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Trade rift awaits Obama in China

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Recent trade spats and charges of protectionism threaten to undermine what has evolved over the past two decades into the most important bilateral economic partnership in the world, many economists say.

The tit-for-tat trade battle between the United States and China, where President Obama arrives Sunday, has involved Chinese tires, coated paper and steel pipe imported into the U.S. and American exports of poultry, autos and auto parts to China.

China exported nearly \$338 billion worth of merchandise to the United States last year, dwarfing the \$71 billion worth of U.S. goods China imported.

America's seemingly insatiable appetite for goods imported from China has been instrumental in fueling China's soaring economic growth rates, which have hovered in the double-digits for decades. At the same time, China's prodigious savings and the recycling of its surging trade surpluses have been indispensable in financing the U.S. government's exploding budget deficits.

"China is definitely [America's] most important bilateral economic partner, because of China's growing role in the world economy and its Asian neighborhood, which is the most dynamic region in the world," said Steven Schrage, an economic specialist at the Center for Strategic and International Studies.

Eswar Prasad, a Cornell University economist and senior fellow at the Brookings Institution, thinks "the bargaining strengths of the two countries are finely balanced." But he agrees the stakes are high. He fears "a dangerous game of chicken that could easily spin out of control if the desire to pander to domestic audiences trumps rational collective policymaking in one or both countries."

The magnitude of the U.S.-Chinese economic relationship is stunning.

During the last 10 years, China has racked up an estimated \$1.7 trillion in cumulative trade surpluses with the United States. China's investment in U.S. Treasury securities has skyrocketed from \$60 billion at the end of 2000 to \$800 billion in August, making it the biggest foreign holder of U.S. government debt in the world. China also holds more than \$400 billion of U.S. agency debt, including securities issued by Fannie Mae and Freddie Mac, which are now effectively guaranteed by the U.S. government.

This symbiotic relationship produced the massive global imbalances that many analysts blame for igniting the worst financial crisis and deepest global recession since the Great Depression.

The fallout from the worldwide economic downturn devastated global trade, which reportedly cost China 20 million manufacturing jobs and has produced a double-digit unemployment rate in the United States for the first time in more than a quarter-century. In the wake of the global upheaval, accusations of trade protectionism and currency manipulation have proliferated around the world.

China charged that Mr. Obama's September decision to slap a 35 percent tariff on imported Chinese tires represented "a serious case of trade protectionism." China responded by filing a complaint with the World Trade Organization and opening dumping investigations of U.S. exports of chicken and auto parts.

After the U.S. decision this month to levy duties on steel pipe from China, the Chinese Ministry of Commerce ratcheted up the rhetoric, accusing America of "abusive protectionism" that has been "rarely seen in history."

Imposing the tariff on tires was a "purely political" decision by President Obama, who was "looking to pick a fight with China over trade to satisfy the labor unions," said Daniel Griswold, a trade specialist at the libertarian Cato Institute, who regards the U.S.-Chinese trade relationship as "mutually beneficial." American consumers benefit from China's low-cost goods, and Chinese savings help to keep U.S. interest rates down and prevent federal borrowing from crowding out private investment, Mr. Griswold said.

Not everyone is so sanguine about the bilateral trade relationship.

"China's leaders have shown absolutely no interest in working cooperatively with the United States to significantly reduce trade and investment surpluses that helped trigger the global economic crisis and that still endanger the world economy," said Alan Tonelson, an analyst at the U.S. Business and Industry Council, which represents small and medium-sized domestic manufacturers. "Therefore, the time for talking trade with Beijing is over. President Obama

needs to show real leadership, use America's still-decisive market power and act unilaterally to rebalance bilateral trade flows."

It is unlikely the two nations will resolve their trade disputes during this week's visit, said Gary Clyde Hufbauer, a senior fellow at the Peterson Institute for International Economics. He described the simmering trade disputes as a way for both sides to "let off some steam" while they concentrate on "managing the big picture."

Many economists consider the value of China's currency to be part of the big picture. "If you don't address the currency issue, you cannot resolve the global imbalances," said Mr. Schrage of the CSIS.

During his presidential campaign, Mr. Obama repeatedly accused China of manipulating its currency by keeping it undervalued in order to fuel its exports to the United States and limit its imports of American products. During his confirmation hearings, Treasury Secretary Timothy F. Geithner told the Senate Finance Committee, in writing, that "President Obama - backed by the conclusions of a broad range of economists - believes China is manipulating its currency."

However, Treasury declined to name China as a currency manipulator in its April and October reports to Congress. Nevertheless, many business leaders, economists and members of Congress continue to level the charge.

After appreciating about 20 percent between July 2005 and July 2008, China's currency, the yuan, has remained fixed at 6.83 to the dollar.

"If China is supposedly on top of the world, growing by 10 percent a year, then why must they infuriate the rest of the world by pegging their currency to the dollar?" asks David Smick, an international economics consultant who questions the reliability of Chinese statistics. "The reason is that they are not really that confident about their recovery."

In order for China to balance its trade with the United States and the world, the yuan would have to appreciate by an additional 40 percent, said Peter Morici, a business professor at the University of Maryland who served as chief economist of the U.S. International Trade Commission.

Mr. Morici discounted China's recent announcement that it would consider other currencies in addition to the dollar in guiding its exchange rate, a signal that some interpreted as a prelude to yuan appreciation.

Such talk is intended to "confuse the issue before Obama arrives," Mr. Morici said. "China has concluded that Obama will remain a good supplicant as long as China uses its dollars to buy Treasury debt to enable Obama to expand the government," Mr. Morici said. "Therefore, Obama will continue to kowtow."

Mr. Hufbauer, who believes the yuan is undervalued by 20 percent, said there will be "no big step" for revaluation at the meetings in China. Instead, he expects the yuan to appreciate gradually.

"Hopes for a meaningful move up by China's dramatically undervalued yuan are misplaced," said Mr. Tonelson, of the U.S. Business and Industry Council. "The yuan's artificially low value is key to maximizing China's exports, and maximum exports are key to keeping Chinese workers employed rather than rioting in the streets."

Mr. Griswold of Cato disagreed. "Currency appreciation is no magic bullet that will solve these problems," he said. The U.S. trade deficit with China is rooted in savings and investment differences, he said.

"We overconsume. They oversave," Mr. Griswold said. "Americans, starting with the federal government, need to save more and consume less."

Meanwhile, China has its own worries about the value of the dollar, which since early 2002 has depreciated about 22 percent against a trade-weighted basket of currencies. The dollar has plunged by about 12 percent since March alone. As China accumulates more and more dollars as a result of its massive trade surpluses with the United States, the purchasing power of those dollars around the world has been declining.

China now holds \$2.2 trillion in foreign-exchange reserves, 70 percent of which are estimated to be invested in dollar-denominated assets. Chinese officials have repeatedly expressed concern about America's soaring budget deficits, which they have helped to finance, and the deficits' potential to cause a collapse in the value of the dollar.

"We have lent a huge amount of money to the U.S.," Chinese Prime Minister Wen Jiabao said in March. "Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried."

Also in March, Zhou Xiaochuan, the head of China's central bank, delivered a speech suggesting the dollar be replaced as the world's reserve currency, a theme the Chinese have since repeated.

These are the big stakes involved in the U.S.-Chinese bilateral economic relationship.

The simmering trade disputes over tires and chickens are "a sideshow to a larger, multilevel chess match, in which both sides need to cooperate to find common moves for both economies," said Mr. Smick.

He was not optimistic.

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