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The Coming U.S.–China Trade Conflict

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A storm is brewing and the media and public are starting to hear the first rumbles of thunder. The American economic slump is running into the Chinese economic slump, creating the conditions for a face-off between Beijing and the U.S. Congress, possibly leading to destabilization of the world's most important bilateral economic relationship. If a clash is to be averted, the U.S. must find a way to make the Strategic Economic Dialogue and other discussions with China more productive while channeling trade complaints into more frequent use of the WTO and WTO-compliant enforcement mechanisms. Otherwise, first American, then global, protectionism could spiral out of control.

Realizing Chinese Weakness. As recently as two months ago, it was a common view that, not only could the People's Republic of China (PRC) weather the global financial crisis, it would be a source of relief to some hard-hit economies. This position was never sensible.

China's slowdown began in October 2007 when the Shanghai stock bubble burst. From its peak on October 16 of last year to October 16 of this year, the Shanghai composite index fell by 68 percent. The next domino was real estate: Sales of residential buildings began to drop in on-year terms as early as December 2007.¹ Tied to the gigantic construction, steel, and aluminum industries, property is at the heart of the Chinese economy. Property is also used as a store of value for investors who enjoy few domestic financial options and cannot easily send money overseas. When stock and property values contract simultaneously, the pinch on wealth is substantial

This pinch manifested itself in declining growth. According to revised data, Chinese GDP growth peaked in the second quarter of 2007 at better than 12 percent. By the third quarter of 2008, it had slipped to 9 percent. While this is still excellent, the trend was clearly and significantly down. Moreover, the 9 percent figure was an exaggeration.²

The other shoe has now dropped. Front-page stories in the December 11 *Wall Street Journal*, *Washington Post*, and *Financial Times* conveyed shock that China's trade volume had contracted outright in November. Such shock is misplaced. Electricity production is a crucial measure of internal economic activity. On-year growth in electricity production peaked at close to 17 percent in September 2007. It has declined steadily since, to the point of a record 7 percent contraction in November.³ In addition, the purchasing manager's index survey of manufacturing activity set successive new lows in August, October, and November of this year.⁴

Authentic Stimulus Lacking. There is potential for significant deflationary pressure in China. Consumer inflation has rapidly declined from an April peak due to cheaper food and energy, which is not by itself worrisome. Harmful deflation, however, could result from sustained supply in excess of demand.

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As the economy has weakened, personal savings have soared. In October 2007, on-year growth in savings deposits was 3.7 percent; in October 2008, it was 26.7 percent.⁵ That rate of saving all but guarantees demand weakness. In the past, Chinese enterprises have been slow to reduce supply when confronted with weak demand. This helps create a vicious cycle where too little money is chasing too many goods, prices decline, consumers prefer to wait for even lower prices, they spend less, and so on.

Announced in November, the much-hyped RMB4 trillion stimulus appears to be a response to such economic concerns. Yet, the stimulus is not what it appears to be.⁶ More important, it reflects well-worn and now especially unhelpful Chinese policy tendencies. What Beijing calls “domestic demand” usually does not involve the consumer. In this case, if lending and investment in infrastructure does rise, it will bring greater use of steel, cement, and similar materials but no short-term consumer benefit. The same is true for interest-rate cuts, because formal borrowing is dominated by firms, not individuals.

In the same vein, China has acted to stimulate exports, which reflect local supply, instead of imports, which reflect local demand. As the decline in growth became clear in July 2008, the yuan’s

appreciation against the dollar stopped. Since the global crisis erupted in September, there have been three major increases in tax rebates on production for export.⁷

Of course, the Communist Party can simply declare all is well and fabricate economic data accordingly, as it has done in difficult situations in the past.⁸ A helpful response is more difficult to come by: For the first time, global demand is not available to replace lost Chinese demand. Thus, any successful stimulus must focus on consumers, not industrial investment. There has been talk of tax reductions as the core of a second, genuine effort at stimulus. This is untrodden ground for the PRC, with an uncertain gain, but at least it would be the right type of action.

The Oncoming Train. If China is unable to reach consumers or otherwise boost import demand, the outcome could ultimately be devastating for an already reeling world economy. Lost in media reports of a November export decline for the first time in seven years was a monthly trade surplus of \$40 billion—the fourth consecutive monthly record.⁹ Under such circumstances, it antagonizes China’s trade partners to bolster exports while imports collapse.

