

Taiwan and the Transformation of Asia-USA Economic Relationship: From the Triangular Trading Bloc to the Four-Corner Structure*

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The objective of this study is to elucidate Taiwan's significance during the different economic period in the region. The article is divided into four parts. The first section gives a brief explanation on the formation of the triangular trading bloc. The second section focuses on the production relations across the Taiwan Strait and the importance of Taiwanese firms in China's exporting sectors. The third section discusses the development of the "four-corner" relationships following Taiwan's massive investment in China. The final section draws the conclusion by putting the "four-corner" structure into the regional economic picture and point out the vulnerability of the "economic interdependence" between the US and East Asia.

I. Taiwan, Japan and the US in the 1970s and 1980s: the triangular trading bloc

Since the 1970s, Taiwan has proved itself to be successful in attracting a lot of FDI (Foreign Direct Investment). Although the KMT's encouragement of FDI was aimed at attracting foreign investors worldwide, these promotional measures attracted US and Japanese investors for the most part. Even though the overseas Chinese investment was also an important capital inflow to Taiwan during the 1970s, it was relatively small scale and had less of an "international business strategy". The arrival of US and Japanese FDI soon made Taiwan become involved in the competition between US and Japanese MNCs (Multinational Corporations) and

more importantly, the formation of the triangular trading bloc.

In Taiwan's trade balance sheet, the US and Japan played the most essential roles. Taiwan's export to the US as a percentage of its total exports increased from about 12% in 1960 to 38% in 1970. In the 1980s, the average exports to the US were 42% of Taiwan's total exports. Especially from 1984 to 1986, nearly half of Taiwan's exports aimed the American market. Concerning imports, the situation was reverse. From 1952 to 1970, Taiwan gradually enlarged its imports from Japan. In 1973, about 43% of Taiwan's imports came from Japan. In the 1980s, the average imports from Japan were almost 30% of Taiwan's total imports¹.

The reason for Taiwan's mounting trade deficit with Japan was the island's strong dependence on Japanese hi-tech imports. That import dependence could be attributed to the following factors. Firstly, because of Japanese strict control on their technology diffusion, instead of producing locally,

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¹ CEPD, *Taiwan Statistical Data Book 2004*, Table 11-9f and Table 11-9h.

the Taiwan-Japan contractual agreement always required the Taiwanese subcontractor to import lots of intermediate goods from Japan. Secondly, the productivity in Taiwan did not rise enough and the domestic industrial upgrade was not able to accompany the needs of exporting various high technology goods². In order to keep the high quality and different kinds of product requests from all over the world, Taiwan's manufacturers became increasingly dependent on Japanese high-tech components.³ As a result, the island has always run a serious trade deficit with Japan. Although the imports of Japanese components allowed Taiwan to export more high technology products, the local producers on the island could hardly learn how to advance their technology level via "technical cooperation" with Japanese investors. Due to the contract restrictions, the technical bottleneck, and quality or price factors, Taiwan was not able to acquire substitutes from other countries or to produce locally. Because of the impossibility to produce the components locally, Japanese investment did not really enhance Taiwanese technological upgrade.

While Japanese MNCs strictly controlled the technology transfer to their Asian affiliates, the American MNCs tended to upgrade the technological level of the Asian affiliates in line with the US in order to reduce the dependence on sourcing Japanese-made components. When the technology in the Asian countries was good enough to compete with the Japanese component suppliers, the US MNCs began to acquire the components from their Asian production partners. In the 1970s, the US MNCs successfully sourced their essential components from other Asian countries by spreading the necessary technology to them⁴. In Taiwan's case, without incurring substantial costs, the American investment stimulated Taiwan's capability to produce manufactured products. Thanks to the reliability in delivery and flexible production, Taiwan's small and medium-size companies were especially favoured by the American buyers. As for the consumer goods,

American buyers not only placed the orders, but they also transferred the necessary technology to make sure the product respected quality standards. Furthermore, the US subsidiaries in electronic sectors on the island served as component suppliers to the parent companies in the US whilst Japanese investors only exported the final goods to a third market after assembling the goods on the island. The well established inter-firm relationship between the US and their Taiwanese partners also helped the US regain its dominant position in the global production of electronic and other high technology goods. Bringing together other subsidiaries to purchase raw materials or to sell intermediate goods across the region of Asia-Pacific, these MNCs brought Taiwan into their production network. However, as the US subsidiaries in Asia exported the final goods to the US much more than the US imported the components from them, America has run an immense trade deficit with the Asian nations, including Taiwan⁵.

