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China-USA: a truly titanic co-existence

ASIA 1

by Romeo Orlandi

Democrats win the next elections, the situation is destined to remain the same. And yet, the two giants of the worldwide economy have many things in common and many reasons not to come to blows

The standard analytical tools don’t seem sufficient to describe the economic relationships between China and the United States. Today, the compromises and the conflicts between the two giants are based on a number of factors that go beyond the economic aspect, but that are directly influenced by it. In all of the topics of the international agenda, China is considered the protagonist next to and obviously behind the first superpower. The “Middle Kingdom” is involved in every decision of planetary importance. From nuclear proliferation to environmental protection, from energy sources to the arms race, from the fight against terrorism to the aid to developing countries, China is considered today an element of stability and growth which cannot be renounced.

However, it is the economy which has enabled this role. From the commencement of the Deng Xiao Ping reform, the GDP has grown without interruption, at very high rates, close to a 10% average for 30 years. There is no country in the world in modern history which has performed such results. Since pure ideology has been put aside, the country has reached economic goals which were both precluded politically and

historically unknown. The economic successes have been the result of this new political strategy and, furthermore, they have created the basis to reinforce it. The economy is leading a change without precedent in the history of China. The country's scientific distinction is recognised and its laws are respected. Over and above the figures, China's task is defined: to enable change, silently and without warfare. A profitable and unrestrained foreign policy has been established, bringing China toward avenues that are relatively new to the country, also, and most of all, in its relations with the United States.
According to a recent report of PricewaterhouseCooper, China will become by 2050 the greatest economy worldwide (in terms of Purchasing-Parity Power). This is not an apocalyptic vision or an original prophecy. Amongst the economists what is under discussion regarding the overtaking is only the date, and not the certainty that it will occur. At that point, an historical order will be re-established and China will recuperate its position in the world. Hence, within a few decades, even the richest economy, the United States, will no longer be the most powerful economy. The broad spectrum repercussions will be inevitable. For the time being, the US and China represent the strongest nation and the most populated one, the sole super-power and the country that grows at the fastest pace. Today China is the 4th worldwide power (2nd in PPP): if the economy is the parameter for judgement, the "Middle Kingdom" could not have done better. Its richness has grown constantly and with stability. This process took place regularly and contrarily to those who forecasted or expected unbearable social tensions as a consequence of the increase in income.
Even just in the last year, the new achievements have been impressive. The trade deficit of the United States with China reached, in 2006, 233 billion USD, 30% of the total value. Beijing's exports to Washington are 6 times the flow in the opposite direction. In the first 4 months of 2007, the trade deficit towards China has grown by 88 per cent. Furthermore, the "Middle Kingdom" has eliminated Canada from its traditional position of supremacy and is now the US's top supplier. At last, in the second half of 2006, China became the second worldwide exporter behind Germany, having exceeded the United States in the world ranking. The White House therefore has new and excellent reasons to be alarmed. The United States is now the second destination for foreign investments, because for four years it has been surpassed by China. The latter attracts international capital, even from the tax havens, because it guarantees protection and profits. Immense and disciplined manpower ensures low production costs; the rising middle classes are ready to buy luxury goods; leadership takes care of the stability. This is why investments are made in China. The repercussions lie at the level of the owned reserves. China is first even in this ranking with already the astronomical figure of 1,200 billion dollars. Hence, conditions exist for a global challenge even if only limited to the economy. The Bush Administration receives requests to contain Chinese

