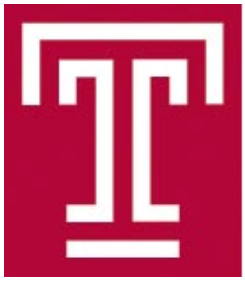

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The Political Economy of the Undervalued Renminbi

by

Ingrid H. Rima

Department of Economics

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The Political Economy of the Undervalued Renminbi

Ingrid H. Rima*

Abstract

A relatively new phase in China's reform since the Cultural Revolution is evidencing itself in the focus given to direct foreign and joint investment in large-scale manufacturing industries that yield increasing returns. The ongoing relative cheapness of the yuan at 6.78 to the dollar is assuredly enhancing the effectiveness of China's export program. The U. S. Congress maintains that a more expensive renminbi would ease the plight of the American manufacturing sector and laid-off workers. However, the argument of this paper is that the success of China's trade is not based on Ricardian comparative advantage. Its trade reforms are better explained in terms of increasing returns as set forth in Nicholas Kaldor's restatement of Verdoorn's Law and Adam Smith's "vent for surplus" principle. This analytical perspective seems particularly relevant, given contemporary political concern about the value of the yuan.

Given the attractiveness of China for direct foreign investment (DFI), what is the likely ultimate effect on the distribution of the world's wealth? It seems possible that trade can alter the distribution of the world's negotiable wealth in the twenty-first century in much the same way as the programs of the World Bank and the IMF enabled the OECD countries and the United States to control some 85 percent of the world's wealth in the twentieth century.

Key words: Cultural Revolution, direct foreign investment, export-led growth, trade reform, vent for surplus, Verdoorn's Law.

*The author is Professor of Economics at Temple U. Philadelphia, and Distinguished Fulbright Professor of Economics (2000-2001), Zhongshan University, Guangzhou, China

The Political Economy of the Undervalued Yuan (Renminbi)

China's central bank lifted its currency peg on the yuan, allowing it to rise to 6.78 against the dollar and 8.44 against the Euro, only a week before a meeting of the G20 in Toronto. Because her current account surplus had recently fallen, the loosening of the currency peg came as somewhat of a surprise to the G20.[1] However, the change was accompanied by a statement on the part of the China's central bank "that the basis for a large scale appreciation of the renminbi exchange rate does not exist". It is the purpose of this paper to clarify the basis for that position, and to put it into the context of the three broad objectives that continue to guide China's ongoing reforms since the Cultural Revolution (1966-76).

The first of these, which is to achieve status as a world class industrial power, has clearly been achieved. China is now in second place behind the U.S. in manufacturing for 2010, and expects to be the world leader in 2011.

Second, it needs to provide employment for its huge labor force;

Third, it has the goal of extending economic development into China's western provinces, which contribute only 15 percent of its gross domestic product (GDP).

In pursuing these goals, it is clear that China's government perceives that the correction of its sectoral imbalance is part of the larger problem of aggregate economic growth. While believing that the underdeveloped provinces of the West are not ready for private enterprise except on a small scale, small and mid-sized private enterprise firms are increasingly prevalent in the substantially developed provinces of the East and Southeast where large scale state enterprises previously dominated. State enterprises have largely been phased out at a human cost of high unemployment, especially in urban centers. China has undertaken major trade reforms with a view to achieving its objectives, which reflect a substantial about face since the end of the Cultural Revolution (1966-1976) from hostility to foreign trade and investment to participation in GATT (General Agreement on Tariffs and Trade) and the WTO (World Trade Organization) as part of the process of becoming market-oriented and privatized.

