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ESSAY

A Trade War with China?

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THE EAGLE AND THE DRAGON

Americans are increasingly disturbed by the growing economic clout of China. With Chinese growth rates consistently above nine percent, they accuse it of stealing U.S. jobs, of keeping the yuan undervalued by pegging it to the dollar, of exporting deflation by selling its products abroad at unfair prices, of violating the rights of its workers to keep labor costs low, and of failing to meet its commitments to the World Trade Organization (WTO). Most of these charges have little merit. But the misunderstandings behind them have opened the way to a trade war between the United States and China -- one that, if it escalates, could do considerable damage to both sides.

China is not stealing U.S. jobs or engaging in unfair trade practices to undercut U.S. economic might and export its way to global power. In fact, almost 60 percent of Chinese exports to the United States are produced by firms owned by foreign companies, many of them American. These firms have moved operations overseas in response to competitive pressures to lower production costs and thereby offer better prices to consumers and higher returns to shareholders. U.S. importers with dominant positions in China, such as Wal-Mart and Hallmark, have the power to compel Chinese suppliers to keep their costs as low as possible. Wal-Mart alone purchased $18 billion worth of Chinese goods in 2004, making it China's eighth-largest trading partner -- ahead of Australia, Canada, and Russia.

So who is really "to blame" for China's "exporting deflation" and for the surge of Chinese exports? American importers, the American consumers who buy their Chinese goods at very low prices, and their American shareholders who demand results. A sustained trade war with China would hurt these groups more than anyone else.

FEELING FOR EACH STONE

One of the principal charges leveled against China in the United States stems from a misunderstanding of the dollar-yuan relationship. A chorus of critics -- from government officials to corporate executives and union leaders -- are charging Beijing with keeping the yuan undervalued by pegging it to the dollar in order to gain an unfair export advantage. This unfair advantage, they assert, is the main cause of the U.S. trade deficit with China, which grew from $124 billion in 2003 to $162 billion in 2004.

The value of the yuan, however, is not the cause of U.S. trade deficits. They have existed since 1975 and reflect long-term trends in the development of global trade and the structure of the U.S. economy. A recent report by the U.S. Treasury -- the release of which was held up until after last November's election -- has absolved China of manipulating its currency to obtain an unfair trade advantage.

First of all, the yuan is not undervalued in world markets. In fact, despite the profusion of claims that Beijing is exporting deflation, it could just as easily be said that China is importing inflation. The prices of the raw materials it imports have skyrocketed. The cost of imported iron ore, steel, and aluminum went up by more than a third in 2003. By 2004, the Chinese government was so afraid that the Chinese economy would overheat that it intervened, using administrative controls to reduce imports that were thought to be contributing to the problem. If the government had not taken such actions to cut imports, China would have imported more goods than it exported. The fact is that China can afford to pay for all the imports it needs to sustain its high growth rates and still outcompete any other country in world export markets.

China's major Asian trading partners, Japan and South Korea, have joined the chorus of disapproval after watching the competitiveness of the yen and the won undercut by a declining dollar-pegged yuan. They should remember, however, that during the Asian financial crisis of the 1990s, they were praising Beijing for keeping the yuan pegged after they had devalued their own currencies, thus preventing a financial meltdown across Asia. As a result, China lost exports in the short term but maintained the long-term stability of its currency. Stability continues to be the determining factor in Beijing's monetary policy.

Some critics point to China's huge foreign reserves -- mostly the result of foreign direct investment and the trade surplus -- as evidence that the yuan is undervalued. The implication is that foreigners who invest in productive facilities in China are doing so solely because of cheap labor and cheap currency. But foreigners are in China for the long term: it has the biggest national market in the world and is the location of choice for any multinational enterprise that wants a global leadership position.

The problem with China is not so much that it manipulates the exchange-rate system, but that it relies too heavily on price and capital controls. In a full-fledged market economy, an exchange rate pegged to the dollar and a substantial accumulation of foreign currency reserves would lead to a rapid expansion of the money supply and rising inflation. This is not happening in China, according to currency experts, because both output and prices in key sectors are regulated. When monetary expansion fuels demand, pushing output to higher and higher levels, the economy overheats but -- thanks to controls -- without the expected increase in inflation. Restrictions on the movement of capital also prevent China's capital markets from fully adjusting to the excessive liquidity created by China's growing reserves of foreign currency.