In short, the different investment strategies largely contributed to Taiwan's special trade relationship with the US and Japan. While the US MNCs sourced components in the host country, the Japanese MNCs preferred to import components from Japan and assemble locally. As both American and Japanese MNCs aimed at exporting final goods to the US market, the increased demand for Japanese components led to a trade imbalance between Taiwan, Japan and the US. With the increase in exports to the US and imports from Japan, Taiwan obtained an enormous trade balance surplus with the US but had a large trade deficit with Japan. Consequently, there was a triangular structure between the US, Japan and Taiwan. However, as Taiwanese firms gradually lost their cost competitiveness as a result of the NT dollar's appreciation in the late 1980s and in order to keep their production competitiveness in the global market, they began to invest in low cost manufacturing sites, such as Southeast Asia and mainland China.

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² Hatch W. and Yamamura K., *Asia in Japan's Embrace: Building a Regional Production Alliance*, Cambridge University Press, 1996, p.30.

³ Taniura T., "The Industrialization of Taiwan: Introduction", in Taniura T. (ed.), *Taiwan's Industrialization: The Formation of International Processing Base of Operation*, 1992, translated from Japanese 1988 Edition, *Taiwan no Kogyoka*, p.13. (in Chinese)

⁴ Borrus M., "Left for Dead: Asian Production Networks and the Revival of US Electronics", BRIE, University of California, Berkeley, *Working Paper*, 100, 1997, pp.14-16.

⁵ Encarnation D.J., *Rivals Beyond Trade: America Versus Japan in Global Competition*, Cornell University Press, New York, 1992, p.180.

Table 1 : The Operational Profile of Taiwanese Firms in China in 2003 (%)

	Chemical Sector	Metal Sector	Electronic and Electric Sector	Plastic Sector	Total Sectors
Source of procurement from:					
Taiwan	3.97	35.03	45.70	49.99	39.37
TIEs in China	1.76	16.47	20.73	20.27	23.91
Non Taiwan-based companies in China	4.47	33.74	8.21	12.58	26.02
Other countries	89.80	14.77	25.35	17.16	10.70
Total	100	100	100	100	100
Foreign orders received by:					
Home Companies in Taiwan	55.42	62.32	77.77	78.19	68.32
Subsidiaries in China	44.58	33.84	18.54	20.93	27.72
Other Subsidiaries in Other regions	0	3.84	3.69	0.88	3.95
Total	100	100	100	100	100
Finished goods exported from:					
Home Companies in Taiwan	57.52	40.55	49.23	45.31	46.98
Subsidiaries in China	42.48	59.27	45.65	50.75	49.80
Other Subsidiaries in other Regions	0	0.18	5.12	3.94	3.22
Total	100	100	100	100	100

Source: Liu M-C, *The Investigation and Analysis on the Operation of Investing Business in the Mainland China*, Chung-Hua Institution for Economic Research, Commissioned by MOEA, December 2004, Figure 19, 21, 22, 23 and Table 6, pp.31-37, (in Chinese)