These institutional changes and China's participation in them signal recognition by the Chinese Communist Party that globalization is an irreversible trend, and that there are prospective gains to be realized from participation in a more liberalized trading system. Apart from the gains inherent in imports that enter China with lower duties or quantitative restrictions, the reciprocity of new trading agreements was expected to increase China's exports. One would have expected China to specialize in low value-added products. This would be consistent with David Ricardo's venerable principle of comparative advantage, as subsequently amended by the Heckscher-Ohlin factor content principle (Heckscher and Ohlin, 1991). Thus, one would expect China to export toys, shoes, apparel, and other low value-added products. What we would *not* expect is that China would shift its production to automobiles and other large scale increasing returns outputs intended for export. This is an outcome that is not explainable in terms of the Ricardo-Heckscher-Ohlin comparative advantage theory which is, at least implicitly, also encapsulated in the GATT and WTO trade agreements.

An Improved Theoretical Foundation for Explaining Trade

This paper will argue that China's trade reforms since the end of the Cultural Revolution can be more clearly linked to the theorizing of the late Cambridge scholar Nicholas Kaldor's recognition, predicated on Verdoorn's Law (1948), of the linkage between increasing returns, economic growth and trade. Verdoorn's Law hypothesizes that disparities in the rates of growth of productivity and output among different economies reflect differences in the relative importance of their industrial sector, which operates under conditions of increasing returns and their agricultural sector, which is subject to diminishing returns. The relevance of Verdoorn's Law to China stems from the productivity differences between its agricultural western provinces and the rapidly industrializing eastern and southeastern coastal provinces. Kaldor learned Verdoorn's Law from his Professor, Allyn Young, concerning the relationship between increasing

returns and economic progress. It was first presented in Italian (1949) and was subsequently overlooked until it was “rediscovered” by Nicholas Kaldor (1966) as part of his inquiry into the reasons for England's slow growth in the mid-twentieth century.Verdoorn's Law hypothesized a positive association between the growth of manufacturing productivity and output as a whole. The essential characteristic of the relationship is that a substantial part of productivity growth is endogenous to the growth process; that is, it is determined by the rate of expansion of output through the effect of economies of scale.

There have been various studies using cross-country data for a dozen advanced countries using early postwar and regional data for advanced and less-advanced countries, which supports the hypothesis that an increase in manufacturing ouput growth will generate a growth of employment. It is from these findings that Kaldor argued that increasing returns in the manufacturing sector of an economy facilitates it growth by enhancing its capacity to export its surplus output.[2] The historical basis for Kaldor's generalization is, in fact, implicit in Adam Smith's *The Wealth of Nations* as the vent for surplus principle. Verdoorn's law also reflects the relevance of Adam Smith's “division of labor” principle for export led growth. Smith's division of labor principle suggests that when a country is not yet developed, and the scope of its market extended, its surplus product may be traded abroad, generating gains to the home country in excess of the costs of producing them. Such gains from trade have enabled China to generate a growth rate that reached approximately 9 percent in the 1995-2010 period, while other Asian and European economies experienced lower or even no growth.[2] A review of China's trade reforms will make it clear why China's export capability is better explained in terms of Kaldor's restatement of Verdoorn's Law and Smith's vent for surplus theory than by Ricardo's comparative advantage theory. This explanation also helps clarify the basis for China's ongoing resistance to more than a small change in value of the renimbi.

The stages of China's move to the market

Decentralization and the dismantling of state enterprises

Chinese leaders from Sun Yat-sen to Mao Zedong deplored the adverse effect on its economy and culture of the forced opening of its markets to foreign imports after the Opium Wars. Its negative experience with foreign influences led the Chinese Communist Party view the role of foreign imports as having caused the destruction of its hand loom weaving industry. A substantial reduction of imports was therefore mandated, along with reform efforts to revitalize manufacturing industries. The 1978 Party plenum also gave formal recognition to private ownership in the form of uncodified worker or manager "collective" property rights in county or township enterprises. As late as 1993, the Party continued to reject out-and-out privatization, and favored public ownership.