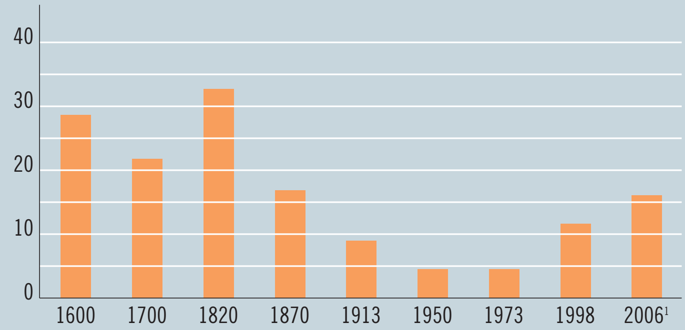
Contrasto-Reuters

progress: pressure to revalue the yuan, threats to impose duties that are unlikely to be carried out, the fight against piracy. Although the two countries gave birth to a "strategic economic dialogue mechanism" to reinforce mutual trust, the US standpoints seem to have become inflexible, creating the same reaction in China. According to a document presented to Congress by the US Trade Representative Susan Schwab, after 5 years since China's entrance into the WTO, the "Middle Kingdom", by not opening its economy to foreign products, did not fulfil its commitments. In the report the following objections were made: the sale of financial services is difficult, American goods are forged, those who are responsible are not punished, the violation of intellectual property rights (software, video, design) continues and increases. Even recognising the progress of China, the document shows unequivocal uncertainties about the future: the Administration will continue to use "two kinds of methods" and hence "will not refrain from using all of the available tools guaranteed by the WTO". A second and probably more important reason for conflict will be the rate of exchange of the yuan *renmimbi* (RMB) with the dollar. The White House laments the low exchange rate of the RMB, not adequately revalued, which makes Chinese goods invulnerable to international competition and invades the markets of the industrialised countries.

Washington's animosity has much to do with domestic politics. The new Democrat majority is decisively more firm with China and promises stronger sanctions. In the capital, different groups have united for fear of what comes from Asia. The old and powerful lobby from Taiwan has found allies in different sectors of the Democrat elect: from ecologists to the human rights defenders, and to the unions that believe China is the cause of the workers' loss of income and of employment. In addition to these concerns, the old free trader policy is being revised (as holds true in the case of the Chinese CNOOC, which was not permitted to acquire UNOCAL due to national interest). Hence, a new situation is developing and it is somewhat absurd: The United States foresees strong State intervention, featuring interventionism and protectionism, while China (a State still formally Communist) communicates economic liberalism and extreme competition. In addition to diplomatic disagreements, the concern of the United States lies in the difficulty of applying sanctions to China. The two economies are by now strongly tied and any one-sided variation has consequences for the other country. In fact, China has a fundamental role in the trade and federal "twin deficit" of the US.

1. A ONCE AND FUTURE GIANT

CHINA'S SHARE OF WORLD GDP, %*



Source: "The World Economy" At purchasing-power parity by Augus Maddison; IMF

The responsibilities of the *renmimbi*

It seems incomprehensible that an unknown and non-convertible currency is able to concern the Oval Office. However, for this reason a trip was organised (without results, however) comprising the most important government delegation that has ever been to China (Dec. 2006) since Nixon's first visit. The Chinese counterpart granted very little. Its economic nationalism imposed a unilateral choice, which was taken autonomously behind the walls of the Forbidden City and without giving way to external pressure. However, such a pressing request could not have been so evidently ignored, therefore the Chinese monetary authorities progressively realigned the RMB, but did not drastically revalue it. This solution, which was put in place in July 2005, created appreciation of 7 per cent. It is known how difficult it is for economists to define the correct value of a currency and hence, even if with the PPP (Purchasing-Parity Power) method, the conversion ratio of the RMB is clearly undervalued with

_The United States is now the second destination for foreign investments, because for four years it has been surpassed by China. Above: U.S. Treasury Secretary Henry Paulson

respect to the US dollar. Furthermore, it is without any doubt that, not having to expose the currency to the foreign exchange market makes the Chinese economy less vulnerable. However, it would be superficial to consider the trade deficit of the US a consequence of the undervalued RMB. In actual fact, the US reflects the variations of the supplies in Asia. Goods, before bought in Japan, Korea and Taiwan now come directly from China. The Asian businesses supply China with parts and components that need to be assembled and sent to the US from Chinese ports. Hence, the entire industrialised world has invested in China. A powerful production system has provided worldwide demand with an unequalled mix of low production costs and valid product quality. More than 60% of the value of goods exported by China comes from investments by multinationals, many of which are obviously American. If it is true that China is invading the markets with its products, it is also true that it does so due to foreign demand, as if it were the “sole industry of the world”. Furthermore, if it is unquestionable that it threatens the mature sectors of the advanced countries, at the same time it is developing a different type of employment, without causing a reduction: in the United States the current unemployment rate (4.5%) is one of the lowest in recent decades. At last, a strong overlapping of the production sectors of the two countries does not exist. If Chinese goods become expensive, it is possible that consumers would turn to imported goods from Vietnam, Indonesia, or the Philippines, with limited consequences on the trade deficit. Therefore, it is reasonable to conclude that it is the propensity to high consumption by Americans, more than the low exchange rate of the RMB, which determines the trade deficit. The invasion of Chinese goods therefore has a US origin, based on production, distribution and consumption. Everyone benefits from the emergence of China. Those who produce directly or indirectly beyond the Great Wall don’t want trade wars. The large-scale retail trade is profitable, buying at Chinese costs and selling at North American prices. Wal-Mart, the greatest retail company in the world, proposes the best of the Made in China, where consumers, with low income who live on minimum salaries or are illegal immigrants, spend their few savings. A more rigid American policy regarding the RMB exchange is not realistic, at least from a strictly economic standpoint.