II. The formation of a new division of labour across the Strait

Since 1993, according to MOEA⁶, the geographic distribution of Taiwanese investment has significantly changed from Southeast Asia to China. The immediate consequence following Taiwan's massive investment in China is the formation of a new division of labour. The typical pattern of Taiwanese investment in China is to import the intermediate and capital goods from Taiwan and export finished goods to the developed countries, mainly to the US. This kind of production has become especially obvious after the mid-1990s. Because of that specific investment pattern, international trade between Taiwan and China gradually intensified. The MOEA survey in 2004 showed that in 2003, lots of the TIE's (Taiwan-Invested Enterprise) manufacturing procurement in China were purchased from either Taiwan (39.37%) or from the other TIEs on the mainland (23.91%). About 26% of manufacturing procurement was from other foreign companies in China and nearly 11% of it was from other countries (See Table 1, p. 3). The manufacturing procurement from Taiwan-based companies either in Taiwan or in China was especially prominent in the plastic, electronic and electric sectors. In the plastic sector, around 50% of the manufacturing procurement was from Taiwan and 20% was from the other TIEs in China. In the electronic and electric sectors, almost 46% of the manufacturing procurement was from Taiwan and 20.73% was from the TIEs in China. In the metal sector, the TIEs imported the raw materials and intermediate goods frequently from Taiwan (35.03%) or other foreign firms in China (33.74%). In the chemical sectors, the dependence on the procurement from Taiwan was less clear. Less than 4% was from Taiwan while nearly 90% of the procurement came from other countries.

The Cross-Strait production relationships resulted from Taiwanese investment shows the transfer of Taiwan's whole local production network from the island to the mainland. As the downstream suppliers of Taiwan also followed the upstream partners in investing in China, more and more TIEs purchased the intermediate goods directly on the mainland. In general, either imported from Taiwan or from other countries, the TIEs in China rarely

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purchase the production necessities from Chinese firms. In other words, most of the TIEs, in the plastic, electronic and electric sectors in particular, only moved their production facilities to China but the production links with foreign and other Taiwanese firms remained the same. Many TIEs in China have established manufacturing bases while the operation headquarters, the research departments, product design, marketing and finance remained in Taiwan. Table 1 reveals that around 68% of the foreign orders were received by the home companies in Taiwan and nearly 50% of the foreign sales were exported by the subsidiaries in China. This is the typical Taiwanese way of production: While the foreign orders are received mainly by the home companies on the island, the subsidiaries in China are responsible for the production and exportation⁷.

The TIEs' dependence on the procurement from Taiwan allowed the island to become one of the most important import sources for China. Meanwhile, in China's total export volume, the TIEs also play an important role. According to the *Top 100 Exporting Company in China* issued by the PRC's Ministry of Commerce in 2004, 53 out of the top 100 exporting companies come from foreign enterprises. Among the 53 foreign companies, 21 are Taiwan, 11 are American, 10 are Korean, 7 are Japanese, 2 are Dutch, 1 is German and 1 is Finnish⁸. In particular, Foxconn, the subsidiary of Hon-Hai Technology Group based in Taiwan, has been the leading exporting company in China, with the export value of US\$ 8.3 milliards in 2004. The second largest exporting company is Quanta Computer. It is also a Taiwanese company invested in China with the export value of US\$ 5.3 milliards in the same year⁹. Among 29 foreign firms on the

⁶ Ministry of Economic Affairs, ROC (Taiwan)

⁷ This particular production pattern has been confirmed by many economic experts and Taiwanese government, see for example, Tung C-Y, "Cross-Strait Economic Relations and Global Economic Division of Labor", *Paper for delivery to the CES Hong Kong Conference-the Integration of the Greater Chinese Economies: Causes, Consequences, and Implications*, June 26-28, 2002, p.14 and MOEA's Press Release concerning the *Report on Overseas Chinese & Foreign Investment, Outward Investment, Mainland China Investment* [2004], available at: <http://www.moeaic.gov.tw/system_external/ctrl?PRO=PrintFriendlyNews&id=114> (in Chinese).

⁸ *The Liberty Times*, 09 August, 2005, available at: <<http://www.libertytimes.com.tw/2005/new/avg/9/today-p4.htm>> (in Chinese); Also see Ministry of Commerce of PRC.

⁹ News from Department of Industrial Technology, MOEA, 04 Jan. 2006; FDI Statistics from *Invest in China*, Ministry of Commerce of the PRC, available at: <<http://www.fdi.gov.cn/main/indexen.htm>>.

mainland with an export value of more than US\$ 1 milliards in 2004, 14 are Taiwanese firms but most of them are registered in a third place like Western Samoa, British Virgin Islands, Cayman Islands and so on¹⁰. These large exports oriented TIEs but registered in third places make the official figures concerning Taiwan's investment in China too low. Concerning the export destination of TIEs in China, it is difficult to access. However, as the TIEs took a large portion of China's exports and the US was the main market for China's final goods, it is widely believed that the US is the chief market for the TIEs on the mainland¹¹.