Revival of manufacturing and access to foreign exchange

The sequence of reform envisioned by the Communist Party Plenum assembled in December 1978 was that agricultural reforms would take precedence, to be followed by the restructuring of low value-added manufacturing industries, such as apparel, shoes, toys, furniture, and household appliances, which were intended primarily for export. Without the need to restrain demand in its agricultural sector during the 1980s and early 1990s, there was no need to withdraw land and labor resources from agriculture to support manufacturing production and its related opportunities for skilled as well as technical professional and managerial labor. There was no inflation, which avoided the "shock therapy" that Central and Eastern European countries experienced in consequence of their reliance on reducing the money supply to constrain demand in the post-Soviet era that began with the "velvet revolution" of 1989. With ample food supplies available, most local labor could be allocated to manufacturing, which was planned, financed, and marketed by businessmen from Hong Kong and Taiwan. Their willingness to risk funds in China, given the limitations of its legal protections to business contracts, is no doubt attributable to the

relatively small size of these early loans, as well as to the short payback (often three years or less) that was arranged. In terms of the Ricardo-Heckscher-Ohlin "factor content" model of economic specialization, the production of low value-added manufactured goods is precisely the sector that economic theory predicts would expand in China. These manufacturing industries relied heavily on buying the inputs they required from abroad. This required the relaxation of import restrictions, which further reversed China's Cultural Revolution hostility against foreign trade, foreign technology, and foreign investment. Investors also encountered difficulty in making payments for imported inputs and for repatriating their profits because of the foreign exchange controls imposed throughout the 1980s by the Bank of China. These circumstances generated a trade deficit, along with the need for foreign exchange. These difficulties eventually led to the creation of foreign exchange adjustment centers where surplus foreign exchange could be sold at market-determined rates. By the late 1990s, Chinese nationals were permitted to legally retain shares of the foreign exchange they earned. Thus, China's foreign exchange market emerged more or less in tandem with trade reforms that were designed to encourage the production of tradable goods.

"Special" economic zones and direct foreign investment (DFI)

Foreign investment in the nineteenth century consisted, in the main, of the ownership of financial assets. Since World War II, however, it became apparent that there are advantages to encouraging foreign firms to make direct foreign investments (DFI). The foreign firms that are most attractive at present to the Chinese are bioengineering, electronic information, aviation, space flight, and new technology agriculture. These industries embody technological externalities that arise from high fixed costs in capital-intensive industries where efficiency gains are achieved at high levels of output. They also encourage more efficient work practices, which enable China to incorporate "best practice" methods, often more rapidly than many other developing countries.

Unlike the firms typical of small-scale production, China's special economic zones are predicated on “Fordist-type” production processes that generate increasing returns. The most unique production joint venture is between the Japanese firm Honda Motors and the Guangzhou Automobile Group, which is a state-owned enterprise (SOE) of the city of Guangzhou that has been in operation since July 1998. Japanese firms have had considerable success in transplanting J-type factories to China as well as Europe and the United States. The joint venture between Honda Motors of Japan and the Guangzhou SOE has been operating under a complex agreement with respect to the scale of output and the sharing of revenues.

The undertaking by Honda Motors in Guangzhou is aimed at reviving the “Japanese miracle”, which was the basis for Japan's success following post World War II in quite literally catapulting its post-feudal economy into a major industrial power in only a few decades. Japan's government agency The Ministry of Industry and Trade (MITI) subsidized numerous industries including steel, electronics, and automobiles to promote comparative advantages that either might never have developed at all under free market conditions, or that would have taken decades longer to accomplish.[5] By building on Japan's technical and management skill, China gave priority to producing manufactured goods for export, particularly to the United States and Europe. Exports have thus taken on an importance in China's economy that reflects a historical departure from that which prevailed during the Cultural Revolution (1966-76).

Because it has been fueled primarily by direct foreign and joint investments that financed increasing return industries along with low value-added goods, such as textiles, shoes, and toys, China's trade pattern is more weighted toward higher value-added products than would be predicted by conventional trade theory. China's export trade is also generating financial balances to a greater extent than imports of goods and services, so that its gains from trade have come chiefly in the form of greater employment and earnings, rather than from a larger volume and variety of goods. China is, in effect, practicing a new

form of mercantilism, which, like the mercantilism of the seventeenth century, has negative effects on its trading partners. Other DFI ventures are certain to follow.

