G2

Prospect Of A Global Trade War

People have to be free to choose in order to increase their well-being – why the U.S. and China both need to acknowledge the limits to protectionism and other forms of state intervention

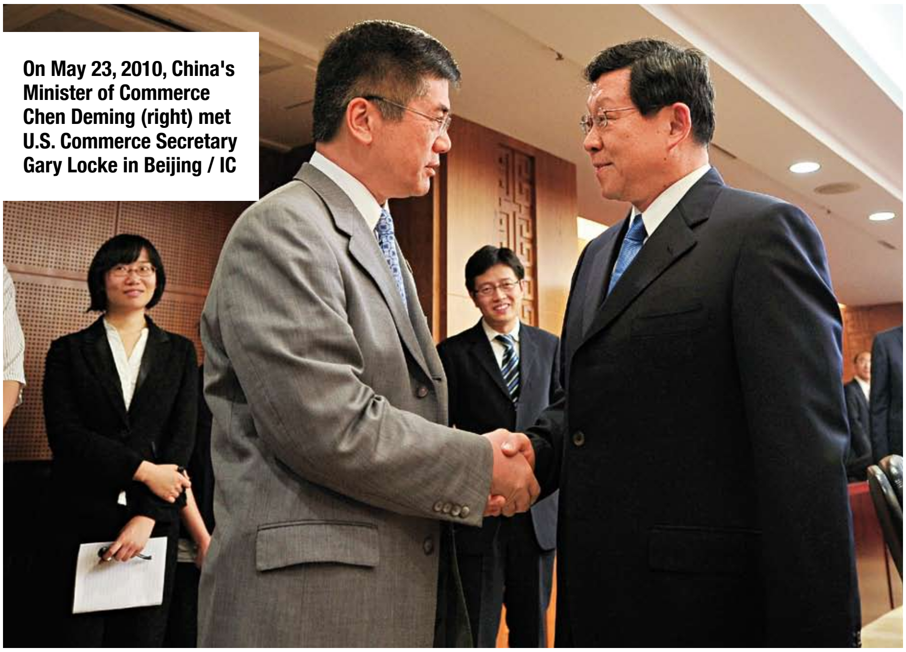
JAMES A. DORN
Vice President for Academic Affairs at the Cato Institute, Washington, D.C.

Economic liberalization since 1978 has propelled China from a small, closed economy to the world's largest exporter and second largest economy overtaking Japan. In the process, China's standard of living has increased dramatically and trading partners have benefited. So why should there be any likelihood of a global trade war?

The deep U.S. recession of 2008-'09, which slowed global economic growth, resulted in a surge of protectionist measures aimed primarily at China, which largely escaped the slowdown. Persistent high unemployment in the U.S., close to 10 percent, has made Americans more skeptical about free-trade agreements and has fanned the flames of economic nationalism. In a recent poll taken by the Wall Street Journal and NBC News, 53 percent of those polled said free-trade agreements have harmed the U.S., compared with 32 percent in 1999. The proportion is even higher for those supporting the Tea Party, with 61 percent having a negative view of free-trade agreements.

One of the few bills that got bipartisan support in the House this year was the Currency Reform for Fair Trade Act, which passed by a wide margin. That bill is aimed primarily at China and is better known as the "China currency bill." If passed by the Senate and signed into law, the bill would mandate that the Department of Commerce treat "currency manipulation" as an actionable subsidy and impose countervailing duties.

Big labor stands firmly behind this legislation, the intent of which is to save American jobs. The widely held belief, as Sander Levin, chairman of the powerful



On May 23, 2010, China's Minister of Commerce Chen Deming (right) met U.S. Commerce Secretary Gary Locke in Beijing / IC

House Ways and Means Committee, stated, is that "China's exchange-rate policy has a major impact on American businesses and American jobs." Yet, it was the U.S. recession – not the relative price of the yuan – that has been the key factor in depressing U.S. employment. The Great Recession was primarily made in Washington, not in Beijing.

U.S. housing policy encouraged sub-prime mortgages while Fannie Mae and Freddie Mac, the two giant government-sponsored mortgage agencies, bought up or guaranteed vast amounts of questionable mortgages. Wall Street helped package them in the form of securities, which the rating agencies signed off on. That highly leveraged debt found its way into domestic and foreign portfolios. When the financial crisis hit the U.S., it spread quickly and affected global markets.

The Federal Reserve kept interest rates too low for too long and helped create an asset bubble in housing. When that burst, deleveraging and an adjustment of relative prices had to occur. That process is still continuing, but is being thwarted by maintaining artificially low interest rates. In particular, the Federal Reserve's new round of quantitative easing (QE2), designed to add another US$ 600 billion or more to its already bloated balance sheet by buying longer-term Treasuries, will exacerbate policy uncertainty and increase exchange-rate volatility.

The U.S. must recognize that China cannot change overnight, and that the Chinese people must ultimately determine the direction and speed of reform

In monetizing a large part of the U.S. fiscal deficit over the next eight months, the U.S. central bank is signaling willingness to let the dollar depreciate, harming holders of U.S. debt and promoting U.S. exports. U.S. President Barack Obama has pledged to double U.S. exports over the next five years and has defended the Fed by arguing that QE2 will increase economic growth, which would be good for the U.S.'s trading partners. But if printing money spurs real growth, why not run the printing presses like Zimbabwe?

Monetary policy is a blunt instrument and is limited: increasing the monetary base – currency held by the public plus reserves at the Fed – ultimately affects nominal income via the impact on the average level of money prices, while unemployment and other real variables are largely determined by market forces and institutions. Stagflation should have taught us that monetary stimulus can backfire.

