America's China *Headache*

By Greg Mastel

No, there will be no new Smoot-Hawley. But the United States and China are fighting a modern trade war all the same.

For the first time, trade with China was a major issue in the U.S. presidential campaign, with both candidates making charges and countercharges in the debates, campaign advertisements, and stump speeches. Economic and trade tensions between Beijing and Washington have been steadily tense for decades, with flash points on issues ranging from supplies of rare earth metals to currency exchange rates. The economic relationship is undeniably complex with each country benefitting in different ways from hundreds of billions of dollars in trade and investment with the other, but seemingly endless disputes have led observers to proclaim multiple times that the two economic behemoths are on the edge of a trade war.

The truth of modern international economics that a "trade war"—a term coined to describe multiple rounds of Great Depression-era tariff increases including the infamous Smoot-Hawley tariff bill—is an outdated concept. But modern trade wars involving complex measures such as investment restriction, abuse of unfair trade laws, and even internet restrictions are not only possible, but a reality.

Within the United States, there is deep disagreement between major political parties on most issues. Trade with China, however, is almost an item of something approaching consensus. Many in Congress have been chomping at the bit to

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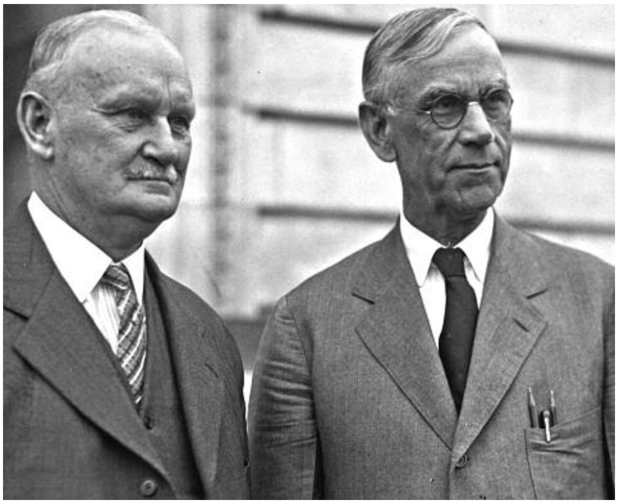

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Rep. Willis C. Hawley *(R-OR) (left) and* **Sen. Reed Smoot** *(R-UT) meeting shortly after the signing of the Smoot-Hawley Tariff Act.*

enact various measures aimed at punishing or sending messages to China. President Obama has launched a number of international trade complaints against China at the World Trade Organization. Republican presidential candidate Mitt Romney announced that he would identify China as a currency manipulator under U.S. law, which would launch a new and probably acrimonious negotiation with Beijing. Despite the unquestioned benefits of U.S.-China trade, the long list of disputes and the high degree of political consensus against China on trade suggests that the United States and China are already in a modern day trade war. The real question is what is the best strategy for the United States in this contentious environment.

CHINA CURRENCY

Perhaps the most important but least understood trade and economic dispute between Beijing and Washington is the exchange rate between the dollar and China's currency, known as the yuan or renminbi. The essence of the dispute is that in order to promote exports and growth, China has consistently held the exchange rate of its renminbi low versus the dollar. This has effectively kept China's exports at artificially low prices and made imports into China more expensive. In essence, an artificially low exchange rate is an across-the-board tariff on imports and an across-the-board subsidy on exports. In large part because of this distortion, China has grown into the world's leading exporter.

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Most major economies allow the exchange rate for their currency to be set primarily by the global market for currencies. Many smaller countries do fix their exchange rate through their central bank as China does. Over the years, many countries have also followed China's strategy of keeping their exchange rate artificially low to boost exports. But China is not a small country on the fringe of the global economy. It is the world's second-largest economy and its largest exporter. The rest of the world simply cannot afford for China to insist on keeping its economy in what amounts to "training wheels" while it leads the race. Since renminbi undervaluation literally impacts every import from China and every export to China, it is the single largest economic dispute with China.

It is complex to calculate the appropriate exchange rate for the renminbi, but a number of outside economic analysts have argued that it has been 25 percent to 40 percent undervalued compared to the dollar. As the International Monetary Fund has noted, Beijing's central bank has allowed some appreciation of the renminbi, though the trend seems to have reversed in early 2012. Further, the economic fundamentals suggest the renminbi should be even stronger and as long as Chinese bureaucrats set the exchange rate, rather than the market, it is highly unlikely that the strategy of export growth through undervalued currency will be abandoned. There are also closely related export benefits of interest rate subsidies and tax benefits to Chinese exporters that—though hard to measure in a closed system—seem to continue.

Like President Clinton and President Bush before him, President Obama has criticized Beijing and pressured its leadership for renminbi appreciation. During the campaign, Governor Romney declared that if he were elected president, he would formally declare China a currency manipulator under U.S. law on his first day in office—a step that President Obama has stopped short of taking and would amount to formally accusing Beijing of manipulating its exchange rate for trade gain. Under questioning, Romney

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went further and suggested that retaliatory tariffs might be used if talks fail. Obviously this was intended and would, in fact, be a significant escalation of the currency issue.