DFI, Export Trade, and Monetary Policy

China's export trade has generated the funds required to meet the contractually established fees due the government of the city or province that is hosing them. DFI firms have generated a pool of investment funds far more reliable for financing growth than the savings emitted by Chinese expats (especially American Chinese) to their families on the mainland.

The value of the pool of funds earned via DFI is maintained by China’s fixed exchange rate regime. The currency was pegged to the U.S. dollar at 8.28 yuan in 1994 from which the rate was allowed to go to 6.78 yuan on June 11, 2010. With the decline in the value of the Euro, it may well be that China will leave the rate uncyhanged in the near future. It has been observed that “the obvious advantage of a fixed exchange rate is that there is one less uncertainty . . . that economic agents need to worry about when they undertake long-term contractual agreements” (Davidson, 1994, pp. 255-6). It does not, of course also follow, that given current U.S. Unemployment rates, that China will not experience political pressure to raise the value of the yuan still further. Unfortunately, it provides little or no help to America's industrial base, which has been shrinbking for the last four decades during which the U.S. Has experienced the dot-com revolution and the shift of its most talented young peiple into financial services and real estate.

China's reason for maintaining a stable value of the yuan was, and continues to be, to promote DFI and export trade with a view to stimulating employment without inflation while extending development into its western provinces and achieving status as a world-class industrial power. Maintaining the value of the yuan requires the purchase of dollars, which has required an ongoing increase in China's money supply. While its concern immediately after the Cultural Revolution was the possibility of deflation, contemporary concern, as is evidenced by the rise in required bank reserves from 6 to 7 percent, seems to

be the prospect of inflationary pressure in consequence of expanded bank lending. If China's future concern becomes the avoidance of inflation, it may allow the yuan to become more expensive relative to the dollar, which would compromise to some degree the aggregated demand stimulus derived from exports.[10] It is, however, unlikely that a more expensive yuan would significantly aid American manufacturing industries (as is urged by the Bush administration). While the cheapness of the yuan is exacerbating the problems of U.S. manufacturing industries, their causes are to be found in a host of complex globally operating influences that have generated structural changes in the U.S. economy that compromise the steady growth of U.S. aggregate demand.[11] China, on the other hand, has expanded its export industries via consistent capital investment financed by almost three decades of substantial DFI in increasing returns to scale industries.

The fact is that the "Japanese miracle", which started in post WWII when Japan's Ministry of Trade and Industry (MITI) subsidized heavy industry, has been transplanted to China as a joint venture. Japan's decade-long depression remains a drag on the economy. Japan's plague of excess capacity has not been reduced by an expanding export market in either the United States or Europe, and Japanese market expansion in China has been restricted by high tariffs on car imports. These factors were clearly a factor in Japan's Honda to participate in the first jointly owned and operated car plant in China dedicated to producing strictly for exports. Among the countries in Asia, China is now the leading DFI destination, topping the United States for the second year. Most people are surprised to learn that Cadillacs are now a major Chinese export.[4]

China's success at exporting outputs, combined with extensive regulation of imports, has led to current account surpluses that the U.S. attributes to an undervalued yuan. It has also been suggested that "economists are still some years from a sophisticated understanding of the factors responsible for China's recent growth" (Yusuf 1994). While not as yet explored in the literature, it is the view of this paper that the heart of a "more sophisticated understanding" is to be found in what economists know about both growth

theory and trade theory. The Chinese have a high propensity to save, but the needs of industry required an infusion of capital in excess of domestic savings and the remittances made by Chinese nationals working abroad. These were supplied primarily through DFI that embodied technological improvements, managerial and marketing practices, and promoted access to foreign exchange. These are factors the conventional theory of comparative cost, which is predicated on competitive markets and given technology and resources, is unable to accommodate.