III. The creation of the four-corner structure

Given the quick expansion of Taiwan's investment in China and the formation of a production network between the two sides of the Strait, the trade between Taiwan and China has become increasingly more intensified. Due to the ROC (Republic of China) government's restraints, most of Taiwan's trade with China was conducted via Hong Kong before 2001. In spite of the limit, the merchandise exchanges between the two nations were not effectively reduced. Since the early 1990s, Taiwan's degree of dependence on the Chinese markets for its exports has exceeded the MOEA's "warning line"¹². Imports from China have also progressively increased. Overall, according to MCA's (Mainland Affairs Council) estimates, Taiwan's exports to China increased from about US\$ 4 milliards in 1991 to US\$ 52 milliards in 2005, or roughly a 12-fold increase. During the same period, Taiwan's

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imports from China, though not as significant as its exports to China in absolute terms, have also largely increased. In 1991, its imports from China was US\$ 765.4 million but rose to nearly US\$ 20 milliards in 2005¹³.

Without considering the transit trade via Hong Kong, Taiwan's exports to the mainland in proportion to its total exports has risen dramatically from 0% in 1993 to 21.6% in 2005. For the imports, its ratio in Taiwan's total imports has also increased from 0.5% in 1990 to 11% in 2005 (See Table 2, p.7). The dramatic increases in Taiwan's trade with China also lead to a transformation in Taiwan's trade relationship with other countries. The significance of Hong Kong as an essential export market for Taiwan lessened. Taiwan's exports to Hong Kong accounted for 23% of its total exports in 1995 but it decreased to 16% in 2005. Imports from Hong Kong have made up a large share of Taiwan's total imports, yet, it is a declining trend. The intensified trade relationship between Taiwan and China not only diminished the significant role of Hong Kong as an important transit spot but also weakened Taiwan's trade dependence on the US. Both Taiwan's exports and imports to and from the US decreased after 1990. Since 2003, China has already replaced the US as Taiwan's top trading partner. In 2005, the US market only took 15% of

Taiwan's total exports while Taiwan's imports from the US also fell to 11.6% of total imports. Exports to Japan decreased from 12.4% in 1990 to 7.6% of Taiwan's total exports in 2005 even though Japan has never been an important export market for the island. Nevertheless, imports from Japan have still remained relatively important. From 1990 to 2005, around 24% to 30% of Taiwan's total imports still came from Japan. The main reason for Taiwan's continuing import dependence on Japan is the "technology gap" between these two countries. Japanese manufacturers only transferred the technology to Taiwan that they considered no longer competitive for domestic production or did not meet with their cost benefit effectiveness¹⁴. Meanwhile, Taiwanese producers only "learned" from Japan but they were not able to "innovate"¹⁵. Although Taiwan has successfully moved up into

¹⁰ Except for Foxconn and Quanta Computer, the other significant exporting companies from Taiwan are the subsidiaries of ASUSTek Computer Inc., Compal Electronics, BenQ, MITAC, INVENTEC, AUO, LITEON and Micro-Star Internal in China. News from Department of Industrial Technology, MOEA, 04 Jan. 2006; FDI Statistics from *Invest in China*, Ministry of Commerce of the PRC.

¹¹ For example Tung pointed out that around one-fifth of Chinese exports to the US were actually produced by Taiwanese companies, see Tung C-Y, 2002, op.cit., p.26 and according to *Business Week's* report, about 40%-80% of China's exports in information and communications hardware are actually made in Taiwanese-owned factories, see *Business Week*, "Why Taiwan matters", 16/05/2005, available at: <http://www.businessweek.com/magazine/content/05_20/b3933011.htm>.

