Perspective
Published March 20, 2010

Time to cool China, US tempers

A failure may result in another economic recession, and perhaps even a new cold war, from which no side would be able to decouple

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MEMBERS of a bipartisan coalition of US lawmakers are accusing the Chinese of a plot to manipulate the value of its currency in order to boost its exports and make American imports harder to sell in China.

NATIONAL INTERESTS
A Chinese refusal to revalue its currency is bound to bring about retaliatory action by Washington and ignite a destructive economic war between the two nations

And the lawmakers have introduced legislation that would force the US Treasury to impose stiff penalties against China and other countries that are engaged in such unfair currency manipulation.

In the House of Representatives 130 members of the House of Representatives signed a letter protesting China's manipulation of its currency while in the Senate, a group of 14 Democrats and Republicans are pressing the Obama Administration to act against the Chinese.

The senators, led by liberal Democrat Charles Schumer from New York and conservative Republican Lindsey Graham from South Carolina, are arguing that past US administrations, worried about the rising economic power of China, had refrained from identifying Beijing as a 'currency manipulator' which would then have required Washington to impose duties on Chinese imports. But with unemployment rate remaining high and as the US trade deficit with China - its second largest trading partner - keeps growing, American lawmakers are responding to public anger by blaming China for using its currency to gain a trade advantage.

The senators want to ensure that the US Treasury's semi-annual report on foreign exchange rate practices that is scheduled to be released next month will, indeed, label China as a 'currency manipulator' and force the administration to come up with 'remedial' legislation that would supposedly compel China to revalue its currency.

Their Bill - 'Currency Exchange Rate Oversight Act' - was introduced following a war of words between the US and China in recent days over the allegedly misaligned Chinese

The global financial imbalances between the US and China helped to create the conditions for the financial meltdown. And unless the two sides take steps to deal with these imbalances, the global financial system could experience more disasters in the future.

currency, the yuan, as well as other policy issues, including the meeting between President Barack Obama and the Dalai Lama at the White House, the US decision to sell arms to Taiwan as well as complaints from American companies about Chinese trade practices and Sino-American disagreements over climate change.

And while the American economy has just started recovering from a painful recession and is showing some growth, the World Bank this week has upped its forecast for China's 2010 GDP growth to 9.5 per cent after it grew at 8.7 per cent last year.

American lawmakers say that some of this impressive export driven economic growth has been achieved in part through Chinese currency manipulation.

The Chinese policies amount to 'cheating', according to Democratic Senator Debbie Stabenow which represents Michigan, a state whose manufacturing sector, including a struggling car industry, has been devastated by the Great Recession and where the official unemployment rate is around 15 per cent (and among African-Americans, close to 50 per cent).

She and her colleagues are complaining that the Chinese government is essentially subsidising its exports by keeping its currency value low and want Washington to stop talking and to finally walk the walk. The Obama Administration needs to pull 'the trigger on (currency) manipulation, explains Mr Graham, whose own state of South Carolina has been experiencing an unemployment rate of more than 13 per cent.

He told reporters that 'we're all living in fear of what China might do' since 'we borrow way too much money from them', adding that 'we need to break that fear and do what's right'.

China has approximately US$2.4 trillion of accumulated foreign reserves which explains why many economists believe that the yuan is undervalued as a result of a calculated policy pursued by China's financial authorities. They buy US dollars and sell their own yuan, a policy that helps to keep the greenback's exchange rate fixed to their own currency. The result is a distortion of trade flows - cheap Chinese exports to the US continue while imports from the US into China remain expensive.

But since the Chinese do not allow their currency to float freely, the same economists also disagree over the degree to which the Chinese undervalue their currency. Economists also differ in estimating the extent to which the appreciation of the Chinese currency will lead to the narrowing of the US trade deficit with China. After all, reducing that deficit seems to be the main rationale for the proposed legislation on Capitol Hill.

In fact, according to the Cato Institute's trade analyst Dan Ikenson, from 2005 to 2008, at a time when the yuan was appreciating against the US dollar, the US trade deficit with China actually increased from US$202 billion to US$268 billion. Thus, the think tank's analyst suggests, the level of the US deficit is determined by many factors other than just the value of the Chinese currency.

For example, Mr Ikenson points out that the yuan was growing stronger between 2005 and 2008, US imports from China increased by US$94.3 billion, or 38.7 per cent. He suggests that one reason for continued US consumption of Chinese goods despite the relative price increase may have been the shortage of or even the lack of substitutes for Chinese-made goods in the US market.

Moreover, only somewhere one-third and one-half of the value of US imports from China is actually Chinese value-added, with the other half to two-thirds reflecting costs of material, labour and inputs from other countries.

Hence, a stronger yuan actually makes imported inputs cheaper for Chinese producers, who may respond by reducing their prices for export, which means that the currency appreciation may lead to a rise - not a reduction - of American imports from China.

Unfortunately, much of this economic common sense is probably not going to counter the political pressure from Congress on the administration to 'do something' that is fuelled, in turn, by America's economic distress and the ensuing populism that makes China such an easy target.

A key Chinese official responded to this pressure from Congress by saying that his government has become a convenient scapegoat for America's trade problems. But this official needs to recognise that that kind of behaviour is a mirror image of sort of the way that some members of the Chinese communist establishment have been exploiting anti-American nationalist sentiment as part of a strategy to mobilise public support for the regime in Beijing.

In a way, scapegoating the 'other' seemed to have become the favourite political weapon by both Americans and the Chinese.

The problem is that the back and forth sniping between Washington and Beijing over China's currency policy is more than just a 'normal' economic dispute between two countries that has been exploited by politicians on both sides.

Indeed, the global financial imbalances between the US (consumption that created deficits) and China (savings that produce surpluses) helped create the conditions for the financial melt-down.

And unless the two sides take steps to deal with these imbalances, the global financial system could experience more disasters in the future.

From that perspective, China's massive trade and foreign exchange surpluses - reflecting the huge surpluses of exports over imports and saving over investment - should be seen not so much as a challenge to American economic interests but as a threat to the entire global economy, and eventually to China itself.

The Americans need to cut their consumption and borrowing. But that could only take place if the US dollars in China's government-controlled banks are being spent to buy American products as opposed to its debts. And if and when that happens, the appreciation of the Chinese currency would be inevitable.

In the meantime, a Chinese refusal to revalue its currency is bound to bring about retaliatory action by Washington and ignite a destructive economic war between the two nations.

And the situation is only going to be aggravated if China continues to respond in a somewhat frantic way to not-very-unusual actions by the Obama Administration (meetings with the Dalai Lama or arms sales to Taiwan).

If anything, China's rising economic and diplomatic power require it to embrace a more nuanced, if not refined, diplomacy that one expects from a great power, especially when it is dealing with the more accommodating administration in Washington.

More important, there is no reason why China and the US should not be able to settle their differences over currency in the same amicable way that the US and Japan were able to during the 1980s.

A failure to do that would be a recipe for another economic recession and perhaps even a new cold war from which no side would be able to decouple.

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