The U.S. and China

Eurasia Group, the New York-based political risk consulting firm, recently ranked U.S.-China relations as the number one global risk for 2010. Politically, a flash point could well be U.S. efforts to tighten economic sanctions against Iran for its nuclear ambitions: China would likely oppose such a step. Another potentially serious issue is the likely resumption of supplies of sophisticated U.S. military weapons and equipment to Taiwan, which China regards as its renegade province.

The major economic issue is the bilateral trade imbalance and the U.S. efforts to persuade China to up-value its currency, in order to reduce it. After appreciating against the dollar by 21%, the rate has been held steady since July 2008. The Chinese exchange rate policy is also creating problems for its Asian trading partners: Vietnam recently devalued its currency by 5%.

The Chinese current account surplus has practically halved from 11% of GDP in 2007 to around 6% last year, even as China became the largest exporter in the world beating Germany. The U.S. deficit too has halved from 7% of GDP to 3%. These changes are the direct result of the financial crisis and economic recession in the U.S. and there is a question mark whether this improvement would continue after the economic recovery: the U.S. deficit has widened in November 2009. Unless there is a major, cultural change in the spending and saving habits of the Americans, the deficit may persist despite the exchange rate changes: after all, the 20% plus fall since 2002 in trade-weighted terms has not helped much – at least so far. And, China accounts for only 30% of the deficit.

Western commentators paint the Chinese policy as a misguided manipulation of the exchange rate, which also hurts its own consumers. To my mind, this oversimplifies the Chinese rationale. For one thing, exchange rate appreciation is a deflationary policy and would surely cut GDP growth. The Chinese leadership believes that 8% growth is necessary for the sake of social stability; they value a harmonious society above anything else. There is also a political dimension to the stand. Having abandoned its ideological moorings, the Chinese Communist Party's legitimacy as the ruler depends on its delivering continuously improving standards of living for the people. And, surely the recent protests in Iran against the allegedly manipulated election results, in the face of a powerful government and religious authority, would make the Chinese all the more anxious to maintain a harmonious and stable social environment.

This apart, the experience of Japan clearly points to the ill effects of an appreciating currency. In the 1980s, the Japanese succumbed to American pressure to allow its currency to appreciate: at one time it had gone as high as JPY 80 to a dollar. The last couple of decades of economic stagnancy would hardly reassure the Chinese of the virtues of a floating exchange rate. They know very well that, as Dani Rodrik argued in his article in this paper (December 12, 2009), "*There is a strong positive relationship across all developing countries between currency undervaluation and economic growth*", something our authorities do not seem to appreciate.

Whatever the Chinese logic, a major risk for the global economy is what the U.S. might do in the face of what it considers as Chinese mercantilism. Would it take trade protectionist measures like imposing duties on Chinese imports? (In recent months, the U.S. has imposed duties on imports of Chinese tires and steel pipes.) Robert Aliber, professor emeritus of international economics and finance at the University of Chicago, recently advocated the imposition of a uniform 10% tariff on all Chinese imports – to be raised by 1% a month six months after its establishment, until the bilateral deficit comes down to manageable levels! It may be recalled that this is exactly what the U.S. did back in the 1970s in order to force an appreciation of the European currencies and the Japanese yen against the dollar, to help improve its worsening trade balance. In such an event, particularly if accompanied by political disagreements over Iran and Taiwan, China may well retaliate by stopping further investments in dollar securities, if not sell off some of its existing stock. What this would mean to the global economy, just coming out of a recession, is not difficult to imagine. The possibility of a U.S. China trade war is a big risk as Stephen Roach, Managing Director, Asia, Morgan Stanley, also argued recently.

In the November Asia Pacific Economic Co-operation Summit in Singapore, the U.S. did manage to get an endorsement of “market-oriented exchange rates that reflect economic fundamentals”. But such declarations are unlikely to persuade the Chinese to change their policy. (Since then, China has entered into a free trade agreement with ASEAN, and ASEAN+3 have entered into a $ 120 bn multilateral currency swap facility between the central banks, under the Chiang Mai Initiative.)

One solution, to my mind, may be an up-valuation of the Chinese currency accompanied by limited fluctuation bands for the G4 currencies in a Bretton Woods II, as I argued some time back in this column.

A.V.Rajwade
Email: avrajwade@gmail.com