Indeed, QE2 is already backfiring, as seen by its heavy criticism. German Finance Minister Wolfgang Schäuble summed it up best when he said, "It doesn't add up when the Americans accuse the Chinese of currency manipulation and then…artificially lower the value of the dollar." Flooding the global economy with yet more dollars could trigger speculative capital inflows into emerging market economies and initiate currency wars as surplus countries try to protect their market share by depreciating their currencies, imposing trade barriers, and using capital controls. Financial protectionism would be a setback to trade liberalization.

One member of the Board of Governors of the Federal Reserve System has raised doubts about the benefits of QE2. According to Kevin Warsh, "As a consequence of more-expansive U.S. monetary policy and other distortions in the international monetary system, we see an increasing tendency by policy makers to intervene in currency markets, administer unilateral measures, institute ad hoc capital controls, and resort to protectionist policies."

In addition to monetary engineering, U.S policy makers are advocating "guidelines" to limit current account surpluses and deficits to 4 percent of GDP – a proposal China's Deputy Foreign Minister Cui Tiankai has called a return "to the days of planned economies."

It is ironic that U.S. liberals like Obama and Treasury Secretary Tim Geithner push international cooperation via the G20, but pursue policies that thwart spontaneous coordination via free markets. QE2 will not reduce over consumption by the public sector; it will crowd out private investment, debase the dollar, and injure U.S.-Sino relations.

Harmony results from a rule of law that protects economic and personal liberties. People have to be free to choose in order to increase their well-being. An open economy is the best route to wealth creation; protectionism may save some jobs but it destroys the wealth of nations. Unilateral trade liberalization has served nations well, including China. The Doha Round has failed because the “negotiations approach” to trade liberalization is fraught with difficulties.

China’s 12th Five-Year Plan (2011–2015) envisions further liberalization, allowing markets to have a bigger say in determining interest rates, exchange rates, energy prices, and the allocation of capital. If macro prices – the exchange rate and interest rates – move closer to true market values, and if capital is freer to move to where it can fetch the highest returns, monetary policy can be focused on domestic price stability.

Those reforms along with greater freedom in labor markets, as a result of making changes to the rigid hukou system, and strengthening land rights would make a strong case for ending the non-market economy status that has unfairly penalized China in determining trade remedies under anti-dumping law.

Improving Sino-U.S. economic relations will require patience on both sides. China must recognize that financial repression and state capitalism are not compatible with true development, in the sense of widening the range of choices open to individuals. Making the yuan fully convertible and ending the dollar peg will allow China’s massive foreign exchange reserves to be used more productively and allow future foreign exchange earnings to be privatized, increasing the power of the people.

The U.S. must recognize that China is in transition and cannot change overnight, and that the Chinese people, not the U.S. government, must ultimately determine the direction and speed of reform. Blaming China for the U.S economic malaise will not solve our problems.

Today the world is on a pure fiat money system with the dollar as the key currency. Monetary disequilibrium in the U.S. is a danger to the global economy. If discretionary monetary policy is incapable of limiting the quantity of dollars – and thus safeguarding their value – then we must come up with a better alternative.

Chinese central bank adviser Xia Bin is correct in warning that “as long as the world exercises no restraint in issuing global currencies such as the dollar, then the occurrence of another crisis is inevitable.” Perhaps it’s time for China to let go of the wobbly dollar anchor and let the yuan float in a sea of domestic monetary stability and capital freedom.

Both the U.S. and China need to move from market socialism to market liberalism

It makes no sense for a capital-poor country like China to be a net exporter of capital and hold US$ 2.7 trillion of foreign exchange reserves, with the bulk “invested” in U.S. government debt. Allowing real appreciation of the yuan and free capital mobility would help normalize China’s current account balance and further increase the standard of living. The U.S. can help by restoring monetary stability, getting its fiscal house in order, and adopting a pro-growth agenda that removes restrictions to private-sector job creation.

Both the U.S. and China need to move from market socialism to market liberalism. The way to do so is through a policy of engagement, not to revert to destructive protectionism. The new U.S. Congress will have an opportunity to limit the size and scope of government, restart stalled free-trade agreements, and give President Obama fast-track authority, which would help move the Doha Round of trade negotiations forward.

One thing we can be sure of: there will be no global trade war. Globalization has greatly expanded consumer choices and created new opportunities for countless people. No one in China wants to go back to the days of autarky before 1978, and no one in the U.S. wants to go back to the protectionism of the 1930s, when trade came to a standstill.

The world is much more interdependent than ever before. We can’t rely on governments to bring about economic and social harmony by a new type of global planning. Rather, we must recognize the limits of government and the power of free private markets to harmonize economic and social life – under a genuine rule of law that protects life, liberty, and property. ■

CHINA'S TRADE WITH THE UNITED STATES

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
US Exports	16.3	19.2	22.1	28.4	34.7	41.8	55.2	65.2	71.5	69.6
% Change	24.4	18.3	15.1	28.5	22.2	20.6	32.1	18.1	9.5	-2.6
US Imports	100.0	102.3	125.2	152.4	196.7	243.5	287.8	321.5	337.8	296.4
% Change	22.3	2.2	22.4	21.7	29.1	23.8	18.2	11.7	5.1	-12.3
Total	116.3	121.5	147.3	180.8	231.4	285.3	343	386.7	409.2	366.0
% Change	22.6	21.4	21.2	22.8	28	23.3	20.2	12.7	5.8	-10.6
US Balance	-83.7	-83.0	-103.1	-124.0	-162.0	-201..6	-232.5	-256.3	-266.3	-226.8

Figures in billion US$

Note: US exports reported on FOB basis; imports on a general customs value, CIF basis
Source: US International Trade Commission