Unlike the firms typical of small-scale production, China's special economic zones are predicated on "Fordist-type" production processes that generate increasing returns. China has and continues to show itself to be fully apprised of the relationship between increasing returns and economic progress that Nicholas Kaldor expressed in the empirical generalization known as Verdoom's Law, hypothesizing a positive association between the growth of manufacturing productivity and that of output as a whole. The essential characteristic of the relationship is that a substantial part of productivity growth is endogenous to growth process; that is, it is determined by the rate of expansion of output through the effect of economies of scale. Kaldor developed a technical progress function that is distinct from the conventional production function, in that the latter is unable to envision the growth process as characterized by cumulative causation.[8]

Concluding Thoughts

The focus of this paper has been on China's program since 1976 to build its export trade, and the substantial change of attitude that this reflects on China's part with respect to its historical hostility toward foreign trade and investment during the "Cultural Revolution." Export trade now reflects a new phase in China's reform toward a market economy via the encouragement being given to direct foreign and joint investment in large-scale manufacturing industries that yield increasing returns. The relative cheapness of the yuan is assuredly enhancing the effectiveness of China's export program, but it is not

the source of the overvaluation of the U.S. dollar that has, in fact, strengthened the profits of American multinationals located in Asia. The argument of this paper has been that, notwithstanding China's membership in the WTO, which is predicated on the assumption that trade is based primarily on simple comparative advantage, the effectiveness of its trade reforms are better explained in terms of increasing returns as set forth in Verdoorn's Law and Adam Smith's "vent for surplus" principle. This analytical perspective seems particularly relevant, given contemporary political concern about the value of the yuan.

The firms financed by DFI appear to be able to enjoy higher than average competitive profits. It would not be surprising if these higher profits become instrumental for the distribution of the world's wealth to Asia, specifically, as the 21st century evolves, much as the OECD countries came to control some 85 percent of the world's wealth during the 20th century. If my inference proves correct, then it may be concluded that there is a component of “new mercantilism” in China's export policy that looks toward trade as a vehicle for wealth creation. The central goal of mercantilism, whether we are talking about the 17th century or the 21st, is building a strong political state. This is different from the goal of maximizing consumers' standard of living that is implicit both in GATT and the WTO.

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NOTES

[1] At present a joint venture in Guangzhou with Honda is already producing some 60,000 vehicles for government and party officials. Honda's rivals are also expectged to engage in new production ventures with the Chinese, which represent a rapidly growing market in China as well as for export.

[2] In practice, the policy of reducing the money supply in the Eastern bloc countries is consistent with the IMF "tight money" prescription that favored stabilization over growth via control of the growth rate of the money supply. The IMF view is that its policy recommendations are consistent with the necessity of low inflation to facilitate the process of transition to a market economy. This policy is embedded in the Maastricht agreement on which the European Union is predicated.

[3] An accessible and comprehensive presentation by A. P. Thirlwall (1983a; 1983b) of Kaldor's approach to economic growth is available in the *Journal of Post Keynesian Economics*, which published a symposium on his growth laws to commemorate his 75th birthday.

[4] Much has been written about the sometimes doubtful reliability of China's industrial value-added statistics on the premise that the urgency of achieving growth targets may encourage falsification. Previous studies (Chow, 1986; Rawsky, 1976), however, conclude that Chinese data, especially since the 1990s, are generally reliable. This is consistent with the directive given by Prime Minister Zhu Rongji that statistics be “fast, clear, and accurate' (kuai, jing, zhun).

[5] Japanese market expansion in China has been restricted by high tariffs on car imports. With a view to circumventing these negatives, Honda Motors of Japan has undertaken the first jointly owned and operated car plant in China dedicated to producing strictly for exports. Most people are surprised to learn that Cadillacs are now a major chinese export.