Some critics are suggesting that China should allow its currency to float. U.S. Federal Reserve Bank Chairman Alan Greenspan and others have warned, however, that the result would be an outflow of deposits from Chinese banks that could destabilize China's banking system. At a time of great change and rapid innovation in China's young capital markets, when financial institutions are scrambling to meet China's commitment to the WTO to open those markets to foreign competition by 2007, a floating currency would introduce more risk and instability than Chinese leaders would tolerate.

The problem today is in fact caused by foreign speculators hoping to reap the benefits of a revaluation of the yuan. Although China does not allow foreign capital to flow freely across its borders, fearing that a panic would destroy its fragile capital markets, its capital controls are porous. Substantial speculative inflows of "hot money" from overseas investors who see revaluation as inevitable make it through. The central bank has stated that instances of illegal foreign-exchange trades number in the tens of thousands; Chinese official estimates show that in the first nine months of 2004, $120 billion entered China from untraceable sources overseas. These funds mostly end up in real estate (Shanghai seems to be the destination of choice), in the Hong Kong stock market, or as "street loans" to friends or private businesses that cannot get financing from the banking system. Meanwhile, China's central bank must buy foreign currency to defend the yuan's peg to the dollar and then neutralize the impact of this new liquidity on the banking system by selling government bonds to the banks. Chinese foreign exchange reserves increased by $206 billion in 2004, almost one-half of that amount in the last three months of the year, and China's central bank appears willing to continue to keep buying dollars.

Speculators are becoming less confident that China will revalue in the near future. At the beginning of this year, offshore "currency-forward markets," in which investors gamble on the future value of the yuan, were predicting a 5-6 percent increase in 2005. Halfway through 2005, they were still counting on a 3-4 percent revaluation. But forward markets have been wrong about currency adjustment for the past two years, and there is no real indication they are right this time. Economists at Hong Kong's biggest lender, Hong Kong and Shanghai Bank, are now saying they do not anticipate that the yuan's value will rise in 2005. After being up 13 percent in 2004, the Hong Kong stock exchange's Hang Seng index has declined so far in 2005, and the number of property transactions in Shanghai has slowed sharply, indicating that hot money is starting to leave its favorite markets.

Chinese government officials claim that their ultimate goal is full convertibility of the yuan through a "gradual and safe" approach toward a more flexible exchange-rate regime, and nothing suggests that they are not sincere. But for now, the government says it will not respond to outside pressure to devalue, which could lead hot-money investors to sit tight, believing that even further pressure could force the government to devalue yet again. Maintaining a stable yuan is important for the proper management of China's economy, and Beijing has decided to allow more movement of capital while holding off on greater currency flexibility.

The International Monetary Fund has chided China for having its priorities backward. In a paper entitled "Putting the Cart Before the Horse?" IMF economists argue that capital liberalization should be a lower priority than exchange-rate flexibility, which should be a prerequisite for opening up capital flows. But China's leaders are simply following Deng Xiaoping's dictum: opening up China's economy is a matter of "crossing a river by feeling for each stone." Caution and experimentation are the watchwords. Recent steps to loosen capital controls include allowing Chinese companies to obtain foreign exchange to buy foreign assets abroad, leading to a spate of overseas investments; insurance companies are now allowed to invest their premiums overseas, and individuals can take more foreign currency out of the country.

NEW KID ON THE BLOCK

The recent attacks on China portray a very different country from the one that, in the decade before it joined the WTO in 2001, reduced tariff barriers so much that it had the lowest protection of any developing country in the world. By mid-2002, China had abolished or amended 2,600 legal statutes and regulations that were not consistent with its WTO accession agreement and had passed legislation on issues such as intellectual property.

China was so determined to join the WTO that it accepted terms that Nicholas Lardy, a China expert at the Institute for International Economics, describes as "so onerous they violate fundamental WTO principles." Most notable was China's agreement to be considered a "nonmarket" economy by other WTO members. This label means that countries accusing China of dumping its goods (selling them below their cost of production) do not have to use actual market prices in China to support their accusation; they can instead use surrogate prices taken from a WTO-designated market economy such as India. According to the U.S.-China Business Council, the procedure is at best arbitrary and at worst grossly unfair to Chinese exporters. Recently, Beijing has been approaching individual trading partners and urging them to waive this classification. So far, only a dozen have agreed to do so. The United States and the European Union are among those that have refused.