The problem of currency manipulation is recognized across the political spectrum. Unfortunately, recognition does not lead to an obvious solution. It is impossible to change the exchange rate of the renminbi without China's cooperation, so presidents are ultimately left with pressuring China to allow appreciation. That strategy has yielded only limited results and does not hold great promise as China has shown itself largely immune to foreign criticism. The U.S. government can address some of the domestic impacts of Chinese currency manipulation by changing its trade laws, but they cannot address the core distortion. At some point, Washington could resort to brute economic force by taking a step such as imposing a sweeping tariff on Chinese goods, but such a step would likely violate World Trade Organization rules and cause significant protest by importers in the United States. There are simply no easy answers to the currency issue, but the cost of ignoring it is enormous from an economy-wide perspective.

CHINESE TRADE BARRIERS

The Office of the United States Trade Representative annually releases a listing of the trade barriers that it believes other countries around the world maintain. China has long had the longest entry, with more than thirty pages now detailing problems ranging from internet restrictions to investment policies designed to fleece foreign companies of their technology to more mundane barriers to agricultural imports.

To address this growing list of trade barriers, the Obama Administration has launched a series of WTO complaints against China on issues ranging from Beijing's export restrictions on rare earths (rare minerals essential to various manufacturing processes) to restraints on automotive trade. The WTO is likely to side with the United States on many of these complaints, but because evidence is difficult to obtain from China's highly opaque system, adjudication will likely stretch out for at least a year or two, and old barriers are often merely replaced with new versions. China has also become increasingly adept at using the WTO to challenge the United States' much more transparent system and fully utilizing its options for delay under the WTO. Still, the *People's Daily* (the voice of China's Communist party) recently railed against these complaints blasting them as "unreasonable requests" and "groundless accusations," arguing that the WTO rules are slanted against China—though a decade ago China eagerly sought to join the WTO and commit to those rules.

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Interestingly, the list of bilateral "trade disputes" with China now also includes problems that might more easily be described as economic espionage or even economic attacks. According to reports in the western media, recent cyberattacks against U.S. companies, including Yahoo, Google, and Dow, may well have been organized by Chinese authorities interested in gaining intellectual property and information on China's "enemies," such as the Dalai Lama and his followers. A report last year from the Office of the Director of Central Intelligence pointed the finger at "Chinese actors" as leading cyberattacks and economic espionage efforts. The House Intelligence Committee recently singled out two Chinese telecommunications/technology companies, Huawei and ZTE, as possible security threats and suggested restricting their activities in the United States. Clearly, these issues reach well beyond traditional trade disputes and have direct potential impact upon national security, human rights, and many other issues.

THE BIG PICTURE

Over the last three decades, China's economic opening to the West has sparked almost unbelievable growth in China. China's seemingly endless double-digit growth has transformed China and the world economy. But the salad days seem to be coming to an end for China. Other countries, such as India and Indonesia, now compete with China's vast labor pool. Growth has brought increasing internal demands for improved wages and working conditions. The Chinese economy seems to be threatened by real estate bubbles of its own. Finally, China's infamous one-child policy has created a looming demographic crisis as the number of elderly skyrockets without the younger workers to support them.

This is not to say that China is on the brink of economic calamity. But all economies face cycles and China is no exception. The era of double-digit growth though is likely to fade and fade quickly. This will put Beijing in the position of dealing with slowing growth and rising unemployment, which is likely to spark at least local unrest and the prospect of political instability.

Exports to the United States in the last decade have been a major and continuing engine of growth for China. Chinese exports to the United States outpace imports from the United

States by an almost four-to-one ratio, generating an annual trade surplus with the United States that approaches $300 billion. More than one-third of China's total exports go to the U.S. market. Faced with a litany of economic challenges, China is likely to loathe seeing its trade surplus with the United States shrink. This suggests that Beijing is likely to be more, not less, intransigent on economic and trade disputes with Washington in coming years. If China is unwilling to allow the renminbi to appreciate when its domestic growth is at 10 percent per year, is it likely to do so when growth has fallen to 5 percent per year? Based on China's recent behavior on a number of fronts, strident denunciation is a much more likely response than quiet reform.

A traditional trade war with each country raising across-the-board tariffs is a historical relic—there will be no new Smoot-Hawley Act. But the United States and China are for all intents and purposes fighting a modern trade war with restraints on investment aimed at supporting industrial policy and protecting national security, WTO complaints, endless struggle over China's exchange rates, and even occasional retaliatory duties. In the last ten years, U.S. trade conflicts with China have eclipsed those with all other trading partners combined.

The heated campaign exchanges are over now, but the president is still faced with a multi-dimension economic contest with Beijing. Success will certainly require diligent attention and a willingness to take strong actions, like identifying China as a currency manipulator, vigorously enforcing U.S. rights under trade agreements, defending the interests of U.S. companies, and responding to new problems such as cyberattacks—even if these actions carry some risks. Like most important issues, the "trade war" with China defies easy answers; still the United States does have leverage in the relationship stemming from China's dependence upon the U.S. market and needs to skillfully bring it to bear. The stakes of economic conflict with Beijing are not as obvious as those associated with terrorist threats or nuclear developments in Iran, but history is likely to judge it to be among the most serious challenges that this president will face. ◆