Trade tensions loom over US and China

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On the surface, two recent announcements by the Chinese and American governments offered signs of improved economic relations. Last week, China's State Administration of Foreign Exchange (SAFE) said it would not dump its huge holdings of US debts, saying that option was the economic equivalent of using an "atomic weapon". The next day, the Obama administration did not name China as a "currency manipulator" in a highly sensitive Treasury report.

In reality, the events highlighted the growing economic tensions between the two states. In both cases, the announcement that a threatened action would not be taken only served to underscore the fact that such drastic steps are being discussed.

Naming China as a currency manipulator would allow Washington to impose punitive tariffs on its goods. The threat to do so, combined with pressure for an appreciation of the yuan, has dominated US-China relations since their sharp disagreements at the Copenhagen climate change summit last November. All this year, the Obama administration has taken an aggressive stance, approving major arms sales to Taiwan, meeting with the Tibetan Dalai Lama and imposing duties on numbers of Chinese-made goods.

The US Treasury report was delayed in April, apparently in exchange for Beijing's vote in the UN Security Council for more severe sanctions against Iran. As soon as Washington secured the UN vote, however, it turned back to China's currency. In an effort to pre-empt pressure from the US, on the eve of the G20 summit in Canada last month Beijing announced it would stop pegging the yuan to the dollar.

Since the mid-1990s, the Chinese central bank has intervened heavily in foreign exchange markets to buy dollars in order to keep the yuan's value low and Chinese exports competitive. Under US pressure, China ended the peg with the dollar in 2005 and floated the yuan upward by 21 percent until mid 2008, when the global financial crisis erupted. Beijing's re-pegging to the dollar to boost its exports drew fire from Washington, especially among Democrats in the Congress, who insisted that the yuan (or renminbi) was "undervalued" by 25-40 percent.

Justifying the decision not to name Beijing as a "manipulator," the Treasury report declared China's loosening of the currency peg "a significant development". But to placate the Congress, Treasury Secretary Tim Geithner declared: "What matters is how far and how fast the renminbi appreciates." He added: "We will closely and regularly monitor the appreciation of the renminbi… in close consultation with Congress."

The Chinese SAFE statement that it would not exercise the "nuclear" option of dumping $900 billion of US government bonds served to remind Washington that China can potentially cause a panic run of investors from the heavily-indebted US government. Amid the growing instabilities and sovereign debt crisis in Europe and around the world, the elephant in the room is the US, which is the most indebted nation of all. The US federal debt is more than $13 trillion, or about 90 percent of the GDP, compared to just 40 percent in 2008—a direct result of huge government bailouts of US banks and financial institutions.

The SAFE, which manages China's $2.45 trillion foreign currency reserves, published a series of questions and answers this month. On July 7, it asked: "Will China use foreign currency reserves as a 'killer' or 'atomic weapon'?" The answer given was that such concern was "completely unnecessary" because China's investment was a "mutually beneficial process" and did not "seek to control the investing subject". Another question posed was whether China would reduce its holding of US debts. The SAFE stated that the US bonds constituted "a very important market for China" and "any increase or decrease in our holdings of US Treasuries is a normal investment operation".

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These answers are hardly reassuring. On the question of whether a large devaluation of the dollar would hurt Chinese dollar assets, the SAFE made another reference to war. "Unless there's a war or a crisis, the central bank won't convert foreign-exchange reserves massively back into yuan so there won't be any actual loss of reserves as a result of dollar depreciation against the yuan."

This statement is also a warning that if there is major domestic credit crisis, China will have to sell dollar assets, in order to prop up its financial system. China's high rates of growth during the global financial turmoil have been sustained by huge stimulus packages based on heavy state bank lending. Most lending went into a real estate bubble, while generating huge government debts. Victor Shih of Northwestern University in Illinois has estimated that by 2011, government-related debt in China will reach $7 trillion or 96 per cent of GDP, and 4.6 times government revenue. A collapse of the property bubble could force Beijing to tap into its foreign currency reserves.

The SAFE called for Washington to be "responsible" in making interests repayments. This reflects fear in Beijing about the US sovereign debt risk, which is large enough to cause a Chinese crash. China launched a Dragon Global Credit Rating agency this week and gave US government debt only a "AA minus" rating, with a "negative outlook"—far worse than the "AAA" ratings given to Washington by Western firms.

China's concerns over US debt instability intensified when two US government-backed housing giants, Fannie Mae and Freddie Mac, pulled out of the share market last month. Their share prices had been hovering around $1, despite being bailed out by Washington to the tune of $148 billion since 2008. Standards & Poor's recently estimated that China held at least $340 billion of bonds in Fannie Mae and Freddie Mac, while others put the figure as high as $500 billion. Due to the ongoing housing slump in the US, the companies recorded combined losses of $93.6 billion in 2009 and $18.2 billion in the first quarter of this year.

While the SAFE has assured investors that the US government, which owns 80 percent of Fannie Mae and Freddie Mac, will guarantee interest payments to China, the fear is that no one will want to buy China's holding of their bonds. The US Congressional Budget Office has estimated that the American government would have to inject at least $389 billion into the two companies for 2009-2019. But according to a Chinese financial analyst, Song Hongbing, who worked for both companies, the bailout could amount to $1.5-2 trillion if the US housing market continues to fall.

The Democrats and so-called liberals in the US political establishment are calling for aggressive trade measures against China, in order to divert mounting social tensions over mass unemployment and public spending cuts at home.

Commenting on Chinese currency policy in the *New York Times* on June 24, economist Paul Krugman wrote: "This policy is very damaging at a time when much of the world economy remains deeply depressed. In normal times, you could argue that Chinese purchases of US bonds, while distorting trade, were at least supplying us with cheap credit—and you could argue that it wasn't China's fault that we used that credit to inflate a vast, destructive housing bubble. But right now we're awash in cheap credit; what's lacking is sufficient demand for goods and services to generate the jobs we need. And China, by running an artificial trade surplus, is aggravating that problem." Krugman called on China to rapidly revalue the yuan. "And if it refuses, it's time to talk about trade sanctions."

The US multinationals that have traditionally played a mediating role due to their investment in China are shifting from that position, because of Beijing's increasing protectionist measures to favour its national corporations. General Electric chief executive Jeff Immelt declared last month: "I'm not sure that in the end they [the Chinese government] want any of us to win or any of us to be successful."

Underlying the tensions is the breakdown of the US-China symbiotic relationship. The US housing and consumer debt bubbles used to provide an expanding market for Chinese goods, while Beijing recycled the dollars earned from exports back to the US financial system. The financial meltdown in 2008 transformed the "mutually beneficial" process into its opposite. The US is seeking to increase exports, reduce trade deficits and cut down government debt, assisted by a competitive devaluation of the dollar. For American workers, it is a policy of lowering wages and cutting consumption so that US corporations can compete with China and other economic rivals on the world market.

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