¹² Chen Ezra N. H., "The Economic Integration of Taiwan and China and Its Implications for Cross-Straight Relations", Weatherhead Centre for International Affairs, Harvard University, *Fellow's Paper*, 2003, p.24, available at: <<http://www.wcfia.harvard.edu/fellows/papers/2002-03/index.htm>>.

¹³ MAC, *Cross-Strait Economic Statistics Monthly*, No. 169, Table 6, p.26.

¹⁴ *United Daily News*, 20 Nov. 1999, the 20th page (in Chinese).

¹⁵ Vincent Wei-cheng Wang, "Developing the Information Industry in Taiwan: Entrepreneurial State, Guerrilla Capitalists, and Accommodative Technologists," *Pacific Affairs*, Vol. 68, No. 4, 1995, p.576

the regional “technological ladder”, thanks to Taiwanese firms’ manufacturing flexibility that fit the needs of foreign MNCs, Japan’s continuing technology upgrading and strict control of essential technology transfer made Taiwan deepen its technology intensive imports from Japan¹⁶.

From the above interpretation, we find that the original triangular trade relationship between Taiwan, Japan and the US is transforming into a “four-corner” trade relationship between Taiwan, Japan, the US and China (See Figure 1, p.8). Even though China is now Taiwan’s top trading partner, a considerable proportion of exports from Taiwan to the mainland are used in goods that are ultimately needed by US firms or in the hands of US consumers. Therefore, Taiwan’s exports to the US are as significant as ever but via China as a processing site. The lesser changed imports from Japan indicates that Taiwan still depends on Japanese imports. While Taiwan depends on exporting the intermediate goods to China for its trade surplus, it still needs Japanese high technology and capital intensive imports and the final goods produced by the TIEs on the mainland go to the American market. In other words, the original production network in the region has not changed. China has only followed the same export-led economic growth as Japan and NICs experienced and inserted itself into the regional production network. However, the enlarged production network is accompanied by the increasing US trade deficit problem.

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IV. After the “four-corner” relationship: American trade deficit with China

Like Japan and the NIC’s (Newly Industrializing Country) export-led development process before, China has replaced them to become a new and large

production base. Indeed, it is often said that China is like the combined export force of Japan and NICs and the US is still the key market. It meant that various exports that used to be made in Japan and NICs are now produced in China.

The mounting imports from China allowed China to overtake the other Asian countries and become the largest import source in Asia for the US. On the world level, imports from the PRC bypassed that of Japan in 2002 and Mexico in 2003 as the second largest import origin for the US. Until 2005, China’s

exports to the US are still behind Canada and the EU countries but its exports are increasing at a more rapid rate. In 2005, the US trade deficit with China constituted 26% of its total trade deficit¹⁷.

The US policies towards China to reduce its trade deficit include three principal means: anti-dumping measures, protection of intellectual property rights and the appreciation of RMB¹⁸. The implementation of these policies is based on the idea that foreign trade barriers against American-made products and the undervalued RMB relative to US dollar are the main causes of the trade deficits. However, the consequence of these policies seems quite limited. As for the RMB appreciation, the PRC adjusted its currency from 8.28 to 8.11 to one dollar in 2005, about 2.1% of appreciation rate. Afterwards, China has continued to allow the RMB’s appreciation but very slowly. However, the US trade deficit with China still increased from about US\$ 202 milliards in 2005 to US\$ 256 milliards in 2007¹⁹. The reasons for not to obtaining the expected result is that these measures did not “suit the remedy to the case”. Instead of blaming foreign trade barriers, we think the explanations below could better clarify the causes of the US trade deficit.

¹⁶ For example, when Taiwan became the key CD-ROM drive producer in the world, the most important element inside the CD-ROM drive, the magnetic head, was still imported from Japan. When Taiwan was able to make the magnetic head by itself, Japan has begun to produce another more advanced CD-ROM drive, a readable and writable one. Therefore, every time Taiwan reaches some technological advancement, Japan has already upgraded its technology further. In other words, the technology gap between Taiwan and Japan does not diminish even though Taiwan also tries to upgrade its technology. Japanese technological innovation is always ahead of Taiwan. And in order to produce “high technology products” to meet the global market needs, the island cannot break it away from importing Japanese high technology. Kung Ming-Hsin, “To Take the Lead on High Technology is the Prerequisite for the Cross-Strait Cooperation”, Discussion Papers in Taiwan ThinkTank, 2003, available at : < http://www.taiwanthinktank.org/tt/servlet/OpenBlock?Template=Article&category_id=17&article_id=172&lan=tc >. (in Chinese)