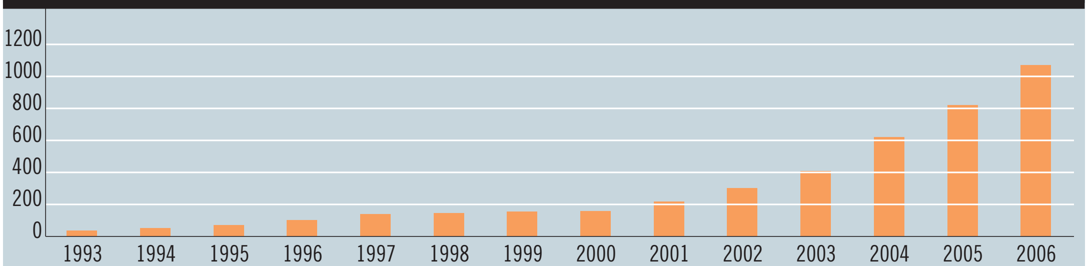
The return of the dollar

China has the highest number of reserves in the world, with a value that exceeded 1,200 billion USD in 2007. This astronomical number was reached through the years by the sum of the trade surplus and foreign direct investments. Financial investments are mostly in dollars. There is no official number that quantifies the purchase of Treasury Bonds, but it is believed that their total value is close to 500 billion dollars. Hence, China sustains Washington's public spending, financing a large portion of the federal deficit. The Federal Reserve is thankful to China for its stabilising role. The billions of dollars that purchase Chinese goods return to the United States. Beijing's trade surplus sustains Washington's deficit, the Chinese surplus reflects the American deficit. China therefore is in a position of partial strength: it can continue to grow with losses that are still tolerated by the US. Beijing obtains the silent consensus of Washington because it continues to buy dollars even if the RMB is undervalued. This "sacrifice" is recognised but it is not guaranteed for the future. If China decides to diversify investment of its reserves, purchasing fewer dollars, the effect on the United States would be more severe, with an increase in inflation and in interest rates which would penalise investments and consumption. The use of reserves to purchase dollars has been motivated also by the prudence of Beijing in its choices in the international financial markets. Now hesitation is ready to be overcome due to pressure coming both from government institutions and from the private sector, which intend to direct investments towards more profitable activities. The recent development of the CIC (China Investment Corporation) and the authorisations given to the QDII (Qualified Domestic Institutional Investor) fulfil this need. The results are already visible, measured by purchases in the mining and energy sectors, mostly in Africa and in Latin America. If investment opportunities increase, the quantities of dollars requested would inevitably decrease, with negative consequences on global demand in the United States. Even this free choice by China is an inevitable phenomenon. The Chinese authorities have fully understood that to continue to become stronger, it is necessary to go beyond their own Great Wall. Probably the pioneering era of accumulation and of industrialisation is over. By now the country is sufficiently robust and respected to have a more incisive role. Some national brands will be successful and those Made in China will not be limited to low added value goods and dependant of foreign clients. The profits that will derive from retail will also come from manufacturing. Growth and support will at last come from a financial system that should be free from bureaucracy and inexperience, a long and heavy heritage of socialism. The development of the national economy will inevitably cause tensions with the United States.

The Chinese leadership feels responsible for, if not guilty about, these tensions. China knows it has strong friends beyond the Pacific Ocean and wants to have relations without conflict with the United States. It is in constant need of modernity, of an advanced tertiary industry and of agricultural products on a large scale. However, it knows that even its counterpart cannot renounce its products and the promise of its market. The novelty of the relationships between the two giants lies in the need for constant dialogue. Their rivalry is not only due to different ideology, but also to the globalisation that has obliged them to co-exist. The economies of the two