The first partner to find Chinese trade practices unacceptable will be the U.S. Up to this point, the

1. National Bureau of Statistics, *China Monthly Statistics*, Beijing, Vol. 12, 2006 through Vol. 3, 2008.
2. Chinese practice is to announce GDP growth three weeks after the end of the quarter, implying (starkly underfunded) surveys of 1.3 billion people can be completed in that time. This is likely to capture growth from the previous quarter.
3. National Bureau of Statistics, *China Monthly Statistics*, Vol. 10 (2007) and Shen Rujen, “China Nov Power Output Falls 7 Pct,” Reuters, December 4, 2008 at <http://www.reuters.com/article/companyNews/idUKSHA30905920081204?symbol=HNPEN> (December 11, 2008).
4. Xinhua, “China’s PMI Falls Below 40% in November,” *China Daily*, December 1, 2008, at http://www.chinadaily.com.cn/china/2008-12/01/content_7256422.htm (December 11, 2008).
5. National Bureau of Statistics, *China Monthly Statistics*, Vol. 11 (2007) and Vol. 11 (2008). Retail sales are the benchmark measure of consumption but include industrial as well as consumer goods and can be difficult to interpret.
6. Derek Scissors, “Official Figures Belie Chinese Spending Claims,” *The Financial Times*, November 17, 2008, at <http://www.ft.com/cms/s/0/a996c290-b447-11dd-8e35-0000779fd18c.html> (December 11, 2008).
7. Transcript, “China’s Latest Export Tax Rebates,” *China Radio International*, December 2, 2008, at <http://english.cri.cn/4026/2008/12/02/1901s428838.htm> (December 11, 2008).
8. During the 1998 financial crisis, the consensus of independent economists was that official growth was at least as twice as fast as true growth, for example see Thomas G. Rawski, “What is Happening to China’s GDP Statistics?” *China Economic Review*, Vol. 12, No.4 (2001), pp. 347–354.
9. Langi Chiang and Zhou Xin, “China’s Exports, Imports Fall as Economy Hits Wall,” Reuters, December 10, 2008, at <http://www.reuters.com/article/usDollarRpt/idUSPEK3160420081210> (December 11, 2008).

pattern of American deficits and Chinese surpluses has been amplified rather than dampened by the global crisis. The Sino–American bilateral trade imbalance reached a record \$28 billion in October, despite a much weaker U.S. economy.¹⁰ This imbalance is on its way to reaching \$275 billion for 2008 and, barring effective consumer stimulus in the PRC, may accelerate in early 2009.

The new Congress and President will be confronted with a record-breaking bilateral deficit in concert with soaring American joblessness. Progress on the exchange rate will no doubt be considered inadequate: It required three years, from July 2005 to July 2008, for the yuan to gain 16 percent against the dollar, whereupon it promptly stalled. In a single month, from September 29 of this year, the yuan gained over 14 percent against the euro.¹¹

When Congress convenes again in January, there will immediately be pressure to act against the PRC. President-elect Barack Obama appears, at least, to be far less committed to open trade than were Presidents Bush and Clinton. But liberalization on the Chinese side should have proceeded much more quickly during the boom years of 2003–2006. Now Beijing is much less willing to accommodate American requirements.

Threat to the Global Trading System. Congress may well pass unprecedented legislation targeting

China in the spring of 2009, featuring a short period of time by which the PRC must satisfy any of a variety of possible American demands or face trade sanctions. The Obama Administration could find it advantageous to let the clock tick. If the Chinese economy has not recovered by next autumn, Beijing will look to sidestep these demands and, for domestic political purposes, will reject at least one outright. Thus, odds are high that the U.S. will impose prohibitive tariffs or erect other barriers to Chinese goods, seeking to reduce its imports from China on the order of \$100 billion. These steps are unlikely to be WTO-compliant. The EU, Japan, and others would then be permitted by WTO rules to raise barriers against diversion of Chinese goods to their markets. Some form of Chinese retaliation is certain. If intemperate, such retaliation will prompt further action by the U.S. and perhaps other countries, threatening the global nature of the trading system.

The mainstream media are just beginning to realize the severity of China's economic problems; they are behind the curve. If the U.S. is to avert a crushing blow to an economic relationship that could have serious consequences for all its trade partners, policy makers have to move far ahead of the curve.

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10. U.S. Census Bureau, U.S. International Trade Statistics at <http://censtats.census.gov/sitc/sitc.shtml> (December 11, 2008).

11. The yuan was overvalued against the euro, but this establishes that rapid movement against a major currency is possible.