¹⁷ Lum T. and Nanto D.K., “China’s Trade with the United States and the World”, *CRS Report for Congress*, Order Code RL31403, 4 January, 2007, pp.6-7, downloadable from the website:

< <http://italy.usembassy.gov/pdf/other/RL31403.pdf> >.

¹⁸ Renminbi (RMB), the currency of People’s Republic of China.

¹⁹ US Census Bureau, *Foreign Trade and Statistics*, website: < <http://www.census.gov/foreign-trade/balance/c5700.html> >.

Table 2 : Taiwan's Trade with its Major Commercial Partners as Percentage of the Total Trade

	Taiwan's trade with China ¹		Taiwan's trade with Hong Kong		Taiwan's trade with the US		Taiwan's trade with Japan	
	Exports to China	Imports from China	Exports to HK	Imports from HK	Exports to the US	Imports from the US	Exports to Japan	Imports from Japan
1990	-	-	12.7	2.7	32.4	23.0	12.4	29.2
1991	0	0.5	16.3	3.1	29.3	22.4	12.1	30.0
1992	0	1.0	18.9	2.5	28.9	21.9	10.9	30.2
1993	0	1.3	21.7	2.2	27.7	21.7	10.6	30.1
1994	0.1	2.2	22.9	1.8	26.2	21.1	11.0	29.0
1995	0.3	3.0	23.4	1.8	23.7	20.1	11.8	29.2
1996	0.5	3.0	23.1	1.7	23.2	19.5	11.8	26.9
1997	0.5	3.4	23.5	1.7	24.2	20.3	9.6	25.4
1998	0.8	3.9	22.4	1.9	26.6	18.8	8.4	25.8
1999	2.1	4.1	21.4	1.9	25.4	17.8	9.8	27.6
2000	2.8	4.4	21.1	1.6	23.5	17.9	11.2	27.5
2001	3.9	5.5	21.9	1.7	22.5	17.0	10.4	24.1
2002	7.6	7.1	23.6	1.5	20.5	16.1	9.2	24.2
2003	14.9	8.6	19.7	1.4	18.0	13.2	8.3	25.6
2004	19.5	9.9	17.1	1.2	16.2	12.9	7.6	26.0
2005	21.6	11.0	16.2	1.0	15.1	11.6	7.6	25.3

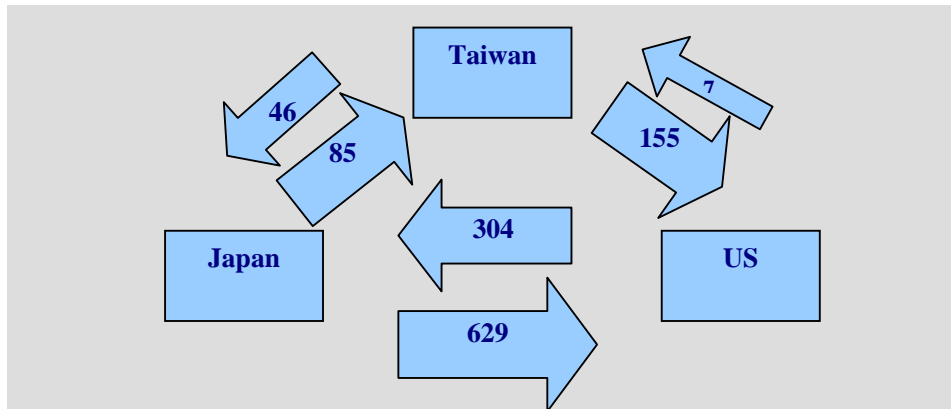
Source: CEPD, *Taiwan Statistical Data Book 2006*, Table 11-9f and Table 11-9h, pp.223-226; MAC, *Cross-Strait Economic Statistics Monthly*, No. 169, Table 8.