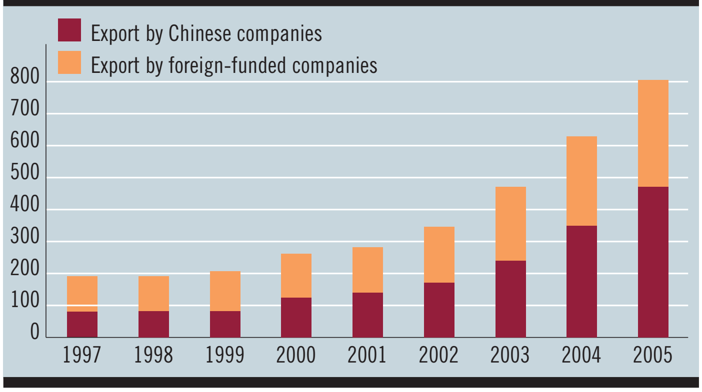
2. FOREIGN EXCHANGE RESERVE IN CHINA

*BLN DOLLARS**



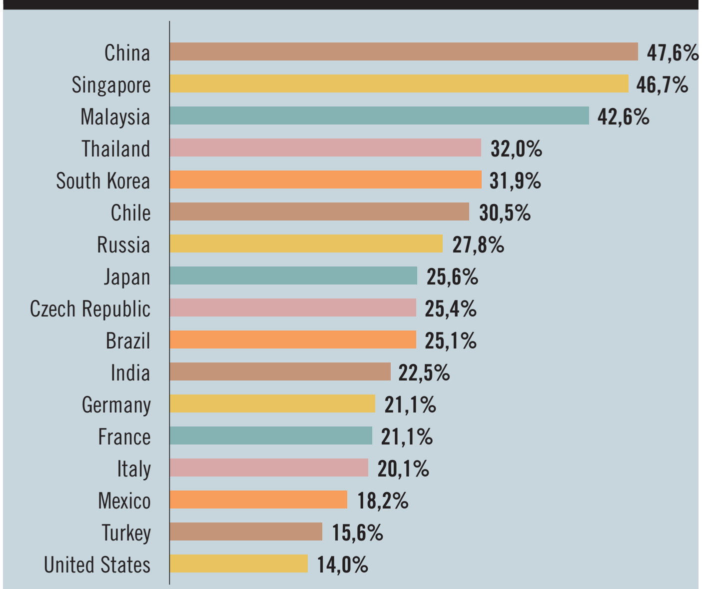
Source: prepared by Osservatorio Asia on World Bank and Reuters data

3. THE TWO COMPONENTS OF EXPORT



4. 2004 GROSS DOMESTIC SAVING

*AS % OF GDP**



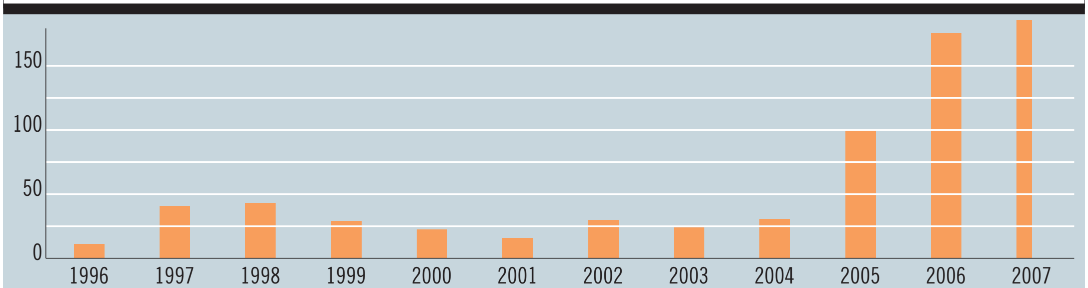
Source: World Development Indicators 2005, World Bank

countries, even if clearly different, are inter-connected more than their political and cultural systems. If the per capita income in the US is much higher than the one in China, the standard of living in the richest country of the world depends on a far-away, antiquated and most of all different nation. The United States deals in such an extended way with no other country in the world. Their pride – and the strength of their numbers – prevents them dealing with China on an equal basis, but having implicitly admitted that another global super-power exists, consulting it on all crucial issues, is the most important event since the end of the Cold War.

In this circumstance of unstable equilibrium, both countries can only try to negotiate as best as possible. Obliged to negotiate are nations which are hostile perhaps, but enemies no more. The competition does not yet involve equal players, but it does not permit unilateral decision-making. Even if the US Administration goes from the strategic partnership of Clinton to the strategic competition of Bush, it must in any case dialogue with China, and find in the latter stability and realism. To do this, it must recognise in China cultural dignity and political grandeur. These are the characteristics that the "Middle Kingdom" believes it has never lost; in fact it is just re-discovering, with its massive presence, the role it always had in history.

5. TRADE BALANCE SURPLUS

*BLN DOLLARS**



Source: "The Economist", May 17th 2007, Chinese statistical data