[5] Such a change is, of course, not equivalent to allowing the yuan to "float." Some economists, Joseph Stiglitz among them, view China's banking system as too underdeveloped to cope with the volatility of a floating exchange rate, which, in his view, would "create imbalances." As an alternative, he suggested that China might consider linking the yuan to a "basket of currencies."

[6] Tom Palley offers an insightful inquiry into the reasons why long term aggregate demand may become reduced (2002).

[7]Export-led growth also served, beginning in the 1960s, as a vehicle favored by the World Bank and the International Monetary Fund (IMF) for encouraging the economic development of the "third world" economies of Asia, Africa, Central America, and the Caribbean area (Myint, 1963).

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to Chinese workers who had substantial experience working in large-scale manufacturing enterprises owned by the state (Perkins, 1994). The aggregate demand aspects of China's trade reform China's bid to achieve a positive impetus to employment and growth through a policy of export-led aggregate demand management revived the vent surplus approach to stimulating growth that was the basis for Japan's success in the post World War II years, quite literally catapulting its post-feudal economy into a major industrial power in only a few decades. Japan's government agency MITI subsidized numerous industries including steel, electronics, and automobiles to promote comparative advantages that either might never have developed at all under free market conditions, or that would have taken decades longer to accomplish. Export-led growth also served, beginning in the 1960s, as a vehicle favored by the World Bank and the International Monetary Fund (IMF) for encouraging the economic development of the "third world" economies of Asia, Africa, Central America, and the Caribbean area (Myint, 1963). The inference is that their experiences have been lessons for China. However, unlike these "plantation economies," China gave priority to producing manufactured goods for export, particularly to the United States and Europe. Exports have thus taken on an importance in China's economy that reflects a historical departure from that which prevailed during the Cultural Revolution (1966-76). Because it has been fueled primarily by direct foreign and joint invest- ments that financed increasing return industries along with low value- added goods, such as textiles, shoes, and toys, China's trade pattern is more weighted toward higher value-added products than would be predicted by conventional trade theory. China's export trade is also generat- ing financial balances to a greater extent than imports of goods and services, so that its gains from trade have come chiefly in the form of greater employment and earnings, rather than from a larger volume and variety of goods. China is, in effect, practicing a new form of mercantil- ism, which, like the mercantilism of the seventeenth century, has negative effects on its

trading partners; that is, it has contributed to the decline of the manufacturing industries of the United States, Canada, the United Kingdom, and Western Europe. However, unlike the mercantilists of the seventeenth century, who sought to accumulate gold, "new" mercantilism has, over time, led to the accumulation of a huge pool of foreign exchange reserves whose value has been pegged since 1994 by China's central bank through the Shanghai foreign exchange market at 8.28 yuan to the dollar. Part of its dollar reserve is invested in U.S. Treasury securities, which helps to hold down U.S. long-term interest rates by offsetting the shortage of savings in the United States. China's reason for maintaining a stable value of the yuan was, and continues to be, to promote DFI and export trade with a view to stimulating employment without inflation while extending development into its western provinces and achieving status as a world-class industrial power. Maintaining the value of the yuan requires the purchase of dollars, which has required an ongoing increase in China's money supply. While its concern immediately after the Cultural Revolution was the possibility of deflation, contemporary concern, as is evidenced by the rise in required bank reserves from 6 to 7 percent, seems to be the prospect of inflationary pressure in consequence of expanded bank lending. If China's future concern becomes the avoidance of inflation, it may allow the yuan to become more expensive relative to the dollar, which would compro- mise to some degree the aggregated demand stimulus derived from exports.[10] It is, however, unlikely that a more expensive yuan would significantly aid American manufacturing industries (as is urged by the Bush administration). While the cheapness of the yuan is exacerbating the problems of U.S. manufacturing industries, their causes are to be found in a host of complex globally operating influences that have generated structural changes in the U.S. economy that compromise the steady growth of U.S. aggregate demand.[11] China, on the other hand, has expanded its export industries via consistent capital investment financed by almost three decades of substantial DFI in increasing returns to scale industries.