Disputes are an inherent part of international trade, and China is the new big kid on the block. Over the past decade, it has been the target of one-seventh of all dumping investigations worldwide -- more than any other nation. The U.S. attack on China started in earnest in 2004. The AFL-CIO petitioned for stiff tariffs on Chinese imports, arguing that China's suppression of workers' rights gives it an unfair competitive advantage and violates a 1974 trade law. The difference between the prices of American-made and Chinese-made goods, the petition contended, was the result of low wages and the lack of workers' rights in China. The Bush administration, to the surprise of many, rejected the petition, dismissing its allegations as general and not supported by conclusive evidence and warning of potential countermeasures by the Chinese. Then U.S. trade representative Robert Zoellick said that acting on the petition would have led the United States toward economic isolation.

Disputes over specific Chinese trade practices have also been on the upswing. China now makes 40 percent of the furniture sold in the United States. In mid-2004, the government responded to a petition by 27 U.S. furniture manufacturers by announcing that it would apply antidumping duties to 135 Chinese furniture exporters, which accounted for two-thirds of bedroom furniture imports in the United States. Washington sent questionnaires to Chinese exporters asking about their pricing policies. It subsequently applied antidumping duties of up to 24 percent on those that responded and of 198 percent on those that did not. China fought back: 120 Chinese companies threatened to go to court, which may have helped motivate the U.S. Department of Commerce's decision to reduce the average duty to 8.6 percent.

A thread of irony runs through the fabric of accusations that the low import prices of Chinese goods are the result of unfair trade practices. On closer inspection, it becomes clear that they are largely a product of competitive forces unleashed by China's economic opening. A prime example is China's television industry. Under China's planned economy, many provinces and large cities had their own TV manufacturers. When the economy opened up, overall capacity far exceeded demand and competition became cutthroat. The result: an all-out price war that has been going on for over a decade, reducing the price of a color TV in China by an astonishing 80 percent in the first five years alone. Now the winners of that race are being penalized for their success: in early 2004, Washington decided to apply antidumping duties of up to 78.5 percent on imports of Chinese color TVs with screens 21 inches or larger.

Insofar as there is a real problem with China's trade policy, it has to do with the implementation of some specific commitments. An especially thorny issue has been rampant piracy of intellectual property, which costs U.S. business $2.5-$4.0 billion a year. The right laws are in place, but China has shown little inclination to crack down on patent, trademark, and copyright infringements, or even outright theft of brands and technology by Chinese companies. The basic problem is sentencing: fines and jail time are too light to be effective; copycat firms accept penalties as just another cost of doing business. If China were really to try to solve this problem, it would have far more credibility in resolving other trade disputes.

CLOTH TIGER

The most recent battle began on December 31, 2004, with the expiration of the 30-year-old Multifiber Arrangement (MFA), which set export quotas for textile-producing countries. The agreement had prevented any single country from becoming a dominant force in the global textile trade. In 2003, China had the largest share of the world market -- 17 percent. The

WTO has predicted that with the quotas now gone, China could increase its share to 50 percent by 2007.

Why is China thought to be so much more competitive than anyone else? To begin with, it has been reforming its textile industry for more than two decades. When the Chinese economy began to open up in the early 1980s, Hong Kong garment makers moved their operations just a ferry ride away, to Shenzhen, on the Chinese mainland. Then came the Taiwanese, followed by the Japanese and the South Koreans. Foreign investors were required by law to form joint ventures with Chinese enterprises, most of which were state owned. By the mid-1990s, China had become the world's biggest exporter of textiles, but it was burdened by serious overcapacity. In three years, the government eliminated almost ten million spindles, and over a million workers were laid off. Intense competition among state-owned, privately owned, and foreign-invested enterprises for rapidly expanding export markets brought huge benefits. Now, the China Chamber of Commerce for Import and Export of Textiles estimates that Chinese textile producers invested $25 billion to retool and streamline their facilities in the last two years alone. China has had additional advantages over other low-cost producing countries: a highly disciplined and skilled work force and its own production of natural and synthetic fibers. The textile industry was also the first industry in China to use the Internet to carry out transactions on-line.

