, practices, or policies of foreign governments that burden U.S. commerce. The definition of unfair practices under Section 301 includes acts, practices, or policies of foreign governments that are unreasonable or discriminatory. So the legal issue in the 2004 Section 301 currency manipulation case was whether it was "unreasonable" for China to have a dramatically undervalued currency vis-a-vis the United States and to therefore be able to put pressure on one U.S. industry after another, including textiles, wood furniture, paper products, and metal parts.

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Section 301 is not the only provision applicable to currency manipulation. Article IV, Section 1(ii), of the Articles of the International Monetary Fund prohibits members from manipulating their currencies in order to gain an unfair competitive advantage in international commerce, and Article XV(4) of the General Agreement on Tariffs and Trade prohibits its signatories from manipulating currency in order to gain a competitive advantage in international trade.

Despite the compelling legal and economic case presented by the China Currency Coalition, the Office of the United States Trade Representative,

at the direction of President George W. Bush, summarily rejected this Section 301 petition within 45 minutes of its filing. This failure of the United States to counter the currency manipulation of China was the functional equivalent of waving the white flag of surrender on trade to China. It has led to the hollowing out of many of America's Rust Belt industries, and indirectly to the election of Donald Trump as president of the United States.

In the years following the rejection of the 2004 Section 301 complaint, China rode the back of an undervalued currency to the largest peacetime transfer of wealth in human history, from the United States to China. Since then, however, China's currency has appreciated. Today, the established yuan/dollar exchange rate is about 6.64 yuan to the dollar, an arguably fair exchange rate. The Section 301 train therefore has left the station with regard to the currency manipulation issue, and it would not be appropriate to retaliate against China now based on the grounds of currency manipulation. Section 301 remains in the U.S. toolbox, however, as an implement that can be used to counter other unfair trade practices by the government of China.

On June 20, 2018, President Trump's Office of the U.S. Trade Representative filed its own Section 301 action aimed at a bevy of Chinese practices related to technology transfer, intellectual property, and innovation. A trade value of $34 billion is covered by this proposed action, which calls for the imposition of an additional ad valorem duty of 25 percent on certain imported products from China. The stakes were raised exponentially on July 10, 2018, when President Trump announced tariffs of 10 percent on an additional $200 billion in Chinese exports to the United States.

The correct approach at this point is a two-track strategy, one relying on unilateral action through a Section 301 complaint based on the valid complaint against forced technology transfers and the theft of U.S. intellectual property, and a second track that would rely on engagement with China through the resurrection of the Trans-Pacific Partnership (TPP).

President Trump withdrew the United States from the TPP negotiations on Jan. 23, 2017. He correctly noted that the TPP was fatally flawed and should not have been approved in its current form. For starters, the agreement does not proscribe currency manipulation, which, as noted above, has been used by China to undermine the United States. In addition, it allows for self-certification of exporters. Thus, Vietnam, for example, could export products duty-free to the United States with 90 percent of the product being produced in China, which is not a TPP member. The TPP, as currently drafted, would actually expand the export possibilities for China into the U.S. market, in effect giving China duty-free treatment with no corresponding concessions on its side.

Fortunately, President Trump has instructed his trade advisors to consider conditions under which the United States can join the TPP.

The suggested two-track strategy, based on pressure and engagement with other nations, is the way to protect American interests and avoid future China trade wars.

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