Note: 1. Taiwan's trade with China excludes the indirect trade via Hong Kong.

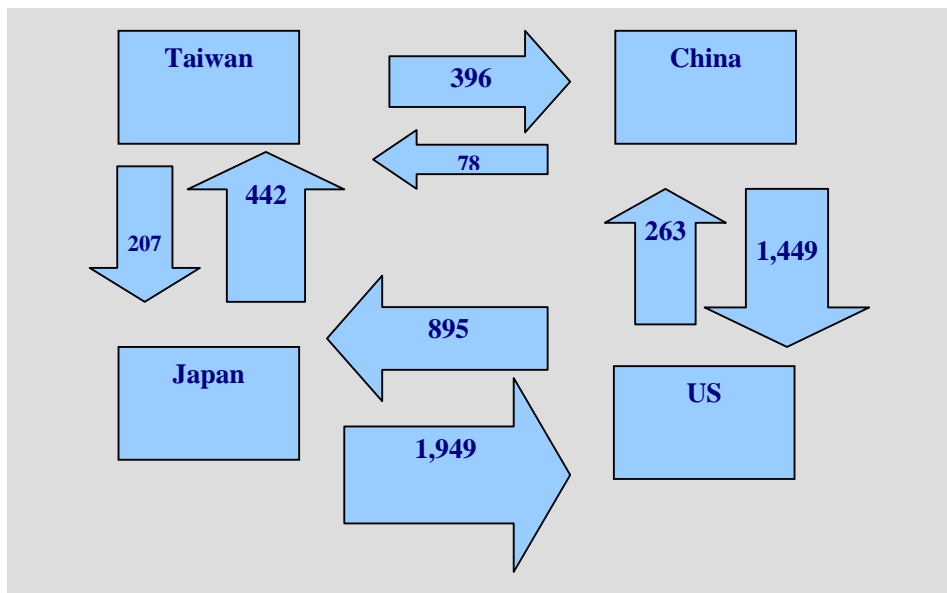
Figure 1

The Transformation of Taiwan's Trade Relationship with its Major Partners

Triangular Trade Relationship in the 1980s



Four-Corner Trade Relationship after the 1990s



Source: IMF, *Direction of Trade Statistics Yearbook and Taiwan Statistical Data Book*, various years.

Note: 1. The amounts indicated are the total value in the 1980s and from 1990 to 2005 in \$US millions.

2. The trade amounts between Taiwan and China are recorded after 1991.

Firstly, it is widely said that the major cause of American trade deficit is the insufficient saving and excessive investment in the US. The US does not save enough to finance its domestic investment. Hence, instead of adjusting the exchange rate, increasing the saving and investment rates are considered as more important solutions to change the trade deficit situation²⁰. Secondly, some have reasoned that the US trade deficit was a result of sluggish export demand, especially after the Asian financial crisis of 1997. The economic slowdown in many Asian countries, except for China, made them unable to absorb many American exports. The Asian financial crisis and the IMF's strict economic adjustment measures that followed led to a reduction in US exports to Asian nations²¹. Although China suffered less from the 1997 financial crisis, its relative low GDP per capita limited the domestic consumption of foreign goods. Therefore, in addition to increased US imports, the inability of America's trade partners to absorb US exports is also quite essential in explaining the increasing US trade deficit. The third reason for the continued trade deficit is America's excessive demand of labour-intensive and consumer goods from China²². In fact, America's excessive demand of consumer goods from other countries had already started in the 1970s which implied the loss of competitiveness for certain US-made products in the international market. Since China has acted as the "world factory", the US trade deficit problem with the rest of the world inevitably transferred to China for the most part. The US MNCs' outward investment and the re-exported goods from host countries to the American market have been the main cause of the US trade deficit. In addition, the weaker structural elasticity of exports than that of imports has made the US balance of payment even worse²³.

The fundamental problem today is not simply the mounting US trade deficit with China but how the US trade deficit can be sustained in the long run?