Today, there are about 30,000 textile exporters in China. Foreign-invested and private Chinese enterprises now account for roughly four-fifths of textile exports. China's one-stop-shopping approach, in which integrated factories with ready availability of raw materials handle spinning, weaving, dyeing, cutting, and sewing operations, is hard to beat. Plus, these factories have the additional benefit of access to efficient transport networks. In an industry where meeting short deadlines with the best quality means the difference between success and failure, China is usually first and best. And with the value of the dollar dropping, competitors in Thailand and South Korea have a hard time matching Chinese prices.

The expiration of the MFA affects all textile-producing countries, and they are scrambling to protect themselves from the expected onslaught of Chinese goods. Yet their fears are exaggerated, at least in the short term. The WTO's prediction that China will control one-half of the world market by 2007 is unlikely to come true because of the WTO's own restrictions. As the price of WTO entry, China gave other WTO members the right to impose a "safeguard restriction" capping the annual growth of Chinese textile imports at 7.5 percent. This restriction will remain in place until the end of 2008. Although some MFA quotas on specific items such as bathrobes, brassieres, and knit fabrics were abolished in 2002, the U.S. Department of Commerce soon applied "safeguard" limits after U.S. producers complained that Chinese products were disrupting the U.S. market.

Even before the MFA's expiration date, the Bush administration had decided to take drastic action to curb the expected flood of Chinese textile imports. Shortly before the presidential election last November, the undersecretary of commerce stated that safeguard quotas could be triggered by the mere threat of a market disruption (as opposed to an actual market disruption). The U.S. textile industry followed up by presenting nine "threat-based" petitions to limit imports of Chinese pants, shirts, and underwear. U.S. textile importers retaliated by filing a lawsuit in the U.S. Court of International Trade. At the end of December 2004, the court issued a temporary injunction barring the administration from considering the petition because it was based only on threats. But by even proposing to link the safeguard provision to threatened rather than actual market disruptions, Washington initiated a major escalation in the battle for the world's textile trade, and the move has infuriated the Chinese, who accuse the United States of violating the principles of free trade.

China is well aware of the panic among other countries as they await the arrival of Chinese textiles on their shores. Beijing has tried to reduce tensions by levying its own tax, ranging from two to six cents, on exports of coats, skirts, shirts, pajamas, and underwear. Although many foreign observers have dismissed this action as a mere token gesture to assuage critics, it will have a significant impact, because the duties cover 60 percent of all Chinese apparel exports. China has thousands of very small-scale producers of low value-added textile goods, which make a modest profit of three percent or less by exporting large volumes at low per-unit costs. The duties will reduce most, if not all, profit margins for many of these enterprises. Still, they will have no real impact on the behavior of other governments, which are feeling enormous pressure to extend the quota system by whatever means. And China knew what the implications were when it agreed to the safeguard restriction, so it cannot really blame other countries that use it.

There are real battles going on to decide who will make the world's cotton pants, shirts, and underwear, products at the low-value end of the textile spectrum, but it is a mistake to see that as a fight simply between the United States and China. Within the United States, textile producers, with the support of the government, are pitted against importers of Chinese textiles. Each side hurls data justifying its point of view, with producers citing data showing that Chinese pant and shirt imports increased between 249 and 1,081 percent in January 2005 and importers citing data showing a mere 28 percent increase in total Chinese textile imports during that period. The huge increases cited by producers, importers argue, exaggerate the impact, because China's quota limit on cotton pants and shirts was extremely low (three percent) prior to this year. They also insist that only aggregate textile-import growth since the end of the quota reveals the true situation: while U.S. apparel imports from China grew 28 percent, U.S. apparel imports from Jordan grew by 69 percent, and imports from small Central American countries -- Guatemala, Honduras, and El Salvador, supposedly the first that would succumb to the Chinese onslaught -- grew by 20 percent or more.

