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## Who's Playing Poker Dangerously?

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### *Will This Fight Become a Brawl?*

Ignorance will cause a Chinese debacle. And the U.S. economy will also feel the burden as the trade war with China gains momentum. Chinese authorities continue refusing to conform to fair trade practices. Beijing has done little to resolve the intellectual property issues and had previously discarded the idea of floating the Yuan and/or voluntarily limiting textile production and exports. This has seriously upset the big boys in Washington. The Schumer-Graham bill calls for a 27.5 percent ad valorem tariff on Chinese imports 180 days after the bill's passage if China does not appreciate the Yuan by 27.5 percent. This percentage number represents the average of 15 and 40 percent, which is the estimated amount that the Yuan has been devalued.[1]

The Chinese reluctance to comply, and their blaming the current U.S. problems on the low American saving rate have increased U.S. policymakers' support to pass the bill. Any economist would think this bill solves little, if nothing. Many would also say that this highest tariff proposal since the notorious 1930 Hawley-Smooth bill would probably exacerbate the problem. However, the current situation is different and more complex than that of the 1930's. While this tariff may cause the snowball to roll faster, causing a downhill economy, Washington will not sit around and let people get away with foul play. Sometimes punishment is necessary to teach a lesson. China has been testing its limits, has gone too far, and a small slap on the wrist does not seem effective.

Although the tariff makes little economic sense, perhaps it is needed to make China a well-respected trading partner in the future if they learn from their mistakes. However, the recent atmosphere has been hostile between China and the U.S. A look at the Hawley-Smoot bill passed in 1930 will provide some insight.

### Hawley-Smoot

To see how this bill came to life, one should consider Hoover's promise to the farmers during his 1928 campaign. International trade, particularly with Canada, had brought prices down and had especially hurt the U.S. farmers' competitiveness. Unemployment in farming had plagued America years before Great Depression. Hoover had promised to protect U.S. farmers, and thus the Hawley-Smoot tariff was the result. One must keep in mind that the bill was passed after the 1929 market crash. However some believe the bill was responsible for prolonging the Great Depression.

Some books have pointed out that other nations had retaliated to Hawley-Smoot. However, some studies show that the tariff's impact on real GDP may have actually been less than expected.

[1] 109$^{th}$ Congress, 1$^{st}$ session S.295

Furthermore, current situations and reasons for the Schumer-Graham bill are different than those for the Hawley-Smoot bill.

**What's Different?**

Americans in those days faced a different situation where monetary and fiscal policies were not employed, the U.S. had fewer trading partners, and information flowed much more slowly. Since 1930, the Federal Reserve's role has greatly changed, far more indeed than from its inception in 1913until 1930. As we know, the Fed now actively engages in monetary policies and will act when it sees warning signs.

The U.S. currently has more trading partners, thus more trade options. While China represents a large trading partner, U.S. consumers and producers will increase trade relations with other nations if Chinese relations remain unfavorable. At the same time, China with its 1.3 billion population represents a marketplace that should not be ignored. Forcing them back into isolation would present unfavorable conditions for all.

Previously inefficient information flows may have also added to the stagnation of the major economies during the Great Depression era. With the rise of the Internet, we have come closer to efficient markets where prices reflect almost real-time information. Prices will correct themselves almost instantly. If China does not comply with U.S. Congress' appeal, market participants will position themselves accordingly. And businesses will effectively find more reliable trading partners.

Still, it is in the best interest to China and U.S. to conclude their negotiation amicably. Hostile relations will only leave both with bruises and injuries. We would hate to see a Mike Tyson move, like biting off an ear by either party. China has shown some progress toward floating the Yuan, which will delay the immediacy of passing the Schumer-Graham bill. If China does not act accordingly, someone is bound to lose an ear.

**Is China Abusing the Carry-Trade Strategy?**

The more that people have attempted to explain Greenspan's conundrum, the more confused everyone seems to be. Well, let's break the situation down. We know that entities have been purchasing long-term Treasuries, pushing down the yields on these securities. Many believe the Chinese have contributed to this phenomenon.

Here is a possible explanation to why entities have bought Treasuries. Before the Asian crisis came to fruition, Asian institutions had been engaged in the "carry-trade." Many hedging institutions use carry-trade strategies to profit handsomely from discrepancies in interest rates between economies. To briefly explain this hedging method, one borrows (short) from the economy with the relatively lower interest rate and lends (long) to that with the higher interest rate.

Under some crucial assumptions, this strategy virtually allows one to make what I like to call free money. However, conventional wisdom tells us that there is no such thing as free lunch. For instance, a cross-border carry-trade method works only under a fixed exchange rate system with interest rate differentials, because exchange risk must be eliminated. Under a floating rate system, participants are vulnerable to foreign exchange risk. If China is abusing the carry-trade strategy, then that may explain their true reluctance to float the Yuan. China has been able to borrow on international capital markets at a lower rate than the World Bank charges.[2] According to Nouriel Roubini, Associate Professor of Economics and International Business at Stern School of Business (NYU), credit in China is reported to be unusually low, both in nominal and real terms.[3]

Certain requirements may provide some light to China's situation. Some participants use derivatives like swap contracts to set their positions and profit from carry-trade. Typically, the only capital involved in swap agreements is the posting of collateral, which is usually in the form of G-5 currencies or government securities (excluding Japanese government securities).[4] Perhaps China has been using swap agreements and has bought U.S. Treasuries for collateral.

As mentioned, this is only a possible explanation because this cannot be confirmed by public data. Entities that use derivatives keep their positions off-balance sheet, allowing users to elude accounting rules or government regulations. China looks as if they are trying to play a good game of poker; but as Kenny Rogers have sang, "You got to know when to hold 'em, know when to fold 'em.  Know when to walk away and know when to run."

**Resources:**

http://en.wikipedia.org/wiki/Smoot-Hawley_Tariff

http://www.eh.net/encyclopedia/?article=obrien.hawley-smoot.tariff

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[2] http://www.dawn.com/2005/07/03/ebr12.htm
[3] http://pages.stern.nyu.edu/~nroubini/ChinaTripReport-Roubini-Setser.pdf
[4] http://www.financialpolicy.org/dscrole.htm

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