To sum up, the US trade deficit problem is not simply a US-PRC bilateral commercial imbalance, but rather, it is a commercial imbalance between the US and the whole East Asia region. China's economic opening up has enlarged the original regional production network but it did not change the Asia-USA commercial relationship. As already mentioned, China is used as a processing base for many Asian export oriented MNCs. Hence, the original US-Asia supply and demand relationship that caused the American trade deficit still remains the same. The only thing that changed is the trade deficit changed from with Japan and the NICs to with China. Therefore, the fundamental problem today is not simply the mounting US trade deficit with China but how the US trade deficit can be sustained in the long run? The economic interdependent framework between the US and East

Asian countries (particularly the NIC, Japan and China) is the following: while the US allows Asian countries to export the goods to the American market, most of the Asian foreign exchange reserves are used to purchase US Treasury securities. Without the Asian nations' large purchases of US Treasury securities, it is hard to imagine how the US could fund its federal budget deficit. But the stability

of the US dollar as an international currency is doubtful. Actually, the US government has already confronted a difficulty with the rising US trade deficit. The international investors will tire of financing the US deficit as they have their own investment interests and strategies. Instead of continuing to buy US Treasury securities, some Asian central banks also began to diversify their foreign exchange holdings²⁴. In order to keep their product competitiveness, the Asian countries are unwilling to appreciate their national currency to finance the US deficit. As a result, the interdependent framework between the US and Asian countries has its limit²⁵. Furthermore, unlike the other Asian economies, China may be less willing to buy American Treasury securities via its enormous foreign exchange reserves. The main reason for this way of thinking is that China today shows more ambitions to strengthen its economic and political force in the world. The long-standing Sino-US rivalry puts China's willingness to finance the American deficit into question. If and when the

²⁰ Griswold D.T., "The Causes and Consequences of the US Trade Deficit", *Congressional Testimony before the Senate Finance Committee*, Washington, D.C., 11 June, 1998, available at: <<http://www.cato.org/testimony/ct-dg061198.html>>.

²¹ Blecker R.A., "The Causes of the U.S. Trade Deficit", *Statement before the Trade Deficit Review Commission*, Washington, D.C., August 1999, pp.11-12, downloadable from the website: <<http://nw08.american.edu/~blecker/policy/TradeDeficitStatement.pdf>>.

²² Lum T. and Nanto D.K., op.cit., 2007, pp.21-22.

²³ Vanel G., "L'économie politique de l'étalon dollar : les Etats-Unis et le nouveau régime financier international", Thèse de Doctorat en Economie Internationale, Université Pierre Mendès France, Grenoble, 2005, p.258.

²⁴ "Greenspan Says Dollar Drop May Reflect Falling US Debt Demand", *Bloomberg News*, available at the website: <<http://www.bloomberg.com/apps/news?pid=20601103&sid=aM8c5RLytlit&refer=news>>.

²⁵ Vanel G., op.cit., 2005, pp.287-296

investors decide to abandon the US dollar, a large financial crisis will surely be unavoidable.

The growing US trade deficit also raises an important question: Will that trade deficit jeopardize the American economic dominance in the world? History tells us that when hegemonic state passes from a net creditor to a net debtor, its dominance in the world might soon decline. Like the UK in the 19th century, Sterling was the most used foreign currency in international trade and main foreign exchange reserve for many holding countries. Its export value was also much more than its imports. However, this dominant position was changed when the UK began to borrow from the US to fight WWI. The US dollar then emerged gradually as a major international currency. The decline in the pound not only led to the loss of British economic dominance but also its military power in the world. Some think that the US today, with the increasing trade deficit, will probably go down the same path as the British Empire did before²⁶. The principal international political economy theories, including Marxist, Realist and Liberalist perspectives, also show an unavoidable decline of a hegemony or a fight for a dominant power between nations when a hegemonic state is no longer strong enough to hold on to its position. Once the US-led economic system collapses, a serious financial crisis that followed will unavoidably lead to a hegemon's crisis in the near future.

²⁶ Frankel J., "Could the Twin Deficits Jeopardize US Hegemony", *Journal of Policy Modeling*, Vol.28, 2006, pp.661-662.

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