Meanwhile, another battle is being fought within China, as 30,000 textile exporters fight for a piece of the action. Over the past five years, competition has already resulted in a 30 percent drop in the average price of textiles. Companies without access to financing or secure input-supply chains are now vulnerable, as are small enterprises that are less able to react to changes in market conditions or pay new export duties. One experienced Chinese exporter predicts that half of the smallest firms -- those with exports of $1 million or less -- will go under. Large Chinese exporters are also complaining that U.S. retail clothing companies are canceling long-term purchase orders because they fear the reimposition of clothing quotas on Chinese exports. In March, one of the largest Chinese exporters, Guangdong Textiles Import and Export Group, reported that because of cancellations, its exports to the United States had grown only three percent in the previous year.

On April 5, 2005, the Bush administration really went into attack mode. Its interagency Committee for the Implementation of Textile Agreements decided not to wait for the textile industry to file a safeguard petition. For the first time, the administration "self-initiated" safeguard proceedings against China under its WTO agreement. Its aim is to determine whether "substantial increases in imports" of Chinese cotton pants (1,500 percent), knit shirts and blouses (1,250 percent), and cotton and synthetic-fiber underwear (300 percent) are disrupting the U.S. market. Although the percentages only reflect preliminary data for the first quarter of 2005, the Bush administration feels confident that it can make a strong case for disruption and the resulting need to impose quotas. In the words of Commerce Secretary Carlos Gutierrez, "free trade must be fair trade, and we will work to ensure that American manufacturers and workers compete on a level playing field." Ironically, it is other textile-exporting countries, not the American manufacturers and workers Gutierrez purports to be protecting, that will fill any void left by China's retreat.

RUFFLED FEATHERS OR TRADE WAR?

Such disputes are taking place at a time of growing concern over China's growing clout in the world economy. Beijing has adopted a "go global" strategy of securing natural resources, going directly to the source rather than relying on global markets; Chinese companies are allowed to make direct investments in foreign producers, thus integrating production to assure the availability of the inputs they need. Beijing has recently signed agreements to invest in production facilities in Algeria, Canada, Gabon, and Sudan (oil); Iran and Saudi Arabia (natural gas); and Australia, Brazil, Jamaica, Papua New Guinea, Peru, and Zambia (mining). It is reportedly trying to buy Noranda, Canada's biggest mining company, for $5.5 billion.

The recent purchase of IBM's personal-computer business by Lenovo Group, China's biggest producer of computers, illustrates another facet of the "go global" policy: the strategy of learning the skills required to run a global-scale enterprise, if necessary by buying a successful multinational company such as IBM. It is also a quick way to develop international brand identification, which Chinese companies still lack. For Americans, the psychological impact of such a deal is huge. IBM has been an icon of American business for a half century. Although the sale apparently does not involve any significant transfer of new technology and IBM's personal-computer business is no longer generating profits, it is viewed with suspicion by U.S. politicians who worry about China getting control of strategic assets and technology. (Washington's Committee on Foreign Investments in the United States has ruled, however, that this concern is not relevant in this case and has given clearance for the sale to proceed.) And the $1.76 billion IBM-Lenovo deal is just one of a rapidly growing number of foreign acquisitions. Chinese companies spent almost $3 billion in 2003 and $7 billion in 2004 buying foreign companies, and they are projected to spend $14 billion in 2005.

Washington is also increasingly concerned about the overall balance of power in eastern Asia. China and Japan are both asserting power more forcefully, and Taiwan has become a focal point of rising tensions. Japan has roiled the troubled waters of the Taiwan Strait by joining the United States in declaring the Taiwan issue a matter of strategic concern. Chinese Premier Wen Jiabao retorted that "solving the Taiwan question is an entirely internal affair and brooks no interference by any outside forces." President Bush followed up by warning European governments that ending the EU embargo on the sale of weapons to China "could change the balance of relations between China and Taiwan."

On a recent trip to the region, Secretary of State Condoleezza Rice reiterated the U.S. position on these issues, as well as Washington's unhappiness with China's failure to get North Korea to return to six-power talks on nuclear weapons. Neither the style nor the substance of Rice's in-your-face speeches went over well in Asia, where saving face is of critical importance and public confrontation does little to open ears or minds. In an ever more integrated global community, such clashes will become more frequent. To avoid an all-out trade war, the American eagle and the Chinese dragon must learn to respect difference and look for common ground in resolving disputes.

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