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Heated Relations Between U.S. and China

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China's Fixed Exchange Rate Regime

The Chinese government has been fixing the Yuan, the base unit of the Renminbi, at 8.28 Renminbi per dollar since 1995.[1] By doing so, the Yuan has been undervalued, thereby keeping Chinese exports relatively cheap compared to U.S. products. This effect entices U.S. consumers to purchase cheaper Chinese products. On the other hand, Chinese consumers face higher priced American goods and many cannot afford to purchase them. This, along with other reasons, has led to U.S. protectionists to tout unfair trade, as U.S. Senators continue pressuring China to revalue the Yuan.

Such pressures will induce speculators, who bet that China would revalue the Renminbi, to flow "hot money" into China. This short-term speculative flow of capital further complicates China's ability to have its currency fixed to the dollar. Despite these complications, China has shown little signs of revaluing the Yuan. China currently refuses to immediately float its currency because doing so would further exacerbate their problems with unemployment (at 20 percent) and the fragile banking system.[2]

Regardless of China's sticky situation, U.S. senators continue to push China into a corner and blame China for the U.S. current account and trade deficits. According to the U.S. International Trade Commission (USITC) DataWeb 2004 figures, U.S. imported $196 billion worth of goods from China, which translates to 13.4 percent of total U.S. imports.[3] Of this amount, more than half of the total imported goods from China were nuclear reactors and parts, mechanical appliances, electrical equipment and toys.[4] Apparel, both knitted and non-knitted, added up to just over 5 percent.[5] According to USITC's data, it appears that the media has exaggerated the impact China's textile imports have in- the U.S.

Protecting the American Workers

By claiming unfair trade, senators are partly referring to the trade imbalance between U.S. and China. U.S. imported $196 billion and exported only $32 billion worth of goods to and from China.[6] This calculates to U.S. having imported 13.4 percent of its total imports from China,

[1] http://www.forbes.com/business/global/2005/0228/048.html
[2] http://gbr.pepperdine.edu/052/hottopic.html
[3] http://dataweb.usitc.gov/scripts/cy_m3_run.asp
[4] http://dataweb.usitc.gov/scripts/cy_m3_run.asp?Fl=m&Phase=HTS2&cc=5700&cn=China
(Harmonized Tariff Schedule (HTS) Categories 84, 85, and 95)
[5] HTS Categories 62 and 61
[6] http://dataweb.usitc.gov/scripts/cy_m3_run.asp

while the authorities in Beijing permitted only 4.5 percent from U.S. exporters. This hardly reveals a "balanced" trade relationship.

Given that China's share of U.S. imports represent approximately 13 percent and assuming all else is held constant, a 27.5 percent appreciation of the Renminbi would impact the trade-weighted dollar exchange value by a mere 3.7 percent. This suggests that the Yuan appreciation would do little to resolve the U.S. current account deficit. Although China accounts for almost a quarter of the U.S trade deficit, hypothetically and completely eliminating all trade relation would not resolve the U.S. current account and trade deficits. I had briefly touched on the U.S. current account deficit picture in my previous report titled "Preparing for an Inverted Yield Curve."

Many senators have claimed that their reasons for pressuring China were not for protectionist purposes. And according to the figures previously mentioned, pressures to revalue the Yuan would have little impact on saving the existing jobs in America. Most manufacturing jobs, particularly electronics related, have gone across borders where labor costs remain lower than they are domestically. In current times where business competition remains fierce, mature corporations must cut costs to stay alive. Such transitions are never easy and producers must make difficult sacrifices to maintain their competitiveness.

However, Chinese authorities do not make such transitions easy for American and other Western companies that decide to move to China. Major problems of American firms conducting business in China include: opaque legal and regulatory systems (particularly regarding the protection of intellectual property) and Chinese bureaucracy favoring local firms (especially state-owned).[7] Another core problem in China remains in its complete lack of labor rights. The widespread violations of labor rights exist in just about every factory.[8] No wonder China has been able to produce such low priced products. U.S. politicians probably view these practices as unfair, as they will likely retaliate further by denying the CNOOC merger with UNOCAL.

Will This Fight Become a Brawl?

Ignorance will cause a Chinese debacle, and "an eye for an eye will leave everyone blind." 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. Some senators claim that Beijing has done little to resolve the intellectual property issues, discarded the idea of floating the Yuan, and not voluntarily limiting exports. On May 20, China claimed that it would raise duties on a number of their textile products. However on May 30, China withdrew its planned tariff increases on textile exports to U.S. and Europe.[9]

This type of misdirecting behavior has seriously upset the big boys in Washington. China's reluctance to comply with fair practices has led senators to call for drastic measures. The

[7] http://www.buyusa.gov/china/en/asianowapr2005.html
[8] http://www.chinabusinessreview.com/public/0403/rosoff.html
[9] http://knowledge.wharton.upenn.edu/index.cfm?fa=printArticle&ID=1219

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.[10]

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, this also comes at a cost to the U.S. consumer who would likely face flying inflation rates if the bill were to pass. 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 the Great Depression. Hoover had promised to protect U.S. farmers, and thus the Hawley-Smoot tariff was the result.[11] The Hawley-Smoot Tariff Act increased tariffs on over 20,000 items to record levels.[12] One must keep in mind that the bill was passed after the notorious 1929 market crash. However some believe the bill was responsible for prolonging the Great Depression.

Some books have pointed out that other nations such as Canada had retaliated to Hawley-Smoot.[13] Nevertheless, some studies show that the tariff's impact on real GDP may have actually been less than expected.[14] Furthermore, current situations and reasons for the Schumer-Graham bill are different than those for the Hawley-Smoot bill.

What's Different?

First of all, the tariffs on the Hawley-Smoot bill were "specific" (predetermined price per good) whereas those of the Schumer-Graham bill are "ad valorem" (percentage of the value of goods). Americans in early 1900's days faced a different situation where monetary and fiscal policies

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[10] 109th Congress, 1st session S.295
[11] http://www.eh.net/encyclopedia/?article=obrien.hawley-smoot.tariff
[12] http://en.wikipedia.org/wiki/Smoot-Hawley_Tariff
[13] http://www.eh.net/encyclopedia/?article=obrien.hawley-smoot.tariff
[14] Ibid

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 1913 until 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 lower-cost-providing 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, even though it currently does not import nearly as much as it exports. Forcing them back into isolation would present unfavorable conditions for all and would not solve anything.

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. The U.S. Senate recently passed the Central American Free Trade Agreement (CAFTA) as America continues to look towards favorable trading relations. Additionally, the G-8 looks to help stabilize situations in Africa who is a promising trading partner in the future.

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. Sure the ear could be sawn back on, but it will still leave a deep scar. 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.

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